Consultation Paper

CP11/31***

Financial Services Authority

Mortgage Market Review:

Proposed package of reforms

December 2011

Financial Services Authority

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 30 March 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_31_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 8794
Email: cp11_31@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 email 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.

Contents

PART IV – Annexes

PART IV – Appendices

Abbreviations used in this paper

BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms (FSA Handbook)
CBA	Cost benefit analysis
CeMAP	Certificate in Mortgage Advice and Practice
CFS	Common Financial Statement
CIU	Collective Investment Undertakings
CML	Council of Mortgage Lenders
CP	Consultation Paper
CPD	Continuing professional development
CRAs	Credit rating agencies
CRD	Capital Requirements Directive
DP	Discussion Paper
DRO	Debt Relief Order
DSR	Debt Service Ratio
EIA	Equality Impact Assessment
ERC	Early Repayment Charge
ESIS	European Standardised Information Sheet
EU	European Union
FCA	Financial Conduct Authority

FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
FTB	First-time Buyer
GDP	Gross Domestic Product
HMRC	HM Revenue & Customs
HNW	High-Net Worth
HPP	Home Purchase Plan
IDD	Initial Disclosure Document
IRB	Internal Rating Based Model
JRF	Joseph Rowntree Foundation
KFI	Key Facts Illustration
LCF	Living Cost and Food survey
LGD	Loss Given Default
LTI	Loan-to-income (ratio)
LTV	Loan-to-value (ratio)
MAS	Money Advice Service
MCOB	Mortgages and Home Finance: Conduct of Business sourcebook (FSA Handbook)
MFA	Market Failure Analysis
MIPRU	Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (FSA Handbook)
MLAR	Mortgage Lending Administration Return
NSFR	Net Stable Funding Ratio
OFT	Office of Fair Trading
OLS	Ordinary-Least-Squares
PD	Propensity to Default

PERG	Perimeter Guidance Manual (FSA Handbook)
PRA	Prudential Regulation Authority
PSD	Product Sales Data
QCF	Qualifications and Credit Framework
RDR	Retail Distribution Review
RMAR	Retail Mediation Activities Return
RTB	Right-to-buy
RWA	Risk Weighted Assets
RWEA	Risk Weighted Exposure Amount
SMI	Support for Mortgage Interest
SMS	Short Message Service
SPV	Special Purpose Vehicle
SRB	Sale and rent back
SRT	Significant Risk Transfer
SUP	Supervision (FSA Handbook)
SVR	Standard Variable Rate
SYSC	Senior Management Arrangements, Systems and Controls (FSA Handbook)
TC	Training and Competence (FSA Handbook)
TPA	Third Party Administrator

Foreword

The UK mortgage market has worked well for the vast majority of consumers. But in the run-up to the financial crisis there was a tail of poor lending to borrowers who could not afford to repay out of income, with both lenders and borrowers assuming that house price rises would make repayment or refinance possible.

As a result, while arrears in this recession have been significantly below the early 1990s, there have been major problems in specific consumer segments and regions, with many customers facing the distress of arrears and repossessions. The scale of payment problems would have been significantly greater if interest rates had not fallen to exceptionally low levels.

The reforms to mortgage market regulation which the FSA is now proposing for consultation, aim to ensure the continued provision of mortgage credit for the great majority of borrowers who can afford it, while preventing the re-emergence of the tail of poor lending practice which led to customer detriment. At the core of our proposals are three principles of good mortgage underwriting.

- Mortgages and loans should only be advanced where there is a reasonable expectation that the customer can repay without relying on uncertain future house price rises. Lenders should assess affordability.
- This affordability assessment should allow for the possibility that interest rates might rise in future: borrowers should not enter contracts which are only affordable on the assumption that low initial interest rates will last forever.
- Interest-only mortgages should be assessed on a repayment basis unless there is a believable strategy for repaying out of capital resources that do not rely on the assumption that house prices will rise.

We believe that these are common sense principles of good underwriting which serve the interests of both lenders and borrowers. We also believe that almost all lenders are currently applying these principles; the excesses of the pre-crisis period have largely disappeared from the current market. But it is important to ensure that better practice endures in future when memories of the crisis recede and the dangers of poor practice return. We are therefore consulting on making these principles FSA rules; in addition, this Consultation Paper brings together several other proposals to reform the mortgage market.

The three key proposals are, we believe, justifiable in principle. But it is important to estimate as best possible what their impact would be – how many consumers would be protected from the unnecessary distress of arrears and repossessions, and, also crucial, how many consumers who could have afforded a mortgage might be constrained to take out a smaller mortgage or to delay house purchase or house move. The Cost Benefit Analysis (CBA) sets out our best estimate of these effects, and of the balance of consumer welfare which might result.

It is important to stress that any such estimates are inherently uncertain, given the methodological and data difficulties which the CBA explains. The estimates suggest, however, that the new rules would have only a marginal effect in current market conditions – and particularly so for first time buyers – but would act as a significant constraint if market practice was in danger of returning to the 2005 to 2007 pattern. If that is indeed the result, it would be a desirable one.

Given the inherent uncertainty of these estimates, however, and the vital need to avoid any shock to the mortgage market in current economic conditions, we are particularly keen in the forthcoming consultation period that lenders provide their detailed assessment of the likely impact of these proposed rules. The more that the feedback can be supported by detailed quantitative analysis – for instance of the interest rates stress procedures lenders are already currently applying and therefore whether our proposed rules would change behaviour significantly – the better the FSA will be able to make appropriate final decisions.

Several other important issues on which we would particularly value feedback are described in the Consultation Paper. One which I would like to highlight is the potential impact of new rules on access to finance for business development. We are very aware that some entrepreneurs use residential property to support business borrowing, and it is important not to constrain the ability of people to take consciously chosen business risks. Our existing rules are already tailored to exempt from their application owners of businesses with turnover over £1m per year, who wish to pledge their home as security for a business loan, This reflects the judgement that such borrowers are making carefully chosen decisions and do not need the protection of our mortgage rules. Our rules do however apply to self-employed sole traders, and we believe that many of these should be protected from taking on unaffordable mortgages. The question is therefore where to draw the line. We are therefore consulting on whether there should be some form of carve-out for clearly defined business borrowing, and would welcome feedback on the most appropriate way to pursue this approach.

The process of developing these proposals has been a long one, commencing in 2009, with several FSA discussion and consultation papers published along the way. That long process has reflected the vital importance of getting the regulation of the mortgage market right, and of basing it on detailed analysis of the current and past market. In the course of this process, the FSA has amended its initial proposals significantly, in the light of feedback and further analysis and reflection.

We are now at the final stage of the process, bringing together all the specific proposals in one document. These proposals are subject to a consultation period which runs from now to the end of March. Thereafter, the FSA Board will consider carefully the final details of proposed rules, and the appropriate timing of implementation, which will not be before 2013.

Adair Turner, FSA Chairman

1 Overview

Introduction

1.1 In October 2009, we published the Mortgage Market Review (MMR) Discussion Paper (DP09/3[1]), which set out our broad concerns about the UK mortgage market and invited debate on a suggested package of reforms to address them.

1.2 In the MMR DP we stated our intention to take immediate action to address poor arrears-management practices identified from our thematic review of lenders' arrears-handling practices. We also signalled our intention to bring all those who advise on or sell mortgage contracts into the Approved Persons regime, to reduce mortgage fraud and raise standards and improve the profile of mortgage advisers. In January 2010 we published the first MMR Consultation Paper (CP10/2[2]) to take these areas forward as a priority.

1.3 We then turned our attention to putting in place a framework to ensure a more sustainable mortgage market that works better for consumers across the economic cycle. We indicated from the outset the importance of taking time to fully understand what went wrong and explore all available options for putting things right, so we adopted a deliberately staged approach to our review.

1.4 In July 2010, we published a Consultation Paper on responsible lending (CP10/16[3]) which focused on the regulatory obligations of lenders and suggested the changes we thought necessary to deliver a more responsible approach to lending – and borrowing – in future.

1.5 This was followed in November 2010 by a Consultation Paper on distribution and disclosure (CP10/28[4]), focused on enhancing the mortgage sales process, the role of intermediaries and improving disclosure of information for consumers.

1 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf
2 CP10/2, *Mortgage Market Review: Arrears and Approved Persons*, (January 2010): www.fsa.gov.uk/pubs/cp/cp10_02.pdf. Implementation of the Approved Persons Regime is currently deferred.
3 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf
4 CP10/28, *Mortgage Market Review: Distribution & Disclosure*, (November 2010): www.fsa.gov.uk/pubs/cp/cp10_28.pdf

1.6 Following formal feedback to those consultations and extensive discussion and debate with market participants, we are now pulling everything together and consulting further on the entire package of MMR proposals. This includes:

- those proposals already consulted on last year (on responsible lending and distribution and disclosure);
- some proposals we are consulting on for the first time (i.e. interest-only proposals, the proposed changes to the prudential regime for non-deposit taking lenders, and read-across to niche mortgage markets);
- the draft rules; and
- the aggregate cost benefit analysis.

1.7 This enables respondents to consider and provide feedback on the proposed package as a whole. We have listened – and continue to listen – very carefully to the views of all stakeholders. This has been a huge task and one that would not have been achieved without the active engagement of the mortgage industry, particularly the trade bodies.

1.8 The feedback we have received to date is summarised in each chapter and we explain how it has helped shape our proposals so far, resulting in the proposals set out in this paper.

1.9 The package includes a wide range of measures which will have a wide range of impacts. By far the biggest impacts will be those associated with the requirements on responsible lending and affordability.

1.10 The estimated aggregate impacts set out in the cost benefit analysis in Annex 1[5] suggest, as we would intuitively expect, that these proposals will not have a big impact in the current market, when firms are voluntarily imposing good lending standards. Our estimate is that, currently, the proposals will impact on about 2.5% of borrowers. However, as the market picks up and our proposals bite to cut-off the tail of poor lending seen in the past, so we expect the impact of our proposals to increase. Our estimate is that the impact would then rise to around 11.3% of borrowers if we were to experience the boom conditions of 2005 – 2007 again, which, helped by the proposals set out in the paper, we do not expect.

1.11 It is clear from responses to previous MMR papers that the market agrees with the general affordability proposals on which the MMR centres. We believe the net result is a package of proportionate measures, appropriately targeted to address the problems we have seen in the market and to achieve the two broad aims of our review: a sustainable market and one that works better for consumers. We want to shape an environment in which, when things pick up again, all market participants can enjoy the benefits of a competitive, flexible and sustainable market without being exposed to unnecessary risks.

1.12 We continue to welcome thoughtful and constructive engagement from all stakeholders and want to stimulate further wide debate and discussion about the proposed package of

5 Annex 1 A1

reforms. As we have said previously, what matters is that collectively we deliver the right outcomes for the market. We look forward to working with all stakeholders over the consultation period to arrive at a shared view on the final MMR package and an understanding of the likely impacts.

Structure of the CP

1.13 This CP is in five parts:

- Part I sets out the entire package of proposed conduct of business reforms;
- Part II discusses prudential reform and the proposed regime for non-deposit taking lenders;
- Part III explains how we plan to tailor our MMR proposals for niche mortgage market sectors – equity release; Home Purchase Plans; Sale and Rent Back; bridging finance; high net worth lending; and business lending;
- Part IV sets out the cost benefit analysis, the equality impact assessment, the Compatibility Statement, a list of the questions asked in the CP and a list of the non-confidential respondents to CP10/16 and CP10/28; and
- Appendix 1 sets out the draft rules.

1.14 We will also be publishing separately, as a supplement to this paper, the *MMR Data pack*[6], a comprehensive statistical analysis of the market. Unless otherwise indicated, all data and exhibits referred to in this paper are from that data pack.

1.15 We summarise the proposed package of reforms in the following overview. Feedback to previous CPs and the detailed analysis, including supporting data, follows in the relevant part of the main body of this CP.

Who should read this CP?

1.16 The proposals in this CP will be of special interest 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.

6 *MMR Data pack*, (December 2011): www.fsa.gov.uk/pubs/other/mmr_datapack2011.pdf

CONSUMERS

This CP will be of interest to consumers who either have a mortgage or anticipate taking one out, as well as their representatives and consumer groups. It may also be of interest to groups who represent those with protected characteristics[7] as they may wish to comment on our equality impact assessment.

Next steps

1.17 The consultation period on these proposals runs until 30 March 2012. We intend to run road shows across the country during the consultation period, as we have done previously, to share views and promote as wide a discussion as possible on our proposals.

1.18 We propose to publish the feedback statement and final rules next summer but we do not propose to implement the proposals before the summer of 2013. We will have regard to market conditions and may defer implementation if that proves necessary. But if there is widespread support for particular proposals, for example in relation to mortgage arrears charges, we may implement some aspects sooner.

1.19 We intend to conduct a formal review of the impact of our proposals not more than five years after implementation.

Summary of the proposals in this paper

Chapter 2: Background to the review (page 41)

1.20 We received broad support for our analysis in DP09/3 of the causes of the market problems, which we briefly recap in Chapter 2 as a reminder of why we have undertaken this work.

1.21 As we note above, our aim is to get the market to a more sustainable position and to prevent consumers taking on mortgages which are clearly unaffordable or where the risk of them becoming unaffordable as a result of reasonably foreseeable developments (such as an increase in interest rates) is high. However, at the same time we are not trying to produce a fundamental change in the scale of the market or the degree of access of creditworthy consumers to mortgage finance.

1.22 The UK mortgage market has overall served many people well. When we published the MMR Discussion Paper in 2009, it was not clear what the eventual scale of arrears and repossessions would be. We felt then that the total numbers would be fewer than in the

7 The protected characteristics are age, disability, gender, pregnancy and maternity, race, religion and belief, sexual orientation and transgender.

1990s as a result of the very different pattern of interest rates. And that appears to be the case. The post-crisis impact has so far been more favourable than feared at the onset of the financial crisis. Arrears levels and repossessions have been below the levels seen in the 1990s.

1.23 However, there is clear evidence that cheap and readily available credit led to some borrowers over-committing themselves. The Bank of England reported[8] that in 2010, 50% of households with a mortgage struggled to pay their bills at least from time to time of which 15.5% were constantly struggling or falling behind on their commitments. But the potential vulnerabilities of many consumers to rising interest rates has not materialised as rates have fallen and mortgage affordability improved.

1.24 And within the reasonably favourable overall picture, we have seen high arrears and repossessions materialising in specific localities and consumer segments. For example, high LTV lending tended to be concentrated in the northern regions and arrears in those regions are 80% higher than those in the south west and south east. Arrears are also particularly high among those credit-impaired consumers who were only able to gain access to mortgage finance as a result of the pre-crisis relaxation in lending standards.

1.25 So there is clear evidence that the vulnerabilities created by the significant tail of poor lending have crystallised. And while low interest rates have flattered the picture and helped some borrowers, there are real dangers that the current low interest rate environment could simply be storing up more problems for the future, with many people taking on low interest rate mortgages now which may subsequently prove unaffordable.

1.26 We also note that easy mortgage credit availability is not necessarily a force for good for groups such as first-time buyers. The easy supply of credit was a factor which, by generating significant house price appreciation, contributed to the declining role of first-time buyers within the market, squeezed by affordability problems.

1.27 We also note in this chapter some of the arguments that have been deployed against the MMR. For example, the claim that we are fighting yesterday's battles; that there is no need for the MMR at all because the risk of irresponsible lending has diminished as risk attitudes have retrenched. But while it may be true that riskier lending has reduced, this reflects the simple fact that a lack of funds has led lenders to concentrate on higher-quality lending. We are concerned that, as money returns to the market, firms will come under increasing pressure to consider riskier lending and will focus more on market share than maintaining lending standards. We need to learn the lessons of the past and act to stop poor lending practices re-emerging in the future.

EU and international developments

1.28 While we are developing our proposals under the MMR, we are also conscious of the European Commission's proposal for a directive on mortgage credit, published in March

8 See Exhibit 3.7: Extent to which mortgage borrowers are struggling to keep up with their payments

this year.[9] The proposal generally adopts a higher-level approach than the MMR, and in many areas the aims of the proposal are closely aligned with our MMR objectives. We discuss the Commission's current proposals in the relevant chapters of this CP.

1.29 Where there are some differences in approach between the MMR and the proposed new directive, we are using the evidence base that the MMR has built up to promote further discussion in Europe. We will keep developments under review, both in terms of substance and timing, as the debate in Europe develops.

1.30 The Financial Stability Board (FSB) is also taking forward work which aims to improve standards in national mortgage markets. One particular piece of work is the development of a principles-based framework for underwriting, recently published for consultation.[10] We have played an active role in this work. We expect this framework to be finalised early in 2012 and we will ensure our final affordability rules take account of this international view.

Financial Conduct Authority

1.31 The government has announced a restructure of financial regulation in the UK, including the development of a new conduct and markets regulator, the Financial Conduct Authority (FCA). This new authority will build on our recent progress towards a tougher, more interventionist and pre-emptive approach to regulating conduct in financial services and markets. This will include the ongoing delivery and implementation of the MMR.

PART I – Conduct of business reforms

Chapter 3: Responsible lending and borrowing (page 53)

1.32 As we note in Chapter 2, a key aim of our proposals is to prevent consumers taking on mortgages which are clearly unaffordable or where the risk of them becoming unaffordable as a result of reasonably foreseeable developments (such as an increase in interest rates) is high. However, at the same time we are not trying to produce a fundamental change in the scale of the market or the degree of access of creditworthy consumers to mortgage finance. We describe in this chapter the difficult balancing act faced in trying to achieve this and the considerable volume of analysis we have undertaken in arriving at the responsible lending proposals set out in this paper. This includes our efforts to identify whether there are any sufficiently predictive indicators of impairment that could be used as a basis for cutting off the significant tail of poor lending decisions, such as loan-to-value (LTV) or loan-to-income (LTI) related measures. And we explain why we have concluded that there is no simple quantitative rule, and therefore why we propose instead to proceed with a more rigorous assessment of affordability.

9 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Credit Agreements relating to residential property – COM (2011)142 (March 2011) http://ec.europa.eu/internal_market/finservices-retail/credit/mortgage_en.htm

10 FSB Principles for Sound Residential Mortgage Underwriting Practices, (October 2011) www.financialstabilityboard.org/publications/r_111026b.pdf.

1.33 We set out the current policy position in the light of the feedback and responses to CP10/16.

1.34 As we have previously explained, when developing the existing mortgage regime we assumed that firms would have a prudential self-interest in managing their credit risk responsibly and therefore that prescriptive conduct requirements were not required. The current mortgage rules therefore require a lender to do nothing more than 'take account' of a borrower's ability to repay their mortgage.

1.35 However, our assumption about firms managing their credit risk responsibly has been shown to be wrong in many cases. There is a general consensus that a key problem underlying many issues in the mortgage market has been firms' failure to perform proper affordability checks, relying instead to a significant extent on the underlying collateral and an assumption that debt burdens were likely to fall with continuous property price appreciation.

1.36 So we proposed in CP10/16 to strengthen our requirements and to be more explicit about the standards we expect. This was centred around the principle of affordability and this remains at the core of our responsible lending proposals.

1.37 The basic principle is that loans should only be granted where there is a reasonable chance of repayment out of income cash flow without a reliance on future property price appreciation. This has three key elements:

- **The affordability assessment**: a lender must verify income and be able to demonstrate that the mortgage is affordable taking into account the borrower's net income and, as a minimum, both the borrower's committed expenditure (which includes the mortgage payments) and basic household expenditure.
- **The interest rate stress test**: the lender must also take account of the impact on mortgage payments of market expectations of future interest rate increases.
- **The interest-only proposals**: the lender must also assess affordability on a capital and interest basis, unless there is a clearly understood and believable alternative source of capital repayment.

1.38 We discuss the first two elements of the affordability principle in Chapter 3. As we are consulting in this CP for the first time on our interest-only proposals, those proposals are set out and discussed separately in Chapter 4.

1.39 The CBA in Annex 1 sets out the impacts of these three key proposals. We noted earlier that the estimated aggregate impact of all three proposals together will not have a big impact in the current market, reflecting the tighter lending criteria, lower-risk lending and more stringent underwriting standards currently being applied. Our estimate is that 2.5% of borrowers will be affected in today's subdued market conditions. This would rise to 11.3% of borrowers if we were to experience the boom market conditions of 2005-2007 again. As noted earlier, this seems intuitively right, as this is when we would expect our proposed reforms to bite to prevent a tail of poor lending similar to that seen in the past.

1.40 The impacts of each element, including the impacts on particular borrower types, is considered in the detailed discussion of our policy proposals in Chapters 3 and 4 and in the summary of each element below.

1.41 The first proposal considered is the affordability assessment, i.e. a lender must verify income and be able to demonstrate that the mortgage is affordable taking into account the borrower's net income and, as a minimum, both the borrower's committed expenditure (including the mortgage payments) and basic household expenditure.

Affordability assessment: Income verification (page 65)

1.42 The vast majority of respondents to CP10/16 were in favour of our proposals on income verification and so we do not propose to change our approach.

1.43 Therefore we propose that in every case, lenders must obtain reliable evidence to confirm the income stated on the mortgage application form to ensure that affordability assessments are based on fact. This will mean the end of self-certification mortgages, and also the end of 'fast-tracked' mortgages, an accelerated approval process under which verification of income may not be required at the lender's discretion.

1.44 We are not proposing to prevent income verification being outsourced to an intermediary with appropriate systems and controls in place – but the lender will be responsible for ensuring that verification of income happens in every case and will be held to account if it does not.

1.45 As well as ensuring that the affordability assessment is based on fact, we expect this to have a significant impact in reducing mortgage fraud, which respondents agreed continues to be a major problem in the UK mortgage market.

1.46 The biggest concern for most respondents about our income proposals was the potential impact on the self-employed.

1.47 We stress here that we have no intention of preventing or making it more difficult for self-employed consumers or those with fixed term contracts, who can afford it, from getting a mortgage. As we explain, lenders have for many years underwritten mortgages for self-employed consumers by making an informed assessment of their circumstances, including their income, and there is no reason why this should not continue. In CP10/16 we did not propose prescriptive requirements for self-employed consumers, such as a minimum period of trading or the type of evidence of income that the lender must request. We made it clear that this would be left to the discretion of the lender - and that remains the case. Our aim is to ensure that lenders take an **informed** lending risk based on the evidence – not disregard the risk altogether.

1.48 Finally, we note the importance placed on evidencing income in international initiatives such as the Commission's proposed directive on mortgage credit and the FSB's underwriting principles.

Affordability assessment: Expenditure (page 80)

1.49 In CP10/16 we suggested that lending decisions should be based on the borrower's 'free disposable income', i.e. the maximum amount of income available to a consumer to repay their mortgage.

1.50 Respondents to the consultation generally agreed that an assessment of expenditure should form part of the affordability assessment, but many thought that our requirements were much too prescriptive and over-engineered. Many respondents also thought that we did not take enough account of a consumer's ability to manage expenditure once they had taken on a mortgage, for example by prioritising mortgage payments over discretionary expenditure such as holidays and recreation.

1.51 In the light of the consultation feedback, we have changed our proposed approach. It is apparent that there is no need for us to be as prescriptive as we originally intended. Many lenders have applied and continue to apply a sensible approach to assessing household expenditure and what we would like to see is a consistent application of that good sense across the market. To help ensure this, our proposal now is that when assessing affordability, a lender should, as a minimum, take explicit account of:

- the committed expenditure of the applicant, such as credit and other contractual commitments that will continue after the mortgage is entered into; and
- the basic essential expenditure of the applicant's household. This can be based on statistical or modelled data. It must cover the bare essential expenditure required to maintain the household's basic needs and to live in the property which cannot be reduced, including heating, water, council tax and buildings insurance. The lender must also consider basic quality of living costs which are hard to reduce, such as clothing, household and personal goods, basic recreation, and childcare. These are items which give consumers a basic quality of life beyond the bare necessities.

1.52 This idea of 'basic essential expenditure' draws on a broad social consensus about basic needs[11] and is also based on helpful information provided to us by lenders and lender trade bodies.

Estimated impact of affordability assessment (page 88)

1.53 We believe that our proposed approach to ensuring a proper assessment of affordability is intuitively the right approach. It allows lenders the freedom to make their own lending decisions while ensuring that those lending decisions are properly informed, based on the circumstances of the consumer. It is clear from responses to previous MMR papers that the market agrees with the principle of affordability and we believe that what we are proposing here represents current good practice.

11 *A minimum income standard for the UK in 2011*, Donald Hirsh, Joseph Rowntree Foundation, (July 2011): www.minimumincomestandard.org/downloads/2011_launch/MIS_report_2011.pdf

1.54 We therefore do not expect the affordability assessment to have a great impact and the CBA estimates confirm this. Our best estimate indicates that the affordability rule will affect only 0.04% of borrowers in subdued conditions, increasing to 3.6% of borrowers in a boom period.

1.55 These results reflect the fact that during today's subdued market conditions, lending criteria are tighter, lending is low-risk and underwriting standards are more stringent than in the boom conditions of 2005-2007. It also indicates that the affordability assessment has the greatest impact when it is most needed – when there is the potential for widespread unaffordable borrowing.

1.56 The CBA shows that within the relatively small group of borrowers affected by the affordability assessment, those borrowers most affected are, again as we would intuitively expect, those who would have self-certified income (21.8% in a boom period) and those with an impaired credit history (66.9% in a boom period). The self-employed would also be more affected in boom conditions (7.3%), reflecting the fact that the self-employed tended to use self-certification and are more likely to have an impaired credit history.

1.57 First-time buyers (FTBs) would be hardly impacted at all in today's subdued conditions and only slightly impacted in boom conditions (less than 3%).

Stress test against possible increases in interest rates (page 90)

1.58 The second key element in our affordability proposals is the interest rate stress test, i.e. the lender must also take account of the impact on mortgage payments of market expectations of future interest rate increases.

1.59 In CP10/16 we proposed that lenders should be required to consider the impact of increasing interest rates on affordability, through applying an interest rate 'stress-test' at the point of each mortgage application. Respondents generally agreed that it is important to consider the impact of interest rate increases on consumers – indeed most lenders said this was their standard practice. However, most were not in favour of the FSA publishing a rate. They were concerned that one single rate would not be appropriate for all borrowers, considering the variety of products and product margins in the market.

1.60 We agree that it would not be appropriate for the FSA to set a single rate for lenders to use. We propose instead to require lenders to undertake stress-testing of interest rates with reference to market expectations for interest rates over the next five years. Lenders cannot make their own forecasts about this – they must be able to justify the stress test applied by reference to an independent published source of market expectations, such as the forward sterling rate published on the Bank of England's website.

1.61 We recognise that interest rate margins on mortgage products can change over the economic cycle, which in practice may influence the margins lenders choose to stress affordability against interest rate rises. We would therefore expect the stress test to be compatible with and not mechanically linked to market expectations.

1.62 Where interest rates are expected to fall, or to rise by less than 1%, lenders must assume a minimum rate increase of 1% over the five-year period.

1.63 Our intention is for lenders to use the expected interest rate curve as a clear interest rate scenario within which to frame their approach – rather than derive a universal stress rate. This approach is designed to give lenders flexibility to set the rate used in a way that reflects their customer base and products, allowing them to retain control and plan ahead while testing the impact of interest rate rises on affordability for each mortgage application. This, to a large extent, also reflects current good market practice.

Estimated impact of interest-rate stress-test proposals (page 92)

1.64 Our understanding from discussions with market participants is that most lenders today are taking account of future interest rates when assessing affordability and therefore we would not expect a significant impact. This is confirmed by the CBA estimates which indicate that applying an interest-rate stress-test on top of the affordability assessment today would impact on an additional 0.25% of borrowers. This is based on an assumption that 90% of lenders are already applying a stress test. If no lenders were stressing in line with the proposal today, the impact would be significantly greater at 3% of borrowers. In the boom period, we have assumed that no lenders applied a stress-test and in this period we estimated that an additional 4% of borrowers would be affected.

1.65 Within this small group of affected borrowers, the CBA indicates that there is a fairly uniform impact across the different borrower types. The addition of an interest rate stress test increases the proportion of borrowers affected in each group (such as FTBs, self-employed, credit impaired) by about 0.3% in subdued conditions and between 6-8% in a boom period.

Interest-only (page 92)

1.66 The third and final element of the affordability principle is the assessment of interest-only mortgages. We are proposing that a lender must assess affordability on a capital and interest basis, unless there is a clearly understood and believable alternative source of capital repayment. As we are consulting for the first time on our interest-only proposals, they are set out separately in Chapter 4. We summarise our proposed policy approach and the impacts at paragraph 1.91 below.

Other responsible lending proposals (page 93)

1.67 In Chapter 3 we also consider a number of other responsible lending proposals considered in CP10/16.

25-year term and impaired credit buffer

1.68 In the light of responses, we are no longer proceeding with two of the other key elements of the proposed framework for responsible lending discussed in CP10/16; the proposal to limit the term over which affordability could be assessed to a maximum of 25 years and the proposal to apply a 'buffer' to the affordability calculation for credit-impaired borrowers. We agree with respondents that these proposals would be unnecessary 'layers' of protection on top of the other affordability proposals.

1.69 We share many respondents' concerns about the impact our proposal to assess affordability on a maximum term of 25 years would have on younger borrowers, particularly first-time buyers, many of whom are already struggling to get on the property ladder. We have also had regard to the removal of compulsory retirement ages and later state pension ages.

1.70 We also agree that building an extra 'buffer' into the affordability assessments for credit-impaired consumers could have the effect of reducing their borrowing capacity, restricting their access to the market and forcing them to borrow from more expensive sources, such as the high-cost credit sector. This would simply have the effect of widening rather than addressing financial inequalities.

1.71 We believe that addressing poor underwriting standards will ensure that mortgages being taken on by all borrowers are affordable. We do not want to restrict access to the mortgage market unnecessarily. We want to ensure that we continue to have a market in which everyone, no matter what their circumstances, can enjoy access to mortgage lending where they can afford it.

Lending beyond state pension age (page 103)

1.72 One issue that proved particularly controversial in CP10/16 related to our proposal that lenders should take account of 'reasonably foreseeable' changes to income and expenditure over the life of a mortgage.

1.73 By suggesting this, we were not expecting lenders to 'crystal ball gaze' or predict future events. The intention was that lenders take account of known or reasonably foreseeable events from the information available to them at the time they are assessing the mortgage application – and we gave retirement during the term of the mortgage as an example.

1.74 In CP10/16 we proposed that lenders should satisfy themselves, so far as is possible, that it is plausible that the level of income beyond state pension age would be sufficient for the mortgage to remain affordable – for example by confirming that the applicant has pension provision and confirming the details (e.g. by reviewing pension statements). We also proposed that lenders should assess the plausibility of the borrower's stated retirement age, where it went beyond state pension age.

1.75 Most respondents agreed that retirement income should be taken into account. However, there was concern about the difficulties in predicting pension income and assessing the plausibility of consumers' retirement plans where retirement is a long way in the future. It was also felt that consumers should share responsibility in planning for retirement.

1.76 We recognise the difficulties in practice of meeting the standards we originally proposed in relation to checking income into retirement. Our aim is to protect consumers from carrying foreseeably unaffordable debt into retirement. We do not want to prevent older consumers from accessing mortgages where they have the means to support the mortgage. So we are proposing that lenders should adopt a prudent and proportionate approach to assessing income beyond state pension age. This means that lenders may take a higher-level approach where retirement is a long way off, for example by requesting evidence of the existence of pension provision. Where retirement is closer, however, lenders might be expected to take more robust steps, for example by considering projections on pension statements.

Estimated impact of our proposals on particular borrower types

1.77 In Chapter 3 we also consider the impact of our proposals on particular borrower types. As noted above, in the context of our income verification proposals, we consider the impact on the self-employed. We have also considered the impact of the affordability proposals on FTBs, as there has been so much popular comment about this group, and also the credit-impaired and those consolidating debt as these are the borrowers most impacted by our proposals.

Estimated impact on first-time buyers (page 95)

1.78 We have no intention of preventing FTBs from entering the mortgage market. FTBs are finding it particularly difficult to get mortgages today – but that is as a result of lenders increasing their deposit requirements in response to funding constraints – 40% of sales to FTBs were at LTVs of 90% or over in the boom period 2005-2007. That has reduced to less than 5% today.

1.79 Many respondents and commentators have claimed that our affordability proposals will disproportionately impact on FTBs, preventing them from getting on the property ladder. In fact, our estimates indicate that FTBs are hardly impacted at all by our affordability proposals in today's subdued market conditions (0.9%) and are slightly less impacted than other borrowers in a boom period (10.5%).

1.80 We explain that this reflects the fact that lenders typically take a more stringent approach to underwriting FTB applications and FTBs themselves are more cautious borrowers, with the vast majority taking out capital repayment mortgages and not relying on self-certification or interest-only mortgages. FTBs do typically take on higher LTV mortgages but our analysis shows that they have a better record of paying mortgages at high LTVs than any other borrower type.[12]

1.81 We therefore do not have a particular concern about FTBs taking out high LTV mortgages and, as we have made clear from the outset, we do not propose to impose any type of LTV restriction on consumer protection grounds.

12 See Exhibit 15.13: Mortgage performance, by borrower type, any record of past or current missed payments, by LTV band

Estimated impact on credit-impaired consumers (page 96)

1.82 An impaired credit history is the strongest predictor of arrears and repossessions. This is the sector of the market where we saw some of the worst underwriting standards – in some cases bordering on the predatory.

1.83 We have already noted our decision not to impose an additional 'buffer' on the affordability assessments for the credit-impaired. We believe that our wider affordability proposals will deal with the biggest issues around impaired credit mortgages, which we believe are largely to do with inadequate assessments of affordability either through the use of self-certification or the generally poor standards applied by many of the lenders who 'specialised' in mortgages to credit-impaired consumers.

1.84 Notwithstanding our proposal not to impose the additional 'buffer', our CBA still estimates that our proposals will have a bigger impact on credit-impaired consumers than any group. We estimate that in today's subdued market conditions 10.5% of credit-impaired borrowers would be impacted. This rises to 69.7% in boom conditions. This reflects the very poor underwriting standards particularly concentrated in this group.

Debt consolidation (page 107)

1.85 In CP10/16 we proposed that where a mortgage is being taken out for debt consolidation purposes, lenders should ensure that debts being consolidated are in fact repaid from the advance as expected.

1.86 There was some support for this, but most lenders and trade bodies (including trade bodies for solicitors) were strongly against. There are various practical and administrative difficulties that make the repayment of debts, in particularly unsecured debts, complex to administer and costly. Our view in the light of responses is that it would not be proportionate for us to apply this requirement to the majority of mortgages. However, we think it is important and appropriate to retain it for credit-impaired consumers, given the significantly higher risk of consumer detriment in this group.

1.87 There are two options we could take to address this. One is that where a credit-impaired borrower is repaying debts from the proceeds of the mortgage, and those debts impact on affordability if they remain outstanding, the lender should take reasonable steps to ensure that those debts are in fact repaid, for example through direct payment by the lender. The second is to expect the lender simply to proceed on the basis that the debts will remain outstanding and therefore that they must be taken into account when assessing affordability.

1.88 There are pros and cons to each. The number of credit-impaired borrowers who consolidate debts are very few – our data suggests 0.05% of total sales today and at the peak of the market less than 1% – and requiring lenders to repay the debts could be costly. But balanced against this is the fact that under the second option, consumers would be prevented from consolidating their debts and may be forced to turn to more expensive solutions. So we open this up for feedback on what might be the most appropriate approach.

Transitional arrangements (page 113)

1.89 Market conditions and commercial considerations have already led many lenders to tighten their lending criteria following the market downturn. As a result, a large number of borrowers may be finding it difficult today to get a mortgage.

1.90 We recognise that our strengthened affordability proposals may also mean that some borrowers – those who self-certified income, for example, or those who took out an interest-only mortgage with no certain plans about repaying the capital, may have difficulty getting a mortgage. To mitigate the impact of the affordability proposals on existing borrowers, we explain here our proposals to put in place special arrangements to help transition borrowers from the current to the new mortgage rules. This will allow a lender (existing or new) to waive some of the new affordability rules if the borrower meets certain conditions. To benefit from this, the borrower must be able to demonstrate a good payment history covering at least the last 12 months; must not be seeking to borrow additional sums; and the monthly payment under the new mortgage must be the same as or lower than their current payment.

Chapter 4: Interest-only mortgages (page 123)

1.91 Interest-only mortgages form the third and final key element of the affordability principle. The detailed proposals are set out separately in Chapter 4 as this is our first formal consultation on our interest-only proposals.

1.92 As noted in CP10/16, interest-only mortgages were originally aimed at particular 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. Before the 1980s it was a relatively small part of the market. During the mid 1980s to early 1990s endowment mortgages became the favoured form of repayment and the sale of interest-only mortgages rocketed, reaching 80% of mortgage sales in 1988. Following reductions in interest rates and projected investment returns it fell out of favour and by 2002 had fallen back to only 10% of mortgage sales. In the run up to 2007, lenders relaxed their lending criteria and became less strict about the repayment strategies and we saw the emergence of a new 'purer' form of interest-only where the sale of the mortgaged property itself became increasingly accepted as an acceptable repayment strategy. At the height of the market in 2007, 33% of all residential mortgages were sold on an interest-only basis. Our analysis shows that very often they have been used to extend affordability, with no firm plan in place to repay the capital.

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

1.94 There is strong market support for interest-only mortgages and we recognise the value they provide to a wide variety of consumers. However, there is also a consensus view that interest-only should be a 'niche' product. We would expect most mainstream lending to take place on a capital and interest basis with interest-only being considered in limited circumstances.

1.95 What we are proposing therefore is that lenders should always assess affordability on a capital and interest basis, unless there is a clearly understood and believable alternative source of capital repayment. We recognise that there are some categories of interest-only that are acceptable, for example, where there is a defined repayment from investment; where down-sizing is a credible option; and where the mortgage is repaid on death. However, property price inflation or any other speculative source of capital repayment (e.g. an uncertain inheritance) will not be an acceptable repayment strategy.

1.96 Where there is an acceptable strategy, affordability may be calculated on an interest-only basis – but the affordability assessment should also take into account (where appropriate) the cost of the repayment strategy (such as payments into an investment vehicle). Where this applies, the lender will need to obtain information on the actual (current) cost of the repayment strategy and not simply estimate that cost.

1.97 Lenders must obtain evidence of the repayment strategy at the application stage, before they enter into an interest-only mortgage, and check, so far as they reasonably can at that point, that the repayment strategy is credible and has the potential to meet the final capital balance. The lender must keep a record setting out the reasons for its decision to lend on an interest-only basis.

1.98 Lenders must also have a clear interest-only policy against which to assess interest-only applications. This must set out the repayment strategies accepted by the lender, and the controls in place around those individual strategies (e.g. limits on LTV, minimum equity requirement and/or regional property price variations, etc.). This policy must be signed off at Board level, and compliance with the policy must be monitored and audited.

1.99 We are also proposing that lenders take reasonable steps to contact borrowers at least once during the mortgage term to check on the repayment strategy. The aim of this is to raise awareness on the part of both the lender and the borrower, so they can work together to come to a solution if the capital is not on track to be repaid.

Estimated impact of interest-only proposals (page 141)

1.100 Out of our three key affordability proposals, we would expect our interest-only proposals to have the biggest impact on the market today. This is because our data suggests that many borrowers do not have a capital repayment strategy in place and may have taken out an interest-only mortgage to stretch affordability and/or take out a bigger mortgage than they would otherwise have got. Those borrowers will have their ability to repay assessed on a capital and interest basis.

1.101 We noted in relation to the affordability assessment that in today's subdued market conditions, 0.04% of borrowers would be affected and in a boom period, such as 2005-2007, this would rise to 3.6%.

1.102 The interest-rate stress-test adds a further 0.25% of borrowers in a subdued period and 4% of borrowers in a boom period.

1.103 The CBA estimates that applying the interest-only proposals on top of the affordability assessment and the interest-rate stress-test would add 2.2% of borrowers in subdued market conditions. In a boom period, an additional 3.7% of borrowers would be affected.

1.104 Within the group of borrowers affected by the interest-only proposals, the CBA indicates that in subdued conditions, there is a significant impact on the self-employed (2.8%) and credit-impaired (9.6%) which reflects the fact that these groups include large proportions of interest-only borrowers. For FTBs by contrast, who tend not to take out interest-only mortgages, the impact is more limited in both periods (0.4% in a subdued period and 4.2% in a boom).

Chapter 5: Distribution and disclosure (page 145)

1.105 In CP10/28 we turned our attention to the mortgage sales process and the role of intermediaries. Despite the post-crisis contraction in the market, intermediaries continue to play a significant role in the distribution of mortgages and their role and influence is an important part of the debate on regulatory reform.

Affordability (page 148)

1.106 Given our responsible lending proposals and the fact that the lender will have ultimate responsibility for assessing affordability, we proposed in CP10/28 that the seller's role in assessing affordability should be limited to checking that the consumer fits within the expected parameters of lenders' affordability criteria.

1.107 Respondents agreed that intermediaries would continue to obtain affordability information regardless of whether our rules explicitly required them to. Firms agreed that we should avoid blurring the distinction between the role of the intermediary and the role of the lender in assessing affordability. So, we propose to remove the existing prescriptive rules about assessing affordability that currently apply to intermediaries and instead rely on a general requirement for intermediaries to ensure that the consumer meets the lender's known eligibility criteria.

Interactive sales (page 152)

1.108 For some time we have had a concern about consumers' lack of understanding about the difference between advised and non-advised sales. Our research shows that consumers do not recognise or even value the distinction and therefore may not appreciate the different regulatory standards applying between the two.

1.109 Most consumers believe that if they speak to an intermediary, they have been given 'advice' no matter how many times they may be told that they are not being given advice and whatever form of service disclosure they are given confirming the position. We note that technological developments are increasingly leading to non-spoken forms of interaction between consumers and firms and that consumers are just as likely to believe they have been advised if the communication between the consumer and adviser is instant communication through some technological means.

1.110 In CP10/28, rather than move to an all-advised market, we proposed to maintain the distinction between advised and non-advised sales but to enhance sales standards in non-advised sales by extending an 'appropriateness test' across all sales, so that all consumers could expect the same protection, irrespective of the sales process.

1.111 The vast majority of respondents agreed that sales standards should be enhanced in non-advised sales. However, there was little support for making this a regulatory requirement as the effect would be to blur even further the distinction between the two types of sale and respondents felt that this would create, in all but name, an all-advised market.

1.112 We agree that the approach proposed in CP10/16, rather than removing the potential for consumer confusion, would have added to it. By requiring that firms assess whether a mortgage is appropriate to the needs and circumstances of a consumer, we are in effect making all sales 'advised' and we believe that terminology should be applied to all sales to avoid any confusion. We are therefore proposing to remove the non-advised sales process.

1.113 We believe that in all sales where there is spoken or other interactive dialogue between the consumer and firm, the firm should assess whether the mortgage is appropriate for the consumer (i.e. advise the consumer). This will cover all forms of interactive dialogue, whether face-to-face, telephone, social media, or online propositions with the facility for live chats or otherwise.

1.114 However, we also believe that it may be appropriate in some limited cases to allow the option for execution-only sales.

Execution-only sales (page 153)

1.115 Our consistent view has been that consumers should have the freedom of choice and that not every consumer needs advice. But taking on a mortgage is one of the biggest financial decisions a consumer makes and the majority opt for help and support through the process. We are also concerned that creating an execution-only sales channel could be exploited as a mechanism to circumvent our rules

1.116 Feedback supported the idea that an execution-only service would be appropriate for very specific consumers. In the light of this, we are therefore proposing that high net worth and professional consumers should be able to opt-out of receiving advice and purchase on an execution-only basis.

Non-interactive sales (page 155)

1.117 There are some sales processes that do not lend themselves to advice and therefore where the sale involves no interactive dialogue (e.g. pure online or some postal sales) we propose to allow consumers to purchase on an execution-only basis.

Advising vulnerable consumers (page 157)

1.118 We are also proposing that certain vulnerable consumers (equity release, right-to-buy, Sale and Rent Back (SRB) and those consolidating debt) must always receive advice and therefore they would not be able to purchase a mortgage by a non-interactive sales process.

1.119 But we also do not want prevent consumers from having the freedom to make their own choice and so, with the exception of SRB consumers, we are proposing that consumers who reject the advice they have been given may still go ahead and purchase the product they want on an execution-only basis.

Sales standards (page 162)

1.120 In CP10/28 we proposed that intermediaries must consider three additional elements as part of their assessment of the consumer's needs and circumstances: borrowing into retirement; taking a further advance; and rolling-up fees into the loan.

1.121 We explain why, in the light of all the responses we received, we have decided not to proceed with the suggestion that intermediaries have responsibilities to consider lending into retirement; why we think that it is important that consumers are told that a further advance may be an appropriate option for them; and why consumers should also understand the consequences of rolling-up fees into the loan, including why we are proposing that this will only be allowed where the consumer expressly consents to it.

Replacing our scope of service labels (page 172)

1.122 In CP10/28 we consulted on using the same labels to describe a firm's scope of service as those proposed under the Retail Distribution Review (RDR) (i.e. 'independent' or 'restricted'). Many respondents considered that these labels were not appropriate for the mortgage market. Some also noted that the need to adapt the RDR labels to fit the mortgage market eroded the benefit of read-across (consistency for the consumer).

1.123 In the light of this feedback, we have amended our proposed approach. Rather than having to use labels, we propose to require firms to give the consumer a plain and simple explanation of whether there are any limitations in the product range they provide.

Enhancing professional standards (page 166)

1.124 We proposed in CP10/28 to require all mortgage intermediaries (including those employed by lenders) to hold a relevant mortgage qualification. Most respondents supported our proposal to standardise the qualification requirement across all mortgage intermediaries.

1.125 Respondents were also supportive of our proposal to review the existing mortgage qualification standards. We therefore intend to take forward both of these proposals.

Replacing the IDD with a requirement to disclose key messages (page 169)

1.126 We believe that it is important that consumers get a proper understanding of a firm's service at the initial contact, so they can make an informed choice whether to buy through it. Our prescribed Initial Disclosure Document (IDD) was designed to give consumers detailed information about a firm. However, subsequent research revealed that consumers neither value nor use the document, instead relying on what they have been told. So, in CP10/28 we proposed to replace the requirement to provide the IDD with a requirement for the firm to disclose the pieces of information that will help a consumer distinguish between one firm and another, e.g. what its product range is and how it will be remunerated. We proposed that this information should be given clearly and prominently in the initial contact between the firm and the consumer.

1.127 Most respondents were in favour, so we are proceeding with this proposal.

Changing the trigger points for the Key Facts Illustration (page 178)

1.128 Our prescribed document for product disclosure, the Key Facts Illustration (KFI), sets out for consumers the main features and risks of a mortgage product. However, our research indicates that many consumers do not use the KFI to compare products. In CP10/28 we suggested that it would be sensible to change some of the existing trigger points for providing a KFI in order to minimise information overload for consumers and reduce the burden on firms. There was universal support for this.

1.129 Under our proposals, all consumers will still get a KFI, but there will not be a requirement to get multiple KFIs before the consumer has selected or been recommended a product or products. At the same time, we are providing firms with increased flexibility to provide consumers with specific information about products outside of the KFI form.

1.130 Also, recognising that a small proportion of consumers do use the KFI to shop around, our revised approach will still require firms to give consumers KFIs when they specifically ask for them, and to inform consumers of their right to do so.

1.131 We are also proposing to make it easier for intermediaries to recommend lenders' 'direct-only' deals to consumers by removing the obligation on them to provide a KFI for these products.

Estimated impact of our distribution and disclosure proposals (page A1:106)

1.132 The CBA estimates that all of the distribution and disclosure proposals taken together will generate one-off costs for firms of between £22m – £33m and ongoing costs of around £2m a year.

Chapter 6: Arrears management (page 183)

Mortgage arrears charges (page 184)

1.133 In DP09/3, we signalled a more interventionist approach to monitoring and enforcing against excessive charging practices in the mortgage market. This work started with a detailed review of firms' arrears charging practices.

1.134 Our mortgage rules require arrears charges to be a reasonable estimate of the additional administration costs faced by the lender as a result of a consumer being in arrears. Despite this, it is clear from our analysis and the fee justifications that we have received from lenders that most of them have not adequately considered the underlying costs when setting their arrears charges.

1.135 We also discovered firms trying to take payments from borrowers and charging a fee each time, regardless of the number of times that the payment had already been returned unpaid. We also identified firms charging excessive monthly arrears charges as soon as a borrower defaulted and front-loading charges into the first month to avoid our rules which currently only apply to charges for 'arrears' i.e. a shortfall equivalent to two or more payments.

1.136 So in CP10/16, we proposed limiting the number of times firms could charge a fee for missed payments; to widen the arrears charges and forbearance rules to cover all payment shortfalls; and to provide further guidance to firms on what costs can and cannot be recovered through arrears charges.

1.137 Respondents were in favour of widening the arrears charges and forbearance rules to cover all payment shortfalls. They were also generally supportive of the new guidance on the recoverability of certain types of administration costs through arrears charges. However, they asked us to be clearer about the number of times a fee for a missed payment can be charged in a month.

1.138 To ensure that borrowers do not face unnecessary additional costs associated with direct debits when they are in financial difficulty, we are proposing to include a new provision that prevents lenders from attempting to collect more than two direct debits in a month.

1.139 We are proposing to replace the rule that permits firms to remove borrowers from concessionary interest rates if they go into payment shortfall. In its place we propose to create a new rule allowing firms to remove concessionary interest rates for borrowers where there is a material breach of the mortgage contract unrelated to a payment shortfall.

Estimated impact of our arrears charges proposals (page A1:104)

1.140 There is already a requirement under our rules for lenders to ensure that their charges are a reasonable reflection of the additional administration costs faced by the lender.[13] This means that the guidance and rules on administration costs discussed above will not necessarily result in any incremental costs for firms.

1.141 Our proposal to prevent a firm from requesting more that two direct debits a month will only impact on those firms which have done this in the past.

1.142 We believe that the proposal to widen the charges and forbearance rules to apply to all payment shortfalls should not have a significant impact and the proposal to prevent firms from withdrawing concessionary rates because a borrower has a payment shortfall is only likely to have a minimal impact.

1.143 Our best estimate is that the impact of the payment shortfall proposals will not be significant, and the associated additional compliance costs will be minimal.

Chapter 7: Other conduct matters (page 195)

Multiple credit search footprints (page 195)

1.144 At the request of the Treasury Select Committee we have investigated whether multiple credit searches have an adverse effect on consumers' credit ratings and we set out our findings here. We have concluded that there is no need for regulatory intervention at this stage. The Credit Reference Agencies (CRAs) are working with lenders and trade bodies to improve the messages consumers are given about the consequences of credit searches. We propose to continue to monitor this issue and to see whether the CRAs' work to improve the messages for consumers has the desired effect.

Responsible borrowing and financial capability (page 197)

1.145 In DP09/3, we discussed the importance of financial capability initiatives in delivering to better informed consumers the decision-making tools necessary to ensure a fully functioning mortgage market.

1.146 It was acknowledged that this work was likely to deliver most benefit over the longer term, but nonetheless there was agreement that there was merit in taking steps now to help consumers better protect themselves in future.

1.147 We noted in CP10/16 that responsibility for financial capability work had passed to the Consumer Financial Education Body, which has since become the Money Advice Service (MAS). In this chapter, we provide an update on the work being undertaken by MAS that complements the MMR.

---

13 MCOB 12.4.1 R(1) https://fsahandbook.info/FSA/html/handbook/MCOB/12/4

Financial crime and mortgage fraud (page 198)

1.148 In DP09/3, we discussed how we were actively addressing financial crime issues in the mortgage market. We explain in this section how our proposed MMR reforms will help to address mortgage fraud, and the other steps we have taken in tackling mortgage fraud since DP09/3 was published.

Scope extensions (page 199)

1.149 Here we provide a summary of a recent change to the Financial Services and Markets Act 2000 (FSMA) to extend our regulatory scope with respect to sale and rent back transactions. We also explain the welcome announcement from the government of its intention to expand the definition of the regulated activity of administering a regulated mortgage contract. This will help to ensure that where mortgage books are sold on to unregulated firms, consumers retain a high level of protection.

1.150 In DP09/3, we explained that a key risk to achieving the overall aims of the MMR is the ability of firms and consumers to 'game' our changes; seeking to avoid the stricter standards applying to first-charge lending by accessing other forms of credit, such as second charge and buy-to-let.

1.151 We therefore welcomed the government's announcement of its intention to transfer responsibility for regulating second charge lending to us. This transfer has been delayed until a decision is taken on the wider transfer of consumer credit. This means that any transfer will not take place until at least April 2014 or beyond.

1.152 Whether we regulate buy-to-let lending remains a decision for government.

Future mortgage market related work (page 200)

1.153 In both DP09/3 and CP10/28, we noted that changes made to our regulatory approach would inevitably result in the need to review the data we collect. We have outlined our current early thoughts on changes that might be needed to the Product Sales Data (PSD), Mortgage Lending and Administration Return (MLAR) and Retail Mediation Activities Return (RMAR) returns. We also see potential benefit in collecting data on fees and charges in future. We would value input from firms and trade bodies to help inform our views.

1.154 We are also undertaking supervisory work looking at lender product charges and charging models to determine whether consumers are suffering significant detriment from excessive charges. We are currently looking at non-arrears related charges including mortgage set-up fees, early repayment charges, valuation fees and mortgage exit fees. We expect to publish detailed findings (with consultation on any necessary related rule changes) in 2012.

PART II – Prudential reforms

Chapter 8: Impact of Basel III (page 209)

1.155 In DP09/3, we explained the fundamental reform of the FSA's prudential policy framework underway. We noted that we did not see a need for any additional prudential measures specific to mortgage lending, other than suggesting the need to strengthen the prudential regime applying to non-deposit taking lenders.

1.156 In this chapter, we consider the capital and liquidity reform package known as Basel III and the key policy changes applying to banks and building societies which will be introduced progressively from 1 January 2013 until 1 January 2019.

1.157 In terms of overall impact on the mortgage market, we note that these reforms are likely to disincentivise firms from expanding lending rapidly in an economic boom and to raise the cost of capital (particularly for high-risk loans) which might also reduce demand in a phase of strong growth.

1.158 Some respondents to previous MMR consultations have argued that conduct of business regulation should only be introduced if it is shown that appropriate consumer outcomes could not be delivered through prudential regulation and focused supervision. We also explain in this chapter that while the prudential reforms under Basel III are significant, they would not of themselves be an effective mechanism for deterring the high-risk lending that the MMR objectives are designed to target.

Chapter 9: Non-deposit taking lenders (page 217)

1.159 In DP09/3 we raised concerns about the volatility of lending provided by non-deposit taking lenders (non-banks). We indicated that we expect the conduct proposals on income verification and affordability assessments to have a large impact on non-banks. Generally, policies aimed at restricting the scope for higher-risk lending across the market are likely to have a proportionately greater impact on non-banks as they have been far less involved in originating prime conforming mortgages. Despite the impact of the conduct proposals, however, we questioned whether there was also a case for prudential reform.

1.160 Subsequently, in CP10/16, we discussed the idea of introducing a risk-based prudential regime for non-banks incorporating some elements of the requirements applied to banks and building societies in the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU). Since then, based on extensive discussions with stakeholders; review of relevant data; consideration of the feedback we received to CP10/16 and further policy analysis, we have continued to develop and refine the policy ideas that we suggested.

1.161 We are now setting out for consultation a package of prudential proposals for non-banks which includes:

- a risk-based capital requirement based on the standardised credit risk and securitisation chapters of BIPRU (applied to firms' assets arising from lending after the implementation date of the new rules but not to their back-books), together with a 1% requirement applied to any other assets as currently required in the Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU);
- restrictions to increase the quality of capital so that at least 20% is in the form of share capital and reserves less any intangible assets;
- high-level systems and controls requirements to manage liquidity risk; and
- application on a solo-basis[14] only and not to firms that are in run-off.

Estimated impact of our non-bank proposal (page A1:88)

1.162 The CBA shows that the total costs that firms would incur if they have to raise additional or better quality capital could range between £24.4m to £126.8m per year, although we expect the lower estimate to be more representative of the likely impact. We also estimate there will be a one-off cost of £2m and annual ongoing costs of up to £500,000 in respect of setting up and maintaining the necessary systems and controls for the proposed regime.

PART III – Niche mortgage markets

Chapter 10: Tailoring for niche markets (page 235)

1.163 Given the outcomes we want to achieve for consumers are broadly the same as in the mainstream market, for most of our MMR proposals we are suggesting a straight read-across. But there are some areas where we think it is necessary to tailor our rules to better fit a niche sector. We have summarised where we believe that the MMR proposals either do not apply or can be read-across to the niche markets in a table at the end of the chapter. We discuss only those proposals that we believe need some tailoring.

Equity release (page 236)

1.164 The equity release market is already the subject of a tailored set of mortgage rules. Currently, the two equity release products, lifetime mortgages and home reversion plans, are regulated as two separate niche sectors. The market sees these as substitutable products and we are therefore proposing to create a single 'equity release' market to reflect this. This will mean that, under our disclosure proposals, intermediaries must explain to consumers that their service is restricted if they only offer one of these product types.

14 Solo basis refers to the situation where our capital requirements are applied only to the authorised firm on a stand-alone basis. This contrasts with the consolidated supervision approach that applies under BIPRU where the position of the authorised firm in the group can trigger the application of the capital requirements to the group as a whole.

1.165 The only other piece of tailoring we believe is required relates to 'rejected sales'. In line with our revised approach to advice, we are proposing that equity release consumers will be one of the vulnerable groups that cannot 'opt-out' of receiving advice. However, they will be able to reject the advice once it has been given and buy the product they want on an execution-only basis. In order to do this, the consumer needs to know the terms of the product they want, with no need for further discussion or information from the intermediary. This information differs from what we expect consumers to know about mortgage contracts and so we have set out the information we would expect both lifetime mortgage and home reversion consumers to know in order to proceed on an execution-only basis.

Home Purchase Plans (page 239)

1.166 Home Purchase Plans (HPPs) also have their own tailored regime. Given that they serve the same purpose and therefore involve similar risks for consumers, we are proposing to read-across the majority of our proposals, but at a high level in keeping with the existing regime.

1.167 There are two pieces of tailoring we believe are required for this market. As for the equity release market, one of these relates to the information the consumer will need to know in order to proceed to purchase on an execution-only basis if they reject advice given to them and press ahead with their own product choice.

1.168 The second arises because the IDD will no longer be required to be provided. We have considered how best to communicate two key messages included in the HPP IDD about whether the provider's services are compliant with Islamic law and about the availability of standard mortgages. Given that providers will need to explain to the consumer whether their services and products comply with Islamic law, we do not propose to make this a regulatory requirement. We do however, propose that as part of assessing whether an HPP is appropriate to the needs and circumstances of the consumer, the provider considers why a conventional mortgage would not be more appropriate.

Sale and rent back (page 242)

1.169 Consumers who take out Sale and Rent Back (SRB) agreements are typically in financial difficulties and facing repossession. Given this, we are proposing that sale and rent back consumers are also one of the vulnerable groups that cannot 'opt-out' of receiving advice. However, given the particular vulnerabilities of SRB consumers, we also propose that a SRB consumer should not be able to press ahead to buy a product of their own choice on an execution-only basis if they reject the advice they have been given.

Bridging finance (page 243)

1.170 Bridging finance is short-term lending, offered by banks and specialist lenders, which is intended to 'bridge' a funding gap. Loans are often advanced on an interest-only basis with interest rolled-up. In such circumstances we are proposing that the lender is not required to assess affordability, but, in line with the firm's interest-only policy, must only lend where it has assessed that the consumer has a credible repayment strategy in place.

1.171 Currently, where the term of a loan is extended, firms are not required to assess the borrower's ability to repay. We are proposing that this should be a requirement and that the consumer must positively elect to have the term extended.

1.172 To prevent gaming, we propose to define bridging finance as a loan of 12 months or less. We will also require intermediaries to consider why it is not appropriate for the consumer to take out a mainstream mortgage.

1.173 We are proposing that non-bank providers of bridging loans are subject to the prudential requirements for non-banks set out in Chapter 9.

High net worth lending (page 250)

1.174 The majority of lending to high net worth (HNW) mortgage consumers is structured on an interest-only, repayable on demand basis with no early repayment charges. This allows consumers the freedom to make lump sum capital reductions or to pay back the borrowing entirely where they have the resources to do so. HNW individuals are usually asset rich so lending decisions will be determined by the repayment strategy rather than the monthly repayment plan or amount. Given the particular structure of HNW lending, in CP10/16 we indicated that this could be an example of a market where our approach to affordability may need to vary and respondents agreed with this.

1.175 A number of credit lines provided to HNW consumers do not require the consumer to make monthly interest payments, for example secured overdrafts or mortgages where the interest is rolled-up. For these loans we are proposing that the lender is not required to assess affordability, as it is the credibility of the consumer's exit strategy that is important.

1.176 We are also proposing to apply the tailored disclosure rules already in place for non-standard mortgage products used by smaller business borrowers (discussed below). In order to do this, we propose to apply an elective approach similar to that applied in the investment market.

1.177 More fundamentally, however, in this chapter we open up a debate about the extent to which our regime should apply at all to those individuals with higher levels of income or wealth. There is an argument that above some level of income and wealth (and we also discuss here how to define 'high net worth') it is perfectly reasonable for a consumer to take greater risks and that regulation is not needed to protect those consumers from the decisions they have made. This reflects the general principle that the optimal risk-return trade-off changes as income and wealth rises. So, for example, the more wealth a consumer has, even if they find themselves unable to repay sums borrowed and lose their home, the consequence is likely to mean moving to a smaller house, not the loss of home ownership altogether. The potential detriment of being unable to repay is not sufficient to justify regulatory intervention.

1.178 We ask whether this general principle should apply in the mortgage market and therefore whether we should disapply the mortgage rules in their entirety for HNW mortgage consumers.

Business lending (page 255)

1.179 When the government first brought mortgage regulation within our scope in 2004, they excluded business lending but their view at the time was that if a borrower's home was at risk, they should be given regulatory protection. We therefore regulate loans for a business purpose secured by a first-charge against the business borrower's home.

1.180 We tailored our approach to regulating smaller business lending however, reflecting the fact that business borrowing is likely to be individually negotiated and by being less commoditised, would sit poorly with the standardised approach to disclosure. We also carved out of the protection of the mortgage rules larger business borrowers (who we defined as those with an annual turnover of more than £1m) on the basis that they were better able to protect their own interests.

1.181 As for HNW consumers, however, we here open up for discussion a more fundamental question about whether it may be appropriate to carve out from our proposed new regime all business loans, given the different risk profile of business consumers raising a mortgage on their home compared to other consumers. There is an argument that if a business borrower and lender want to take an informed risk and the business borrower is happy to use his home as collateral for a business venture, why should he be inhibited in any way from doing so? It is important not to constrain the ability of consumers to take consciously chosen business risks. But what of those less able to protect their own interests, such as sole traders borrowing against their home as a last resort to keep their business afloat? They more obviously need regulatory protection. There are many different types of small businesses and it is less clear whether we can and if so where we would draw a line between those small business borrowers who can take a risk and should be allowed to do so and those who cannot and need regulatory protection.

1.182 In terms of tailoring of the MMR proposals, we are proposing that where credit lines provided to business borrowers do not require the consumer to make monthly interest payments, such as secured overdrafts or mortgages where the interest is rolled-up, the lender is not required to assess affordability, as it is the credibility of the consumer's exit strategy that is important.

1.183 For interest-only business lending, we are proposing that, provided there is a credible strategy for repaying the capital, affordability can be assessed on an interest-only basis. As proposed for the mainstream market, business lenders will be required to have a Board-approved interest-only policy which should be clear about the exit strategies the lender would consider acceptable.

1.184 We are also proposing that business sales staff should be subject to out Training and Competence regime.

Estimated impact of our niche market proposals (page A1:108)

1.185 The CBA estimates that all of the niche markets proposals taken together will generate one-off costs for firms of up to £0.5m and minimal ongoing costs.

PART IV – Annexes

Annex 1: Cost benefit analysis

1.186 The Financial Services Market Act 2000 (FSMA) requires us to publish a cost benefit analysis (CBA) of our proposed rules, 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 3 to 10 of this CP.

1.187 Our standard approach to CBA considers six possible impacts of regulation. These are: the direct costs to the FSA; the compliance costs to the regulated firms; the costs or benefits to firms and consumers arising from changes in the quantity, quality and variety of transactions; and the efficiency of competition. Given the important role of mortgage lending in the economy, we have also considered the potential well-being and macroeconomic impacts of our proposals in this CBA.

1.188 Our analysis suggests that the responsible lending and borrowing and interest-only proposals described in Chapter 3 and 4 of this CP will have much greater impacts than our other proposals. They are likely to have the most significant impacts on:

- the quantity of lending and the number of borrowers affected by the MMR
- the associated well-being effects for the borrowers that will not be able to get a mortgage or will only able to get a smaller mortgage,
- households and the macro-economy, and
- the levels of arrears and repossession and the associated costs.

The CBA shows that, overall, the MMR as a whole is likely to be net beneficial.

Annex 2: Equality impact assessment

1.189 Our initial equality impact assessment leads us to conclude the proposals set out in this paper do not result in direct discrimination for any groups with protected characteristics[15]

15 The protected characteristics are age, disability, gender, pregnancy and maternity, race, religion and belief, sexual orientation and transgender.

covered by the Equality Act 2010. However, we are conscious that elements of our responsible lending, distribution and disclosure and niche markets proposals may result in indirect discrimination or have a disproportionate impact on some protected groups.

1.190 In order to uncover the extent to which any protected groups are affected by these proposals, we need data about protected groups' mortgage needs and habits, and are seeking input from stakeholders. Currently we do not have enough evidence of detriment to justify amending our proposals. Rather, we believe the benefits these proposals will bring will outweigh any potential detriment. However, we will continue to ensure we fully investigate these issues in the light of any new evidence we uncover.

Annex 3: Compatibility statement

1.191 In this annex 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.

Annex 4: List of consultation questions

1.192 This annex includes a list of the questions we ask in this CP.

Annex 5: List of non-confidential respondents to CP10/16 and CP10/28

1.193 This annex includes a list of non-confidential respondents to CP10/16 and CP10/28.

PART V – Appendices

Appendix 1

1.194 This appendix sets out our draft rules.

2

Background to the review

2.1 Just over two years ago, in October 2009, we published a Discussion Paper (DP09/3[16]) on the case for regulatory reform of the mortgage market. It was launched into an extremely fragile market, facing enormous disruption in the wake of the near collapse of the global financial system a year earlier.

2.2 The timing of that publication led some commentators to criticise the Mortgage Market Review (MMR) as a knee jerk reaction to the crisis; action symptomatic of policymakers needing to be seen to be doing something after the event. In fact, we had started examining the market and the effectiveness of the new mortgage regime back in 2005 – a year after statutory mortgage regulation started – and had undertaken a whole series of thematic reviews in the intervening period.

2.3 Those reviews had given us a consistent message that firms were not complying with our requirements, including our requirements for responsible lending. But trade bodies and firms were urging us at that stage not to rush into change; to let the new regime bed-in; to work with them in achieving the outcomes we wanted. And the regulatory philosophy at the time was reactive and retrospective, not intervening until there was an observable factual basis for doing so. Our priority instead was to work with the market to achieve measurable improvements in firms meeting their existing regulatory requirements.

2.4 Our regulatory approach to supervision and risk assessment changed fundamentally in the wake of the crisis – and the MMR proposals in DP09/3 reflected this. We signalled a willingness to proactively analyse risks at an individual firm level, to make our own judgements about the prudential and conduct risks firms and consumers may face through, for example, high-risk lending strategies and to intervene as necessary, even if that meant curbing sales that both consumers and firms were happy to enter into, such as self-certification mortgages. It was apparent that for some consumers the market had not worked well at all, there were significant vulnerabilities in the market and very real issues around sustainability. The existing framework had not worked to prevent this.

16 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

2.5 In DP09/3, we set out the wider macroeconomic backdrop to our work and the significance of the very major changes in the structure of the UK housing and mortgage markets which occurred in the decade running up to the crisis.

2.6 We summed the mortgage market problems up as:

- a general across-the-market problem of rapid credit expansion and then withdrawal had made the overall economy volatile and would probably lead to significant credit losses, even if not necessarily as bad as in 1989-94; and
- a significant tail of very poor lending decisions, reflecting the extension of credit to consumers whose capacity to afford it was producing very high losses in particular categories of mortgage.

2.7 As we then noted, some of the drivers of the unsustainable growth we saw are outside the FSA's regulatory scope and regulation alone would therefore be unable to resolve all the problems in the UK mortgage market. But we believed that the overall reforms proposed to our prudential capital and liquidity regimes would largely address the first problem of the major financial stability risks that arose from the rapid expansion of new funding sources pre-crisis.

2.8 The second problem raised issues of consumer protection and conduct of business standards. We saw widely held expectations of a continuing growth in property values compounded by the fact that the risks could be passed onto others (e.g. by securitisation) lead many lenders to feel insulated from losses arising from poor lending. Lending decisions began to be based to a significant extent on the underlying collateral without undertaking a proper assessment of the consumer's ability to repay the sum lent.

2.9 Increased competition – particularly from the specialist 'non-bank' lenders – pushed lending further along the risk curve and high-risk loans came to account for a significant share of the total market. There was a rapid growth in the number of 'income non-verified mortgages'; interest-only mortgages (many of which had no identifiable source of repayment); high loan-to-value (LTV) lending; and credit began to be extended to groups of increasingly marginal credit-worthy consumers who previously had enjoyed only very limited access to mortgages.

2.10 The development of these products and processes created the risk of unsustainable debt burdens and a vulnerability to the withdrawal of credit (i.e. the removal of aggressively priced fixed or discounted rates which enabled consumers to regularly remortgage to new low initial period loans), interest rate increases or falls in property prices. This all crystallised when, in the wake of the crisis, mortgage credit availability rapidly declined and house prices fell significantly.

2.11 We recognised in DP09/3 that the mortgage market had worked well for the majority of consumers. There are now many consumers who own their own homes – many of them outright – who will feel well served by the mortgage market. We also acknowledged that most consumers will have come through this recession meeting their payments, keeping their homes and perfectly happy with the borrowing decisions they made.

2.12 This has often been quoted back at us as a reason why there is no need for us to propose change. The problem for the 'few', the argument goes, has been caused by unavoidable life events not poor lending and should be addressed by a better safety net (such as the government provided Support for Mortgage Interest (SMI) or private insurance such as Mortgage Payment Protection Insurance); not wholesale regulatory change to lending standards which could have the effect of preventing perfectly credit-worthy borrowers having access to the market and achieving their home ownership aspirations.

2.13 But the 'few' represents quite a significant number for whom the mortgage market has not worked at all well. When we published DP09/3, it was not clear what the eventual scale of arrears and repossessions might be. We felt then that the total numbers would be fewer than in the 1990s as a result of the very different pattern of interest rates. And that appears to be the case. The post-crisis impact has been more favourable than feared at the onset of the financial crisis. Arrears levels appear to have peaked at well below the 1990 to 1992 levels. Repossessions have also been below the levels seen in the 1990s.

2.14 As we discuss in Chapter 3, there is clear evidence that cheap and readily available credit led to borrowers over-committing themselves. The Bank of England data[17] suggests that in 2010, 50% of households with a mortgage struggled to pay their bills at least from time to time, of which 15.5% were constantly struggling or falling behind on their commitments. But the potential vulnerabilities of many consumers to rising interest rates has not materialised as rates have fallen and mortgage affordability improved. The overall unemployment rate is not as high as in the early 1990s and the most significant percentage increases in unemployment have occurred in the 16-24 year old age group, which is minimally exposed to mortgage debt.

2.15 The lower interest rate environment combined with steeper falls in house prices during this downturn also mean that lenders have stronger incentives to exercise forbearance than in the early 1990s. There is significant evidence that repossessions and write-offs are being kept low by the extensive use of forbearance strategies.[18]

2.16 Although there may be a reasonably favourable picture overall, we have seen high arrears and repossessions materialising in specific localities and consumer segments. The potential scale of the problems in these segments could get even worse if unemployment or interest rates rise.

2.17 Arrears levels are much higher for high LTV loans. High LTV lending tended to be concentrated in northern regions and arrears in those regions are about 80% higher than those in the south west and south east. This impact of higher initial LTVs has been exacerbated by the fact that house price falls have been larger in northern regions. As a

17 See Exhibit 3.7: Extent to which mortgage borrowers are struggling to keep up with their payments
18 See Exhibit 6.4: Extent of lenders' forbearance on residential loans

result, the incidence of negative equity is also regionally variable. Within regions, meanwhile, negative equity is concentrated in primarily low income sub-regions.

2.18 Arrears for first-time buyers (FTBs) are also considerably above those for home movers, again reflecting their higher than average initial LTVs.

2.19 Arrears are also particularly high among those credit-impaired consumers who were only able to gain access to mortgage finance as a result of the pre-crisis relaxation in lending standards and arrears are very much higher for loans where income was self-certified.

2.20 Arrears have also been very much higher for buy-to-let loans than for loans for owner occupation house purchase. And dramatically high levels of arrears and repossessions have emerged in some specific localities – such as new apartment developments in inner cities, one of the few categories of location in which the UK credit and house price boom was also a construction boom.

2.21 So there is clear evidence that the vulnerabilities created by the significant tail of poor lending have crystallised. It is also noticeable that some of these problems were emerging in 2006-2007, before the financial crisis produced a shock to overall confidence: arrears had begun to increase in 2007, even before unemployment began to rise.

2.22 It is also important not to assume, as some industry commentators sometimes do, that easy mortgage credit availability is necessarily beneficial for groups such as FTBs, on which much popular comment has focused.

2.23 The easy supply of credit in the decade before the crisis was a factor which, by generating significant house price appreciation, contributed to the declining role of FTBs within the market, squeezed by affordability problems.

2.24 Some commentators also suggest that we are fighting yesterday's battles; that there is no need for regulatory intervention at all because the risk of irresponsible lending has diminished as risk attitudes have retrenched. The industry itself acknowledges that a few lenders acted irresponsibly in their pricing of some products, in their relaxation of lending standards and over-reliance on the securitisation market. But those firms are said to have now gone from the market, having paid the penalty of relying too heavily on house price increases or borrowers refinancing to bail them out from bad lending decisions.[19] Lenders are again properly pricing for risk, have removed high-risk products such as self-certified and sub-prime mortgages, have curtailed the use of interest-only mortgages and have demonstrated that they are rebuilding their businesses responsibly and not taking undue risk.

2.25 But with funding much thinner on the ground, it is simple business sense that available funds are used to support higher-quality lending.

2.26 And there does seem to be a tendency to collective amnesia on the part of some trade bodies and lenders with respect to previous crises. In May 2004, in the run-up to the

19 From presentation by Michael Coogan, Director General Council of Mortgage Lenders 12 May 2009 at FSA Mortgage Conference: www.cml.org.uk/cml/filegrab/FSAMortgageconferenceMay09_2_.pdf?ref=6403

introduction of mortgage regulation, the FSA's then Chief Executive John Tiner said the following in his speech to the Building Societies Association Annual Conference in 2004:[20]

> "*…I realise you will say that it is obvious that no lender would advance money in the expectation that repayment could only be achieved through sale of the security held. But if we dip back into not too distant history we find a picture which has reminded me to emphasise this point. In the late 1980s, the most profitable and fastest growing mortgage lenders were those that lent money to the most marginally creditworthy customers: their business model was predicated on the belief that property prices were a one way bet – at least in nominal terms – so the property held as security could be relied upon to increase in value at a rate that would cover not just the principal advanced and interest, but also all the fines for late or non-payment of monthly installments, and all the legal costs of taking possession. In short, they found that lending to distressed borrowers was a highly remunerative activity – until house prices unexpectedly fell. By no stretch of the imagination could that be called responsible lending. Suffice to say that hardly any of those lenders – which included some building societies – outlasted the housing market downturn of the early 1990s.* ***I think lessons have been learned from the experience of 12-15 years ago****…*"

2.27 But clearly lessons were not learned. While risky, lower-quality lending may currently be restricted, there is a real danger that, as funding comes back into the market and lending starts to pick up again, there will be increasing pressure on firms to consider higher-risk lending and focus more on market share than maintaining lending standards.

2.28 To ensure we learn the lessons of the past, we believe that it is necessary to put in place measures that will prevent the re-emergence of poor lending practices. Our intention is not to fundamentally affect the ability of most people to get a mortgage – just to ensure that the common-sense standards that we have seen being applied in the market recently are maintained and endure across the economic cycle.

EU and international developments

2.29 European interest in mortgage policy initiatives started nearly a decade ago, before we began regulating mortgages, so we have faced the prospect for some time of action at that level. We flagged this dependency for the MMR in DP09/3, and have returned to the subject in subsequent consultations.

2.30 We have the largest and probably the most diverse mortgage market in Europe. The comprehensive analysis of the market undertaken for the purposes of the MMR means that we have had a strong evidence base to help inform EU institutions and stakeholders in their thinking on possible European action. So, for example, we have been able to

20 The Regulator's View: Speech to the Building Societies Association. Speech by John Tiner at the Building Societies Association Annual Conference 2004 (6 May 2004): www.fsa.gov.uk/Pages/Library/Communication/Speeches/2004/SP176.shtml

contribute a wealth of analysis on the role of lending thresholds, use the regulatory data reported to us by firms[21] to tell a comprehensive story about market trends and relate some seven years of experience with, and share our review of the effectiveness of, prescriptive disclosure requirements.

2.31 The European policy process resulted in the Commission publishing in March this year a proposal for a directive on mortgage credit.[22] The Commission's proposal generally adopts a higher-level approach than the MMR and is not intended to be a substitute for national policy makers developing the appropriate detailed framework. This is an inevitable consequence of having to address Member State markets that remain very different in their character. The Commission explained that their proposal has a number of objectives; namely on market integration, consumer protection and financial stability. In some respects these aims align closely with the MMR objectives. So, for example, both our policy development and that at a European level aims to ensure more responsible lending. Moreover, there is considerable consistency in the preferred approach. We both believe the key is a robust assessment of the affordability of any new lending.

2.32 The proposed directive is also concerned with raising standards of professionalism. This is another area where the MMR and the European policy developments follow similar lines. In both cases there is particular emphasis on ensuring the good standards and the ongoing competence of intermediaries.

2.33 Inevitably there are differences between the MMR and the proposed new directive. In many cases this stems from the already mentioned differences in objectives. So, for example, the MMR is not aiming to create a unified European market and so it does not need to address the passporting of credit intermediaries or the harmonisation of product disclosure. However, there are a small number of areas where the original European proposal deals with an issue that the MMR also considers, and proposes a different approach, such as limiting the ability of lenders to give advice. In such cases, we have been using the evidence base that the MMR has built up to promote further discussion in Europe.

2.34 Those aspects of the original proposed directive where we would prefer to see change include:

- **Scope**. The proposal applies to almost all secured residential lending. We think it is more appropriate and more proportionate for the proposal to focus on mass market consumer borrowing, recognising that there are many niche mortgage activities (buy-to-let, bridging finance, credit union lending, etc) that it will remain better to regulate at a national level.

- **Disclosure**. The proposal could add significantly to the pre-sale information given to consumers. There might be a particular increase in the volume of material in advertising and at the initial disclosure stage. Much of this is generic information, which FSA research has found few consumers use. The proposal might also result in the

21 Product sales data has been particularly valuable, as detailed transaction-level information of this kind is not commonly available for other European markets.

22 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on credit agreements relating to residential property – COM (2011)142 (March 2011) http://ec.europa.eu/internal_market/finservices-retail/credit/mortgage_en.htm.

Key Facts Illustration (KFI) being replaced with the European Standardised Information Sheet (ESIS). The ESIS lacks important information that is included in the KFI, and also has language and format differences so it will mean expensive systems changes for firms. In addition, the proposal expects firms to complement written disclosure with an adequate explanation of the borrowing on offer. We have a concern that the end result will be information overload, the amount of required disclosure drowning out the key messages, something our MMR proposals have been designed to address.

- **Passporting**. A possible benefit of the proposed directive is that it would allow authorised UK intermediaries to enter new markets without having to go through further authorisation or registration in those markets. The same benefit would exist for European firms looking to start up business here. While we support this, we have been arguing to ensure that the conduct standards that apply to firms setting up branches in the UK are the same as those applying nationally and that we can take appropriate supervisory action even if the firm is passporting in from aboard.

- **Delegation**. Several aspects of the original proposal, e.g. on disclosure, professional standards and the assessment of creditworthiness, also include a further power for the European Commission to supplement requirements and add more detail. We think these issues are central to the proposal and therefore not appropriate to be dealt with through delegation. Moreover, with national markets likely to remain very different in character there is a real risk that future prescription will lead to 'one size fits all' answers that will fail to adequately preserve valuable diversity and flexibility.

2.35 Discussions on the European proposal still have a considerable way to go and we are continuing to work with the government in promoting the UK's position. The European Parliament is currently considering its position and Member States will also have to reach a view. The final outcome is difficult to determine, as is the date when this will be reached. What we do know, with a reasonable degree of certainty, is that when there is agreement the UK and other Member States will have two years to implement. During this period we would need to consult on any necessary changes to our rules. The likelihood of changes is impossible to comment on while the European proposal is still being negotiated. However, at least four factors may well help to limit their extent:

- our close involvement with the negotiations, including providing technical support to government;

- our continuing awareness of the direction of European policy thinking as we consider changes to our own regime;

- the necessity of the proposal taking a high level approach because of the differences in national markets; and

- the directive approach being mainly one of minimum harmonisation, allowing Members States to adopt or retain national measures necessary for the specific risks and features of their market.

2.36 Given the uncertainty of the European timetable, and our continuing need to address UK market and regulatory failings that are not considered in the directive, we do not believe that we should delay the MMR because of the possibility of European changes. Indeed, there is a risk that national jurisdictions not looking to tackle issues in their own markets might prompt other policy-makers to seek to fill a perceived vacuum. We will remain mindful though of the need to ensure the timing of any implementation of MMR or European reforms is sensibly aligned to minimise burdens on firms.

Financial Stability Board

2.37 Wider international concern has seen the Financial Stability Board (FSB) take the lead in new work aiming to improve standards in national mortgage markets. Much of this work has focused on mortgage underwriting practices. The FSB carried out a survey of existing practices and controls in the course of 2010, publishing a report in March.[23]

2.38 Overall, the FSB found that good progress was being made towards more consistent underwriting standards. However, it was thought that more could be done to promote this and so the FSB is now developing an international principles-based framework for sound underwriting practices.

2.39 We have contributed to both phases of this work, and are members of the FSB working group that is drafting the framework. The aim of the framework is not to constrain national regulation intended to deliver sound and effective lending standards. Just as the European Commission has identified that national markets will differ greatly in terms of underlying property law, views on home ownership and borrowing culture, the FSB is adopting a framework approach because of the differences it sees in risks both across and within countries. A framework has the advantage of flexing to the needs and circumstances of individual markets.

2.40 The FSB is now consulting on a draft of the proposed principles-based framework for mortgage underwriting.[24] Where there is read-across to the MMR proposals we have reflected this in our approach. Moreover we will continue to play an active part in discussions on the framework as the FSB finalises it. The framework is currently expected to be confirmed early in 2012, meaning that there should be an opportunity to sense-check our final rules against an international view of the basis for high quality lending decisions.

23 Thematic review of mortgage underwriting and origination practices – peer review report. Financial Stability Board (March 2011): www.financialstabilityboard.org/publications/r_110318a.pdf

24 FSB Principles for Sound Residential Mortgage Underwriting Practices (October 2011): www.financialstabilityboard.org/publications/r_111026b.pdf.

Financial Conduct Authority

2.41 The government intends a new regulatory framework for financial services.[25] Under the government's plans, the UK will move to a model whereby the Financial Policy Committee (FPC), sitting within the Bank of England, will be responsible for protecting the stability of the financial system and for macro-prudential regulation. The Prudential Regulation Authority (PRA) will be set up as a subsidiary of the Bank of England, and will prudentially supervise deposit takers (including many mortgage lenders), insurers and a small number of significant investment firms. The third new body is the Financial Conduct Authority (FCA), which will be responsible for regulating conduct in both retail and wholesale markets, and for the prudential regulation of firms not overseen by the PRA.

2.42 Under the proposed new architecture[26] the FCA will have the single strategic objective of protecting and enhancing confidence in the UK financial system, and three operational objectives:

- securing an appropriate degree of protection for consumers;
- promoting efficiency and choice in the market for financial services; and
- protecting and enhancing the integrity of the UK financial system.

2.43 The FCA will also have a duty to discharge its functions in a way that promotes competition, so far as is compatible with its objectives. In addition, it will have a duty to have regard to the importance of taking action to minimise the extent to which regulated businesses may be used for a purpose connected with financial crime.

2.44 In establishing the FCA the government's intention is that the authority will, amongst other things:

- intervene earlier to tackle potential risk to consumers and market integrity before they crystallise; and
- be tougher and bolder, building on and enhancing our credible deterrence strategy, using its new powers of intervention and enforcement.

2.45 We have set out our initial thinking on how the FCA could approach the delivery of its objectives.[27] We think this approach will build on many changes we have already made, or commitments we have signalled, for example:

- over the past four years we have radically changed our approach to enforcement, bringing many more cases and imposing higher penalties;

---

25 A new approach to financial regulation: building a stronger system. HM Treasury (February 2011) www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf

26 A new approach to financial regulation: the blueprint for reform. HM Treasury White Paper, (June 2011): www.hm-treasury.gov.uk/d/consult_finreg__new_approach_blueprint.pdf

27 The Financial Conduct Authority: approach to regulation. FSA, (June 2011): www.fsa.gov.uk/pubs/events/fca_approach.pdf

- major policy initiatives that seek to address fundamental market deficiencies (both the Retail Distribution Review and the MMR) rather than dealing solely with adverse outcomes; and
- our proposals (as set out in the FCA approach document and the Product Intervention Discussion Paper[28]) for a new and intrusive approach to the way firms bring financial services products to the retail market. Firms have already experienced this. Where significant new product launches or changes are proposed we expect firms to be able to explain the research and analysis they have carried out. We have found this lacking in some recent cases. We will focus particularly on product design and governance issues such as whether there is an identified need for the product, and the actions taken to identify and mitigate risks to consumers.

2.46 These structural changes will not deflect us from delivering our reforms of the mortgage market.

28 DP11/1, *Product Intervention*, (January 2011): www.fsa.gov.uk/pubs/discussion/dp11_01.pdf

PART I
Conduct of business reforms

3

Responsible lending and borrowing

Summary of key proposals

- Mortgages should only be granted where there is a reasonable chance of repayment out of income cash flow without a reliance on future property price appreciation.
- Lenders must verify income and be able to demonstrate that the mortgage is affordable taking into account the borrower's net income and, as a minimum, both the borrower's committed expenditure (which includes the mortgage payments) and basic household expenditure.
- Lenders must take account of the impact on mortgage payments of market expectations of future interest rate increases.
- Lenders should adopt a prudent and proportionate approach to assessing income beyond state pension age.
- Lenders should adopt additional measures to protect credit-impaired consumers who are consolidating debts.
- To mitigate the impact of the new proposals, transitional arrangements will allow lenders (existing or new) in certain circumstances to waive some of the proposed affordability requirements for existing borrowers.

Introduction

3.1 Our Responsible Lending Consultation Paper (CP10/16[29]) proved to be controversial, stimulating extensive debate in the mortgage industry and beyond and provoking a large number of responses.

3.2 Given that we are consulting further on all of our proposals, we have not included a formal Feedback Statement to CP10/16. Instead, in this chapter we summarise and discuss the replies that we received.

3.3 The revised approach we set out here has been shaped by the very many formal responses we received to the proposals from a wide variety of stakeholders, our many discussions with stakeholders since and our further policy analysis.

3.4 The cost benefit analysis (CBA) for these proposals is in Annex 1 and the compatibility statement in Annex 3. The proposed new responsible lending rules are set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1.

3.5 Throughout this chapter, any reference made to 'Exhibit', unless otherwise indicated, means the relevant exhibit in the *MMR Data pack*.[30]

Background

3.6 When developing the existing mortgage regime, we assumed that firms would have a prudential self-interest in managing their credit risk responsibly and therefore that prescriptive conduct requirements were not required. The current responsible lending mortgage rules therefore require a lender to do little more than 'take account' of a borrower's ability to repay their mortgage.[31]

3.7 As we have said in previous MMR papers, our assumption about firms managing their credit risk responsibly has been shown to be wrong in many cases. There is a general consensus that a key problem underlying many issues in the mortgage market has been firms' failure to perform proper affordability checks, relying instead to a significant extent on the underlying collateral and an assumption that debt burdens were likely to fall with continuous property price appreciation. Although there has been some self-correction in the market following the downturn, as discussed in Chapter 2, we believe it is necessary to put in place measures to prevent similar problems re-emerging in the future.

3.8 We have always recognised that for the majority of consumers, the mortgage market has worked well. We predicted in the MMR Discussion Paper (DP09/3[32]) that most consumers will come through this recession meeting their mortgage payments and happy with the borrowing decisions they made. And so far, that has proved to be the case. As we noted in Chapter 2, this picture has been somewhat flattered by the low interest rate environment,

29 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf
30 *MMR Data pack*, (December 2011): www.fsa.gov.uk/pubs/other/mmr_datapack2011.pdf
31 MCOB 11.3.1R(1) http://fsahandbook.info/FSA/html/handbook/MCOB/11/3
32 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

which makes debt servicing easier. But, even allowing for that effect, much of the market has seen responsible lending.

3.9 We do not want to take any action that has the effect of unreasonably restricting the access of perfectly credit-worthy consumers to mortgage finance. We also recognise that a zero-risk mortgage market is not possible – there will be always be borrowers whose mortgages are perfectly affordable when taken out but who get into payment difficulties as a result of unpredictable life events, such as unemployment.

3.10 However, it is also clear – and recognised by the industry itself – that there was a significant tail of poor lending, where bad underwriting clearly led borrowers into commitments they could not afford and where the probability of the borrower defaulting was high.

3.11 Our aim therefore is to put in place measures which prevent that tail of poor lending, and which ensure that mortgages being taken on are affordable both now, and in the future (in cases where borrower circumstances are due to change foreseeably during the mortgage term). We want to ensure that in future downturns there will be significantly fewer borrowers suffering the trauma of arrears and repossessions and struggling to keep up their mortgage payments, and therefore their homes, than in this recession. But we also want to ensure that we continue to have a market in which a large number of people can enjoy access to mortgage lending.

3.12 We have spent some considerable time since CP10/16 analysing how we might achieve this. We have tried to identify whether there are any sufficiently predictive indicators of impairment that could be used as the basis of a quantitative rule that would enable us to cut off the tail of poor lending with some degree of precision.

3.13 We initially investigated two approaches:

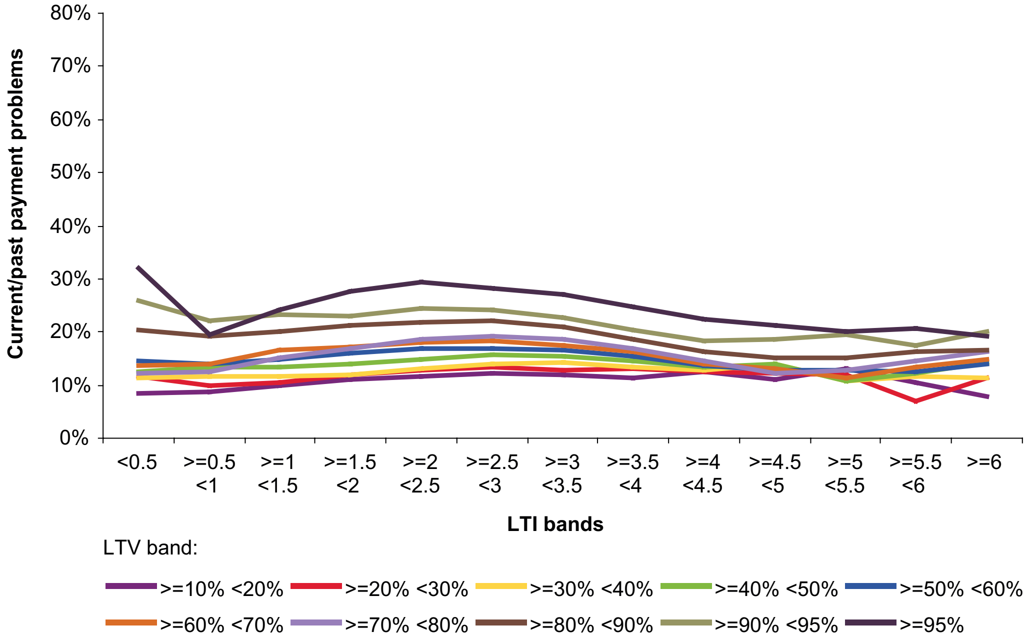
- precise quantitative rules relating to maximum levels of asset or income leverage; and
- affordability rules based upon the precise specification of required levels of expenditure.

Quantitative asset or income leverage ratios

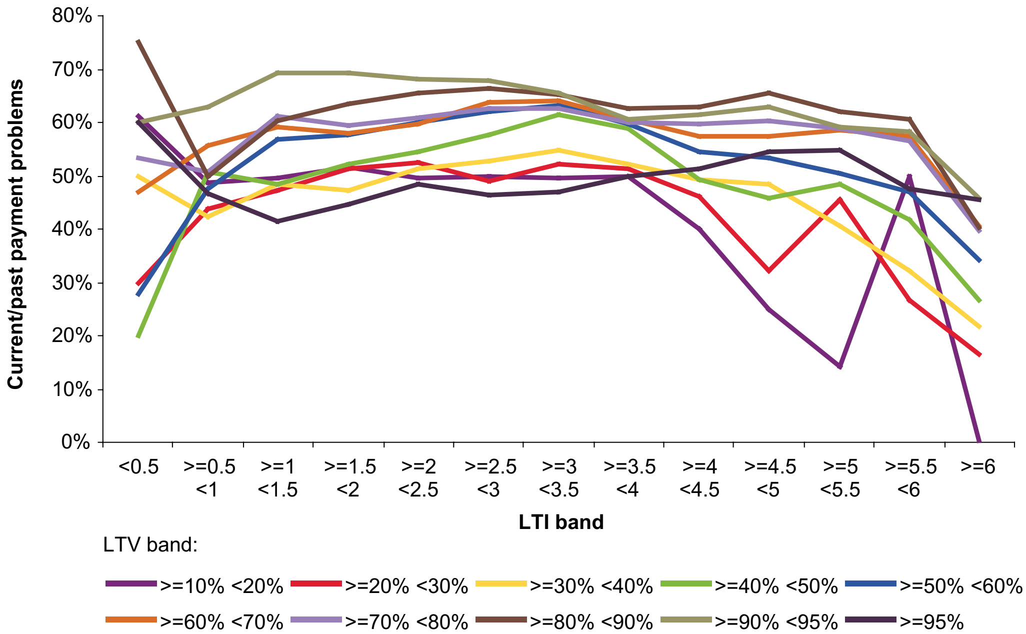
3.14 One possible way to address the tail of poor lending would be through setting numerical cut-off points in relation to some level of leverage. Two obvious ways by which to assess credit worthiness are by looking at loan-to-value (LTV) or loan-to-income (LTI) related measures. This is something we looked at in some detail in DP09/3 and also CP10/16. As we noted then, of the two measures, it is LTV which displays the strongest correlation with arrears (see Exhibit 1).

Exhibit 1: Link between LTV and LTI

Banks, building societies and subsidiaries of banks, 91% of the sample



Non-banks and subsidiaries of building societies, 9% of the sample



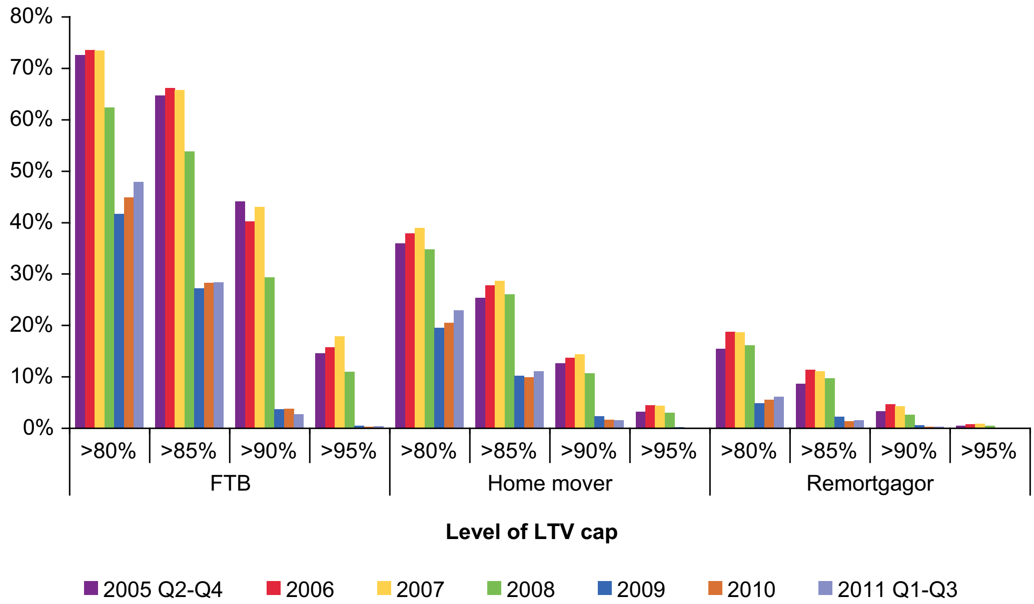
Source: PSD performance data 2011

3.15 It is not obvious why arrears behaviour should be more closely correlated with LTV than with LTI, as LTV is not a direct measure of income or whether a consumer can afford to pay each month. In DP09/3, we suggested that the explanation may be that a lower LTV ratio means that a borrower has greater equity in the property which could increase their willingness and incentive to repay. And borrowers without equity can be less able to borrow to survive income shocks.

3.16 Despite the correlation, however, we remain very wary of having a single across-the-board LTV cut-off point for consumer protection purposes. In particular, we are concerned that introducing absolute LTV limits alone may restrict first-time buyer (FTB) access to mortgages. So we have not changed our initial view that we should not propose such absolute LTV limits on conduct grounds.[33]

3.17 Exhibit 2 illustrates the degree to which FTBs have recently purchased mortgages with high LTVs compared to other market participants.

Exhibit 2: Higher-LTV mortgages



Source: FSA PSD

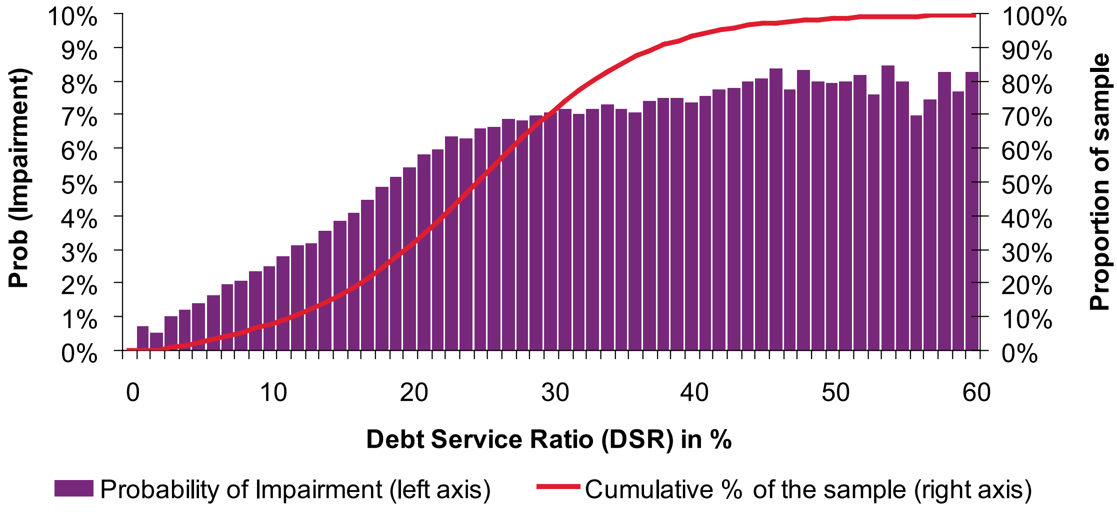
3.18 Turning to LTI-type measures, the most promising measure appeared to be the debt servicing ratio (DSR) defined here as the ratio of mortgage payment to net income. The higher the mortgage payment compared to the borrower's net income at origination, the less likely the borrower will be able to fall back on the option of reducing expenditure and savings to meet a mortgage payment.[34] From our Product Sales Data (PSD), we have the ability to look in detail at frequency distributions of DSRs, and we can identify these for different years and for different types of loan, such as capital and interest mortgages versus interest-only, or by characteristics of the borrower, such as income deciles, as illustrated in Exhibit 3.

33 However we still do not rule out implementing such thresholds on macro-prudential grounds. The Financial Policy Committee is currently considering the case for such an instrument in the context of its macro-prudential toolkit. http://www.bankofengland.co.uk/publications/records/fpc/pdf/2011/record1110.pdf

34 Other debts would of course make the position worse. We do not collect data on this but our analysis suggests that 65% of borrowers have additional unsecured debt to pay each month. See Exhibit 7.7: Mortgage borrowers with unsecured debt: how much they spend each month on unsecured debt payments.

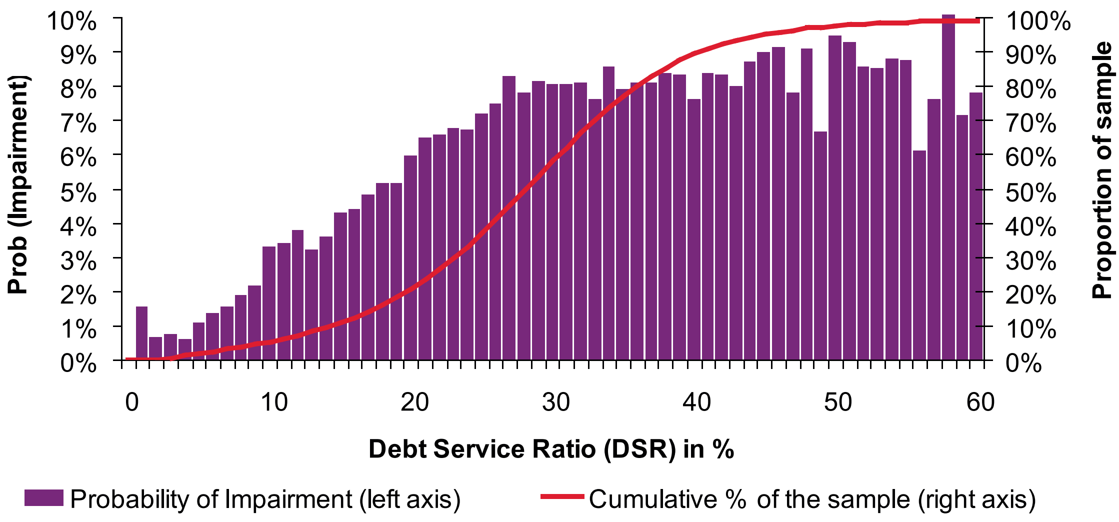
Exhibit 3: Probability of mortgage impairment and DSR for different income bands

3a) Probability of impairment and DSR



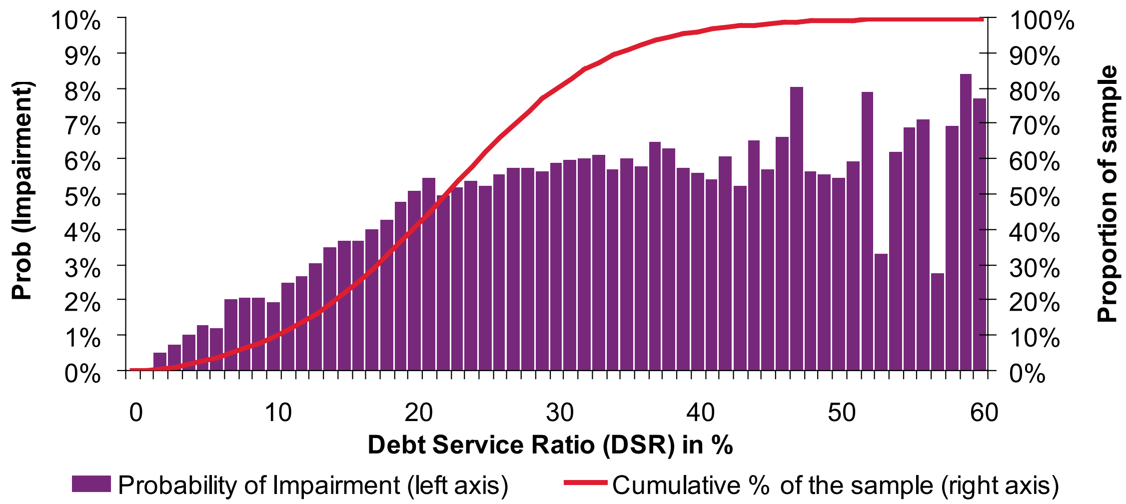
Source: PSD Performance data 2011

3b) Relationship for second lowest income decile



Source: PSD Performance data 2011

3c) Relationship for second highest income decile



Source: PSD Performance data 2011

3.19 We therefore considered whether there were sensible cut-off points of DSR – beyond which lending should either not be allowed, or only in specific circumstances and subject to careful analysis – as a route to cutting-off the tail of poor lending, while minimising the effect on mortgage market access for the great majority of borrowers.

3.20 When we looked at the correlation of DSR and arrears, however, we found that:

- while the correlation of DSR and arrears increases up to a certain level of DSR, there is a point beyond which the correlation becomes constant with, presumably, a huge variety of exceptional circumstances explaining why many very high DSR loans are still credit worthy;
- while there is a clear correlation of arrears rates and DSR, the explanatory power of DSR is not great: there are clearly many other drivers of credit worthiness; and
- the level of arrears even at quite high DSRs is sufficiently low that, if we were restricting access above this level, many more good borrowers would be prevented from borrowing than bad borrowers.

3.21 The weakness of the correlation, and the existence of very high DSRs without high arrears, may of course be a consequence of the period of abnormally low interest rates. It is possible that in more normal interest rate environments, the correlation would be stronger and that the DSR based cut-off point might look more appropriate. Moreover, DSR only captures income and mortgage servicing costs, and does not allow for other debts or essential or difficult to reduce expenditure. Therefore, certainly currently, the evidence does not support proceeding with a DSR based cut-off.[35] But it is possible that with better data and further analysis over time this quantitative approach may become possible.

35 However, we do use DSRs to help us estimate the impact of some of our other proposals in the CBA. See Annex 1 A4.

Detailed expenditure-based approach

3.22 We then investigated ways of using expenditure data to construct a better predictor of mortgage affordability.

3.23 The simplest measure would have been a total expenditure to net income ratio. But the problem with 'total expenditure' is that this does not give us an indication of what consumers need to spend – it indicates what they have spent, and many people on average spend their entire income after mortgages. This measure also assumes that a borrower would not be able to reduce any expenditure to meet mortgage payments, which is unrealistic. What we needed to establish was *essential* expenditure i.e. those items of expenditure which a borrower could not reduce to meet a mortgage payment.

3.24 To assess affordability with an expenditure approach however, whether total or essential, we need expenditure data for both individual borrowers, and their households (such as number of dependants, as this is a key driver of expenditure). We faced the fundamental problem that none of this data is provided in PSD, and there are no alternative direct measures gathered of 'essential' or 'unavoidable' expenditure.

3.25 One way to address this was simply to use our own judgement about what expenditure was 'essential' and 'non-essential'. We attempted this, working through 484 expenditure categories, and building a regression model predicting essential expenditure for individual borrowers in PSD. However we were uncomfortable with this approach as making a judgement about what is or is not essential expenditure is inherently political and inevitably somewhat arbitrary.

3.26 We therefore tried to map external data about expenditure and household size into PSD. There are several estimates available, e.g. benchmark figures used by the Insolvency Service, trigger figures used in the Common Financial Statements and the level of welfare benefits or minimum income standards estimated by the Joseph Rowntree Foundation. However, we found that external measures of basic expenditure were not a good measure of our proposed affordability approach because, of their methodological biases and as they varied widely according to the purpose for which they had been constructed, which did not necessarily match the purposes of the MMR.

3.27 So we concluded that, until we have better data, it is not possible to proceed with a detailed quantitative, rule-defined expenditure approach either.

3.28 Annex 1[36] provides further detail of the analyses we carried out and the problems we encountered with both the income leverage and expenditure approaches.

3.29 Our analysis has highlighted limitations in the data we currently collect. As we explain further in Chapter 7, we are proposing to expand the data we collect from firms to include, for example, expenditure and household size. This would help us monitor compliance with the proposed new rules, and also increase both firms' and our ability to assess the

36 See Annex 1 A7.

predictive power of different affordability measures. At a later stage, this may result in a more quantitative rule-based approach becoming possible.

The principle of affordability

3.30 Instead of a quantitative leverage cut-off point (whether on an asset or income basis or a detailed expenditure based approach), we therefore propose to proceed on the basis of establishing a clear principle of good underwriting. The essential principle is that loans should only be granted where there is a reasonable chance of repayment from identifiable income cash flow or capital sources, and should not rely on the assumption of property price appreciation.

3.31 This has three key elements:

- **The affordability assessment**: a lender must verify income and be able to demonstrate that the mortgage is affordable taking into account the borrower's net income and, as a minimum, the borrower's committed expenditure (which includes the mortgage payments) and basic household expenditure.
- **The interest rate stress test**: the lender must also take account of the impact on mortgage payments of market expectations of future interest rate increases.
- **The interest-only proposals**: the lender must also assess affordability on a capital and interest basis, unless there is a clearly understood and believable alternative source of capital repayment.

3.32 We discuss the first two elements of the affordability principle in this chapter. As we are consulting in this CP for the first time on our interest-only proposals, those proposals are set out and discussed separately in Chapter 4.

3.33 We believe that our proposed approach is intuitively the right approach, allowing lenders the freedom to make lending decisions, while ensuring those decisions are properly informed, based on the circumstances of the consumer. We have had extensive discussions with the market to inform our approach, and believe that it reflects much of the current good practice in the market today. So we do not expect the affordability proposals to have a great impact in the current market.

3.34 Because the rules are largely qualitative, it is difficult to quantify the impact with any degree of certainty. We have estimated the expected impacts, which we set out in Annex 1, but because the evidence base available to us is imperfect, we have been forced to make assumptions for modelling purposes.

3.35 We would welcome views and comments on not only our policy proposals, but also on the estimated impacts. We propose to work closely with the industry over the consultation period to arrive at a shared understanding of the impacts.

Mortgages and high-risk lending

3.36 This approach based on the principle of affordability is about ensuring good underwriting standards across the board. It aims to cut off the significant tail of very poor lending discussed in Chapter 2. It does not of itself, however, prevent higher-risk lending.

3.37 We concluded in CP10/16 that banning high-risk lending combinations would be too blunt an approach to distinguish between those who will and those who will not repay, and would unfairly penalise some consumers. For example, our risk combinations analysis (Exhibit 4) found a strong link between payment difficulties and characteristics such as whether the borrower is self-employed or a right-to-buy consumer.

3.38 We believe it would be unfair to prevent all such higher-risk consumers from being able to access mortgages. Instead we prefer an approach where all consumers are able to obtain a mortgage, as long as they can demonstrate that they can afford it.

Exhibit 4: Risk combinations and mortgage performance

							Outstanding mortgages			All sales
Risk type	Credit impaired	LTV>=80%	Self-employed	Debt consolidation	Right-to-buy	% of sales	Total: any record of payment problems	Total: current missed payments or arrears	Total: current arrears 2+ months	Total: possession or possession order
1	NO	NO	NO	NO	NO	53.3%	14.0%	3.8%	1.3%	0.3%
2	NO	YES	NO	NO	NO	23.9%	21.2%	8.0%	4.2%	2.2%
3	NO	NO	YES	NO	NO	9.3%	22.6%	7.2%	3.3%	0.7%
4	NO	NO	NO	YES	NO	3.1%	22.8%	7.9%	3.3%	0.4%
5	NO	NO	NO	NO	YES	0.6%	32.1%	10.5%	4.8%	1.8%
6	NO	YES	NO	YES	NO	1.2%	35.1%	15.7%	8.2%	2.9%
7	NO	YES	YES	NO	NO	4.4%	36.1%	16.2%	9.4%	4.5%
8	NO	NO	YES	YES	NO	0.5%	36.9%	15.5%	7.6%	1.1%
9	NO	YES	NO	NO	YES	0.2%	41.5%	19.5%	11.8%	6.5%
10	NO	NO	YES	NO	YES	0.1%	43.6%	16.6%	9.7%	3.4%
11	NO	YES	YES	YES	NO	0.3%	52.5%	27.2%	16.1%	5.6%
12	NO	YES	YES	NO	YES	0.0%	57.3%	29.6%	19.0%	9.7%
13	YES	NO	NO	NO	NO	1.0%	58.1%	29.1%	17.4%	5.4%
14	YES	YES	NO	NO	NO	0.8%	63.6%	35.2%	22.8%	12.0%
15	YES	NO	NO	YES	NO	0.2%	65.3%	33.1%	19.6%	4.6%
16	YES	NO	YES	NO	NO	0.4%	72.4%	39.8%	26.6%	8.8%
17	YES	YES	NO	YES	NO	0.2%	74.4%	41.1%	25.9%	11.7%
18	YES	NO	NO	NO	YES	0.1%	76.7%	34.7%	23.6%	9.3%
19	YES	NO	YES	YES	NO	0.1%	79.0%	43.1%	29.0%	6.8%
20	YES	YES	YES	NO	NO	0.3%	79.4%	50.2%	35.8%	17.3%
21	YES	YES	NO	NO	YES	0.0%	81.3%	45.1%	31.3%	15.7%
22	YES	YES	YES	NO	YES	0.0%	82.2%	45.8%	35.4%	21.1%
23	YES	YES	YES	YES	NO	0.0%	85.4%	53.1%	36.8%	16.7%
24	YES	NO	YES	NO	YES	0.0%	87.6%	39.5%	25.3%	10.0%
Total						100.0%	19.9%	7.1%	3.4%	1.3%

Note: the data is sorted on the basis on the ‘any record of payment problems’ figure, from the lowest to the highest.
Source: PSD Performance data 2011

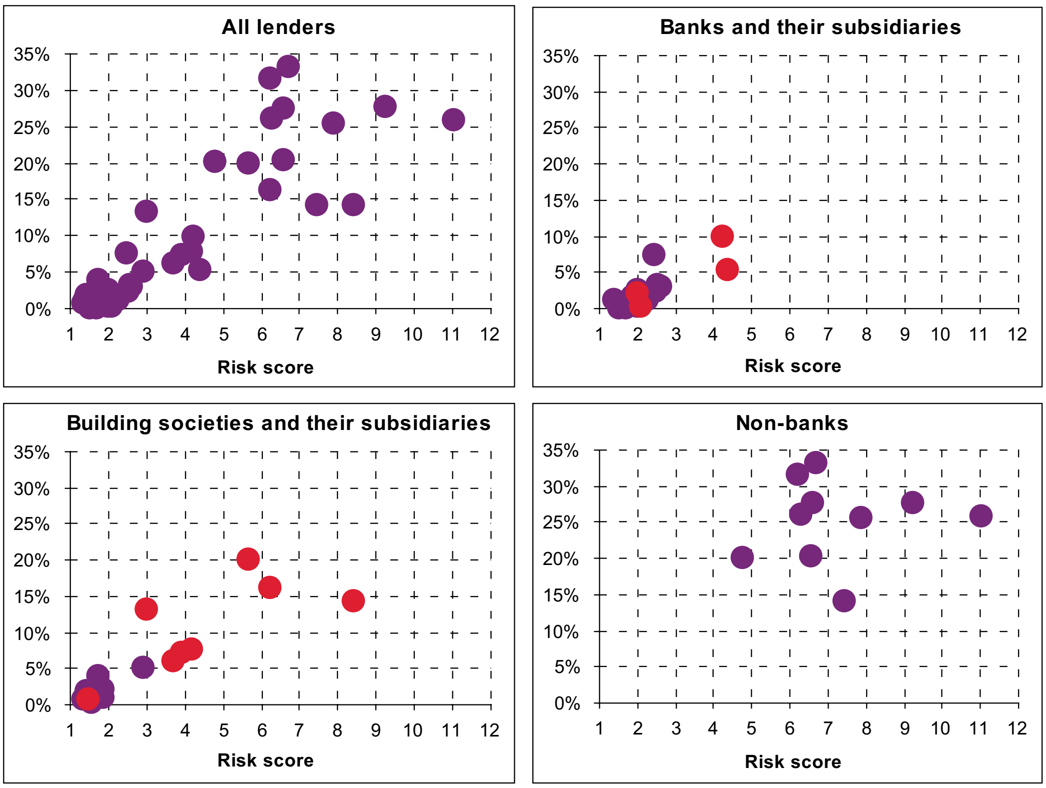
3.39 When considering higher-risk products, we would expect them to lead to higher payment problems. We therefore, in principle, accept that those lenders taking higher risks will have higher levels of default.

3.40 There are various drivers of lenders' arrears levels including:

- the amount of intrinsically risky products (for example, self-certification mortgages, debt consolidation);
- the amount of lending to intrinsically risky borrowers (for example, credit-impaired, right-to-buy); and
- the quality of underwriting (for example, income and expenses are not checked; financial commitments exceed income, or the impact on affordability of interest rate rises is not considered).

3.41 While the incidence of arrears rises according to the level of risk taken by the lender, there are some lenders who are significant outliers, with arrears levels much higher than other lenders who have taken similar levels of risk, in terms of product and borrower type. This is illustrated in Exhibit 5, and it is particularly evident amongst non-banks. These differences may be due to variation in underwriting standards between lenders – with poorer underwriting standards leading to higher levels of arrears.

Exhibit 5: Relationship between level of mortgage risk and arrears[37]



Note: (1) Red dots represent subsidiaries.
Source: PSD Performance data 2011

37 Risk score is a weighted average risk taken by lenders consisting of five characteristics of risk that we use for illustrative purposes in this consultation paper. For more information on the included types of risk and on the weights applied see Exhibit 6.9 and notes on data and methodology in Annex 1 of the *MMR data pack*.

3.42 We expect that in practice, by raising underwriting standards through appropriate affordability checks, this will reduce the number of higher-risk products in the market.

3.43 We can already see this from the self-correction that has happened in the market before we have made any changes. For example:

- the number of lenders offering self-certified mortgages was 44 in August 2007. Today none offer such mortgages; and
- the number of sub-prime lenders in the market in 2007 was 37. Until earlier this year, it was none, although we have recently seen some 'complex prime' products on offer.

3.44 This change in the risk profile of new mortgage lending between 2007 and 2010 is illustrated in Exhibit 6 below, which shows a really very significant reduction in the risk profile of new lending in 2010 compared with 2007.

Exhibit 6: Risk profile of new mortgage lending in 2007 and 2010, by lender

Note: Lenders shown as purple dots lent both in 2007 and 2010; Lenders shown as yellow dots left the market or merged with other lenders
Source: PSD from sample of lenders who took part in 2011 Mortgage Performance Survey

3.45 Our aim is that, when the new affordability rules are implemented, lenders will not relax their lending standards to the degree seen in the last boom, and therefore the risk profile of new lending will not increase to the levels seen in 2007. While we do not want to prevent lending to higher-risk consumers, we want lenders to take informed decisions about such lending.

3.46 As noted above, over time the improvement in the PSD database may enable us to establish more clearly the predictive power of an expenditure-based approach and to develop a quantitative rule.

3.47 We intend to conduct a formal review of the impact of our proposals not more than five years after implementation. We may then reconsider whether there is an acceptable cut-off point beyond which lending should either not be allowed or allowed only in specific circumstances, particularly if we find that high arrears levels persist for new lending. We may also move to restrict risk combinations that appear particularly toxic (for example, risk types 22, 23 and 24 in Exhibit 4 above).

The principle of affordability

3.48 As noted earlier, our responsible lending proposals are centred around the principle of affordability. There are three key elements to this, the first of which is the affordability assessment which we discuss below, i.e. a lender must verify income and be able to demonstrate that the mortgage is affordable taking into account the borrower's net income and, as a minimum, both committed expenditure (including the mortgage payments) and basic household expenditure. The second key element is the interest rate stress-test which we discuss in paragraph in 3.186 to 3.206. The third element is interest-only mortgages which we discuss in Chapter 4.

Affordability assessment: Income verification

3.49 In DP09/3 we discussed our concerns about the growth in the sale of mortgages where income was not verified, and described how such mortgages had grown way beyond their original niche target audience of self-employed consumers.

3.50 In 2006/2007, at the height of the market, lenders granted £581bn worth of mortgages. Almost half of this, £269bn, was granted without any checks being made that the borrower had the income they claimed they had to support the amount being lent to them. Some of these loans were granted on a self-certification of income basis, which is a type of mortgage product where evidence of income is not required. A much larger proportion was 'fast-tracked' business, where the lender reserves the right to request evidence of income, but does not do so in most cases.[38]

38 See Exhibit 8.4: Mortgage sales where income was not verified, by type of non-verification

3.51 66% of those borrowers whose income was not verified during 2006/2007 were employed, where checking income should have been relatively straightforward.[39]

3.52 We expressed concerns about such mortgages, including that:

- They allowed consumers to exaggerate income declared on mortgage applications, at a time when average earnings were falling behind rising property values. Property values increased by almost 200% in the decade before the onset of the financial crisis whereas over the same period the growth in average earnings amounted to only 50%. As a result, many applicants were tempted (and in some cases encouraged) to inflate the income stated on their application.
- Arrears rates were three to four times higher than for mortgages where income had been verified.
- This market segment had shown itself to be unsustainable, suffering a much more severe contraction than the wider mortgage market: 44 lenders offered self-certification mortgages in August 2007; that had dropped to 22 in August 2008 and is zero today.

3.53 We concluded that the best way to deter individuals from applying for and lenders from accepting inflated applications was to require income verification in every case.

3.54 We thought that the case for this was clear and non-controversial. But in fact, this proved to be one of the most controversial suggestions made in DP09/3. There was a lot of support from consumer representatives, intermediaries and some trade bodies who agreed that everyone should be able to verify their income, even where sources are diverse or income streams irregular. However, others raised concerns about the impact on the self-employed, and the larger lenders and trade bodies voiced particular concerns about the impact on fast-tracked mortgages.

3.55 In CP10/16 we continued the discussion. We acknowledged that fast-tracked mortgages perform generally better than self-certification mortgages, and in fact often perform better than standard income-verified mortgages. However, we continued to have strong concerns over the opportunities that allowing fast-tracked mortgages to continue would provide for exploitation.

3.56 A key concern was the prospect of a loosening of standards as credit conditions improve. Despite the fact that fast-tracked mortgages are characterised as being tightly controlled and provided only to low-risk consumers, many high LTV (therefore higher-risk) mortgages were not income-verified. For example, in 2007, 15% of applications above 95% LTV and 40% of mortgages in the 85-90% LTV band did not have income verified. This added to our concerns that competitive pressures would lead to the widened availability of fast-tracked mortgages as credit conditions improved.[40]

39 See Exhibit 8.6: Mortgage sales with non-verified income, by employment status
40 See Exhibit 8.2: Higher-LTV mortgages where income was not verified

3.57 We were also concerned about fast-tracked mortgages becoming a substitute for self-certification. In the last boom we saw fast-tracked schemes overtly marketed to intermediaries as not needing evidence of income, therefore becoming a substitute for self-certification.

3.58 We also had very serious concerns about mortgage fraud. We noted in CP10/16 that the HM Revenue & Customs (HMRC) pilot scheme, which enabled lenders to check suspect income details against information supplied to HMRC (such as tax returns), reported that £111.4m of mortgage fraud had been prevented. This highlighted the importance of income verification in the fight against such fraud.

3.59 Given our concerns, we concluded that both self-certified and fast-tracked mortgages should not be allowed to continue and proposed that lenders must verify income for all applications, to ensure that affordability assessments were based on fact.

3.60 We did not propose to be prescriptive about the types of income lenders had to take into account when assessing affordability. But we did propose to require that the lender should take account of the variability of income over time in their assessment. We were not expecting 'crystal-ball gazing' at the time of underwriting. We gave examples of where a one-off sum or short-term overtime may have led to temporarily increased income which could have masked the long-term affordability of the loan. Similarly, for the self-employed, we indicated that lenders would have to consider the variability of their income over time in assessing affordability – but we left the lender to decide how best to do this.

3.61 In CP10/16 we asked two questions about income verification:

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

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

3.62 The majority of respondents supported our income verification proposals. Most agreed that all consumers should be able to prove their income, and welcomed our non-prescriptive approach. But some lenders and trade bodies continued to express support for fast-tracked mortgages, and some respondents were concerned about the impact on self-employed borrowers.

3.63 Given the significant debate around our proposals on fast-tracked mortgages, and the impact of our proposals on the self-employed, we deal with those issues separately before dealing with the other points raised in the consultation.

Fast-tracked mortgages

3.64 We use the term 'fast-tracked' to refer to mortgage applications where the lender reserves the right to request evidence of income during the mortgage application process, but does not do so in most cases (anecdotal evidence suggests around 90% or more of cases) because they consider the consumer to be low risk. So, although 'fast-track' was sometimes overtly advertised as a product where evidence of income was not required, it was primarily developed as a way to process mortgage applications more efficiently.

3.65 Gaming remains our principal concern about fast-tracked mortgages and there was some agreement for this view from respondents to CP10/16. They agreed that standards for fast-tracked mortgages would inevitably be relaxed as the market picks up, with a real risk that they would be used as a route for 'gaming' income verification requirements.

3.66 Some of the bigger lenders and trade bodies argued that we misunderstood fast-tracked mortgages and failed to recognise that evidence of income is always required at some stage in the application process - it is just that it is not always checked by the lender. Importantly, they argued, the decision not to verify is not communicated to the borrower and/or intermediary and therefore we were overstating the risk of the potential for gaming.

3.67 We noted in CP10/16 that fast-tracked mortgages have been used to game affordability requirements where lenders have weak controls. Those concerns were borne out by thematic work on mortgage fraud[41] which found that:

- fast-tracked mortgages allow anti-fraud checks to be bypassed; and
- intermediaries are able to learn different lenders' internal fast-track thresholds and exploit this to submit fraudulent business that escapes internal scrutiny.

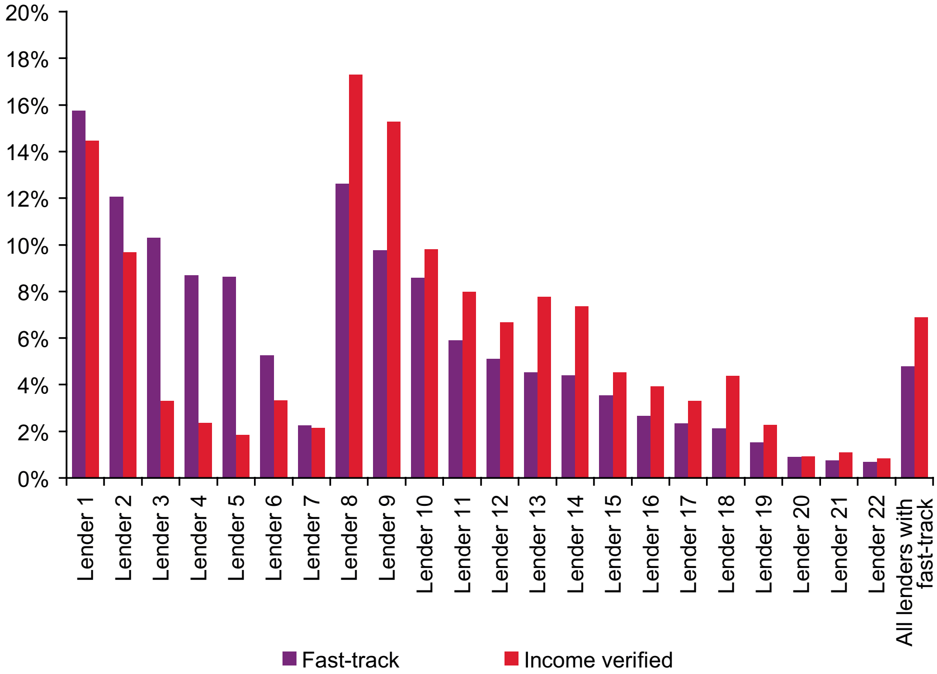
3.68 One example given was of a large lender which sampled only 5% of its fast-tracked mortgage applications. This was done at the point of application, so the broker knew instantly whether the case required income verification and could simply withdraw the application if they could not supply evidence of income, claiming that the consumer had decided not to proceed.

3.69 The arguments put forward in support of fast-tracked mortgages are mainly based on performance. The larger lenders and trade bodies in particular argued that the fast-tracked process works well, demonstrated by their low arrears rates. The fact that most fast-tracked mortgages perform well, in terms of the level of arrears and repossessions, should of course not be surprising, given that fast-tracked mortgages should be offered only to lower risk consumers, according to factors such as credit score, LTV and borrower type.

3.70 We recognise that some lenders apply stringent criteria to such applications and that many fast-tracked mortgages have performed well. However, our most recent analysis shows that when the lower risk of fast-tracked mortgages is controlled for, there is in fact little difference in the performance of fast-tracked and income-verified mortgages.[42] Just under a third of the lenders on whom we have data have fast-tracked mortgages that performed worse than income-verified mortgages. For some of those lenders, fast-tracked mortgages performed considerably worse, as illustrated in Exhibit 7.

41 *Mortgage fraud against lenders*, (June 2011): www.fsa.gov.uk/pubs/other/mortgage_fraud.pdf
42 See Exhibit 8.9: Mortgage performance, by type of income verification

Exhibit 7: Proportion of mortgages with current payment shortfalls or arrears: fast-tracked and income-verified



Source: PSD Performance data 2011

3.71 As we have seen, the parameters used by lenders to control fast-tracked lending, such as credit scoring, LTV and borrower type, can easily be relaxed according to the risk appetite of the lender and their desire to increase their market share at any given time.

3.72 Some bigger lenders and trade bodies suggested that we address this by applying a 'regulatory boundary' around fast-tracked mortgages, such as:

- confining them to borrowers with a good existing payment history, a high credit score, and/or low LTVs;
- subjecting them to appropriate controls such as fraud and sampling checks; and
- banning specific fast-tracked products or the marketing of fast-tracked mortgages.

3.73 We could stipulate the parameters that lenders must apply. However, putting set limits on the circumstances on which a borrower could qualify for a fast-tracked mortgage would be a 'one-size-fits-all' approach, which may penalise some borrowers.

3.74 Putting such limits in place may also lead to unintended consequences, providing an incentive, for example, for properties to be overvalued to meet LTV requirements. It could also lead to the targeting and exploitation of some groups who may typically have lower LTV mortgages, such as older consumers or right-to-buy borrowers.

3.75 Setting limits around credit scoring would also be problematic, because credit scoring is not standardised. So it would be difficult to apply and enforce one relevant and consistent standard across the board.

3.76 It is clear from responses that evidence of income is usually obtained at some point in the fast-tracked mortgage application process, usually by an intermediary, but the intermediary is not then required to pass the evidence on to the lender, unless specifically requested. As there are already systems in place to pass the evidence to the lender for their non fast-tracked business (which currently accounts for over 70% of mortgages granted[43]) it does not appear to be overly onerous to propose that this happens for all applications, given the benefits that would be achieved.

3.77 It is also important to bear in mind the wider international context when discussing the issue of fast-tracked mortgages. As we noted in CP10/16, the only other countries we are aware of that had a significant non-income-verified market were 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 experienced similar 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, fared much better and have experienced lower rates of arrears.[44]

3.78 The emphasis placed on evidencing income in the Financial Stability Board's (FSB) Principles for Sound Residential Mortgage Underwriting Practices[45] illustrates the importance of this internationally. The proposed European Commission's (the Commission's) directive also recognises the importance of consumers providing evidence about their financial situation.[46] There is a risk that confidence in the UK mortgage market may suffer if mortgages continue to be offered without appropriate evidence of income.

Income verification and self-employed consumers

3.79 The biggest concern for most respondents about our income verification proposals, however, was not fast-tracked mortgages, but the impact on the self-employed. There was a lot of concern that our proposals would lead to lenders setting criteria too strict for many self-employed borrowers to meet. There was also concern that the self-employed would find it more difficult and expensive than employed consumers to provide up-to-date evidence of income, and this would therefore impact on their borrowing capacity.

3.80 We want to be clear that we do not intend to prevent or make it difficult for self-employed consumers or those with fixed terms contracts, who can afford it, from getting a mortgage. Lenders have, for many years, underwritten mortgages for self-employed consumers by making an informed assessment of their circumstances, including their income, and there is no reason why this should not continue. Our aim is to ensure that lenders take informed risks – not disregard the risks altogether.

---

43 See Exhibit 8.1: Proportion of mortgages where income was not verified

44 See Exhibit 3.8: Mortgage arrears of 90+ days, by country

45 *FSB Principles for Sound Residential Mortgage Underwriting Practices*, Financial Stability Board, (October 2011): www.financialstabilityboard.org/publications/r_111026b.pdf

46 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on credit agreements relating to residential property – COM (2011)142 (March 2011) http://ec.europa.eu/internal_market/finservices-retail/credit/mortgage_en.htm, Article 15

3.81 We do not consider that the self-employed will be disadvantaged by our income verification proposals. There is no reason why self-employed consumers will be unable to provide evidence of their taxable income, beyond a possible delay in being able to produce evidence of income, and we are not proposing to prevent lenders from accepting projections of future income, where these form part of a credible business plan. Everyone is required, by law, to pay tax on their income, and therefore everyone should be in a position to provide evidence of that income.

3.82 The self-employed are not a homogenous group. They currently make up about 12% of the total 'economically active' population of the UK.[47] Around 48% are sole traders, 37% run limited companies or are partners in businesses and practices, and 15% work as subcontractors, agency workers or freelancers.[48] [49]

3.83 Different risks arise from lending to the different categories of self-employed because of factors such as volatility of income and the risks of setting up a new business. As we noted in CP10/16, the survival rates for new business ventures are not high, with less than 50% surviving for five years or more.[50]

3.84 Self-employed consumers are more likely than employees to have an impaired credit history (the self-employed represent 30% of credit-impaired borrowers). This may be because for some self-employed consumers, sole traders in particular, personal finances are often mixed with business finances. For example, up to 14% of business owners have secured bank loans.[51] So business debts and defaults can easily affect personal finances.

3.85 These are factors that lenders will already take into account when assessing mortgage applications, in a way that is appropriate to the particular circumstances of the consumer. For example, a lender will consider the incomes of a self employed IT contractor, a partner in a professional practice, or a sole trader running a catering business each in a different way. This is no different to the approach taken when considering the risks associated with different types of employees. Underwriting criteria will recognise, for example, the risks of lending to an employee in a new job compared with an employee long established in their role.

3.86 In CP10/16 we did not propose prescriptive requirements for self-employed borrowers. For example, we did not specify a minimum period of trading or the type of evidence of income that the lender must request. We made it clear that this would be left to the discretion of the lender.

3.87 Where the problem and potential misunderstanding appears to have arisen relates to our proposal that lenders should consider the variability of income *over time*. This was

---

47 See Exhibit 14.1: Proportion of self-employed in total economically active population

48 See Exhibit 14.2: Self-employed mortgage borrowers, by type, as % of all mortgage borrowers

49 See Exhibit 14.4: Home ownership by type of employment: owning outright and with a mortgage. The level of home ownership between these different groups varies considerably. For example nearly 90% of self-employed people running limited companies or who are partners in businesses or practices are home owners, compared with 55% of agency workers.

50 See Exhibit 14.6: Survival rates of businesses born in 2004

51 *Voice of Small Business Annual Survey, Federation of Small Businesses*, (February 2010): www.fsb.org.uk/policy/rpu/london/assets/fsb%20annual%20survey%202009_london.pdf

interpreted by some respondents as meaning that we were requiring an assessment to be made about the volatility and variability of income in the future as well as at the point of underwriting the application. As we noted earlier, it was not our intention to require lenders to look to the future and 'crystal-ball gaze', as we have since clarified in our discussions with firms.

3.88 Two specific examples were given in responses to CP10/16[52] to illustrate concerns about lending to the self-employed in the light of our proposals. It was claimed that in the past lenders would make their own judgement about the risk of lending in these cases, but under our proposals lenders would have to assess 'additional regulatory risk'. The examples were as follows:

3.89 **Example 1**. A 30-year-old IT consultant with income in the last three years of £0, £20,000 and £200,000. All income can be verified but should the lender lend and, if so, against what income: Last year's income? Average over the last three years? Future earning potential given profession and potential limited earning potential as an IT consultant?

3.90 **Example 2**. A 35-year-old used van dealership owner. Trading for two years. Lost £3,000 in year 1, made £27,000 in year two, but only after a £16,000 personal cash injection. Should a loan be given? If so, on what basis?

3.91 In both cases we would expect there to be no difference whatsoever in the approach taken by lenders to underwriting such cases under our proposed rules than in the past. We would expect lenders to make an informed judgement about each, according to their own lending risk policies. So in relation to each of the above:

3.92 **Example 1**: The lender would assess the income according to their policy for self-employed borrowers, which is likely to set out their approach to different types of self-employed income. In this example, where a contractor's income has significantly increased in year three, the lender may be inclined to investigate why the income has increased so materially, and whether this appears sustainable. If, for example, the consumer has a contract with a large, well-established company that is due to run for the next five years, then the lender may be more likely to rely on the level of income in year three than for a one-off contract that has expired and unlikely to be repeated. In this latter case the lender may consider it more realistic to take the earlier years' figures.

3.93 **Example 2**: The lender would have a policy on how long a sole trader must have been trading before they will lend, and how they treat income for different type of self-employment. In this case, they may consider net profit, but adjusting the amount to take account of other factors such as the cash injection.

52 *Mortgage Market Review: Responsible Lending, Response by the Council of Mortgage Lenders to the Financial Service Authority's Consultation Paper CP10/16*, Council of Mortgage Lenders, (November 2010): www.cml.org.uk/cml/filegrab/mmr-response-to-fsa-cp10-16.pdf?ref=7444 (page 35)

3.94 We can see no reason why lenders' approaches to the self-employed should change. We are expecting lenders to continue to properly underwrite such cases and make an informed lending decision based on what evidence they have of the borrower's income.

3.95 Our PSD performance data is not detailed enough for us to differentiate between the arrears performance of different types of self-employed consumer. Overall, our data tells us that, in the absence of other risk factors, payment difficulties and repossession rates for self-employed borrowers are a little higher than for other employment types.[53]

3.96 However, the performance of mortgages for the self-employed does deteriorate markedly where other risk factors are involved, such as having an impaired credit history or remortgaging for debt consolidation purposes, as illustrated by our risk combinations work.[54] This may illustrate the close link between some self-employed borrowers' personal and business finances.

3.97 Our impact analysis (see Annex 1) estimates that the impact of our proposals will be higher than average on self-employed borrowers, particularly during boom periods. This is largely due to the use self-employed consumers have made of mortgages without income verification.[55]

3.98 The increased risk associated with lending on a self-certified basis, in particular, to self-employed borrowers is clearly reflected in the arrears statistics. More than half (around 54%) of outstanding self-certified mortgages to self-employed borrowers have a record of payment shortfalls or arrears at some point during their term; 26% have current missed payments; and 16% are at least two months behind.[56]

3.99 The number of self-employed borrowers who have had their homes repossessed is also much higher where income was self-certified. For all sales made to self-employed borrowers between April 2005 and September 2010, approximately 1 in 40 ended in repossession, compared with 1 in 14 where income had been self-certified.[57]

3.100 Some self-employed consumers (around 30-45% in the period 2005-2008) continued to obtain mortgages on a full-status basis[58] despite the availability of self-certification and fast-tracked mortgages. We estimate that 30% self-certified their incomes and 25-40% had fast-tracked mortgages (so they would have provided evidence of income somewhere in the mortgage application process, usually to an intermediary).

3.101 Since 2009 the proportion of mortgage sales to the self-employed without income verification is broadly the same as employed consumers, reflecting the tightening of credit conditions and the demise of the unsustainable self-certification sector.

53 See Exhibits 14.11: Mortgage performance, by type of employment' and Exhibit 14.12: 'Mortgage repossessions, by type of employment
54 See Exhibit 6.9: Risk combinations and mortgage performance
55 Also the use of interest-only mortgages by self-employed borrowers, which we discuss in Chapter 4.
56 See Exhibit 14.9: Performance of mortgages to self-employed, by type of income verification
57 See Exhibit 14.10: Repossessions on mortgages to self-employed, by type of income verification
58 See Exhibit 14.7: Mortgage sales with non-verified income, by employment status

3.102 In terms of assessing income, many respondents thought that self-employed consumers may be adversely affected by the time lag in the production of accounts (usually produced a significant period beyond the end of the trading year). This means that even the most recent set of accounts may not reflect their true current income position – and therefore might restrict the amount they can borrow. They may also experience higher costs, particularly if additional information from their accountant is requested by the lender. Some respondents were also concerned that self-employed borrowers who minimise their taxable income would not be able to provide evidence of their true income, therefore restricting the amount they could borrow.

3.103 We recognise that self-employed consumers may take longer than employees to gather a track record of income sufficient to meet lenders' requirements. There are also built in delays in the process of obtaining evidence of income (such as tax returns) compared with employees. However, many self-employed consumers have relatively well established businesses[59] with around 64% having been in their current business for over five years. So many self-employed consumers should not be overly delayed when applying for a mortgage, particularly as the lender is able to accept projections of income where these form part of a credible business plan. So while it may take longer for those just starting up a business to provide evidence of income, it is clearly in their interests that it does. Beyond this possible delay, we do not consider that the self-employed should be disadvantaged by our income verification requirements.

3.104 Our approach to business lending differs from our proposed approach to mainstream mortgages, which reflects the different risk profile of those consumers who raise a mortgage on their home for a business purpose. We discuss this in more detail in Chapter 10. In particular we consider whether it is appropriate to carve out from our proposed new approach business loans where both the lender and the borrower have made an informed decision to use the business owner's residential property as collateral for a business venture.

3.105 Leaving this question to one side, business loans where no payments are due during the term (because interest is rolled-up) may fall under our proposed definition of an 'interest roll-up' mortgage. In such cases, our affordability proposals do not apply, because there are no scheduled repayments. Instead, the lender's assessment would focus on how the borrower proposes to repay the loan at the end of the term.

Human intervention in income verification

3.106 In CP10/16, we said that we would expect lenders to be active in verifying income and, therefore, expected human intervention in the process to assess the credibility of the evidence provided and to guard against fraud.

3.107 Several lenders were opposed to such a requirement. They thought that this would be detrimental to the development of automated processes and would simply add time and

59 See Exhibit 14.3: 'Self-employed mortgage borrowers, by type of self-employment and year, when business started'

costs with little added value, as verification would become a 'tick box' exercise. They also thought that this would encourage a reliance on paper-based verification, which can be more vulnerable to fraud than electronic verification methods.

3.108 We agree and we do not propose to proceed with this proposal. We believe that it is unlikely to add any real benefit to the process, and may add costs and restrict innovation. However we expect automated processes to be appropriately robust, particularly in guarding against fraud. For example, by the use of appropriate fraud risk flags in the automated process, which identifies suspect cases so the lender can manually review them before further processing the application.

Income verification and mortgage fraud

3.109 We share the many concerns expressed in responses about mortgage fraud. This continues to be a major issue of concern in the UK mortgage market. This serves to underline for us the importance of robust income verification. For example:

- In January 2011, the National Fraud Authority published its second annual fraud indicator which estimated the cost of mortgage fraud in the UK to be £1bn.[60]
- The July 2011 Fraudscape report[61] noted that the nature of mortgage frauds has changed recently. There has been a move away from historic 'boom time' fraud, to mortgage application fraud relating to individuals unable to meet lending criteria – most in relation to false evidence of income, employment details and altered or false documents.
- In December 2011 Experian reported that attempted mortgage fraud had increased dramatically in the three months to the end of September, up 77% on the same period in 2010. They stated that more than 90% of such fraud tends to originate from genuine individuals misrepresenting their financial situations attempting to buy property that would ordinarily be out of reach.[62]
- Our recent thematic work on mortgage fraud[63] found weaknesses in lenders' fraud controls, including weaknesses in relation to fast-tracked mortgages (as noted above).
- And in 2010, eight of the lenders taking part in a nine-month long HMRC pilot mortgage verification scheme in 2009 reported that, in that short time, £111.4m of mortgage fraud had been prevented.

3.110 Several respondents to CP10/16 felt that rather than reducing fraud, the emphasis on obtaining evidence of income would actually encourage fraud, particularly through the production of fake documents, such as those made to order through some websites. Many

60 *Fraud costs the UK over £38 billion, says the National Fraud Authority*, (27 January 2011): www.homeoffice.gov.uk/agencies-public-bodies/nfa/news/press-releases/fraud-costs-over-38-billion/
61 *Fraudscape bulletin*, CIFAS, (July 2011): www.cifas.org.uk/secure/contentPORT/uploads/documents/CIFAS%20Reports/CIFAS_Fraudscape_Bulletin_July2011.pdf
62 Experian Press Release: *Surge in UK Mortgage Fraud,* (8 December 2011): http://press.experian.com/United-Kingdom/Press-Release/surge-in-uk-mortgage-fraud.aspx
63 *Mortgage fraud against lenders*, (June 2011): www.fsa.gov.uk/pubs/other/mortgage_fraud.pdf

respondents expressed strong support for HMRC to extend its mortgage verification scheme, which is currently available only for fraud prevention purposes.

3.111 There are an increasing number of industry innovations to combat mortgage application fraud. This includes HMRC's recent full launch of its mortgage verification scheme, which allows lenders to check income details with HMRC where they reasonably suspect mortgage fraud. Lenders are also making increasing use of electronic data designed to detect fraud, through industry wide and bespoke solutions.

3.112 We have already taken steps to reduce mortgage fraud and raise standards of intermediaries through the proposed extension of our Approved Persons regime. And as we note in Chapter 7, since 2010 we have increased our proactive approach to tackling mortgage fraud through our Mortgage Fraud Strategy.

3.113 Lenders already have anti-fraud controls in place (for example, to deal with suspicious payslips or identify applications that may pose a higher risk of mortgage fraud). In the light of the generally recognised concerns about the extent of mortgage fraud, and to ensure this is considered at an appropriate level within lenders, we are proposing that they must detail in their Board approved responsible lending policy how they incorporate anti-fraud controls into affordability assessments.

3.114 The aim of this proposal is to ensure that lenders give this the importance it deserves, are 'joined-up' in their thinking about fraud and explicitly consider fraud in the context of their underwriting processes. It is not envisaged that this proposal will require lenders to implement any additional fraud controls, but rather that they will be explicit about their approach to fraud controls in their affordability assessments. This would cover, for example, how automated fraud detection systems are deployed in the mortgage application process; how lenders detect and deal with fake documentation; and the indicators of fraud that lenders expect underwriters to look out for.

Q1: Do you agree that lenders should detail how they incorporate anti-fraud controls into their affordability assessments in their responsible lending policy?

Income verification and consumer responsibility

3.115 Some respondents to CP10/16 felt that our income requirements eroded consumer responsibility, and would lead to an imbalance in the responsibilities of lenders and consumers. Some felt lenders would be held responsible for inaccurate or misleading information supplied by consumers. Respondents welcomed the inclusion of a clear statement that false or misleading information provided on a mortgage application is mortgage fraud in the mortgages section of the Money Advice Service website.[64]

64 www.moneyadviceservice.org.uk/yourmoney/mortgages_and_homes/mortgages/how_much_can_you_borrow.aspx. The Money Advice Service website was previously known as Moneymadeclear.

3.116 Several respondents suggested that a clear set of sanctions should be applied to consumers who do not provide accurate and genuine information when applying for a mortgage. One trade body[65] suggested that we should adopt similar proposals to those set out in the Commission's proposed directive on mortgage credit.[66]

3.117 Our view is that our proposals do not diminish consumer responsibility. Consumers will be required to declare their income knowing that this will be verified, whether through documents they supply or through third party sources. Therefore, falsifying income details and evidence of income will be overt and intentional fraud in a more direct and explicit way than in the past. Consumers will face existing criminal sanctions if they commit or attempt to defraud a lender by falsifying their income in a mortgage application. So these sanctions are in fact consistent with the proposed directive on mortgage credit.

Assessment of income

3.118 Respondents were generally in favour of the approach to assessing income we proposed in CP10/16, particularly the flexibility in terms of the forms of evidence of income allowed and the sources of income that may be considered.

3.119 There were some specific issues raised about the self-employed, which we have discussed above. A few lenders also argued that flexibility might lead to uncertainty and lenders might apply unnecessarily conservative lending criteria to protect themselves from regulatory risk, which we have also discussed above in relation to the self-employed. However, an example was also provided about potential underwriting difficulties in relation to the employed under our proposed approach.

3.120 We were asked about the case of a police officer in the third year of his probation.[67] The respondent questioned how the lender should respond to this. For example, he may not complete his probation. Should he be lent to now? If he does complete probation, his earnings will increase. Should this be considered now? Practically, how can lenders know they are complying with the rules?

3.121 Our view is again that the way a lender would deal with this situation under our proposed approach is no different from what it would be today. Lenders will have a policy on whether they lend to someone on probation. Whether they take that risk is entirely a matter for them and this will not change under the MMR.

3.122 Some respondents felt that our approach was too prescriptive and would restrict consumer choice. In contrast, others wanted more prescription. For example, one consumer

65 *Mortgage Market Review: Responsible Lending, Response by the Council of Mortgage Lenders to the Financial Service Authority's Consultation Paper CP10/16*, Council of Mortgage Lenders, (November 2010): http://www.cml.org.uk/cml/filegrab/mmr-response-to-fsa-cp10-16.pdf?ref=7444 page 31

66 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on credit agreements relating to residential property – COM (2011)142 (March 2011) http://ec.europa.eu/internal_market/finservices-retail/credit/mortgage_en.htm, Articles 15 and 24

67 Mortgage Market Review: Responsible Lending, Response by the Council of Mortgage Lenders to the Financial Service Authority's Consultation Paper CP10/16, Council of Mortgage Lenders, (November 2010): http://www.cml.org.uk/cml/filegrab/mmr-response-to-fsa-cp10-16.pdf?ref=7444 (page 37)

representative thought we should be more prescriptive about the type and proportion of income streams (such as a particular percentage of bonuses or overtime) that a lender could consider – for example by preventing bonuses being taken into account because of their link with periods of higher economic performance.

3.123 Some respondents were particularly concerned that our income verification proposals would provide a competitive advantage to larger lenders with current account customers, as they would be able to verify income without obtaining any further information from the consumer. A few respondents questioned whether third-party current account data would be acceptable (e.g. if it was provided through a third-party such as a credit reference agency).

3.124 One respondent noted that income composition may not be clear where current account information is used as evidence of income, and therefore it would not be possible to determine the proportion of income made up from variable components such as bonuses or overtime. However it was also noted that the same issue arises for other income verification methods, including bank statements and tax returns. We address this in paragraph 3.133 below.

3.125 Some firms noted that some consumers, particularly high net worth (HNW) consumers, repay mortgages through assets rather than income (e.g. investments, shares, businesses, family trusts etc.). They therefore asked us to make provision for this. We discuss this further in relation to niche markets in Chapter 10.

Our income proposals

3.126 We are not proposing to substantively change our overall approach to income verification, although we have amended some of the detail in response to feedback.

3.127 To ensure that affordability assessments are based on accurate information and to protect against mortgage fraud, we continue to believe that lenders must be responsible for verifying income in every case. It is the lender which will be held to account for the lending decision it makes, whether it chooses to employ third parties to assist in the process or not.

3.128 We remain firmly of the view that self-certification of income is not acceptable, nor are fast-tracked mortgages, where the lender does not verify income.

3.129 By ‘income’ we mean income earned through employment, as well as income earned from other sources that is declared as income for the purpose of the mortgage applications, such as returns on investments. We have proposed a different approach for niche markets, such as that for HNW consumers, which we explain in Chapter 10.

3.130 We propose to continue to allow lenders flexibility in how they verify income. We do not propose to be prescriptive about evidence of income, either in terms of the type of evidence that is acceptable, or the period that it should cover. Instead we are proposing that the evidence must be of a type and covering a period that is adequate to support each element of income that the mortgage lender is taking into account. Therefore, the lender will need to consider factors such as:

- whether the applicant has more than one source of income (such as a second job);
- the length of employment;
- the nature of employment (e.g. employed, self-employed or a contractor); and
- whether any elements of income are not contractually guaranteed.

3.131 Evidence of income should be independent of the applicant although it may be supplied by the applicant. So the applicant may pass their payslips or bank statements on to the lender, perhaps via an intermediary. However the applicant may not self-certify their income in any way, for example by writing their own income reference or providing a declaration confirming that they can afford the mortgage. Nor may the lender accept a third party declaration of affordability (such as from an accountant).

3.132 Evidence may be document-based or derived from electronic sources. We propose to allow lenders to use evidence they already hold on an applicant, such as current account information. They may also accept similar information obtained from third parties, including from electronic sources. This will allow scope for future innovation in income verification, and reduce the impact of any competitive advantage held by lenders with current accounts.

3.133 We recognise that it is not possible to verify the exact amount of each income stream received by the applicant from some sources of evidence. For example, it is not possible to distinguish the amount of overtime or bonus that is included in a salary payment when looking at sources such as a bank statement, current account data or a tax return. We will expect lenders to satisfy themselves that the income they are taking into account in the affordability assessment is representative of the income declared by the applicant, for example by gathering information covering a period adequate to support each element of income that the lender is taking into account.

3.134 Lenders will also be able to accept projections, if they form part of a credible business plan, when assessing the income of self-employed consumers. The purpose of this is to allow lenders to consider expected future income, if they want to. It does not mean that we expect them to investigate future income.

3.135 We are not proposing to prevent lenders from outsourcing verification of income to an intermediary, but the lender will remain responsible for ensuring that income is verified in every case, and will be held to account if it is not. If lenders do outsource this activity, they will need to have appropriate systems and controls in place, and they must be able to meet relevant outsourcing obligations, such as those set out in our Handbook.[68]

3.136 During discussions about CP10/16, some lenders questioned whether evidence of income held by lenders' branch staff would need to be sent to the central office where underwriting takes place, to qualify as having been verified by the lender. We can see no reason why

68 SYSC 8: http://fsahandbook.info/FSA/html/handbook/SYSC/8/1

submission to a central office should be required, as long as income has been verified by an appropriate staff member. Lenders would, of course, need to ensure compliance with our requirements, including those relating to record keeping.

Q2: Do you have any comments on our income proposals?

Affordability assessment: Expenditure

3.137 To address weaknesses in affordability assessments, we suggested in DP09/3 that lenders should assess the level of consumers' expenditure. The aim of this was to ensure that lending decisions are based on a consumer's 'free disposable income' i.e. the money they have left once their expenditure is deducted from their income. Past thematic reviews had found weaknesses in the way lenders had considered a consumer's expenditure, particularly in the subprime segment of the market.[69] Poor underwriting practices, with inadequate consideration of the level of some consumers' debts, have in many cases led to extremely high arrears rates, with rates for some lenders currently running at 50% or more.

3.138 In CP10/16 we outlined our concerns about mortgage affordability. Our research indicated that many consumers may be left with little or no money once mortgage payments and living costs were deducted from their income.[70] We were therefore concerned that a significant number of borrowers may be under financial pressure because of the level of their financial commitments and expenditure in relation to income. External data also supports this view, such as surveys conducted by NMG and Policis.[71]

3.139 Even though income shocks are often cited as a main trigger of arrears, expenditure appears to play a significant role. This is illustrated by the following quote from a court desk adviser from the Citizens Advice Bureau.[72]

> '*I've seen quite a lot of people who have re-mortgaged in the last three or four years, usually to pay off unsecured debt, and the payments have been larger than they can afford. It is quite often where there are two people working as well, so it's not because their circumstances have changed. It was never really watertight enough that they could actually afford the payments. It was OK as long as everything went fine, but as soon as large household bills, car packing up or something like that happened, then everything goes into meltdown.*'

69 *FSA finds poor practice by intermediaries and lenders within sub-prime market*, (July 2007): www.fsa.gov.uk/pages/Library/Communication/PR/2007/081.shtml
70 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf paragraphs 2.3-2.12
71 See Exhibit 3.7: Extent to which mortgage borrowers are struggling to keep up with their payments
72 *Set up to fail – full report*, Citizens Advice Bureau, (December 2007): www.citizensadvice.org.uk/set_up_to_fail

3.140 The BSA report *Understanding Mortgage Arrears*[73] states that building societies reported that 19% of arrears cases were caused by borrowers having to fund other essential expenditure and 18% by borrowers paying off other debts. An additional survey carried out for the report found that 51% of respondents cited financial problems/expenditure events as the cause of arrears, such as an increase in the monthly payment amount (16%), other essential/unplanned expenditure (16%), and paying off other debt (14%).

3.141 To date our rules have not detailed exactly how lenders should consider the level of expenditure in their affordability assessments. This has been left to the discretion of the firm as part of our general requirement for them to take account of the consumer's ability to repay.

Free disposable income

3.142 We included in DP09/3 an example of industry best practice in establishing 'free disposable income'.[74] We also proposed that there should be no lending above the consumer's borrowing capacity and that the lender should be required to check the plausibility of the level of expenditure declared by a consumer. We modified the free disposable income example in CP10/16[75] to reflect some of the feedback received. However we continued to propose that affordability assessments should be based on free disposable income. This would be calculated by deducting credit commitments, committed, personal and contingency expenditure from income. Free disposable income would then be used to calculate maximum borrowing capacity.

3.143 In CP10/16 we asked:

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

3.144 Most respondents supported the concept of calculating free disposable income. However, almost all expressed some degree of concern over the methodology proposed in CP10/16 and felt that the draft rules were too prescriptive. They also felt that the proposals would be time consuming and expensive to implement, would restrict the amount consumers could borrow but would not necessarily be effective.

3.145 Lenders and trade bodies in particular disagreed with the priority of mortgage payments when calculating free disposable income, arguing that mortgage payments should be considered as expenditure, and the focus should then be on assessing whether the borrower has adequate income remaining to support a reasonable lifestyle. They felt that it is not the role of the regulator to decide on consumers' spending habits. They also noted that consumers are able to 'flex' their expenditure by adapting their spending to prioritise housing costs. Therefore, deducting expenditure items such as recreation and holidays

73 *Understanding Mortgage Arrears*, Andrew Gall, Building Societies Association, (August 2009): www.bsa.org.uk/docs/publications/understanding_mortgage_arrears.pdf
74 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf Chapter 4, Exhibit 4.16
75 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf Chapter 2, Exhibit 2.7

before the mortgage commitment was not appropriate and did not reflect the importance of housing costs in a consumer's budget.

3.146 Many respondents expressed concerns about the draft rules in CP10/16[76] around free disposable income. They were particularly worried about the draft rule[77] which stated that a mortgage is not affordable if it is foreseeable that the payments due for any particular month (or other agreed payment interval) over the term of the mortgage are more than the consumer's free disposable income in that period.

3.147 Respondents felt that taking a view of a consumer's income and expenditure over the full term of the mortgage is not a realistic proposal, and many borrowers would fail this test, particularly where they receive income irregularly or over a period longer than a month.

3.148 Rather than predicting future spending, some respondents noted that past spending habits are a better predictor of future behaviour, hence the use of credit scoring in assessing mortgage applications.

3.149 The view that consumers flex their expenditure is confirmed by survey data, for example, research by Policis.[78] 69% of consumers saw their mortgages as their number one financial priority, not only because housing is a fundamental need, but also because of what a home represents in terms of future ambitions and security. They also found that 87% of the borrowers in their sample who experienced an income shock have absorbed it with relatively little serious strain on their finances, beyond budgeting more carefully and prioritising spending. Most of those who had suffered income shocks reacted by reducing spending and prioritising essentials (52%), or coped because they always spend less than they earn anyway (23%). However, Policis noted that there are limit to how far this process can be taken – particularly if an income famine extends for a significant period, or households have no savings buffer or irreducible commitments.

3.150 The Bank of England/NMG[79] survey looked at the actions struggling borrowers consider to resolve difficulties in meeting bills and credit commitments. They found that many proposed to either cut back on spending, or get extra income, for example, by working longer hours or taking a second or better paid job. However, it is not clear how realistic either of these options would be, particularly in tough economic times. Worryingly, our analysis of the data indicates that for those who were constantly struggling, 8% said they would take out another loan and 12% would take out another mortgage on their house.

3.151 The Policis[80] research found that savings played an important role in coping with reduced income and unemployment, with 45% of borrowers using existing savings to get by.

---

76 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf Appendix 1 – Part 1

77 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf Appendix 1 – Part 1, MCOB 11.3.12R(1)

78 *New approaches to Mortgage Market Regulation*, Policis, 2010: www.cml.org.uk/cml/filegrab/research-appendix-3-full-report-new-approaches-to-mortgage-regulation.pdf?ref=7434

79 *The financial position of British households: evidence from the 2010 NMG Consulting survey*, Bank of England, (Quarterly Bulletin 2010 Q4): www.bankofengland.co.uk/publications/quarterlybulletin/qb100408.pdf See Table D

80 *New approaches to Mortgage Market Regulation*, Policis, 2010: www.cml.org.uk/cml/filegrab/research-appendix-3-full-report-new-approaches-to-mortgage-regulation.pdf?ref=7434

However, borrowers who are struggling and falling behind following income shocks are more likely than others to have borrowed on existing credit lines (around 42%), or taken on new credit (10%). This suggests that borrowers can get by for a period of time using their savings, but they become more exposed when their savings run out. Therefore flexing expenditure for an indefinite period is not necessarily an option.

3.152 Following further consideration of our approach to affordability, in response to feedback to CP10/16 and our further discussions with stakeholders, we no longer propose to use the concept of 'free disposable income'. Instead we propose to adopt a more principles-based approach, where lenders must take full account of income and expenditure, and must be able to demonstrate that a mortgage is affordable – but giving lenders the freedom to decide how they will calculate this. We discuss this in more detail below.

Calculating expenditure

3.153 In CP10/16, we recognised that there are practical difficulties in gathering comprehensive and reliable expenditure data directly from consumers, and that many lenders have developed robust expenditure models based on statistical data to estimate expenditure. In response to feedback and discussions with stakeholders we therefore moved away from the idea that lenders should undertake a line-by-line assessment of all expenditure for each individual applicant. Instead we proposed that lenders should have the flexibility to use statistical data and their own affordability models, but that they should still take the categories of committed, personal and contingency expenditure into account.

3.154 In CP10/16 we asked:

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

3.155 The views of respondents on this were polarised. There was strong support from consumer representatives and consumers, but trade bodies and lenders were less supportive.

3.156 Lenders were pleased to note that the proposals would allow them to use their own statistical models, but some consumer representatives felt that this would give lenders too much discretion and therefore we should set a standard expenditure model for use across the industry.

3.157 Many respondents had concerns about the practical implementation of the model outlined in CP10/16. Some thought the proposed rules were complex and prescriptive and would be costly to implement. They argued that current affordability models used by lenders were effective, and therefore prescriptive rules around expenditure were not necessary.

3.158 There was also some concern about the category of 'contingency' expenditure, which we proposed so that lenders would make a prudent allowance for undeclared or underestimated expenditure. Some respondents felt that lenders would set the level of contingency expenditure based on competitive considerations, for example by reducing the acceptable level when they want to increase lending volumes, or by amending it on an ad hoc basis to make the consumer 'fit' affordability requirements. Others felt that some consumers might have their mortgage applications unnecessarily rejected if lenders set the contingency expenditure level too high.

Our expenditure proposals

3.159 In response to feedback, we have revised our approach to expenditure. We are now proposing that lenders should consider the debts and ongoing contractual commitments of the applicant, and make reasonable allowance for expenditure for basic unavoidable and hard to reduce living costs.

3.160 The aim of this is to ensure that lenders consider whether borrowers can afford their mortgage, in addition to other debts and basic expenditure, without being stretched to the limit. Beyond this it is:

- up to the consumer to decide how much they are comfortable borrowing, trading mortgage costs against other types of expenditure; and
- for the lender to decide how much they are prepared to lend.

3.161 Our proposal is that the lender must as a minimum take account of the following specific elements of expenditure in their affordability assessments:

- committed expenditure;
- basic essential expenditure; and
- basic quality of living costs.

Committed expenditure

3.162 Committed expenditure is the expenditure that the applicant is committed to that will continue after the mortgage has been entered into. This may take the form of credit commitments, whether secured or unsecured, including outstanding loans, credit card balances and hire purchase agreements. It also includes contractual commitments and other commitments the consumer has to meet, such as child maintenance, alimony and any costs relating to the repayment strategy for an interest-only mortgage. The level of credit commitments varies very widely between consumers, and therefore it would not be realistic to apply statistical data to this type of commitment.

3.163 Our thematic work[81] highlighted that some lenders paid lip service to existing commitments. We saw examples of:

81 *FSA finds poor practice by intermediaries and lenders within sub-prime market*, (July 2007): www.fsa.gov.uk/pages/Library/Communication/PR/2007/081.shtml

- A lender who did not undertake a full credit check or other detailed scrutiny of a consumer's level of debt, despite dealing with a target audience of consumers who typically had high levels of indebtedness, many of whom were remortgaging to consolidate one or more debts.
- A lender who undertook only a public information credit search showing voters roll and county court judgement information, rather than a full credit search showing outstanding credit commitments. They instead relied on the monthly commitments figure declared in the application form, even where this figure was unrealistically low, or where they had a full credit check on file (supplied by an intermediary) that contradicted this information.

3.164 However, there is also good practice in the market. For example, in our recent discussions with lenders, some have described how they consider the higher of customer-declared information and credit commitments showing on the credit check. We have also seen examples of lenders undertaking detailed scrutiny of bank and credit card statements to ascertain the credit commitments and spending habits of mortgage applicants.

3.165 In line with this good practice, and to counter the poor practice seen in thematic work, we propose to require that credit and other contractual commitments must be evidenced and specifically taken into account in assessing expenditure.

3.166 We are proposing that lenders take reasonable steps to obtain the details of the applicant's credit commitments. This includes corroborating any customer-declared information about credit commitments that has been provided in the mortgage application process.

3.167 Credit searches are already widely undertaken by most lenders for every mortgage application, to evidence a borrower's credit commitments (amongst other reasons) and are a relatively inexpensive way to obtain accurate information about a consumer's credit position. However, they are not the only way to obtain such data, and our proposed rules will not prevent a lender from using alternative methods, such as undertaking detailed scrutiny of sources such as bank or credit card statements.

3.168 Where credit commitments are shortly due to end, we will expect lenders to take a common sense approach to deciding whether it is appropriate to include these commitments in their assessments.

Basic essential expenditure

3.169 We noted earlier the various difficulties we encountered in trying to establish a quantitative rule based on household expenditure. It is not our intention to regulate what consumers should spend or how they prioritise their finances. But there are clearly some items of expenditure which it is very difficult to avoid, or significantly reduce. We have therefore split the basic expenditure which we believe lenders should consider into two types: basic essential expenditure and basic quality of living costs.

3.170 We have discussed this approach with the industry, and believe that this approach represents best practice already widely used across the mortgage market.

3.171 Basic essential expenditure covers the bare essential expenditure that the applicant's household needs to maintain basic needs such as food, hygiene and utilities, while living in the property. These are the types of expenditure which it is not realistically possible for the applicant to reduce or go without. We are proposing that the lender must consider the following items in this category of expenditure for every affordability assessment it undertakes:

- basic housekeeping costs (food and washing);
- gas, electricity and other heating;
- water;
- telephone;
- council tax;
- buildings insurance;
- ground rent and service charge for leasehold properties; and
- essential travel (including to work or school).

3.172 We do not propose to prescribe the values that lenders must take into account for these items. The lender must establish the costs, either using actual customer-declared information, or estimated modelled data (whether based on statistical data, such as that available through the Office of National Statistics, or other methods of modelling) that is appropriate to the particular household.

Basic quality of living costs

3.173 Basic quality of living costs cover hard to reduce expenditure that gives the applicant a basic quality of living beyond the absolutely bare essential living costs captured above.

3.174 It is not our intention to require lenders to ensure that their borrowers enjoy any particular minimum standard of living.[82] However, we do want lenders to make allowance for the expenditure which most consumers have which is difficult to go without or significantly reduce over the medium term. Disregarding such costs at the outset of the mortgage increases the likelihood that consumers will experience payment difficulties, even without any significant payment shocks or adverse life events, because consumers will be unable to avoid this expenditure during the course of daily life.

82 For example, in relation to the poverty line, or in terms of minimum standards such the minimum income standard proposed by the Joseph Rowntree Foundation. *A minimum income standard for the UK in 2011*, Donald Hirsh, Joseph Rowntree Foundation, (July 2011): www.minimumincomestandard.org/downloads/2011_launch/MIS_report_2011.pdf

3.175 This idea of 'basic essential expenditure' draws on a broad social consensus about basic needs[83] and is also based on helpful information provided to us by lenders and lender trade bodies. We do not propose to prescribe the list of expenditure types in this category. A non-exhaustive list of examples of expenditure items a lender might consider include:

- clothing;
- household goods (such as furniture, appliances, repairs);
- personal goods (such as toiletries);
- basic recreation (television, some allowance for basic recreational activities, some non-essential transport); and
- childcare.

3.176 We have included childcare in this category of expenditure, though we recognise that many consumers consider this essential expenditure (where, for example, they need to pay for childcare in order to go to work). We have not included it in the essential category because it does not apply to all households. However, we recognise childcare can be a significant cost for some consumers.

3.177 We are not suggesting that lenders should be required to consider all these items (for example, by assuming average expenditure for all possible expenditure items). We recognise that expenditure may vary between consumers and household types, and there is scope for flexing expenditure. We will, however, expect lenders to keep a record of how they have accounted for these items and the assumptions they have made.

3.178 As with basic essential expenditure, the lender may use customer-declared information or modelled data (which may, for example, be based on statistical data).

3.179 For both types of basic expenditure:

- the lender should use customer-declared information only where it considers that the information is believable; and
- where statistical or modelled data is used, the lender must apply realistic assumptions to determine the level of expenditure.

3.180 References to 'household' mean the borrower(s) plus dependent children and any other dependents that will live in the property.

Q3: Do you agree with this approach to expenditure? Do you have any comments on the categories of expenditure? Do you have any practical concerns about implementing this approach?

83 Such as the minimum income standards proposed by the Joseph Rowntree Foundation ibid.

Estimated impact of the affordability assessment

3.181 As we explain earlier in this chapter, we believe that our proposed approach to affordability is intuitively the right approach. It will allow lenders the freedom to make lending decisions, while ensuring those decisions are properly informed, based on the circumstances of the consumer. It is clear from the responses to previous MMR papers that the market agrees with the general principle of affordability. We have had extensive discussions with the market to inform our approach, and believe that our proposals reflect current good practice. So we do not expect the affordability proposals to have a great impact in the current market.

3.182 Because the rules are qualitative, it is difficult to quantify the impact with any degree of certainty. Because the evidence base available to us is imperfect, we have had to make some assumptions in order to model the impact. Both the methodology and expected impacts are set out in full in Annex 1.

3.183 The CBA estimates suggest the affordability rules will not have a great impact in the current 'subdued' market (0.04% of borrowers), although the impact increases in a boom period (to 3.6% of borrowers). As noted earlier, these results reflect the fact that during today's subdued market conditions, lending criteria are tighter, lending is low-risk and underwriting standards are more stringent than in the boom conditions of 2005-2007. It also indicates that the affordability assessment has the greatest impact when it is most needed – when there is a potential for widespread unaffordable borrowing.

3.184 The CBA shows that within the relatively small group of borrowers affected by the affordability assessment, those borrowers most affected are, as we would intuitively expect, those who would have self-certified income (21.8% in a boom period) and those with an impaired credit history (66.9% in a boom period) . The self-employed would also be more affected in boom conditions (7.3%), reflecting the fact that the self-employed tended to use self-certification and are more likely to have an impaired credit history.

3.185 First-time buyers would be hardly impacted at all in today's subdued conditions and only slightly impacted in boom conditions (less than 3%).

Taking account of future interest rate increases

3.186 The second key element in our affordability proposals is the interest-rate stress-test, i.e. the lender must also take account of the impact on mortgage payments of market expectations of future interest rate increases. It is clearly important that, when assessing affordability, lenders take account of initially low interest rates or interest rates that are low for cyclical macroeconomic reasons.

3.187 In CP10/16 we proposed that lenders should be required to consider the impact of increasing interest rates on affordability, through applying an interest rate 'stress-test' at the point of each mortgage application. In DP09/3 we had suggested this should be a flat rate of 2% above the lender's standard variable rate (SVR). But following feedback, which suggested that this may not be appropriate over the whole economic cycle, we instead sought the market's views in CP10/16 on the proposals that we publish on our website, a minimum stress-testing rate, based on forward swap rates (i.e. medium term rates such as five year swap rates) which we could change in line with economic conditions.

3.188 Borrowers on variable rates are particularly at risk as their rate can increase shortly after they take out a mortgage. Following the reduction in SVRs since 2008 there has been a large increase in the proportion of borrowers on variable rates. At the end of Q2 2011, 65% of regulated mortgage balances were on variable rates, compared to 40% in 2007.[84] So future rate rises are likely to impact on a large proportion of borrowers.

3.189 Most lenders do currently consider the impact of future interest rate rises on the affordability of individual mortgages, but this has not always been the case. We are not able to assess from our data how borrowers in general have coped with interest rate rises, because our data covers a period of decreasing interest rates. However, the small proportion (6%) of borrowers in our dataset who have higher rates now than their initial rate do have a higher incidence of arrears than average, even though the average increase was quite small (£28 per month).[85]

3.190 In CP10/16 we asked:

> ***Q8:*** *Do you agree with our approach to testing 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?*

3.191 The vast majority of respondents supported some form of testing of affordability against future interest rate increases. However many respondents – particularly lenders, trade bodies and others representatives of the mortgage and construction industry – thought lenders should be able to set their own methods of doing this, rather than using a rate set by the FSA. They argued that they should be able to do so as long as their method was robust and open to challenge by supervisors, and perhaps supported by guidance issued by us or the trade bodies.

3.192 Some respondents stated that lenders already test affordability against future interest rate changes, through a variety of approaches. They questioned whether a guideline rate set by us would be more effective then lenders' existing processes, and noted that an externally set guideline rate would make it difficult for lenders to plan ahead effectively.

3.193 Some respondents emphasised that care should be taken when setting a guideline rate, as setting a rate too low would be ineffective, but setting it too high would unnecessarily restrict some consumers from getting a mortgage. One trade body in particular was

84 See Exhibit 10.7: Change in standard variable rate (SVR) and in the proportion of regulated mortgages balances on variable rates
85 See Exhibit 10.8: Change in interest rates on mortgages, from year of sale to December 2010 – February 2011; and Exhibit 10.9: Median change in monthly mortgage payment

concerned about the impact of this proposal, combined with other forms of 'buffer' set out in the draft rules (for example contingency expenditure, restrictions on loan size based on capital and interest and a maximum term of 25 years, and the impaired credit buffer). It was concerned that the level of a guideline rate could have a significant impact on consumers' ability to borrow.

3.194 Many respondents also questioned whether one guideline rate would be an appropriate test of affordability for all borrowers. For example, there are many different types of variable rates, including SVRs, LIBOR-linked rates and base rate trackers, which include varying degrees of margin, reflecting factors such as risk, profit margin and which may vary across the economic cycle.

3.195 Specific concerns were raised about the use of swap rates as the basis for setting a guideline margin. Many were concerned about their volatility and unpredictability, and the fact that they are influenced by a wide range of economic and non-economic factors, including single events such as terrorist attacks. Some therefore thought that some form of 'smoothing' would be required when setting the guideline rate to ensure it does not reflect short-term volatility. Some respondents questioned whether swap rates were in fact a reliable predictor of actual future interest rates.

3.196 The main practical issues raised related to how quickly firms would be expected to implement a change to the guideline rate, and the effect on pipeline business. Lenders in particular wanted to know whether they would be required to reassess affordability for pipeline cases that had already been assessed according to the previous guideline rates. Some respondents also raised the issue of IT costs.

Our proposals for taking account of future interest rate increases

3.197 We continue to believe that it is important to consider the impact of future interest rate increases when assessing affordability. However, in the light of the feedback received, we no longer propose to set a single rate for lenders to use. While we will expect lenders to consider the impact of future interest rate rises when assessing affordability, we propose to allow firms to set their own basis for this, but within a framework.

3.198 Unless a mortgage rate is fixed for a period of five years or more (or fixed for the term, if the term is less than five years), we propose that the lender must:

- consider the expected interest rate environment for a future period of at least five years;
- not make their own forecasts of the general level of interest rates, but instead be able to justify the basis used to assess the impact of future increases on affordability, with reference to market expectations for future interest rate increases – for example, through externally published sources such as the forward sterling rate published on the Bank of England website[86]; and

86 For example, the UK instantaneous nominal forward curve, published on the Bank of England website: www.bankofengland.co.uk/statistics/yieldcurve/UKNOM(month_end).xls; www.bankofengland.co.uk/statistics/yieldcurve/archive.htm,

- assume a minimum interest rate increase of 1% over the five year period, even where the market expects interest rates to rise by less than this or to fall over that period.

3.199 Lenders' stress tests should be compatible with, but not mechanically linked to market expectations.

3.200 We recognise that interest rate margins on mortgage products can change over the economic cycle, which, in practice, may influence the margins lenders choose to stress affordability against interest rate rises.

3.201 For example, mortgage rates do not move precisely in line with market rates (as we explain in more detail in Annex 1[87]). Changes in mortgage rates tend to be less than those in base rates, and, in general, mortgage margins fall as base rates rise. In the recent low interest rate environment, banks and building societies have in some cases set deposit rates that are higher than the base rate, whilst increasing margins on mortgage rates. In alternative economic conditions, the situation might be reversed. This may inform lenders' stress tests.

3.202 Our proposals will also allow lenders to consider what interest rate expectations might imply for their mortgages, given the terms and features of the products they offer. For example, in the case of a tracker rate, if the spread between the mortgage rate and the base rate varies according to the level of the base rate, this might also be taken into account in the stress test applied by the lender.

3.203 This approach is designed to give lenders flexibility to set the rate used in a way that is appropriate to their customer base and products offered, allowing them to retain control and plan ahead, while testing the impact of interest rate rises on affordability for each mortgage application.

3.204 The proposals will not tie lenders into rigid and impractical processes such as changing their 'stress rate' on a daily basis in reaction to market events, or to re-assessing the affordability of their pipeline of offered business every time market expectations change. Instead, our intention is for lenders to use the expected interest rate curve as a clear interest rate scenario.

3.205 Lenders will be free to assume higher standards than those required by our rules. For example, they will be able to assume future interest increases greater than are expected by the market, or to consider the impact of increasing rates over a longer period than five years, as long as they still comply with the standards set out in the rules.

3.206 We propose to require lenders to clearly set out how future rates are taken into account when assessing affordability in their responsible lending policy and record the rate or assumptions used for each mortgage as part of the record-keeping requirements.

87 Annex 1, A4

Q4: Do you have any comments on our proposed approach to assessing affordability against future interest rate increases?

The impact of taking account of future interest rate rises

3.207 Our understanding from discussion with market participants is that most lenders today are taking account of future interest rate rises when assessing affordability. So we do not expect our proposals to have a significant impact. This is confirmed by the CBA estimates which indicate that this proposal will would impact a further 0.25% of borrowers in a subdued period, and a further 4% in a boom period.

3.208 As we explain in the CBA, it is not possible to measure the exact impacts of the proposals. We have therefore designed a methodology that broadly models and illustrates the impact we expect. For this proposal we measured the impact using a simple approach of modelling how affordability, as measured by debt servicing ratio (DSR), would be shifted by the application of interest rate stress. This was subject to an adjustment for the proportion of mortgages that we already expected to be stressed by lenders, which we understand from our discussions with the market to be around 90% of lenders.

3.209 However, if we assume that no lenders have been applying a stress test, then the impact of our proposals rises significantly, to 3% in a subdued period.

3.210 We further discuss the impacts of this rule in Annex 1.

Q5: Do you agree with our assumption that 90% of lenders already apply a stress-test?

Q6: Do you think that lenders are currently applying a stress test of a similar degree to the test we propose?

Interest-only

3.211 The third and final element of the affordability principle is the assessment of interest-only mortgages. We are proposing that a lender must assess affordability on a capital and interest basis unless there is a clearly understood and believable alternative source of capital repayment.

3.212 As we are consulting for the first time on our interest-only proposals, they are set out separately in Chapter 4.

Other responsible lending proposals

3.213 There were a number of other responsible lending proposals considered in CP10/16[88]. In addition to considering the applicant's income and expenditure, we proposed that when assessing affordability and the amount to lend to a particular applicant, lenders should:

- assume that the mortgage is on a capital and interest basis;
- that the mortgage term is no more than 25 years; and
- apply an additional 'buffer' to credit-impaired consumers.

Capital and interest basis

3.214 In DP09/3, we expressed our concern that many interest-only mortgages had been taken out on affordability grounds, to maximise borrowing capacity, without adequately considering how the capital was to be repaid.

3.215 To ensure affordability, we felt that lenders should normally assess affordability on a capital and interest basis, even where the mortgage was being taken out on an interest-only basis. In CP10/16 we consulted on this basis. However, we said that we were considering whether there should be some limited exceptions where it may be appropriate to assess affordability on an interest-only basis.

3.216 We are now formally consulting on our interest-only proposals, which are set out in the following chapter, Chapter 4, where we also summarise the feedback received to this proposal. We explain there that we are proposing some clearly defined exceptions where assessing affordability on an interest-only basis may be appropriate.

Mortgage term

3.217 We also had concerns about the mortgage term being used to stretch affordability. As we noted in CP10/16, our analysis shows a clear upward trend in terms for higher LTV mortgages, with over 60% of very high LTV mortgages sales (i.e. 95% LTV or more) in 2007 with terms longer than 25 years.[89] This suggested that terms may have been extended to stretch affordability, and we thought this trend could be exacerbated if tightened requirements prevented interest-only mortgages being taken out to stretch affordability. We therefore proposed that affordability should be calculated on a maximum term of 25 years.

3.218 In CP10/16 we asked:

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

88 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf
89 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf, Chapter 2, Exhibit 2.8

3.219 Consumer representatives supported this proposal. One in particular wanted us to go further and impose a compulsory limit on the length of a mortgage, to reduce intergenerational and inter-consumer inequalities. Several lenders also noted that it was already their practice to assess affordability over a maximum of 25 years in most cases. However, most respondents did not support this proposal. They felt that it was restrictive and arbitrary and could be deemed as unfair.

3.220 Many respondents were very concerned about the impact of this proposal on younger borrowers, particularly FTBs. Several thought that longer term capital and interest mortgages would be better for FTBs than interest-only mortgages with affordability calculated over 25 years. Many also thought that this proposal ran counter to current demographic changes, where later retirement is becoming more common. Some noted that even where mortgages have a long initial term, inflation and income increases over the term improve affordability and allow borrowers to overpay or shorten the term. A couple of lenders noted that this proposal would have a marked impact on their ability to lend to a significant proportion of their customers. The consensus view was a thorough assessment of affordability at the outset of the mortgage was the most important consideration.

3.221 We agree with respondents and have decided not to proceed with this proposal. We share respondents' concerns about the impact this might have on younger buyers, many of whom are already struggling to get on the property ladder. Our data confirms that it is FTBs who take longer terms.[90] We have also had regard to the removal of compulsory retirement ages and later state pension ages. We believe that our wider affordability proposals, including the approach to reasonably foreseeable changes to future income (such as lending beyond state pension age discussed below) will address our concerns and prevent consumers from stretching terms into retirement when they do not realistically have the income to support mortgage payments.

Q7: Do you have any comments on our proposal to drop the requirement that affordability should be assessed on a maximum term of 25 years?

Impacts of our proposals on different borrower types

3.222 Our proposals will impact different borrower types in different ways. We discussed self-employed consumers above, in the context of income verification. We have also considered the impact on FTBs, as there has been much comment on the impact of our proposals on this group; and credit-impaired consumers, particularly those consolidating debt, as they will be the group impacted most by our proposals.

90 See Exhibit 12.1: Average mortgage term at origination, by type of borrower

First-time buyers

3.223 Many respondents and commentators have commented that our affordability proposals will disproportionately impact on FTBs, preventing them from getting on the property ladder. We have no intention of preventing FTBs from entering the mortgage market, in fact, we believe our proposals will impact FTBs less than other groups of borrowers. This is confirmed by the results of our CBA (see Annex 1). Our estimates indicate that FTBs are hardly impacted at all in a subdued period. 0.9% would be impacted by all three main responsible lending proposals (the affordability assessment, interest rate stress test and interest-only), compared with the average of 2.5%. In a boom period, 10.5% of FTBs would impacted, compared to 11.3% of all borrowers. This is unsurprising, as lenders typically take a more stringent approach to underwriting FTB applications.

3.224 FTBs are also less likely than other groups to take mortgages where income is not verified, or to take interest-only mortgages. They therefore will not be greatly impacted by our income verification and interest-only proposals.[91] For example, currently, around 15% of FTB mortgage sales are without income verification, compared with over 30% for home movers[92]; and around 5% have interest-only mortgages, compared with over 20% of home movers.[93]

3.225 As noted above, we have decided not to proceed with the proposal to limit the assessment of affordability to 25 years, so this will enable affordability to be assessed over the actual term, allowing longer terms for younger borrowers.

3.226 In current market conditions, increased deposit requirements have made it particularly difficult for FTBs, because they typically take on higher LTV mortgages.[94] Over 40% of sales to FTBs in the period 2005-2007 were at 90% LTV or higher. Since 2009, the proportion of FTBs taking LTVs of 90% or more has reduced drastically, and is currently 3%[95].

3.227 The market has withdrawn high LTV products in response to funding constraints though we are now seeing higher LTVs gradually returning to the market (at a price[96]). But mortgages above 90% LTV are still not widely available.

3.228 We do not have a particular concern about FTBs taking on high LTV mortgages, as our data shows that FTBs have a better record of repaying mortgages at higher LTVs than other types of borrowers.[97] What matters to us is that a FTB, just like any other borrower, can afford to repay the sums they borrow.

3.229 Our proposals do not impose any type of LTV restriction. In paragraph 3.16, we explained that we have not changed our view on this. What really matters is a proper assessment of affordability at an individual level.

91 See Chapter 4 for more details on our interest-only proposals.
92 See Exhibit 15.9: Proportion of mortgages where income was not verified, by borrower type
93 See Exhibit 15.8: Proportion of borrowers with repayment mortgages, by borrower type
94 See Exhibit 15.16: Higher-LTV sale, by type of borrower
95 Source: FSA PSD Q3 2100
96 See Exhibit 15.15: Average initial interest rates on mortgages to FTBs, by LTV band
97 See Exhibit 15.13: Mortgage performance, by borrower type, any record of past or current missed payments, by LTV band

Credit-impaired consumers

3.230 An impaired credit history is the strongest predictor of arrears and repossessions of all the risk factors we investigated in our risk combinations work.[98] In CP10/16 we expressed concerns about credit-impaired consumers with unmanageable levels of debt, which they cannot finance from their income once mortgage and other living expenses are paid out.

3.231 Our analysis established a striking difference in the occurrence of mortgage payment problems between borrowers with and without an impaired credit history:[99]

- 66% of credit-impaired mortgages have had some degree of mortgage payment problem compared with 20% of all mortgages; and
- 23% of credit-impaired borrowers have current arrears of two months or more, compared with 3.4% of all mortgages.

3.232 A similar story emerges when looking at repossessions.[100] Around 9% of credit-impaired mortgages have been repossessed or have a possession order (i.e. 1 in 11 mortgages), compared with around 1% of mortgages (i.e. 1 in 100) where the borrower does not have an impaired credit history.

3.233 Payment difficulties are even more severe for some types of credit-impaired borrower. For example, for those borrowers with a history of arrears and county court judgements, over 80% have developed arrears on their mortgages.[101]

3.234 Evidence suggests that many borrowers from the more financially vulnerable and lower income groups were struggling with unaffordable levels of debt even before the financial crisis. For example, repossessions have been consistently concentrated in particular geo-demographic groups such as 'on the breadline', and 'credit-hungry families'.[102] There is also much anecdotal evidence from consumer groups about the extent to which mortgages have been given to vulnerable borrowers without the income to be able to service their mortgages as well as other debts and living expenses from their incomes.

3.235 This sector of the market is where we saw some of the worst underwriting standards[103], and, in some cases, lending practices bordering on the predatory. The poor underwriting standards found in the subprime mortgage sector have been well documented. The following examples come from a 2007 report published by the Citizen's Advice Bureau (CAB)[104], and highlight some of the issues common across the sector, including self certification mortgages and right-to-buy (RTB).

98 See Exhibit 17.7: Risk combinations and mortgage performance, credit-impaired
99 See Exhibit 17.5: Mortgage performance, by type of credit history
100 See Exhibit 17.6: Mortgage repossessions, by type of credit history
101 See Exhibit 17.8: Mortgage performance, by type of credit impairment
102 See Exhibit 7.10: Repossessions on mortgages sold in April 2005 – September 2010: geo-demographic distribution
103 For example, as found in our thematic work. FSA finds poor practice by intermediaries and lenders within sub-prime market, July 2007: http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/081.shtml
104 Set up to fail – full report, Citizens Advice Bureau, (December 2007): www.citizensadvice.org.uk/set_up_to_fail

- *'A 54 year old man visited a West Midlands CAB about his mortgage arrears. He had been offered a mortgage of £91,000 around two years earlier while he was unable to work for medical reasons and in receipt of income support. The mortgage was from a subprime lender and he was paying a higher rate of interest because he was a risk. He fell behind with the repayments due to his circumstances and was taken to court for repossession by his lender.'*
- *'A CAB in Surrey saw a 75 year old man who had had a stroke and was in receipt of state retirement pension and disability living allowance. He had been sold a mortgage by brokers but had not been able to afford the repayments and the property was repossessed. He is now being pursued for a shortfall debt of £18,000. The mortgage application was completed by his daughter who was advised by the broker to falsify information by stating his occupation as an antique dealer.'*
- *'A CAB in south London saw a 71 year old single man whose first language was not English. He had been living in a one bedroom council flat since 1999 and said he had been managing well on state retirement pension, a small Merchant Navy pension, and benefits until he exercised his right to buy. In 2004, when he was 68, he was approached on his doorstep by an agent for a mortgage lender, and persuaded to borrow £75,000 over 20 years to buy his council flat. He had apparently received no independent advice, and there was no attempt to check that he could afford to pay the mortgage. His total monthly income was £520 and the mortgage payments were £455 per month, nearly 90 per cent of his income. The man was also persuaded to borrow £15,000 over and above the discounted cost of the property. When this ran out, he got into arrears and was subsequently evicted.'*

3.236 The decline in the availability of mortgages for credit-impaired borrowers has been well documented. At the peak of the market in 2007 there were more than 8,000 mortgage products available for credit-impaired consumers, compared with only a handful today.[105] There were over 90,000 sales in 2006, compared to 3,000 sales in 2010.[106] However, impaired credit mortgages have always been a small part of the market and never accounted for more than 5% of mortgage sales.

3.237 In CP10/16, to mitigate our concerns about credit-impaired borrowers, we proposed to build a 'buffer' into affordability assessments for impaired credit consumers. The purpose of this would be to provide an allowance for debts that are under-declared by applicants, particularly those debts that do not show up on credit checks. We asked the market for its views on the form that this buffer might take, for example, whether it should be a percentage of the applicant's free disposable income, and asked for feedback on how this might work.

105 See Exhibit 4.10: Number of residential mortgage products
106 See Exhibit 17.1: Mortgage sales to credit-impaired borrowers

3.238 We asked:

> ***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?*

3.239 Most respondents recognised the additional risks involved in impaired-credit lending. However, few agreed with the proposal to impose an additional buffer on the calculation of free disposable income, and very few gave suggestions on how this could be made to work.

3.240 The main concern raised with the idea was that it would be an inflexible 'one-size-fits-all' approach that would not achieve the goal of consumer protection. It would significantly reduce the borrowing capacity of credit-impaired consumers, restricting their access to the market and forcing them to borrow from more expensive sources, such as the high-cost credit sector, therefore widening financial inequalities.

3.241 There was also a concern that the proposed approach would not reflect the true level of risk as it would not recognise the cause of arrears (for example, a life event such as redundancy or divorce, as opposed to financial mismanagement), or the time since the issue (recent missed payments can be a strong indicator of developing financial problems). Similarly, the proposed definition of a credit-impaired consumer would not differentiate between those with differing levels of impaired credit.

3.242 Respondents noted that credit-impaired consumers are subject to a natural affordability buffer in the form of higher interest rates, and therefore thought that applying an additional buffer was simply not necessary. Several respondents thought that it would be difficult to set a practical and meaningful buffer, for which there would be no optimal level. Instead most respondents strongly supported a thorough affordability assessment supported by an appropriate credit risk assessment and robust underwriting.

3.243 We agree and, in response to this feedback, we have decided not to proceed with this proposal. We believe that our wider affordability proposals will deal with the biggest issues around impaired credit mortgages, which we believe are largely to do with inadequate assessment of affordability, whether from self-certified mortgages or generally poor affordability assessments applied by many of those lenders who offered mortgages to credit-impaired consumers.

3.244 We are also aware that ongoing improvements in coverage of credit reference agencies are reducing the instances of 'hidden' credit commitments as more firms in the high cost credit sector sign up to provide data.

3.245 Although we are not proceeding with this proposal, our impact analysis (see Annex 1) still estimates that our proposals will have a bigger impact on credit-impaired consumers than any other group. In total, we estimate that all three main proposals (affordability assessments, interest rate stress-test and interest-only) would impact 10.5% of credit impaired borrowers in a subdued period (compared with an average of 2.5%), and 69.7% in a boom period (compared with an average of 11.3%). This is because, as described above, poor underwriting practices were concentrated in the sector, and levels of arrears and repossession are particularly high.

3.246 We believe that addressing poor underwriting standards will ensure that mortgages being taken on by **all** borrowers are affordable. As we noted earlier, we want to ensure that in future downturns the number of borrowers suffering the trauma of arrears and repossessions will be significantly less than in this recession. But we also want to ensure that we continue to have a market in which a large number of people, no matter what their circumstances, can enjoy access to mortgage lending where they can afford it.

3.247 Although we are not proceeding with this particular proposal, given our concerns about credit-impaired borrowers, we propose to implement other measures designed to protect them. We are proposing to:

- make advice for debt consolidation mortgages compulsory (see Chapter 5); and
- strengthen our requirements around debt consolidation mortgages for credit-impaired consumers (see paragraphs 3.318 to 3.328).

Q8: Do you have any comments on our proposals to protect credit-impaired consumers?

Right-to-buy mortgages

3.248 In DP09/3, we noted that there were a number of concerns in the right-to-buy (RTB) mortgage market, particularly concerning the sale of unsuitable or unaffordable mortgages. We noted the enforcement action we had taken against firms in the RTB market and also that we considered our proposed MMR reforms, including strengthened affordability rules and sales standards, should address the problems within the market.

3.249 The market for RTB mortgages is currently very small, with just over 3,000 mortgage sales in 2010, down from a peak of over 160,000 sales per year in the early 1980s.[107] The volume of sales may, however, increase as a result of government plans to raise RTB discounts as set out in the government's recent Housing Strategy[108] and Autumn Statement.[109]

3.250 RTB borrowers are the borrower type[110] historically most likely to experience arrears and payment problems.[111] 40% of current RTB mortgages have a record of payment problems

107 See Exhibit 18.1: Right-to-buy sales in England – time trend, 1980-2011
108 *Laying the foundations: A housing strategy for England*, Department for Communities and Local Government, (21 November 2011): www.communities.gov.uk/documents/housing/pdf/2033676.pdf
109 *Autumn Statement*, HM Treasury, (November 2011): http://cdn.hm-treasury.gov.uk/autumn_statement.pdf
110 Compared to first-time buyers, movers and remortgagors
111 See Exhibit 15.11: Mortgage performance, by type of borrower

of some kind, with 9% in current arrears of two payments or more. This may reflect the fact that more RTB consumers have impaired credit histories than other borrower types.

3.251 Following the tightening of lending criteria post-crisis, the quality of RTB mortgage sales has improved. Today only 0.5% of RTB borrowers are credit-impaired compared to 21% in Q3 2005.

3.252 We believe that our strengthened affordability proposals will act to help ensure that standards are maintained across this market. This will also be helped by our enhanced sales standards proposals, which will mean that all RTB consumers will get advice in future. It is vital to ensure a proper assessment of whether a RTB mortgage is appropriate for the consumer.

3.253 We believe that these proposals will adequately deliver increased protection for RTB consumers.

> **Q9: Do you think that our proposed enhanced sales standards will provide adequate protection for right-to-buy consumers? Are further measures required?**

Different approaches to assessing affordability

3.254 We believe that our approach to affordability reflects current best practice in the market, and will not involve fundamental change for most lenders. Following the publication of CP10/16 we have had extensive face-to-face discussions with a wide variety of lenders, and we recognise that there are differences in the ways lenders approach affordability. For example:

- larger lenders tend to use a more systems-based approach and affordability models; and
- smaller lenders rely more on manual underwriting and an assessment of affordability based on income multiples.

3.255 There appears to be no reason why both approaches cannot be accommodated under our proposed rules.

Affordability models

3.256 Many of the larger lenders we spoke to during the consultation process used affordability models that take into account the applicant's income, committed expenditure, and actual or modelled/statistical expenditure data, as well as considering the impact of future interest rate rises. This is usually combined with credit scoring to assess the applicant's propensity to repay. This approach allows the lender to consider individual consumer circumstances within a streamlined process aimed at processing a high volume of applications, with only outlier or marginal applications underwritten manually. These systems are unlikely to require major change to meet the proposed rules, although some minor changes are likely to be required to ensure that all relevant categories of expenditure are required and record keeping requirements met.

Income multiples

3.257 Many smaller lenders use income multiples, in conjunction with a more manual underwriting process. This typically involves considering the applicant's income and committed expenditure, to assess the maximum loan allowed using the income multiple. Expenditure is indirectly accounted for in the income multiple, and assessed manually, for example through an assessment of bank accounts and whether the applicant lives within their means.

3.258 Now that we have moved away from the 'free disposable income' approach towards a more principles-based affordability assessment, we do not see income multiples as being incompatible with our proposals, provided that the lender can demonstrate that the loan has been assessed as affordable, having taken full account of the consumer's actual income and expenditure based on household composition, and that the approach is applied conservatively. The lender would also need to be able to demonstrate how they have taken account of the impact of future likely interest rate increases on affordability.

3.259 We would particularly welcome feedback on whether the use of an income multiple approach is compatible with our proposed approach and/or whether any of our proposed requirements might require changes that we have not anticipated.

> **Q10: Do you think income multiples could work under our proposed rules? If not, why?**

Credit scoring

3.260 Many respondents to CP10/16 highlighted the important role that credit scoring plays in assessing the whether a consumer will repay their mortgage. Some respondents argued that credit scoring is a more important consideration when assessing a mortgage application than considering affordability or collecting evidence of income, as they felt its predictive power is much greater.

3.261 We recognise that credit scoring can be a valuable tool for determining the risk of lending to individual consumers, and assessing their propensity to repay, based on factors such as past management of their financial affairs and their current circumstances. However, credit scoring does not establish whether the consumer has the means to repay the mortgage, and it is a tool that is implemented in a way that primarily protects lenders from taking on risks that they deem unacceptable, rather than being focused on protecting individual consumers from taking on unaffordable debt.

3.262 When lenders are being cautious, credit scoring may work to protect consumers. However, the cut-off point for acceptable credit scores is opaque and can be varied over time according to the lender's risk appetite, and commercial considerations, such as a desire to increase or decrease market share.

3.263 While credit scoring can act to reduce the incidence of unaffordable mortgages, it is not targeted to do so, and therefore cannot be relied on to protect consumers from taking on unaffordable mortgages. This is particularly true in the boom times when credit is more freely available, and lenders' (and consumers') appetite for risk grows.

3.264 We believe that responsible lending needs to be underpinned by a proper assessment of affordability at an individual level and underwriting standards that remain stable across the economic cycle.

Other responsible lending issues

Reasonably foreseeable changes to income and expenditure

3.265 In CP10/16 we proposed that lenders should take account of the applicant's ability to pay over the life of the loan. We noted that there are clearly limitations to this approach, as lenders are not able to predict future events. However, we thought that they should consider 'foreseeable' events, and we gave retirement during the term of the mortgage as an example.

3.266 We received a lot of feedback on this from respondents concerned about the extent to which lenders would be expected to foresee future events. We touched on this briefly in relation to the self-employed in paragraph 3.87.

3.267 Several respondents suggested that we should align our proposals with the Office of Fair Trading's (OFT) *Irresponsible lending – OFT guidance for Creditors*.[112]

3.268 Some also referred to Oxera's report on our proposed rules[113] which concluded that it would not be possible for lenders to take into account foreseeable changes in income and any attempt to do this would not achieve the desired outcome.

3.269 Many respondents also felt that the proposal to consider future changes to income and expenditure represents a significant shift in responsibility from the consumer to the lender, and argued that the consumer should retain responsibility for their future spending habits and mortgage commitments

3.270 We recognise that it is not possible to predict future events. We do not expect lenders to 'crystal ball gaze' or take account of information that has not been provided to them. However, we do expect lenders to take account of information that they know or should reasonably be aware of, from the information that they have at the time they are assessing

112 *Irresponsible lending – OFT guidance for Creditors*, Office of Fair Trading, (2010, updated 2011): www.oft.gov.uk/shared_oft/business_leaflets/general/oft1107.pdf

113 *An assessment of the FSA's proposed rules for mortgages. A report prepared for the Council of Mortgage Lenders*, Oxera, (November 2010): www.cml.org.uk/cml/filegrab/?ref=7432

the mortgage application. And we expect lenders to make reasonable enquiries to ascertain this information, for example by asking relevant questions during the mortgage application process, and undertaking a reasonable assessment of the information provided to them during the application process.

3.271 We have significantly amended our proposed rule to make this clear.[114]

Lending beyond state pension age

3.272 We do not have any objection in principle to lending into retirement, and for many borrowers this will be entirely appropriate.

3.273 The main risk of mortgages that extend into retirement is that the borrower may not be able to afford mortgage payments later in life if their income reduces. Our thematic work has shown that some lenders have not considered whether consumers will be able to afford their mortgages after retirement. This formed part of the enforcement action we took against DB mortgages,[115] for example. We published good and poor practice guidance for mortgage lenders[116] on this topic in 2007.

3.274 Affordability problems for mortgages extending into retirement may not become apparent until well into the term of the mortgage, often not until the borrower has retired. Our data shows a somewhat higher record of payment problems and repossessions for borrowers whose mortgages extend into retirement, compared with those that do not[117] – but the difference is not pronounced. It is likely that the full impact of poorly underwritten mortgages into retirement in the recent boom period is not yet fully evident.

3.275 A significant proportion (26%) of borrowers has mortgages that extend beyond the age of 65[118], of which 5% will not be paid off until after the age of 80.[119]

3.276 Consumer research undertaken by Policis[120 121] found that 53% of borrowers over 50 have mortgages that stretch beyond the age of 65. An even larger proportion of borrowers over 50 (65%) said that they had specific plans to borrow into retirement. Many of these planned to downsize to smaller properties, but rather than doing this to clear their mortgages, they planned to increase their borrowing to support their quality of life in retirement and allow them to help the younger generation enter the property market.

114 See Appendix 1, draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6.12R
115 Final Notice DB, (15 December 2010): www.fsa.gov.uk/pubs/final/db_uk.pdf
116 *Mortgages running into retirement. Examples of good and poor practice for mortgage lenders*, (July 2007): www.fsa.gov.uk/pubs/other/mortgage_lender.pdf
117 See Exhibit 13.13: Mortgage performance, if mortgage extends into retirement; and Exhibit 13.14 Mortgage repossessions, if mortgage extends into retirement
118 See Exhibit 13.2: Proportion of mortgages extending into retirement
119 See Exhibit 13.8: Expected age at redemption for borrowers whose mortgages extend into retirement (April 2005 – September 2011)
120 *New approaches to Mortgage Market Regulation*, Policis, 2010: www.cml.org.uk/cml/filegrab/research-appendix-3-full-report-new-approaches-to-mortgage-regulation.pdf?ref=7434
121 See Exhibit 13.11: Mortgagors over 50 – by whether they have or want mortgage term past age 65

3.277 A significant proportion of these borrowers stated that they will have to retain their mortgages into retirement because of financial pressures. 51% said they were not in a position to pay off a mortgage before retirement, and 14% said that they have too many expenses to afford to pay off their mortgage before retirement.[122]

3.278 Older borrowers are also more likely to have interest-only mortgages than younger borrowers. 28% of borrowers in our PSD dataset have interest-only mortgages. 48% of those in the 56-60 age group have interest-only mortgages; 60% of those in the 61-65 age group and 63% of those over the age of 66.[123]

3.279 This could reflect the fact that many mortgages sold in the 1980s and 1990s were endowment mortgages. However, it may also indicate that some borrowers have switched to interest-only mortgages later in life to improve the affordability of monthly payments or to enable them to borrow more against their homes.

3.280 In 2009, 52% of claimants (117,000 people) on Support for Mortgage Interest (SMI) were pensioners.[124] Although the average weekly payment for claimants over 65 years is low (around £27), state benefits are not a guaranteed source of income, and are subject to changes in government policy. This highlights for us the critical importance of considering affordability of mortgages into retirement.

3.281 In CP10/16 we proposed that a lender should consider the effect of retirement on the income of the consumer if a mortgage will extend into retirement. We also proposed that lenders should assess the plausibility of the stated retirement age.

3.282 In CP10/16 we asked:

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

3.283 The majority of respondents thought that the level of income in retirement should be a consideration when granting a loan extending into retirement. However many, including most firms and trade bodies, had concerns about how this might work in practice.

3.284 One common concern was the effectiveness of assessing income in retirement. Respondents thought that lenders would not have staff sufficiently experienced in pension planning and therefore would not be able to assess the likely level of income. There was also a concern that if they did attempt to do this, it could be seen as straying into investment advice.

3.285 Pension income is also seen as very difficult to estimate with any degree of accuracy, due to the unpredictability of variables such as investment performance, annuity rates, lack of certainty over actual retirement date, and the complexity of some consumers' pension provision (for example, having several different pensions).

122 See Exhibit 13.12: Reasons for wanting mortgage stretching past age 65
123 See Exhibit 11.23: Proportion of interest-only mortgage sales, by borrower's age at origination (April 2005 – September 2011)
124 See Exhibit 13.15: Support for mortgage interest benefit: number of claimants in 2009

3.286 The task becomes even more difficult when retirement is a long way in the future. Some respondents welcomed our recognition in CP10/16[125] that assessing retirement income is not foolproof and that lenders should not be held responsible where they had made an attempt to consider this. However, they thought the draft rules did not fully reflect this policy intention. So they were concerned that lenders would be held responsible if pension income proves inadequate.

3.287 The net effect of all of this was that many respondents thought that our proposals would encourage an excessively cautious approach on the part of lenders, thus restricting the availability and increasing the cost of mortgages into retirement.

3.288 Many respondents also questioned our proposal that lenders should assess the plausibility of the retirement ages declared by mortgage applicants. Some questioned how realistic it was for plausibility to be assessed in each individual case, beyond applicants confirming their intention. For example, we were asked whether this meant that lenders would have to assess the health and fitness of the applicant or the likely state of the future employment market.

3.289 Several respondents supported a proportionate approach where the time left until pension age would dictate the level of detail at which income in retirement should be considered. Some thought that the responsibility for making payments in retirement should lie squarely with consumers, possibly supported by some form of warning reminding them of the importance of adequate pension provision.

3.290 However, respondents representing consumers were very supportive of the proposals. One respondent representing older consumers was concerned about the extent to which consumers carry unaffordable levels of debt into retirement, while others with more than adequate resources to sustain mortgages into retirement are refused mortgages because of their age. So they favoured assessing affordability on a case-by-case basis.

3.291 The Citizens Advice Bureau (CAB) gave some example of cases where they had seen poor lending decisions in this area, including the following:

- ’*A CAB in Berkshire saw a recently retired man who was in receipt of state retirement pension and pension credit. He had been granted a 20 year mortgage for £135,000 18 months earlier by a lender who knew his age and knew he was approaching retirement. He fell into arrears and the lender applied to the court for possession.*’
- ’*In April 2009, a Lincolnshire CAB told us about a woman who was 60 years old, working, and in debt when she was advised to take out a 40 year term mortgage by a lender, five years earlier. The woman was now on state pension and was currently paying interest-only. She also had £70,000 of other debt, and was under considerable mental stress paying all her financial commitments. The CAB felt that the client would find it very difficult to stay in her home and queried why the lender, a high street bank, had given her such a long term loan at that stage of her life.*’

125 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf, paragraph 2.75

Our proposals for lending beyond state pension age

3.292 Our aim is to protect consumers from carrying unaffordable debt into retirement. We do not want to prevent older consumers from accessing mortgages where they have the means to support payments, as many do whether from employment, pensions or other sources of income such as investments.

3.293 We recognise that retirement age is becoming increasingly fluid, as state pension ages are put back. We also recognise that it is not possible to accurately predict retirement income, particularly where consumers are many years away from retirement. However, the proportion of consumers who work beyond state pension age is not high, with, for example, 11% of men aged 65-69 working full-time, falling to 1.4% aged 70 or over.[126] However, the proportion of those working beyond state pension age has been rising, particularly over the last ten years.[127] So lenders should be mindful that income beyond state pension age in many cases is likely to be largely based on pension income.

3.294 We are therefore proposing that the lender should adopt a prudent and proportionate approach to assessing income where the mortgage term extends beyond the state pension age of the applicant.

3.295 By this we mean that the degree of scrutiny that the lender applies may vary according to the period of time remaining to state pension age. The closer it is, the more robust the evidence of the level of income in retirement should be. For example, where state pension age is many years away, it may be sufficient for the lender to merely confirm the existence of pension provision (by, for example, obtaining a pension statement). Where the applicant is closer to state pension age, the lender would need to take more robust steps, for example by considering projections provided on pension statements. As pension income forms part of income, the lender must obtain some form of evidence.

3.296 In response to fears expressed in feedback about the level of responsibility lenders will be required to take for borrowers' pensions, we want to make it clear that it is not our intention to:

- require that lenders undertake a detailed analysis of the likelihood that an applicant's pension will be sufficient to repay a mortgage; or
- hold lenders responsible in the event that a borrower's pension turns out to be insufficient to support their mortgage payments in retirement.

3.297 Instead, as for any other mortgage, we want lenders to make an informed lending decision, based on appropriate evidence.

126 See Exhibit 13.5: Full-time and part-time employment, by age and sex
127 See Exhibit 13.4: Employment rates at 65+ for men and 60+ for women

Credit commitments expected to become due during the mortgage term

3.298 There may be scenarios where a consumer has credit commitments where no payments are being made at the time of the mortgage application, but where repayments will become due during the mortgage term, thus increasing the financial burden on the consumer. An example of this would be a shared equity loan, where payments may not become due for several years.

3.299 Where this is the case, we propose that the lender should consider the impact of the commitment on affordability at the time of the application. We do not propose to prescribe how lenders should do this. We simply propose to require the lender to consider whether the mortgage is likely to remain affordable when the additional commitment becomes due.

3.300 There may, of course, be some situations where the borrower has some other appropriate repayment strategy which means that the future commitment does not impact on affordability.

Q11: Do you have any comments on our proposal to require lenders to take into account information about future changes to income and expenditure?

Equity withdrawal

3.301 In DP09/3, we raised the question of whether we should seek to limit the amount of equity that a consumer can withdraw from their home. We were concerned that, while equity withdrawal provides consumers with a flexible way in which to manage their finances, it can be used to disguise and exacerbate affordability problems. Some consumers in financial difficulty would be better off in the long term by not withdrawing equity to temporarily fix debt problems.

3.302 Having undertaken further analysis, we indicated in CP10/16 that we consider that our affordability proposals will significantly reduce the risk of consumers withdrawing equity when it is likely to be most harmful to them. And we continue to take this view. We are therefore not proposing to impose any limits on equity withdrawal.

Debt consolidation

3.303 Although we do not propose to impose any limits on equity withdrawal, we do have some concerns about the impact of remortgages for debt consolidation on affordability.

3.304 The incidence of payment problems is higher for remortgages with an element of debt consolidation than for other types of remortgages, or indeed mortgages in general.[128]

128 See Exhibit 16.9: Mortgage repossessions, by type of remortgage

3.305 Our data shows that many credit-impaired borrowers remortgaged for debt consolidation purposes[129], and a higher proportion of debt consolidation mortgages self-certified their income, compared with other mortgages.[130]

3.306 The risk combination work published in CP10/16 found that remortgaging for debt consolidation purposes was one of the top five risk factors that predicted future financial difficulties.[131] This risk of arrears is heightened where the borrower has an impaired credit history.

3.307 The volume of mortgage sales for debt consolidation has decreased significantly since the downturn, from a peak of 175,000 in 2007 to 45,000 in 2010.[132] However, this area of lending has the potential to take off again when market conditions improve.

3.308 To address the risks around debt consolidation, in CP10/16 we proposed that where the purpose of a mortgage is debt consolidation, lenders should ensure that debts that are to be cleared through the mortgage advance are in fact repaid as expected (e.g. by paying proceeds of the advance directly to creditors, or paying through a solicitor). The purpose of this was to ensure that borrowers did not take on mortgage debt to consolidate other debts which they did not then repay, therefore putting an unexpected strain on affordability.

3.309 In CP10/16 we asked:

> ***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?*

3.310 Most respondents were in favour of this proposal, including a small number of lenders who said they already meet the proposal to some extent. However many respondents thought we should undertake further investigation into the associated costs of requiring lenders to do this.

3.311 A significant minority of respondents, particularly lenders, trade bodies and professional bodies, were strongly opposed to this proposal. They argued that it would be cost prohibitive and procedurally complex to implement, as lenders would have to administer time consuming processes, such as obtaining redemption balances and requiring the creditor to confirm receipt, across a range of different creditors. This would significantly slow down the application process, causing detriment to consumers.

3.312 They also argued that the proposal would not address the root of the problem, as there would be little to prevent a consumer from swiftly accumulating more debt after the debts have been repaid by the lender.

129 See Exhibit 16.3: Remortgage for debt consolidation in total remortgages, by type of credit history
130 See Exhibit 16.5: Proportion of borrowers whose income was not verified in the run-up to the market downturn, by mortgage type
131 See Exhibit 16.10: Risk combinations and mortgage performance, debt consolidation
132 See Exhibit 16.2: Number and value of debt consolidation mortgages

3.313 Some of these respondents thought that this requirement would cause lenders to exit from the debt consolidation market, thus restricting consumer choice. Others thought lenders would as a result include credit commitments to be repaid in the affordability assessment in any event, thereby reducing the ability of consumers to restructure their finances.

3.314 Several respondents felt that further advances should be included in this proposal, as taking a further advance is a popular method of debt consolidation. Some also noted that if the proposals were not applied to further advances there would be a 'gaming' opportunity, with consumers remortgaging and then taking a further advance immediately afterwards.

3.315 Some respondents suggested that the requirement should apply only where the affordability test does not pass if the debts remain outstanding. If the loan is affordable without repayment of existing debts, it would be the borrower's responsibility to repay them.

3.316 Professional bodies representing solicitors highlighted that the provisions contained in the solicitor's code of conduct and the Council of Mortgage Lenders (CML) Handbook restrict dealings with unsecured loans. These provisions are in place to avoid conflicts of interests between the lender and the borrower, as solicitors often act for both parties. It would not be possible for the lender to insist on a solicitor making payments of this kind without amending these rules. It was suggested that lenders could appoint a separate solicitor to act for them, but this could prove to be a costly option, given the time it might take to administer repayment of debts for each case.

3.317 Professional bodies were also concerned that the proposals would encourage lenders to pass their obligations on to solicitors. They felt that the FSA obligations should fall squarely on the FSA-authorised party entering into the transaction. They also highlighted that some operational difficulties may arise from Data Protection Act requirements which would make it difficult for the solicitors to follow lender instructions on this.

3.318 Taking all of this into account, we have decided not to proceed with this proposal across the board. We appreciate that debt consolidation can be in the interest of consumers and that many consumers are able to take responsibility for repaying creditors directly.

3.319 However, because of the increased risks around credit-impaired consumers, we propose to proceed with this proposal for consumers with impaired credit, for both new regulated mortgage contracts and further advances. Given the small number of debt consolidation mortgages to the credit impaired (less than 1% of total mortgage sales in 2007 and 0.05% now[133]) we believe that this is an appropriate and proportionate response to protect consumers.

3.320 To make this proposal work, we believe that we need to provide a definition of a 'credit-impaired consumer'. If we do not set a definition we are concerned that firms may apply differing interpretations, which may lead to some consumers not being protected by this rule. Lenders may also compete on their definition of a credit- impaired consumer, leading to lower standards across the market.

133 Source: FSA PSD

3.321 We propose to use a definition based on the existing definition used for regulatory reporting purposes, which is a consumer who:

- within the last two years has owed overdue payments, 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
- 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 an individual voluntary arrangement or bankruptcy order which was in force at any time within the last three years.[134]

3.322 We are suggesting two alternative approaches to this issue.

3.323 **Option 1**. The lender would be required to take reasonable steps to ensure that committed expenditure to be repaid by the mortgage advance is repaid as expected, if the loan is not affordable if the commitment is not repaid (i.e. when the debts are included as 'committed expenditure' in the affordability assessment). Repayment of the debts may be achieved by the lender repaying the debt directly to the creditor. The lender would not be required to ensure that the debts are repaid in cases where the loan is still affordable if the debt remains outstanding (i.e. when the debt is considered as committed expenditure in the affordability assessment).

3.324 We recognise that there may be some practical difficulties and administrative costs for lenders if this approach was adopted, however, a small but vulnerable group of consumers would be protected from taking on unaffordable debt.

3.325 **Option 2.** The lender would be required to assume that the debts to be consolidated will remain outstanding following the mortgage advance, by including them as 'committed expenditure' in the affordability assessment.

3.326 This option would be simpler for the lender to administer – however, it will prevent some borrowers from being able to consolidate debts if they cannot demonstrate affordability, and they may be forced to turn to more expensive solutions.

3.327 We will decide how to proceed after considering feedback to this consultation.

3.328 We also propose to provide additional protection to consumers who are consolidating debt by requiring that they get mortgage advice. This is discussed in Chapter 5.

> Q12: **Do you agree, that to ensure these proposals work, we should define a credit-impaired consumer? Do you agree with our proposed definition?**

134 Note that we may propose to amend this definition in future to reflect changes in the definition of impaired credit for reporting, if, for example, we amend the definition to include Debt Relief Orders. See Chapter 7 for more information.

Q13: Which option do you prefer? Option 1, where the lender would be required to take reasonable steps to ensure that debts to be consolidated are repaid? Or option 2 where the lender would be required to assume that debts to be consolidated remain outstanding for purposes of assessing affordability? If you disagree with both options, what do you suggest as an alternative?

Systems and controls

3.329 We are proposing to require lenders to enhance their systems and controls around responsible lending. This is particularly important as we are now proposing a less prescriptive approach to assessing affordability. In order to supervise effectively, we need to be able to be able to see and clearly understand the approaches that lenders are taking. In particular, we intend to apply new requirements for monitoring responsible lending and to extend existing requirements around lenders' responsible lending policies and record keeping. To a large extent these proposals reflect existing good practice in the market.

Responsible lending policy

3.330 We already require lenders to have a responsible lending policy in place, setting out the factors they take into account when assessing a consumer's ability to repay. We are now proposing to be more explicit in our requirements, to ensure that lenders fully capture appropriate information in their policies. The policy must be signed-off by the Board of the lender. It must include[135] information on:

- how the lender goes about assessing income and expenditure, including the evidence accepted;
- how anti-fraud controls are incorporated into affordability assessments;
- how the lender's affordability model is monitored;
- how regular audits of compliance with the policy are undertaken;
- how record keeping requirements are met;
- where relevant, details of the lender's interest-only policy (see Chapter 4 for more details on this); and
- where relevant, how the lender will apply the transitional arrangements (see paragraph 3.344 for more information on this).

135 See Appendix 1, draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6.18R

Internal monitoring

3.331 We will expect lenders to be able to demonstrate that they have systems in place to monitor and audit the effectiveness of their affordability assessments in a consistent and meaningful way. We will then expect lenders to adjust and improve they way they assess affordability, to address any issues they find.

3.332 Monitoring should take place on an ongoing basis through regular reviews. However, we propose that lenders should set key performance indicators, so that reviews can be triggered between regular scheduled reviews, where the key performance indicators are breached. We do not propose to prescribe the key performance indicators, however we propose that they are set out clearly in lenders' responsible lending policies. Examples of key performance indicators would be arrears levels, including the levels of early arrears.

3.333 We are also proposing that lenders must undertake an audit of compliance with their responsible lending policy at least annually.

Record keeping

3.334 We propose to extend lenders' record-keeping requirements to demonstrate compliance with the responsible lending rules. In most cases the requirements are being extended from one to three years. The exception to this relates to the transitional arrangements, where the record-keeping requirement for the information set out in the second bullet of paragraph 3.370 below, will extend for the term of the contract.

3.335 We do not believe that extending record keeping requirements will be an issue for lenders, as it is already market practice to keep information for longer than the current required period of one year for other purposes, such as complaints handling.

3.336 In addition, we are proposing that lenders must keep a record of the key information taken into account for each affordability assessment, so that the basis of the lending decision can be reconstructed with relative ease from the customer file (whether paper or electronic). The purpose of this is to ensure that lending decisions are transparent, so when re-assessed in future, it is easy to see how the calculation has been made, the evidence it is based on and the assumptions that have been used. Our understanding is that lenders already keep this information.

3.337 We propose that the record must include:

- information on income and expenditure used in each affordability assessment, including the evidence relied on;
- the rate or assumptions used to test affordability against future interest rate rises;
- the repayment type and term of the mortgage; and
- the calculation used to determine whether the loan is affordable.

3.338 Where full details of the lender's affordability model is not directly recorded on the customer file, there should be a clear indication of which version of the affordability model was used, so that it is transparent how the decision has been made when the file is reviewed in conjunction with details of the affordability model.

3.339 We have additional record keeping requirements for interest-only mortgages, and mortgages entered into under our proposed transitional arrangements.

3.340 The lender must also make and keep up to date an adequate record of its responsible lending policy. When the policy is changed, a record of the previous policy must be retained for three years from the date of the change.

3.341 The proposals for record keeping requirements are set out in full in Appendix 1.[136]

Q14: Do you agree with our proposals to strengthen lender's systems and controls around responsible lending?

Supervising the MMR

3.342 As we described in Chapter 2, the Financial Conduct Authority (FCA) will build on our recent progress towards a tougher, more interventionist and pre-emptive approach to regulating conduct in financial services, including the ongoing delivery of the MMR.

3.343 These proposals will introduce efficiencies for supervisors. The new approach introduces clearer and more detailed responsible lending requirements than have applied in the past, including more detailed record keeping requirements. This provides firms with more clarity about our expectations, and provides us with clearer and less ambiguous evidence of compliance than has been the case to date.

Transitional arrangements to mitigate the impact of our responsible lending rules on existing borrowers

3.344 Market conditions and commercial considerations have already led many lenders to tighten their lending criteria following the market downturn. As a result, consumers are finding it difficult to get mortgages. For example, we estimate that around half of all borrowers who took their mortgages out between 2005 and 2010 could potentially be impacted if we assume that borrowers with an LTV above 85% and/or a history of credit problems might find it difficult to obtain a mortgage in current market conditions. This rises to around 65% of borrowers who were FTBs.[137]

136 See Appendix 1, draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6.42R
137 See Exhibit 5.1: 'Mortgage prisoners', by borrower type

3.345 At present, most borrowers 'trapped' with their current lender are in this situation because of the limited availability of higher LTV mortgages.[138] In addition, we estimate that up to 15% of borrowers who took out mortgages between 2005 and 2010 could be in negative equity[139], with borrowers in some regions of the UK more impacted than others,[140] A significant proportion of some borrower types (such as RTB and borrowers who have already remortgaged) are also impacted by their history of payment problems.[141]

3.346 We estimate that the MMR proposals will have much less impact than existing market conditions. As we set out in Annex 1, we estimate the MMR responsible lending proposals taken altogether might impact 2.5% of borrowers in subdued conditions, and 11.3% in boom conditions. However, some consumers – particularly those who self-certified income, took out an interest-only mortgage, or have an impaired credit history – will continue to find it difficult to get the mortgage they want.

3.347 Difficulty in obtaining a mortgage will affect consumers in a variety of ways. Some may solve this problem by purchasing a cheaper property than they had originally intended, saving for longer to get a bigger deposit, or deciding not to move or remortgage to withdraw equity.

3.348 The situation may be more problematic for others. For example, some existing borrowers may be unable to remortgage to obtain a better deal, despite the fact they require no extra borrowing and their personal circumstances have not changed since taking the original mortgage. Similarly a borrower may be unable to move house to take up a job in a different region.

3.349 We are also concerned about the potential risks to borrowers 'trapped' with their current lender, for example, the risk of 'price gouging' (i.e. being charged a high interest rate because they are unable to go elsewhere). Our concern applies both to borrowers who are already trapped, because they do not meet current tightened lending criteria, and those who may be trapped in the future following implementation of the MMR.

Our approach

3.350 We already have some tools that we can use to prevent the unfair treatment of mortgage borrowers. For example, Principle 6 requires firms to 'pay due regard to the interests of its customers and treat them fairly'. We also have the power to challenge unfair contract terms and have used this in the past where lenders have made unfair changes to interest rates. In addition, borrowers have the right to refer complaints to the Financial Ombudsman Service, if they feel that they have been treated unfairly by their lender, and are not happy with the lender's response to their complaint.

138 See Exhibit 5.2: 'Mortgage prisoners' – reasons
139 See Exhibit 5.7: Negative equity, by borrower type, Q4 2010
140 See Exhibit 5.8: Negative equity, by region, Q4 2010
141 See Exhibit 5.3: 'Mortgage prisoners', by borrower type – reasons

3.351 We are also proposing to apply some 'transitional' arrangements[142] to help existing borrowers. These are designed specifically to mitigate the impact of the introduction of our proposals on existing borrowers who:

- cannot demonstrate affordability for their new mortgage as required by the new affordability requirements; or
- do not have an acceptable repayment strategy in place, according to our interest-only proposals, and are unable to demonstrate affordability on a capital and interest basis.

3.352 In practice, the transitional arrangements may help both consumers impacted by the MMR and those impacted by lending criteria changed by lenders for commercial reasons. This is because once the MMR has been implemented it may be difficult to determine whether a lender has amended their lending criteria in response to the MMR or commercial considerations.

How will these arrangements work?

3.353 The aim of these arrangements is to allow existing borrowers with a good payment history to be able to enter into a new mortgage for the same amount or less. We do not want them to be prevented from doing so because they cannot meet stricter affordability assessments introduced as a result of the MMR. In practice, we will need to put some conditions in place to ensure that these arrangements are used appropriately. We set out below how we propose that these might work. We would, however, welcome feedback on how this might be improved or simplified.

3.354 Under our proposals, the transitional arrangements will **enable** a lender (whether the existing lender or another lender) to waive some of the proposed affordability rules, when entering into a new regulated mortgage contract, if the borrower meets certain conditions. However, the transitional arrangements **will not compel the lender to lend,** even where the borrower meets the relevant conditions. Whether to lend is a commercial decision for a lender to make. It is not our role, or within our remit as a regulator, to make lending decisions for the lender.

3.355 Our proposed affordability rules will apply when a lender enters into a new regulated mortgage contract, or makes a further advance, as is already the case with our existing responsible lending rules. These transitional arrangements will apply only when a lender is going to enter into a new mortgage contract with a new or existing borrower. This includes rate switches where the lender structures these as new regulated mortgage contracts.

3.356 The affordability rules do not apply to a variation of contract where there is no additional borrowing. Therefore, rate switches and other transactions (such as a change of term, change to repayment method, or the addition or removal of a party to the mortgage) structured as a variation of contract, and where there is no additional borrowing, are not impacted by our

142 See Appendix 1, draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.7.1R

affordability rules, and therefore these transitional arrangements do not come into play. The lender is able to continue to operate their usual processes. We recognise that lenders may carry out some form of affordability assessment in some of these situations, even where not compelled to do so by our rules. It is not our intention to disrupt such practices.

3.357 Examples of where the transitional arrangements do and do not apply are set out in Exhibit 8.

Exhibit 8: When do the proposed transitional arrangements apply?

The transitional arrangements come into play only where there is a regulatory requirement to undertake an affordability assessment i.e. **a new regulated mortgage contract**, or **a further advance**.

	Can the transitional arrangements be applied by the borrower's **existing lender**?	Can the transitional arrangements be applied by **another lender**?
1. Moving to a different property		
no additional borrowing **and** the new monthly payment will be the same or less as current payment	**YES**	**YES**
additional borrowing **and/or** the new monthly payment will be more than current payment	**NO**	**NO**
2. Remortgage (i.e. a new regulated mortgage contract)		
no additional borrowing **and** the new monthly payment will be the same or less	**YES**	**YES**
no additional borrowing **and/or** the new monthly payment will be more than current payment	**NO**	**NO**
A remortgage that involves material change to the mortgage, such as changes to: • the term; • the repayment method (e.g. a move from capital and interest to interest-only); and/or • a change to the parties on the mortgage (addition or removal).	**NO**	**NO**

<table>
<tr><td colspan="3">The transitional arrangements come into play only where there is a regulatory requirement to undertake an affordability assessment i.e. a new regulated mortgage contract, or a further advance.</td></tr>
<tr><td></td><td>Can the transitional arrangements be applied by the borrower's existing lender?</td><td>Can the transitional arrangements be applied by another lender?</td></tr>
<tr><td colspan="3">3. Additional borrowing</td></tr>
<tr><td>To undertake essential repair or maintenance works to protect the property (whether a new regulated mortgage contract or a further advance)</td><td>YES</td><td>NO</td></tr>
<tr><td>For reasons other than for essential repairs to maintain value of property</td><td>NO</td><td>NO</td></tr>
<tr><td colspan="3">4. No new regulated mortgage contract and no additional borrowing</td></tr>
<tr><td>Variation to an existing regulated mortgage contract where there is no additional borrowing, for example, to:
• move to a different rate (whether resulting in a higher or lower payment);
• change repayment method (e.g. capital and interest to repayment or vice-versa); and/or
• extend the term.</td><td colspan="2">An affordability assessment is not triggered by a variation to contract where there is no additional borrowing.
Therefore the transitional arrangements are not relevant.</td></tr>
<tr><td>The borrower's existing mortgage deal expires (e.g. a fixed or tracker rate) and the borrowers moves on to the lender's standard variable rate.</td><td colspan="2">An affordability assessment is not triggered by this routine event.
Therefore the transitional arrangements are not relevant.</td></tr>
</table>

Eligibility criteria

3.358 For a borrower to be eligible for the transitional arrangements, we are proposing that the following conditions must be met:

- The borrower's mortgage must have either:
  - been in existence when the MMR affordability rules come into force; or
  - been entered into under these transitional arrangements. We do not propose to limit the number of times that these arrangements can be used for any particular borrower (e.g. they may remortgage to change rate a number of times over the remaining term of the mortgage). Nor do we propose to prevent the arrangements from being applied where the mortgage has been transferred, sold on or remortgaged to another lender.

- No additional borrowing is required (subject to the exception for essential repairs described in paragraph 3.359 below), although product and arrangement fees may be added to the loan at the discretion of the lender.[143]
- The monthly payments under the new mortgage should be the same or lower than the existing mortgage payments, excluding the cost of any additional borrowing provided for essential repairs, or product-related fees.
- The borrower must be able to demonstrate affordability through having a good payment history for their current mortgage covering at least the last 12 months, with no arrears or payment shortfall during this time. The lender must have evidence of the mortgage payment history.
- The lender is not aware of any information which means that the borrower will not be able, or is unlikely to be able, to continue to make the mortgage payments at the expected level.
- The customer has not increased the size of the mortgage since the MMR came into force (other than for essential repairs or to add product and arrangement fees). The rationale for this is that if a borrower has obtained additional funds after the MMR has been implemented, it is not the new MMR requirements that are subsequently preventing them from entering into a new mortgage contract, but their circumstances, or commercial changes to the lending environment.

3.359 We propose to allow an exception to the 'no additional borrowing' condition, but only where the security is at risk if repairs or maintenance work is not carried out. In this situation, which we would expect to be a rare occurrence, the existing lender (and **not** another lender) would be able to advance additional funds to be used to repair the property. This will protect both the borrower and the lender. In this circumstance the lender must obtain evidence of the cost of the essential repairs. The other conditions remain in place, including that there should be a good payment history and the lender is not aware of any facts indicating that the borrower will be unable to maintain their payments. There will be no compulsion for the lender to advance additional funds on this basis.

3.360 We have considered whether it might be beneficial to allow borrowers to benefit from these transitional arrangements where the regular payments under the new mortgage will be higher than the existing mortgage. For example, where the new payments on a fixed rate are higher than the consumer's existing SVR. In an environment where rates are rising, it could be argued that the consumer might be protected by fixing their rate, even if it results in higher payments, as the SVR might end up being higher than the fixed rate. Our current view is that full affordability requirements should only be waived where the monthly payment will not be higher.

143 Subject to our wider requirements for the rolling-up of fees. See Chapter 5 (paragraphs 5.118 and 5.121 to 5.134) for more information

3.361 We are not proposing to allow material changes to be made to the mortgage contract when entering into a new mortgage contract under these arrangements, for example, a change to term or repayment type. This is because we are concerned that the transitional arrangements might be used to disguise other amendments to the mortgage which might materially affect affordability, and which the lender may not agree to under their normal processes (for example, extending the term of the mortgage beyond state pension age without giving adequate consideration to the circumstances of the borrower or changing to an interest-only mortgage without considering how the capital will be repaid). This does not mean that borrowers cannot make changes to their mortgage, but rather that the lender should make an informed decision about such changes, according to their normal processes.

3.362 However, we recognise that it could be argued that material changes to the mortgage should be permitted under the transitional arrangements, in some circumstances, if it does not put the borrower in a worse position. For example, allowing removal of a borrower following a divorce, given that, from a legal point of view, both borrowers are jointly and severally liable for the mortgage debt anyway, and so the borrower would not be in worse position. We would welcome feedback on this.

3.363 In line with their obligation to treat their customers fairly, we would expect lenders to offer their existing borrowers who remortgage under these arrangements, the same products as other existing borrowers with similar characteristics (according to that lender's product framework, where products may, for example, be priced according to characteristics such as LTV or credit score), rather than creating a separate suite of products for 'trapped' borrowers.

3.364 Where a lender is applying these arrangements to the existing borrower of another lender, we are not proposing to apply any particular restrictions to the products that can be offered, in terms of fees or rates. In practice, however, the new lender will be constrained by the fact that the monthly payment cannot be higher than the borrower's existing payment.

3.365 Where the existing lender does not offer a borrower a mortgage under these arrangements, because they have reason to believe that the borrower will not be able to maintain the mortgage payments, we will expect the lender to treat the customer fairly, and offer appropriate forbearance options, where relevant.

3.366 Before entering into a mortgage contract under these arrangements, we propose that the lender must clearly and prominently communicate to the borrower, in a durable medium (i.e. such as on paper or in a form that can be stored electronically)[144], that the new mortgage is being offered as an exceptional arrangement outside normal lending criteria, on the basis that the borrower has demonstrated that they can afford the mortgage by keeping their existing mortgage payments up to date for at least the last 12 months. We do not propose to prescribe in detail how the lender should do this. However, the lender may satisfy this requirement by disclosing this information in the mortgage offer document.

144 See FSA Handbook glossary for full definition of a durable medium: http://fsahandbook.info/FSA/html/handbook/Glossary/D

3.367 We will expect lenders to take all reasonable steps to establish whether the applicant meets the eligibility criteria for the transitional arrangements. While this may be straightforward for the current lender, we recognise that it may be less so for a new lender.

3.368 Checking the payment history should not be a problem, as the lender can check this using sources such as a credit reference agency or a mortgage statement or reference. However checking that the mortgage was in place prior to implementation of the MMR, and details of the mortgage such as the balance, the term and the repayment method will be less straightforward, particularly if the mortgage has already been moved under the transitional arrangements.

3.369 Therefore, where a lender uses these arrangements to enter into a mortgage with a customer of another lender they should keep a record of the current balance, term and repayment type at the beginning of the new mortgage for the life of the mortgage, so they can pass it on to the next lender should the borrower wish to take advantage of these arrangements again.

3.370 We propose to require lenders to set out how they apply the transitional arrangements as part of their responsible lending policy.

3.371 Record-keeping requirements will apply to:

- evidence of the payment history of the borrower;
- the term, repayment type, parties to the mortgage, and outstanding balance of the mortgage when the transitional arrangement is entered into by the lender; and
- evidence of the cost of repairs (where additional funds are being advanced for essential repairs).

3.372 Further information on record-keeping requirements are set out above in paragraphs 3.334 to 3.341.

Q15: Do you have any comments on our proposed transitional arrangements? Do you think they will be sufficient to address risks to consumers? Will they create any additional risks to consumers?

Q16: Do you think that there is sufficient protection for mortgage borrowers who are 'trapped' with their current lender? If not, what additional protection do you suggest?

Q17: Do you think the eligibility requirements are appropriate? Should we allow these transitional arrangements to be used where the new monthly payment is higher?

Q18: Should we allow the transitional arrangements to be used where there is a material change to the mortgage, such as the removal of a borrower following a divorce? How could gaming be prevented?

Q19: Do you think these arrangements will be practical to implement? How could they be improved or simplified?

Q20: Do you agree that the draft rules on responsible lending in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012*, at Appendix 1, reflect the stated policy intention?

Summary of the affordability proposals

3.373 Our proposed affordability rules as set out above are less prescriptive than those we proposed in the CP10/16. However, taken altogether, they represent a considerable strengthening of the conduct standards expected of firms, compared with the existing responsible lending requirements, as illustrated below.

SUMMARY OF EXISTING AFFORDABILITY RULE[145]

- A lender must be able to show that before deciding to enter into, or making a further advance on a regulated mortgage contract, account was taken of the customer's ability to repay.
- The lender must make and retain for a year an adequate record to demonstrate this.
- In taking account of a customer's ability to repay, a lender may rely upon self-certification of income in circumstances where the lender considers it to be appropriate, having regard to the interests of the customer and where the lender has no reasonable grounds for doubting the information provided.
- A mortgage lender must put in place and operate in accordance with a written policy setting out the factors it will take into account in assessing a customer's ability to repay and must make, keep up to date and retain for a year from change an adequate record of the policy.

145 For full text of the existing responsible lending rules see Mortgages and Home Finance: Conduct of Business sourcebook Chapter 11 http://fsahandbook.info/FSA/html/handbook/MCOB/11

SUMMARY OF THE MAIN FEATURES OF THE PROPOSED NEW AFFORDABILITY RULES[146]

Before entering into a regulated mortgage contract or a making a further advance, a lender must:

- assess whether the customer will be able to repay the sums and interest advanced; and
- be able to demonstrate that the mortgage is affordable for the customer.

When assessing affordability, the lender:

- must not rely on:
  - an expected increase in property prices; or
  - equity in the property except in circumstances where the release of equity is part of a credible repayment strategy;
- must take full account of:
  - the net income of the customer;
  - the customer's committed expenditure; and
  - the basic essential expenditure and basic quality of living costs of the customer's household.

The lender must also:

- take account of likely future interest rate increases on affordability; and
- assess affordability on a capital and interest basis except where, for an interest-only mortgage, the lender has assessed that the customer has a clearly understood and credible repayment strategy.

In addition:

- record keeping requirements will be extended to three years;
- lenders will be required to have a responsible lending policy; and
- lenders will be required to monitor and audit the effectiveness of their affordability assessments.

146 See Appendix 1, draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6

4

Interest-only mortgages

Summary of key proposals

- Generally lenders must assess affordability on a capital and interest basis.
- Lenders may assess affordability on an interest-only basis where there is a clearly understood and believable alternative source of capital repayment.
- Where the repayment strategy requires the borrower to make regular payments from income, lenders must assess affordability taking the cost of the repayment strategy into account.
- Lenders must obtain evidence of the repayment strategy before entering into the interest-only mortgage and check, so far as they reasonably can at that point, that the repayment strategy is credible and has the potential to repay the capital and interest where applicable.
- Lenders must check on the repayment strategy at least once during the term.

Introduction

4.1 Although we have raised issues about interest-only mortgages in previous MMR papers, this is our first formal consultation on our interest-only proposals.

4.2 Our proposed approach is based on the market's reaction to the proposals outlined in the MMR Discussion Paper (DP09/3[147]) and our consultation on responsible lending (CP10/16[148]); our subsequent discussions with stakeholders; and our further policy analysis. We would particularly like to thank the Council of Mortgage Lenders (CML) and those lenders who participated in an interest-only industry working group, which provided helpful market input as we developed our proposals.

147 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf
148 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf

4.3 The *MMR Data pack*, published as a separate supplement to this paper, includes a section on interest-only mortgages.[149] Unless otherwise indicated, all data and exhibits referred to in this chapter are from that data pack.

4.4 The cost benefit analysis (CBA) and compatibility statement for these proposals is set out in Annex 1 and Annex 3 respectively. The draft rules are in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1.

Background

4.5 Under an interest-only mortgage, the principal sum borrowed becomes payable in full only at the end of the mortgage term. So the borrower pays the scheduled interest payments only and must make separate arrangements to repay the capital.

4.6 The repayment of capital is usually funded through the borrower's income, whether invested during the term and used to repay the mortgage at maturity or used to periodically reduce the capital balance during the term. Repayment of capital may also be funded by capital resources already held by the borrower, such as the sale of a second property or another asset. In some cases, the sale of the mortgaged property itself may be used to repay the mortgage.

4.7 Before the 1980s interest-only mortgages were a relatively small part of the market. Then it became a mainstream product in the form of endowment mortgages. Rather than pay a sum from income towards the capital each month, the borrower could make a payment towards an endowment policy. The endowment was designed to pay a lump sum at the end of the mortgage term sufficient to meet the capital repayment, plus an extra capital amount.

4.8 When assessing a consumer's ability to repay, lenders took account of the regular payment into the repayment vehicle. They also took an assignment of the investment policy, which meant that they were legally entitled to use the endowment proceeds to pay the capital sum at the end of the term. So lenders had some degree of certainty that the capital sum would be repaid. They also often charged a premium on the interest rate to protect themselves against the increased risk of being paid interest-only throughout the term.

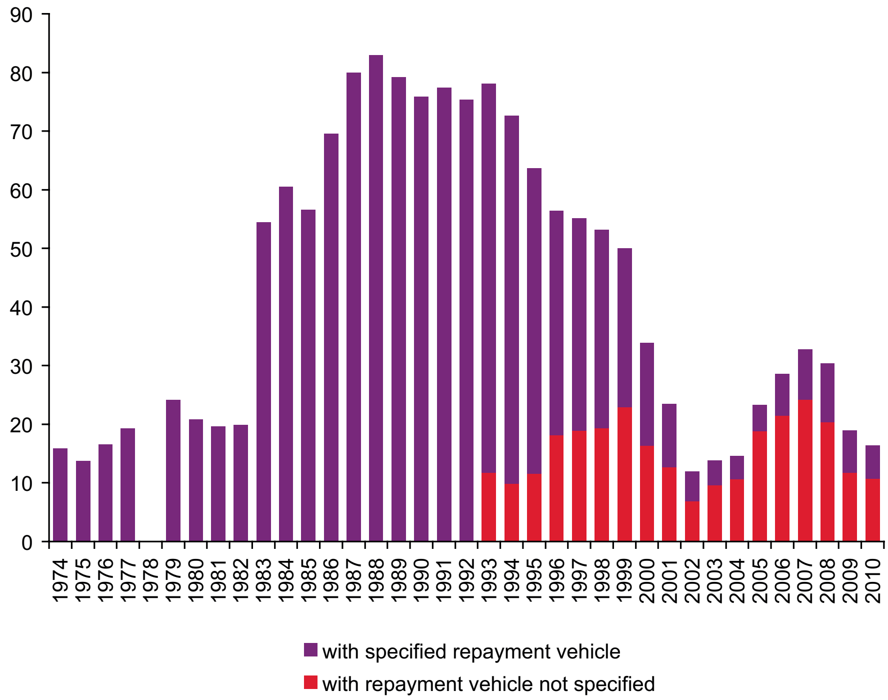
4.9 During the mid 1980s to early 1990s, this type of mortgage appeared attractive because of high interest rates and a favourable investment environment and it became the favoured choice of repayment. The sale of interest-only mortgages rocketed, accounting for over 80% of mortgage sales in 1988, as illustrated in Exhibit 9.

4.10 However, over time, endowment mortgages became less popular following reductions in interest rates and projected investment returns. And the issues around endowment mis-selling and shortfalls have been well documented. By 2002, interest-only mortgages accounted for just over 10% of mortgage sales.

149 MMR *Data pack* (December 2011): www.fsa.gov.uk/pubs/other/mmr_datapack2011.pdf

4.11 In the run up to 2007, as discussed in Chapter 2, we went through a prolonged period of house price increases, during which time lenders increasingly relaxed their lending criteria. Assignment of investment policies became less common, as the extra administrative cost was seen as unnecessary because of the cushion of equity provided by rising property values. From around 2001 onwards, a new variant of interest-only grew rapidly. This was quite different from the endowment mortgage product.

Exhibit 9: Interest-only lending, % of all new loans for house purchase, by year



Note: Data for 1978 is not available
Source: CML

4.12 Lenders became less strict about the repayment strategies accepted, and moved towards a purer form of interest-only lending. In particular, the sale of the mortgaged property itself began to be increasingly accepted as a repayment strategy, based on an assumption that equity in the property would grow to the extent that the borrower would not have any trouble repaying the capital at the end of the term, and would be able to fund future accommodation plans.

4.13 Consumers had an incentive to take interest-only mortgages, as this was a means by which they could increase their borrowing capacity at a time when property prices were rapidly out-pacing wage increases.[150] Competitive pressures and continued house price rises perpetuated this cycle.

150 See Exhibit 3.5: Average house prices and average earnings

4.14 Therefore the sale of interest-only mortgages grew once again, peaking at a third of all mortgage sales in 2007, as shown in Exhibit 9. But this time, unlike in the 1980s and 1990s, many of these mortgages were not tied to a tangible method of repayment. In 2007 around 75% of interest-only mortgages had no reported repayment vehicle.

4.15 Sales of interest-only mortgages have declined sharply since their peak in 2007, and today account for less than 20% of mortgage sales. As we noted in CP10/16, in a buoyant mortgage market, lenders can rely on consumers remortgaging elsewhere long before they reach the end of their mortgage term. In today's subdued market conditions, however, the restricted availability of remortgages and low standard variable rates have given consumers less incentive to remortgage. As a result, we have seen lenders take action to restrict their criteria for new interest-only lending by narrowing the range of acceptable repayment strategies and loan-to-value (LTV) ratios.

4.16 There is a range of different types of interest-only borrower, some for whom interest-only is perfectly appropriate, and some for whom it is not.

Exhibit 10: Sale of regulated interest-only mortgages in 2009-2010

Distribution, by LTV band

	Interest-only
<50%	34%
50%-75%	47%
75%-90%	18%
90%+	1%
All LTVs	100%

Percentage, by income group

	Interest-only
< £20K	16%
>= £20K < £30K	14%
>= £30K < £50K	17%
>= £50K < £100K	24%
>= £100K	43%
All incomes	21%

Percentage, by borrower type

	Interest-only
Right-to-buy	12%
First-time buyers	9%
Home movers	23%
Remortgagors	25%
All borrower types	21%

Average mortgage size, £

Interest-only	Other mortgages	All mortgages
191,293	122,512	136,966

Average borrower's age, years

Interest-only	Other mortgages	All mortgages
46	39	40

Source: FSA PSD

4.17 It is noticeable from Exhibit 10 above that for interest-only mortgages, on average, LTVs are lower, loan sizes slightly higher, income sizes higher and borrowers slightly older. This may illustrate an appropriate use of interest-only mortgages by borrowers with sufficient equity to repay. But it is also important to note that there is a significant percentage of interest-only borrowers in high-LTV bands and with lower incomes. It is also noticeable that the percentage of borrowers having interest-only mortgages is least for first-time buyers (FTBs), which means that the introduction of the interest-only proposals is likely to have the least impact on this sector.

4.18 Many consumers with no repayment strategy in place propose to rely on future house price increases or uncertain life events to repay their mortgage, and some have no plans at all. One consumer survey found that over 50% had uncertain plans, including 28% who were relying on sale of the mortgaged property, 21% intending to change to a repayment mortgage, and 6% who did not know how they proposed to repay the mortgage.[151] Consumer research also indicates that current interest-only borrowers have an increased reliance on uncertain methods of payment compared to those home-owners who have already repaid an interest-only mortgage.[152] This is concerning given that today's borrowers may well find themselves less able to rely on property inflation to erode the value of the outstanding capital than the previous generation of interest-only borrowers.

4.19 In general, the risk of interest-only lending does not translate into high arrears rates, because mortgages are more affordable, in terms of their monthly mortgage payments than an equivalent repayment mortgage. The risks typically crystallise many years later, at the end of the term, when the capital is due for repayment.

4.20 In the next 10 years, we estimate that around 1.5m interest-only mortgages worth around £120bn will be due for repayment.[153] The risk of an increasing number of interest-only mortgages reaching maturity without adequate repayment strategies is likely to pose a significant challenge for both consumers and lenders alike over the coming years.

Interest-only mortgages and affordability

4.21 In DP09/3, we suggested that affordability of interest-only mortgages should always be calculated on a capital and interest basis. This was to ensure the affordability of interest-only mortgages and also prevent gaming of our tightened approach to affordability assessments generally.

4.22 The feedback received supported the idea that most mortgage applications should be assessed on a capital and interest basis. However, commentators also felt that there are circumstances where interest-only can be appropriate.

4.23 In CP10/16, we therefore opened up a discussion about the circumstances in which an assessment on an interest-only basis may be appropriate. The view we expressed was that this could only be where there was a realistic and credible capital repayment method in place. By a 'valid repayment method' we explained that we meant a credible 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.

151 See Exhibit 11.18: Owners with interest-only mortgage and no linked investment: how they propose to repay the mortgage (2007/08)
152 See Exhibit 11.17: Intended plans and realised plans for interest-only mortgagors
153 See Exhibit 11.25: Number of interest-only mortgages maturing in the next ten years

4.24 We received a wide variety of views on this. Consumer representatives felt that any exceptions to the general rule that affordability should be assessed on a capital and interest basis should be kept to an absolute minimum, to ensure robust affordability checks in every case and to prevent creating loopholes which could be readily exploited. At the other end of the spectrum, a few respondents felt that as long as a consumer is comfortable with an interest-only mortgage, assessment on an interest-only basis should be an acceptable option, and that anything more would interfere with the consumer's right to make their own decisions.

4.25 Most commentators agreed, however, that affordability should be able to be assessed on an interest-only basis where there is a repayment strategy in place. Suggestions for an appropriate strategy included the sale of second homes, investment properties, or other saleable assets, or a certain inheritance (e.g. a family trust fund). Some also suggested the sale of the mortgaged property, particularly where borrowers have sufficient equity in their property to repay their mortgage and buy a smaller property.

4.26 Having considered the issues further and analysed in more detail the characteristics of interest-only borrowers, we are going ahead with the proposal that, while as a general rule mortgages should be assessed on a capital and interest basis, where a consumer has a clearly understood and credible strategy to repay the capital at the end of the term, affordability may be assessed on an interest-only basis.

4.27 Where the repayment strategy requires the borrower to make a continuing financial commitment, such as making payments into a savings or investment policy, we are proposing that the affordability assessment must take the cost of this into account as 'committed expenditure'[154] in the normal way.

4.28 We recognise that the cost of repayment strategies can vary greatly, and is not always in line with the cost of a capital and interest mortgage, particularly over shorter terms. However, we continue to believe that the cost of repaying the capital should be recognised in the affordability assessment. This is an approach already adopted by many lenders. Moreover, it is consistent with the approach that the draft Financial Stability Board (FSB) principle on debt service coverage proposes in its consultation on the development of a principles-based framework for underwriting.[155]

4.29 Where the repayment strategy does not require further funding from the consumer during the mortgage term, we propose to allow lenders to assess affordability on an interest-only basis, but only where they have evidence of the capital repayment strategy the consumer proposes to use.

Q21: What is your view on our approach to assessing affordability for interest-only mortgages?

154 See Chapter 3, paragraph 3.162

155 *FSB Principles for Sound Residential Mortgage Underwriting Practices*, Financial Stability Board, (October 2011): www.financialstabilityboard.org/publications/r_111026b.pdf

Interest-only mortgages and different consumer types

4.30 As Exhibit 10 illustrates, interest-only mortgages are popular among a diverse group of consumers, who may have very different motivations for taking interest-only mortgages, ranging from:

- higher income, wealthier and older consumers often using interest-only mortgages as a way of borrowing against already accumulated housing wealth; and
- consumers using interest-only mortgages to stretch their commitments and therefore buy more expensive properties.

4.31 For some consumers, therefore, interest-only mortgages are clearly a sensible option. But for others they are not. The regulatory challenge is to meet these diverse needs and have a regime which allows consumers to access the obvious benefits of interest-only while at the same time protecting others from the clear risks.

4.32 In CP10/16, to help inform our policy approach to interest-only mortgages, we asked for views on whether there were particular consumer types who would benefit from interest-only mortgages and where we might take a different approach. We suggested, for example:

- FTBs 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; and
- high net worth (HNW) or financially capable consumers who have the means to repay capital, for example through realising their assets, whether the mortgaged property itself or other assets.

4.33 Most commentators agreed with this list of customer types who could benefit from interest-only, but also felt that within each type there would be some consumers who would benefit, and some who would not. The consensus was that it would not be appropriate to classify consumers for regulatory purposes, due to the wide variation in their circumstances. They thought that an individual assessment of consumer circumstances was more important than defining broad consumer types.

4.34 We also asked for views in particular, on whether some form of interest-only mortgage without a repayment strategy might be appropriate for FTBs, on a temporary basis, to keep their initial payments low, while they set up their new homes.

4.35 Views on this were mixed. Some saw a clear benefit in helping FTBs on to the housing ladder, providing them with flexibility and keeping payments low, particularly where incomes are likely to increase significantly over the short to medium term (e.g. certain newly-qualified professionals). However, others felt that FTBs were particularly vulnerable to the risks of interest-only, through their potential inexperience in financial management, and some questioned whether interest-only mortgages could ever be considered appropriate for FTBs.

4.36 Having taken account of all of the views received, we agree that an individual assessment of consumer circumstances is more important than defining broad consumer types and therefore have not proposed to change our requirements according to the type of consumer.

4.37 Nor do we propose to make any specific provision in our rules for short-term interest-only products for FTBs without a repayment strategy. This suggestion did not get strong support and we agree that there is a potential for significant payment shock when these borrowers return to a higher level of payments. There is also a gaming risk that consumers use this as a route to access interest-only mortgages without having a credible repayment strategy in place.

4.38 We have also taken note of the fact that only a relatively small proportion of FTBs take on mortgages on an interest-only basis today. At the peak of the market, in 2007, it was significant with 30% of FTBs taking an interest-only mortgage. This has dropped to less than 4% today.[156]

4.39 Finally, as we are no longer proceeding with the proposal to limit the assessment of affordability to a maximum 25 year term, there will be an option for FTBs to repay on a capital and interest basis over a longer term as an alternative to keeping costs down through an interest-only mortgage.

Q22: Do you agree that we should apply a consistent approach to regulating interest-only across the board and that we should not adapt our approach according to different consumer types?

Interest-only mortgages as an alternative to renting

4.40 During the consultation process, several respondents (including intermediaries and a trade body) expressed the opinion that interest-only mortgages, where there is no repayment strategy, should be available to offer consumers an alternative to renting. The suggestion was that this would offer a valuable option for consumers, particularly where interest-only mortgage payments are cheaper than equivalent

156 Source: FSA PSD Q3

rental payments, offering consumers stability in their housing and the opportunity to benefit from rising property prices.

4.41 Lenders, however, did not appear to have any appetite for this type of product, and it is not clear whether it would be commercially viable. It would tie-up capital for long periods of time, and there would be a risk that properties would be in poor condition at the end of the term, as property maintenance during the term would be the responsibility of the borrower. Lenders would also risk the costs and reputational damage that could arise if borrowers did not (or were unable to) sell the property at the end of the term and the lender had to repossess.

4.42 We therefore do not propose to make specific provision for this type of product in our interest-only rules.

Repayment strategies

4.43 In CP10/16, we asked how prescriptive we should be in defining what constituted a valid repayment strategy. Views were polarised on this. A small group of commentators – mainly consumer representatives who deal with vulnerable consumers, some smaller firms and some individual consumers – strongly supported a prescriptive approach to defining repayment strategies. Consumer representatives, in particular, thought a prescriptive approach was necessary, to safeguard those vulnerable consumers who either do not clearly understand the need to make separate arrangements to repay the capital, or who cannot realistically afford to make such arrangements. Others who supported prescription felt it would reduce ambiguity around what constitutes a valid repayment strategy and would create consistency across the market.

4.44 However, the majority of respondents – including most trade bodies, lenders, intermediaries, and some consumer representatives – did not support a prescriptive approach. The biggest concern for most was that a prescriptive approach would limit flexibility and lead to a 'one size fits all' market, unable to cater for the diverse needs of consumers. While recognising that prescriptive measures may protect particularly vulnerable consumers, respondents felt that consumers in general would be disadvantaged and choice restricted if potentially valid repayment strategies were excluded.

4.45 There was a concern that it would be difficult to capture all relevant repayment strategies in an exhaustive list of 'acceptable' strategies, particularly given that some repayment strategies may be 'bespoke' according to the circumstances of the consumer. Some had practical concerns about keeping a defined list of valid repayment strategies up to date, given constantly changing market conditions. Several were also cautious about defining any repayment strategy as being 'valid', as it might give the impression that it had a higher level of reliability (in terms of certainty of repaying capital) than might actually be the case. This might mislead consumers or give them a false sense of security.

4.46 We recognise that consumers can benefit from a wide variety of repayment strategies, which may vary greatly according to the particular needs and circumstances of the consumer. So we are not proposing a prescriptive approach to repayment strategies. We agree that a preferable approach is to allow lenders to consider repayment strategies according to the individual circumstances of each consumer, within a framework of appropriate controls. Examples of possible repayment strategies include:

- regular savings into an investment product;
- sale of other assets, such as property or other land owned;
- periodic repayment of capital from irregular sources of income (such as bonuses or some sources of self-employed income);
- on death, for example in the case of a lifetime mortgage; or
- sale of the mortgaged property, where this is a credible strategy because of down-sizing or repayment at death.

4.47 In our view, the most important point is that the repayment strategy must be credible given the circumstances of the consumer. For example, a consumer who usually receives an annual bonus of £1,000 is unlikely to be able to repay a mortgage of £100,000 through their bonuses; and a consumer living in a small property in an area of low house prices is unlikely to be able to downsize from the proceeds of the sale of their property.

4.48 We also believe that purely speculative strategies should not be accepted, such as reliance on increasing house prices, or an expected, but uncertain, inheritance. Our concern about repayment strategies that rely on house price appreciation is echoed in the draft mortgage underwriting standards being developed by the Financial Stability Board.[157]

4.49 This leaves a wide variety of possible repayment strategies to repay the capital, whether as a lump sum at the end of the term (or earlier), or as a regular or occasional method of reducing the capital. We have included a non-exhaustive list of possible repayment strategies in the draft rules.[158]

Q23: Do you agree with our non-prescriptive approach to repayment strategies, or do you have any comments on this approach?

157 FSB Principles for Sound Residential Mortgage Underwriting Practices, Financial Stability Board, (October 2011): www.financialstabilityboard.org/publications/r_111026b.pdf

158 See Appendix 1 draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6.28G

Controls on repayment strategies

4.50 We also asked in CP10/16 for views on the controls we should put in place around interest-only lending. Most respondents agreed that there should be some form of control on repayment strategies. Consumer representatives and individual consumers tended to favour controls set through regulation. Consumer representatives were particularly concerned about the long-term consequences of interest-only, such as shortfalls at the end of term and consumers carrying debts into retirement. They felt that repayment strategies should be robustly controlled, and also saw a role for consumer education in helping consumers understand their responsibility for repaying the capital.

4.51 Most respondents did not, however, support the application of across-the-board controls through regulation. Lenders, trade bodies and intermediaries preferred an approach where lenders set their own controls, tailored according to the consumer segments they serve. While many respondents could see the benefit in some use of controls, such as LTV or minimum equity requirements, they felt many other factors could come into play. For example, where the mortgaged property is being used as the repayment strategy, regional variations in property prices may be a significant factor, because they may affect the likelihood of any set percentage of equity (say 30%) being enough to buy a smaller property at the end of the term. The wide variety of consumer circumstances also impacts on the relevance of particular repayment strategies for particular consumers, for example employment or family situations, or property related issues (such as the number of bedrooms in the property when considering downsizing).

4.52 Therefore, many respondents felt that setting caps would be arbitrary and would unnecessarily exclude some consumers. Instead, they favoured lenders setting their own controls, which would allow tailoring according to factors such as regional variations, consumer type and specific consumer circumstances.

4.53 Our view is that lenders should apply relevant controls to each type of repayment strategy they accept but we agree that lenders should be allowed to set appropriate controls themselves. Examples of controls that might be used include:

- maximum LTV limits;
- minimum equity requirements; and
- in some cases, regional factors, such as property prices.

4.54 We have particular concerns about the sale of the mortgaged property as a repayment strategy during the life of the borrower. While in some circumstances this may be an acceptable strategy, it poses risks for both the lender and consumer. The consumer will need to sell and leave their home at the end of the term – which is far easier to state as an intent at the outset of the mortgage than when the time comes. If a borrower wishes to downsize at the end of the term, but does not have enough equity to buy a smaller property, they may find themselves in difficulty, particularly if they have reached the end of their working life and have not budgeted for ongoing housing costs in retirement.

4.55 Lenders should consider whether it is reasonable to expect the property to have the potential to provide sufficient funds to repay the mortgage and also enable the borrower to buy a cheaper property to live in, for example, without relying on increased property prices. When making this assessment, the lender may wish to consider factors such as the equity in the property in relation to property prices in the relevant area.

4.56 In addition, to ensure that lenders appropriately control their interest-only lending and have a clear framework in place to assess interest-only applications, we are proposing that they must operate within a clearly defined interest-only policy, which should form part of their wider responsible lending policy. This policy should be considered and signed-off at Board level, and should clearly outline:

- the repayment strategies accepted;
- the controls in place for each accepted repayment strategy type;
- the lender's appetite for interest-only lending, in terms of expected volumes of business and proportion of their overall lending, over what period, and when this will be reviewed;
- the procedures for checking the adequacy of the repayment strategy, including the evidence of the repayment strategy required at application stage;
- the procedures for checking the status of the repayment strategy at least once during the term (discussed below); and
- the arrangements for monitoring and auditing compliance with the policy.

4.57 Full requirements for lenders' interest-only policies are set out in the draft rules in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1.[159]

Q24: Do you agree that lenders should be free to set their own appropriate controls around repayment strategies?

Q25: What is your view of our proposals for lenders' interest-only policies?

159 See Appendix 1 draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6.33R

Assessing the repayment strategy

4.58 In CP10/16 we stated that 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, we also thought that it seemed important for the lender to monitor the existence and adequacy of the repayment method throughout the life of the mortgage. We asked for views on both of these issues.

4.59 Most of those commenting on this agreed in principle that lenders should undertake some degree of assessment to check that there is a valid repayment strategy in place at the start of the mortgage, with some emphasising that a thorough assessment at application stage is critical in minimising the risks that might occur later in the term. However, some lenders and trade bodies were concerned about the depth of the assessment that they might be required to undertake, and the costs and risks that might arise from this. They were then concerned that costs and risks would multiply if further checking was required throughout the term.

Assessing the repayment strategy at application stage

4.60 Lenders and trade bodies had particular concerns about being required to assess the adequacy of investment products to repay the capital. They felt this would be a difficult task, given the long-term nature of mortgages and the volatility of markets, and their assumptions may, in the fullness of time, turn out to have been inaccurate. In addition, lenders generally felt that their staff are not qualified to make such judgements. They were also concerned that making this type of judgement may be seen as investment advice, and consumers may see them as liable for subsequent poor performance even where, as in the majority of cases, the lender had not sold the investment product. Some also felt that assessment of the repayment strategy by the lender at application (and then possibly throughout the term), might be another factor that would give borrowers a false sense of security, encouraging them to be complacent about their own responsibilities for monitoring performance. Some lenders emphasised that while they accept the risk that some borrowers will be unable to repay loans in full on maturity, ultimate responsibility for repayment should lie with the borrower.

4.61 Therefore, many lenders felt that any requirement for checking the repayment strategy should not give the impression of endorsing it or its ability to repay the capital. Instead they preferred an approach where lenders would be required to conduct a high-level assessment of the plausibility or reasonableness of the repayment strategy, such as whether it had the potential to meet the final capital balance. For example, one lender suggested that in the case of a pension mortgage, the lender should check the pension is in place, the maturity date is in line with the maturity date of the mortgage, and the maturity value detailed in the illustration is sufficient to repay the capital.

4.62 We recognise that interest-only mortgages will always carry risk, and that repayment of the capital cannot be guaranteed. This may be because the repayment strategy does not perform as expected, or because the borrower does not act as they have agreed (i.e. they do not fund the repayment strategy). Lenders are not able to eliminate all possible risk, and we do not expect them to do so. The repayment of a mortgage is the ultimate responsibility of the borrower. However, we do not expect lenders to enter into interest-only mortgages where the repayment strategy is clearly inadequate. And we believe that risks to both the consumer and the lender will be significantly reduced if lenders assess the repayment strategy, in line with a consumer's particular circumstances and their own lending policy, before entering into a mortgage on an interest-only basis.

4.63 This is why we are proposing that lenders must obtain evidence of the repayment strategy before entering into the mortgage, and that they lend only where, as far as they are reasonably able to assess, it is has the potential to repay the mortgage. We also propose that the lender must keep a clear and detailed record of each decision to lend on an interest-only basis, going beyond a tick-box approach, including the reasons behind the decision.[160]

4.64 We do not expect lenders to predict the future, but we do expect them to make an informed decision in line with their interest-only policy. We do not propose to be prescriptive around the evidence that the lender must obtain, but we will expect lenders to set this out, for each type of repayment strategy they accept, in their interest-only policy.

4.65 In relation to concerns raised in comments about lenders' staff not being qualified to assess repayment strategies (for example, mortgage processing and underwriting staff are unlikely to be investment or pension experts), this is a matter for the lenders to manage appropriately. Their approach is likely to vary according to the type of assessment that the staff member is carrying out, for example, staff fact-checking within the framework of a clear policy may need a different skillset to those undertaking a bespoke or in-depth analysis.

4.66 Some lenders and trade bodies expressed strong concerns over the increased costs that checking repayment strategies would incur, in terms of increased processing time, increased headcount, additional training requirements and possible systems changes. These costs would rise accordingly subject to the frequency of any subsequent checks required during the term. Several lenders suggested that the additional costs and risks involved, particularly if combined with periodic checking, would be high enough to make them leave the interest-only market, therefore restricting consumer choice.

4.67 We accept that collecting evidence and assessing the repayment strategy is likely to increase costs to lenders, and these costs may then be passed to consumers.

160 See Appendix 1 draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6.42R(3)

However, we believe that the benefits, in terms of better understanding of the risks and preventing lending where there is no credible repayment strategy, will outweigh the costs.

Q26: What are your views on our approach to requiring lenders to assess the repayment strategy prior to entering into the mortgage?

Periodic checking

4.68 There was mixed support for lenders being required to check the repayment strategy periodically through the term of the mortgage, with lenders and trade bodies in particular opposing this. Those supporting this suggestion had a variety of views about how often this should be done, ranging from annually, to every five to ten years, to once during the term.

4.69 Many respondents thought that checking of repayment strategies was more relevant in the mid to latter years of a mortgage (such as year 15 of a 25 year term). However, they thought this should be balanced with the need to consider remedial action at a point where there was still time for action. So, the optimum time to check may vary according to factors such as term and expected retirement age. However, some respondents noted any check would only offer a snapshot in time and would not guarantee ultimate repayment of the capital.

4.70 Some thought checks could be tied into specific trigger points, such as the end of the initial fixed or discounted period, a change in product, an application for further borrowing, a set number of years before retirement, or upon a change in the circumstances of the borrower.

4.71 We are proposing that lenders must strengthen their management of interest-only lending over the mortgage term, by requiring the lender to contact interest-only borrowers at least once during the term of the mortgage, to establish whether a repayment strategy remains in place and it is still reasonable to expect that it has the potential to repay the mortgage (except where there the repayment strategy is certain, such as on death for a lifetime mortgage, where this requirement will not apply). The purpose of this check is to raise awareness of potential issues, to both the lender and borrower, so that they can work together to consider a way forward if there appears to be risk of a shortfall. We recognise that there could be limited options available to remedy the situation, but we believe there is value in being alerted to potential issues when there is at least some time to consider remedial action, rather than waiting until the end of the term where options may be even more limited.

4.72 We do not propose to prescribe the point when this check should happen, so that lenders can design the process to take advantage of natural contact points, when contact is made with the borrower for other reasons, or where the borrower is likely to contact the lender. The contact point may vary, according to factors such as the term of the loan and the age of the borrower. However, the review must be carried out at a stage in the term where there is likely to be time to take steps to address the situation.

4.73 Several issues were raised in feedback about the practicalities of periodic checking, in particular the difficulties of obtaining up-to-date and reliable information from borrowers. Many thought that response rates would be low, particularly from borrowers without a valid repayment strategy. Lenders questioned the number of times they would be required to attempt contact with borrowers, and the action they would take where no response was received. Some respondents thought that borrowers would be more likely to engage at a point where they initiate contact with the lender, rather than vice versa, and therefore this would support making use of such trigger events.

4.74 We recognise that some borrowers will not respond to contact from the lender. In this situation we would expect lenders to make reasonable efforts to contact the borrower. The lender's policies should state what their procedures are in this situation. The lender may, for example, set a trigger to discuss this matter the next time it is contacted by the borrower.

4.75 Respondents were also concerned about assessing the status of a repayment strategy during the term, particularly investment products which may not grow in a linear fashion. Therefore, performance at any particular point in time might not be an accurate indicator of ultimate performance. They also questioned the action that would be taken if a repayment strategy was found not to be on track to repay the mortgage. Lenders were concerned that they would be limited by contractual issues and legal/regulatory requirements such as Principle 6 (Customers' interests)[161] and the Unfair Terms Regulations.[162]

4.76 Others were concerned about consumers being mistreated or exploited as a result of a repayment strategy not being on track, for example being pressured into buying alternative repayment vehicles, or being offered less favourable mortgage terms, particularly if they could not remortgage away to a different lender.

4.77 When considering how to remedy the situation, we will expect lenders to continue to treat their customers fairly, as well as complying with relevant regulations such as the Unfair Terms Regulations.

161 Principle 6 (Customers' interests): http://fsahandbook.info/FSA/html/handbook/PRIN/2/1
162 Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083), as amended by SI 2001/1186 and SI 2001/3649: www.legislation.gov.uk/uksi/1999/2083/contents/made

4.78 The procedures for undertaking this check must be set out in the lender's interest-only policy. This must cover:

- when the review should take place;
- the content of the review (including what questions are asked of the borrower);
- how it is decided whether the repayment strategy still has the potential to repay the mortgage;
- the steps to be considered if there is no longer a reasonable expectation that the repayment strategy will repay the mortgage, based on the individual circumstances of the borrower; and
- the actions taken if the borrower does not cooperate with the review (e.g. they do not respond to contact from the lender).

4.79 These proposals for the ongoing management of interest-only mortgages will apply only to new mortgage lending undertaken when the rules have come into force. They will not apply to existing interest-only loans.

4.80 We propose that lenders should keep a record of the result of the check for the remainder of the term.

4.81 We do not propose to change the disclosure requirements around interest-only mortgages, for example, in the annual statement. These will remain as they are, subject to some minor consequential changes as set out below.

Q27: What is your view of our proposals for the ongoing management of interest-only loans? Do you foresee any practical issues?

Interest-only as a forbearance method

4.82 We do not propose to restrict interest-only from being used, where appropriate, on a temporary basis as a forbearance method for borrowers with, or at risk of, payment difficulties.[163]

Handbook definitions

4.83 A variety of terms are in use to describe the method used to repay the capital for an interest-only mortgage. These include 'repayment vehicle', 'repayment method' and 'repayment strategy'.

163 See Appendix 1 draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6.26R

4.84 These terms can mean different things to different people. Our preferred term is 'repayment strategy'. This term reflects the variety of strategies that can be used to repay capital, beyond (but which may include) traditional repayment vehicles used in the past, such as endowments, Individual Savings Accounts, Personal Equity Plans and pensions.

4.85 We therefore propose to change the Handbook Glossary term from 'repayment vehicle' to 'repayment strategy'.

4.86 We are also proposing to make a small amendment to the definition of a *repayment mortgage*, to make it clearer that the interest-only rules apply to a mortgage where some (but not all) of the capital is repaid over the term. The proposed definition is:

'A *regulated mortgage contract* under which the *customer* is obliged to make payments of interest and capital which are designed to repay the mortgage <u>in full</u> over the stated term.'

Other consequential changes to the handbook

4.87 As a consequence of amending the glossary term from repayment vehicle to repayment strategy, a change is required to the existing rule about offer documents.[164] This currently requires the lender to state the repayment vehicle on the offer document only where the lender knows what the repayment vehicle is. Under our proposals the lender must know what the repayment strategy is in all cases. So we propose to amend the rule to reflect this. However, to avoid disproportionate costs to firms, we are proposing that this can either be in the illustration section of the offer, or the wider offer document.

4.88 There are also a number of other consequential changes, mainly to the disclosure rules, to replace the term 'repayment vehicle' with 'repayment strategy'. We do not anticipate that these changes will result in material costs to firms, as they do not result in any changes to disclosure documents.

Q28: Do you have any comments on the proposed changes to the glossary term, or the consequential changes?

Q29: Do you have any comments on the draft interest-only rules set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1? Do you think the rules reflect the stated policy intention?

164 MCOB 6.4.4R http://fsahandbook.info/FSA/html/handbook/MCOB/6/4

The impact of our proposals

4.89 We have set out our estimates of the impact of our interest-only proposals in the CBA in Annex 1.

4.90 For the purposes of modelling the impact of the proposals for the CBA we have made some assumptions, as we have limited data on borrowers' repayment strategies, and the costs of those strategies. We estimated that 40% of interest-only borrowers would be in a position to be assessed on an interest-only basis. This 40% is made up of consumers with repayment strategies that do not require additional contribution from income, such as borrowers with sufficient equity to support downsizing; borrowers with sufficient investments to repay the capital; and borrowers who intend to repay the capital on death, or on the sale of another property. We have assumed that the remaining 60% will be assessed on a capital and interest basis, either because they do not have a credible repayment strategy, or because their repayment strategy requires funding from their income.

4.91 The main impact of our interest-only rules will derive from the fact that some borrowers will be assessed on a capital and interest basis. For the purposes of the CBA we assume that borrowers with a credible repayment strategy would either:

- be able to demonstrate affordability on a capital and interest basis (because they are planning to make payments into some kind of repayment strategy on top of their interest-only mortgage payments); or
- need only to demonstrate affordability on an interest-only basis because they have a repayment strategy that does not require further funding.

4.92 Therefore, our proposals will only affect those consumers who cannot afford to pay both the capital and the interest elements of a mortgage.

4.93 As we explain in the CBA, it is not possible to measure the exact impacts of the proposals, and therefore we have designed a methodology that broadly models and illustrates the impacts we expect. For the interest-only proposals this is based on an estimation of which loans would be assessed on a capital and interest basis. The impacts are then modelled by estimating the proportion of borrowers whose debt servicing ratio[165] (DSR) would be pushed beyond a particular level if assessed on a capital and interest basis.

4.94 We noted in relation to the affordability assessment that in today's subdued market conditions 0.04% of borrowers would be affected and in a boom period, such as 2005 – 2007, this would rise to 3.6%.

4.95 The interest-rate stress-test adds a further 0.25% of borrowers in a subdued period and 4% in a boom period.

165 Debt servicing ratio is defined here as the ratio of mortgage payment to net income

4.96 The CBA estimates that applying the interest-only proposals on top of the affordability assessment and the interest-rate stress-test would add 2.2% of borrowers in subdued market conditions. In a boom period, an additional 3.7% of borrowers would be affected.

4.97 Within the group of borrowers affected by the interest-only proposals, the CBA indicates that there is a significant impact on the self-employed (2.8% in a subdued period and 11.8% in a boom period) and credit-impaired borrowers (9.6% in a subdued period and 68.1% in a boom). This reflects that these groups include a large proportion of interest-only borrowers. For FTBs by contrast, who tend not to take out interest-only mortgages, the impact is relatively small in both periods (0.4% in a subdued period and 4.2% in a boom).

4.98 We seek views in Annex 1 on both the modelling approach we have taken, and the estimated impacts.

Addressing past problems

4.99 Our interest-only proposals are forward looking, addressing issues round the future sales of interest-only mortgages. However, as we noted earlier, in the next ten years, around 1.5m interest-only mortgages, worth around £120bn, will be due for repayment.[166]

4.100 Even after a period of record property inflation there are signs that interest-only borrowers are having problems repaying capital at the end of the term. This is of particular concern where borrowers are at or near retirement without the income to be able to sustain mortgage payments indefinitely. Data from the Department for Work and Pensions[167] indicates that 52% of people claiming support for mortgage interest benefit (SMI) in 2009 were retired. While this has, so far, affected a relatively small number of consumers, this issue has the potential to increase significantly over the coming years.

4.101 Some lenders have a significant exposure to interest-only lending. Non-banks have the highest exposure, with an average of 54% of their total regulated mortgage balances being interest-only loans, and building societies have the lowest exposure, with 21%.[168] But there is great variation between individual lenders, with some lenders having more than 60% of their outstanding mortgage loans on an interest-only basis.[169]

166 See Exhibit 11.25: Number of interest-only mortgages maturing in the next ten years
167 See Exhibit 13.15: Support for mortgage interest benefit: number of claimants in 2009
168 See Exhibit 11.26: Regulated interest-only mortgage balances, by type of lender, Q2 2011
169 See Exhibit 11.27: Regulated interest-only mortgage balances, % exposure by lender, Q2 2011'

4.102 So, as we noted earlier, the risk of an increasing number of interest-only mortgages reaching maturity without adequate repayment strategies is likely to pose a significant challenge to both consumers and lenders over the coming years. This issue, including the fair treatment of borrowers in this situation, is something that we will be monitoring closely. In particular, we are planning to undertake thematic work to inform our view on the conduct issues that arise when interest-only borrowers reach mortgage maturity without the means of capital repayment. This will examine the policies, procedures and strategies in place across a range of firms and consider their compatibility with the fair treatment of customers. We will also undertake market analysis and consumer profiling to further inform our view on the size and time horizon for this issue.

4.103 We also welcome and support initiatives such as the CML's work with its members to identify appropriate methods of assisting existing interest-only borrowers who may not have sufficient means to repay the capital by the end of the term. In doing this it seeks to ensure that those borrowers who actually experience a capital repayment shortfall are treated fairly, with repossession remaining the last resort.

Summary of the interest-only proposals

4.104 Our proposed interest-only rules represent a significant strengthening of conduct standards, compared with our existing requirements, while allowing lenders the discretion to make informed lending decisions, as illustrated below.

SUMMARY OF EXISTING RESPONSIBLE LENDING INTEREST-ONLY REQUIREMENTS[170]

- When taking account of the customer's ability to repay, the lender should take into account the level of initial and subsequent repayments, including, for interest-only mortgages, the cost of any associated repayment vehicle.
- If the lender is unable to establish the cost of the repayment vehicle, the level of payments may be based on an equivalent repayment mortgage.

170 For full text of the existing interest-only requirements see Mortgages and Home Finance: Conduct of Business sourcebook Chapter 11 http://fsahandbook.info/FSA/html/handbook/MCOB/11

SUMMARY OF MAIN FEATURES OF OUR INTEREST-ONLY PROPOSALS[171]

For most mortgages, affordability should be assessed on a capital and interest basis.

Affordability may be assessed on an interest-only basis for interest-only mortgages if:

- the lender has evidence that the consumer will have in place a clearly understood and credible repayment strategy; and
- as far as it is reasonably able to assess, the repayment strategy has the potential to repay the mortgage.

Any costs of the repayment strategy must be considered by the lender as committed expenditure in the affordability assessment.

The lender may not accept speculative repayment strategies. Examples of speculative strategies may include reliance on increasing property prices or an expected, but uncertain inheritance.

The lender must set out their approach to interest-only mortgages in their responsible lending policy including:

- the types of repayment strategy accepted, the evidential requirements and other controls applied; and
- the procedures for checking the existence and adequacy of the repayment strategy in line with the policy.

The lender must carry out a review at least once during the term to check that the consumer's repayment strategy is still in place and it is still reasonable to expect that it has the potential to repay the mortgage.

In addition:

- Lenders must keep relevant records for three years, including:
- their decision to offer an interest-only mortgage; and
- evidence of the customer's repayment strategy and its cost.

171 See Appendix 1 draft *Mortgage Market Review (Conduct of Business) Instrument 2012* MCOB 11.6 for full details of the proposals

5
Distribution and disclosure

Summary of key proposals

Distribution

- The intermediary's role in assessing affordability is limited to checking that the consumer meets the lender's eligibility criteria.
- The non-advised sales process is removed.
- Advice is given whenever there is spoken, or other interactive, dialogue with the consumer.
- High net worth and professional consumers can opt-out of receiving advice and purchase on an execution-only basis.
- Where the sale involves no interactive dialogue (e.g. pure online or some postal sales) consumers can purchase on an execution-only basis.
- Vulnerable consumers (equity release, right-to-buy, Sale and Rent Back (SRB) and those consolidating debt) must always receive advice and therefore cannot purchase a mortgage by a non-interactive sales process.
- With the exception of SRB consumers, consumers who reject the advice they have been given may still go ahead and purchase the product they want on an execution-only basis.

Disclosure

- The requirement to provide an Initial Disclosure Document is removed.
- Intermediaries must disclose the scope of their service and their remuneration at the beginning of the sales process.
- Intermediaries must explain whether there are limitations to the range of products they offer, rather than using particular labels.
- Trigger points for the Key Facts Illustration (KFI) are changed and intermediaries will be allowed greater freedom to provide comparative information on products.

Introduction

5.1 The *MMR Data pack*[172], which is published as a separate supplement to this paper, includes a chapter on the intermediary market. Unless otherwise indicated, all data and exhibits referred to in this chapter are from that data pack.

5.2 Given that we are consulting further on all of our proposals, we have not included a formal Feedback Statement to our Distribution and Disclosure Consultation Paper (CP10/28[173]). Instead, throughout this chapter we summarise and discuss the replies that we received to the proposals in Chapter 2 (Distribution proposals) and Chapter 3 (Disclosure proposals) of CP10/28.

5.3 The revised approach set out in this paper has been shaped by the formal responses we received to the proposals, our many discussions with stakeholders, including the feedback received through the highly successful series of intermediary road shows held across the country during the consultation period, and our further policy analysis.

5.4 The cost benefit analysis (CBA) for these proposals is in Annex 1 of this paper and the compatibility statement is in Annex 3. The proposed new distribution and disclosure rules are set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1.

Background

5.5 Discussion about the MMR has been dominated by the responsible lending proposals and the potential market impacts associated with those requirements. However, our requirements in relation to distribution and disclosure are equally important in complementing the rules on affordability and increasing consumer protection at the point of sale.

5.6 As we have noted in our previous papers, intermediaries play an important role in the UK mortgage market. The rapid growth in mortgage lending discussed in Chapter 2 was accompanied by important shifts in mortgage distribution.

5.7 Lenders increasingly used intermediaries to grow market share in a quick and cost-efficient way. This led to intermediaries exercising considerable influence over lenders in terms of product development to meet competitive demands. Which subsequently led to a proliferation of high-risk products, particularly for the credit-impaired.

5.8 The connection between lender and borrower began to widen. We saw intermediaries begin to take increasing responsibility for data gathering relevant to creditworthiness and this created a risk that less rigorous credit assessments could result from divided responsibilities.

172 *MMR Data pack* (December 2011): www.fsa.gov.uk/pubs/other/mmr_datapack2011.pdf
173 CP10/28, *Mortgage Market Review: Distribution & Disclosure*, (November 2010): www.fsa.gov.uk/pubs/cp/cp10_28.pdf

5.9 We also saw a very rapid growth in the number of specialist lenders, some of which were subsidiaries of building societies and banks, but some non-deposit taking lenders (non-banks). These non-banks, with no high-street presence, used the existing well-developed intermediary distribution channel in the UK to rapidly grow market share. The net result was that from an estimated 35% share of regulated mortgage sales in 2000, intermediaries' share grew to almost 65% by mid 2007.[174]

5.10 Since the downturn, there has been a significant contraction in the intermediary sector, partly due to the decline of specialist lenders. Compared to the height of the market in 2007, there are around half as many intermediaries active today.[175] Unsurprisingly, the decline in intermediaries has resulted in a decline in intermediated sales[176] but, despite this, intermediaries have maintained a significant share of the total regulated mortgage market. Today, intermediaries are still facilitating around 50% of all mortgage sales.

5.11 The preferred way of buying a mortgage has also remained relatively unchanged over the years. Face-to-face is still the most popular way for consumers to get a mortgage – making up around 56% of all sales. Sales over the telephone now make up around 19% of the market, while 6% of mortgages are reported to be bought by post. An increasing focus on technology means that around 12% of consumers are now reported to purchase mortgages online.[177]

5.12 As we discuss later in this chapter, technology continues to develop apace and consumers can now access information about mortgages and other home finance products on social media sites and through a wide variety of means, including mobile devices. When first designing the current mortgage regime, our aim was to be technologically neutral and, so far as practically possible, that remains our aim. The increasing use of technology is an important development we have kept in mind when developing our proposals.

5.13 Throughout the remainder of this chapter, the terms 'intermediary' or 'intermediaries' include reference to the product sales staff of lenders, unless otherwise indicated. The proposals set out here apply equally to both groups.

Our detailed proposals

5.14 In the MMR Discussion Paper (DP09/3[178]) and in CP10/28[179] we set out some specific concerns we have about how the sales process is working for consumers. We noted that consumers are often unclear in their minds about whether they had received advice, and the potentially significant number of vulnerable consumers who had been sold a mortgage

174 See Exhibit 20.2: Share of mortgage sales by brokers
175 See Exhibit 20.6: Number of broker firms and regulated mortgage sales
176 See Exhibit 20.6: Number of broker firms and regulated mortgage sales
177 Source: Datamonitor UK Retail Banking Study 2010. Datamonitor surveyed consumers who had completed a mortgage application during the specified period. The 12% of consumers who used the internet to purchase their mortgage is inclusive of consumers who used the internet to switch their existing deals.
178 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf
179 CP10/28, *Mortgage Market Review: Distribution & Disclosure:* (November 2010), www.fsa.gov.uk/pubs/cp/cp10_28.pdf

without any assessment of whether that mortgage was appropriate for them, based on their particular needs and circumstances.

5.15 In CP10/28, we set out a number of proposals to address our concerns about sales standards.

Intermediaries' role in assessing affordability

5.16 The first of these concerned the role of intermediaries in assessing affordability. In DP09/3 we explained that, in our view, a key problem underlying many of the issues in the mortgage market has been firms' failure to perform proper affordability checks. This has been compounded by the fact that, under the existing rules, lenders and intermediaries are each subject to separate requirements to check affordability, which has blurred the lines of overall responsibility.

5.17 To address this, our proposed responsible lending rules place ultimate responsibility for assessing affordability with the lender (see Chapter 3).

5.18 To put the matter beyond any doubt, and to ensure that our rules are very clear on this point, in CP10/28 we proposed to remove all the existing detailed regulatory requirements for checking affordability from intermediaries.

5.19 We asked:

> ***Q2:*** *Do you agree with removing from intermediaries any requirement to assess affordability?*

> ***Q3:*** *Can you see any risks from us adopting this approach?*

5.20 Almost all respondents agreed that ultimate responsibility for assessing affordability should rest with the lender, but were not in favour of removing completely the regulatory requirement for intermediaries to assess affordability.

5.21 Some respondents felt strongly that intermediaries could not act in the consumer's best interests without assessing whether the consumer could repay, particularly in an advised sale, and therefore concluded that two assessments of affordability would be required – one by the intermediary and one by the lender.

5.22 By proposing to remove the current detailed regulatory requirements, we did not mean that intermediaries should have **no** role at all in assessing affordability. We agree with respondents that intermediaries will inevitably consider affordability as part of the sales process. We intend to limit the regulatory requirement imposed on intermediaries to one of determining whether the consumer meets the lender's expected affordability criteria. We still believe that this is the right approach.

5.23 Respondents also questioned whether this proposal would extend to intermediaries working directly for lenders. Lender intermediaries would be privy to the detailed underwriting and affordability criteria of their own firm and so they asked whether it would still be necessary for them to separately determine affordability.

5.24 Our proposals apply equally to intermediaries and the sales staff of lenders. In our view, at the point of sale, an intermediary should not be accepting a mortgage application which they consider likely to be outside the lending criteria known to them at the time, whether that is the intermediary's own firm's criteria or any other.

5.25 Some respondents, including consumer representatives, were concerned that because non-lender intermediaries do not have access to precise details about lenders' affordability criteria, implementing this proposal could lead to them applying on behalf of the consumer to several lenders.

5.26 On receiving applications, lenders perform credit searches to get the information they need about a consumer's current credit commitments and credit history to aid their lending decision. This leaves a 'footprint' record that remains on the consumer's credit file for 12 months, allowing lenders to meet their own information-sharing rules and obligations.

5.27 So intermediaries submitting applications on behalf of a consumer to a number of lenders, could have an adverse impact on that consumer's credit rating (given the possibility that it may increase the number of credit search footprints on the consumer's credit file).

5.28 There has been a lot of concern about this. This prompted the Treasury Select Committee earlier this year to ask us to investigate whether we should be taking action to address this.

5.29 We have therefore specifically looked into the potential damage multiple credit search footprints can cause. Our conclusion is that there is no need for regulatory intervention at this stage. Further detail about this is set out in Chapter 7.

Q30: Do you have any comments on our proposed approach to intermediaries' role in assessing affordability?

Intermediaries' role in assessing the 'appropriateness' of mortgages

5.30 In DP09/3, we also raised a concern about consumers' lack of understanding about the difference between advised and non-advised sales. A considerable body of evidence establishes that consumers do not recognise or even value the distinction and believe that they have been given advice, no matter what the sales process.

5.31 Yet our current regulatory approach draws a very clear distinction between the two. In an advised sale, the intermediary is required to assess whether a mortgage is suitable for the consumer based on their particular needs and circumstances. And the intermediary giving the advice is subject to specific training and competency standards, including an examination requirement.

5.32 In a non-advised sale, by contrast, all the intermediary is expected to do is tell the consumer to seek advice if they feel that the mortgage the consumer wants is clearly inappropriate for them. And intermediaries who do not give advice are only required to meet basic high-level competency standards.

5.33 This means that in almost one-third of all mortgage sales[180], there is no requirement for a qualified intermediary to check that the consumer's product choice is appropriate for them. This is of particular concern given that a large proportion of non-advised sales have been to consumers with higher-risk characteristics.[181]

5.34 We felt that this was not delivering adequate consumer protection and the vast majority of respondents to DP09/3 supported this view. In CP10/28, therefore, we proposed to strengthen the selling standards for non-advised sales by applying the same basic sales standards across all sales, whether advised or non-advised.

5.35 We asked:

> ***Q4:*** *Do you agree with our proposed approach to ensuring appropriateness is assessed in every sale…?*

5.36 The vast majority of respondents agreed in principle that we should strengthen the standards in non-advised sales.

5.37 In fact, one lender trade body indicated that intermediaries already undertake an assessment of whether the mortgage is appropriate in all sales. This was confirmed by lenders in responding to the questionnaire requesting data for the CBA. When asked whether they apply an 'appropriateness test' similar to the current advised requirements in all sales (i.e. assess whether the mortgage meets the needs and circumstances of the consumer) the vast majority confirmed that this was something they already did.

5.38 There was, however, very little support for making this a **regulatory requirement** across all sales. There was a concern that, by requiring largely the same sales process and professional standards[182] for both advised and non-advised sales, we would be creating, in all but name, an all-advised market. The concern was that this would simply serve to heighten the potential for consumer confusion.

5.39 A number of respondents suggested that it would be more proportionate, instead, to introduce a high-level requirement for all mortgages to be 'appropriate' and leave it up to intermediaries to determine what 'appropriate' means. Others felt that our main focus

---

180 See Exhibit 20.9: Proportion of advised and non-advised mortgage sales

181 See Exhibit 20.13: Provision of advice by risk type

182 In CP10/28 we proposed to standardise our qualification requirement across all sales. Paragraph 5.135 to 5.144 sets out the feedback to that proposal.

should be to ensure consumers clearly recognise and understand the distinction between both types of sales.

5.40 A broad range of stakeholders were concerned that this proposal would not allow consumers to take responsibility for making their own decisions. A number felt that our approach did not provide sufficient flexibility for the wide variety of consumers in the mortgage market. For example, respondents were concerned that by imposing appropriateness checks in all sales, we were not allowing any flexibility for particularly knowledgeable consumers.

5.41 One lender trade body also felt that the data did not support a view that non-advised sales were more detrimental for consumers. Our analysis of the likelihood of the consumer defaulting when the product has been sold on a non-advised basis compared with advised shows that there is, in fact, very little difference between the performance of the two.[183] However, the fact is that impairment is more likely to be driven by affordability issues and is not necessarily a good indicator of product suitability.

5.42 We agree with respondents that the approach we proposed in CP10/28, rather than removing the potential for consumer confusion, would have blurred the distinction further. The only distinction between an advised sale and a non-advised sale under the proposals in CP10/28, would be that in an advised sale the intermediary would be making a specific recommendation to the consumer about the appropriate product to buy whereas in a non-advised sale, the consumer would be making the choice for themselves.

5.43 The Regulated Activities Order[184] defines regulated mortgage advice as advice on the merits of the borrower entering into (or varying the terms of) a particular regulated mortgage contract. We explain further in the Perimeter Guidance on regulated activities connected with mortgages[185] that advice is where the consumer is explicitly or implicitly steered in the direction of a mortgage, or more than one mortgage, because of its features.

5.44 Whether the intermediary recommends a particular product, or the consumer makes the ultimate choice for themselves, is therefore immaterial and not a valid justification for drawing a distinction between the two sales processes. Where an intermediary assesses whether a product meets a consumer's needs and circumstances it means that they are steering (whether implicitly or explicitly) that consumer in the direction of a product because of its features and therefore that they are advising the consumer.[186]

---

183 See Exhibit 20.14: Mortgage performance, advised and non-advised sales (current arrears and payment shortfalls)

184 The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 1) Order 2003: www.legislation.gov.uk/uksi/2003/1475/article/13/made

185 PERG 4.6.5G – 4.6.9G: http://fsahandbook.info/FSA/html/handbook/PERG/4/6

186 The concept of an information-providing non-advised process (i.e. 'guided sales') was considered in the investment market. It quickly became clear, however, how difficult it would be to develop a commercially viable non-advised guided sales model. The general view of the industry was that without either an explicit or an implicit steering of the consumer in a particular direction, there would be insufficient take-up of products to make the process commercially viable. Consumers needed that final 'push' to buy and in doing so firms were providing an implicit personal recommendation – meaning that they were providing advice.

5.45 So we propose to remove the non-advised sales process and instead require that mortgages are sold either on an advised basis or, in the limited circumstances discussed in paragraph 5.54, on an execution-only basis.

Interactive sales

5.46 We noted earlier the fact that most consumers need help when buying a mortgage and, for the majority of those, the help they seek out tends to be through spoken interaction, mainly face-to-face, but also over the telephone.

5.47 We have also noted previously that most consumers believe that if they speak to an intermediary, they have been given 'advice', no matter how many times they may be told they are not being given advice and whatever form of written service disclosure they are given confirming the position.

5.48 In reality, it is very difficult for an intermediary speaking to a consumer not to stray into inadvertently giving advice. In past thematic reviews, we have listened in on non-advised scripted sales over the telephone. That demonstrated just how difficult it is to control conversations at the point of sale and to ensure the discussion is kept within the strict confines of a passive non-advised script, especially if a consumer does not have a clear idea of their needs.

5.49 Technological developments are increasingly leading to non-spoken forms of interaction between consumers and firms. For example, social media sites, which facilitate private messaging between users, Short Message Service (SMS) and instant messaging which allows users to communicate, in real time, through mobile devices. It is perfectly possible for intermediaries today to provide mortgage advice to consumers by these means. And although their use is still quite limited, the importance of these forms of communication for firms will continue to grow as one generation gives way to another, and social media and 'smart devices' become increasingly popular.

5.50 We are also starting to see the development of online systems in direct sales which provide consumers with a 'live chat' option, where an individual, within the firm, will answer questions from consumers online in real time.

5.51 We noted above that consumers who have spoken to an adviser in the mortgage sales process believe that they have been given advice. In our view, a consumer is just as likely to believe that they have been advised if the communication between the consumer and adviser is instant communication through some technological means.

5.52 So we propose that all sales involving some form of interactive dialogue between the intermediary and the consumer – whether face-to-face, over the telephone, through social media, mobile devices, online propositions with the facility for live chats or otherwise – will be advised sales. This means that an intermediary must always assess whether a mortgage is appropriate for the consumer based on the consumer's particular needs and circumstances. We discuss the advised sales process in more detail in paragraphs 5.93 to 5.95.

5.53 For both spoken and other interactive sales, however, we believe that it may be appropriate in some limited cases, to allow the option of execution-only sales.

Execution-only sales

5.54 In CP10/28, we stopped short of proposing a move to an all-advised market as we felt that it was important to continue to allow consumers the freedom to choose a product for themselves, rather than being forced down an advised route.

5.55 We asked:

> ***Q1:*** *Do you agree that we should continue to allow consumers to get a mortgage without advice? If not, what other options should we consider and how would these result in better outcomes for consumers?*

5.56 The overwhelming majority of respondents were in favour of continuing to allow consumers to buy a mortgage without advice. Intermediary representatives thought all mortgage sales should be advised, with an opt-out for the minority who were confident enough to purchase without it. Lender representatives agreed that intermediaries – but not lenders – should be required to provide advice in every case. This was on the basis that consumers who approached lenders directly to purchase their mortgage would usually know which product they wanted and therefore would not need advice.

5.57 A large number of respondents believed that for more sophisticated consumers, purchasing a mortgage without any advice was entirely appropriate as long as the consumer clearly understood the options available to them.

5.58 We have thought carefully about whether to allow execution-only sales. We have consistently said in our previous papers that consumers should have freedom of choice and that not every consumer needs advice. Clearly there are some consumers who are well able to make their own informed choice about which service they want and what product to purchase. But buying a mortgage is one of the biggest financial decisions a consumer makes and the vast majority of consumers opt for help and support through the buying process.

5.59 Moreover, as we discussed in CP10/28, we are concerned that creating an execution-only channel, to accommodate a minority of consumers, could be used by less scrupulous intermediaries as a means of circumventing the more rigorous advised sales standards. Also there is a real risk that, just like self-certification, it becomes considered as the norm and is used way beyond the small group for which it was created.

5.60 We asked in CP10/28, in the context of waiving the appropriateness test, whether there were sufficiently robust controls to mitigate those risks:

> ***Q4:*** *…in what circumstances do you believe the checks should be waived and how could we prevent this being used as a mechanism to circumvent our rules?*

5.61 There was a general recognition in the responses that finding a mechanism to prevent our requirements from being circumvented would be difficult. But both lender and intermediary representatives felt that an execution-only service would be appropriate for very specific consumers, namely high net worth (HNW) individuals, mainly because these consumers would be receiving advice from other professionals on their wider wealth management, and 'professionals' who work, or had previously worked, in the mortgage market and therefore did not need help.

5.62 We agree with this and, in the light of this helpful feedback, we propose to allow HNW consumers and mortgage professionals to opt-out of receiving advice and to be able to buy a product on an execution-only basis, regardless of whether the sale involves some form of interactive dialogue with an intermediary. We discuss the advised sales process in more detail in paragraphs 5.93 to 5.95.

5.63 In terms of what we mean by a 'professional', the investment market already has a helpful definition which, in part, we intend to draw on.[187] This describes a professional as someone who works, or has worked, in the financial sector for at least one year in a professional position which requires knowledge of the transactions or services envisaged. Our proposed definition of a professional for the purposes of the mortgage rules is in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1.

5.64 We discuss the definition of a HNW consumer in Chapter 10.[188]

> Q31: **(i) Do you have any comments on our proposed approach which allows high net worth consumers and mortgage professionals to opt-out of receiving advice and purchase on an execution-only basis?**
>
> **(ii) Do you have any comments on our proposed definition of a 'mortgage professional'? (A question about the definition of a high net worth consumer is at the end of paragraph 10.83 in Chapter 10.)**

187 COBS 3.5.3R – Elective professional clients http://fsahandbook.info/FSA/html/handbook/COBS/3/5
188 Paragraphs 10.81 to 10.84.

(iii) Is there anything we can do to mitigate the risk of intermediaries using these exceptions to circumvent the rules?

(iv) Are there any other consumer types you think should be able to purchase on an execution-only basis in an interactive sale?

Non-interactive sales

Internet sales

5.65 In a conventional online sales service, a computer system is programmed to react in a set way to information provided by the consumer. Although we noted earlier that technological developments mean that it is possible for an online sales service to be tailored to deliver advice (through live online chats), most online sales do not have this facility. Instead, the consumer is prompted to call an intermediary for advice. There are very few pure online sales systems today.

5.66 Aside from the practical difficulties for firms in providing a pure online advised service, it remains, behaviourally, a very big step for a consumer to buy a mortgage online. Which? conducted a survey in 2010 of consumers who had, in the last 12 months, used a comparison website to search for financial products. Only 3% of consumers used these sites to search for mortgages (compared with 70% of consumers using them to search for car insurance). Out of that 3%, none actually took the leap and bought their mortgage online.[189] In fact, in the same survey, mortgages were one of the products consumers indicated they were least likely to purchase online given their complex nature.

5.67 For online sales, the consumer may need to provide certain information about what they want to enable the system to identify the specific product the consumer wants to purchase. For example, a consumer may need to indicate that they want an interest-only rather than a repayment mortgage and/or that they are looking for a fixed rather than variable rate product.

5.68 If the system was set up to ask the consumer questions which have the potential to steer them towards a particular product or product feature, rather than simply facilitating the consumer's purchase by asking them to make a choice between the possible options, that is likely to be an advised service. But pure online systems, that do nothing more than give effect to the consumer's instructions to buy a particular product, are more likely to be execution-only.

189 Which? study '*Comparison website satisfaction survey*'. 2,431 members of the Which? online Connect community completed the survey between 6 and 16 August 2010. Which? surveyed a proportion of consumers who has used a comparison site to source a financial product within the period specified.

5.69 There is a risk that some intermediaries may encourage consumers to use this route to avoid the advised sales standards. So we are proposing a new rule that expressly forbids this. But, in our view, this risk is mitigated to a large extent by the fact that it remains a very big step for a consumer to purchase a mortgage online without first seeking advice. And technological advances are likely to lead to such sales being more interactive (and therefore more clearly tailored to provide an advised service) in future.

Postal sales

5.70 We believe that the majority of sales by post today are retention deals. This is where a lender writes to an existing borrower coming to the end of their current mortgage deal to invite them to take out a new mortgage with the lender on new terms.

5.71 In such cases, the lender is clearly steering the consumer towards a particular mortgage that it believes is appropriate, on the basis of the information it has. Therefore, under our proposed new approach, retention deals will be advised sales.

5.72 This raises an interesting issue about just how current the information is that the lender has about the consumer's needs and circumstances. We would expect the lender to make it clear to the borrower that the retention deal is offered on the basis that their circumstances have not changed since their last application and that, if this is not the case, it is important that the borrower tells them. If there is a subsequent exchange about whether that mortgage is in fact appropriate for the consumer, the sale is likely to be an advised sale.

5.73 Consumers may also make an application by post for a particular mortgage. This is usually in response to Best Buy tables, where, for example, they may be given a contact number to request an application form, or they may pick up an application form in a branch. When a consumer submits an application for a particular mortgage, the lender may respond by suggesting other deals which may be appropriate for the consumer. In such a case, the sale would be advised. However, in most cases, the lender will simply give effect to the consumer's instructions, in which case the sale will be execution-only.

5.74 We are proposing that, subject to the discussion below about 'vulnerable' consumers, consumers choosing to buy a mortgage direct either online or by post where there is no further interaction with the lender should be able to purchase on an execution-only basis without having to be given advice.

> Q32: **Do you have any comments on our proposed approach which allows consumers to opt-out of advice when purchasing products online or by post and allows them to purchase on an execution-only basis?**

Advising vulnerable consumers

5.75 The final concern we expressed in CP10/28 was about the proportion of higher-risk consumers who had been sold a mortgage without advice.

5.76 While respondents agreed that there were some consumers sufficiently capable of making their own choices without getting advice, there was equal support for requiring that certain 'vulnerable' (or higher-risk) consumers get advice in every case.

5.77 Opinions were divided on which consumer types should be considered 'vulnerable'. First-time (inexperienced) buyers; those consolidating debt; those with an impaired credit history; and those borrowing into retirement were suggested, along with those buying higher-risk products, such as interest-only, equity release, Sale and Rent Back (SRB) and right-to-buy (RTB).

5.78 We agree that in the mortgage market there are consumers who are potentially more vulnerable and who would benefit from advice more than others.

5.79 We already address particular vulnerabilities through our existing standards for advised sales. For example, when giving advice to a consumer consolidating unsecured debts, intermediaries are required to consider whether it is appropriate for the consumer to be doing this. Yet according to data for 2010, 47% of sales where consumers were consolidating debt were on a non-advised basis.[190] So in almost half of these sales, the consumer did not benefit from the specific requirements put in place to deal with their vulnerable circumstances.

5.80 We also recognise the particular vulnerabilities of SRB consumers, very often facing the imminent loss of their home. We already require that the intermediary considers whether SRB is appropriate for the consumer, so that the consumer is helped to look beyond finding an immediate solution to their problems and understand the significant medium to long term implications for them of entering into an SRB agreement.

5.81 We also have concerns that those consumers who want to release equity from their property in order to fund their retirement may not fully appreciate the wider implications of doing so, such as the impact on their tax position or their eligibility for State benefits.

5.82 A number of respondents suggested that first-time buyers (FTBs) and credit-impaired consumers should also be categorised as 'vulnerable'.

5.83 We have carefully considered this. FTBs make up a significant proportion of the overall mortgage market[191] and include a wide variety of consumer types. Many FTBs thoroughly research the mortgage market before buying and are well able to make their own decisions about which is the appropriate product for them. Unlike other consumer groups we have identified as being vulnerable, therefore, we do not believe that there are additional high-risk factors intermediaries need to consider for FTBs compared with any other consumer.

190 Source: Product Sales Data (PSD)
191 Just over 15% according to Product Sales Data (PSD) - Q2 2005 to Q1 2009

5.84 Similarly, there can be any number of reasons why a consumer has an impaired credit history – some may have been unavoidably affected by a life event such as job loss, whereas others may recklessly pursue an unaffordable lifestyle. While for the latter, advice may lead to a better outcome, we believe that the affordability proposals set out in Chapter 3 are a more effective way of addressing the problem. Moreover, there is the practical issue that identifying a credit-impaired borrower (at the outset of the sale) will be much more difficult for a non-lender intermediary, who would not necessarily be able to access the consumer's credit reference information.

5.85 We therefore do not think that advice should be compulsory for FTBs or the credit-impaired.

5.86 However, given the broad support for this across the market, we agree that advice should always be given in relation to certain higher-risk products – namely, equity release, SRB and RTB products and also to the highest-risk consumer type, namely those where the main purpose for raising funds is to consolidate existing debt.[192]

5.87 Under the proposals we have set out above, this would mean that these vulnerable consumer types will not be able to buy mortgages through a non-interactive online or postal sales service.

5.88 We believe however, that a HNW consumer or a mortgage professional should be able to opt for an execution-only sale irrespective of whether they are 'vulnerable' or not. We consider HNW consumers and mortgage professionals to have sufficient knowledge and/or support to make their own decisions. But we would welcome views on this.

5.89 Our approach to niche mortgage markets (equity release and SRB) is set out in Chapter 10. We consider RTB in Chapter 3.

> Q33: **(i) We are proposing that consumers who are vulnerable (i.e. equity release, Sale and Rent Back or right-to-buy consumers and those who are consolidating debt) should always be advised and therefore will not be able to purchase their mortgage through a non-interactive process. Do you have any comments on this approach?**
>
> **(ii) What are your views on our proposal to allow high net worth consumers and mortgage professionals to opt-out of receiving advice irrespective of whether they are considered to be vulnerable?**

192 We outline our reasons for categorising consumers in the niche mortgage markets (equity release and SRB) as vulnerable in Chapter 10.

(iii) Are there any other consumer types you think should always receive advice?

Aggregator and price comparison websites

5.90 Rather than buy directly from a lender's website, some consumers may use an aggregator or price comparison website to identify what mortgage products may be available to them. These sites are used by a large proportion of consumers, and although more prevalent in the insurance market, they also have a presence in the mortgage market.

5.91 Consumers can compare several different mortgages from a variety of providers, and depending on their preference, filter the product choice down to those which they feel meet their needs and circumstances. They are, usually, then redirected to the lenders' own websites to finalise their purchase. If the aggregator site is collecting a breadth of information from the consumer and using sophisticated decision-tree questioning in order to filter down their product range, they may be providing advice. Again, it will depend on whether the consumer is being steered towards a particular product or product feature which may influence their decision.

5.92 We recently published guidance in the insurance market on the role of aggregator sites and we would encourage firms to review this guidance, in the context of their mortgage activity, to ensure that they are providing a service which is consistent with their existing permissions.[193]

The process for an advised sale

5.93 To ensure that consumers are being asked appropriate questions and to provide consistency across the market, we have set out in the draft rules the minimum set of factors we would expect an intermediary to consider in relation to a consumer's needs and circumstances. These are broadly consistent with those consulted on in CP10/28.

5.94 The factors listed do not form an exhaustive list. Some respondents felt that our list should be exhaustive but we do not think this is possible given the many different types of products and consumers in the market. The individual needs of the consumer, rather than the process, should dictate whether there are other considerations the intermediary should explore beyond those we have specified.

5.95 We propose to leave it up to an intermediary to decide how to deliver their advised sales process. The draft rules do not prevent intermediaries from using scripted questions, for example, in order to standardise the way they gather the necessary information from the consumer about their needs and circumstances. However, in order to ensure the consumer receives a suitable product, the intermediary will have to make a judgement about whether

193 Guidance on the: Selling of general insurance policies through price comparison websites, (October 2011): www.fsa.gov.uk/pubs/guidance/fg11_17.pdf.

a product meets the consumer's particular needs and circumstances, and so is appropriate for that consumer.

Allowing consumers to reject advice

5.96 Our revised policy aim is to ensure that, in interactive sales, the vast majority of consumers have the benefit of advice in every case. But we also do not want to prevent consumers from having the freedom to make their own choice. Our existing rules allow for this, as a consumer is currently able to reject any advice given and proceed on a non-advised basis.

5.97 We believe that consumers should continue to be able to make their own choice and, with the exception of SRB consumers, we are proposing that consumers who reject the advice they have been given may still go ahead and purchase the product they want on an execution-only basis.

5.98 But in order to provide an extra protection we are proposing that, where a customer wishes to reject the firm's advice and proceed on an execution-only basis, the firm must not proceed with the sale unless it has told the customer , clearly and prominently and in a durable medium (and orally in any case where the sale involves the firm and the customer speaking to one another), that it considers the mortgage the customer has chosen to be unsuitable, and the customer has confirmed in writing that he is aware of this.

5.99 In relation to SRB consumers, we are proposing that, given their particular vulnerabilities, they should not be allowed to reject the advice given and proceed on an execution-only basis. See Chapter 10.

Q34: **Do you agree that, except in the case of Sale and Rent Back, we should allow consumers to reject advice and proceed on an execution-only basis?**

The process for execution-only sales

5.100 For the consumer to purchase on an execution-only basis, we believe they must know precisely what they want to buy. In relation to a mortgage, we would expect the consumer to know, and to be able to provide the intermediary with, the following information about the product:

- the lender's name;
- the rate of interest;
- the interest rate type (for example, fixed, variable etc.);
- the price or value of the property (estimated where necessary);
- the length of term required;

- the sum the consumer wishes to borrow; and
- whether they want an interest-only or a repayment mortgage.

5.101 If a consumer chooses to make their own decision about the product they want, then they should accept full responsibility for that decision. To ensure that the consumer understands this, once they have instructed the intermediary to buy a particular product, on an execution-only basis, we propose that the intermediary should explain the implications of this clearly and prominently in a durable medium.

Monitoring execution-only business

5.102 We are proposing to allow execution-only sales in only limited circumstances. So, to ensure that intermediaries are effectively managing and monitoring their execution-only business, we are proposing that they have a policy in place which sets out:

- the amount of business the firm expects to carry out on an execution-only basis;
- its processes and procedures for ensuring compliance with the rules surrounding the sale of products on an execution-only basis, including the controls to ensure that, where the sale is interactive, only HNW consumers and mortgage professionals are able to purchase on an execution-only basis without first receiving advice; and
- the arrangements for regularly monitoring and auditing compliance with its own policy, processes and procedures.

Q35: **(i) We are proposing that intermediaries monitor their execution-only business. Do you have any comments on our proposed approach to monitoring?**

(ii) Are there any other steps we should take to ensure that consumers are protected when purchasing on a non-interactive basis, e.g. should we place any other limitations on the types of consumers who are able to purchase online?

5.103 We propose to regularly collect data on the volume and value of sales on an execution-only basis.[194] We will also consider consulting on proposals to collect other data, for example on the types of clients to whom these products are sold, to ensure that the service is reaching its intended audience.

194 See Chapter 7 paragraph 7.37.

Sales standards

5.104 As well as enhancing the standards in non-advised sales, in CP10/28 we proposed a number of measures to enhance the sales standards where advice is given to ensure consumers only purchase products which are suitable for them.

Most suitable rule

5.105 Our existing rules oblige intermediaries to recommend the 'most suitable' product from all those available to them. This is a difficult standard to attain and prove given that at the height of the market there were many thousands of comparable mortgage products available, a number of which could be considered to be the 'most suitable' for the consumer.

5.106 So, in CP10/28, we proposed to replace this with a requirement for intermediaries to 'act in their client's best interests'.

5.107 We asked:

> ***Q5:*** *Do you agree with our proposal for a 'client's best interest rule' and removing the obligation for a recommended mortgage to be the 'most suitable' product?*

5.108 Most smaller firms were in favour of this proposal, although the larger trade associations were opposed. The latter group felt that the term 'client's best interests' is a higher standard, no clearer than 'most suitable', yet more difficult to evidence compliance with. Conversely, consumer representatives viewed a 'client's best interests' rule as a watered-down version of the 'most suitable rule' and did not feel that we had justified a change to the existing requirement.

5.109 Those respondents who supported the proposal believed that it was a more meaningful requirement than 'most suitable'. While some mortgage lenders were concerned that the rule would mean their direct sales force needed to consider products outside of their own limited range.

5.110 Acting in the consumer's best interests is a provision already recognised in the retail investment market. There, the standard is about more than just price and is intended to prevent intermediaries from exploiting information asymmetries between itself and its consumers which could otherwise operate to disadvantage those consumers. In the mortgage market an intermediary, who is acting for the consumer, owes him a duty of reasonable care as part of their relationship, including a duty to 'act in the customer's best interests'. Moreover, the European Commission's proposal for a directive on mortgage credit includes a similar obligation.[195] We therefore still feel that this is a more appropriate standard to apply in the mortgage market. This does not mean that intermediaries with

195 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on credit agreements relating to residential property – COM (2011)142 (March 2011) http://ec.europa.eu/internal_market/finservices-retail/credit/mortgage_en.htm

limited access to products will have to consider deals outside of their own range, but they will need to demonstrate that they have acted in their consumers' best interests in the provision of their advice.

5.111 In an execution-only sale, intermediaries will still be required to 'act in their customer's best interests'. We would consider any attempt to persuade a consumer to take an execution-only route where the consumer was uncertain about their product needs, to be in breach of this requirement.

Enhancing our sales standards

5.112 When considering the consumer's needs and circumstances we wanted to ensure our selling standards took account of the wider financial impacts a mortgage could have on the consumer's financial situation. Therefore, in CP10/28 we proposed that intermediaries consider three additional elements when determining whether a product was suitable:

- whether a mortgage which runs into the consumer's retirement remains appropriate;
- whether it may be more appropriate for a consumer to seek a further advance with their existing lender before looking across the market at other deals; and
- whether it is appropriate for the consumer to roll-up the fees into the loan.

5.113 We asked:

> ***Q7:*** *Do you agree with our proposals to include these three elements, (borrowing into retirement, taking a further advance and rolling-up of fees) as part of the new appropriateness test?*

5.114 Most respondents felt that the issue about whether a mortgage runs into the consumer's retirement is one about affordability. Given that the responsibility for assessing affordability in these cases would be the lender's, respondents questioned why we would require intermediaries to carry out the same checks. We agree and in light of the feedback, we are not proposing to proceed with this proposal.

5.115 Given that there may be additional fees and charges levied on the consumer when they take a **further advance**, we also proposed that intermediaries should be required to determine whether a further advance would be more appropriate for the consumer than remortgaging with another lender.

5.116 Respondents were generally unsupportive of this proposal. Lenders questioned how they would meet this obligation given that they were unable to recommend products outside of their limited range. And intermediaries felt that lenders would be reluctant to share personal information on a consumer's existing mortgage commitments, which would make it difficult for them to comply with this requirement.

5.117 In light of the feedback, we have revised our approach. We are now proposing that, unless the intermediary is aware that a further advance would not be available, if a consumer wants to increase their borrowing, the intermediary should tell the consumer, either orally or in writing, that it may be possible and more appropriate for them to take a further advance with their existing lender than to remortgage with another. The intermediary will be under no obligation to determine whether a further advance would, in fact, be more appropriate.

5.118 Finally, we asked whether we should require intermediaries to consider whether **rolling-up fees** into the loan was appropriate for the consumer. There was strong support for this proposal. Respondents agreed that intermediaries should explore whether it was appropriate for a consumer to pay the fees up front or roll-them up into the loan amount. We are therefore proposing to proceed with this proposal. We consider this further in paragraph 5.121 to 5.134.

Interest-only

5.119 In CP10/28 we did not make any specific proposals about intermediaries and interest-only mortgages. But we want to ensure that before an application is submitted to the lender, the consumer is aware that they will need to demonstrate to the lender that they have a credible repayment strategy in place to repay the loan.

5.120 Requiring the intermediary to carry out the same checks as the lender risks blurring the boundaries of responsibility. So, instead of requiring intermediaries to verify the consumer's repayment strategy, we are simply proposing intermediaries alert the consumer to the fact that they will have to demonstrate to the lender that they have a clearly understood and credible repayment strategy in place. This does not mean that intermediaries are under any obligation to determine whether the consumer's capital repayment strategy will in fact repay the capital element at the end of the loan, nor does it mean that the intermediary is required to provide advice on the proposed strategy.

Rolling-up fees and charges

5.121 In DP09/3 we raised concerns about the rolling-up of fees and charges into the mortgage loan. Our concern was that where consumers do this, they are unlikely to focus on the levels of such fees and it diminishes consumer price sensitivity.

5.122 Almost all respondents to DP09/3 felt that it would not be appropriate to ban the rolling-up of fees and charges into the mortgage. There were concerns that this could be readily circumvented by consumers who could simply obtain a larger mortgage and pay the fees out of the additional borrowing or pay for the fees using more expensive unsecured credit. In addition, it was recognised that in some circumstances rolling-up the fees into the loan might be in the best interests of the consumer, such as FTBs who may have limited upfront funds.

5.123 In light of this, in CP10/28, we agreed that a ban on the rolling-up of fees and charges into a loan was not appropriate. However, to improve consumers' awareness of the impact of this we proposed that intermediaries should provide consumers with a second Key Facts Illustration (KFI) where the roll-up of fees was being considered – one illustrating the overall cost to the consumer of rolling the fees into the loan and the other demonstrating the overall costs without the fees being added. We also proposed that intermediaries and lenders should offer consumers a choice about whether to roll-up the fees and charges, coupled with a requirement for firms to record the consumer's choice.

5.124 We asked:

> ***Q8:*** *Do you agree with our proposal to improve the disclosure of the impact of the roll-up of fees through the provision of a second KFI?*

> ***Q9:*** *Do you agree with our proposals to require firms to present consumers with a choice of rolling-up the fees and charges, and to record the decision made?*

5.125 The vast majority of respondents were not in favour of intermediaries having to provide two KFIs. There was a concern that consumers would be overloaded with information, which, in turn, would lead to consumer confusion. Some respondents also highlighted the additional cost of printing two KFIs and the higher record-keeping cost. Some said this would only have limited benefit to consumers and that the proposal was disproportionate to the potential detriment.

5.126 A number of respondents considered that the better approach would be to amend the current format of the KFI to illustrate the impact of rolling-up fees, rather than to require the production of two KFIs. However, several respondents were concerned about the system costs of changing the format of the current KFI, relative to the perceived low benefit to consumers.

5.127 A few respondents considered that a more viable alternative would be for the impact of the roll-up of fees to be disclosed in a more flexible non-KFI format. And to make it more proportionate, several respondents suggested that additional disclosure requirements should only be imposed in circumstances where the fees being rolled-up exceeded certain monetary or percentage limits (relative to the loan).

5.128 While respondents universally opposed the provision of two KFIs, most respondents were in favour of requiring consumers to positively elect to roll-up fees into the loan. However, a number of lenders were concerned that the draft rules covering this placed the burden of getting the positive election on the mortgage lender only when it would be more appropriate for this to apply to intermediaries.

5.129 In light of the feedback received and the cost of the alternative option of changing the format of the current KFI[196], we are not proposing to proceed with this proposal. However, we are proposing to proceed with a requirement for firms to offer consumers a choice of whether to roll-up their fees into the loan, given that this was widely supported.

5.130 This will mean that in an advised sale, the intermediary will need to keep a record of the consumer's positive election. We agree that the intermediary (rather than the lender) will be best placed to record the consumer's choice and we have amended the draft rules to reflect this position.

5.131 Finally, on the subject of rolling-up fees we asked:

> ***Q10:*** *Do you agree or have any other suggestions about how to improve consumer awareness of the impact of rolling-up fees and charges?*

5.132 One respondent believed that any tool which allowed consumers to assess the impact of rolling-up fees into the mortgage should also show the impact of borrowing through other, potentially more expensive, forms of credit, such as credit cards. Those who were unsupportive did not consider that the detriment identified warranted the level of intervention proposed.

5.133 Others supported using Money Advice Service (MAS) material to draw consumers' attention to the monetary impact of rolling fees into the loan. One respondent suggested that a standard calculator could be produced for the Service's website which illustrated the impact, over 25 years, of adding different amounts to the loan, at different average interest rates. One larger lender felt that we should go further and require intermediaries to disclose to consumers that adding any fees or charges to the mortgage will increase the monthly payments, the total amount repayable over the term and the interest accrued.

5.134 We agree that steps to increase consumer awareness should help consumers to think about the issue of rolling-up of fees and the possible implications for them. The MAS has updated its consumer information on the roll-up of fees and we are considering creating a downloadable consumer guide explaining what rolling-up is. These proposals should help address our concerns and keep any potential consumer detriment in this area to a minimum.

Enhancing professional standards

5.135 In CP10/28 we proposed that all individuals selling mortgages should meet the same qualification standards. This was a direct result of our proposal to require that intermediaries carry out an assessment of appropriateness in all sales. We proposed that this

196 It is estimated that changing any content of the KFI would cost the industry around £23m.
Source: *What costs would be incurred as a result of the MMR sales and advice process reforms*, Oxera (November 2010): http://www.fsa.gov.uk/pubs/policy/oxera_report_mmr.pdf

qualification requirement would apply to non-advised sellers as well as those designing scripted questions.

5.136 To ensure consistency with the Retail Distribution Review (RDR) we noted our intention to:

- Give intermediaries 30 months to pass all modules of a relevant qualification from the date our rules come into force. Any individual joining a firm after our rules are in force would also be given 30 months in which to achieve the required qualification standard.
- Allow firms to use other assessment methodologies to achieve the equivalent of a Qualifications and Credit Framework (QCF) level three standard[197], although this would depend on market appetite.
- Review the mortgage exam standards every three years to see if changes were needed.

5.137 The mortgage exam syllabus has not been reviewed since 2004 and in CP10/28 we outlined our plans to do so. This is still our intention however, given that the MMR is such a wide ranging review of the mortgage market we feel that it is sensible to delay our review until we have a clear package of measures accompanied by an agreed implementation date.

5.138 We asked:

> ***Q6:*** *Do you agree with our approach to applying common professional standards across the mortgage market?*

5.139 Most respondents, particularly consumer representatives, supported the introduction of a qualification requirement across all sales and the adoption of a Code of Ethics.

5.140 One trade association suggested that a level playing field for professionalism will become even more crucial given the proposed requirements for a single sales standard (the appropriateness test) across all sales. However, they were concerned that we might apply a prescriptive Continuous Professional Development (CPD) requirement on intermediaries.

5.141 A small number of respondents felt that mortgage advisers who are qualified should be able to use CPD to fill any gaps in their knowledge. Some were concerned that allowing intermediaries 30 months to obtain the relevant qualification was too long a time frame. In their view, new advisers should reach this level at the outset and, for those who were more experienced there should be a period much shorter than 30 months.

5.142 A number of lenders felt that applying a qualification standard to non-advised sales could increase costs for lenders, which would ultimately be borne by the consumer. Others suggested that the incremental cost would be minimal given that most already require, or support completion of, the Certificate in Mortgage Advice and Practice (CeMAP). While professional bodies supported our approach, they noted that although mortgages may be

197 Since we published CP10/28, and as part of the RDR, we have produced further information on the use of other assessment methodologies. For more on our current thinking, see our formal response to the TSC: www.fsa.gov.uk/pubs/other/andrew_tyrie_rdr.pdf

less complex than investment products, the implications for a consumer if something should go wrong could be as significant.

5.143 Given that we are proposing to require advice to be provided whenever a sale involves interactive dialogue (except for HNW consumers and mortgage professionals), we are proposing to proceed with a requirement for all intermediaries to obtain a relevant professional qualification, including those designing scripted questions which may be used, for example, in a face-to-face or online sale.

5.144 The implementation of a Code of Ethics for the mortgage market remains a condition of the extension of the Approved Persons regime to mortgage intermediaries.

Record keeping

5.145 Our detailed record keeping requirements in the current mortgage rules only apply to sales where advice is given. As we are proposing a number of changes to our sales standards obligations, we have also reviewed our approach to record keeping. In an advised sales, we are proposing that an intermediary should retain a record for a minimum of three years of:

- the consumer's information, including that which has been collected in relation to their needs and circumstances;
- the reasons why the advice provided by the intermediary is suitable; and
- where fees are rolled-up into the loan a record of the consumer's positive election to do so (as outlined in paragraph 5.130).

5.146 **In an execution-only sale**, we would require the intermediary to retain a record for a minimum of three years of the following information:

- where the consumer has rejected the advice given and has chosen to proceed on a execution-only basis details of the advice given, the reasons why it was rejected (paragraph 5.96 to 5.99);
- the product information provided by the consumer (as outlined in paragraph 5.100);
- the relevant disclosure around the protections the consumer will lose and, where the sale involves human interaction, the positive election to proceed (paragraph 5.101); and
- the intermediary's execution-only policy (paragraph 5.102).

Disclosure requirements

5.147 Another key concern in the sales process is the level of consumer engagement and how consumers respond to information disclosed to them. Our research has found that consumers do not always use the prescribed detailed disclosure material to assist with their choices.[198] In light of this, we proposed in CP10/28 revising our wider approach to mortgage regulation to lessen our reliance on disclosure and have stronger controls in other areas (e.g. responsible lending). However, disclosure potentially remains an important tool and we want to re-focus our requirements so that the key messages are brought to consumers' attention at the right time and in a way they are most likely to be receptive to.

Consumer information about an intermediary's service

5.148 The initial contact that the consumer has with a mortgage intermediary is very important, as it can help shape the consumer's decision as to whether to use the intermediary's service. The role of disclosure at this point is to ensure that the consumer has the right information to make an informed decision.

5.149 Our Initial Disclosure Document (IDD) was designed to provide consumers with detailed information about an intermediary's service. However, our consumer research[199] found that consumers do not engage with the IDD at the initial stage of the sales process – they instead rely on what they have been told.

5.150 In CP10/28, we consulted on replacing the requirement to provide an IDD with a requirement to disclose key information about an intermediary's service – the basis of their remuneration and their scope of service – in a clear and prominent manner. Where there is spoken interaction with the consumer in the initial contact, this means that the messages had to be given orally. We also proposed that the messages be provided in a durable medium (and that intermediaries could continue to give the IDD to meet this requirement if they wished to). We asked:

> ***Q13:*** *Do you agree that it is appropriate to focus our service disclosure on these key messages [scope of service and basis of remuneration]? Do you agree that this is the correct approach for communicating these messages to consumers?*

5.151 Most respondents agreed that scope of service and basis of remuneration were the right messages on which to try and focus consumers' attention. Given this support, we continue to consider it sensible to make this change from the IDD to these messages.[200]

5.152 In CP10/28 we noted that the basis of an intermediary's remuneration is how the intermediary is being paid and what it is being paid for. In relation to the former, this

198 Disclosure in the prime mortgage market – Research report, Illuminas, (December 2008): www.fsa.gov.uk/pubs/consumer-research/crpr81.pdf and Mortgage effectiveness review – Stage 2 Report, (March 2008): www.fsa.gov.uk/pubs/other/MER2_report.pdf

199 Disclosure in the prime mortgage market – Research report, Illuminas, (December 2008): www.fsa.gov.uk/pubs/consumer-research/crpr81.pdf and Mortgage effectiveness review – Stage 2 Report, (March 2008): www.fsa.gov.uk/pubs/other/MER2_report.pdf

200 The proposals referred to here relate to our requirements for disclosure at the initial contact with the consumer for all sales. Those sales covered by the Distance Marketing Directive are subject to further obligations. See paragraph 5.186

includes any fees the intermediary would charge the consumer, when these are payable and reimbursable, and whether the intermediary will receive commission from a third party (and circumstances where it might be offset against any fee charged). Some respondents to the CP had misinterpreted the proposed requirement to mean that details of individual staff remuneration had to be given – this was not, and is not, our intention.

5.153 We are proposing to clarify how intermediaries should disclose fees that are not a simple flat fee:

- If the intermediary charges a fee that is percentage-based, it will have to give a representative illustrative example in cash terms.
- If the intermediary charges a cash fee that is not clear from the outset because it falls within a range of possible cash fees, its description of its fee must include the minimum and maximum possible fee in cash terms. It will also have to note what factors will determine where in the range the fee will be.
- If the intermediary charges a percentage fee that is not clear from the outset because it falls within a range of possible percentage fees, then we would want it to provide a number of pieces of information. These are a representative illustrative example in cash terms, the minimum and maximum possible fee in percentage terms and what factors will determine where in the range the fee will be.
- If the intermediary charges an hourly rate, and it is not clear how many hours it will spend on the transaction, the intermediary will have to specify the rate in cash terms, and outline what factors will determine how many hours are spent on the consumer's transaction.

Q36: Do you agree that we should be specific about the appropriate method of disclosing service fees that are not simple flat fees?

5.154 In relation to what the intermediary is being paid for, CP10/28 proposed that the intermediary should tell the consumer whether it would give them one or more personal recommendations on a product as part of the service (e.g. advice). In light of the changed approach to sales standards discussed earlier in this chapter, it will no longer be necessary for intermediaries to explain this (as most consumers will be getting advice unless they actively opt for the execution-only route). So we have amended our draft rules to remove this disclosure requirement.

5.155 In terms of the delivery of the messages, many intermediaries responding to CP10/28 welcomed the flexibility within our proposals of being able to give consumers the messages in a durable medium of their choice, including the option of retaining the IDD if they wished. Many respondents noted the increased compliance costs that would be associated with oral disclosure, though some intermediaries noted that they already give the required information both verbally and in writing.

5.156 A number of respondents highlighted that consumers' choice of intermediary is more often than not determined by personal recommendations and past experiences. They considered that changes to the disclosure requirements are unlikely to influence consumers' decisions.

5.157 Many respondents also argued that there are benefits in requiring intermediaries to provide information in a standard format. They considered that allowing flexibility in the written disclosure increases the risk of inconsistencies, making it difficult for consumers to compare providers and their service.

5.158 Our consumer research provides the basis for how disclosure has worked in practice and it demonstrates that consumers do not take messages on board from the IDD and instead tend to rely on what they have been told. So we continue to see the importance of the key messages being given 'clearly and prominently' – orally where the sale involves spoken interaction. After further reflecting on the research, particularly that consumers did not value the IDD document, we no longer see a strong case for requiring the messages to be given in a durable medium (and therefore propose not to explicitly require this). Intermediaries could of course continue to give these messages in writing if they wish to, but we will not require them to do so.

5.159 In response to some concern expressed in feedback about a lack of clarity around the requirements for clear and prominent disclosure, we are proposing to make it clear in the rules that:

- where there is spoken interaction in the initial contact (e.g. in face-to-face and telephone sales) the messages must be given orally; and
- where there is no spoken interaction in the initial contact, the messages must be given prominently and appear separately from other messages in the communication.

5.160 Non-spoken interaction with the consumer, including the examples of social media outlined earlier in paragraphs 5.49 and 5.50, would fall into the latter category.

5.161 We are also proposing to specify that, if the communication is made electronically (which could include social media with non-spoken interaction as well as purely online or non-interactive sales propositions), the consumer must not be able to progress onto the next stage of the sale until the messages have been communicated to them. It would not be sufficient on a website sale, for example, for the messages to be accessible only by clicking on an optional link to another page.

5.162 These requirements mean that, for example, in a postal sale, an intermediary might comply by setting out the messages in a clear covering letter. In an internet sale, the messages could be displayed clearly on one of the initial web-pages a consumer accesses. Where the initial contact is by email, the messages could be contained clearly and prominently early on in the body of the email.

5.163 Some respondents also raised concerns about how intermediaries will prove they are complying with oral disclosure requirements. It is not our intention that intermediaries record every conversation they have with consumers, or make every consumer sign a declaration that they have received the messages. We have included guidance in the rules about how intermediaries might demonstrate compliance with this requirement. This includes, for example, building the requirements into their staff training, as evidenced by their training and compliance manuals, inserting appropriate prompts into paper-based or automated sales systems, and having procedures in place to monitor staff compliance with the rules.

Q37: **Do you have any comments about our revised approach to the requirements for the messages on product range and remuneration to be given 'clearly and prominently'?**

5.164 We propose to update the combined IDD[201] template on the FSA website[202] so it can be used by intermediaries who want to give it to consumers, particularly where they are simultaneously offering the consumer other financial services (e.g. investment or insurance products) or conducting a sale that would fall under the Distance Marketing Directive.[203]

5.165 However, we are sceptical about the ongoing usefulness of this template for mortgages, given that we are not specifically requiring the key messages regarding an intermediary's service to be given in a durable medium. At the same time, the proposal for a European directive on mortgage credit might mean that intermediaries will have to provide information in a durable medium in future and that an updated version of the template might remain useful. We are interested in stakeholders' views on this.

Q38: **Do you consider that the combined IDD template remains useful with respect to mortgage service disclosure?**

Information on the scope of an intermediary's service

5.166 In the DP09/3, we noted that there are a variety of intermediary service labels that ostensibly aim to clarify for consumers the service an intermediary will offer them. These include 'independent', 'limited', 'single' or 'whole of market'. We proposed to replace these labels with the much simpler and readily understandable 'independent' and 'restricted' in line with the approach adopted by the RDR.

5.167 Respondents agreed and therefore in CP10/28, we consulted on applying the RDR's labels to the mortgage market. We thought that aligning with the RDR approach would make sense for intermediaries and would be less confusing for consumers.

201 As outlined in Chapter 7, we propose to delete the mortgages IDD template. Firms will now be able to use the combined IDD template to produce a document that outlines their services for one type of mortgage product (as the IDD currently does) or for a combination of different products.

202 IDD template: http://fsahandbook.info/FSA/docs/cobs/future/cobs6_annex_2_010110.pdf

203 The Distance Marketing of Consumer Financial Services Directive (DMD) (Directive 2002/65/EC): http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002L0065:EN:HTML

5.168 In reading these labels across, it was necessary to make a number of amendments to adapt them to the mortgage market. For an intermediary to call itself ‘independent’, it would have had to source products from a ‘comprehensive and fair analysis of the relevant market’. For mortgages, we explained that the relevant market is the relevant type of home finance transaction (e.g. the regulated mortgage contract market, the equity release market etc.). We proposed that an independent intermediary would not have to include ‘direct-only deals’ (deals that are only available to the consumer if they go directly to the lender) in its search, but we wanted to ensure that consumers understood whether these deals were included or not. So we proposed that an independent intermediary must disclose to the consumer whether it was considering these direct-only deals. We also proposed that, since we had not seen significant evidence of commission bias in the mortgage market, we would not retain the rule that an intermediary must offer consumers the option of paying a fee for their service in order to hold themselves out as ‘independent’.

5.169 In CP10/28 we asked:

> ***Q14:*** *(i) Do you agree with our application of the ‘independent’ and ‘restricted’ labels to the mortgage market?*
>
> *(ii) Do you agree that we should require ‘independent’ intermediaries to disclose whether they consider direct-only deals?*
>
> *(iii) Do you agree that we do not need to retain a fee option as part of our requirements for the label of ‘independent’?*

5.170 There was general support for greater clarity in the labelling of intermediaries’ services in the mortgage market. Many respondents saw merit in applying the ‘independent’ and ‘restricted’ labels. However, many other respondents considered that these labels were not appropriate for the mortgage market. Some considered that a variety of other terms more appropriately described the service distinction (e.g. ‘limited’, ‘sales representatives’, ‘information-only’, ‘selected range of products’, ‘commissioned’ etc). Some were concerned that the term ‘restricted’ could be misinterpreted as a description of the quality of advice rather than the range of products. Some also felt that, because the labels had been adapted to suit the mortgage market, there might be confusion for consumers participating in both the mortgage and investment markets, as opposed to the simplicity and consistency that was intended.

5.171 In light of the feedback received, we have reconsidered whether using the ‘independent’ and ‘restricted’ labels is in fact the correct approach for the mortgage market. We recognise that this market is different to the retail investment market, and what we are trying to emphasise for the consumer also differs. In the retail investment market, there can be a number of different types of investment products that might meet a consumer's needs (e.g. for retirement planning), and often a range of providers for each product. The 'independent' label therefore has a significant role to play in the investment market, indicating to consumers that the intermediary will consider a number of different investment options available to meet their overall needs. The mortgage market, on the other hand, is much simpler. For each consumer, there will usually only be one type of home finance transaction (e.g. a mortgage or a sale and rent back transaction) that will be a suitable way to meet the consumer's funding needs. The important differentiation in scope of service is about the number of providers and products the intermediary will consider when sourcing the particular home finance transaction suitable for the consumer.

5.172 Ultimately, what we want to achieve in the mortgage market is that the consumer clearly understands from the outset whether the product range available to them through a particular intermediary is limited. This is also the approach we prefer on the draft European legislation. That way a consumer can, if they want to, shop around to see what may be available elsewhere. We think that the best way to achieve this is simply to impose a requirement on intermediaries to explain to consumers in clear and straightforward terms whether the product choice available to the consumer through them is limited and, if so, in what way.

5.173 We therefore propose to drop any requirement for intermediaries to use labels in the mortgage market. This revised approach should allow intermediaries to explain their product range in a way that is meaningful for the consumer and that is better tailored to the mortgage market.

5.174 As part of giving a clear explanation to consumers of their product range, we propose that those intermediaries who have limitations in their product range will either have to tell the consumer the number of lenders they source products from or list the name of each lender as part of their disclosure. Where they opt to give the number, then (in line with the existing requirement currently in the IDD) they will also have to tell the consumer that they can request a list of these lenders, and provide this list on request. This list should also indicate whether they offer all of the products generally available from these lenders.

5.175 We have included in the draft guidance some examples of what the disclosure could look like.[204] For example:

- 'We are not limited in the range of mortgages we will consider for you';
- 'We only offer mortgages from [number] lender(s). We can provide you with a list of these';
- 'We only offer some, but not all, of the mortgages available from [number] lender(s). We can provide you with a list of these';
- 'We only offer mortgages from [name of lender(s)]';
- 'We only offer some, but not all, of the mortgages from [name of lender(s)]'.

204 See Appendix 1 draft *Mortgage Market Review (Conduct of Business) Instrument 2012* (MCOB 4.4A.6)

5.176 In assessing whether there are any limitations in their product range, the intermediary would have to consider this in the context of the 'relevant market'[205] from which they are sourcing the home finance product. Although we would not generally expect that many consumers would be interested in products from more than one relevant market at any one point in time, if they were, intermediaries would have to disclose whether there were any limitations in their product range separately for each relevant market. An example of what disclosure could look like in such a case is:

- 'We are not limited in the range of mortgages we will consider for you. For equity release we only offer home reversion plans and not lifetime mortgages. We offer home reversions from [name of provider] and we only offer some, and not all of their products'.

5.177 There was general support in responses to CP10/28 for 'independent' intermediaries having to disclose to consumers whether they were considering direct-only products or not. Some intermediaries felt that there should also be a requirement on lenders to disclose that they were not considering all products that a consumer could get from an intermediary looking at the wider market (though this would of course be implicit in a lender stating what its product range is).

5.178 Our views on consumer awareness regarding direct-only deals remain the same following our consultation. We continue to consider that an intermediary should be able to tell a consumer that it sources products from a comprehensive range across the market where it does so in relation to products available to intermediaries generally. This means that the fact that it does not offer deals that are only available direct from providers is not a limitation on the service it provides consumers for the purposes of these disclosure requirements. However, it is important that consumers know that the intermediary does not consider direct-only deals and we therefore propose to have a requirement that intermediaries disclose this fact to the consumer. An example of what disclosure could like in such a case is:

- 'We offer a comprehensive range of mortgages from across the market, but not mortgages that you can only obtain by going direct to a lender'.

5.179 We also recognise the presence of 'exclusive deals' in the mortgage market (e.g. mortgage products that some lenders will only sell through one or a limited number of non-lender intermediaries). It will be difficult for other intermediaries to be aware of the existence of these deals, and therefore we propose to reflect in our guidance that intermediaries will not have to take these into account when considering whether their product range is limited.

5.180 We propose to retain and update our guidance on the situations where using a 'panel' or selection of products would still enable an intermediary to tell consumers that their product range is not limited. In these cases, an intermediary would have to ensure its selection was sufficiently broad and reviewed regularly and that its use did not materially disadvantage any consumer. It should be updated where a product had become generally available that had an improved feature, or a better interest rate, than products in its current range.

205 MCOB rules define 'relevant market' by the type of home finance transaction. For example, there is one relevant market for regulated mortgage contracts that are not lifetime mortgages or business loans. There is one relevant market for business loans.

5.181 Under this revised approach, intermediaries can choose to use the RDR labels of 'independent' and 'restricted' in the way that they describe their service if they wish to (providing it is an accurate and clear description of their service). Intermediaries operating in both the investment and mortgage markets might find that this helps them to give a comprehensive explanation of their services to consumers.

5.182 We propose to include guidance that explains that an intermediary offering a different service for different product types should not disclose that it offers one type of service for its business as a whole. For example, an intermediary that provides independent advice on retail investment products but only considers a limited range of mortgage products should ensure it discloses to the consumer that its service differs for the different products.

5.183 We have also highlighted in the draft guidance that the requirements under the Principles and mortgage rules for clear, fair and not misleading communications[206] apply more generally in the way that an intermediary might describe itself to a consumer, e.g. the trading name. We would consider it a breach of these if, for example, an intermediary named itself an 'independent mortgage adviser' where this did not accurately reflect the service it gave its consumers, (i.e. where it did not offer an unlimited product range from across the relevant market).

5.184 In response to CP10/28 on the question of whether the requirement to provide the option for consumers to pay by fee should be retained as part of the 'independent' label, most respondents considered that it was not required. Many noted that it is currently rarely taken up by the consumer in practice. Given there was strong support for the proposal to remove the requirement, we plan to proceed on this basis.

5.185 The proposed changes to the way intermediaries disclose their product range will have consequential impacts on the way they report this to us.[207] Once we have finalised the policy in this area we will consult on amending the reporting mechanisms as necessary.

> Q39: **Do you agree that we should not apply the 'independent' and 'restricted' labels to the mortgage market, but instead require intermediaries to explain to the consumer in clear and straightforward terms any limitations to their service?**

Complying with the Distance Marketing Directive

5.186 In light of the broader changes we are proposing to service disclosure, we also need to update our rules relating to disclosure requirements under the Distance Marketing

206 Principle 7 (Communications with clients): http://fsahandbook.info/FSA/html/handbook/PRIN/2/1 and rules MCOB 2.2.6R: http://fsahandbook.info/FSA/html/handbook/MCOB/2/2

207 Intermediaries currently report their product range via Section G of the Retail Mediation Activities Return (RMAR), with guidance given in the Supervision handbook (SUP 16 Annex 18bg). The new proposals will mean the tick box fields in RMAR will no longer match the MCOB requirements and SUP will have incorrect MCOB references.

Directive.[208] This will help to ensure that intermediaries selling mortgages at a distance still meet all the EU requirements. We have made some small changes to the draft rules consulted on in CP10/28 in light of our revised disclosure proposals.

Presenting products to consumers

Reminding consumers of an intermediary's scope of service

5.187 After the intermediary has considered what products are appropriate for the consumer, the next step will be to actually describe these products to the consumer. We proposed in CP10/28 that an intermediary should reiterate its scope of service when presenting the consumer with specific information about a product, following an assessment of their needs and circumstances. This will remind consumers about the need to consider whether there might be other products on the market that are more suitable for them.

5.188 In CP10/28 we asked:

> ***Q15:*** *Do you agree that firms should reiterate their scope at the point that they put the product(s) forward?*

5.189 There was a mixed response to this proposal. Many respondents, including consumer representatives, supported it. It was noted that being told again about the scope of an intermediary's service would be a useful reminder to the consumer at this point in the sale.

5.190 Other respondents did not support the proposal, considering it unnecessary because the information would already be given to the consumer at the initial disclosure stage. Some pointed to the potential costs to intermediaries.

5.191 In light of the support we received for this proposal from consumer representatives, we intend to press ahead with the proposal. However, in those execution-only sales where an assessment of the consumer's needs and circumstances has not been undertaken, because the customer knows exactly what product they want, there would be no need to reiterate what the intermediary's product range is. So it will not be required in those circumstances.

5.192 Some respondents asked us to be clearer about how the disclosure would be required to be given. In response to this, our proposal is only that this information be given clearly and prominently, and we have left it up to intermediaries to fit this appropriately within their sales process. In terms of demonstrating compliance with this requirement, we have included guidance in our draft rules explaining that intermediaries might, for example, do one or more of the following: give the information clearly in writing; build the requirements into the training of staff, as evidenced by training and compliance manuals;

208 The Distance Marketing of Consumer Financial Services Directive (DMD) (Directive 2002/65/EC) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002L0065:EN:HTML

insert appropriate prompts into paper-based or automated sales systems; and/or have procedures in place to monitor staff compliance with the rules.

Providing information on specific products

5.193 Delivering information to consumers on specific products is very important, as it can influence both their choice and their future understanding of how their mortgage will work. Our prescribed document for product disclosure, the KFI, outlines the main features and risks of a mortgage product. Our consumer research[209] has found that it is valued by consumers. However, this is more as a record of the product purchased, with most consumers not using it as a tool to make comparisons between products as we had intended.

5.194 In CP10/28 we proposed retaining the KFI in its current form. This was on the grounds that it is useful as a consumer record, and that the estimated costs for making changes to the format of it were very high (£23m across the industry[210]). These costs would be difficult to justify if a future European directive on mortgage credit required intermediaries to adopt a different document and incur similar costs again.

5.195 However, in recognition of the fact that most consumers do not to use the KFI to compare different products, we proposed changing the trigger points for when a pre-application KFI has to be given. Currently, consumers must receive a KFI each time they get information about a product from an intermediary that is specific to the amount they wish to borrow. The change would mean that, unless the consumer had received advice to take a product, they would only receive a KFI once they had indicated which product they wanted to proceed with. This change was intended to help to minimise information overload on the consumer and the burden on intermediaries.

5.196 In CP10/28 we asked:

> ***Q16:*** *(i) Do you agree that we make these changes to the trigger points for the pre-application KFI?*

5.197 A significant majority of respondents supported this proposal. It was noted that it was a more sensible approach to give a KFI for the product the consumer wants to buy, rather than all options available to them and that this will help to prevent information overload. We are therefore continuing with this proposal.

5.198 However, the proposed trigger points in the draft rules in this document vary slightly from those in CP10/28. This largely reflects the changes to the sales process outlined earlier and the need for a consumer to be able to request a KFI for a product that the intermediary has not assessed in relation to their needs (if they are considering going down the execution-

209 Disclosure in the prime mortgage market – Research report, Illuminas, (December 2008): www.fsa.gov.uk/pubs/consumer-research/crpr81.pdf and Mortgage effectiveness review – Stage 2 Report, (March 2008): www.fsa.gov.uk/pubs/other/MER2_report.pdf

210 Oxera estimated that the one-off costs to the industry of changing the format of the KFI as £23m www.fsa.gov.uk/pubs/policy/oxera_report_mmr.pdf

only route) and to receive a KFI in an execution-only sale. We would only require the intermediary to give a KFI upon the consumer's request where they can sell the mortgage to the consumer, and where they are not aware, at that stage, of any reason why the consumer would be ineligible for the product. We are now proposing that the trigger points for when a consumer has to be given a pre-application KFI are when:

- an intermediary gives advice to the consumer to take out one or more products (a KFI should be provided for each product);
- the consumer requests a KFI, unless the intermediary is aware that it is unable to offer that product to them; or
- the consumer has provided the intermediary with details of a product it would like to proceed with under the execution-only sales route.

5.199 Though we suggested changes to the trigger points in CP10/28 we also acknowledged it was important to continue to encourage those consumers who do use the KFI to shop around to do so. In light of this, we proposed that consumers be explicitly informed of their right to request a KFI. We asked:

> ***Q16*** *(ii) Do you agree that we should have a requirement to make firms tell consumers that they can request a KFI for any product they offer?*

5.200 Most respondents also agreed that it was appropriate for consumers to be informed of this. We are therefore continuing with this proposal. We have updated our proposed rules on this requirement so that it also applies to the execution-only route.

5.201 We also proposed in CP10/28 that we would remove the restrictions on the circumstances in which intermediaries can give consumers information about products that is specific to the amount they wish to borrow. Currently, there are only very limited ways in which this information can be given outside of a KFI (e.g. orally, on a screen or in a supplementary document to a KFI). Our proposal was designed to give more flexibility to present product information and comparisons by removing these restrictions and instead reminding intermediaries of their obligations to present information in a clear, fair and not misleading manner and to act in the best interests of the consumer. We continue to consider that this is the correct approach.

5.202 Direct-only deals continue to represent a significant proportion of products on the mortgage market[211], and we want to make it easier for intermediaries to consider whether one of these deals is the best option for their consumers. In CP10/28, we proposed that we should remove the requirement for an intermediary to provide the consumer with a KFI when it puts forward a direct-only deal that it does not offer. We instead proposed to require that they give the consumer a record when they have recommended a direct-only

211 See Exhibit 20.5: Proportion of products available direct and through brokers

deal. This record could be in the form of a KFI if the firm wished, though it would not have to be. Where it is in the form of the KFI, we would not hold the intermediary liable for the precise accuracy of it (though it will still need to be clear, fair and not misleading). We also proposed to clarify our current rules to make it clear that intermediaries can charge consumers a fee for advice where they do not take the application forward, e.g. in the case of direct-only deals.

5.203 We asked:

> ***Q16:*** *(iii) Do you agree that we should require firms to provide the consumer with a record, rather than a KFI, where they recommend a direct-only deal?*

5.204 There was general agreement that intermediaries should not have to provide a KFI when they are presenting the consumer with a direct-only product (that they cannot sell themselves) and that instead the consumer should be provided with a record where the intermediary recommends such a product. Many noted that this was a practical solution and would make it easier for an intermediary to recommend a direct-only deal where this was most appropriate for the consumer. Therefore, we are continuing with these proposals.

> Q40: **Do you have any views about our updated proposals for product disclosure?**

Suitability letters

5.205 We continue to take the view that there is not a strong case for a compulsory requirement for intermediaries to provide consumers with a post-sale suitability letter. By the time this is received, a consumer will have already proceeded with a mortgage and will probably not be able to change products without incurring significant cost. The record-keeping requirements as part of the sales process will also provide a solid basis for investigating any complaints about the appropriateness of a product. However, intermediaries will remain free to provide consumers with these letters where they consider this to be good business practice.

Better engaged consumers

5.206 In DP09/3 we outlined the importance of consumers engaging in the mortgage-buying process. In CP10/28 we further considered this in respect of the sales process and concluded that the mis-buying we have seen to date provides clear evidence that some consumers are failing to recognise their purchasing responsibilities. We outlined a number of options we had considered to promote consumer engagement and expressed a view that they would not have a significant impact on consumer purchasing behaviour. However, we opened up the debate to stakeholders and asked:

> ***Q11:*** *Do you have any views on other ways in which we could promote consumer engagement?*

5.207 Most respondents mentioned the importance of MAS in raising consumer awareness. Two respondents felt the recent campaign to raise consumer awareness of the Financial Services Compensation Scheme (FSCS) was successful and thought a similar campaign should be launched stressing the importance of consumer responsibility. One went on to suggest that the campaign should promote a clear distinction between advised and non-advised sales.

5.208 Only a few respondents supported the introduction of a compulsory budget planner which we had presented as an idea in CP10/28. Most agreed with our own analysis that the practical difficulties of doing so outweighed the perceived benefits. A number of respondents felt that the sales documentation provided to the consumer should include risk warnings about irresponsible borrowing. One respondent proposed that consumers should be given an 'extended health warning document' that highlighted key considerations when entering into a mortgage.

5.209 Intermediaries, lenders and trade bodies expressed concern that we were attempting to over compensate for poor consumer decision-making by imposing greater restrictions on lenders and intermediaries. The same respondents stressed the importance, where appropriate, of the consumer taking responsibility for their own decisions. These respondents were concerned that our proposals risked 'over protecting' consumers and removing their responsibility altogether. Several lenders felt that the current prescriptive approach to disclosure was an example of where regulatory obligations were preventing consumers from receiving appropriate information. They said it prevented firms from tailoring information to specific consumer needs and did not allow them to give sufficient focus to explaining what could go wrong. However, respondents acknowledged that the balance between responsibility and protection was a difficult one to get right.

5.210 We recognise the concerns expressed by respondents. We do not plan to reopen the debate about consumer responsibility. There is a long-standing debate about the appropriate level of consumer protection. Throughout the MMR we have stressed the importance of maintaining the right balance between consumer responsibility and regulatory protection, but as respondents have acknowledged, this is a difficult balance to get right.

5.211 We already have a wider range of resources available to improve financial capability with a view to creating more informed, better educated and more confident consumers – much of this work is outlined in Chapter 7. We continue to believe that helping consumers to understand their responsibilities as well as what they can do to protect their own interests, is both helpful and consistent with our statutory objectives and we will continue our work with the MAS in order to take this forward through our financial capability agenda.

Feedback on rules

5.212 Finally, in CP10/28 we gave respondents the opportunity to comment on our draft rules on distribution and disclosure. We asked:

> ***Q22:*** *Do you have any comments on the draft rules?*

5.213 In some areas, respondents felt that our draft rules did not reflect our published policy intention and called for greater clarity in our drafting. We have incorporated these views, as appropriate, into our revised package of measures.

> **Q41: Do you have any comments on the draft rules on distribution and disclosure as set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1?**

6 Arrears management

Summary of key proposals

- Further clarification provided on how firms should be calculating arrears charges.
- Limiting the number of times direct debits can be presented each month.
- Widening the arrears charges and forbearance rules to cover all payment shortfalls.
- Removal of the rule allowing firms to remove borrowers from concessionary interest rates if they go into payment shortfall.

Introduction

6.1 In the MMR Discussion Paper (DP09/3[212]), we discussed the outcomes from our thematic review of firms' arrears-management practices. The outcomes from that review indicated that our high-level regulatory approach had not sufficiently protected consumers. Indeed, some of the practices we found were so poor that it led to us to take enforcement action against five lenders resulting in fines and estimated consumer redress totalling over £19m.[213]

6.2 In addition to that enforcement action, as a priority first stage in the MMR, we took immediate steps to strengthen the existing rules to ensure that consumers who fell into payment difficulties were treated fairly. Those strengthened arrears rules were introduced in 2010.[214]

212 DP09/3, Mortgage Market Review, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf
213 GMAC-RFC (www.fsa.gov.uk/pages/Library/Communication/PR/2009/147.shtml), Kensington Mortgages (www.fsa.gov.uk/pages/Library/Communication/PR/2010/065.shtml), Redstone Mortgages Limited (www.fsa.gov.uk/pages/Library/Communication/PR/2010/120.shtml), DB Mortgages (www.fsa.gov.uk/pages/Library/Communication/PR/2011/025.shtml) and Swift 1st Limited (www.fsa.gov.uk/pages/Library/Communication/PR/2011/079.shtml)
214 PS10/9, *Mortgage Market Review: Arrears and Approved Persons – Feedback to CP10/2 and final policy*, (June 2010): www.fsa.gov.uk/pubs/policy/ps10_09.pdf

6.3 We followed this up by including in the Consultation Paper on responsible lending (CP10/16[215]) a number of further proposals to strengthen our arrears rules. As we are consulting further on all of our proposals, we have not included a formal Feedback Statement on the proposals relating to arrears charges included in CP10/16. Instead, we summarise and discuss the responses we received in explaining the current policy position set out in this chapter.

6.4 We received a large number of responses from a wide range of respondents, including consumer representatives, trade bodies, lenders, intermediaries, systems providers and individual consumers. In general, respondents supported our proposals. A number of practical issues were raised, along with a great deal of constructive and helpful feedback. These responses have helped to shape the proposed policy approach set out here.

6.5 The cost benefit analysis (CBA) for these proposals is in Annex 1 of this paper and the compatibility statement in Annex 3. The proposed new arrears charges rules are set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1.

Clarification of how firms should be calculating arrears charges

6.6 Part of the immediate action we took in 2010 related to arrears-charging practices. We expect arrears charges to be a fair reflection of the additional administration costs faced by the lender, not – as we discovered in the thematic review – a way to increase profits or offset costs from other parts of the business. So we took immediate action to ban the most obvious unfair practice we had found, i.e. the continued application of a monthly arrears administration charge where a borrower was adhering to an arrangement to pay. Furthermore, in CP10/2[216] we consulted on proposals to use guidance to clarify our requirements prohibiting the inclusion of arrears charges within early repayment charges (ERCs).

6.7 We also indicated that we would conduct a more detailed analysis of arrears charges across the market. In CP10/16 we presented the findings of that analysis, which included a review of the tariff of mortgage charges and a review of fee justifications from 26 lenders. The main factual findings from our review are set out in Annex 2 of CP10/16.

6.8 That analysis exposed some fundamental issues. The mortgage rules require arrears charges to be a reasonable estimate of the additional administration costs faced by the lender as a result of a borrower being in arrears[217]. Despite this, it was clear from the fee justifications we received – some five years after the introduction of the mortgage regime – that most lenders had not adequately considered (and in some cases not considered at all) the underlying administration costs (as the rules require) on which to base their arrears charges. The result was that firms were both under-charging and over-charging relative to their additional administration costs.

215 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf
216 CP10/2, Mortgage Market Review: Arrears and Approved Persons, (January 2010): www.fsa.gov.uk/pubs/cp/cp10_02.pdf
217 MCOB 12.4.1 R(1) https://fsahandbook.info/FSA/html/handbook/MCOB/12/4

6.9 Examples of poor practice identified included lenders who set their arrears fees and charges by simply benchmarking against their competitors, rather than calculating what their additional administration costs were. We also identified firms charging a percentage of the outstanding debt rather than a charge which properly reflected their actual administration costs. And we saw some firms charging a quarterly or annualised arrears charge even though the borrower had only been in arrears for a short time.

6.10 Some lenders were also seeking to recover overheads and indirect costs which were too remote or unconnected with the administration of accounts in arrears. These included executive board costs, funding costs, some financial reporting costs and unrecovered fees.

6.11 In CP10/16 we therefore proposed to clarify how firms should be calculating arrears charges under our rules, in particular by ensuring that the only costs charged are those clearly and directly attributable to the additional administration incurred by a firm when dealing with borrowers in arrears.

6.12 In CP10/16 we asked:

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

6.13 The draft instrument in CP10/16 included guidance on the costs which we considered were likely to be recoverable. Most respondents were either neutral about or supported our proposals. A significant majority of respondents agreed with the proposal to ban arrears charges based on a percentage of the loan, as well as our proposed guidance making it clear that quarterly or annualised arrears charges should not be charged to borrowers who only remain in arrears for a short period of time.

6.14 The main concerns raised by respondents related to the potential for increased compliance costs to deal with the proposed new rules, and the inability to recover executive staff costs and financial reporting costs. The ability to recover executive staff costs was a particular concern for some smaller building societies. Some lenders indicated that there are some financial reporting costs which relate to the analysis and management of accounts in arrears and could be directly attributed to those borrowers. One building society noted that this type of financial reporting can be used to forecast and plan future arrears-management needs.

6.15 Although some respondents identified specific examples where the guidance on the recoverability of costs might not be applicable to their particular business, we do not propose to change the costs we included in the guidance, as they will apply in the vast majority of cases. We are proposing, however, to turn the proposed guidance into a rule, setting out the types of costs that must not be taken into account. In the light of the responses, we are also proposing to include two specific exceptions to the general rule about the costs that cannot be taken into account.

6.16 The first exception recognises that, for some of the smallest lenders, executive staff costs relating to the day-to-day management of individual payment shortfall cases will be a reasonable cost to recover through arrears charges. Firms should adopt a common sense approach to this and consider whether it is necessary and appropriate for executive staff to be dealing with arrears cases.

6.17 Time spent by executive staff on company strategy, including arrears strategy, is not a cost that should be recovered through arrears charges. In our view, this is part of the general oversight of the firm and is not sufficiently related to the day-to-day management of arrears cases.

6.18 For the purposes of our rules, 'executive staff' will mean the staff or business owners responsible for managing the business, which, for some of the very small lenders, might be Executive Board members.

6.19 The second exception we propose is for those financial reporting costs which can be attributed solely to the analysis and management of accounts in arrears. However, firms should not recover more general financial reporting costs, including all legal and regulatory reporting costs, through arrears charges.

6.20 Some respondents would have liked us to be more prescriptive about which costs could and could not be recovered. But it is difficult for us to provide exhaustive lists of the costs which are and are not recoverable, given the many different costs firms apply. Moreover, costs can very easily be reclassified for the purposes of avoiding prescriptive rules.

6.21 We still think that funding or capital costs do not represent an additional administration cost of borrowers being in arrears. Several respondents raised concerns about the proposed treatment of these costs. While we recognise that funding and capital costs may increase as a result of borrowers being in arrears, our view is that these costs should be recovered through the mortgage product interest rate rather than through arrears charges.

6.22 Some respondents were concerned about increased compliance costs as a result of our proposals. But we see no reason why compliance costs should increase significantly. Although some firms may need to undertake an exercise on a fee-type by fee-type basis to calculate the relevant administration costs, we expect that, for most firms, the relevant attributable costs can be readily calculated from standard management information. And while any subsequent increase in arrears charges will need to be supported by an exercise to identify the relevant administration costs, we do not expect firms to continually analyse in detail their arrears costs. Rather, as part of their ongoing management oversight of the business, we would expect firms to monitor any significant cost variances which might indicate that the firm's arrears charges are higher than the relevant costs.

6.23 In addition to the changes set out above, the draft instrument has been updated to ensure that firms cannot impose arrears charges except where the charge is a 'reasonable **calculation**' of the cost of the additional administration, rather than a 'reasonable **estimate**' of the cost. This change is proposed to ensure that firms undertake appropriate calculations to identify the relevant costs.

6.24 We also propose to amend the current guidance to make it clear that firms should be calculating the additional administration costs for each type of arrears charge. Monthly arrears-management charges are an example of one type of arrears charge.

> **Q42: Do you have any comments on the proposed policy approach on the calculation of payment shortfall charges?**

Limiting the number of times missed payment fees are charged

6.25 Our arrears thematic review also identified firms which were re-presenting direct debits and charging a fee each time, regardless of the number of times it had already been returned unpaid. We identified one lender, in particular, who between March 2007 and March 2008 had collected revenue of over £2m from failed payment charges alone. Re-presenting failed payments was unlikely to result in payment of the shortfall and the practice simply exacerbated borrowers' payment problems. So we proposed limiting the number of times that missed payment fees could be charged.

6.26 In CP10/16 we asked three questions about missed payment charges:

> *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?*

6.27 The overwhelming majority of respondents agreed in principle with our proposal to limit the number of times fees for missed payments are charged. They supported the need to ensure borrowers in arrears are treated fairly. However, a small number of lenders felt that it was not necessary for us to introduce prescriptive rules around this area.

6.28 Many respondents queried a perceived mismatch between the policy, which proposed that a firm must not charge a fee for re-presentation more than once and the draft rules which permitted the fee to be charged twice.

6.29 Respondents also indicated that it is common practice amongst lenders to re-present the direct debit a number of days (usually ten days) after the first attempt. During this time, the lenders contact the borrower to agree a revised payment date. So they argued that, where a re-presentation is made with the borrower's consent, the lender should have the right to impose a charge if the direct debit is then not honoured.

6.30 Lenders also noted that, whilst they can control the charges they apply when a direct debit is requested more than twice in a month, they have no powers to control the charges imposed by the borrower's bank for the failed payments. They highlighted that our proposal will not prevent repeated charges for failed payments from the borrower's bank.

6.31 Given the widespread support received for this proposal, we intend to limit the number of times a borrower can be charged for missed payments. We propose to allow a firm to charge twice each month for failed direct debit requests.

6.32 In addition, and in response to the feedback about bank charges, we think that it is appropriate not only to limit the number of times a firm can charge the borrower for a failed direct debit, but also to impose a limit on the number of times a firm can request a direct debit in a month. We think this should be limited to two in a month. It is unlikely that any further attempts within a month will be successful and attempting more simply serves to impose on the borrower repeated failed payment charges from their bank. The proposed new rule to this effect will not prevent a borrower from making payments using other methods following the failed direct debits, and the firm from imposing an appropriate administrative charge if that payment subsequently fails.

6.33 Lenders also indicated our proposal, that they should review and consider the suitability of the method of payment following repeated failed direct debit attempts in two consecutive months, may not prevent borrowers from being charged numerous times. This is because there could be many months where the payment pattern could indicate difficulties but without the direct debit failing twice in a month over two consecutive months. For example, there might be a pattern of the borrowers only being able to honour their direct debit payment at the second time of asking in each month.

6.34 Several respondents also queried how this proposal would work in practice. In particular, they asked what the borrower's and lender's respective roles would be in the decision-making process. And, in cases where the borrower does not engage with the lender, they asked whether the lender will be expected to make the final decision about the suitability or otherwise of the continued use of direct debits as a repayment method.

6.35 In response to the feedback, we are proposing to amend the proposed rule that requires firms to review the payment method when direct debits have failed in consecutive months. This change is intended to make it clear that we expect the review of the payment method to be undertaken where there is at least one direct debit failure in each of two consecutive months. This will ensure any payment difficulties are identified and a payment review undertaken at the earliest opportunity.

6.36 That review should establish whether payment by direct debit is the appropriate payment method. The suitability of the payment method will depend on each borrower's individual circumstance and compliance can be evidenced through appropriate record keeping.

However, we recognise the difficulties for firms where the borrower fails to respond to their reasonable efforts to make contact. In these circumstances, we feel that the firm should be entitled to continue to request the monthly payment via direct debit, as originally agreed with the borrower, and to recover fees for doing so, subject to the maximum of two requests per month discussed previously.

6.37 Finally, the original draft instrument included references to 'payment requests' and 'direct debit' requests. In response to feedback we have amended the draft rule to replace references to 'payment requests' with 'direct debit requests'.

6.38 It was apparent from responses that a small number of firms already follow practices in line with what we are proposing. But most firms said they would need a transitional period of six to 12 months to make the necessary changes to meet the proposed new requirements. We will take this into account when considering implementation of the final proposals.

Q43: Do you have any comments on the proposed policy approach on direct debit payments?

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

6.39 In CP10/16, we also proposed to amend the charges rules so that they applied to all payment shortfalls and not just to 'arrears' (defined as a shortfall equivalent to two or more payments). In our thematic review of firms' arrears-charging practices, we found that some firms were charging excessive monthly arrears fees as soon as a borrower missed a payment and we were unable to take action to ensure those fees were cost-based as the charges technically fell outside the rules. So we proposed to close that gap and to prevent firms front-loading arrears charges into the first month in order to circumvent our rules.

6.40 In CP10/16 we asked :

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)?

6.41 The majority of respondents agreed with this proposal in principle, with some lenders indicating that they already comply. One trade body was concerned that in some lenders' systems, there may be a time lag from when the payment is missed to when the lender classes the account as having a shortfall. They thought the rules imply that systems must be altered to remove this time lag, resulting in significant costs.

6.42 The definition of 'payment shortfall' is the 'outstanding amount to be measured against the amount of payments which have become due' under a regulated mortgage contract or home purchase plan, including any arrears amount due. This, we believe, is broad enough to cater for the different monthly cycles of all lenders. Firms will simply class the payment as outstanding at a different time in the monthly cycle. Therefore, systems changes should not be required.

6.43 Respondents also noted that, within the industry, the term 'payment shortfall' relates to any shortfall that remains following the sale of a repossessed property and therefore thought that a different term should be considered.

6.44 The term 'payment shortfall' is already used in our Handbook in the broad sense in which we propose to use it in our new definition. Also, the outstanding amount following the sale of a repossessed property is defined as a 'sale shortfall' in our Handbook, which we think makes the distinction between the two types of shortfall clear.

6.45 There were a range of views on how long a transitional period firms would require, ranging from none for those lenders who already comply, to six months for the majority of respondents, and 12 months for a minority. We will take this into account when considering implementation of the final proposals.

Q44: Do you have any comments on the proposal to extend the application of MCOB 12.4 and 13.3 rules to include payment shortfalls?

Removal of concessionary rates if a borrower has a payment shortfall

6.46 One area of arrears-management practices that we have not previously raised relates to lenders' removal of concessionary interest rates if a borrower has a payment shortfall.

6.47 Our existing arrears charges rules specifically allow firms to withdraw concessionary rates.[218] The original policy approach recognised that a concession is precisely that. Across a whole range of financial and non-financial transactions, a breach of contract typically has the result of putting concessions at risk.

6.48 But we are concerned that removing a concessionary rate for a borrower in payment difficulties is simply going to have the effect of making that borrower's financial position

218 MCOB 12.4.1R(2) https://fsahandbook.info/FSA/html/handbook/MCOB/12/4

worse. This would also remove the certainty of fixed payments for those borrowers who had made a conscious decision not to face the uncertainty of variable rates.

6.49 Our concern appears borne out by the approach taken by firms generally in relation to this provision. In response to the media highlighting the practice of one particular lender which had withdrawn a concessionary rate when only one payment had been missed, we undertook some analysis. This aimed to identify those lenders who have mortgage contract terms which allow them to move borrowers from a special concessionary rate to the firm's standard variable rate if they fall behind with their mortgage payments.

6.50 That analysis established that although many lenders have contractual terms which allow them to do this, very few would enforce the term in practice. Certain lenders considered that this would be seen to be unfair treatment as by doing this the firm would be penalising a borrower twice for falling into arrears (i.e. by applying an increased rate on top of the imposition of arrears charges). Of the few firms who indicated they would enforce the term, most indicated that they would only do so in extreme circumstances. One said that it would not remove the concessionary rate where it knew that applying the term would exacerbate known financial distress.

6.51 We acknowledge that there may be circumstances when removing a concessionary rate for a material breach of a mortgage term is entirely justified. But we agree with what appears to be a consensus view amongst lenders that it would not be appropriate or reasonable to remove a concessionary rate when a borrower falls behind with their mortgage payments.

6.52 We therefore propose to delete the existing arrears charges rule which allows firms to do this. However, we do propose to include in its place a new general provision which recognises that a firm should be able to consider withdrawing a concessionary rate for material breaches of contract unrelated to mortgage payment shortfalls.

Q45: Do you have any comments on the proposal to replace MCOB 12.4.1 R (2) with a rule permitting firms to remove concessionary rates where there is a material breach of contract unrelated to payment shortfall?

Q46: Do you have any comments on the draft rules on arrears management as set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1?

Forbearance and impairment provisions

6.53 In Chapter 2 we noted that, in the current economic environment, lenders have stronger incentives to exercise forbearance and, therefore, repossessions and write-offs are being kept low. However, where forbearance is provided without due care or any knowledge or understanding of the impacts, it can have adverse implications for the borrower, the firm's understanding of the risks inherent within its lending book and, in turn, the regulator and the market.

6.54 In October 2011, we published our forbearance and impairment provisions good and poor practice guidance[219] to help firms comply with their responsibilities for this under the rules set out in our Handbook. This is focused on firms' practices that impact on the loss risks of accounts (forbearance provided to support financial stress), the effective management of these risks and the mechanisms for their recognition and reporting.

6.55 The guidance covers the following:

- the provision of forbearance support for borrowers undergoing financial stress;
- the recognition of impairment within the book through management committees and Board reporting; and
- the disclosure of impairment and its recognition through loss provisions in external reporting.

6.56 We recognise the potential for tensions in respect of prudential and conduct interests when looking at topics such as forbearance. We believe forbearance based on sound conduct principles provides for sound prudential management, and that forbearance should be based on an individual assessment of the borrower. Where this principle is applied we do not believe there is any conflict between the prudential and conduct regulatory requirements for firms.

Third-party administrators

6.57 In the DP09/3, we noted that our mortgage arrears-handling thematic work had highlighted changes in the relationship between lenders and third-party administrators (TPAs). We indicated that we would be undertaking a review of our approach to TPAs. We will publish our wider conclusions and proposals on TPAs at a later date.

6.58 TPAs should also note the government's proposal for us to regulate all firms which purchase regulated mortgage books, which we discuss in Chapter 7. This involves important changes to the regulated activity of 'administering' a regulated mortgage contract. This proposal will affect mainly TPAs, as they are most likely to be providing administration services to unregulated buyers of mortgage books. We will consult in due

219 *Forbearance and Impairment Provisions – 'Mortgages'*, FSA (2011): www.fsa.gov.uk/pubs/guidance/fg11_15.pdf

course on any changes to our rules that might be needed as a result of this proposed legislative change.

Early repayment charges

6.59 As noted in paragraph 6.6, we consulted on clarifying our requirements prohibiting the inclusion of arrears charges on the charges within ERCs. The feedback received to this proposal highlighted a more general issue about ERCs.

6.60 The existing mortgage rules require an ERC to be a reasonable pre-estimate of the costs incurred by a firm as a result of the borrower repaying the mortgage early. It was clear from responses, however, that there are widely divergent approaches to calculating ERCs. This has prompted us to review market practice in relation to ERCs, which we will report on as part of our wider charges work, discussed further in Chapter 7.

7

Other conduct matters

Introduction

7.1 In this chapter we set out a number of other conduct matters mentioned in previous MMR papers. These are updates on the current position and indicate some of the policy work that will continue after the formal MMR project has come to an end, including, in particular, our ongoing work in relation to regulatory reporting and mortgage charges. We also report the outcomes of our review into multiple credit search footprints for the Treasury Select Committee, mentioned in Chapter 5. At the end of the chapter we summarise all of the miscellaneous changes to the Handbook resulting from the MMR proposals.

Multiple credit search footprints

7.2 When they receive mortgage applications, lenders perform credit searches to obtain the information they need about a consumer's current credit commitments and credit history to aid their lending decision. They have to get the consumer's authority to do this as it leaves a record called a 'footprint' that stays on the consumer's credit file for 12 months, allowing lenders to meet their own information sharing rules and obligations.

7.3 Lenders share the fact that a consumer has applied to them for credit because multiple search footprints can be an indication of fraud or credit problems. The fact that a consumer has made multiple applications for credit can reduce their credit score and evidence of multiple search footprints will tend to make lenders more cautious about lending to an individual.

7.4 We noted in Chapter 5 that the Treasury Select Committee had asked us to investigate the potential adverse effect of multiple credit searches on consumers' credit ratings.

7.5 Some respondents to CP10/28[220] raised concerns about our proposal to remove from intermediaries all the existing detailed regulatory requirements to assess affordability. Our proposal is that the only requirement on intermediaries will be to determine whether a consumer meets a lender's affordability criteria. As intermediaries do not have access to

220 CP10/28, *Mortgage Market Review: Distribution & Disclosure*, (November 2010): www.fsa.gov.uk/pubs/cp/cp10_28.pdf

precise details about lenders' affordability criteria, a concern was raised by respondents that this might lead intermediaries to submit many applications on behalf of a consumer to several lenders to establish whether the consumer meets their lending criteria. This could have an adverse impact on that consumer's credit rating.

7.6 We have discussed the recent concerns raised about this with lenders, intermediaries and also the Credit Reference Agencies (CRAs). The CRAs and lenders indicated that the number of search footprints actually forms a very small element of the overall credit scoring process today and certainly has less impact than in the past.

7.7 When we discussed this issue with intermediaries, they indicated that lenders do still call them to question why there are so many searches, and will then often ask about other elements of the application that would not normally be questioned. However, lenders assured us that they would not decline a case on the grounds of multiple search footprints alone.

7.8 The only evidence of detriment we have uncovered is from the CRAs. It appears that consumers are regularly questioning the number of search footprints appearing on their credit file – across all products and not just mortgages. Some consumers believe that they had done nothing more than make an initial enquiry, with no firm intention of applying for the credit and others could not remember authorising a search at all.

7.9 The CRAs are working with lenders and trade bodies to improve the messages consumers are given about the consequences of credit searches and they believe that this will go a long way to addressing this issue.

7.10 Where the consumer is not asking for a commitment to lend, it is possible for lenders to get the information they require about a consumer's credit history through what is known as a quotation search. This does not leave a search footprint on a consumer's file. Some firms already do this as standard practice.

7.11 We have considered whether we should intervene to require all lenders only to use quotation searches. However, search footprints serve a useful purpose in alerting lenders to possible fraudulent applications or debt problems and it is right that lenders should be aware of this and in a position to investigate further if they have concerns.

7.12 Lenders have also assured us that the fact of multiple search footprints alone would not lead to them declining an application. Moreover, in order to justify regulatory intervention, we would need to be sure that the benefits to consumers would outweigh the costs to lenders. Lenders have indicated that requiring them to use quotation searches would have significant systems and costs implications. And we simply do not have sufficient evidence of consumer detriment currently to justify imposing those costs on lenders.

7.13 So we have concluded that there is no need for regulatory intervention at this stage. However, we will continue to monitor this issue and to see whether the CRAs' work with lenders and trade bodies to improve the messages to consumers about credit searches has the desired effect.

Responsible borrowing and financial capability

7.14 Throughout the MMR we have referred to the importance of increasing financial capability in order to help consumers make informed decisions. This reflects the importance we place on consumers being properly engaged in the process and sharing responsibility for making the right choice. We saw significant evidence of 'irresponsible borrowing', including, for example, consumers:

- using self-certification to inflate income;
- opting for interest-only products to borrow more than they could afford on a capital repayment basis, without any thought about how to repay the capital in the longer term; and
- focusing only on the short-term cost of their mortgage – seduced by an initial low-rate – with little consideration about how they would afford the loan in the longer-term.

7.15 The reforms we are proposing in Chapters 3, 4 and 5 will increase protections for consumers in the lending and sales process. However, it is equally important to have measures that encourage consumers to take responsibility for the longer-term viability of their mortgage. We continue to work closely with the Money Advice Service (MAS) which was set up under the Financial Services Act 2010 to enhance the public's understanding and knowledge of financial matters and their ability to manage their own financial affairs. As noted in Chapter 5 most respondents to CP10/28 recognised the important role that the MAS plays in raising consumer awareness. In both the short and longer term, the MAS can help consumers become more engaged with and informed about their mortgage decisions.

7.16 The MAS has recently updated its written materials for consumers, its website and also launched an online money health check in June 2011. The health check provides people with a personal action plan, showing the steps they can take to help take control of their money straight away, and how to plan for future goals. If a user states that they plan to buy a home soon, their action plan will give advice on what to do, taking into account their wider financial situation.

7.17 The MAS also provides updated information and advice for consumers on its website, including for first-time buyers (FTBs) and those consumers looking at investing in property, reflecting risks identified in the MMR.

7.18 The Service is available face-to-face, by telephone or online, and mortgages and credit remain amongst the more popular topics. Face-to-face and telephone Money Advisers proactively explore if there are mortgage issues, amongst other issues, for people going through certain life events.

7.19 For those consumers who already have mortgages, there is ongoing support and guidance to help them stay in control. The Service has a 'Stay on top of your mortgage' campaign and worked with a wide range of stakeholders to ensure that information and advice reached people who would be most affected by an increase in interest rates.

7.20 Consumers who have fallen into arrears can also be in significant need of guidance on how to manage their situation. The MAS provides information and advice aimed at people who are going through life events that are known to be key triggers for arrears. It has also taken on responsibility for co-ordinating debt advice services, so these can be put on a more sustainable footing.

7.21 Following a comprehensive review of its products and services, the Service intends to develop a more personalised service designed to enable people to take action, with a greater emphasis on digital tools, whilst maintaining its face-to-face and telephony provision, and providing advice rather than information. It will set out its future proposition in its Business Plan in March 2012. The Service's mortgage-related content will be reviewed as part of developing its new proposition so that it is more closely designed to drive appropriate action and deliver against its statutory objectives.

Financial crime and mortgage fraud

7.22 As noted in Chapter 3, mortgage fraud continues to be a major concern in the UK market. Several proposals outlined in this CP, combined with more sophisticated fraud detection techniques, are expected to help address mortgage fraud. These are:

- making income verification a requirement for all mortgages;
- clarifying that ultimate responsibility to assess affordability lies with lender, who will be held accountable;
- more prescriptive rules on affordability checking;
- requiring evidence of a repayment strategy for interest-only mortgages; and
- requiring all mortgage intermediaries to be Approved Persons and to hold a mortgage qualification.

7.23 In addition, since 2010 we have increased our proactive approach to tackling mortgage fraud through our Mortgage Fraud Strategy. This encompasses existing activities such as: enhancing our industry communications; the Information From Lenders (IFL) scheme; and improving mortgage fraud investigation methods.

7.24 New initiatives have included: setting up a regular Mortgage Fraud Round Table with the participation of major lenders and the Council of Mortgage Lenders (CML); an outbound calling programme with lenders with improved IFL referrals and information sharing; and greater collaboration with external bodies and industry links such as the police and fraud-solution providers. We also continue to maintain our credible deterrence message through enforcement action.

7.25 In June 2011, we published our thematic report[221] on the adequacy of lenders' systems and controls against mortgage fraud. Our review found that although the industry has made some improvements, there are still weaknesses common to many firms. The report details key findings in the following areas: Governance and Management Information; Underwriting; Third-Party Management; Mortgage Fraud Prevention; Training and Compliance; and Internal Audit. One of the key findings in the report is the importance of information sharing.

7.26 We would encourage firms to engage with cross-industry information sharing initiatives, including HMRC's recently launched verification scheme and our own IFL scheme.

7.27 We will also continue to look at lenders' mortgage fraud systems and controls, and firms should take note of our findings and the good and poor practice guidance contained in our report.

Scope extensions

7.28 The government has recently made changes to the Financial Services and Markets Act 2000 to extend our regulatory scope to include commercial sale and rent back (SRB) transactions that fell outside of the 'by way of business' test. The changes make it clear that anybody who conducts SRB business, even if only a single transaction, must be authorised by the FSA, unless they are related to the customer. This has brought more consumers of these higher-risk products within the our protection. We have also consulted[222] and made changes to our Perimeter Guidance to reflect the legislation.[223]

7.29 As noted in Chapter 6 in relation to third-party administrators, the government has also announced its intention to expand the definition of the regulated activity of administering a regulated mortgage contract. This will help to ensure that where mortgage books are sold on to an unregulated firm, consumers do not lose the regulatory protection they previously enjoyed. The government is currently working on the detail.[224] Once Parliament has made these changes, we will consult on any rule changes.

7.30 In DP09/3[225] we outlined the potential 'gaming' risks that would arise from us placing tighter controls around lending for FSA-regulated mortgages. Where a consumer could not borrow as high an amount as they would like under these rules, they might seek to take the additional borrowing as a second charge loan or to fraudulently disguise their residential mortgage as a buy-to-let mortgage.

221 *Mortgage fraud against lenders – A thematic review of lenders' systems and controls to detect and prevent mortgage fraud*, (June 2011): www.fsa.gov.uk/pubs/other/mortgage_fraud.pdf
222 CP11/18, *Quarterly consultation paper No.30*, (September 2011): www.fsa.gov.uk/pubs/cp/cp11_18.pdf
223 Handbook Notice 115 (December 2011): www.fsa.gov.uk/pubs/handbook/hb_notice115.pdf
224 Enhancing consumer protection in the mortgage market: www.hm-treasury.gov.uk/fin_sector_mortgages_enhancing_consumer_protection.htm
225 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

7.31 The government has since announced its intention to transfer responsibility for regulating second charge lending to us. This transfer has been delayed until a decision is taken on the wider transfer of consumer credit. This means that any transfer will not take place until at least April 2014 or beyond. As well as addressing the 'gaming risk', the transfer will result in more consistent regulation for first and second charge lending. This move will also align the UK position with that of the European Commission's proposed directive on mortgage credit (which covers both types of lending).

7.32 We are currently seeing anecdotal evidence of buy-to-let mortgages being used by borrowers who would otherwise be denied an owner-occupied mortgage. We remain concerned that this problem may be exacerbated with the implementation of our responsible lending proposals.

7.33 Whether we regulate buy-to-let lending is a decision for the government.

Future mortgage market related work

Data requirements

7.34 In both DP09/3 and CP10/28 we noted that changes to our regulatory approach would inevitably result in a need to review the current data collected through Product Sales Data (PSD), the Mortgage Lending and Administration Return (MLAR) and to a lesser extent the Retail Mediation Activities Return (RMAR).

7.35 We set out here our current thoughts about the changes that may be needed. It is important to stress that our thinking in this area is still developing but we want to engage the industry at as early a stage as possible on this. Before making any firm commitments about change, we would welcome a comprehensive discussion about our proposals with firms and trade bodies and an understanding of the cost implications both for industry as well as ourselves. We also need to consider carefully the timing of any changes we make.

Product Sales Data

7.36 Since 1 April 2005, product providers have given us transaction-level data on all sales of regulated mortgage contracts. The data we currently collect includes various mortgage and borrower characteristics and measures, most of which are compulsory for lenders to report.[226]

7.37 The changes we have been thinking about making to Product Sales Data (PSD) reporting include:

- making the reporting of some data fields that are currently optional mandatory;

226 Summary statistics from these returns are available on our website as PSD trend reports: www.fsa.gov.uk/Pages/Doing/Regulated/Returns/psd/publications/index.shtml

- adding new data fields to monitor compliance with the regulatory requirements;
- adding new data fields to gather better evidence for FSA policymaking and supervision (specifically, data on arrears, possessions and forbearance); and
- clarifying the definition of credit impairment.

7.38 We explain the rationale for our views in the sections below.

Mandatory reporting of some data fields that are currently optional

7.39 A number of data fields are currently reported in PSD on a voluntary basis, including:

- the date any incentive rate ends;
- the date an early repayment charge (ERC) ends; and
- the initial gross interest rate.

7.40 We think that it would help if completing these fields was mandatory rather than optional. This is because interest rate data would help us monitor compliance with our responsible lending requirements. Data on the date when incentive rates and ERCs end would help us understand better when borrowers are likely to remortgage and what effect changes in interest rates may have on borrowers' ability to service their debt.

Adding new data fields to monitor compliance with regulatory requirements

7.41 If the affordability proposals in this paper go ahead, to effectively monitor compliance with the new standards, we need to have more data on borrowers' income and expenditure. For example, we may consider collecting data on the following, to help us understand the financial position of mortgage applicants and monitor how lenders assess affordability:

- **Borrowers' income**. Currently, in PSD, gross income is reported. Where there is more than one borrower, their joint (total) income is reported. But mortgage affordability assessments must be based on take-home (net) income. Although, we can estimate from gross income how much the net income is approximately (which we have done successfully for our analysis), we recognise that in some cases this estimation could be inaccurate, particularly where there are two or more mortgage applicants or where an applicant is receiving some benefits. So it could be easier for us to monitor how lenders assess affordability, if, in addition to gross joint income, we collect data on net income. It would also be useful to know the incomes of each borrower in a mortgage application. To improve the quality of income data reporting in PSD, it would also help if we could introduce additional 'flags' for lenders to complete, which would allow us to identify 'special cases' where the reported borrowers' income does not reflect the borrower's circumstances, such as 'staff mortgage', 'guaranteed mortgage', 'regulated buy-to-let mortgage', or 'regulated business mortgage'.[227]

- **Household size**. At present, we cannot tell from PSD how many people are supported by the income stated on the mortgage application. However, this information is very important in assessing affordability. So we are considering asking lenders to report to us how many adults and children are in the borrower's household.
- **Estimated expenditure**. We propose in this CP that lenders should take explicit account of certain elements of borrowers' expenditure. So that we can monitor how lenders are doing this, we are considering collecting some data on the types of expenditure that we propose lenders must assess, for example:
  - The other committed expenditure of the applicant, which will continue after the mortgage is entered into, i.e. credit commitments and other contractual commitments.
  - Basic essential expenditure and basic quality of living costs. This could be the actual expenditure that the lender has collected from the mortgage borrower, or an estimate that the lender has applied using statistical data or modelled from their own data. We may also ask lenders to indicate in their returns whether the expenditure data they have reported was the actual expenditure or whether the lender applied an estimate.

7.42 In this CP, we have proposed that consumers can buy a mortgage with advice or on an execution-only basis. We want to be able to monitor how much business firms do in each of these areas. In PSD, we already collect data on advice at the point of sale. Recent advancements in technology have led to some changes in the mortgage distribution channels, with more consumers buying their mortgages without face-to-face contact with a lender or an intermediary. We understand that at present this is relatively limited, but may become more common in future. Therefore, we are considering collecting data on distribution channels in PSD, so that we know the means by which the borrower has bought the mortgage and can monitor any future changes in this area.

Adding new data fields to gather better evidence for FSA policy making and supervision – arrears, possessions and forbearance

7.43 Although we collect data on both individual mortgage transactions (PSD) and arrears/possessions/forbearance (MLAR), we are not currently able to link individual cases of non-performance back to the original transaction. This limits the extent that we can analyse the drivers of mortgage non-performance at an individual transaction level.

7.44 In 2009, the CML helped us obtain a one-off transactional arrears and possessions data report from a cross-section of banks, building societies and non-bank lenders – covering April 2005 to August 2009. In 2010, we repeated this data collection, again with help from

227 We discovered serious problems with the quality of income data when we looked at individual transactions reported by lenders as part of our analysis for CP10/16.

the CML, and obtained data on performance of mortgages sold between April 2005 – September 2010, which also included some data on historic payment problems and on forbearance. On both occasions, the vast majority of lenders were able to report this data to a good standard within a relatively short period. This data proved invaluable for our policy analysis and helped inform many of our responsible lending proposals. In future, we would like to make this a regular part of firms' regulatory reporting requirements.

7.45 We raised the prospect of collecting transactional arrears and possessions data in DP09/3. We asked whether respondents agreed that we should collect data to enable us to track arrears and possessions cases back to the original product transaction.

7.46 Most respondents supported this proposal. Some felt that having such data would enable us to analyse risks taken by the lenders and to ensure that firms comply with the principles of responsible lending. A few though expressed concerns that linking arrears back to product characteristics would have limited value as payment difficulties are often caused by life events, such as unemployment or illness. Some respondents noted that the arrears and possessions data is already available to lenders and should not be difficult or costly to report. However, others expressed concerns that the additional data collection requirement may necessitate changes to IT systems and that the cost of this could be significant.

Clarifying the definition of credit impairment

7.47 Because of recent legal developments, we may need to expand the types of credit impairment currently collected in PSD to include Debt Relief Orders (DROs). DROs were introduced by the Tribunals Courts and Enforcement Act 2007[228] and came into force in England and Wales on 6 April 2009. These are a new type of bankruptcy instrument that are not explicitly captured in the current definition used in PSD (although it is arguable that they might be implicitly captured). As DROs are new, they are not very prevalent at the moment, but might become more so in future. For example, according to the Insolvency Service, in 2009 there were 11,831 recorded DROs in England and Wales and in 2010 there were 25,179 DROs.

7.48 As a result of these changes, we may also introduce changes to the definition of county court judgements.

Mortgage Lending and Administration Return

7.49 Since the beginning of 2007, regulated mortgage lenders and administrators have had to submit the MLAR each quarter, providing aggregate data on their mortgage lending and administration activities.

7.50 We have recently published guidance on forbearance and impairment provisions which provides guidance on practices, internal reporting and disclosures. Changes to regulatory reporting to cover forbearance has not been detailed in the guidance which will be reviewed separately. We will report on the outcome of this review in due course.

228 Tribunals, Courts and Enforcement Act 2007: www.legislation.gov.uk/ukpga/2007/15/contents

Retail Mediation Activities Return

7.51 Since July 2005 retail intermediaries have had to provide us with aggregate data on their business in the RMAR.

7.52 Minor changes to RMAR will be needed if the proposals discussed in Chapter 5 on changing the scope of service description requirements go ahead.

Fees and charges

7.53 In DP09/3 we announced our desire to collect data on fees and charges and we reiterated this intention in CP10/28. We are still considering what would be the most cost-effective way to collect this information. For lenders, we think it may not be feasible to require this data for every individual borrower at a transactional level. However, we would like to collect regular information on lenders' charges and procuration fees. Intermediaries currently report fee income from regulated mortgages in their RMAR. It is, however, difficult to determine with any degree of accuracy what the fees are on a case-by-case basis. So we are considering how we can refine this data requirement.

7.54 As noted earlier, our thinking about changes to data reporting is still developing. Before we make any firm proposals about change, we would value input from firms and trade bodies to help inform our views.

Review of other mortgage charges

7.55 In DP09/3 we said we would undertake supervisory work looking at lender product charges and charging models. We are currently reviewing non-arrears related charges and as part of this work we are considering mortgage set-up fees, early repayment charges, valuation fees and mortgage exit fees. This review aims to determine more conclusively whether consumers are suffering significant financial detriment from excessive charges imposed by lenders as well as assessing whether our charging rules[229] are fit for purpose and whether changes are required.

7.56 Under our rules firms cannot charge an early repayment charge (ERC) unless it is able to be expressed as a cash value and be a reasonable pre-estimate of the costs as a result of the customer repaying the amount due under the mortgage contract.[230] As part of the early repayment charges work we have obtained information from a number of different lenders on the methodology they use to set their ERC rates and explanations on how they ensure that their approaches to ERCs are compliant with our rules, as well as gaining an understanding of the actual costs lenders incur on early redemption. We are also analysing ERC rates on different products using Defaqto market snapshots in different years to help us gain an understanding of how ERC rates have changed over time.

229 MCOB 12: http://fsahandbook.info/FSA/html/handbook/MCOB/12
230 MCOB 12.3: http://fsahandbook.info/FSA/html/handbook/MCOB/12/3

7.57 DP09/3 set out how application fees had increased significantly between 2002 and 2009 for a number of lenders. Several lenders have given us information on the application costs that they incur as well as commentary on the impact of mortgage set-up fees on mortgage product pricing. For a number of products we are examining the trade-off between interest rates and product/ application fees and consumer product selection. In addition to the work on application fees and ERCs, we are also getting information from lenders on mortgage exit and valuation fees, including the costs that are incurred as part of the mortgage redemption process and the costs, both internal and external, relating to the valuation fees.

7.58 We plan to publish the detailed findings from the mortgage charges review and, if necessary, consult on related rule changes in 2012.

Summary of consequential or simplification changes to the Handbook

7.59 In addition to the reforms outlined earlier in this CP, our proposed Handbook changes also contain some amendments that simplify or clarify the mortgage rules, or that are consequential changes to other areas of the Handbook. These are outlined in the following table.

Summary of consequential or simplification changes to the Handbook

Handbook Reference	Change made
Glossary definition of *early repayment charge*	The words 'or event' have been added in order to clarify when that charge is applied to lifetime mortgages, which do not have a fixed term.
COBS 6.2.A4 G (1) and (1A)	Amended to clarify how the rules apply to firms who provide advice on retail investment products as well as offering regulated mortgage contracts and contracts of insurance, and to make it consistent with the revised approach to scope of service labelling in MCOB
MCOB 2.6A.5B R	A defined term has been put in italics.
MCOB 4.4	Wide scale re-writing and simplification alongside the reforms proposed in this CP.
MCOB 4.7	Wide scale re-writing and simplification alongside the reforms proposed in this CP.
MCOB 4.11	Wide scale re-writing and simplification alongside the reforms proposed in this CP.
MCOB 4 Annex 1R: Initial disclosure document	The Initial Disclosure Document template has been deleted and amendments have been made to the combined Initial Disclosure Document template in COBS 6 Annex 2 to allow it to function as an individual or combined Initial Disclosure Document for all home finance transactions as appropriate.

Handbook Reference	Change made
MCOB 6.9	Some text has been simplified and defined terms put in italics.
MCOB 8 Annex 1R: Initial disclosure document	Same as for MCOB 4 Annex1R.
MCOB 13.4.4 R (2)	A time limit of 15 business days has been added to add consistency within the rule
Widening MCOB 12.4 and 13.3 to cover all payment shortfalls.	Consequential amendments (where applicable) to other rules within MCOB to reflect this change,
MCOB Chapters 2, 5, 6 and 7	References to glossary term *repayment vehicle* replaced with *repayment strategy*
MCOB 6.4.4R(7) (c)	Amended to reflect definition of *repayment strategy*
MCOB 6.4.4R(7), MCOB 6.4.4R(7A) and 6.4.11AR	Rules amended to reflect that the lender will know what the repayment strategy is. Firms may state the repayment strategy the customer intends to use in the illustration section of the offer document, or as part of the wider offer document.

PART II
Prudential reform

8

Impact of Basel III

Introduction

8.1 In the MMR Discussion Paper (DP09/3[231]), we noted the fundamental reform of the FSA's prudential framework already underway in 2009 and discussed the likely impact of that reform on the mortgage market. We felt that the changes would have a significant impact on the UK mortgage market and so we saw no need to propose additional prudential measures specific to mortgage lending, other than suggesting the need to strengthen the prudential regime applying to non-deposit taking lenders (discussed in Chapter 9).

8.2 We summarised the feedback we received to the questions in DP09/3, including those on prudential reforms, in the MMR Feedback Statement (FS10/1[232]).

8.3 The most significant development since DP09/3 has been the publication of the capital and liquidity reform package, known as Basel III, on 16 December 2010 by the Basel Committee on Banking Supervision. The implementation of Basel III will considerably increase the minimum quality of banks' capital and significantly raise the required level of capital in each case from current levels. In addition, it will provide a macro-prudential overlay to better deal with systemic risk. The new requirements will be introduced progressively from 1 January 2013 until 1 January 2019.

8.4 This chapter discusses whether it is appropriate to use prudential – as opposed to conduct of business – policy levers to achieve the objectives of the MMR. In doing so, we outline the prudential reforms embodied in Basel III and consider the likely impacts of these changes on the mortgage market.

8.5 We believe that while the prudential reforms under Basel III are significant, they would not be an effective mechanism for deterring the high-risk lending that the MMR objectives are designed to target. So we believe that additional reforms on the conduct of business side are required to reduce the risk of consumer detriment in the mortgage market due to relaxed lending standards and over-rapid credit expansion in a boom period.

231 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf
232 FS10/1, *Mortgage Market Review*, (March 2010): www.fsa.gov.uk/pubs/discussion/fs10_01.pdf

Key Basel III policy changes

8.6 The key Basel III policy changes include:

- an increase in the quality and quantity of capital required in the form of higher minimums for common equity and Tier 1 capital;
- a more strict definition of common equity Tier 1 capital;
- the implementation of a leverage ratio that provides a backstop to the risk-based regime;
- the introduction of a new liquidity framework, which includes two minimum liquidity risk ratios, namely a 30-day Liquidity Coverage Ratio and a 1-year Net Stable Funding Ratio (NSFR); and
- the introduction of a capital conservation buffer and a counter-cyclical capital buffer.

Higher quality and a higher quantity of minimum capital

8.7 Basel III will considerably improve the quality of bank capital. Under the Basel II capital standards it is, in principle, possible for a firm to hold common equity equal to as little as 2% of Risk Weighted Assets (RWAs). Furthermore, under the current formula, firms are permitted to write down against lower quality Tier 1 and total capital the value of certain assets which cannot absorb losses during stress. Under Basel III, in general, such write-downs will be made against common equity Tier 1. This represents a substantial strengthening of the definition of the highest-quality part of banks' capital, and hence of banks' loss-absorbing capacity on a going concern basis.

8.8 However, recent financial market events have shown that better quality capital alone is not enough; there also needs to be more capital in the banking sector. Basel III increases the minimum common equity requirement from 2% to 4.5% of RWAs, and the total minimum Tier 1 ratio from 4% to 6% of RWAs. Banks will also be required to hold a capital conservation buffer of 2.5% of common equity to withstand future periods of stress.

8.9 These policy changes will apply across banks' balance sheets and therefore should not have particular effects on mortgage loans *relative* to other loan classes. In general mortgages attract low or very low risk weights vis-à-vis other categories of loans, particularly unsecured household and corporate lending. As a result the costs of higher regulatory capital requirements are generally modest for mortgages.

8.10 For mortgages with higher-risk characteristics the amount of high-quality capital required will be greater. For example, if a high-risk mortgage has a risk weight three times greater than that for a prime mortgage with a modest loan-to-value ratio (LTV), then the absolute amount of additional capital required under the new regime will be three times larger for the high-risk loan. However, we expect that overall the volume and pricing of mortgage lending will be only modestly affected by Basel III, although proportionately there should be a larger impact on mortgages with higher measured risk characteristics.

8.11 Other reforms in the Basel III package that will have an effect on the mortgage market are set out at the end of this Chapter.

Impact of Basel III reforms on lending standards

8.12 Concerns have been expressed by firms and other market participants in response to previous MMR papers about the 'layering' of the FSA's conduct and prudential proposals. Some respondents argued that conduct of business regulation should only be introduced if it is shown that appropriate consumer outcomes could not be delivered through prudential regulation and focused supervision. There was also concern that the cumulative effects of regulation could have an adverse effect on competition and innovation, thereby stifling the mortgage market.

8.13 In DP09/3, we considered whether it would be possible to employ prudential policy tools to achieve conduct of business objectives, i.e. whether appropriate consumer outcomes could be delivered through prudential regulation. Prudential policy is designed to limit negative externalities inherent in bank failure and to maintain market confidence, and we concluded that it could not be appropriately targeted to protect consumers as borrowers. To try to do so would represent a fundamental departure from our existing approach to prudential regulation.

8.14 In light of the concerns set out above, we have reassessed whether conduct reform is needed on top of the ongoing prudential reforms, in particular those embodied in Basel III. Having done so, we still think that, despite the significant reforms under Basel III, conduct reforms are still needed.

8.15 So why do we believe this?

8.16 Basel III requires banks to hold a higher quantity and a better quality of capital against any lending undertaken. Since holding more and higher quality capital raises the cost to banks of writing loans, banks and building societies respond to higher capital requirements by both raising additional capital *and* re-pricing their loans, which raises borrowing costs for consumers and reduces the volume of lending. In addition, as a greater proportion of capital must be held against riskier loans, banks can reduce the amount of additional capital they need to raise by increasing the price of higher-risk loans to a greater extent than for lower-risk loans. The Basel III requirements are therefore likely to reduce, to some extent, banks' riskier mortgage lending.

8.17 However, any reduction in risk brought about by banks re-pricing of loans will not necessarily reduce the risk of consumer detriment. Consumer detriment will only be reduced if the factors banks use to calculate risk, and thereby determine the amount of higher quality capital that needs to be held, are the same factors that cause significant consumer detriment.

8.18 There are two methods for calculating risk used: the standardised approach and the Internal Ratings Based (IRB) approach. Under the standardised approach, the LTV ratio is used to calculate the regulatory capital requirements, with risk weights increasing for mortgage loans with a balance above 80% LTV. Under the Internal Ratings Based (IRB) approach, firms can use their own models of key risk parameters to establish the expected loss of a loan decision and therefore the capital requirements that will apply. This may vary by product type, LTV ratio and a large number of borrower specific variables such as payment history, loan-to-income (LTI), age, employment status, time in employment and number of debt products held. Nevertheless, LTV features strongly in lenders' assessments of the expected loss under the IRB approach, which is calculated by measuring the borrower's propensity to default (PD) with the Loss Given Default (LGD) (the difference between the outstanding loan and proceeds of sale of the repossessed property). The LGD is primarily influenced by the LTV ratio and it also features strongly in relation to PD. However, the factors driving consumer detriment is the affordability of the loan which is dependent more broadly on consumer incomes and expenditure which are not captured by the LTV ratio (see Chapter 3).

8.19 This correlation between LTV and probability of default was discussed in DP09/3. As we then highlighted, LTV ratios displayed a stronger correlation with arrears than LTI ratios. Despite the correlation, however, our analysis showed that LTV is much less important than other factors. Differences in the category of mortgage (for example, whether it is a self-certified or credit-impaired product) are a more powerful predictor of default.[233]

8.20 Although prudential requirements alone are unlikely to meet the objectives of the MMR, steps have been taken on the supervisory side to prevent unduly risky business models and strategies that work to the detriment of consumers. We have adopted a more intensive and outcomes-based approach to supervision, based on our 'core prudential programme' of oversight and credible deterrence. Although not specific to the mortgage market, our approach is centred on intervening in a proactive way, and taking forward-looking judgements about Very High Impact Firms, based on in-depth analysis on a rolling basis and comprehensive and rigorous stress testing.[234] For the mortgage market, this involves taking a deeper look at firms' business models, firms' levels and attitudes to risk, how firms understand and oversee control of their mortgage books, and the levels of regulatory capital held against exposures to mortgages. Where concerns around lending practices are identified, early intervention to mitigate risks are taken through stronger controls and/or more capital.

8.21 However, Basel III and this more intensive approach to prudential supervision are not primarily aimed at protecting consumers. The aim is to ensure the soundness of the banking sector and to maintain market confidence.

233 Exhibit 4.5: Default rate of 10 of the largest lenders by mortgage type and LTV at origination during 2008 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

234 Incremental implementation of this new approach began in 2010; we are working with firms to learn from the experience.

8.22 As we highlighted in DP09/3, in the run up to the crisis, we saw the emergence of business models built specifically around consumers with impaired credit histories but with equity in their properties. Sustained house price growth meant there appeared to be less risk of a loss on sale and, as a result, the borrower's propensity to default appeared a less important lending risk to consider. The fact that consumers might not be able to repay came to be considered less relevant to these firms. In fact, many entered the market with the expectation that a large number of their consumers would not be able to pay and would either have to remortgage or face repossession.

8.23 From a prudential perspective, if a lender decides to lend to a particularly risky group of borrowers and estimates that there is a probability of 35% defaulting on their loans, provided the risk that the lender is taking is adequately reflected in the pricing of the product, i.e. there is an adequate premium to cover the higher lending costs and there is a realistic prospect of recovering the lending from the sale of the repossessed property, it is possible that the potential financial consequences for the lender could be absorbed through provisions and capital. As such the firm would be able to continue meeting its regulatory capital requirements even in an adverse scenario.

8.24 It may be the case that banks will be more cautious in mortgage lending in the future, and the rapid decline in mortgage credit availability over the past couple of years lends some support to this. However, this decline has not been driven directly by prudential reforms under Basel III but rather by changes in banks' risk appetite. It remains possible that, in a future period of robustly rising UK house prices, that risk appetite might change again. In other words, banks could meet the Basel III provisions, including holding more and better quality capital, and still run unacceptable risk to customers in the form of the risky mortgage loans seen in the past. Had these reforms been in place before the crisis, they are unlikely to have been enough to prevent the significant tail of extremely poor lending decisions which are now producing very high losses in particular categories of mortgage.

8.25 So, while the prudential reforms under Basel III are significant, in our view they would not be an effective mechanism for deterring the high-risk lending that the MMR objectives are designed to target. We therefore consider that the additional reforms on the conduct of business side discussed in Part 1 of this CP are required to reduce the risk of consumer detriment in the mortgage market due to relaxed lending standards and over-rapid credit expansion in a boom period.

Q47: Do you agree that the new prudential requirements are unsuited to meeting the objectives of the MMR, specifically deterring high-risk lending?

Leverage ratio

8.26 Basel III also introduces a leverage ratio to constrain the build up of excessive leverage in the banking system and protect against model risk and measurement error. It has been agreed to test a minimum Tier 1 leverage ratio of 3% during the so-called 'parallel run period' which will begin in January 2013 and run until 2017. The leverage ratio will be introduced as a Pillar 2 measure within the Basel III framework, but it is expected that it will transition to Pillar 1 as a binding minimum requirement on 1 January 2018, based on review and appropriate calibration. These transitional arrangements will allow supervisors a greater opportunity to assess a bank's approach to measuring and managing its leverage risks.

8.27 The goal of the leverage ratio is to prevent a firm from expanding its balance sheet excessively if the models used to measure the risk are not sufficiently sensitive to accelerating risks, particularly over long periods of strong economic growth. In the context of the mortgage market, if a lender's business strategy was focused on strong growth in a period of economic expansion, a leverage ratio could limit the extent to which this 'model arbitrage' is possible by requiring a fixed minimum amount of capital per unit of exposure.

8.28 The impact of the leverage ratio will be most significant for banks with significant trading activities and those which specialise in residential mortgage lending and whose assets are dominated by prime mortgages. In both cases the risk weights for these kinds of exposures are low and as a result a leverage requirement based on the balance sheet value of the asset is much more likely to be binding.

Liquidity reforms

8.29 Basel III introduces global minimum liquidity standards for the first time. The new Liquidity Coverage Ratio, which will be introduced on 1 January 2015, is designed to promote banks' short-term resilience to potential liquidity disruptions. It will require banks to hold a buffer of high-quality liquid assets sufficient to withstand the cash outflows encountered in a short-term stress scenario as specified by supervisors. The other minimum liquidity standard introduced by Basel III is the Net Stable Funding Ratio (NSFR). This requirement, which will be introduced by 1 January 2018, is designed to address funding mismatches and encourage banks to use stable sources to fund their activities.

8.30 It is likely that the above measures will affect the cost of funding for all lending, including mortgages. Banks will have to do more to self-insure against periods of stressed liquidity, just as they have to hold capital to absorb unexpected losses. In addition, more stable funding, as required by the NSFR, should help reduce the risk of the scenario that developed in the years leading up to summer 2007, where banks relied excessively on short-term funding during the boom phase of the cycle, unduly increasing the mismatch between their liability profile and the maturity of their assets.

Counter-cyclical buffer

8.31 Basel III also introduces a counter-cyclical capital buffer above regulatory minimum requirements and the capital conservation buffer. Capital buffers will be built up during credit cycle upswings to be drawn down during downswings. The intention is to achieve the broader macro-prudential goal of making the banking sector more resilient to procyclicality.

8.32 As with other prudential reforms under Basel III, the counter-cyclical capital framework is not specific to mortgage lending. However, it might help to disincentivise mortgage lenders from expanding lending rapidly in an economic boom when the likelihood of relatively short-term losses is perceived to be low. The counter-cyclical buffer regime may also act to raise the cost of credit and therefore dampen its demand in a phase of strong growth when there is evidence that the stock of credit has expanded to excessive levels relative to the benchmarks of past experience. Also, as the expansion of mortgage lending during an upswing is more likely to occur in the high-risk segments of the market, a counter-cyclical buffer could affect the riskiness of mortgage lending during this time, as incentives for mortgage lenders might shift towards less risky lending.

Due diligence and retention

8.33 All of the Basel III policy changes set out above apply to all assets held on lenders' balance sheets, including mortgages. In the run up to the financial crisis, a large proportion of mortgages were securitised and hence the associated risk was no longer retained by lenders. Prudential reforms with respect to securitisation are therefore relevant to understanding the possible future dynamics of the mortgage market.

8.34 Enhancements have already been made to the Basel framework, which are being implemented in Europe through the Capital Requirements Directive (CRD) 2 and CRD3. These include higher capital requirements for re-securitisations and upgraded disclosure and underwriting standards. CRD2 also includes a requirement that prohibits banks from investing in securitisation positions unless the originator or distributor retains a net economic interest of at least 5%.

8.35 We believe that the above-mentioned changes will address some of the issues that emerged in the securitised credit model by better aligning interests in the securitisation market and raising the cost of securitisation. We think they will therefore influence the strategies, including mortgage lending strategies, of banks that originate or invest in structured finance transactions. As a result, they are likely to help constrain poor quality lending and excessively rapid growth of lending into new market segments.

9

Non-deposit taking lenders

Summary of key proposals

- A risk-based capital requirement based on the standardised credit risk and securitisation chapters of BIPRU (applied to the firm's assets arising from lending after the implementation date of the new rules but not to their back-books), together with a 1% requirement applied to any other assets (as currently required in MIPRU).
- Restrictions to increase the quality of capital so that at least 20% is in the form of share capital and reserves less any intangible assets.
- High-level systems and controls requirements to manage liquidity risk.
- Application on a solo-basis only and not to firms that are in run-off.

Introduction

9.1 Although we have raised issues about non-deposit taking lenders (non-banks) in previous MMR papers, this is our first formal consultation on a proposed new prudential regime for non-banks.

9.2 Our proposed approach is based on the market's reaction to the regime we outlined in our consultation on responsible lending (CP10/16[235]); our subsequent discussions with stakeholders; and our further policy analysis. We are grateful for the constructive and helpful views we have received. We would particularly like to thank the Intermediary Mortgage Lenders Association (IMLA) and those non-banks who provided support and guidance to us as we developed our proposals.

9.3 There are two important factors to note in terms of the future prudential regulation of non-banks beyond the proposals we set out here:

235 CP10/16, *Mortgage Market Review: Responsible Lending*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf

a) This will continue to be considered outside the scope of the MMR, in the broader context of the objectives of the Financial Conduct Authority (FCA) and the developing regulatory approach of the Financial Policy Committee (FPC), which will be responsible for considering financial stability issues. In due course the capital buffers, which have been developed under the Basel III[236] process for banks and building societies, may need to be introduced to some extent for non-banks given the potential pro-cyclical impacts of non-bank lending on asset bubbles and market volatility. And to achieve this objective, consolidated supervision or some other form of group oversight process could be applied to non-bank groups, particularly if some of them grow rapidly in the future.

b) On 20 July 2011, the European Commission issued proposals for the Capital Requirements Directive 4 (CRD4), which comprise a directive and regulations that will replace the current Capital Requirements Directive. We will monitor CRD4 developments closely in terms of timing and substance and the potential impact on implementing the proposed changes discussed in this chapter.

9.4 Throughout this chapter, any reference made to 'prudential' should be read as a reference to both capital and liquidity requirements.

9.5 The cost benefit analysis (CBA) for these proposals is in Annex 1 of this paper and the compatibility statement in Annex 3. The proposed new rules are in the draft *Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (Non-Bank Lenders) Instrument 2012* at Appendix 1.

Background

9.6 In the MMR Discussion Paper (DP09/3[237]) and in CP10/16, we noted the role played by non-banks in the rapid expansion of mortgage lending that fed rising house prices in the UK. We highlighted the greater volatility in lending provided by entities not funded by deposits and also noted the rapid exit that can be forced on non-banks in a downturn when wholesale funding becomes illiquid or too expensive.

9.7 As we noted, the quick entry and exit of such an important lending supply has a particularly significant impact on mortgage borrowers in the UK (particularly the credit-impaired) who switch mortgages frequently and depend on the continued availability of mortgage deals.

9.8 We also expressed concern about arrears rates and the degree of lending risk apparently taken by non-banks. Of course, non-banks target higher-risk and specialist categories of lending to charge a premium to cover their higher lending costs. But our analysis highlighted a concentration of particularly risky lending in non-banks. That analysis also

236 By Basel III we mean the capital and liquidity reform package published on 16 December 2010 by the Basel Committee on Banking Supervision.

237 DP09/3, *Mortgage Market Review*, (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

established materially higher arrears rates for non-banks, even after account was taken of the inherently risky lending being undertaken.[238]

9.9 In the DP09/3 we noted that the proposed changes to the capital requirements for banks and building societies would have an indirect impact on non-banks, but we also questioned whether we needed to go further and reform the prudential regime currently applying to them.

9.10 Our subsequent analysis led us to believe that there was such a need and in Chapter 6 of CP10/16 we asked the market for its views on an enhanced prudential regime for non-banks, incorporating some elements of the requirements applied to banks and building societies as set out in the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU).

9.11 In summary we said that a risk-based prudential regime could consist of the following:

a) More risk-based capital requirements, incorporating:
   - a securitisation requirement;
   - a standardised credit risk requirement;
   - an operational risk requirement; and
   - an other assets requirement.

b) Restrictions on the quality of eligible capital.

c) A tailored liquidity requirement.

9.12 We argued that by increasing the capital requirements and basing them more closely on the risks, we would help address concerns around the pro-cyclical effects that non-banks can have and the degree of lending risk they run. We said that increased capital requirements could potentially constrain the level of non-bank lending. We expected that the requirements would be applied using the relevant BIPRU rules on a solo basis.[239]

9.13 Overall, there was broad acceptance from those who commented on the need to move towards a more risk-based prudential regime. Some expressed caution, though, that such a regime should be proportionate and should not set up uncompetitive barriers to entry into the sector which would lead to mortgage finance becoming less available because of reduced competition between lenders. And there was a clear view that the regime should not be the same as that for banks. Some commented that our analysis of the failings in the sub-prime market was unfair and did not properly reflect the contribution of banks and their subsidiaries.

238 See Chapter 3 – Exhibit 5

239 Solo basis refers to the situation where our capital requirements are applied only to the authorised firm on a stand-alone basis. This contrasts with the consolidated supervision approach that applies under BIPRU where the position of the authorised firm in the group can trigger the application of the capital requirements to the group as a whole.

Overview of the proposed regime – a change to our approach

9.14 In light of all of the comments received, we have made a number of significant changes to the approach originally suggested. We are now consulting formally on a proposed regime consisting of:

- a risk-based capital requirement based on the standardised credit risk and securitisation chapters of BIPRU (applied to the firm's assets arising from lending and exposures to collective investment schemes entered into on and after the implementation date of the new rules), together with a 1% requirement applied to any other assets;
- restrictions to increase the quality of capital so that at least 20% is in the form of share capital and reserves less any intangible assets; and
- high-level systems and controls requirements to manage liquidity risk.

Risk-based capital requirement

9.15 A more risk-based capital requirement should provide incentives for better risk-management and reduce the size of losses associated with the default of any firm. As our proposed approach would bring the requirement more in line with that for banks and building societies, it should also limit the opportunities for regulatory arbitrage.[240]

9.16 We propose that a non-bank should meet a minimum capital requirement, which comprises:

a) 8% of the firm's risk weighted assets derived from a proportionate application of:
   - the standardised credit risk requirement (as in BIPRU Chapter 3); plus
   - the standardised securitisation requirement (as in BIPRU Chapter 9); and

b) an other assets requirement calculated as 1% of relevant assets.

9.17 The application of the BIPRU Chapters 3 and 9 requirements would be limited to those on-balance sheet assets that relate to lending activities or exposures to collective investment schemes entered into on or after the implementation date of the new rules. Any other tangible assets (including loans and securitisation positions entered into before the implementation date of the new rules) would be subject to the 1% other assets charge as currently applied in the Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU).

9.18 The following are policy issues that are particularly important for the application of the proposed requirements.

240 By regulatory arbitrage we mean the situation where a firm opts to use one business model rather than another for the same regulated activity in order to reduce its capital requirement.

Credit risk

9.19 Many views were expressed about the proposal to apply BIPRU Chapter 3 to non-banks. The BIPRU Chapter 3 requirement was viewed as a disproportionate charge, which could curtail any high loan-to-value (LTV) lending (not all of which, it was argued, is hazardous).

9.20 It was also felt that there could be a significant impact on those non-banks with a low quality mortgage book, where exit or recovery strategies could have an impact on consumers, including repossessions, and would need careful management. The standardised approach will substantially raise the capital required for future lending, particularly above 80% LTV, which has been an important market for non-banks. The preference expressed was for a new regime that would further incentivise responsible lending in the future, through allowing non-banks to use an Internal Ratings Based (IRB) model.

9.21 It was felt that many non-banks already possess the data and sophistication to make IRB calculations and those that do not could use third-party data-pooling. It was pointed out that many smaller building societies operate in this way and that restricting the calculation method would create an unfair competitive landscape with BIPRU firms.

9.22 We were asked whether:

- The credit risk requirements would apply to existing mortgage portfolios (the back-book). If so, it was argued that the cost of the extra capital required to support the back-book will be a significant burden and will inevitably be passed on to the customer.
- The 1% capital requirement would continue to apply to buy-to-let loans (rather than the relevant BIPRU Chapter 3 requirement). If so, it was argued that this could potentially distort future business and credit flows, if such business remained unregulated.
- The credit risk requirement would apply to all of a firm's exposures, including any unsecured lending (which, it was argued, should not be the case.)

9.23 Having considered this further, we are proposing that the BIPRU Chapter 3 capital requirements will only apply to loans entered into on or after the implementation date of the new rules. The aim of our proposals is to prevent a recurrence of poor lending practices and so should focus on future lending. In our view it would be unfair to impose the new higher capital requirements retrospectively.

9.24 There are a number of situations where the precise meaning of this cut-off between past and future lending needs to be clarified. We set out below how we propose firms should deal with: loan books acquired; increases in existing mortgages; loans that are renewed with different terms, such as the interest rate or the repayment basis; the capitalisation of interest; and loans renewed with a different underlying security, including 'portable' loans.

9.25 The broad principle we propose to apply is that the new requirements should apply where there is a substantially new arrangement entered into on or after the implementation date, where the borrower has the opportunity of seeking a loan from an alternative lender (even if not exercised).

9.26 So this approach would exclude from the new requirement loan books acquired to the extent that the original loans were made before the cut-off date. It would also exclude arrangements made as a result of forbearance procedures, including a change in the basis of the interest payments from variable to fixed rate or from a repayment arrangement to interest-only and capitalisation of interest which increases the principal outstanding, where there is no element of new borrowing.

9.27 To avoid regulatory arbitrage and deal with situations that are effectively in direct competition with new lending, the new requirement would apply to other increases in the amount of the loan advanced[241]; any loan that is reissued with a different security (except where the original contractual loan agreement provides for 'portability'); and any other circumstances linked to changes to the contractual terms which are not as a result of forbearance.

9.28 This proposed approach will ensure a level playing field with firms that are in run-off (i.e. only have a back book) and therefore under the terms of our proposed scope of application (which we discuss later in this chapter) are not subject to the new requirement to hold additional capital.

9.29 We propose to apply the new requirements to assets arising from all lending undertaken by the regulated firm, and not just those relating to regulated mortgage contracts. So this would include second charge mortgages, buy-to-let and unsecured lending. We consider this an appropriate, risk-based approach which also reflects the fact that the other lending may be brought into our regulatory scope in due course.

9.30 We also propose to apply the requirement to any investments the non-bank may have in collective investment schemes. This is because of the potential for regulatory arbitrage, where firms may use such investments to hold lending assets rather than directly on the balance sheet.

9.31 We do not propose to allow non-banks to use the IRB approach to compute the credit risk requirement. We are under no directive obligation to allow the IRB approach and, as we are not proposing to apply the full BIPRU regime to non-banks, they will not be subject to Pillar 2 capital assessments (nor the Basel III proposed leverage requirements in due course).

9.32 Although second charge mortgage loans are not regulated at present, a number of firms authorised for first-charge lending have such loans on their balance sheet. In the situation where the first-charge and second charge loans are provided by the same lender, BIPRU is explicit about the approach to be adopted to assess the capital charge.[242]

9.33 Where the second loan is from a different lender, the firm should add together the first and second charge loans to identify which LTV factor[243] to apply to the second charge loan to

241 In this situation we would expect that the new requirement would be applied to the whole of the new loan.
242 BIPRU 3.4.87G http://fsahandbook.info/FSA/html/handbook/BIPRU/3/4
243 For LTV up to 80% the risk weight is 35%: for the portion of the LTV over 80% the risk weight is 75%.

compute the capital charge. For example if, on a property valued at £100,000, there is a first-charge of £70,000 and second of £20,000 then, of the £20,000 second charge loan, £10,000 would be risk-weighted at 35% and £10,000 at 75%.

Securitisation

9.34 There were also a number of views expressed about the proposed securitisation requirement, which commentators felt would have a significant impact on non-banks. The capital charge could be substantial depending on the rating of the issue and this would be a radical step-change compared to the current MIPRU rules. It was suggested we should consider a mid-point solution which would provide a more appropriate position between the current requirement and BIPRU Chapter 9.

9.35 Some understood the argument for introducing the requirement for new business as it creates an incentive to consider more fully the risks associated with new lending. However, they questioned the rationale if the requirement also applied to closed books, as firms have little influence over the risk profile of loans already made.

9.36 Others felt that the combination of our proposals and the CRD amendments, which came into force at the end of 2010[244], will substantially raise the capital required to back securitisation transactions. It was noted that this would strongly discourage higher-risk lending, which would fall into low-rated tranches.

9.37 Having taken into account all the views expressed, we are proposing that the BIPRU Chapter 9 requirements will only apply to securitisation positions originated on or after the implementation date of the rules. This means that the requirements will only apply to new securitisations issued on or after that date, or to existing securitisations where new underlying exposures are added or substituted after that date (this includes the addition of new loans to an existing master trust structure).

9.38 We also propose that non-banks should be subject to the BIPRU Chapter 9 provisions relating to the standardised approach to securitisation. Under this approach, if the securitisation position is rated, the Risk-Weighted Exposure Amount (RWEA) is calculated by applying to the exposure value the risk weight associated with the relevant credit quality step. If the position is unrated, the non-bank may apply a concentration ratio, provided certain criteria are met.[245] Where a position is unrated and the concentration ratio cannot be used, the non-bank must apply a 1,250% risk weight.[246]

9.39 BIPRU Chapter 9 also includes a provision (under the CRD Article 122a) that prohibits European Union (EU) credit institutions from investing in securitisation positions unless the originator, sponsor or original lender has retained a net economic interest of at least 5%. Although not directly applicable to non-banks, we would expect non-banks to retain the 5%

244 These changes were effected through CP10/17, *Strengthening Capital Standards 3 – feedback to CP09/29, final rules for CRD 2, and further consultation*, (July 2010): www.fsa.gov.uk/pubs/cp/cp10_17.pdf
245 BIPRU 9.11.6 R http://fsahandbook.info/FSA/html/handbook/BIPRU/9/11
246 BIPRU 9.11.4 R http://fsahandbook.info/FSA/html/handbook/BIPRU/9/11

net economic interest required under Article 122a in circumstances where they expected the EU credit institutions to be potential investors in their originated securitisations and where they were the relevant party to retain under Article 122a. All retained exposures would then need to be risk-weighted in accordance with the relevant BIPRU requirements.

9.40 Our proposed approach is that the securitisation requirements apply to regulated firms on a solo-basis only. There will be no consolidated supervision of non-regulated entities, as we do not regard it as a proportionate regulatory tool for the prudential risks currently posed. However, to be clear, the securitisation requirements will most likely apply on a consolidated basis to those non-banks that are in groups containing banks or building societies that are themselves subject to BIPRU Chapter 9.

9.41 In applying securitisation requirements to the regulated firm on a solo-basis, a potential avoidance mechanism is available if the non-bank is able to hold any retained securitisation positions in a non-regulated entity within the group that is not subject to the MIPRU capital requirements. Specifically, loans could be originated in the regulated entity and subsequently transferred to the balance sheet of an unregulated entity. The unregulated entity could then securitise the loans and be treated as the originator of the securitisation who is eligible to retain the 5% net economic interest required under Article 122a. This would mean that the relevant BIPRU risk weights would not apply to the retained positions.

9.42 This would undermine the intent and rationale behind Article 122a and the proposed non-bank regime. Therefore, as part of our application of the rules at the solo level, we would expect the originator of the loans being securitised (which we would typically expect to be the regulated non-bank) to meet the retention and hold capital against the retained position accordingly.

9.43 We propose that firms will be required to transfer significant credit risk associated with securitised exposures to third parties before those exposures can be excluded from the calculation of RWEAs. The credit risk transfer will only be considered significant when the proportion transferred is commensurate with, or exceeds, the proportionate reduction in regulatory capital when comparing the firm's securitisation positions and the underlying exposures. The policy aim is to prevent firms from taking advantage of a reduced capital charge without the corresponding reduction to their actual risk position and to ensure adequate capital is held against retained securitisation positions.

9.44 In circumstances in which a firm achieves significant risk transfer (SRT), it should hold RWEA against any retained positions in the securitisation rather than against the exposures that have been securitised. Where a firm does not achieve SRT, it will need to continue to hold RWEA against the underlying exposures as if not securitised (under the standardised credit risk framework).

9.45 BIPRU Chapter 9 restricts the amount of capital to be held against securitisation positions to the amount of capital that would be required for the underlying exposures as calculated under BIPRU Chapter 3. Specifically, in circumstances where SRT has been achieved, this 'cap' limits the RWEAs on the retained securitisation positions to the RWEAs which would be calculated for the securitised exposures had they not been securitised, subject to the presumed application of a 150% risk weight to all past due items and items belonging to regulatory high-risk categories among the securitised exposures.

9.46 The limit that is imposed on the RWEA of the retained securitisation positions is the RWEAs held against the entire pool of underlying exposures; it is not applied on a tranche by tranche basis. So, if for example a firm securitised a pool of exposures and retained some of the securitisation positions, the regulatory capital it would need to hold against those positions should not exceed that held against all of the underlying exposures.

9.47 One particular issue highlighted in our discussions with non-banks when considering solo application, is where a non-bank uses a group warehousing facility, before completing the securitisation process.

9.48 Our view is that warehousing would not remove the need for a regulated firm to hold capital against the assets in the warehouse to the extent it is providing funding for those assets. This is because if the warehouse is a securitisation (in which case the credit risk of the loans in the warehouse SPV must be tranched), and if the non-bank could demonstrate that SRT had been achieved via the transfer of assets to the warehouse SPV, then any funding provided by the firm to the warehouse should be considered a retained securitisation position and risk weighted accordingly. If SRT has not been achieved, the non-bank should hold capital against the transferred assets as if not securitised (i.e. under the standardised credit risk requirements).

Operational risk requirement

9.49 In the outline prudential regime in CP10/16, we suggested applying an operational risk charge based on the requirements of BIPRU Chapter 6.

9.50 Those commenting felt quite strongly that this would not be appropriate.

9.51 One felt that this would have a significant impact on costs and barriers to entry which was not justified as, unlike banks, non-banks have no depositors. Another rejected the need for the charge, both because of the limited risk non-banks pose and because contingency planning is generally built into their structure, for example allowing mortgage servicing to survive even in the event of the failure of the originator. They suggested that the link between operational risk and the firm's income is not obvious and it would be better to focus on credit risk as the main driver. Another pointed out that their servicing operations are subject to considerable external scrutiny from ratings agencies, arrangers and key investors.

9.52 One agreed that it is important for banks to hold capital to cover operational risk. However, non-banks operate a fundamentally different funding model where future funding maturities are known and, on this basis, there is no need for them to hold such capital.

They argued that this is an area which can be reviewed and controlled through the supervisory approach as it will form an integral part of the firm's business model.

9.53 We agree with the views expressed on this and have decided not to apply this requirement.

> Q48: **Do you have any comments on the proposed risk-based capital requirement?**

Restrictions on the quality of capital

9.54 The calculation of eligible capital is as set out in the current rules in MIPRU Chapter 4 and comprises A minus B where:

- A includes: share capital; capital other than share capital; reserves; interim net profits; revaluation reserves; general/collective provisions; and subordinated loans.
- B includes: investments in own shares; intangible assets; interim net losses; and the excess of drawings over profits.

9.55 As non-banks do not have depositors and fewer implications for financial stability then we consider it reasonable that they should be able to rely on subordinated loans, which only absorb losses in a gone concern, to a greater extent than banks can. However, as the cost of capital is likely to bite more on the owner of the firm when share capital and reserves are required, we propose that a minimum proportion of the capital requirement should be met in this form to motivate better risk management.

9.56 At present there is no restriction on the use of subordinated loans. We therefore propose to prescribe, as suggested in CP10/16, that at least 20% of the eligible capital used to meet the capital requirement should be share capital and reserves less intangible assets. This is in line with the current MIPRU restriction applied to some mortgage firms and our view is that this would be a proportionate requirement for non-banks actively undertaking lending to ensure that the quality of their capital is adequate. This requirement would not apply to any firm with a Part IV permission restriction which prohibits it from entering into new mortgage lending.

> Q49: **Do you have any comments on the proposed restriction in the eligible capital calculation?**

Liquidity regime

9.57 The suggested regime outlined in CP10/16 also included a liquidity requirement. Again, those commenting on this felt quite strongly about it. Some suggested that it would be inappropriate to implement a liquidity regime because it is not proportionate and would have a significant impact on costs and barriers to entry which is not justified, as unlike banks, non-banks have no depositors or retail investors.

9.58 It was pointed out that non-banks operate a fundamentally different model where future funding redemptions are either known or net-off against asset redemptions. The experience of the recent financial crisis demonstrated this difference, as those firms with maturing funding facilities were able to run them down without customer detriment.

9.59 It was also felt that a one-size-fits-all approach should not be used and that we should recognise the profile of non-banks and their risk. As many are smaller businesses, any reporting and stress-testing required must be proportionate and avoid over-burdensome procedures.

9.60 It was also pointed out that such a requirement is important for banks because they engage in maturity transformation. Non-banks do not follow this business model but instead only lend after agreeing secured, ring-fenced funding arrangements of defined maturity. Many use just one or two such facilities, therefore having few funding counterparties and maturity dates to manage. If the non-bank cannot refinance the facility, it is usually rolled over or, in the worst-case scenario, the wholesale lender enforces its security over the mortgage assets originated using the facility. This means the wholesale lender is not exposed to the creditworthiness or liquidity of the originator.

9.61 One respondent stated that their business model is fundamentally different to a bank's, with funding being committed for a longer term with known maturities that can be planned for. They are funded by the parent company and their liquidity and cash planning is tightly controlled. They suggested that any liquidity requirements may be met by undrawn committed facilities as opposed to holding liquid assets. They also felt we should consider the inflow of cash from mortgage pay-downs and calculate the requirement based on a net of the inflows and outflows.

9.62 Another view was that the most appropriate way for us to manage liquidity would be, as part of our supervisory oversight, to understand a lender's treasury policy and procedures and oversee compliance with these, ensuring that adequate controls are in place.

9.63 After considering the views expressed about this, we agree that it would not be appropriate to specify a quantitative liquidity requirement for non-banks. Given the nature of non-bank business models, where there are no depositors and future funding requirements are generally well known and covered, we do not regard the costs of implementing such a requirement, including introducing new systems and reporting, as being proportionate to the benefits.

9.64 Our view, though, is that there should be a clear and consistent approach to liquidity for all firms. So we propose a high-level qualitative requirement, focusing on requiring non-banks to maintain appropriate systems and controls to manage their liquidity risks. Under this proposal, non-banks that actively undertake mortgage lending will need to have robust strategies, policies, processes and systems to identify, measure, manage and monitor such risks. They should also have reliable management information to ensure they have relevant and timely forward-looking data. This requirement would not apply to any firm with a Part IV permission restriction that prohibits it from entering into new mortgage lending.

Q50: Do you have any comments on this proposed liquidity regime?

Scope and application

9.65 A number of respondents expressed views on what should or should not be within the scope of our new requirements. One suggested that lifetime mortgages should be kept outside the scope of the new requirements. Another argued that any new requirements should not apply to short-term lenders as they did not withdraw from the market during the financial crisis as some subprime lenders did and they did not raise their rates to existing borrowers. A third stated that any new regime should only apply to new entrants or existing active lenders and not firms that are in run-off.

9.66 As the new prudential regime is intended to reduce the lending risk in future transactions, we propose to apply it only to non-banks actively involved in first-charge regulated mortgage lending. The quality of capital and liquidity requirements will also only apply to firms that enter into new lending. If firms wish to demonstrate that they no longer enter into lending activities and should be excluded from compliance with these requirements, we would expect them to apply for a variation of their Part IV permission to reflect the fact that they will not be entering into any new lending in future.

9.67 We propose that the new credit risk and securitisation calculations will apply to all firms but only to their loans and securitisation positions entered into on or after the implementation date of the new rules. This would mean that firms that are in run-off only (i.e. do not undertake any new lending and have not undertaken any new lending since the effective date of the rules) will remain on the current capital requirements set out in MIPRU (i.e. 1% of tangible assets) and will not be affected by the new proposals to hold additional capital.

9.68 We have not previously raised the issue of consolidated supervision. However, one respondent argued that the application of any new prudential regime for non-banks should be restricted to regulated entities. They saw no reason why a new regime should have a wider impact, as such firms do not have retail depositors to protect. If a regulated subsidiary has an impact on its parent company more widely, they argued, then the parent company would have to evaluate the broader consequences of retaining that regulated entity.

9.69 Another wanted confirmation that any new regime would not apply to subsidiaries of banks and building societies and therefore that their requirements would remain unchanged.

9.70 We propose to apply the requirements on a solo-basis. This means that a firm in a bank or building society group will only be excluded from the new requirements if it is solo-consolidated. Our view is that it would not currently be proportionate to apply the consolidated supervision requirements in BIPRU Chapter 8 given that relatively few non-banks are in groups not already subject to consolidated supervision, and consolidated supervision is primarily aimed at reducing financial stability concerns.

Q51: Do you have any comments on the proposed scope and application of the regime?

Rules in MIPRU with cross references to BIPRU

9.71 Comments on our suggested approach in CP10/16 also included the suggestion that, rather than referring firms to the BIPRU rules, we should include the new proposals as standalone text in MIPRU.

9.72 It was suggested that within MIPRU there should be a capital charge which comprises: a rate of 2.8% applied to mortgage assets; a 100% deduction for retained first-loss pieces in securitisations; and an other assets requirement of 1% (as in MIPRU at present).

9.73 Another supported strengthening the current MIPRU capital requirement to one that is sensitive to non-banks' business models and underlying assets. They argued that this would suggest a capital requirement of 2.8%, and provide naturally an enhanced barrier to entry.

9.74 We propose to implement the new prudential regime in Chapter 4 of MIPRU with appropriate cross references to BIPRU. Our normal approach is to avoid duplicative copy out of the rules and, if we did duplicate in this case, we would lose the facility for MIPRU to be automatically updated for any relevant changes made to the applicable BIPRU rules under the usual procedures that we might regard as also being appropriate for non-banks.

9.75 In our view it would not be effective, efficient, practical or proportionate to replicate the BIPRU rules in MIPRU. Given the number of non-banks compared to intermediaries[247] this would also distort the balance of MIPRU.

9.76 Under our proposed approach, any reference in the proposed MIPRU rules to a BIPRU rule will automatically have a link through to BIPRU, which should help users.[248]

Q52: Do you have any comments on the draft rules set out in the draft *Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (Non-Bank Lenders) Instrument 2012* at Appendix 1? Do you think the rules reflect the stated policy intention?

247 Approximately there are 120 non-banks compared to 10,000 intermediaries.

248 As mentioned previously, this approach will have to be reviewed as part of the decision–making process on what will happen to BIPRU as the European Commission legislates to implement Basel III via the CRD4.

Macro-prudential considerations

9.77 We also commented in CP10/16 on the macro-prudential context for non-banks. The Financial Policy Committee (FPC) will have the responsibility and tools to look across the economy at the macro-prudential issues that may threaten economic and financial stability and take appropriate action in response. One important component could be to require the build-up of additional resources in the banking system in times of excessive credit growth that would be available to absorb losses or sustain lending in subsequent downturns.

9.78 We said that 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 macro-prudential regulations such as capital buffers to those firms. We were not proposing that macro-prudential regulations should be applied to non-banks, but neither were we ruling out the possibility in the future.

9.79 Just over half of those who commented on this supported the extension of any macro-prudential regulation for banks to non-banks, although some pointed out that it would need to be proportionate and not restrictive.

9.80 There were a wide variety of views expressed, including that:

- With the significant recent decline in new lending, the focus now should be on the macro-prudential risks attached to the large existing stock of mortgages in an environment characterised by abnormally low interest rates and elevated house prices.
- The competition implications of any moves that are aimed at keeping non-banks out of the market must be carefully examined, otherwise consumers risk being saved from cyclical house price movements only to be caught by the limited access to mortgage funding and/or higher pricing. Properly capitalised non-banks should be encouraged for a competitive, healthy mortgage industry.
- Such measures are unnecessary for non-banks which pose limited systemic risk as they operate with committed long-term funding from wholesale investors who are capable of making informed judgements.
- It is equally important to reduce impediments to risk-taking and lending during the downswing. Imposing excessive requirements at that point in the cycle would undermine our objective as well as leading to inevitable pressure during the upswing to loosen rather than tighten regulation.
- It is important that we take into account the wider factors that had an impact on the sector over the last three years, in particular the absence of government and Bank of England support for non-banks compared with the significant assistance that has been extended to some lenders.

9.81 The views expressed by respondents suggest that applying macro-prudential regulations to non-banks at this time is not proportionate. These issues though are for consideration by the FPC, which will be responsible for considering financial stability issues, and we therefore make no conclusion on them.

PART III
Niche markets

10
Tailoring for niche markets

Introduction

10.1 In Parts I and II of this CP, we have set out details of the reforms proposed for the main stream first charge residential mortgage market. In this part (III), we set out the changes we propose to the regulatory regime that currently applies to a number of the more niche sectors of the mortgage market, namely:

- Equity Release (Lifetime Mortgages and Home Reversion Plans);
- Home Purchase Plans;
- Sale and Rent Back;
- Bridging Finance;
- High net worth lending; and
- Business lending.

10.2 Given that we want to achieve the same broad outcomes for niche consumers as for conventional mortgage consumers, we are proposing a straight read-across of the majority of our proposals. Some proposals of course do not apply, and there are some areas where we believe some tailoring of our approach is necessary in order to avoid unintended consequences or to address issues specific to the niche markets. In this chapter, we discuss the tailoring we believe is required.

10.3 The cost benefit analysis (CBA) for these proposals is in Annex 1 of this paper and the compatibility statement in Annex 3. The proposed new rules are set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1.

Equity release

Introduction

10.4 Equity release products are designed for older consumers, enabling them to release the equity tied up in their homes.[249]

10.5 There are two types:

a) *Lifetime mortgages*

This is like a conventional mortgage in the sense that the consumer retains ownership of their home but borrows against it and the lender secures the sum borrowed by taking a first charge over the property. The borrowing can take the form of a lump sum, or a regular income, or a facility which the borrower can tap into, or a combination of all three. Although some lenders offer the option for the consumer to make regular interest-only payments, in the vast majority of cases the consumer does not make any payments. Instead, interest is rolled-up and repaid along with the capital sum on the sale of the property following the death of the borrower or their moving out permanently, for example into long-term care.

b) *Home reversion plans*

Under a home reversion plan, the consumer sells their home to the provider. A home reversion can be either 'full', where the consumer sells their entire interest in the property to the provider, or 'partial', where the consumer retains a financial or 'beneficial' interest in the property. In either case, the provider becomes the legal owner of the property. In return the consumer gets a lump sum or an income for life, or both, and the right to stay as a tenant of their former home, usually for a peppercorn (that is very low) rent for life or until a specified event such as moving permanently into long-term care.

10.6 Both markets are small. The lifetime mortgage market has averaged around 22,000 sales and just under £1bn of lending each year over the last five years. This is equivalent to less than 1% of the residential mortgage market over the same period. The home reversion market is even smaller, with less than a thousand plans sold per year.

10.7 Similar to mainstream mortgages, lifetime mortgages are provided by a mixture of banks, building societies and specialised non-deposit taking lenders (non-banks). However, home reversion plans come from a small number of financial services firms (typically those who also provide annuities) and specialist providers. Distribution of both products is mainly through intermediaries, with over 1300 reporting at least one lifetime mortgage sale during 2010. But the majority of sales come from a handful of specialist equity release advisers or from the provider's own advisory services. Between 2007 and 2010 only 5% of all lifetime mortgage sales and 10% of home reversion sales were non-advised.[250]

249 Current market practice restricts lifetime mortgages to consumers aged 55 years or above, while home reversion plans tend to only be available to those aged 65 years or above.

250 Source: FSA Product Sales Data (PSD)

10.8 We have previously consulted with the market about our approach to lifetime mortgages[251] and home reversions[252] and therefore do not discuss the existing regimes in any detail here.

10.9 The table at the end of this chapter summarises the MMR proposals and indicates where, in our view, the proposals are not applicable, can be subject to a straight read-across and therefore the relevant section in Part I applies or, as discussed below, need to be tailored to fit the current approach to the equity release market.

Tailored approach for the equity release market

Scope of service

10.10 The equity release market is widely referred to as a single market, although it comprises two distinct sectors selling the two different types of products. Some firms focus on only one sector while others are active in both. Lifetime mortgages became regulated in 2004, followed by home reversions in 2007 and, as a result, they have been treated for regulatory purposes as separate markets, with firms being allowed to describe themselves as 'independent' if they offer products from one sector only rather than both.

10.11 When we first regulated home reversions, there was a consensus view that the long-term goal should be a single equity release market. We are now proposing to bring that into effect and to define equity release as a single 'relevant market', made up of the substitutable products of lifetime mortgages and home reversion plans. Firms will not have to change their current permissions however, this will have an impact on how they describe the scope of their service to consumers.

10.12 In paragraphs 5.166 to 5.185 we explained our proposed new approach to how intermediaries should describe the scope of their service.

10.13 Treating equity release as a single market will have the effect that intermediaries offering only lifetime mortgages or only home reversion plans will need to explain to consumers that their service is limited and describe the limitation in terms of the wider equity release market. An example of what disclosure could look like for an intermediary offering only home reversion plans from a comprehensive range across the market is:

- 'I sell home reversion plans only and not lifetime mortgages, though I will consider all home reversion plans available in the market.'

Rejected sales

10.14 As discussed in paragraphs 5.75 to 5.89, we propose to treat equity release consumers as vulnerable consumers who therefore must always be given advice.

251 CP186, *Mortgage regulation: Draft conduct of business rules and feedback on CP146* (May 2003) www.fsa.gov.uk/Pages/Library/Policy/CP/2003/186.shtml, chapter 5.
252 CP06/8: *Regulation of Home Reversion and Home Purchase Plans* (April 2006) www.fsa.gov.uk/pubs/cp/cp06_08.pdf, chapter 6.

10.15 In the responses to CP10/28, there was strong support for making advice compulsory in every equity release sale. Respondents pointed out that, although equity release consumers are often more financially capable than younger consumers, they may not consider everything that is important for them without the help of an adviser. For example, changes to their income following the loss of a partner, or the need to involve their family members in decision making. This view was also supported by responses to our proposals for the mainstream mortgage market, where the consensus was that certain vulnerable consumers, including older consumers taking out equity release products, should always be advised.

10.16 We noted in paragraphs 5.96 to 5.99 that, provided a consumer has been advised by an intermediary, they should have the right to reject that advice and opt for a product of their choice on an execution-only basis. But in order to do so, the consumer would need to have done their homework in advance and be in a position to give specific instructions about the product they want to purchase, with no need for further discussion or information from the intermediary.

10.17 For lifetime mortgages the information we would expect the customer to know in order to proceed on an execution-only basis would include:

- the lender's name;
- the interest rate and product type;
- the value of the property; and
- the amount they want to borrow (this should include the amount of any lump sum, any regular drawdown or flexible facility, or any combination of amounts being applied for).

And for home reversion plans:

- the provider name;
- the lump sum required from the provider (this should include any future sums required as well as the initial amount);
- the value of the property; and
- the amount or percentage of protected equity they require if it is not a 100% reversion.

Q53: Do you have any comments on our views, summarised in the table at the end of this chapter, about the MMR proposals which are either not applicable or where a straight read-across to the equity release market is appropriate?

Q54: What are your views on our proposal to treat the equity release market as a single market for regulatory purposes?

Q55: Do you have any comments on the tailoring we propose in relation to execution-only sales following rejected advice and scope of service?

Q56: Is any other tailoring required for the equity release market? If yes, please explain.

Q57: Overall, do you have any other comments on our proposed read-across of the MMR to the equity release market?

Home Purchase Plans

Introduction

10.18 Home Purchase Plans (HPPs) are popularly known as 'Islamic mortgages'. They serve the same purpose as a mortgage, by providing consumers with finance to buy a home, but they are structured in a way that makes them acceptable under Islamic law.

10.19 They are essentially long-term sale and leaseback arrangements. The provider buys the property, becomes the legal owner and enters into a lease with the consumer giving him the right to rent the property for a defined term, typically 25 years. During this period, the consumer makes regular payments to the provider consisting partly of the rental payment and partly towards the purchase of the property. At the end of the term, when all payments have been made, the legal ownership of the property is transferred to the consumer.

10.20 Although they are structured differently to mortgages, they involve many similar risks and features. The current regime applying to HPPs, introduced in 2007, is therefore based on the regime applying to the mainstream mortgage market, although, recognising the small size of the HPP market, some of the requirements are pitched at a higher level to ensure proportionality.

10.21 Six providers were active when regulation began in 2007. One withdrew at the end of 2009 and the other five have remained in the market. The market is still very small, with sales averaging under 1000 per year in the last three years. Almost all sales are made direct to consumers by the providers on a non-advised basis.[253] Most providers have only one HPP product on offer.

10.22 We have also previously consulted with the market about our approach to HPPs[254] and therefore do not discuss the existing regime in any detail here. The table at the end

253 Source: FSA Product Sales Data (PSD). PSD data shows that 83% of all HPPs sales between Q4 2007 and Q4 2010 were direct and non-advised.
254 CP06/8: *Regulation of Home Reversion and Home Purchase Plans* (April 2006) www.fsa.gov.uk/pubs/cp/cp06_08.pdf, chapter 7

indicates where, in our view, the MMR proposals are not applicable, can be subject to a straight read-across and therefore the relevant section in Part I applies or, as discussed below, need to be tailored to fit the current approach to the HPP market.

Tailored approach for the Home Purchase Plan market

Rejected advice

10.23 We recognise that virtually all HPP sales are non-advised[255], so reading across our distribution proposals, as set out in Chapter 5, will have implications for HPP providers, who will need to adopt an advised sales process whenever there is spoken or other interactive dialogue with the consumer.

10.24 As noted above in relation to equity release, in Chapter 5, paragraphs 5.96 to 5.99, we discuss our proposal to allow a consumer to reject the advice they have been given and opt for a product of their choice on an execution-only basis. But in order to do so, the consumer needs to have done their homework in advance and be in a position to give specific instructions about the product they want to purchase, with no need for further discussion or information from the intermediary.

10.25 The information the HPP consumer will need to know about the product in order to proceed on an execution-only basis will differ to that for mortgages, as there is no interest rate or product type for them to choose. Instead we propose that the consumer specify precisely:

- the provider name;
- the term they require; and
- the amount they need from the provider in order to complete the purchase.

Enhancing sales standards

10.26 In Chapter 5, paragraphs 5.148 to 5.165, we discuss our proposal to remove the requirement to provide an IDD with a requirement to disclose key information about an intermediary's service.

10.27 There are two main differences between the HPP IDD and the mortgage IDD:

- An HPP document contains information about whether the provider provides services compliant with Islamic law; and
- There is a warning at the end of the IDD about the possible need for the consumer to get separate advice or information on standard mortgages.

255 FSA Product Sales Data shows 99% of HPP sales were non-advised between Q4 2007 and Q4 2010.

10.28 As the IDD will no longer be required to be provided to an HPP consumer, we have considered how best to ensure these key messages are still communicated. As explained in paragraphs 5.148 to 5.165, in the mainstream market we are proposing to focus on two key messages around scope and remuneration for initial disclosure.

10.29 The statement about compliance with Islamic law is clearly a key message for prospective HPP consumers. However, providers have told us that they will always explain how their services and products comply with Islamic law, regardless of our requirements. In view of this, we do not believe there is a need to add this to our key messages as a regulatory requirement.

10.30 From discussions with community representatives and consumers when first designing the HPP regime, we are aware that a standard mortgage product may be more appropriate to the needs and circumstances of some HPP consumers. We therefore included the warning noted above in the HPP IDD as an alert to the consumer about the fact that they may wish to take separate advice about whether a mortgage may be more suitable for them. This was aimed, in particular, at preventing consumers being sold a more expensive HPP product when a mortgage would have been an entirely appropriate and acceptable choice. We still believe that this is an important message for HPP consumers. We are therefore proposing that, as part of assessing whether an HPP is appropriate to the needs and circumstances of the consumer, the provider considers why a conventional mortgage would not be appropriate.

Q58: Do you have any comments on our views, summarised in the table at the end of this chapter, about those mainstream MMR proposals which are either not applicable or where a straight read-across to the Home Purchase Plan market is appropriate?

Q59: Do you have any comments on the tailoring we propose in relation to execution-only Home Purchase Plan sales following rejected advice and enhancing sales standards?

Q60: Is any other tailoring required for the Home Purchase Plan market? If yes, please explain.

Q61: Overall, do you have any other comments on our proposed read-across of the MMR to the Home Purchase Plan market?

Sale and rent back

Introduction

10.31 Sale and Rent Back (SRB) agreements involve a consumer selling their home to a provider, usually at a discount (we understand the typical SRB sale to be around 70% of the open market value of the property). In return they are allowed to stay in their home as tenants under a tenancy agreement with a minimum term of 5 years. Consumers who take out SRB agreements are typically vulnerable consumers, facing financial difficulties or even repossession. We regard SRB as a particularly high-risk product that should only be considered as a last resort.

10.32 Our regulation of SRB firms began on 1 July 2009 under an interim regime, with a full regime being introduced on 30 June 2010. The number of active firms in this market has reduced as the property market has slowed and now just over 20 firms are authorised under our full regime. However, the Government is concerned that a number of unauthorised individuals and small firms may be active in the market and, as discussed in Chapter 7, has recently made changes to the by way of business test for entering into sale and rent back agreements to make it clear that small firms and individual investors who conduct SRB business, even if entering into just a single transaction, must be authorised by the FSA, unless they are related to the customer.[256]

10.33 As we have only very recently consulted with the market about our approach to SRB[257] we do not discuss the existing regime in any detail here.

10.34 The table at the end of this chapter summarises the MMR proposals and indicates where, in our view, the proposals are not applicable, can be subject to a straight read-across and therefore the relevant section in Part I applies or, as discussed below, need to be tailored to fit the current approach to the SRB market.

Tailored approach for the sale and rent back market

Rejected advice

10.35 As discussed in paragraphs 5.75 to 5.89, we propose to treat SRB consumers as vulnerable consumers who therefore must always be given advice.

10.36 We noted in paragraphs 5.96 to 5.99 and in relation to equity release and HPP consumers that, provided a consumer has been advised by an intermediary, they should have the right to reject that advice and opt for a product of their choice on an execution-only basis. But given the particular vulnerability of many SRB consumers, we do think it would be appropriate and therefore have not made provision to enable them to do this.

256 The definition of a 'related person' is set out in our handbook. See Q37A of PERG 14.4A. http://fsahandbook.info/FSA/html/handbook/PERG/14/4A
257 CP10/4, *Sale and rent back (full regime)*, (January 2010): www.fsa.gov.uk/pubs/cp/cp10_04.pdf

Q62: Do you have any comments on our views, summarised in the table at the end of this chapter, about those mainstream MMR proposals which are either not applicable or where a straight read-across to the Sale and Rent Back market is appropriate?

Q63: Do you have any comments on the tailoring we propose in relation to not allowing Sale and Rent Back consumers to reject advice?

Q64: Is any other tailoring required for the Sale and Rent Back market? If yes, please explain.

Q65: Overall, do you have any other comments on our proposed read-across of the MMR to the Sale and Rent Back market?

Bridging finance

Introduction

10.37 A bridging loan is a form of short-term financing, secured by a charge on a borrower's residential property, until permanent or the next stage of financing is obtained.

10.38 Bridging loans secured by a first charge are regulated mortgage contracts and are currently subject to the same regime as the mainstream mortgage market.

10.39 Because of the speed at which finance is provided, and given the shorter term nature of the product, bridging loans are more expensive than mainstream mortgage products, with interest rates fixed typically between 12 and 16% per year. Loans are almost exclusively offered on an interest-only basis, although interest is usually rolled up, meaning that the consumer will never actually make regular monthly payments.

10.40 It is very difficult for us to obtain accurate data on the bridging market. This is predominantly because 'bridging loan' is not a defined term for reporting purposes. What little data we do have is based on knowledge of some firms operating in the regulated market. This is supplemented by quarterly data shared with us by the bridging finance trade association.[258] Based on our data, the regulated first charge bridging market makes up a very small part of the overall regulated mortgage market. In fact the regulated market

258 Association of short term lenders (ASTL).

share has reduced since 2007 from 0.03% of the market to 0.02% in Q2 2011.[259] Interestingly, over the same period, those lenders' non-regulated business (e.g. second charge and buy-to-let) has more than doubled.[260]

10.41 A bridging loan, by its very nature, relies on speed to complete the transaction as quickly as possible, so we need to strike a careful balance between maintaining it as a viable niche product (i.e. not creating an unnecessarily burdensome regime), and ensuring that lenders are lending responsibly.

10.42 We have spent considerable time speaking to bridging lenders and intermediaries to understand clearly the impact of our proposed reforms. This extensive engagement has been helpful in developing our proposals.

10.43 We have a number of concerns about this market, namely:

- Whether it is appropriate for bridging finance to be used as a means of repaying mortgage arrears, particularly for those particularly vulnerable consumers facing repossession.
- Given the decline in the sub-prime market, whether bridging products are being inappropriately targeted at vulnerable, credit-impaired consumers, with promises that they will rehabilitate the consumer and improve their credit scores.
- Whether bridging finance is being offered as a last resort where mainstream finance is suitable.
- The quality of lender underwriting practices, both at the time the loan is advanced and, where applicable, where the loan is extended.
- The extent to which regulated business is being reported inaccurately as non-regulated loans.

10.44 The expensive nature of bridging finance means that it should only be used where it is appropriate. This also makes it very important that intermediaries and lenders carry out careful checks to ensure that the consumer will ultimately be in a position to repay.

10.45 We have not discussed bridging finance specifically in any detail in past consultations on the mortgage market and would be particularly interested in feedback from the market on the issues raised here.

10.46 The table at the end of this chapter indicates where, in our view, the MMR proposals are not applicable, can be subject to a straight read-across and therefore the relevant section in Part I applies or, as discussed below, need to be tailored to fit the current approach to bridging finance. Some of the proposals set out here are new.

259 Source: FSA Product Sales Data (PSD). Based on 14 bridging lenders and covering their regulated activity only for *Q2 2007 and Q2 2011*

260 Source: FSA Product Sales Data (PSD). Based on 14 bridging lenders and covering their regulated activity only for *Q2 2007 and Q2 2011*.

Tailored approach for bridging finance

New proposal: defining a bridging loan

10.47 As we are proposing to tailor the regime for bridging finance, we consider it important to have a clear definition to avoid any doubts about when the tailored approach applies. We are therefore proposing to define a bridging loan as a regulated mortgage contract with a term of 12 months or less, which appears to be consistent with current market practice.

> Q66: **Do you have any comments on our proposal to define a bridging loan as a regulated mortgage contract with a term of 12 months or less?**

Affordability proposals

10.48 As we have already noted, the vast majority of bridging finance is advanced on an interest roll-up basis. This means that the consumer is never actually required to make monthly payments (of either interest or capital). Repayment of both is required at the end of the term. For these loans, it is not the consumer's ability to repay out of income that is the important factor in the lending decision, but the credibility of the consumer's exit strategy (i.e. their ability to repay the loan at the end of the term). Therefore in these cases, the lender would not need to make an assessment of the applicant's ability to afford regular monthly mortgage payments. However, where the customer is required to meet monthly payments (whether it be interest-only or interest plus capital), we would propose to read-across our affordability rules.

> Q67: **Do you have any comments on how the affordability proposals should be applied to consumers taking out bridging finance?**

Interest-only

10.49 In Chapter 3, we discuss our proposals in relation to interest-only mortgages and the need for a credible repayment strategy. Lenders must have a clear policy to assess interest-only applications against. This must set out those repayment strategies which the lender will accept, and the controls in place around them, for example limits on maximum loan-to-value (LTV) and consumer type. Given the cost of bridging finance, and therefore the speed at which equity may erode, it is arguably more important for the consumer to have a credible method of exiting the loan. Therefore we are proposing that bridging lenders are also required to have an interest-only policy (signed off by their Board) in place.

10.50 The policy should be clear about which short-term exit strategies the lender considers to be credible. For example, the policy could state whether the lender will accept consumers who are using proceeds from the sale of their property to repay the loan, or those who are proposing to refinance to a longer-term deal. The policy must also confirm what evidence the lender would expect to see in order to be satisfied that the consumer's exit strategy is credible.

10.51 Lenders in the bridging market should not accept speculative methods for repayment of bridging loans. We believe that an expectation on the part of the customer that by entering into a bridging loan their credit status will be repaired sufficiently to enable the consumer to refinance to a mainstream, longer-term, mortgage product, would be a speculative method of repayment (except where the lender has evidence of a guaranteed offer).

> **Q68:** **Do you have any comments on our proposed read-across of our interest-only proposals to bridging finance?**

> **Q69:** **Do you have any comments on our proposal that lenders consider the repayment or exit strategy of the borrower, and have a clear lending policy that reflects this?**

New proposal: Extending the term of a loan

10.52 The average term of a bridging loan is around eight months. However, it is common for bridging loans to be extended beyond their original term. Data from lenders suggested that in February 2011, 33% of their total loan book was extended.[261] We understand that for some consumers this may be unavoidable because, for example, building work has exceeded its completion date, but 33% is nonetheless a very high proportion of loans.

10.53 We are concerned that lenders may be extending the term of the loan when, in reality, the chance of the consumer being able to repay (the second time around) is no greater. Where a repayment strategy has failed once, it is important that lenders consider whether extending the loan will provide the consumer with a more realistic chance of repaying or whether they are just increasing the overall debt, reducing the remaining equity and therefore delaying the inevitable.

10.54 Currently, our rules only require that a consumer's ability to repay is assessed at the outset (i.e. when the loan is advanced), and not where the loan is extended and no new sums are being advanced. Given that this is the case for 33% of bridging loans, we are proposing that lenders treat every term extension as a new loan in respect only of reassessing the consumer's ability to repay. We are not expecting the lender to issue new Key Facts information or offer document.

10.55 Where the loan is an interest-only loan, this simply means that the lender will need to carry out the same checks (as documented in their interest-only policy) as if the loan was being advanced for the first time. So, for example where the customer is making monthly

261 Source: Association of Short Term Lenders (ASTL). Information is based on loans advanced between January and February 2011 and is based on responses from nine short-term lenders to that question.

payments on the loan, we would expect the lender to carry out a full affordability check (in line with our proposed responsible lending rules). To draw the consumer's attention to the implications of extending the loan term, we also propose that they should positively elect to do so. The lender should subsequently retain a record of that election. This will ensure that both the lender and consumer properly consider whether the repayment or exit strategy remains viable and on track. It also prompts the consumer to think about the implications of extending the term in respect of the additional cost involved.

Q70: Do you have any comments on our proposals about extending bridging finance loans?

Enhancing sales standards

10.56 According to data we have received from lenders in the market, around 70%[262]of bridging sales are intermediated. Of these, only about 40%[263] are sold with advice. We are concerned that consumers may be taking out bridging finance when a mainstream mortgage product would have been available and more appropriate. In order to address this risk we are proposing to require that where an intermediary is providing advice, he determines, as part of the sales process, why a mainstream mortgage was not appropriate for the consumer.

10.57 In order to ensure that the intermediary is asking appropriate questions to identify whether a bridging loan is suitable for the consumer, we are proposing to require firms to consider the following factors:

- whether it is appropriate for the customer to access finance quickly; and
- whether it is appropriate for the customer to make regular payments.

10.58 Once the intermediary has identified a bridging loan as being the appropriate product, they must make sure the consumer is aware that they will need to demonstrate to the bridging lender that they have a clearly understood and credible repayment strategy in place to repay the loan.

Q71: Are there any other factors that firms should consider in order to determine that a bridging loan is appropriate?

262 Source: Association of Short Term Lenders (ASTL). Information is based on loans advanced between January and February 2011 and is based on responses from ten short-term lenders to that question.
263 Source: Association of Short Term Lenders (ASTL). Information is based on loans advanced between January and February 2011 and is based on responses from ten short-term lenders to that question.

Service disclosure

10.59 In Chapter 5 we explain our proposed new approach to service disclosure, which requires intermediaries to give a clear and straightforward description of the service they offer. Regulated bridging loans are part of the regulated mortgage market and therefore under this proposal an intermediary that only offers bridging loans must describe its service as restricted within the wider mortgage market. Below is an example of such a disclosure:

- 'I sell bridging finance products only from [name of lender(s)]. I do not offer products from across the mortgage market'.

Q72: **Do you have any comments on our proposal which requires that intermediaries who only offer bridging loans should describe the restriction on their service to the consumer?**

The prudential regime applying to bridging finance

10.60 In Chapter 9, we set out our proposed prudential approach for non-deposit taking lenders (non-banks). This is based on feedback received to CP10/16. A number of bridging firms, who would be caught by our proposed enhanced prudential regime, also responded to that CP, in particular challenging that:

- the pro-cyclical effects that traditional non-banks have demonstrated had not been mirrored by bridging lenders who continue to lend during the recent troubles in the market;
- the capital adequacy and liquidity issues in the bridging finance market are substantially different to those of longer-term (mainstream) lenders due to the maturity profile of the loans; and
- the suggested changes in the regime could have a negative impact on the availability of short-term lending.

10.61 The view of respondents was that the different dynamics associated with bridging finance products meant the proposed enhanced prudential rules should not apply. Lenders felt that the higher capital and liquidity requirements would likely increase the cost of products to consumers and ultimately reduce the amount of lending available. The overall level of capital requirements we propose to apply to non-banks, was determined using analysis of a wide range of information (including information on bridging loans). However, to address lenders' concerns, we carried out a separate piece of analysis designed to understand the impact and ensure that our proposals are proportionate to apply to this niche market.

10.62 We accept that bridging finance has not meaningfully contributed to the pro-cyclicality of the mortgage market and that this type of lending may give rise to different liquidity needs and/or profiles when compared with a longer-term lender. However, we believe this can be appropriately incorporated into the proposed qualitative liquidity requirements.

10.63 The proposed approach for credit risk applies the same capital requirement (relative to the size of the exposure) for all loans where the LTVs are equal to, or lower than, 80%. We would expect most, if not all, bridging loans fit into this category. Therefore, while we acknowledge that the approach may in practice offer a relatively limited risk-differentiation, we believe that the capital requirements resulting from the proposed approach are appropriate.

10.64 In the case of bridging finance the primary default risk is not necessarily reflected in the LTV, as default will typically relate to circumstances where the consumer's exit strategy fails to materialise. However, in the event of default the magnitude of losses incurred by the lender is likely to be determined by the LTV. This is because the lender has a charge secured over the property which can then be sold to cover some, or all, of the outstanding loan amount. The higher the value of the property relative to the outstanding loan amount (i.e. the lower the LTV) the more likely the lender is to avoid loss.

10.65 Many bridging finance loans will attract the lowest capital requirement under the proposed regime (for the given balance sheet carry value of the loan). This capital requirement relates to a fully and completely secured exposure which appears appropriate. In cases where loans are above 80% LTV, which we expect to see in a small number, this will result in a higher capital requirement, reflecting the greater probability of incurring material losses.

10.66 Another characteristic of a bridging loan identified by respondents as a reason for not introducing new prudential requirements is their short-term nature. The term of a loan does not have an impact on the level of capital the firm is required to hold against it under the proposed prudential approach. However, we do not believe this means it is inappropriate for bridging loans for the following reasons:

- The shorter term of the loan only reflects a low risk where there is no material increase in probability of default at the end of the term of the loan (i.e. no repayment risk). In the absence of repayment risk a short loan term corresponds to a shorter length of time for default to occur. However, in the case of bridging loans the primary risk is that the proposed source of repayment does not materialise. The primary risk therefore relates to the consumer's ability to exit the loan. As a consequence, we do not believe the risk is inherently reduced by the shorter term;

- Most providers of bridging loans will allow the consumer to extend (or roll over) the initial term of their loan where necessary. Therefore the term at the outset may not be an accurate reflection of the time until the loan is repaid (as set out in paragraph 10.52 available data reveals that 33% of loans were extended beyond their original term); and

- The term of a mortgage loan does not impact on the level of capital a firm is required to hold against it under any of the current regulatory capital regimes. Capital requirements are designed to cover future losses that could occur over a one year time horizon but are based on the present balance sheet. The requirement of holding the same capital for loans (all else being equal) which expire within the year, compared with those that do not, can be considered a proxy for new business.

10.67 From a credit risk capital perspective, the proposed prudential approach appears to offer an appropriate regime for bridging lenders.

10.68 The proposed approach results in a higher capital requirement relative to the existing MIPRU approach for all credit exposures (although the MIPRU minimum capital requirement means a smaller firm's overall capital requirement will not necessarily increase). The impact of this, and the form of the capital that is required, has been considered within the cost benefit analysis for the proposed prudential regime (see Chapter 9).

Q73: **Do you have any comments on the proposed prudential regime for bridging lenders?**

Q74: **Do you agree with our views, summarised in the table at the end of this chapter, about the MMR proposals which are either not applicable or where a straight read-across to the bridging finance market is appropriate?**

Q75: **In addition to the proposed tailoring set out above, is any other tailoring required for the bridging finance market? If yes, please explain.**

Q76: **Overall, do you have any other comments on our proposed read-across of the MMR to the bridging finance market?**

High net worth lending

Introduction

10.69 We estimate that lending to individuals earning over £1m per year makes up around 0.77%[264] by value of the overall regulated mortgage market. The majority of this lending is structured on an interest-only, repayable on demand basis with no early repayment charges.[265] This allows consumers the freedom to make lump sum capital reductions, or to pay back the borrowing entirely where they have the resources to do so. High net worth (HNW) individuals are usually asset rich so lending decisions will be determined by the

264 Source: FSA Product Sales Data (PSD): 2005 to 2011.
265 Source: FSA Product Sales Data (PSD): 2005 to 2011. 80% of loans were advanced on an interest-only basis. This is based on total income £1m.

repayment strategy (how ultimately they intend to repay the borrowing, and how achievable this is) rather than the monthly repayment plan or amount.[266]

10.70 Credit facilities are diverse and are often not limited to standard mortgages. Loans secured on the borrower's home can be used as security for an overdraft, contingent liability or any other purchase the borrower may want to make.

10.71 HNW borrowers face the same risks when they take out a loan secured against their homes as any other consumer. This includes the risk that they may ultimately lose their home. When setting the scope of mortgage regulation in 2004, the then government was not persuaded that a specific exemption for HNW consumers was required and felt they should be afforded the same protections as any other consumer. Our mortgage rules reflect this and apply to all regulated mortgage contracts, including those taken out by HNW consumers.

10.72 Given the particular structure of HNW lending, in CP10/16 we indicated that this could be an example of a market where our approach to affordability may need to vary. Almost all respondents thought that HNW consumers would benefit from an alternative approach because of the complex nature of their income and sometimes a very short term of the loan (typically five years).

10.73 However, we have we have also been considering whether a more fundamental change in approach to HNW consumers would be appropriate. This has extended to considering whether our regime should apply at all to those individuals with higher levels of income or wealth.

New proposal: Carve-out for high net worth mortgage consumers

10.74 As we noted in Chapter 5, in paragraphs 5.54 to 5.64, there is a fairly widely-held view that HNW consumers do not need the same level of protection as other consumers. There is an argument that, above some level of income and wealth (we discuss below defining 'HNW') it is perfectly reasonable for a consumer to take greater risks and that regulation is not needed to protect those consumers from the decisions they make.

10.75 We expect most consumers to borrow affordably, i.e. to limit the risk of impairment that they take on. And we would expect our affordability rules to help many consumers do this better.

10.76 At the same time, however, there may be some consumers who are quite willing and able to risk impairment. This reflects the general principle that the optimal risk-return trade-off changes as income and wealth rises. So, for example, the more wealth a consumer has, the more willing they may be to take a risk on borrowing sums to fund, for example, a high-risk business venture. If the venture does not work out, and as a result they lose their home, the consequence for them is more likely to mean moving to a smaller house rather than the loss of home ownership altogether.

266 One respondent estimates that around 10% of HNW borrowers have PAYE income that would service the typical repayment for the loan.

10.77 So we believe that it may be reasonable for us to take a more 'free market' approach to such individuals and allow them to willingly forgo the protection and remedies that would otherwise be available to them.

10.78 There are two ways in which we could do this. We could disapply the mortgage rules for HNW consumers, or we could allow the consumer to choose for themselves whether to forego the protections of the mortgage rules. This latter approach would mean adopting an elective approach similar to that in the investment market.

10.79 We would welcome feedback on this and whether we should make a more fundamental change to our approach to HNW consumers than the limited tailoring approach described below.

Q77: **What are your views on our approach to high net worth consumers? Should we adopt a more free-market approach, recognising that for some consumers, regulation is not needed to protect them from the decisions they make?**

Q78: **Would an elective approach similar to that adopted in the investment market be appropriate?**

Q79: **Would it be appropriate for all mortgage rules to be foregone?**

Q80: **Would it be appropriate for all regulatory protections for high net worth consumers to be forgone or should some, such as redress, for example, be retained?**

Tailored approach for high net worth mortgage consumers

New proposal: defining 'high net worth'

10.80 We propose that lenders should obtain a declaration from a professional (such as a lawyer or accountant) that the individual meets the definition of 'high net worth' in order to use the tailored approach and given this and the fact that we propose some specific tailoring of our mortgage rules for HNW consumers, we need to define what we mean by 'high net worth'.

10.81 The aim would be for our definition to carve out a small subset of genuinely wealthy borrowers. We have very limited data on HNW borrowers. The data we have does not draw an absolute correlation between income and asset values but there is some evidence that the average wealth of a HNW consumer equals approximately 11 times their earned annual gross income.[267] According to some of the private banks we have spoken to, many require individuals to earn a minimum gross income of £1m per year to use their services. But this would lead to a net asset figure of around £10m, which seems a very high figure. A better benchmark might be (pre tax) income of £300,000 which would mean net assets of around £3m. However, that seems too low an income figure.

10.82 Our starting point for the purpose of our draft rules is to define a HNW consumer, in relation to a home finance transaction, as a consumer with a gross income of no less than £1m per year or net assets of no less than £3m, but we would particularly welcome feedback on this.

10.83 We understand that HNW consumers will often be in a position to assist close family members to buy their homes and we therefore propose to extend the definition to cover HNW consumers who act as guarantors.

Q81: What are your views on defining high net worth consumers – what do you consider the appropriate figures for income and assets?

Q82: Do you agree that it is appropriate to extend the definition to include high net worth consumers acting as guarantors?

Affordability proposals

10.84 A number of credit lines provided to HNW borrowers do not require them to make monthly interest payments, for example a secured overdraft or mortgages where the interest is rolled-up. For these loans, it is not the consumer's ability to repay out of income that is the important factor in the lending decision, but the credibility of the consumer's exit strategy (i.e. their ability to repay the loan at the end of the term). Therefore in these cases, the lender would not need to make an assessment of the applicant's ability to afford regular monthly mortgage payments. However, where the customer is required to meet monthly payments (whether it be interest-only or interest plus capital), we would propose to read-across our affordability rules.

Interest-only

10.85 One of the biggest concerns raised by firms who deal with HNW borrowers (in response to CP10/16) was the suggestion that the affordability of interest-only loans could only be assessed on a capital repayment basis. They felt this would be unduly restrictive in the HNW market because individuals often borrow sums on an interest-only basis that their income would not necessarily support on an equivalent capital repayment basis. Instead,

267 See Exhibit 22.5: Earned annual income and wealth multiple

HNW consumers will have credible repayment strategies in place, usually involving other assets or equity in their homes.

10.86 As discussed in Chapter 4, provided there is a realistic and credible strategy for repaying the capital, affordability can be assessed on an interest-only basis. As proposed in the mainstream market, HNW lenders will be required to have a (Board approved) interest-only policy which should be clear about which exit strategies the lender considers credible. For example, the policy could address whether the lender will accept consumers who are using proceeds from the sale of their property to repay the loan. The policy must also outline the evidence the lender would expect to see in order to be satisfied that the consumers exit strategy is credible.

Q83: **Do you have any comments on how the affordability proposals should be applied to high net worth consumers?**

Product disclosure

10.87 As already noted, there are many 'non-standard' mortgage products designed for HNW consumers which do not lend themselves to the structured disclosure regime set out in the current mortgage rules. As a result, since regulation began in 2004, many lenders have needed to apply for modifications to our rules to ensure consumers receive meaningful information about the product they are purchasing.

10.88 We have already made accommodation in our mortgage rules for non-standard products used by smaller business borrowers. During our round-table discussions with lenders in the HNW market, a number of them asked us to apply these tailored provisions to loans for HNW consumers.

10.89 We agree that such an extension makes sense to avoid repeat applications for modifications to our rules and we are therefore proposing to extend the application of the business loan tailored disclosure rules to HNW consumers. Firms can either opt to apply the mortgage rules in full, disregarding the tailored provisions, or opt to replace the mainstream rules with all of our tailored provisions. Firms are not able to choose to use some of the tailored provisions and not others. In order to achieve this, we believe an elective approach similar to that adopted in the investment market would be appropriate.

Q84: **Do you have any comments on our proposal to extend the tailored disclosure rules to high net worth consumers?**

Q85: **Do you think that to achieve this, an elective approach similar to that adopted in the investment market would be appropriate?**

Q86: Do you agree with our views summarised in the table at the end of this chapter about the MMR proposals which are either not applicable or where a straight read-across to high net worth lending is appropriate?

Q87: In addition to the proposed tailoring set out above, is any other tailoring required for high net worth lending? If yes, please explain.

Q88: Overall, do you have any other comments on our proposed read-across of the MMR to high net worth lending?

Business lending

10.90 When the Government first brought mortgage regulation within our scope in 2004, they excluded business lending but their view at the time (reached after consultation and despite representations from the banking sector) was that if a borrower's home was at risk, they should be given regulatory protection, irrespective of the borrower, for example whether a natural person, a HNW individual or a sole trader. Therefore we regulate loans for a business purpose secured by a first charge against the business borrower's home.

10.91 However, we tailored our approach to regulating smaller business lending following detailed discussion with business lenders. The tailoring we applied to our rules was intended to reflect that:

- business borrowing is likely to be individually negotiated, and by being less commoditised will sit poorly with the standardised approach to disclosure; and
- larger business borrowers (who we defined as those with an annual turnover of more than £1m) are better able to protect their own interests.

10.92 We have very limited data on small business lending. Our PSD does not distinguish between those self-employed borrowers taking out a conventional mortgage and those who are taking out a mortgage for a business purpose. Very often the lender will not know whether a further advance or a remortgage is used for a business purpose. As we noted in Chapter 3, we do know that the survival rate for small businesses generally is not particularly good. Exhibit 14.6 shows that, of the all businesses set up in 2004, by 2009 less than 50% still survived.

10.93 The different risk profile of business consumers raising a mortgage on their home compared to other consumers has also led us to consider whether it may be appropriate to carve out business loans from our proposed new regime entirely. There is an argument that if a business borrower and lender want to take an informed risk and the business borrower is happy to use his home as collateral for a business venture, why should he be inhibited in any way from doing so? It is important not to constrain the ability of consumers to take consciously chosen business risks. But what of those less able to protect their own interests, such as sole traders borrowing against their home as a last resort to keep their business afloat? They more obviously need regulatory protection.

10.94 So, it is not clear whether we can and, if so, where we would draw a line between those small business borrowers who can take the risk and should be allowed to do so and those who cannot. And there is also an issue about how we would prevent this from being exploited as a means to avoid our new affordability proposals. We acknowledge that one response might be that for those small business borrowers wishing to take out a loan outside of our regulation, a ready answer exists in becoming incorporated. However, incorporation may have disadvantages for the borrower.

10.95 Again we would welcome market feedback on this and whether we should make a more fundamental change to our approach to business borrowers than that described below. Given the need to protect some small business borrowers, we believe that it would be appropriate to allow the consumer to choose whether to forego the protections of the mortgage rules. We therefore could propose to adopt an elective approach to this, similar to that taken in the investment market. However, it may be appropriate to maintain some mortgage rules, for example the arrears rules rather than forego all protections. We would welcome feedback on this.

Q89: **What are your views on our approach to business lending? Should we adopt a similar approach to that proposed for high net worth consumers, recognising that for some consumers, regulation is not needed to protect them from the decisions they make?**

Q90: **How would we draw a line between those business borrowers able to take the risk and those who are not?**

Q91: **How would we prevent this proposal from being exploited as a means of circumventing our affordability proposals?**

Q92: **Would it be appropriate for all mortgage rules to be forgone or should some, for example the arrears rules, be retained?**

10.96 The remainder of this section considers the specific tailoring of our MMR proposals that will be required for business lending. The table at the end of this chapter indicates where, in our view, the MMR proposals are not applicable, can be subject to a straight read-across and therefore the relevant section in Part I applies or, as discussed below, need to be tailored to fit business lending.

Tailored approach for business lending

Affordability assessments

10.97 As for lending to HNW consumers, credit facilities for smaller business borrowers can take many forms. A charge over the consumer's property may be used to secure a fixed term loan, a business overdraft, or for a range of other credit facilities. These facilities may not require the business borrower to make monthly interest payments and, as in the case of HNW consumers, for these loans it is not the consumer's ability to repay out of income that is the important factor in the lending decision, but the credibility of the consumer's exit strategy (i.e. their ability to repay the loan at the end of the term).

10.98 We therefore propose that where no payments are scheduled during the expected term of the mortgage, the lender is not required to assess the applicant's ability to afford regular monthly mortgage payments. However, where the customer is required to meet monthly payments (whether it be interest-only or interest plus capital), our responsible lending rules will apply.

Interest-only

10.99 As with HNW consumers, we are proposing that, provided there is a realistic and credible strategy for repaying the capital, affordability can be assessed on an interest-only basis. As proposed for the mainstream market, business lenders will be required to have a (Board approved) interest-only policy which should be clear about which exit strategies the lender considers credible.

> **Q93: Do you have any comments on how the affordability proposals should be applied to business borrowers?**

Professional standards

10.100 Extending the Approved Persons regime to advisers and arrangers (including those dealing with business loans), will mean that firms must assess their employees as competent. Firms will need to have a process in place to do so. In the mainstream market all intermediaries (both independent and those employed directly by lenders) will be required to hold a qualification. There is not, nor (due to the size of the market) is there likely to be, a qualification which is specific to secured business borrowing. We will not therefore require intermediaries who operate solely in the business market to obtain a relevant mortgage qualification. We will, however, require firms to ensure individuals selling business loans are competent. Our proposal is therefore to include business sales staff in our Training and Competence (TC) regime but not require them to hold a qualification.

Q94: **Do you have any comments on the proposed approach to professional standards in business lending?**

Q95: **Do you agree with our views summarised in the table at the end of this chapter about the MMR proposals which are either not applicable or where a straight read-across to business lending is appropriate?**

Q96: **In addition to the proposed tailoring set out above, is any other tailoring required for business lending? If yes, please explain.**

Q97: **Overall, do you have any other comments on our proposed read-across of the MMR to business lending?**

Q98: **Do you have any comments on the draft rules specific to niche mortgage markets in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1? Do you think the rules reflect the stated policy intention?**

Summary of read across of MMR proposals to niche markets

Key:

✘	Not applicable
✓	Straight read across
○	Tailored approach

Proposal	Equity Release		Home Purchase Plans	Sale and rent back	Bridging Finance	High net worth	Business lending
	Life-time	HRs					
Chapter 3: Responsible lending and borrowing							
Income and affordability assessment.	✓	✘	✓	✘	○	○	○
Stress test against interest rate increases.	✓	✘	✘	✘	✓	✓	✓
Assessing income beyond state pension age.	✓	✘	✓	✘	✓	✓	✓
Consolidating debts.	✓	✘	✓	✘	✓	✓	✓
Transitional arrangements.	✓	✘	✓	✘	✓	✓	✓
Chapter 4: Interest-only							
Lenders must assess affordability on a capital and interest basis unless there is a believable repayment strategy. Lenders must have a clearly defined interest-only lending policy.	✓	✘	✘	✘	✓	✓	✓
Lenders must assess and obtain evidence of repayment strategy at the application stage.	✓	✘	✘	✘	○	✓	✓
Lenders must periodically check the repayment strategy.	✘	✘	✘	✘	✓	✓	✓

Proposal	**Equity Release**		**Home Purchase Plans**	**Sale and rent back**	**Bridging Finance**	**High net worth**	**Business lending**
	Life-time	**HRs**					
Chapter 5: Distribution and Disclosure							
Intermediaries’ role in assessing affordability and appropriateness.	✓	✓	✓	✗	✓	✓	✓
Advice is given whenever there is spoken or interactive dialogue.	✓	✓	✓	✗	✓	✓	✓
Execution only sales are allowed in limited circumstances (for example, rejected advice)	○	○	○	○	✓	✓	✓
Vulnerable consumers must always receive advice.	✓	✓	✓	✓	✓	✓	✓
Enhanced sales standards.	✓	✓	○	✗	○	✓	✓
Rolling-up fees and charges.	✓	✗	✗	✗	✓	✓	✓
All sellers to hold a relevant qualification.	✓	✓	✗	✗	✓	✓	○
Replacing the IDD with a requirement to disclose key messages.	✓	✓	○	✗	✓	✓	✓
Explanation of scope of service – sellers to inform consumers of any limitations to their service, both at initial disclosure and presentation stages.	○	○	✓	✗	○	✓	✓
Changes to the trigger points for presentation of the KFI/FIS and removal of the need for a KFI/FIS for ‘direct-only’ deals.	✓	✓	✓	✗	✓	✓	✓

Proposal	Equity Release		Home Purchase Plans	Sale and rent back	Bridging Finance	High net worth	Business lending
	Life-time	HRs					
Chapter 6: Arrears and repossessions							
Clarification of how firms should be calculating arrears charges and limiting the number of times fees for missed payments can be charged.	✓	✗	✓	✗	✓	✓	✓
Widening the arrears charges and forbearance rules to cover all payment shortfalls. Removing the the rule that allows lenders to withdraw concessionary rates if a consumer has a payment shortfall.	✓	✗	✓	✗	✓	✓	✓
Chapter 9: Non-deposit taking lenders (non-banks)							
Enhanced prudential requirements for non-bank lenders.	✓	✗	✓	✗	✓	✓	✓

PART IV
Annexes

Annex 1

Cost benefit analysis

Contents

A1

Executive summary

1. The Mortgage Market Review (MMR) seeks to strengthen responsible lending, the prudential regulation of non-bank mortgage lenders, the conduct and prudential standards of niche market lenders and the distribution and disclosure of mortgages. This cost benefit analysis (CBA) presents our analysis of the costs and benefits of the package. Overall, our analysis suggests that the package of proposals is likely to be net beneficial.

2. The CBA is based on mortgage data for the period 2005-2010. It assesses what would have happened to the mortgage market over that period if the MMR had been in place. The period is informative because it includes years in which the housing market was booming (2005-7) and years in which it was subdued (2009-2010). We refer to these two periods, 2005-7 and 2009-10, collectively as our 'sample period'.

3. Our analysis suggests that the responsible lending requirements will have much greater impacts than our other proposals. The impacts are expected to be far larger in boom periods when lending standards tend to be relaxed than they are in subdued periods in the housing market. An impact on lending is not per se a cost or a benefit. To identify costs and benefits, we explore the material and well-being consequences of changes in lending.

4. Affordability – preventing consumers taking mortgages that are clearly unaffordable or where the risk of them becoming unaffordable as a result of reasonably foreseeable developments (including increases in interest rates) is high – is intuitively a sound principle. However, since it is a principle rather than a set of quantitative rules and certain data, for example on relevant households' expenditure, are not available, this CBA has been unusually difficult to prepare. There remains a wide margin of uncertainty around its results and we therefore welcome comments on it. We would particularly value industry participants providing their own detailed and quantitative assessments of the likely impacts of the affordability assessment, the interest rate stress and the interest-only proposals.

Responsible lending requirements

5. We refer to the affordability assessment, the interest rate stress and the interest-only proposals collectively as the responsible lending requirements. We expect these requirements to result in the most significant impacts of the MMR package of proposals. These requirements may be summarised as follows:

- *the affordability assessment:* the lender must verify income and be able to demonstrate that the mortgage is affordable, taking into account income and, as a minimum, the borrower's committed expenditure (which includes the mortgage payments) and essential household expenditure (discussed in Chapter 3 of the CP);
- *the interest rate stress test:* the lender must consider the impact of future interest rate increases on affordability, with reference to market expectations for interest rates over the next five years (discussed in Chapter 3 of the CP); and
- *the interest-only proposals:* the lender must assess affordability on a capital and interest basis, unless there is a clearly understood and believable alternative source of capital repayment (as discussed in Chapter 4 of the CP).

6. It is extremely difficult to identify exactly how the responsible lending requirements will change borrowing in the market or the likely scale of this. It requires some judgemental assumptions on the basis of imperfect evidence. It is, though, important to produce best estimates of what the impact of the new rules might be, in order to inform and check our policy judgement. These estimates need to cover the number of people who will obtain a smaller mortgage or who will have to delay their borrowing because of the new rules, and the costs and benefits arising. Costs arise when people are prevented from taking out the mortgage they want. Benefits arise when people are protected from mortgage impairment. We have no data on the duration of the delays in borrowing caused by the MMR.

Estimating the impacts of the affordability assessment

7. With data on expenditure and a precise definition of hard-to-reduce living costs, we could try to identify directly which loans are unaffordable and therefore in principle affected by the MMR. But, lacking these, we used an alternative approach, aimed at identifying mortgages that were poorly underwritten (i.e. based on weak assessments of credit and other factors), as these are the mortgages most likely to be affected by our proposals.

8. The approach is as follows:

- we assess the drivers of mortgage impairment, and isolate underwriting factors to construct a quality of underwriting score for each mortgage in our dataset;

- we determine a quality of underwriting cut-off point, this being the point at which lender underwriting standards deteriorate markedly, to identify which mortgages are likely to be affected by our new responsible lending requirements; and
- we assess the impacts separately over the boom and subdued periods (2005-07 and 2009-10), which had different underwriting standards.

Estimating the impacts of the interest-rate stress test and interest-only proposals

9. Using this approach to model the impact of the interest rate stress test and interest-only proposals would have been very complex. Instead we employed a methodology that used our database on the distribution of debt-service ratios (DSRs), which is the ratio of borrower's mortgage payments to income after tax and national insurance. Here DSR is used as a proxy rather than as a precise measure of affordability.

10. Specifically, our proxy for the proportion of borrowers who would be affected by the addition of the interest rate stress and interest-only proposals is the proportion of borrowers whose mortgages had passed the basic affordability test, but whose DSR exceeds 45% once the effects of these proposals are added to initial mortgage payments. To be clear, we are not assuming that it is these specific borrowers (those with DSR exceeding 45%) who will in fact be affected by the interest rate stress and interest-only proposals.

11. We know that high DSR is only weakly associated with affordability as proxied by impairment. This is partly because affordability itself, as assessed and regulated at inception of a loan, is only partially correlated with impairment. The level of impairment is materially influenced, upwards and downwards, by post-inception events and circumstances. We expect our approach to lead us to overestimate the number of borrowers who would be affected by the MMR but whose mortgages would have turned out to be affordable.

Estimating the macroeconomic and well-being impacts

12. We also assessed the macroeconomic and well-being costs and benefits of the proposals.

13. We use the National Institute for Economic and Social Research's NiGEM model to calculate the macroeconomic impacts of the reduction in lending resulting from the MMR. We assess the macroeconomic impacts relative to a base case which takes account of changes to prudential regulation. This separates the impacts of the MMR from the impacts of prudential regulation.

14. We measure changes in well-being arising from the MMR.

- Some people experience increased well-being (a benefit) by avoiding mortgage impairment.
- Others whose borrowing is affected by the MMR would in any case not have experienced mortgage impairment. These people experience only a reduction in well-being (a cost), for example, from having to buy a less desirable property, from delaying their property purchase or, in the case of some remortgagors, from not obtaining desired additional lending to support consumption.

15. Deciding what relative weight to put on these positives and negatives is inherently highly uncertain. To a significant extent, therefore, the decision on whether to proceed with the proposed rules has to be based on social and political judgements, but the trade-offs involved are best informed by the results of our well-being analysis.

16. We found that the *number* of borrowers estimated to experience reduced well-being under the MMR is greater than the number estimated to enjoy increased well-being under the MMR.[1] In fact, given the low overall level of mortgage impairment in our sample period, any policy, but more so any quantitative rules, is likely to stop more loans that would not have become impaired than loans that would have become impaired. The MMR can still, however, deliver net benefits, as we explain below.

17. Whether the overall well-being impacts are net beneficial or costly depends on two factors:

- the relative size of the well-being weights associated with increased and reduced well-being; and
- the ratio of loans that would have become impaired to all loans prevented or reduced by the responsible lending proposals.

18. We estimate the tipping point for this ratio to be around 20-22%. This is because the well-being gain for those borrowers who benefit from the MMR is much higher than the well-being loss for those borrowers losing out because of the MMR. As we estimate that up to about 30% of the borrowers affected by our overall package of proposals would have gone into impairment, we believe that the policy is net beneficial in well-being terms.

19. It is important to keep in mind that a significant proportion of mortgage payment difficulties are caused by 'facts of life', such as divorce and unemployment, not by initial unaffordability associated with poor mortgage underwriting. The MMR cannot prevent impairment caused by facts of life. It will, however, prevent some loans that would have become unaffordable due to facts of life, and the benefit of this is included in the tipping point estimated above. The well-being cost of loans that were unaffordable at inception and therefore would be prevented or reduced under the MMR, but that would not have gone into impairment because post-inception the borrowers' circumstances changed for the better, is also included.

1 The borrowers estimated to experience reduced well-being under the MMR are those whose borrowing is constrained by the MMR but who would not have faced any form of mortgage impairment without the MMR. The borrowers estimated to experience increased well-being under the MMR are those whose borrowing is constrained by the MMR and who would have faced mortgage impairment without the MMR.

Other impacts

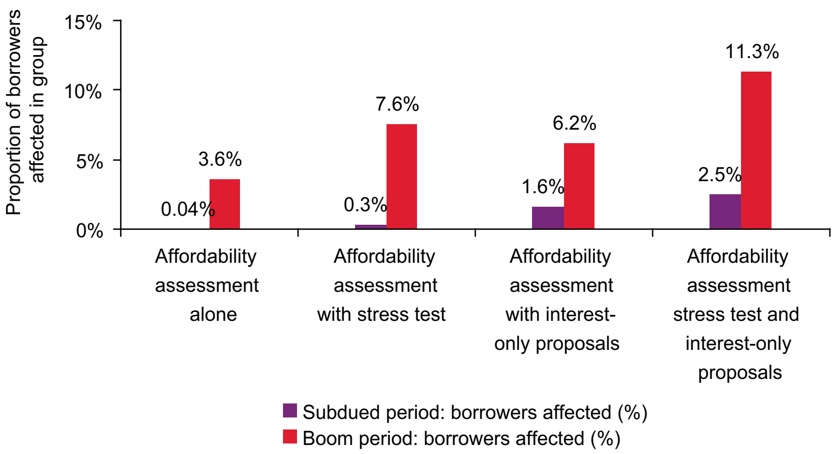
20. There are additional benefits and costs from the proposals. Consumers, who would have otherwise taken on an unaffordable mortgage, avoid detriment because they do not incur the arrears and repossession charges that would have arisen. While these charges are transfers from consumers to firms, there is an underlying social benefit. This is the value of the resources, such as labour, saved by the MMR i.e. the resources that would have been spent on administration of arrears and repossession. There will also be further social costs, in particular the incremental compliance costs of the MMR.

CBA results

21. Our high-level conclusions are set out below. These are central estimates that depend on the key assumptions explained in Chapter A4, and they must be viewed as sitting within broad ranges.

- **Impacts on borrowers:** The affordability assessment, the interest rate stress test and the interest-only proposals together are estimated to affect 2.5% of borrowers in subdued market conditions and 11.3% in boom market conditions. Figure A1.1 presents the combined impact of the affordability assessment, interest-rate stress and the interest-only proposals, as well as of two other combinations and of the affordability assessment by itself.

Figure A1.1 – Responsible lending requirements – estimated total proportion of borrowers affected[2]



2 The incremental impact of the interest-rate stress and interest-only proposals together (2.5% in subdued, 7.7 % in boom) is greater than the sum of the incremental impacts of the interest-rate stress and the interest-only proposals (1.8% in subdued, 6.6% in boom). This is due to the interest-only and interest-rate stress tests proposals acting together to affect borrowers who would not be affected by either of the two proposals alone. For example, an interest-only borrower may pass an affordability assessment with the interest-rate stress, and may also pass an affordability assessment with the interest-only proposals, but not pass an affordability assessment where both the interest-rate stress and the interest-only proposals are applied. Modelling the combined impact of the three proposals together captures further borrowers.

Our analysis of the affordability assessment alone shows that its impact is minimal in the subdued period. In the boom period, its impact is less on first-time buyers (FTBs) than on remortgagors. Throughout the sample period, the greatest impact is on self-certified borrowers and the credit-impaired, with credit-impaired by far the most affected. Because many self-employed borrowers were self-certified, there is also a significant impact on this group from the affordability assessment in the boom period.

- **Lending impacts**: The impacts of the responsible lending requirements on mortgage lending depend on the type of borrower.
  - When a *first-time buyer* does not take out a mortgage, the impact on net lending is the full amount of the mortgage that would have been granted in the absence of the MMR.
  - In contrast, a *home-mover* typically has an existing mortgage, so one who does not obtain a mortgage keeps their existing mortgage. In this case, the impact on net lending is any difference between the amount outstanding on their existing mortgage and what they would have been borrowed under the new mortgage.
  - Broadly, the position of *remortgagors* is similar to that of home-movers. One difference, however, is that the goal of some remortgagors is only to lower the rate of interest they pay. In these cases, there is no impact on net lending whether the transaction goes ahead or is prevented under the MMR.

  Thus the per capita impact on lending volume arising from the MMR preventing first-time buyers from borrowing is typically much greater than the per capita impact on other categories of borrower. Aggregating our estimates for each of these categories, our best estimate is that the responsible lending requirements would reduce the value of mortgage lending by about 2% in subdued market conditions and 10% in boom market conditions.

- **Macroeconomic effects:** We estimate the long-term impact on GDP growth to be an annualised GDP increase of around £$^1/_3$bn. This is because part of banks' response to reductions in domestic mortgage lending is increased corporate lending that increases business investment. In the short to medium-term, however, there will be a small fall in GDP as the reduction in mortgage lending leads to lower consumer expenditure. The maximum fall is about £3bn, or 0.2% of GDP, seven years after implementation of the MMR. In the short to medium term (up to about eight years after the implementation of the MMR), house price growth will be lower relative to house price growth without the MMR. At a maximum, house price growth decreases by about 2% per annum about four years after implementation. Overall, if house price growth would have been 34% over the years 2014 to 2022 without the MMR, we estimate that it would be 23% with the MMR.

  We measure the macroeconomic impacts of the MMR relative to a base case which assumes slow economic recovery emerging in 2013 and the return of relatively benign macroeconomic conditions by 2014. For as long as the economy continues scarcely to grow, with subdued conditions persisting in the housing market, the macroeconomic impact of the MMR is likely to be trivial.

- **Well-being impacts:** Over our sample period, we estimate that up to about 30% of impacted borrowers (about 200,000 out of 730,000) would have gone into arrears. This means that:
  - c.200,000 consumers impacted by the MMR would otherwise have experienced a well-being loss associated with impairment; and
  - c.530,000 consumers would have been impacted by the MMR would not have experienced impairment.

  30% is above the tipping point described above (20-22%) for net well-being benefits to arise from the MMR (i.e. for the well-being benefits enjoyed by those prevented from experiencing mortgage impairment by the MMR to more than offset the well-being costs incurred by those who are constrained in their borrowing by the MMR). The benefits of this – avoiding the material loss of well-being associated with mortgage impairment – are likely to be very substantial.

- **Reduction in costs of arrears and repossessions for consumers:** Over our sample period, we estimate a reduction in the number of arrears of about 175,000 and a reduction in the number of repossessions of about 30,000. The benefit from the decrease in arrears and repossessions, measured as a saving in resource costs would have been around £60m. In addition, transfers[3] from borrowers whose homes were repossessed to other consumers would have been reduced by around £900m over the sample period. As these transfers are from the repossessed borrowers to the property purchasers, reducing them is likely to be regarded as socially beneficial.

- **Compliance costs from the MMR:** As set out in Chapter A6, we expect the total ongoing compliance costs of the MMR proposals to range between £47m and £170m a year. Total one-off costs are expected to be between £40m and £65m. The figures quoted here are valuations of the economic resources that will be absorbed in implementing and operating the rules proposed in the MMR.

- **Overall CBA balance:** The MMR as a whole is likely to be net beneficial. On a per mortgage borrower basis:
  - the net well-being benefit is about £350;
  - the benefit from reduced arrears is about £10; and
  - the compliance costs are up to about £120 per borrower.

3 In this case, the ‘transfer’ arises because the fire sales typically associated with repossessions lead repossessed property sellers to lose the amount by which their property is discounted and the buyers to gain the discount. The amount of the discount is the amount of the transfer.

Taken together this implies a net per borrower benefit of about £240. In estimating the overall cost-benefit balance we are not taking into account the benefits associated with the transfers described above or with the impact on GDP, because we have not attempted to estimate the former and the margin of error inherent in the estimation of the macroeconomic impacts means that in reality this impact could either be positive or negative.

Impacts of other proposals

22. The MMR also includes measures on the prudential regulation of non-bank mortgage lenders, the conduct and prudential standards of niche market lenders and the distribution and disclosure of mortgages. The impact of these proposals is likely to be small relative to the overall impacts of the MMR affordability proposals. The main impacts of these other proposals are capital and other compliance costs, an improvement in risk pricing and a reduction in regulatory arbitrage. These costs but not the associated benefits are included in the overall cost-benefit assessment in the previous paragraph.

Structure of the CBA

23. Chapter A2 is introductory and sets the MMR in the context of the wider economy. Chapter A3 describes the market failures addressed by the MMR. Chapter A4 describes the costs and benefits arising from the lending impacts of the responsible lending requirements. Chapter A5 explores the costs and benefits of the non-bank prudential proposals. Chapter A6 sets out other costs and benefits and briefly discusses competition issues.

A2

Introduction

1. The Financial Services Market Act (FSMA) requires us to publish a cost benefit analysis (CBA) of our proposed rules, 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 costs and benefits of the proposed requirements set out in Chapters 3 to 10 of the CP.

2. Our standard approach to 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 changes in the quantity, quality and variety of transactions and in the efficiency of competition. Given the important role of mortgage lending in the economy, we have also considered the macroeconomic impacts of our proposals in this CBA.

3. The costs and benefits of the MMR arise at different points during the housing market cycle. In principle, one needs to take account of the timing differences by using the present value of the costs and benefits. However, this proves to be very difficult here. For example, compliance costs will be incurred from the time of implementation of the MMR and it would be easy to calculate the present value of the compliance costs. On the other hand the benefits of the MMR will largely arise in booming housing markets and it is highly uncertain at what point in time boom housing market conditions will return (this may be when the MMR is implemented or later). Any reported estimates of the present value of the benefits would therefore be greatly influenced by judgements that would be little better than guesses. So we have decided not to report present values of the costs and benefits.

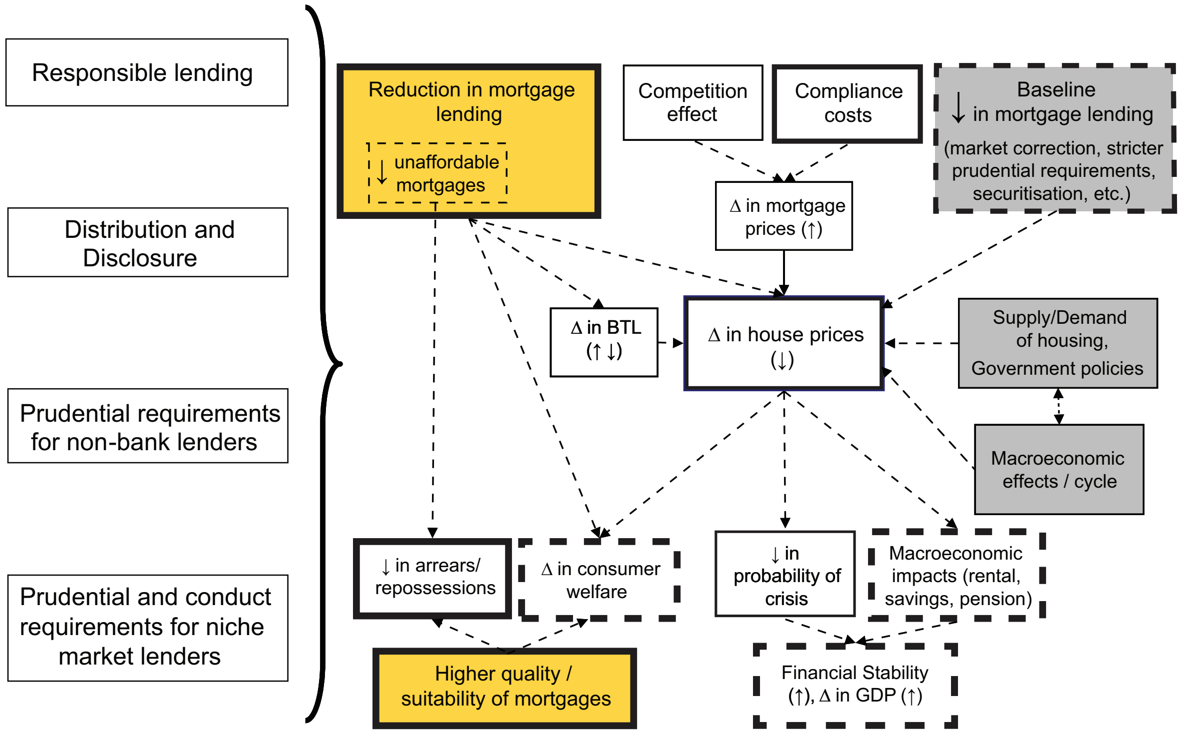
4. The Mortgage Market Review (MMR) will create economic impacts through a number of transmission channels. To provide context for the more detailed CBA that follows, this chapter presents a high-level description of these transmission channels on an economy-wide level and at the household level. Subsequent chapters describe the key impacts of the policy proposals and their associated costs and benefits in detail.

Overview of the economy-wide impacts of the MMR

5. Figure A2.1 provides an overview of the impacts of the MMR at an economy-wide level. It also shows many factors that are not related to the MMR, but which have significant impacts on the mortgage market. To assess the incremental impact of the MMR, it is necessary to separate the impacts of these other factors. In our CBA, we do this as far as possible, but it is not feasible in all cases (e.g. changes in housing supply and demand due to government policies). This is an important caveat for the interpretation of the results in this CBA.

6. Figure A2.1 also shows the impacts that are quantified in the CBA. Impacts outlined in bold are estimated and those with a dashed outline are partially estimated. Most of our work has been carried out to estimate the impact the MMR will have in reducing lending, since this impact is likely to be by far the most significant and it drives other important impacts. For example, by reducing the amount consumers can borrow, the MMR will reduce mortgage impairment (arrears or repossession) but this will constrain housing choices. Together these impacts affect consumer well-being, as discussed in Chapter A4. The reduction in lending is most likely to lead to changes in house prices and to macroeconomic impacts, which are also estimated in Chapter A4 below. Compliance costs are estimated (see Chapter A6), but are less significant than the direct impact the MMR will have on the lending that can take place. The other impacts are discussed qualitatively because they are unlikely to be significant or because data constraints prevent us from providing any meaningful estimate.

Figure A2.1 – Overview of MMR Impacts



7. The key impacts of the MMR will result from the proposed affordability rule in the responsible lending package. The new rule is more prescriptive than previous requirements and focuses on improving the quality of underwriting on the basis of a strengthened affordability assessment. With the requisite supervisory and enforcement effort, the affordability rule will raise underwriting standards and reduce the proportion of unaffordable mortgages. Overall, this will result in a reduction in mortgage lending and an associated reduction in arrears and repossessions compared to a situation where the MMR was not introduced (see Chapter A4 in this CBA for the detailed discussion of the impacts on the quantity of lending).

8. The impact of the MMR is highly likely to be cyclical, with higher impacts during a housing boom and lower impacts during a more subdued housing market. This is because, as our market failure analysis in Chapter A3 explains, the quality of mortgage underwriting is lower during a housing boom and higher in a more subdued housing market where lenders typically tighten their lending criteria. Regulations that raise general underwriting quality are thus less likely to have an impact in a subdued period when underwriting quality is any case quite high.

9. Our estimate of the reduction in house price growth from the MMR is in our analysis of macroeconomic impacts in Chapter A4. The MMR may also affect the buy-to-let market. Fewer consumers entering the housing market will increase demand in the rental market, thus making buy-to-let investments more attractive as a result of the increased rental yield. On the other hand, lower expected capital gains from reduced house price growth will lower incentives for buy-to-let investors to enter the market, possibly implying a further increase in rental yields to clear the market. Impacts on the buy-to-let market may in turn have further impacts on house price growth.

10. The MMR will also have macroeconomic effects. The restrictions on some consumers' borrowing opportunities (e.g. equity withdrawal and equity release) are expected to influence consumption/savings decisions and consequently aggregate demand and aggregate price levels in the economy. The partial reallocation of lending resources, away from unaffordable mortgage opportunities towards other types of household lending and business investment, should in theory stimulate investment in the long term and thus GDP growth. The expected reduced volatility in house prices contributes to dampening the probability of future financial crises occurring. In Chapter A4 we discuss the macroeconomic impacts in more detail and present related estimates.

11. The MMR will also affect house prices through other channels. Compliance costs arising from the MMR will to some extent be passed on to borrowers, leading to higher mortgage prices (see Chapter A6 for an analysis of the compliance costs). If the MMR were to have a negative impact on competition in the mortgage market this would also lead to higher mortgage prices. This would lead to a lower demand for mortgages and lower demand will potentially lead to lower house price growth (see Chapter A6 for an analysis of the competition impacts).

12. Some factors unrelated to the MMR have led to a reduction in mortgage lending and have thus affected house prices. Their impacts do not belong in this CBA:

- Prudential standards have been tightened post-crisis. The introduction of the 'Basel III' policies has already led banks to increase their capital levels significantly. This will lead deposit-taking mortgage lenders to moderate their lending independently of the MMR. In our analysis of the macroeconomic impacts we take account of the impact of Basel III on lending in order to isolate these impacts from the impacts of the MMR package.
- Lenders have tightened their lending standards post-crisis. This process started before the MMR policy proposals were first discussed in the FSA's Discussion Paper 09/03.[4] In our analysis, we take this into account by distinguishing the impacts the MMR will have between 'subdued' and 'boom' periods in the housing market.

13. Other important non-MMR factors that have an impact on the housing market and house prices are the business cycle and government policies affecting the supply of and demand for housing.

14. On a more granular level, Table A2.1 sets out the different policy proposals and their expected impact. The impacts are described in more detail in the remainder of the CBA.

4 www.fsa.gov.uk/pages/Library/Policy/DP/2009/09_03.shtml

Table A2.1 – Policy proposals and their main impacts

Policy proposals	Impact categories
Responsible lending • Income verification • Affordability rule • Interest rate stress test • Interest-only • Debt consolidation • Lending into retirement • Arrears charges • Transitional arrangements	• Compliance costs • Impact on quality of lending • Impact on variety of lending • Potential competition impacts • Impact on quantity of mortgage lending (affordability rule, interest rate stress test, interest-only proposals)
Prudential requirements for non-banks • Risk sensitive capital level • Increase capital quality requirement • High-level liquidity requirements	• Compliance costs • Impact on quality of lending • Impact on variety of lending • Competition impacts • Potential impacts on quantity of mortgage lending
Distribution and Disclosure • Affordability • Sales standards • Requiring sellers to hold a mortgage qualification • Disclosure of key messages on firms' service • Change to description of scope of service • Changes to trigger points for Key Facts Illustration and other product information rules	• Compliance costs • Impact on quality of lending • Impact on variety of lending • Potential competition impacts
Conduct and prudential requirements for niche mortgage markets • Bridging finance • High-net worth individuals • Small businesses • Equity release • Home purchase plans • Sale and rent back	*Compliance costs* • Minimal impacts for conduct requirements • Compliance costs for prudential requirements *Quantity of mortgage lending* • Minimal impact on overall level of mortgage lending due to small size of niche markets, but potentially significant impacts within the respective markets

Overview of MMR impacts on households

15. In this section we set out the direct and indirect impact of the MMR on households.

16. The affordability rules aim to target borrowers who would have been granted an unaffordable mortgage due to poor quality of underwriting. The rules aim to prevent these borrowers from obtaining an unaffordable mortgage. This is beneficial in the classical economic welfare sense i.e. in helping borrowers choose what they would prefer in the

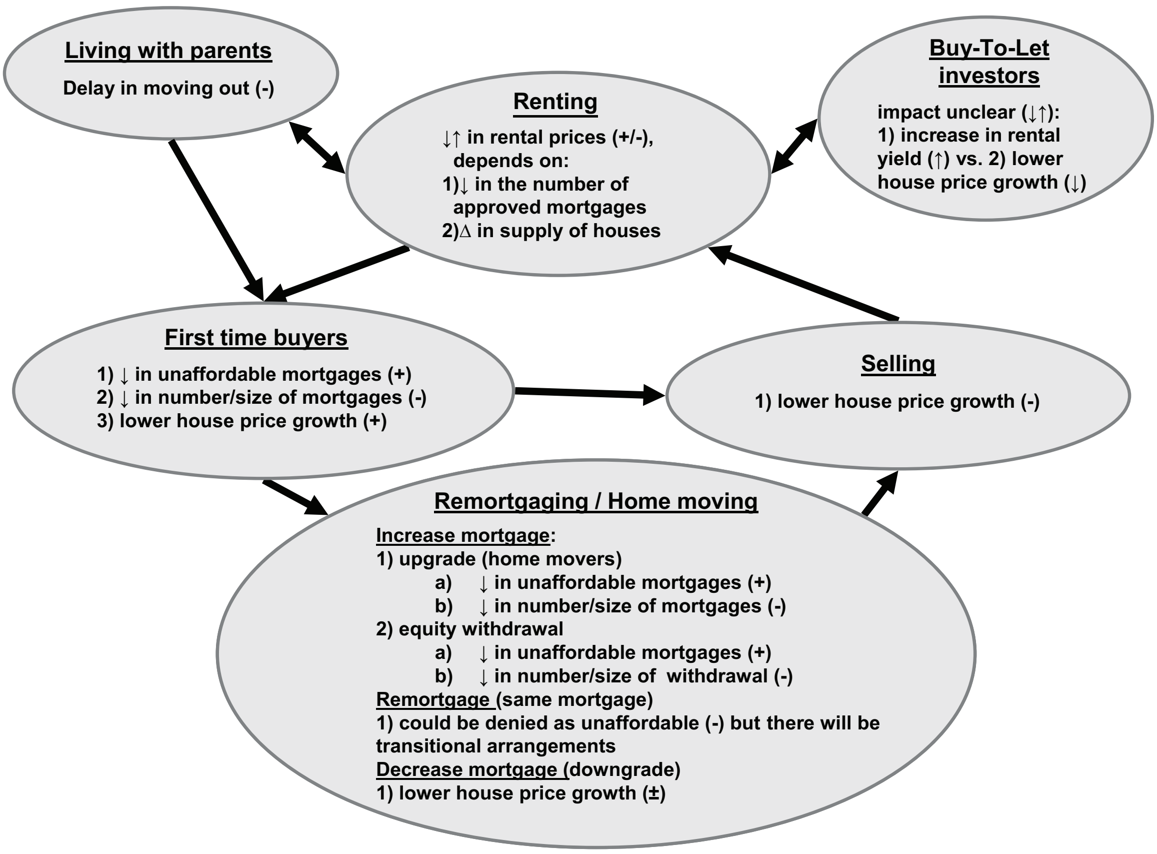
absence of behavioural biases and information problems (see the market failure analysis in Chapter A3 for further discussion of these problems).

17. The MMR affects households in the following ways:

- Some households will be directly affected by the new mortgage approval regulatory standard.
- Some households will be affected by the changes in the growth of house prices and house rents.
- All households will be affected by the macroeconomic implications of the MMR.

18. Figure A2.2 identifies how different types of households, whether directly or indirectly, will be impacted by the reduction in lending associated with the responsible lending requirements. As the diagram shows, there are many different impacts that are interlinked. We analyse each of these impacts.

Figure A2.2 – MMR impacts on households



Direct impacts on households from the responsible lending requirements

19. We first describe the direct impacts of the responsible lending requirements on households (i.e. those who have to delay their borrowing or will only be able to borrow a smaller amount).

- *First-time buyers, home movers and remortgagors who would have experienced payment problems, arrears and repossession events*, will gain from avoiding the distress associated with each of those events. In addition, they will be able to avoid all the expenses that are normally associated with the legal and administrative processes characterising arrears and property repossession events.
- *First-time buyers who have their mortgage application refused* will have to remain in the rental market, or in accommodation shared with parents/family members, and will experience a well-being (and welfare) loss due to having to delay home ownership.
- *First-time buyers whose mortgage application is approved for a reduced amount* will have to buy a less desirable property and will thus experience a well-being (and welfare) loss due to being less satisfied with the property they end up occupying.
- *Remortgagors for equity withdrawal* who are not able to obtain the remortgage they want, will lose the possibility of supporting their income and/or consolidating their previous debt by means of the resources they would have obtained from re-mortgaging.
- *Remortgagors wanting to improve their property and home movers moving to a bigger property* will experience a well-being (and welfare) loss due to the forgone improvement in housing quality.

20. In Chapter A4 we set out estimates for the well-being impact of the above effects.

Indirect impacts on households from changes in house and rent prices

21. Reduced lending due to the responsible lending requirements will also impact on:

- *Rental prices* – to the extent that the responsible lending requirements push households into renting, the increased demand for rental properties may lead to increased rental prices. Increased demand for rental properties makes buy-to-let investments more attractive, potentially leading to increased rental supply. The overall impact on rental prices is therefore unclear.
- *House prices* – to the extent that the responsible lending requirements reduce the demand for houses, the growth of house prices will be lower. Overall, despite the possible increase in the attractiveness of buy-to-let investments, we expect demand to purchase housing to fall. This is because some people refused a mortgage as a result of the MMR will continue to share accommodation, for example with parents. Thus average household size will increase under the MMR. Lower house price growth is beneficial for first-time buyers and those borrowers who do want to move up the

housing ladder. Borrowers who already have significant housing equity will lose from the reduction in house price growth.[5]

22. The detailed breakdown of the impacts on households reported in figure A2.2 are:

- *Renters* will be affected by any changes in rents.
- The overall effect on *buy-to-let investors* is unclear. Buy-to-let investment is less attractive due to reduced house price growth. On the other hand, it may be more attractive, if rental yields increase.
- *First-time buyers* will profit from lower house price growth.
- *Property owners planning to upgrade* to a more valuable property, will benefit from the reduction in house price growth.
- *Property owners planning to downsize* to a less valuable property, will lose from the reduction in house price growth.
- *Remortgagors* planning to take out extra borrowing against their existing property will be negatively impacted by the reduced equity growth in their property.
- *Property owners* will see lower levels of housing accumulated wealth as a result of the reduction in house price growth.
- *Property owners engaging in housing equity release* contracts might find it more difficult due to lower house prices growth expected under the MMR.

23. The significance of these impacts depends on the extent to which the MMR proposals would lead to lower house price growth. The MMR impact on house price growth is discussed in Chapter A4.

5 If our expectation of reduced demand to purchase housing is correct, landowners and builders would in principle make less new housing available than would have been the case without the MMR. This possible reduction in the supply of new housing might counteract the effects described here. The position is, however, hard to assess, due to time lags and possibly off-setting local and national governmental interventions in the supply of housing.

A3

Market failure analysis

1. We have identified a number of market failures in the mortgage market in the UK. We discussed them extensively in our papers, DP09/3, CP10/16 and CP10/28, and in again in this CP. For this reason, we summarise the market failures only briefly in this chapter. We also briefly discuss what additional issues we have identified in the market segments where non-bank lenders operate.

The underlying market failures

2. Three main market failures affect the UK market for retail mortgages:

- information asymmetries;
- externalities; and
- behavioural biases.

3. Mortgages can also result in bad consumer outcomes because of 'facts of life' (e.g. unemployment, divorce etc.) that have nothing to do with the proper functioning of the market. While these are a general source of detriment, financial regulation can do little about them.

Information asymmetries

4. In most cases, potential borrowers are likely to know less about the probability of their ending up in arrears than lenders and intermediaries do. The latter groups have some incentives to exploit this asymmetry to encourage consumers to over-borrow.

5. On the other hand, there are some specific pieces of information that potential borrowers are likely to know with more precision than lenders and intermediaries. An example is the amount they earn or their expenditure patterns. They may exploit this to increase the size of the loan they get because they might believe that house prices will rise in the future and

by 'extending' themselves they will be able to reap higher future benefits from their investment in housing.

Externalities

6. The information asymmetries could be the origin of coordination problems that generate negative externalities. If a sufficiently high number of lenders encourage over-borrowing, house prices will increase more than it is justified by fundamentals, materially increasing the risk of financial crisis. Realising the security by foreclosing the loan will then become unattractive for lenders as doing so on a large scale will drive down the value of the properties on which the mortgages are secured, probably leading to a market in which moving home is difficult. Poor underwriting that leads to extensive foreclosures and materially lower property values is also likely to have negative externalities for small businesses since finance for many of these is secured on homes of directors or owners.

7. Each repossession or forced sale will reduce the value of the assets for all lenders in the market.

Behavioural biases

8. Economic literature has identified a number of biases in consumers' (and sometimes firms') behaviour that can, at times, be improved upon with appropriate regulatory intervention.[6]

9. A non-exhaustive list of biases that are likely to be relevant to the mortgage market is:

- *Over-optimism and momentum behaviour*: borrowers will tend to attribute their successes to their abilities and bad outcomes to luck or to external factors. They are also often likely to rely on a short time series of data as a base for predicting the future, i.e. they base their forecasts on the last few available observations. Therefore, if house prices have been increasing for a few years, over-optimism can lead consumers to believe that house prices will continue to increase.[7]
- *Hyperbolic discounting*: consumers do not put enough emphasis on the future consequences of their actions (e.g. probability of ending up in arrears) as long as they get their immediate reward (i.e. the house they want).
- *Anchoring*: the prices at which houses sell are not independent of some anchor on which consumers base their evaluations and purchase prices. This could be, for instance, the asking price or the peak reached by prices in the past.
- *Regret* can be a source of problems both from a buyer and a seller perspective. Buyers may be encouraged to buy even if, in their opinion, a more cautious approach would

6 See Andrew Farlow, (2004), *The UK Housing Market: Bubbles and Buyers*, for a discussion of behavioural biases in the context of the housing market.

7 Momentum behaviour is also likely to depress house prices 'too much' if they are on a declining trend. However, this is less likely to persist for a long time as the investors that are not subject to such a bias will spot an investment opportunity and buy houses. This does not happen to the same extent when house prices are increasing because it is very difficult, if not impossible, to 'short' houses, so it is likely that house price booms can develop more easily than busts.

have been more appropriate as they see prices increasing. Sellers may regret the 'loss' associated with selling their house at a price lower than they feel is 'fair', thereby increasing the stickiness of prices.

10. The above behavioural biases are often associated solely with consumers. However firms may be subject to similar biases even if to a lesser extent. For instance, lenders may see other firms engaged in apparently profit-making activities and enter the market only in order to increase their short-run profitability, which is an example of 'regret'. Such deviations from perfect competition (competition on quality and price whose outcome is the appropriate rate of return for shareholders) may be exacerbated by weaknesses in governance.

Niche markets

11. Most of the above market failures apply to the mortgage market as a whole as they reflect the different information available to parties in the transaction or biases that are inherent in human nature. However, for a subset of market segments, some of the failures may be less pervasive or even non-existent, given that they may not have been present in the first place or may have been solved by previous regulatory interventions.

12. Here we briefly consider these niche markets and how market failures may be different in these:

- *Bridging finance* is short-term lending that is typically used to 'bridge' the funding gap where a consumer has had an offer accepted on a new property but is yet to sell their existing home. Usually there are no monthly repayments and the loan and retained interest are repaid together when the sale of the existing home is completed. The market failures described above come into play here, but they mostly relate to the mortgage borrowers take out in the longer term, not to the bridging loan. For instance, the extent to which lenders can rely on house price appreciation for capital repayment to be paid back is reduced as the contract has a short duration.
- *High net worth* individuals are likely on average to be more sophisticated than other consumers. They can also pay for more or higher quality advice. So some of the information asymmetries and behavioural biases present in the main market are likely to be less of an issue in these cases. We also note that high net worth individuals may be less averse to taking on high-risk mortgages since they can sustain much greater losses and yet maintain a reasonable standard of living, without for example having to move to rented accommodation in the way that other borrowers taking on similar risks might have to.
- Some unincorporated *small businesses* draw funds secured on residential property as it can be advantageous for them; for instance because the interest rate offered is lower. Although some of the market failures discussed above such as, for example, the over-reliance on increased house prices may be less pervasive in this market, there are many others that are as significant as for mainstream loans, such as information asymmetries between borrowers and lenders. We note that any impacts of the MMR on mortgages

whose proceeds are used in small businesses may be negative but we lack the data to quantify these impacts.

- For *Home Purchase Plans* and *Equity release* schemes, most of the same market failures are likely to arise. However, in cases where regular payments are not made (i.e. in some equity release schemes) it is obvious that the risk of consumers overextending themselves is not present and that some behavioural biases are less likely to represent an issue. On balance, the level of protection in these markets should be similar to the protection for standard mortgages.

Non-bank lenders

13. In terms of market failures, we see information asymmetries and externalities that are a particular characteristic of the markets where non-banks operate. These are in addition to the general market failures we have discussed above.

14. Compared with banks and building societies, non-banks are likely to extend mortgages on the basis of less information on their prospective borrowers, simply because of the scale of their operations and the amount of time they have spent actively in the market. In search for market share, non-banks may also be driven to extend mortgages to borrowers that other lenders would regard as too risky. Although these mortgages may command a higher interest rate as a result and therefore be profitable in the short term, some non-banks may end up with poorly performing loans on their balance sheets when market conditions deteriorate.

15. Some non-banks therefore have an incentive to securitise the mortgages and sell them to other investors to reduce the risks they carried on their balance sheets. Given the other market failures present in the market and the mis-pricing of risk that resulted from them, non-banks can exacerbate negative externalities by selling securitised mortgages whose risk is under-priced in the financial system. This is especially true in periods of rising house prices when the risk inherent in non-banks mortgages is unlikely to materialise in the short term. In boom markets, investors will still have an appetite for buying these under-priced, high returning securitised loans, incentivising non-banks to keep granting them.

16. An element of regulatory failure increased the size of these problems. As non-banks are subject to less stringent capital requirements (for the same assets) there is also an incentive for banks and building societies to transfer business to them. This increased the scale of harm associated with non-banks’ securitisation activities.

The extent of market failures in different states of the housing market

17. Taken together, the market failures described above are likely to result in:

- an incentive for consumers to over-borrow and lenders to over-lend when market conditions are favourable;
- an undervaluation of the risk of declining house prices;

- an incentive to follow the behaviour of other market participants; and
- an amplified house-price cycle.

18. A consequence of the above is that the pervasiveness and size of the market failures are likely to be substantially larger during boom times, as compared to times when the housing market is subdued.

19. For instance, if the market is in a period of low house price growth or declining house prices, lenders have stronger incentives to assess the level of risk of the loan to avoid losses. This is because they cannot rely on higher house prices to recoup the money they lend. Similarly, borrowers would then be less likely to rely on rising house prices to repay their loans.

20. Overall, the search for short-term high profits pushes firms towards relaxing lending standards and decreasing the quality of underwriting when consumers and firms perceive that not borrowing/lending will result in consumers missing the opportunity to buy a house that will appreciate over time and lenders missing the opportunity to have substantial income-generating assets on their balance sheet (as noted above, this may represent a serious distortion of competition).

21. This is confirmed by the data that we have available. There is clear evidence that different market conditions are associated with different levels of leverage at the point of sale.

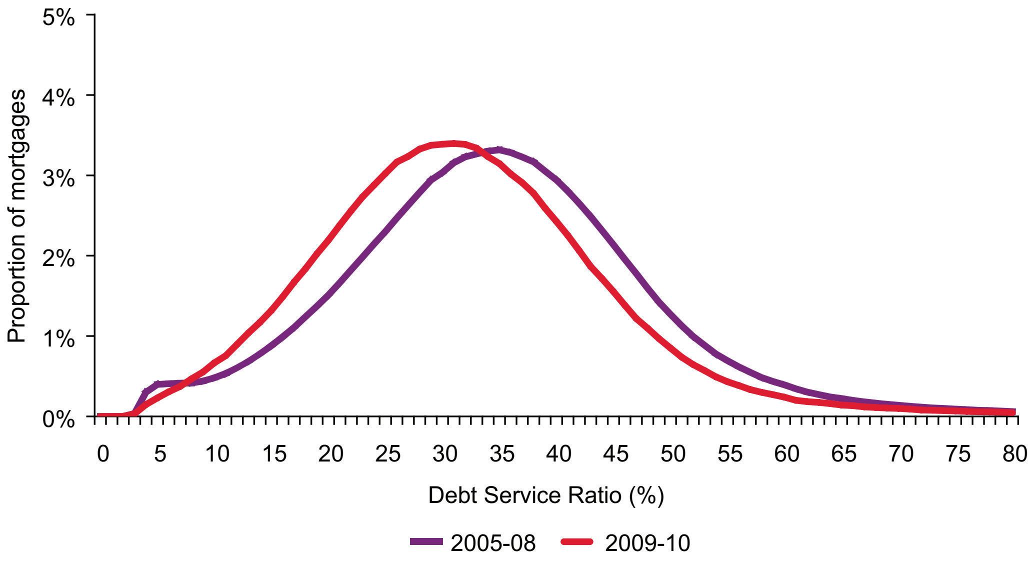
22. Some mortgage impairment is not predictable because at inception the mortgage was perfectly affordable. Rather, the impairment is due to subsequent life events, such as divorce or serious illness. Of course, financial regulation cannot prevent life events since they are not market failures. However, by preventing or reducing transactions that create exposures to life events, it can mitigate the adverse consequences of life events. For example, a borrower who is prevented from borrowing by the MMR may be incidentally 'better off' if they later become unemployed. We include such incidental benefits in our estimation of the benefits in this CBA.

23. We also include incidental costs of the MMR. These arise, for instance, when the MMR prevents an unaffordable loan from being granted, but where impairment would not in fact have materialised because of 'good fortune'. This may arise from events such as a promotion at work, high inflation or inheritance.

24. We believe that these incidental benefits and costs are material to our results, but we do not know which of them is larger. They may on average be roughly the same size as each other, although the relationship is likely to vary across the economic cycle, with 'good fortune' becoming scarcer in subdued periods. We discuss potential over-estimation of incidental costs from this below.

25. Figure A3.1 shows borrowers were more highly leveraged in the last housing market boom from 2005 to 2008, as compared to more subdued market conditions in 2009 and 2010. In Figure A3.1 the Debt Service Ratio (DSR), which is the ratio of mortgage payments to income after tax and National Insurance contributions, is used as a measure of leverage.

Figure A3.1 – Frequency distribution of DSR in 2005-08 and 2009-10



26. The rules proposed in this CP would make a substantial contribution to solving the market failures described above. For instance, by requiring lenders to assess properly the affordability of the loan by obtaining proof of income in all cases and to apply an interest rate stress test the likelihood of consumers over-borrowing would diminish. Similarly, by applying risk-sensitive capital requirements to non-bank lenders the proposals would reduce the chances of a financial stability problem occurring.

27. The proposed rules would affect the market more when lenders, intermediaries and consumers all have an incentive to participate in a transaction that would most likely result in bad consumer outcomes after it has been completed. This is also supported by our analysis of the impact on lending of the affordability rules, presented in Chapter A4 below, which show more significant impacts during the boom than during subdued periods in the housing market.

28. In fact, the net benefits of the MMR arise in boom markets as the ratio of those who gain from the MMR to those who lose from it is much lower in subdued periods in the housing market. To realise these net benefits, the proposals need to be in place before the next housing boom. It is obviously uncertain when boom conditions in the housing market will return. Costs (e.g. compliance costs) will be incurred irrespective of market conditions.

29. Despite the additional proposals discussed in this CP, consumers will still be exposed to individual risk: unemployment, divorce, health problems and other life events could still cause consumers to experience arrears and repossessions. This is the case even if, at origination, the loan was perfectly affordable. Our rules are not designed to address such life events but to make sure that consumers get mortgages that can reasonably be assessed as affordable when granted.

A4

Costs and benefits from the lending impacts of the responsible lending requirements

Overview

1. This chapter presents the cost and benefit analysis (CBA) for the proposed responsible lending requirements. In simplified terms these are:

- **The affordability assessment**: the lender must verify income and be able to demonstrate that the mortgage is affordable, taking into account income and, as a minimum, the borrower's committed expenditure (which includes the mortgage payments) and essential household expenditure (discussed in Chapter 3 of the CP).
- **The interest rate stress test**: the lender must consider the impact of future interest rate increases on affordability, with reference to market expectations for interest rates over the next five years (also discussed in Chapter 3 of the CP).
- **The interest-only proposals**: the lender must assess affordability on a capital and interest basis, unless there is a clearly understood and believable alternative source of capital repayment (discussed in Chapter 4 of the CP).

2. These proposed rules reflect a principle of affordable lending that is set out in Chapter 3 of the CP. It says that loans should only be granted where there is a reasonable chance of repayment from identifiable income and no reliance is placed on assumed property price appreciation. The affordability assessment reflects this by requiring current income to be sufficient to cover mortgage payments and essential expenditure. The interest rate stress strengthens this by requiring that the borrower's income be sufficient to cover mortgage payments (after essential expenditure) under a foreseeable increase in interest rates. The

interest-only proposals add to this by requiring those with interest-only loans also to have a credible strategy to repay the capital.

3. The proposed rules elaborate on the principle of affordability in a largely qualitative way. Given this, the rules proposed should be considered appropriate if the principle is appropriate, and we hope that respondents to the consultation will give feedback on the principle of affordability itself. Also, as noted in the Executive Summary of this CBA, we would like feedback on the key elements of this CBA.

4. Our high-level conclusions are set out below. These are central estimates that depend on the key assumptions explained in this chapter and they must be viewed as sitting within broad ranges. The impacts are expected to be far larger in boom periods when lending standards tend to be relaxed than they are in subdued periods in the housing market.

- **Impacts on borrowers**: The responsible lending requirements (the affordability assessment, the interest rate stress test and the interest-only proposals) together are estimated to affect 2.5% of borrowers in subdued market conditions and 11.3% in boom market conditions. Our analysis of the affordability assessment alone shows that its impact is minimal in the subdued period. In the boom period, its impact is less on FTBs than on remortgagors. Throughout the sample period, the greatest impact is on self-certified borrowers and the credit-impaired, with the credit-impaired by far the most affected. Because many self-employed borrowers are also self-certified, the affordability assessment has a significant effect on self-employed borrowers in the boom period.

- **Quantity of lending impacts**: The impacts of the responsible lending requirements on mortgage lending differ by type of borrower.

  - When a *first time buyer* does not take out a mortgage, the impact on net lending is the full amount of the mortgage that would have been granted in the absence of the MMR.

  - In contrast, a *home-mover* typically has an existing mortgage, so one who does not obtain a mortgage keeps their existing mortgage. In this case, the impact on net lending is any difference between the amount outstanding on the existing mortgage and what would have been borrowed under the new mortgage.

  - Broadly, the position of *remortgagors* is similar to that of home-movers. One difference, however, is that the goal of some remortgagors is only to lower the rate of interest they pay. In these cases, there is no impact on net lending whether the transaction goes ahead or is prevented under the MMR.

  Thus the per capita impact on lending volume arising from the MMR preventing first-time buyers from borrowing is typically much greater than the per capita impact on other categories of borrowers. Aggregating our estimates for each of these categories, our best estimate is that the responsible lending requirements would reduce the value of mortgage lending by about 2% in subdued market conditions and 10% in boom market conditions.

- **Macroeconomic effects**: We estimate the long-term impact on GDP growth to be an annualised GDP increase of around £$^1/_3$bn. This is because part of banks' response to reductions in domestic mortgage lending is increased corporate lending, which increases business investment. In the short to medium-term, however, there will be a small fall in GDP as the reduction in mortgage lending leads to lower consumer expenditure. The maximum fall is about £3bn, or 0.2% of GDP, seven years after implementation of the MMR. In the short to medium term (up to about eight years after implementation of the MMR), house price growth will be lower relative to house price growth without the MMR. The maximum decrease in house price growth is about 2% per annum about four years after implementation of the MMR. Overall, if house price growth would have been 34% over the years 2014 to 2022[8] without the MMR, we estimate that it would be 23% with the MMR.

  We measure the macroeconomic impacts of the MMR relative to a base case which assumes slow economic recovery emerging in 2013 and the return of relatively benign macroeconomic conditions by 2014. However, for as long as the economy continues scarcely to grow, with subdued conditions persisting in the housing market, the macroeconomic impact of the MMR is likely to be trivial.

- **Well-being impacts**: Some consumers experience increased well-being (a benefit) by avoiding mortgage impairment as a result of the MMR. Others whose borrowing is affected by the MMR would in any case not have experienced mortgage impairment. These consumers experience only a reduction in well-being (a cost), for example from having to buy a less desirable property, from delaying their property purchase or, in the case of some remortgagors, from not obtaining desired additional lending to support consumption.

  Deciding what relative weight to put on these positives and negatives is inherently highly uncertain. To a significant extent, therefore, the decision on whether to proceed with the proposed rules has to be based on social and political judgements, but the trade-offs involved are best informed by the results of our well-being analysis.

  Whether the overall well-being impacts are net beneficial or costly depends on two factors:

  i) the relative size of the well-being weights associated with increased and reduced well-being, and

  ii) the ratio of loans that would have become impaired without the MMR to all loans prevented or reduced by the responsible lending proposals.

8 This is based on the assumption that the MMR will be introduced in mid-2013.

We estimate the tipping point for this ratio to be around 20-22%. This is because the well-being gain for those borrowers who would benefit from the MMR is much higher than the well-being loss for those borrowers who would lose out under the MMR.

Over our sample period, we estimate that up to about 30% of impacted borrowers (about 200,000 out of 730,000) would have gone into arrears. This means that:

- c.200,000 consumers impacted by the MMR would otherwise have experienced a well-being loss associated with impairment; and
- c.530,000 consumers impacted by the MMR would not have experienced impairment.

30% is above the tipping point described above (20-22%) for net well-being benefits to arise from the MMR. The benefits of this – avoiding the material loss of well-being associated with mortgage impairment – are likely to be very substantial.

- **Reduction in costs of arrears and repossessions for consumers**: Consumers who are saved by the MMR from taking on an unaffordable mortgage do not incur the arrears and repossession charges that would otherwise have arisen. Over our sample period, we estimate a reduction in the number of arrears of about 175,000 and a reduction in the number of repossessions of about 30,000. The expected benefit from the associated decrease in arrears and repossessions charges is expected to be around £60m over the sample period. This is a social benefit since it is a saving in resource costs associated with the MMR. In addition, we expect transfers from borrowers whose homes are being repossessed to other consumers to be reduced by around £900m over the sample period. As these transfers are from the repossessed borrowers to the property purchasers, reducing them is likely to be regarded as socially beneficial (but it is difficult to assess the size of the benefit relative to the size of the transfer).
- **Compliance costs**: Over our sample period, we expect the incremental compliance costs of the responsible lending requirements to range between £30m and £40m per year. These are discussed in Chapter A6. The figures quoted here are valuations of the economic resources that will be absorbed in implementing and operating the rules proposed in the MMR.
- **CBA balance of the responsible lending requirements themselves**: The responsible lending requirements are likely to be net beneficial. On a per mortgage borrower basis:
  - the net well-being benefit is about £350;
  - the benefit from reduced arrears is about £10; and
  - the compliance costs for the reponsible lending requirements (but not the other MMR proposals) are about £30.

  Taken altogether this implies to a net per borrower benefit from the responsible lending requirements of about £330. In estimating the overall cost-benefit balance we are not taking into account the benefits associated with the transfers described above or with the impact on GDP, because we have not attempted to estimate the former and the margin of error inherent in the estimation of the macroeconomic impacts means that in reality this impact could either be positive or negative.

Structure of this chapter

5. This chapter covers many different issues. For ease of navigation, here we present the structure of the CBA of the responsible lending requirements:

A) **Estimating the impact of the affordability assessment**
Methodology

1) Estimating the impairment risk for each mortgage in our dataset
2) Constructing a measure of risk due to poor underwriting
3) Explanation of our underwriting risk score
4) Estimating borrowers affected by the affordability assessment
5) Summary of methodology

Borrowers affected by the affordability assessment

B) **Estimating the impact of the interest rate stress test**
Methodology

1) How we modelled the size of the interest-rate stress
2) How we estimated the additional effect of the interest-rate stress test
3) Summary of methodology

Borrowers affected by the interest-rate stress test

C) **Estimating the impact of the interest-only proposals**
Background and methodology

Borrowers affected by the interest-only proposals

D) **Combined impact of the responsible lending requirements on borrowers**

E) **Other lending provisions**
The impact of the income verification proposal

Transitional arrangements

F) **Other issues relevant to the impacts of the responsible lending requirements and the other lending provisions**
How future MMR impacts may differ from the impacts above

The effectiveness of the proposed requirements (possibility of gaming)

G) **Quantity of lending impacts and their macroeconomic effects**
Impacts on lending

Macroeconomic effects

H) **Well-being impacts**
The responsible lending requirements and welfare

The responsible lending requirements and well-being

1) Methodology

2) Well-being effects

I) **Reduction in costs of arrears and repossession for consumers**

A. Estimating the impact of the affordability assessment

6. The proposed affordability assessment states that when assessing affordability the lender must take explicit account of the following:

- the net income of the applicant(s);
- the committed expenditure of the applicant(s), which includes credit and other contractual commitments that will continue after the mortgage is entered into; and
- basic essential expenditure (i.e. the bare essentials) of the applicant(s)' household and a level of discretionary expenditure needed to maintain a basic quality of living (which can be reduced but with difficulty).

7. Because of limitations in the data we have and the partly qualitative form of the affordability assessment, the way we have estimated the impacts of the affordability assessment is complex. Yet it is important to understand it when interpreting the results we present. For this reason, this section begins with a description of the methodology we used

and why. This is followed by a presentation and discussion of the lending impacts we estimate from the affordability assessment.

Methodology

8. Our approach to estimating impacts works by modelling how past mortgages would have been different if the affordability rule had been in place. This means we need a way to estimate which specific mortgages in our historical data would not have met the affordability rule. Since the affordability assessment is partly qualitative, however, its impacts will depend on how firms interpret and enact the rule and on the FSA/FCA's supervisory approach. As a result, there is an element of judgement in our analysis about which mortgages this rule will affect.

9. In CP10/16 we used the debt service ratio (DSR), the ratio of the monthly mortgage payment to income after tax and national insurance, as our measure of whether a mortgage was affordable. However, our subsequent analysis of more recent data showed that the DSR did not discriminate strongly between affordable and unaffordable mortgages amongst the mortgages likely to be affected by the affordability proposals. To remedy this, we investigated ways to use expenditure data to construct more robust affordability measures. However, the expenditure data available to us also did not allow us adequately to measure mortgage affordability. Chapter 3 in the CP and Chapter A7 in this CBA describe the analyses we carried out in depth.

10. For this reason, we have developed an alternative approach to estimating the impacts of the affordability assessment. This assigns an underwriting risk score to each mortgage in our dataset. The underwriting risk score was constructed to capture the goal of the proposed affordability rule i.e. to improve affordability assessments so that mortgages are not unaffordable because of poor underwriting standards. Our underwriting approach differs from the DSR and expenditure approaches by measuring mortgage affordability using the risk of impairment from poor underwriting (the basis of the proposed rule), rather than from information on income and expenditure at origination.

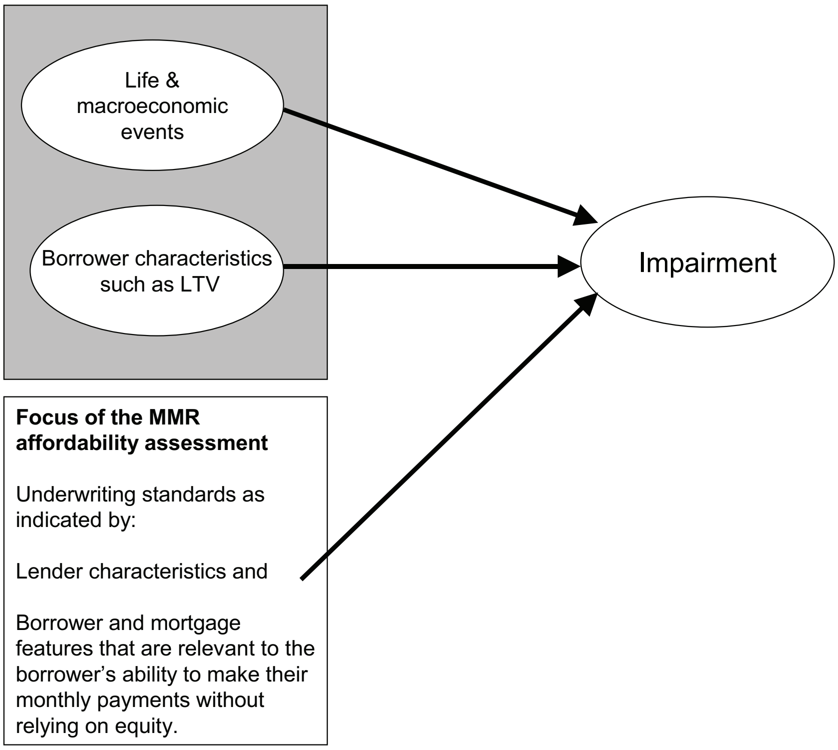
11. Unaffordability due to poor lender underwriting is not the same as impairment risk. For example, life events (e.g. divorce, having children, illness, unemployment etc.) can lead borrowers to struggle with a mortgage that was affordable originally.[9] This difference is also reflected in the proposed affordability assessment, which does not aim to prevent higher-risk borrowers from borrowing just because they are in a higher-risk group.[10] As long as a borrower has income after expenditure and credit commitments such that they would reasonably be expected to make their mortgage payments they should not be prevented from borrowing by the affordability assessment.

9 Also, some life events, such as promotions at work or inheritance or inflation driving wages but not interest rates higher, can prevent impairment even when lender underwriting is poor.

10 Higher-risk groups are, however, expected to be more affected by the affordability assessment because they are more likely to borrow in ways the affordability assessment aims to prevent.

12. Figure A4.1 illustrates this using the drivers of mortgage impairment. The point is that affordability is not the only driver of impairment. As the diagram shows, the aim of the affordability assessment is to ensure lenders have good underwriting standards and subsequent impairment is only a concern where this has arisen because a lender did not exercise sufficiently robust checks on a borrower's ability to repay his or her mortgage.

Figure A4.1 – Drivers of mortgage impairment



13. A challenge we faced in modelling the impacts of the affordability assessment was that we did not have detailed data on lenders' underwriting processes, how these operated and what factors lenders took into account when granting mortgages. Such data might have permitted us to construct a direct measure of the quality of a lender's underwriting. Without this data, however, we decided instead to measure underwriting standards indirectly, by trying to identify the impairment risk that could be attributed to poor underwriting. This was done in two steps.

1. Estimating the impairment risk for each mortgage in our dataset

14. The the first step is to estimate the overall impairment risk for each mortgage in our sample i.e. the impairment risk from all of the factors in Figure A4.1, not just those that are the focus of the affordability rule. It is important to note here that every mortgage in our sample either did or did not become impaired. So the aim of this step was to construct by 'going back in time' a probability that the mortgage would have gone into impairment when it was originated. This gives a measure of impairment risk relevant to the decision to

grant the mortgage or not, since (of course) lenders do not know which mortgages will in fact go into impairment when deciding whether to grant a mortgage.[11]

15. In our model of impairment risk we used data on a wide range of factors (borrower, lender and mortgage data at origination), macroeconomic data (at and after origination) and our data on which mortgages went into impairment. We carried out a logistic regression of the actual impairment data on the other data to estimate of the probability that each mortgage would go into impairment. This yielded a measure of impairment risk for each mortgage in our dataset.

16. The logistic regression model is a standard approach to estimating risk of uncertain events. This and the large dataset we have used give us some confidence in our results. There are, however, caveats to consider. In particular, the data reflect a period of generally low (by historical standards) and falling interest rates. Also, at the end of the period (2009 onwards), mortgage impairment was mitigated by very low interest rates and by the forbearance measures adopted by lenders. By historical standards, therefore, mortgage impairment in this data may be relatively low. So our measure of impairment risk may underestimate the actual impairment risk of future mortgages.

17. This has implications for the costs and benefits we estimate. If the logistic regression is systematically underestimating impairment risk for mortgages – because of the conditions that prevailed in the time period of our data – then our estimate of the benefits, which is based largely on estimates of how much impairment would have been prevented, is likely to be an underestimate of the actual benefits from the responsible lending requirements.

2. Constructing a measure of risk due to poor underwriting

18. To construct our underwriting measure, we needed a way to isolate the part of this impairment risk due to poor underwriting. This was done in two steps:

A) we estimated using an ordinary-least-squares (OLS) regression the contribution of the different risk factors in the logistic regression (mentioned in A4.15) to impairment risk; and

B) we selected risk factors that were clearly relevant to underwriting and defined our underwriting risk measure as the combined impact of these on impairment risk.

19. For the first of these steps, we needed a way to break our measure of overall impairment risk down into components arising from different risk factors. We could not do this using the logistic regression, because in that model the contribution of one factor to impairment risk depends on the value of the other factors. We therefore carried out a second regression analysis to split up impairment risk. Specifically, we used an ordinary-least-squares (OLS) model to regress our probability of impairment, estimated from the first regression, on the impairment

11 An important caveat here is that we also included post-origination macroeconomic data in estimating impairment risk. The macroeconomic factors were included to avoid erroneously associating impairment from subsequent macroeconomic events to factors at origination. Put simply, including the later macroeconomic data helps to filter out their influence on later mortgage impairment.

risk factors. The OLS regression estimates a constant marginal impact on impairment risk from each risk factor. This provided the decomposition of the impairment risk measure (probability of impairment) into the parts associated with different risk factors.[12]

20. For the second step, we needed to select risk factors that were relevant to underwriting. Here we needed to exercise a judgement because the affordability rule sets outs good underwriting standards in partly qualitative terms (i.e. income must be verified by lenders: income, expenditure and credit commitments must be taken into account by the lender and property appreciation must not be taken into account) and we did not have detailed data about lender underwriting processes.

21. Table A4.1 splits the relevant risk factors for impairment into those that are relevant to underwriting and those that are not. The approach we took was to include factors as relevant where – from the proposed affordability assessment – we thought that factor was indicative of good or bad underwriting. Our choice aimed to capture the good underwriting that the affordability assessment aims at within the constraints of our modelling approach and the data limitations we faced. Table A4.1 sets out why different factors were included or excluded.

Table A4.1 – Impairment risk factors treated as relevant to underwriting

Factors included	Factors excluded	Reason for inclusion/exclusion
Lender		Different lenders have different underwriting standards (for a wide range of reasons)
Self-certified borrower		Self-certified borrowers go through a less stringent underwriting process
Self-employed borrower		Some self-employed borrowers have tended not to provide evidence of income
Credit-impaired borrower		Credit-impaired borrowers have had credit problems in the past
Debt-consolidation		Debt-consolidation tends to indicate history of past credit problems
DSR		Proxies affordability of the mortgage at origination.
	Macroeconomic events	Macroeconomic events after origination cannot be relevant to an underwriting decision
	LTV	*Although LTV is relevant to underwriting from a lender's perspective,* the principle underlying the affordability assessment is that lenders should not rely on property appreciation in their decision as to whether or not to grant a mortgage
	Other borrower and mortgage characteristics	Not clearly underwriting-relevant

22. Our decision on whether or not factors are relevant to underwriting is a decision that was not entirely clear-cut. For example, it could be argued that other borrower characteristics,

12 Another way to understand this step is that the OLS model calculates an average constant marginal impact on impairment risk for each risk factor in the logistic regression.

such as whether a borrower is a first-time buyer or a right-to-buy borrower, are also underwriting-relevant and should have been included here. However, we decided not to include these because the affordability assessment does not specifically aim to prevent borrowers from borrowing just because they are in a higher risk group. Instead the aim when classifying factors was to include factors that were directly informative about lenders' underwriting processes, borrowers' credit history or whether the borrower had sufficient income at origination to afford their mortgage (e.g. DSR).

23. It is also important to note that the factors chosen here do *not* define what is good underwriting by lenders for the purposes of the MMR affordability assessment. The factors chosen in Table A4.1 are rough indicators of good underwriting for the purposes of the CBA, and have been chosen in a context of limited data. So, for example, we are not suggesting that mortgages to the self-employed and credit-impaired, or for debt-consolidation purposes cannot be made under the MMR, provided the lender checks that these mortgages are affordable.

24. Based on the factors relevant to underwriting, we defined our 'underwriting risk score' (URS) for a mortgage as the combined impact of the included factors on impairment risk.[13] Mortgages with a higher underwriting risk score indicate poorer underwriting; mortgages with a lower underwriting risk score indicate better underwriting.

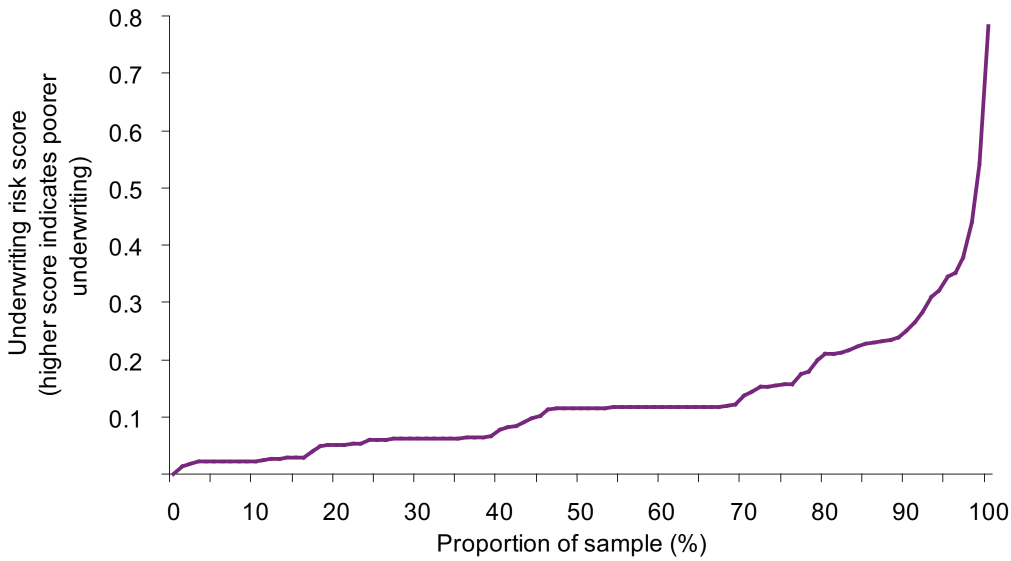
25. Although the underwriting risk score is approximate in that it relies on partial data and judgements about what is relevant, we believe that it is informative. This is because the model of impairment risk (the logistic regression) on which the score is based is statistically robust and fits the impairment data well (i.e. it correctly predicts most non-impairment and impairment events both in and out of the data sample). Also, the underwriting adjustment is better than simply using an unadjusted measure of impairment risk, which would fully include impairment risk from non-underwriting relevant factors.

3. Explanation of our underwriting risk score

26. What does the underwriting risk score tell us? Figure A4.2 presents the underwriting score for all of the mortgages in our data (Q2 2005 to Q3 2010), starting with the mortgage with the best underwriting and finishing with that with the worst underwriting. It shows that, as measured using our score, a significant majority of mortgages (90%) have a relatively low underwriting risk score (with scores between 0 and 0.25). Beyond this point (i.e. for the remaining 10% of mortgages), the underwriting risk score begins to increase more and more steeply, indicating increasing risk of impairment from poor underwriting. This means that well-targeted rules in the MMR can achieve substantial benefits without having significant impacts on most of the market.

13 In technical terms we use as the URS the sum of: these factors multiplied by their regression coefficients in the OLS regression.

Figure A4.2 – Underwriting risk score for mortgage population (2005-10)



27. Having constructed an underwriting risk score, the next step was to determine a threshold for the underwriting score above which mortgages would likely have been affected by the affordability assessment. If the affordability assessment were a purely quantitative rule, we might have been able to use the details of the rule to help specify where to set this threshold. However, as the affordability assessment is partly qualitative, we needed to adopt a different approach.

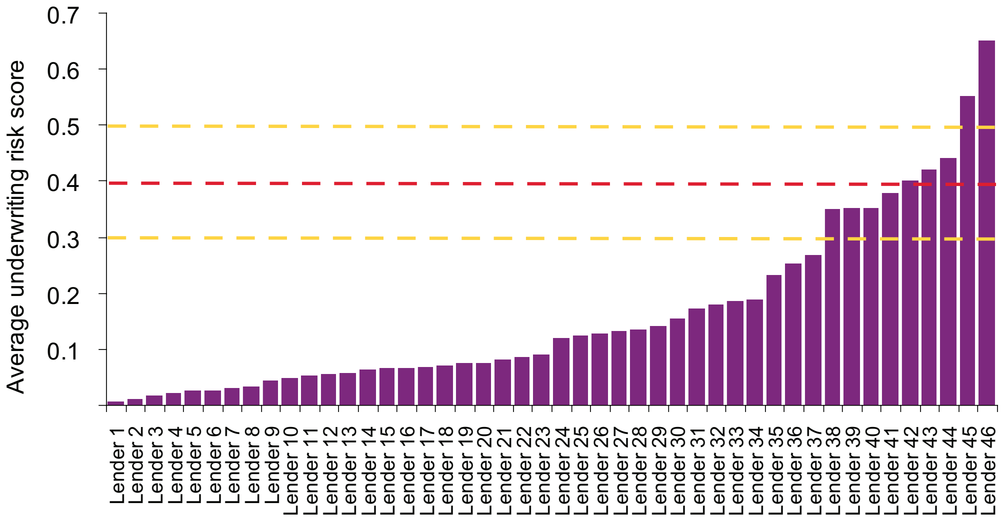
28. The affordability assessment aims to limit consumer detriment from poor underwriting, and the underwriting score is a measure of poor underwriting that leads to impairment. So it is likely that if the affordability assessment had been in place during the period of our data it would have predominantly affected lenders whose underwriting was markedly poorer than others, leading to high rates of impairment. This suggested a method to determine an underwriting risk threshold i.e. to look at how the average underwriting score varied by lender and to identify a point at which there was a marked deterioration and to use this as a threshold for the underwriting score. This is the approach we have adopted to estimate the impacts of the affordability assessment.

29. The average underwriting risk score by lender is shown in Figure A4.3.[14] Up to lender 38 there is a rather gradual increase in the impairment risk from poor underwriting. From lender 38 to lender 46 the average underwriting risk score increases much more rapidly. We think it likely therefore that the affordability assessment would have predominantly affected lenders 38 to 46. As a specific threshold, we chose lender 42's average underwriting score as our central estimate of the point beyond which the affordability assessment would have affected mortgages. Lender 42 was chosen because it is the median lender between lender 38 (where the poor lending begins to be visible) and lender 46 (the worst lender). In this way,

14 The graph in Figure A4.3 also acted as a check on our measure of underwriting risk since it showed that lenders with the highest underwriting scores were also those for which we had anecdotal evidence of poor lending practices.

lender 42's average underwriting score of 0.4 provided us with a central threshold beyond which we believe mortgages would have been affected by the affordability assessment.

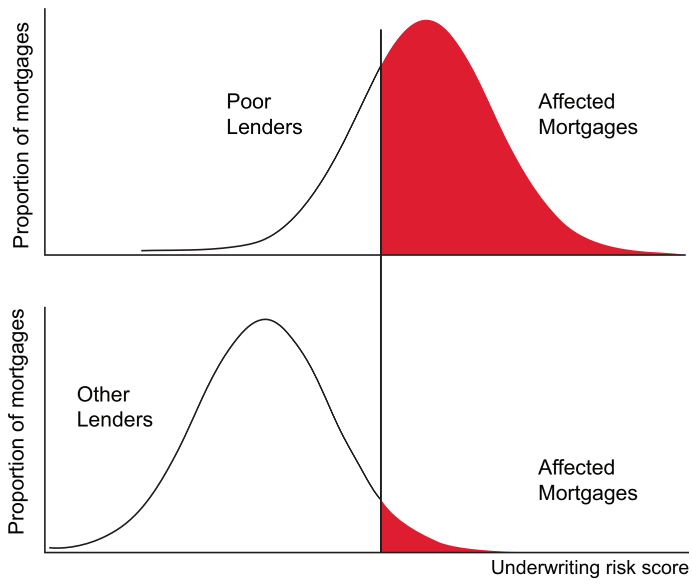
Figure A4.3 – Average underwriting score by lender



30. Of course, it is difficult to determine precisely where mortgage lending was unaffordable and so would have been affected by the affordability assessment had it been in place. To capture this uncertainty we also chose a higher and a lower threshold for the mortgages that might have been affected by the affordability rule. We did this by choosing more extreme points, at underwriting risk scores of 0.3 and 0.5 respectively. This results in a range for the threshold beyond which mortgages would be affected. These upper and lower thresholds are also shown in Figure A4.3. Having a range for the threshold allows us to estimate ranges for the impacts, reflecting the uncertainty in the impacts the affordability assessment would have had.

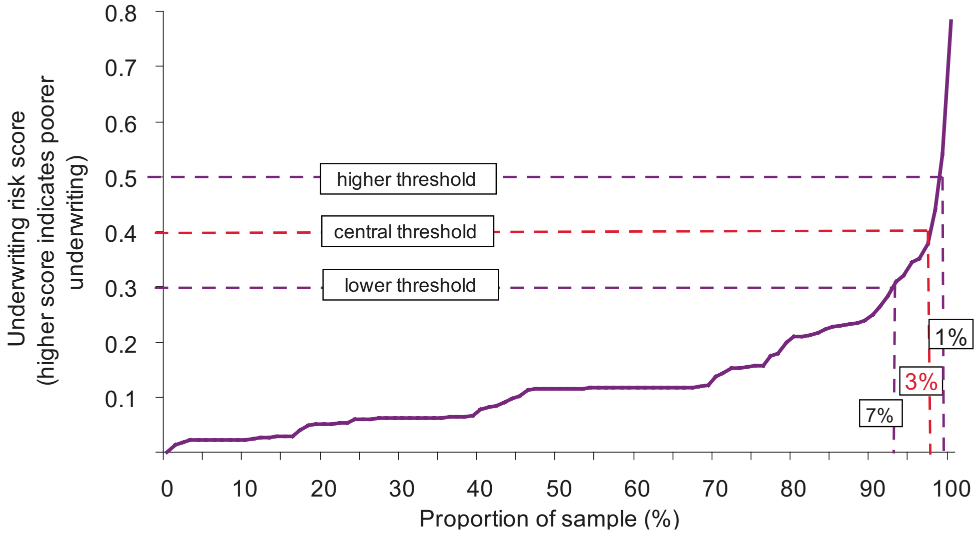
31. Picking a threshold using a lender comparison and analysing impacts on this basis might be read as suggesting that we expect only the poorest lenders would have been affected by the affordability assessment. This would not be correct, since we expect the affordability assessment would have affected all lenders to a greater or lesser extent and this is modelled in our approach. This is because each lender had a range of underwriting quality for the mortgages it provided. As illustrated in Figure A4.4, for any given underwriting risk threshold there would have been a larger impact on the poorer lenders, but better lenders would also have been required to curb relatively small pockets of poor quality underwriting. This is because in the model the threshold is applied on a mortgage-by-mortgage basis and not on a lender-by-lender basis. This mortgage-by-mortgage approach reflects the affordability assessment that applies at the mortgage level.

Figure A4.4 – Affected mortgages by lender type



32. Using the thresholds described above, we can estimate the percentage of borrowers that might have been affected by the affordability assessment over the whole 2005 to 2010 period from the underwriting risk score graph for mortgages. This is done in Figure A4.5. We can see that if the affordability assessment had affected all *mortgages* with an underwriting risk score above 0.4 then about 3% of borrowers in the 2005 to 2010 period would have been affected by the introduction of the affordability assessment. If the affordability assessment was instead captured by the lower threshold for underwriting risk of 0.3 the proportion of borrowers affected would have been higher, at 7%. On the other hand, if the threshold were set at 0.5, then the affordability assessment would have affected only about 1% of borrowers. Together these give an indication of the proportion of borrowers that might have been affected by the affordability assessment i.e. a central estimate of 3% borrowers affected within a range of about 1% to 7%.

Figure A4.5 – Underwriting risk score thresholds



4. Estimating borrowers affected by the affordability assessment

33. As illustrated in Figure A4.5, we used the underwriting risk scores for different mortgages and our chosen thresholds to construct estimates for the borrowers affected by the affordability assessment. Since this tells us precisely whether any mortgage in our dataset was affected, we can also use this to analyse which borrower groups would likely have been affected by the affordability assessment.

34. In addition, in our analysis of the impacts of the affordability assessment and the other responsible lending proposals, we distinguish between the impacts we might expect in 'boom' periods and 'subdued' periods of lending. To do this, we estimated impacts for two different sub-periods, 2005 to 2007, the pre-crisis period which we took to be a representative of 'boom' periods of lending, and the 2009 to 2010 crisis and post-crisis period which we took to be a representative 'subdued' period of lending.[15] We have excluded 2008 from our analysis because it is a period of transition between boom conditions and subdued conditions, and does not fit well in either.

35. Also important is *how* affected borrowers would have been affected. Some would have obtained smaller mortgages. Others would have not have taken out a mortgage because a smaller mortgage would not meet their needs and thus need to delay their borrowing. Impacts on lending also differ by borrower. For example, when a first-time buyer does not take out a mortgage, the impact on net lending is the full amount of the mortgage that would have been granted in the absence of the MMR. In contrast, a borrower who has an existing mortgage (e.g. remortgagors) and who does not obtain a mortgage keeps their existing mortgage. In this

15 Since our underwriting risk measure has been constructed to remove (as much as possible) the influence of macroeconomic factors, the underwriting risk measure is taken to be independent of macroeconomic conditions. For this reason, the same underwriting risk score thresholds apply in both boom and subdued periods.

case, the impact on net lending is any difference between the amount outstanding on their existing mortgage and what they would have borrowed with the new mortgage. In our analysis, impacts on lending are analysed on an aggregate basis (i.e. for all borrowers rather than for subgroups) when we present the macroeconomic impacts.

5. Summary of methodology

36. Putting all of the steps together, our approach to estimating the impacts of the affordability assessment was:

- we used a logistic regression to estimate the probability of impairment for each mortgage in the PSD (covering 2005 to 2010);
- we used an OLS regression of the probability of impairment on the risk factors to identify the contribution each risk factor made to impairment risk;
- we selected impairment risk factors that were relevant to underwriting;
- we defined our underwriting risk score as the combined impact of these selected risk factors on impairment risk;
- we chose an underwriting risk score threshold at a point where lender underwriting standards deteriorated markedly; our rationale was that this would have been where the affordability assessment would have predominantly affected mortgages whose poor underwriting led to the greatest impairment risk;
- mortgages in our data whose underwriting risk score was above the cut-offs were taken to be those that might have been affected by the affordability rule; and
- we distinguished between impacts in 2005 to 2007 and 2009 to 2010 to construct different estimates of the impacts the affordability assessment would have in boom and subdued periods.

Borrowers affected by the affordability assessment

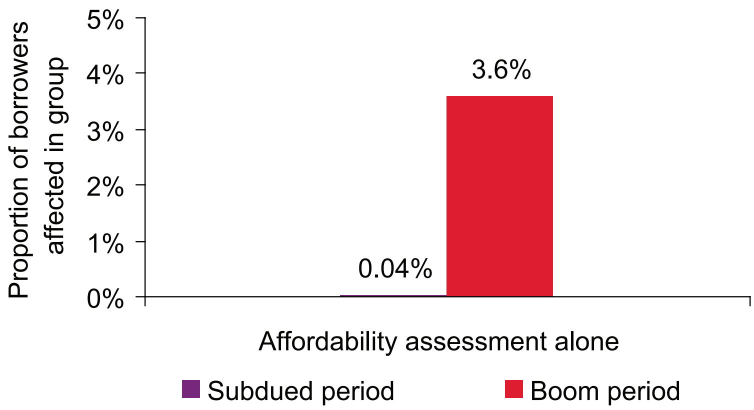
37. In this section we present our estimates of the proportion of borrowers affected by the affordability assessment, estimated using our central threshold (0.4) for underwriting risk score. These borrowers would either have to take out a smaller mortgage or would have to postpone their borrowing.[16] We present the percentage of borrowers that would have been affected had the affordability rule been in place over the 'subdued' period (2009 to 2010) and over the earlier 'boom' period (2005 to 2007) leading up to the crisis. These give an indication of the impacts we might expect for future 'subdued' and 'boom' periods in the credit cycle.

16 As previously mentioned, we have no data about the duration of the postponement of borrowing.

38. In the next section we present the effects when the interest rate stress is added to the affordability rule, and in the section after that we present the effects with the further addition of the interest-only proposals. We then discuss the effects of all three of the lending proposals together.

39. For the affordability assessment alone, our central estimate is that only 0.04% of borrowers would have been affected in the subdued period. In the boom period our central estimate is 3.6% of borrowers. Using the higher and lower thresholds for underwriting (0.5 and 0.3) we estimate that the impacts in the subdued period would range from between 0% and 0.4%, and 1.7% and 10.5% for the boom period. Figure A4.6 illustrates the impacts for the central threshold.

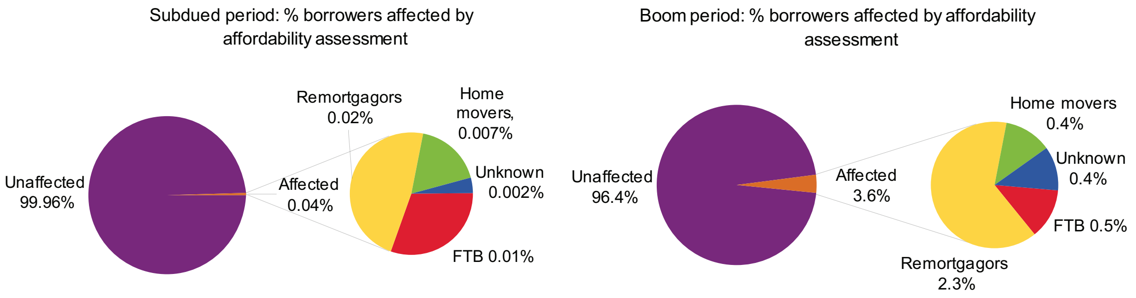
Figure A4.6 – Proportion of borrowers affected by the affordability assessment



40. The results show that impacts would have been very low in the subdued period and significantly greater during the boom period. This reflects the fact that during the subdued period, lending criteria have been tighter, lending has been lower risk and underwriting standards have been more stringent than in the boom period. It is also in line with what one would expect i.e. that the affordability assessment would have a larger impact in times when it is most needed, such as when there is more unaffordable borrowing taking place. In addition, the low estimated impact in the subdued period indicates that the MMR affordability assessment would be likely to have minimal impacts on mortgage lending if it were implemented during the current period.

41. These results give an indication of the general impact of the MMR affordability assessment for our sample period. However, different borrower groups would have been affected differently. To illustrate this, Figure A4.7 breaks the overall effects on borrowers for the central threshold into the parts that affect different borrower groups.

Figure A4.7 – Breakdown of borrowers affected by the affordability assessment



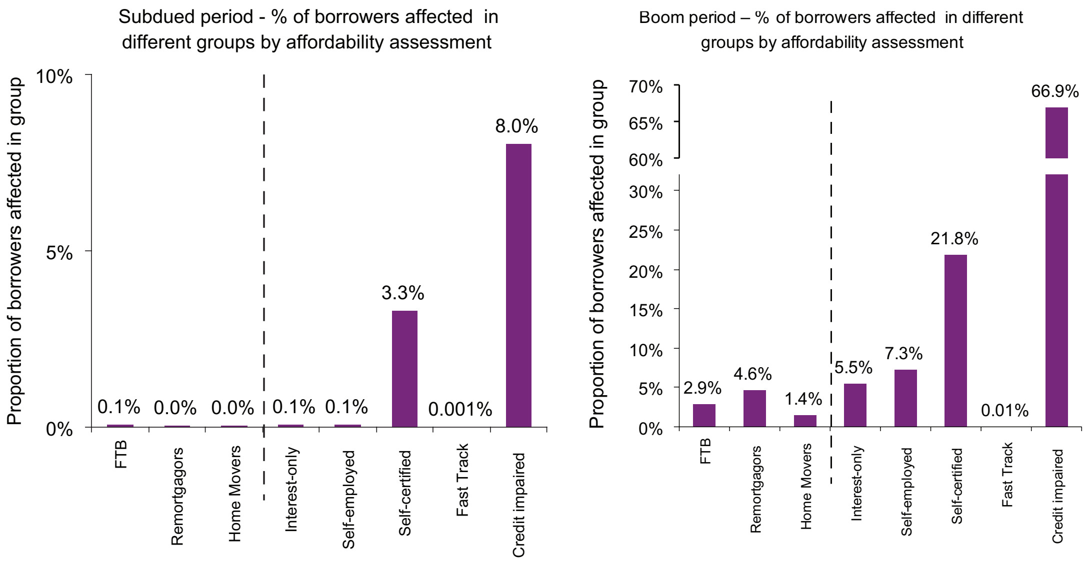
42. The decomposition of impacts shows that most of the impact of the affordability rule – in both subdued and boom periods – would have been on remortgagors. First-time buyers and home-movers account for a smaller part of total impacts. It indicates that underwriting was poorest among those remortgaging or that in respect of remortgagors lenders use information not available to us.

43. Although, the decompositions break up the overall impacts into the parts that affect different borrowers, they do not give an indication of the proportion in each borrower group that would have been affected by the affordability rule, since it does not take into account the relative sizes of the different borrower groups.

44. To give an indication of how likely it would be that borrowers in different groups would have been affected by the affordability rule, Figure A4.8 presents the proportion of borrowers within different groups that would have been affected in both the subdued and boom periods. First-time buyers, remortgagors and home movers are mutually exclusive groups and between them include all mortgages, while the other groups overlap and do not cover all mortgages (e.g. a credit-impaired borrower could also be a remortgagor and an interest-only borrower). This should be borne in mind when interpreting the results;[17]

17 The difference between the groups is also why in Figure A4.8, and in the similar figures that follow below, we have a dashed line separating the two sets of groups.

Figure A4.8 – Proportions affected in different borrower groups



45. While Figure A4.7 illustrates that among affected first-time buyers, remortgagors and home-movers, remortgagors would have been the most affected, Figure A4.8, however, shows that the vast majority of all remortgagors would not have been affected in either the subdued or the boom period.

46. Figure A4.8 also shows that the groups that would have been most affected are the self-certified[18] and the credit-impaired. This is intuitive since much of the borrowing in these groups, particularly in the earlier boom period, was higher-risk and with lenders who had relaxed lending standards, much of which is likely to have taken place with relatively poor underwriting. Also, credit-impaired borrowers typically find it more difficult to borrow from lenders with tighter lending criteria and would gravitate to lenders with the weakest lending and underwriting standards. Self-certified borrowers did not need to present independent proof of income, a characteristic that is strongly associated with poor underwriting. Fast-track borrowers are barely affected at all because they are generally lower risk than other borrowers.

47. Although the self-certified would have been significantly affected, the impact on the self-employed, who made a significant use of self-certified mortgages, would have been lower than other groups who self-certified. It indicates that some of the poorest lending (particularly in the subdued period) in self-certified was likely to be due, at least in part, to higher risk borrowers and lenders with weaker underwriting standards taking advantage of lending conditions that allowed self-certification.

18 Self-certified borrowing will no longer be permitted under the income-verification proposals. By 'self-certified borrowers' we mean those who were (or would be) self-certified without the MMR. Clearly, these borrowers cannot be 'self-certified' under the MMR. Self-certified borrowers are distinct from fast-track borrowers, who have the mortgage application accelerated, a characteristic which, unlike self-certification, tends to be associated with lower risk borrowing.

48. First-time buyers would have been hardly affected at all in the subdued period and only slightly impacted (less than 3% affected) in the boom period. In the subdued period, the very low impact is likely to be due to the fact that it has been more difficult for first-time buyers to borrow since the crisis. Higher deposit requirements, in particular, have made it difficult for first-time buyers to enter the mortgage market. As a result, those first-time buyers who have been borrowing have had higher deposits and are more likely to have been borrowing affordably.

49. Some of the affected borrowers would obtain a smaller mortgage because of the affordability assessment; others would have to delay their borrowing. In our section on lending impacts we consider how lending impacts will differ among first-time buyers, home-movers, and remortgagors. We use this to construct estimates for the lending impacts arising from the responsible lending requirements.

50. At this point we would particularly value industry views on our estimates for the impacts of the affordability assessment.

> Q99: **Do you have any comments on our estimates for the impacts of the affordability assessment? Do you have any data and/or analyses that could be informative about these impacts?**

B. Estimating the impact of the interest rate stress test

51. In this section we consider the second of the three MMR responsible lending requirements, the interest rate stress test which requires that in addition to the affordability assessment, the affordability of the mortgage be stressed with reference to a future increase in interest rates. The proposed test is to require lenders to undertake stress-testing of the interest rate, with reference to market expectations for interest rates over the next five years, when carrying out their affordability assessment. The proposal is that their stress tests be compatible with but not mechanically linked to market expectations for interest rates, for example, from externally published sources such as the forward sterling rate published on the Bank of England website. Where the market expects interest rates to rise by less than 1% over the next five years, the proposal is that lenders must assume a minimum interest rate rise of 1% over that period.

52. As in our section on the affordability rule, the section begins with a discussion of how we estimated the effects, followed by a presentation and discussion of those estimates.

Methodology

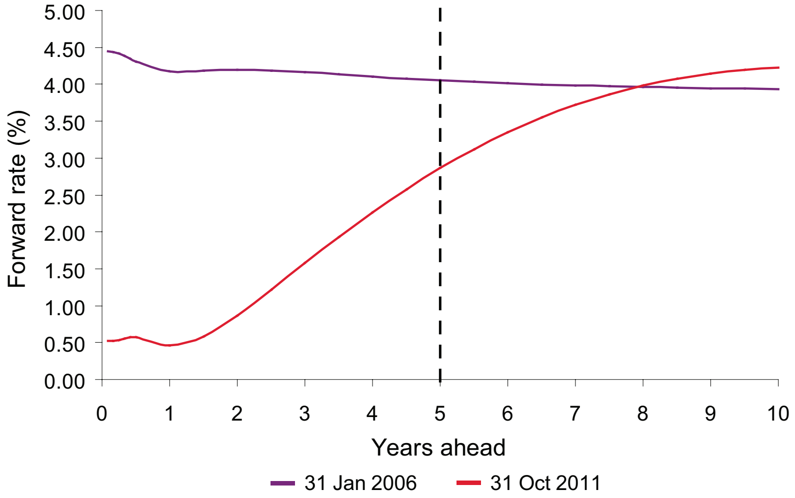
53. The interest rate stress proposal ties the size of the stress to when the mortgage is originated in the business cycle. The stress itself is likely to be more demanding when the bank rate[19] is low, which under conventional monetary policy will typically be in subdued periods, than when the bank rate is high, as we would expect it to be during boom periods. Our aim is to help prevent the granting of loans that are affordable when rates are low but predictably unaffordable when rates rise. In boom periods, rates are likely to be high anyway, so that the core affordability test will need less support from a stress test.

54. To illustrate this and the stress test more generally, consider that the Bank of England bank rate was 4.5 % in January 2006. As can be seen from the inverted forward curve[20] at that time (shown in Figure A4.9 using Bank of England data) market expectations were that interest rates would fall slightly over the next five years (by about 0.5%[21]). If the proposed interest rate stress test had been in place at this time, then the minimum stress, which is designed to cover minor fluctuations in rates, would have applied i.e. a 1% increment to the mortgage rate would have been made.

55. In contrast, the market currently expects a bank rate rise of approximately 2.4% over the next five years, as shown by the current forward curve, shown in Figure A4.9.[22] This could therefore provide the basis for the current stress tests. For example, 2.4% could be added to the lender's standard variable rate (SVR) and mortgage affordability then checked by using this rate. However, the fact that the market currently expects an increase of about 2.4% does not mean that all interest rate stress tests would have to include a stress of exactly 2.4% on top of the SVR.

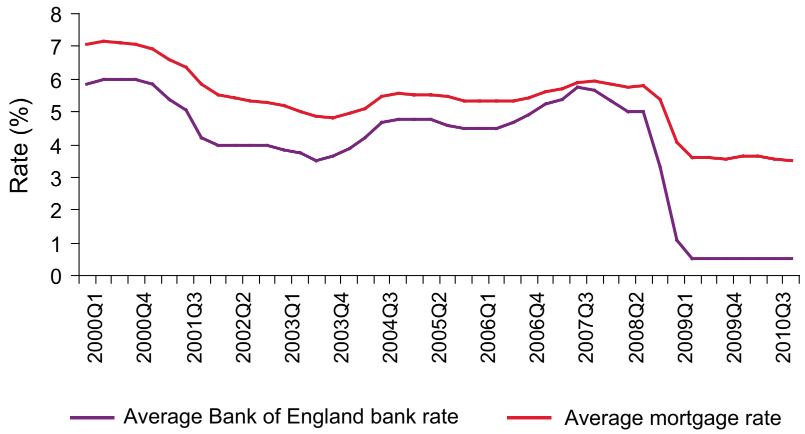
19 By 'bank rate' we mean the Official Bank Rate of the Bank of England.
20 Forward rates are interest rates for future periods implied by the yields on current bonds of different maturities. The instantaneous rates presented here can be interpreted as a market expectation of the future bank rate. So, for example, the current instantaneous forward rate for one year ahead can be read as the market expectation of the bank rate one year from now.
21 Calculated by subtracting the Bank of England bank rate (4.5%) from the Bank five-year forward rate (4%) as of 31 January 2006.
22 Calculated by subtracting the Bank of England bank rate (0.5%) from the Bank five-year forward rate (2.9%) as of 31 October 2011.

Figure A4.9 – UK instantaneous nominal forward curves, 31 January 2006 and 31 October 2011



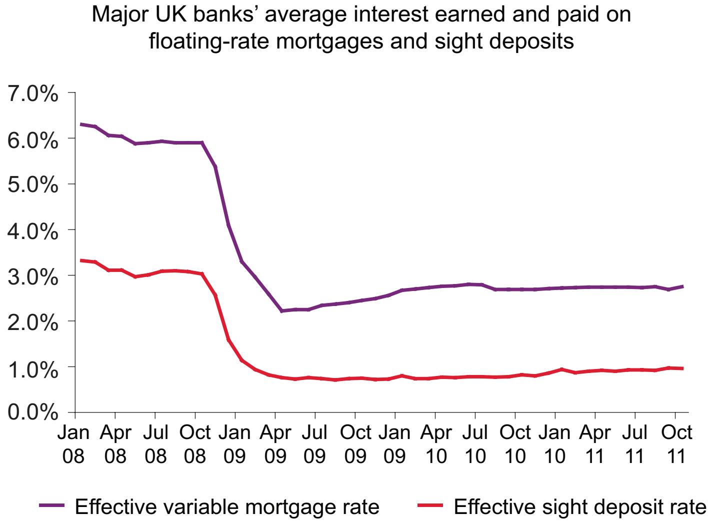
56. Other stresses could also reasonably be used. Mortgage rates, for example, do not move precisely in line with market rates, but instead tend to exhibit damped oscillation (i.e. changes in mortgage rates tend to be less than those in the bank rate and, in general, mortgage margins tend to fall as the bank rate rises). This is illustrated in Figure A4.10, which plots quarterly average mortgage rates and the bank rate using Bank of England data.

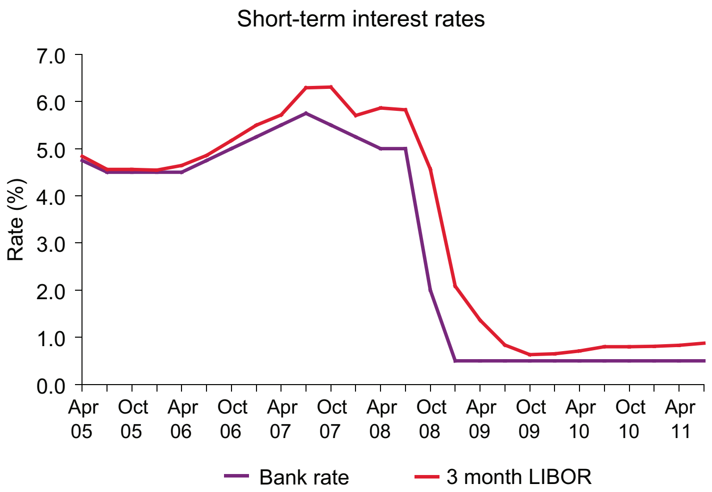
Figure A4.10 – Average bank rate and mortgage rates 2000 to 2010



57. In the recent extremely low interest rate environment, banks and building societies have set deposit rates that are in some cases higher than the bank rate. To recover the lost revenue from this, banks have increased margins in their mortgage rates. This is shown in Figure A4.11 (which reproduces two charts from the FSA's Prudential Risk Outlook 2011, p.83). Comparing the short-term interest rates with the deposit rates and mortgage rates one can see how the margins on deposits (relative to bank rate) have shrunk and how margins on mortgage rates (relative to bank rate) have increased.

Figure A4.11 – Average bank deposit rates, variable mortgage rates and short term interest rates





58. Given this, one would expect the reverse effect, that is, mortgage margins would decrease (and margins on deposits would increase) when interest rates rise again. This expectation could also inform lenders' stress tests. So, a stress that assumed the mortgage rate would increase by less than 2.4%, where this is justified by expectations on how the margins will change with the interest rate rise, could be compatible with an increase in the bank rate of 2.4%. The stresses that lenders apply could also reflect the particular terms and conditions of the relevant mortgage contract. For example, a tracker mortgage that stipulated in its terms and conditions that the spread between the mortgage rate and the bank rate would

decrease if the bank rate rose beyond a certain level could also be taken into account by the lender in the stress test, i.e. to decrease the size of the stress appropriately.

1. How we modelled the size of the interest rate stress

59. For the CBA we need to model the additional impact the interest rates stress would have had, which first requires modelling what the interest rate stress would imply for the mortgages in our dataset. Unfortunately, given the variety of mortgage contract terms and the fact that we lacked data on SVRs, we were not in a position to model how individual mortgage rates would change under the stress test.

60. Instead we adopted a simpler approach. We stressed the original mortgage rate by taking the higher of (a) the mortgage inception rate (which includes margin at origination) plus 1% and (b) an estimate for the SVR expected in five years. For a) we modelled the stresses using the mortgage rate at origination as we do not have individual mortgage data on SVRs.

61. For b) we constructed an estimate for the stressed SVR, i.e. the SVR the market expects in five years. This was done in the following way:

- we investigated the evolution of margins (SVR less the bank rate) from past observed patterns of the average SVR relative to bank rate;
- we estimated a linear relationship for the average margin in terms of the average bank rate from our data;
- using the five year forward rate as a market forecast for the bank rate in five years, we used the relationship for the average margin above, to estimate the margin expected in five years; and
- we added this to the five year forward rate to construct an estimate of the average SVR the market expects in five years.[23]

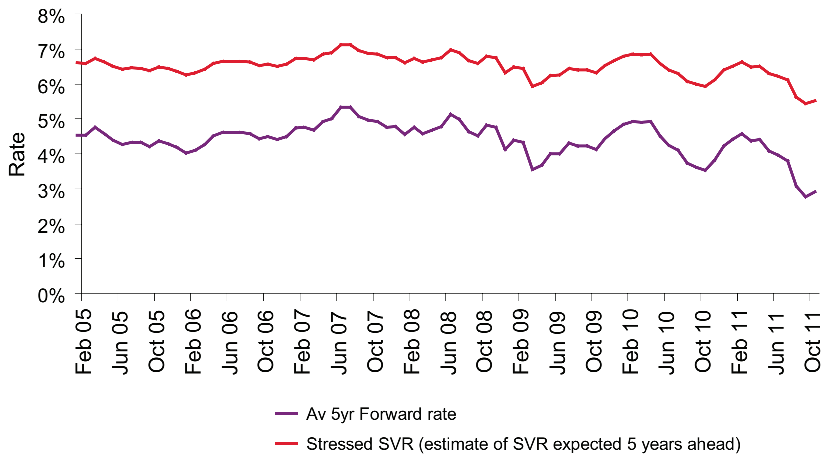
62. It is important to note that our approach does not capture the whole of the variation in margin because five year forward rates themselves are weak predictors of future base rates. However, use of the five year forward rate is market practice and therefore reflected in our policy.

63. Figure A4.12 shows the estimate of the SVR expected in 5 years, which is used to stress the SVR for step (b) above. From the information we have, this estimate of the SVR fits well with the rates lenders have been applying when stressing their recent mortgage lending.[24]

23 Specifically, we used Bank of England data, first to estimate the average spread between the Bank of England bank rate and the average mortgage rate for two periods (2005 to 2007) and (2009 to 2010). These two periods were chosen because, as illustrated in Figure A4.9, the spread is markedly different between these periods, yet relatively constant within each period. Using the resulting two data points for average spread and average bank rate in each of the two periods, we estimated a linear relationship for the average spread in terms of the bank rate. Then, using the five-year forward rate as a forecast for the bank rate in five years, we used this relationship to construct a forecast for each mortgage of the spread expected five years after origination. By adding this expected spread to the expected bank rate (forecast using the five-year forward rate) we estimated the SVR expected in five years after origination.

24 The fact that most lenders have recently been using a stress test as part of their mortgage origination process lowers the impact we expect from the interest rate stress in the subdued period.

Figure A4.12 – Five year forward rate and the stressed SVR



64. At this stage we could simply have applied the higher of the origination rate + 1% and the stressed SVR (as estimated above) to model the interest rate stress. One problem with this approach is that recently five-year forward rates have fallen significantly. Therefore, if we had used our estimate for the SVR from the subdued period (2009 to 2010), we would have overestimated the impact of the interest rate stress for the current period. Since the historical subdued period is ultimately of interest for estimating impacts for the current subdued period, we chose to stress mortgages that were originated in the subdued period using the SVR we currently expect on the basis of the current five-year forward rate, 2.9%.[25] This led to a stressed SVR of 5.5% for the subdued period. This figure is constructed by combining the current five-year forward rate, 2.9%, with our estimate for the spread expected between the average SVR and the base rate in five year's time which is 2.6%.[26]

65. So, for mortgages originated in 2009 to 2010, we modelled the interest rate stress as the higher of the origination rate + 1% and the currently expected SVR (using our model above). For mortgages in the boom period (2005 to 2007) we use the higher of the origination rate + 1% and the SVR expected five years after origination. This was done because unlike in the subdued period, there was no reason to expect that using this approach would overestimate the impacts of the interest rate stress in future boom periods.

2. How we estimated the additional effect of the interest rate stress test

66. The next step was to use this to model the impact of the interest rate stress test on the additional borrowers affected by it. The first approach we explored was to investigate how

25 This is the five year implied nominal forward rate from Bank of England data on 31 October 2011.

26 The estimate of the stressed SVR, 5.5%, may appear high when compared to the current average SVR which is 4.1% (source Bank of England). This difference is due to the stressed SVR being an estimate of the average SVR the market expects in 5 years rather than an estimate of the current SVR. This difference, between current rates and rates in five years, is captured in our model by the use of the five year forward rate as a market forecast for the bank rate in five years and, as the current five year forward rate, 2.9%, is much greater than the current bank rate, 0.5%, this results in a stressed SVR that is significantly higher than the current average SVR.

the interest rate stress test would change the underwriting risk score of a mortgage. If one could model this shift, then by using the same threshold for underwriting risk as used in modelling the affordability assessment, we could have estimated the additional impact of the interest rate stress test from the borrowers pushed over the underwriting threshold by it. We investigated doing this in two steps using the debt service ratio (DSR). First, we would identify a relationship between the underwriting risk score and the DSR, and second, use this relationship to estimate the increase in underwriting risk score from an increase in DSR inferred from the stressed rate. As it happened, however, it proved difficult to identify a suitably robust relationship between a DSR increase and an increase in underwriting risk.[27]

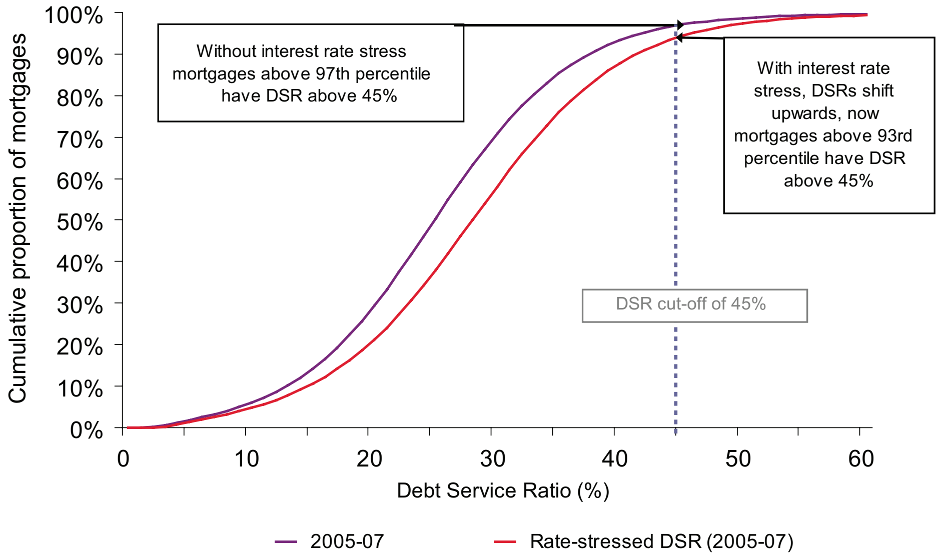
67. Because of these difficulties, we decided to use a simpler approach to estimate the incremental impact of the interest rate stress test. Our method looks at how it shifts mortgage affordability, as measured by DSR rather than underwriting risk score.

68. To estimate the incremental effect of the interest rate stress test, we first identified what proportion of the borrowers who would have obtained a mortgage under the affordability assessment would be pushed beyond a DSR threshold by the interest rate stress if all borrowers were affected by the stress. We then scaled this impact downwards to take into account information we have about lenders that were already stress-testing their mortgages (since borrowers who were lending from these lenders would not be affected by the interest rate stress test).

69. An illustration of how this approach works can be seen by looking at the impact of the interest rate stress test on the distribution DSR across mortgages. This impact is shown in Figure A4.13 as the extent to which the cumulative distribution of DSR for our mortgage dataset shifts to the right when the interest rate at origination is stressed.

27 This is perhaps unsurprising given the difficulties we encountered in finding a robust relationship between DSR and impairment risk (which is closely related to the underwriting risk score). These difficulties are discussed in detail in Chapter 3 of the CP and in Chapter A7.

Figure A4.13 – DSR distribution shifted by an interest rate stress (2005-07)



70. Figure A4.13 can be interpreted as follows. Suppose our affordability rule were a simple DSR threshold, under which mortgages with a DSR greater than 45% would be affected by the affordability assessment. Then, if the stress test were applied to all mortgages, it can be seen that adding the stress would lead to approximately a further 4% of loans being affected over 2005 to 2007. This method can be used to model the impact of the interest rate stress test if no lenders were already stressing their mortgages.

71. As we discuss in Chapter A7, DSR does not include information about expenditure and household characteristics that are important determinants of impairment risk at origination. As a result – and because of the particularities of the period of data we have[28] – DSR is only weakly associated with higher impairment risk for mortgages likely to be affected by the MMR. This is not ideal because it means that our approach – which picks out higher-DSR borrowers that are affected by the interest rate stress – will not pick out exactly those borrowers we would expect to be affected by it i.e. those borrowers who would face a significant increase in foreseeable impairment risk from an interest rate increase.

72. Nonetheless, we chose this approach because DSR is the only mortgage-expense related variable available to us. More importantly, we also think that it is a reasonable way to estimate the proportion of borrowers affected by the addition of the interest rate stress test. This is because the DSR is a measure of affordability at origination so the *proportion* of borrowers pushed beyond a DSR threshold when the interest rate stress is taken into account should be broadly illustrative of the incremental impact of the interest rate stress

28 Our data period 2005 to 2010 is by and large a period of falling interest rates in which forbearance measures were used quite widely by lenders. Together these have reduced impairment levels in the data from what we might have otherwise expected. This is likely to have limited our ability to identify a stronger relationship between DSR and subsequent impairment from our data.

test when it is added to the affordability assessment.[29] However, a limitation of this approach is that it combines two models which assumed different measures of affordability. As a result, the aggregate impacts may be more difficult to interpret.

73. It is also important to note that there is not a DSR cut-off that clearly corresponds to the point at which a mortgage becomes unaffordable. Given this difficulty, we selected a DSR threshold of 45% based on a judgement about what might be a reasonable level for such a cut-off. As this is not a precise or an empirically-based threshold, we also considered two other thresholds (40% and 50%) to construct a range for the incremental impacts of the interest rate stress.

74. Our current information about lenders' recent lending activities indicates that they have been stressing their mortgages at origination with stresses that are in line with the proposed stress test. Our best estimate, from the information we have, is that for 90% of borrowers their lenders are currently stressing their mortgages and we have used this to adjust the impacts of the interest rate stress in the subdued period i.e. impacts overall are one tenth what they would be if no lender was applying a stress test. We do not make a similar correction in the boom period as it is less clear that lenders were then stress-testing their mortgages and there is clear evidence that lenders relaxed their underwriting standards during this period.

3. Summary of methodology

75. In summary our method for estimating the borrowers affected by the interest rate stress is:

- we modelled the interest rate stress test by taking the higher of the origination rate + 1% and an estimate of possible SVR in five years;
- we constructed a simple forecast for the expected SVR in five years using the five-year nominal implied forward rate;
- for mortgages in the subdued period we used the currently expected SVR not the SVR at origination, because current five-year forward rates are significantly lower than during 2009 and 2010; this was to avoid overestimating impacts from the interest rate stress level we would expect to apply currently;
- by shifting their distribution of DSR to reflect the interest rate stress, we estimated the proportion of borrowers who would have been affected by the addition of the interest rate stress; and
- for the subdued period, we estimate that 90% of lenders are already carrying out stresses; we used this to adjust the impacts of the interest rate stress in the subdued period.

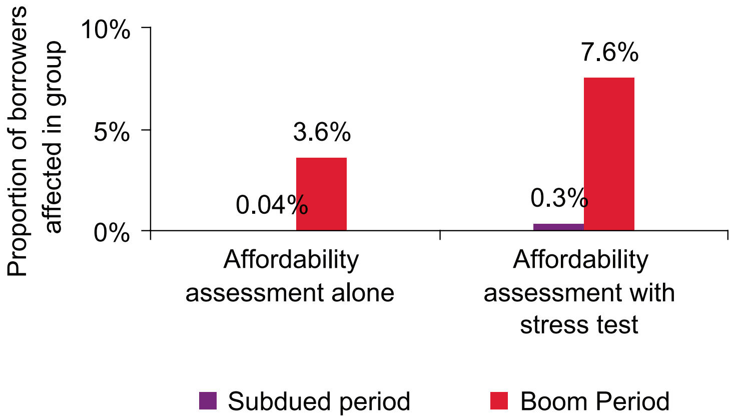
29 In technical terms, we are assuming the distribution of DSR among borrowers is a reasonable proxy for the distribution of affordability targeted by the affordability assessment, rather than assuming that DSR at the individual borrower level is a reasonable proxy for the affordability targeted by the affordability assessment.

Borrowers affected by the interest rate stress test

76. In this section we present our estimates of the borrowers affected by the addition of the interest rate stress test to the affordability assessment.

77. Figure A4.14 presents the overall impacts of adding the interest rate stress test to the affordability assessment. Our central estimate is that the affordability assessment and the interest rate stress test together would have affected 0.3% of borrowers in the subdued period and that this impact would have been between 0.2% and 0.7% (using DSR thresholds of 50% and 40% respectively). In the subdued period we have assumed that 90% of lenders are already stressing in line with the proposal. If no lenders had been stressing in the subdued period the impact would increase significantly i.e. 3% of borrowers would have been affected by the affordability assessment and the stress test together, and the range would have been between 1.2% and 6.5%. In the boom period we assume that no lenders were stressing. In this period our central estimate is 7.6% of borrowers with a range for this impact of between 5.3% and 11.6%.

Figure A4.14 – Proportion of borrowers affected by the affordability assessment combined with the interest rate stress test

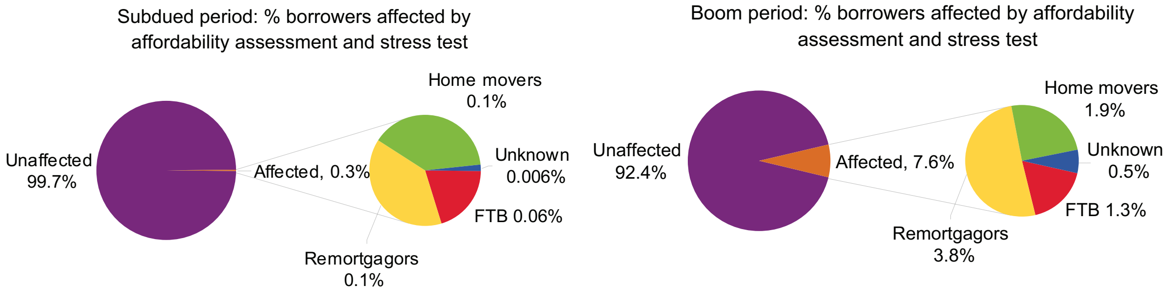


78. In the subdued period, the incremental effect of the interest rate stress test over the affordability assessment alone is – in our central estimate – that an estimated additional 0.25% of total borrowers would have been affected. In the boom period, the incremental effect over the affordability rule is an estimated additional 4% of total borrowers affected.

79. In the subdued period we observe low interest rates and strongly upward-sloping forward curves. In this period the interest rate stress test would have been much more demanding than the 1% incremental stress that is generally binding over the boom period (when rates were significantly higher). Impacts in the subdued period remain low overall because most lenders have already been stressing their mortgages at origination and this has been taken into account in the estimate here.

80. Different borrower groups would have been affected differently by the addition of the interest rate stress. To illustrate this, Figure A4.14 breaks the overall impacts on borrowers for the central threshold into the parts that affect different borrower groups.

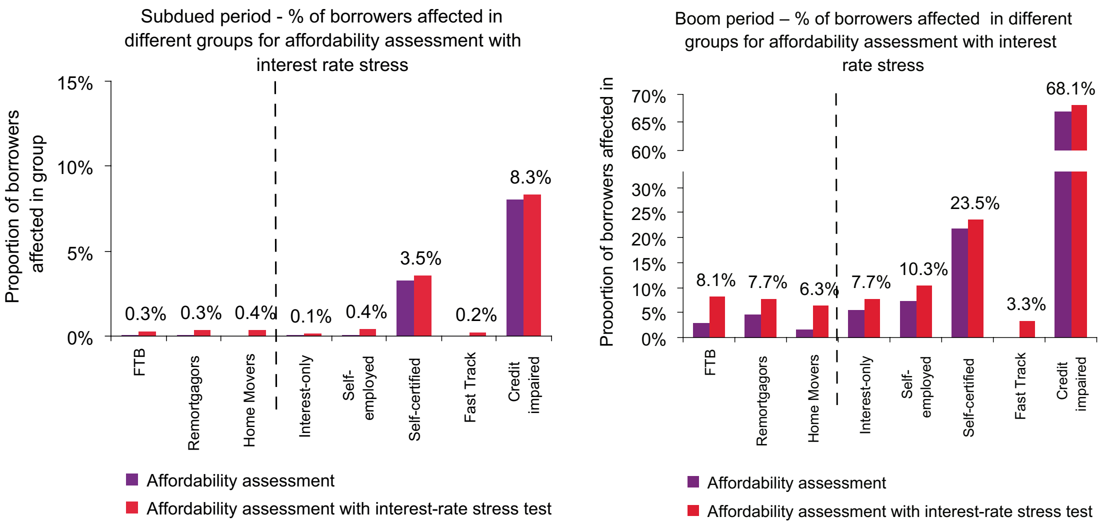
Figure A4.15 – Breakdown of borrowers affected by the affordability assessment and the interest rate stress test



81. Compared with the impacts of the affordability assessment alone (see Figure A4.7) the addition of the interest rate stress leads to impacts more evenly spread across borrower types. Home-movers are now more affected and in the subdued period account for a slightly larger proportion of the borrowers affected than remortgagors. In the boom period, however, remortgagors remain by far the largest affected category of borrowers. First-time buyers (FTBs) still account for a relatively small proportion of the borrowers affected.

82. To supplement the decomposition, Figure A4.16 presents the proportion of borrowers within different groups that would have been affected in both the subdued and boom periods by the affordability assessment combined with the interest rate stress test. Some of these borrower groups overlap (e.g. a credit-impaired borrower could also be a remortgagor and an interest-only borrower).

Figure A4.16 – Proportions affected in different borrower groups



83. Figure A4.16 shows that in the subdued period the addition of the interest rate stress increases the proportion of borrowers affected in each group by about 0.3%, with the exception of interest-only borrowers who are barely affected. This low estimate is due to interest-only borrowers having lower debt-service ratios on average than other borrowers and thus, on average fewer of these are pushed over the 45% threshold by the addition of the stress test. However, as we see in the next section, the addition of the interest-only proposals compensates for this, where correspondingly more interest-only borrowers are affected. In the boom period, the addition of the interest rate stress test leads to similar proportions of borrowers being affected among FTBs, remortgagors and home-movers (between 6-8%). Self-employed, self-certified, fast-track and credit-impaired borrowers are all only slightly more affected.

84. Here we would particularly value industry views on our estimates for the impacts of the stress test.

> **Q100: Do you have any comments on our estimates for the impacts of the interest rate stress test? Do you have any data and/or analyses that could be informative about these impacts?**

C. Estimating the impact of the interest-only proposals

85. In this section, we present our analysis of the third responsible lending requirement in the MMR, the interest-only proposal that lenders should assess affordability on a capital and interest basis unless there is a credible alternative source of capital repayment. Where

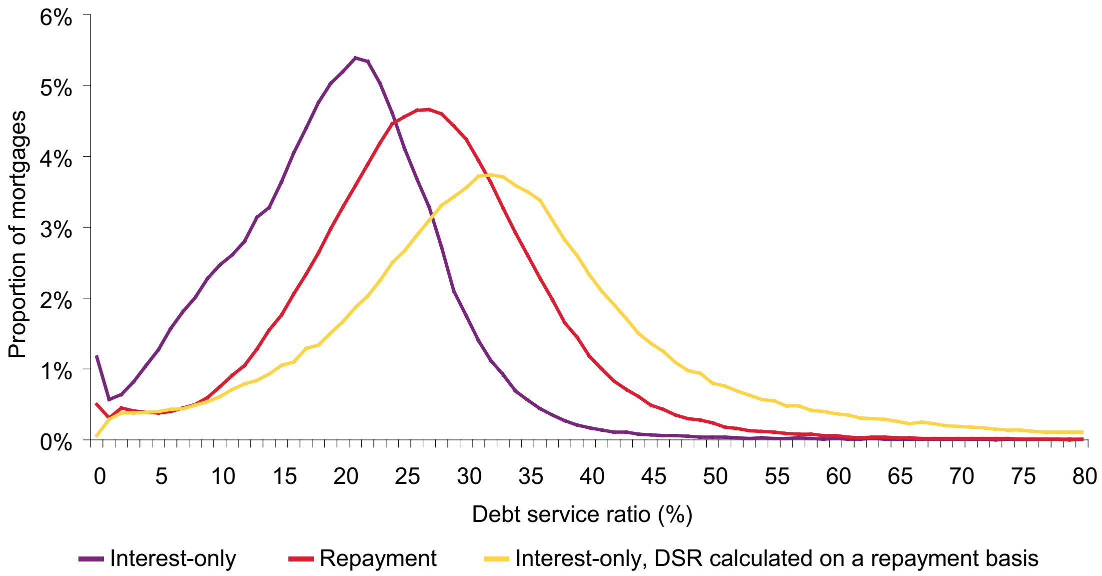
there is such an alternative source of capital repayment, affordability may be calculated on an interest-only basis, but the affordability assessment should also take into account the cash-flow cost to the borrower of the repayment strategy (in terms of considering it as an ongoing financial commitment), if it has one.

Background and methodology

86. Interest-only borrowing is used for a variety of purposes. Some borrowers can reasonably expect to repay their mortgage and use the interest-only feature to lower their monthly payments. Others, however, who do not have a credible means of repaying their mortgage may exploit the fact that for the same monthly mortgage payment a borrower can borrow a larger amount with an interest-only rather than a repayment mortgage. In effect, these borrowers use interest-only as a way of stretching affordability, a practice which the interest-only proposal seeks to address.

87. This is illustrated in Figure A4.17, which shows the distribution of DSR for interest-only versus repayment mortgages for one year of our sample, 2006. Although it shows that DSR is lower for interest-only borrowers than for repayment mortgages, when DSRs for interest-only borrowers are recalculated on a repayment basis these show a higher DSR than repayment mortgages.

Figure A4.17 – Distribution of DSR for interest-only vs. repayment mortgages (2006)



88. In estimating and thinking about the impact of the interest-only proposals, it helps to break it down as follows:

X: The proportion of mortgages that is interest-only.

Y: The proportion of interest-only borrowers who would be assessed on a capital and interest basis under the proposals.

Z: The proportion of interest-only borrowers who would be assessed on a capital and interest basis and be affected as a result.

89. The proportion of borrowers affected is the product of these three factors (X*Y*Z). This highlights an important point, that the impacts of the interest-only proposals stem from the impact it has on interest-only borrowers who would be assessed on a repayment basis rather than an interest-only basis.

90. Concentrating first on factor X, Figure A4.18 shows the overall percentage of mortgages which are interest-only by year, while Figure A4.19 shows the breakdown by borrower type for both the boom period (2005 to 2007) and the subdued period (2009 to 2010).

Figure A4.18 – Interest-only mortgages: proportion in total number and value of sales

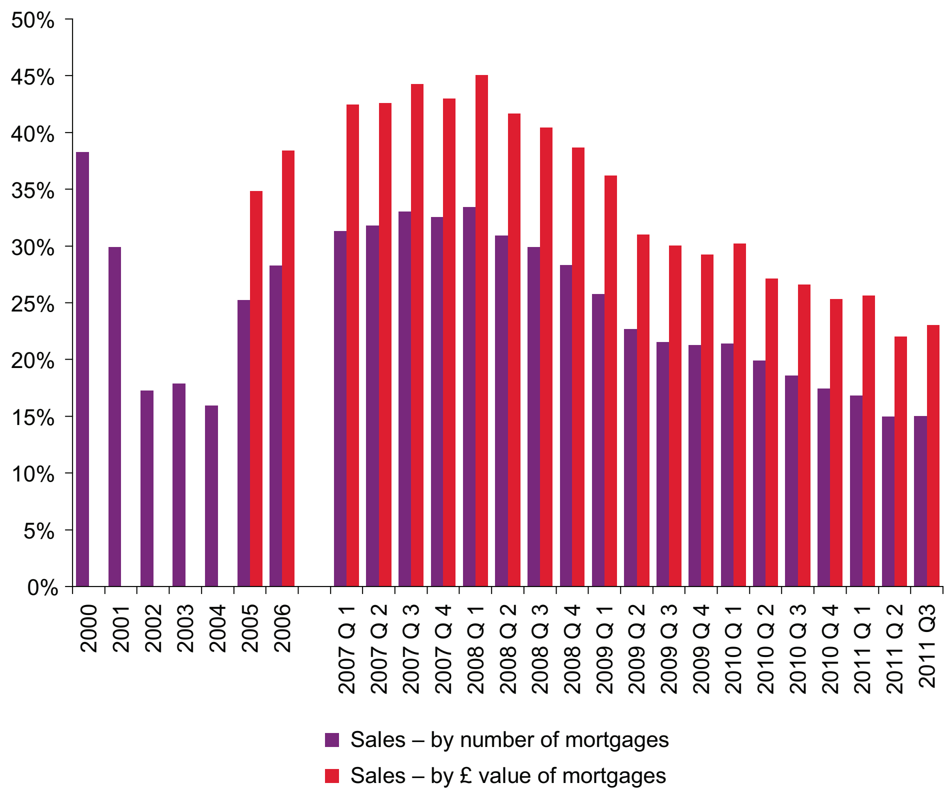
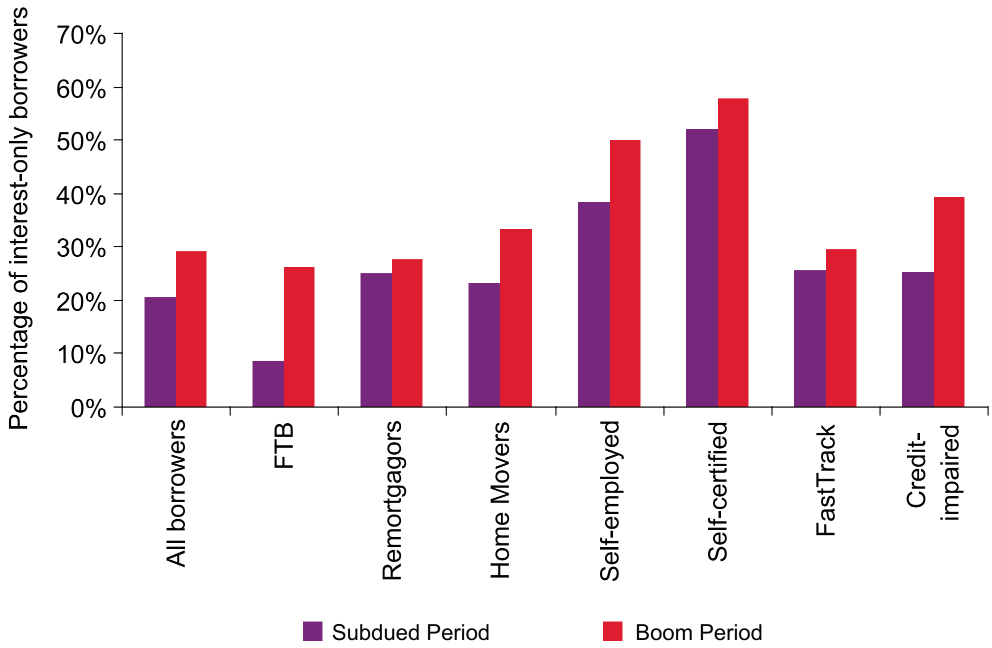


Figure A4.19 – Interest-only borrowers in different borrower groups



Source: PSD

91. These figures show that 20.7% of the new mortgages in 2009 and 2010 were interest-only, but that the percentage was considerably lower (9%) for first-time buyers. Interest-only mortgages were a greater proportion of mortgages over the boom period (for example 29.1% for all borrowers and 26% for first-time buyers).

92. To estimate factor Y, we need to analyse data relating to the characteristics of interest-only borrowers, and the likelihood that they will have credible capital repayment strategies. In Chapter 4 of the CP, the following are given as examples of credible repayment strategies:

- regular saving into an investment product;
- sale of other assets, such as property or other land owned;
- periodic repayment of capital from irregular sources of income (such as bonuses or some sources of self-employed income);
- on death, for example in the case of a lifetime mortgage; or
- sale of the mortgaged property, where this is a credible strategy because of down-sizing or repayment at death.

93. Unfortunately, we had limited data on borrowers with financial repayment vehicles in the PSD. Because of this we also used other data sources to estimate the proportion of interest-only borrowers who had some kind of repayment vehicle. These are set out in Table A4.2.

Table A4.2 – Interest-only borrowers by repayment strategy

Type of strategy	Estimate from the data we have	Source
Contributory repayment strategies (require regular contributions), of which:	25%	
ISA	16%	PSD
Endowment	8%	PSD
Private Pension	2%	PSD (estimate)
Non-contributory repayment strategies (do not require regular contributions), of which:	25%	
Company pension	1%	
Sufficient equity to support downsizing	13%	PSD (estimate)
Sale of other property	8%	DCLG
Repayment on death*	1%	HMRC
Some other repayment method or strategy	2%	FSA estimate
Total with repayment strategy	50%	
Total with no repayment strategy	50%	

* Repayment on death reflects the current observed pattern (i.e. the extent to which there are mortgages outstanding at the point of death). However, the percentage of interest-only borrowers for whom this could be a credible strategy could be considerably higher.

94. In Table A4.2 the downsizing category was estimated as follows. Where an interest-only borrower had sufficient equity when taking out the mortgage to purchase (outright) a property worth the average house price in their region, we assumed that the borrower would have been able to afford to repay the capital on their loan and have sufficient funds to move to another property in their region. We then modelled the impacts of the MMR on the basis that these loans would have been assessed on an interest-only basis. In our dataset, 13% of interest-only borrowers meet this condition.

95. Table A4.2 also distinguishes interest-only borrowers with repayment vehicles that require a regular contribution from income (contributory) and those that do not (non-contributory). Non-contributory repayment vehicles, since they do not require additional income, suggest that the interest-only borrower can reasonably be assessed on an interest-only basis. For interest-only borrowers with contributory repayment vehicles, only those borrowers who have already built up sufficient wealth to repay the mortgage without further contribution would be in a position to pay their mortgage purely on an interest-only basis. Since we lacked further data about the proportion of contributory interest-only borrowers in this category, we assumed as a very simple estimate that half of these could be assessed on a repayment basis. Taken together this implies that of the 50% of interest-only borrowers with a repayment strategy, 37.5% (25% + 12.5%) would be in a position to have their interest-only mortgage assessed on an interest-only basis. To simplify, we rounded this figure up to 40%. This is our estimate of factor Y.

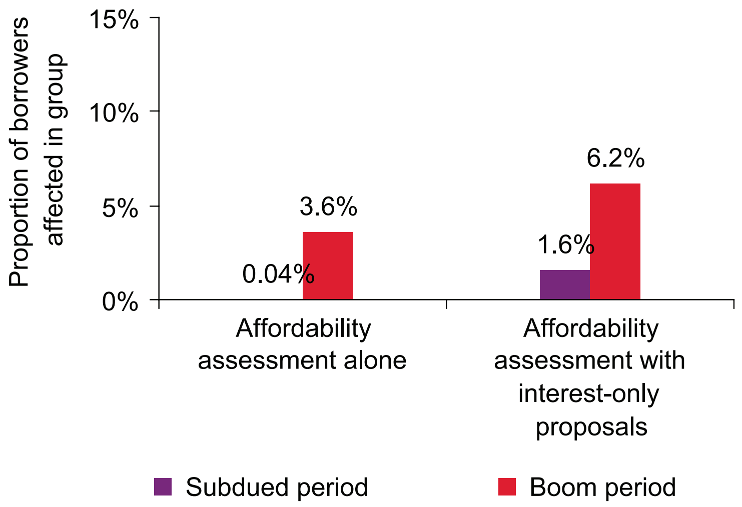
96. To model factor Z – the percentage of interest-only borrowers whose mortgages would appear to be unaffordable when assessed on a repayment basis – we used a similar method to that used for the interest rate stress test. We first estimated the proportion of interest-only

borrowers whose DSR would be pushed over the 45% DSR level if all interest-only mortgage were assessed on repayment basis.[30] We then adjusted this impact (reducing it by 40%) to estimate the impact if only 60% of interest-only borrowers were assessed on a repayment basis.

Borrowers affected by the interest-only proposals

97. This section presents our estimates of the impacts of the addition of the interest-only proposals to the affordability assessment. The overall impacts of the affordability assessment combined with the interest-only proposals are presented in Figure A4.20. Our central estimate is that the affordability assessment and the interest-only proposals together would have affected 1.6% of borrowers in the subdued period and that this impact could have been between 1.2% and 2.2% (using DSR thresholds of 50% and 40% respectively). In the boom period our central estimate is that the affordability assessment and the interest-only proposals together would have affected 6.2% of borrowers, with a range for this impact of between 5.3% and 7.7%.

Figure A4.20 – Proportion of borrowers affected by the affordability assessment combined with the interest-only proposals.



98. This shows that the addition of the interest-only proposals to the affordability assessment increases impacts significantly. In the subdued period, the incremental effect is an additional 1.6% of total borrowers affected. In the boom period, the incremental effect of adding the interest-only proposals is that an estimated additional 2.6 % of borrowers would have been

30 On a separate point, we took account of the fact that borrowers with short term interest-only mortgages are likely to have already been contributing to their capital repayment vehicle for some considerable time. To capture the lower capital repayments for such borrowers, we assessed those mortgages assuming a 25 year term rather than their actual term. Mortgages with terms in excess of 25 years have been assessed on their actual term.

affected. (In the next section, where we discuss the impacts of the three responsible lending requirements together, we show that the addition of the interest-only proposals to the affordability assessment and the interest rate stress test together would have led to an additional 2.2% of borrowers being affected in the subdued period and additional 3.7% being affected in the boom period.)

99. Table A4.3 illustrates how the 1.6% and 2.6% figures result from the three factors outlined in paragraph A4.88.

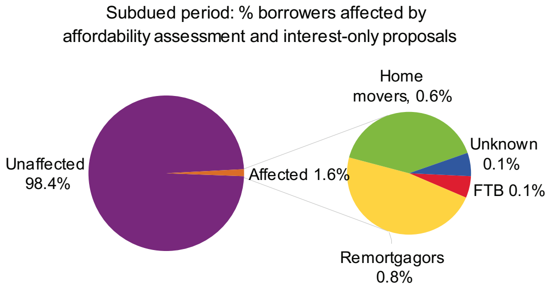
Table A4.3. Interest-only impact illustrative calculation

	Proportion of interest-only mortgages (from PSD)	Proportion of interest-only borrowers assessed on a repayment basis (estimated above)	Proportion of interest-only borrowers assessed on a repayment basis who are affected by the addition of the interest-only proposals	Proportion of all borrowers affected by addition of the interest-only proposals
	X	Y	Z	= X*Y*Z
Subdued period	20.7%	60%	12.4%	1.6%
Boom period	29.1%	60%	14.7%	2.6%

100. Table A4.3 shows that the interest-only proposals affect 12.4% of the interest-only borrowers who would be assessed on a repayment basis in the subdued period, and 14.7% in the boom period. These significant impacts reflect the intended effects of the interest-only proposals i.e. requiring that interest-only borrowers can afford to repay both the interest and the capital.

101. Figure A4.21 breaks down the impacts of the affordability assessment combined with the interest-only proposals to show the first-time buyers, remortgagors and home-movers affected. (The estimates here are for our central DSR threshold of 45%).

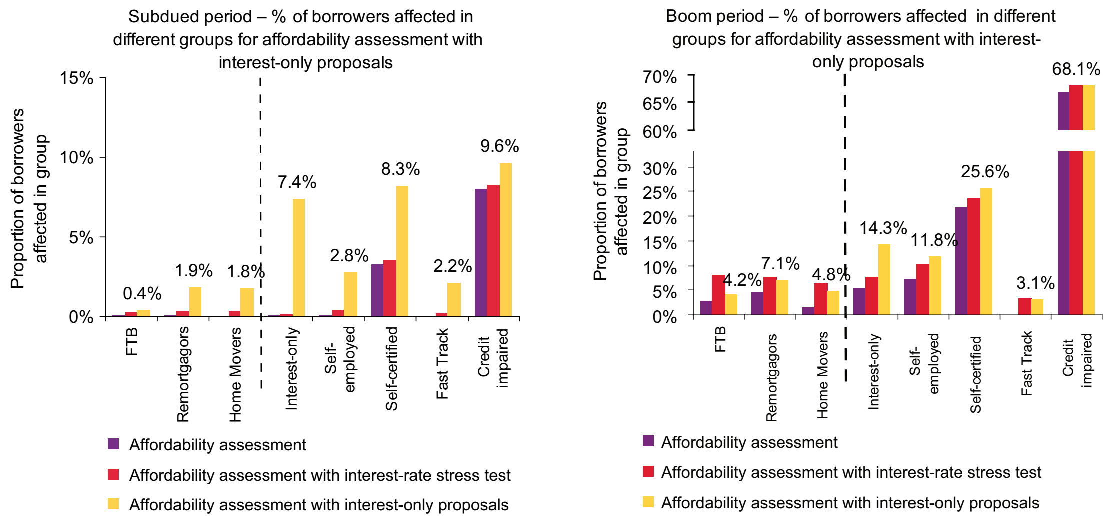
Figure A4.21 – Breakdown of borrowers affected by the affordability assessment combined with the interest-only proposals.



102. Compared with the impacts of the affordability assessment alone (see Figure A4.7), the addition of the interest-only proposals noticeably increases the proportion of home-movers among affected borrowers. Nevertheless, remortgagors still account for most of the affected borrowers in both periods. FTBs are a very small proportion of those affected in both periods. In the subdued period, this automatically follows from the small percentage of FTBs who are taking out interest-only mortgages (see Figure A4.19).

103. Figure A4.22 presents the proportion of borrowers within different groups that would have been affected in the subdued and boom periods by the affordability assessment with the interest-only proposals.

Figure A4.22 – Proportions affected in different borrower groups



104. In the subdued period there are marked increases among self-employed, self-certified and credit-impaired borrowers, all groups which include large proportions of interest-only borrowers (see Figure A4.19). In the boom period, however, the interest-only proposals lead to less significant increases for these groups. This is likely to be due to a significant proportion of the interest-only borrowers in these groups already having been affected by the affordability

assessment. (Our results are somewhat sensitive to the order in which the three responsible lending proposals are analysed.)

105. In our lending impacts section we consider how the impact on lending will differ among first-time buyers, home-movers, and remortgagors and we use this to construct estimates of the amount of lending impacted from the responsible lending requirements, including the interest-only proposals.

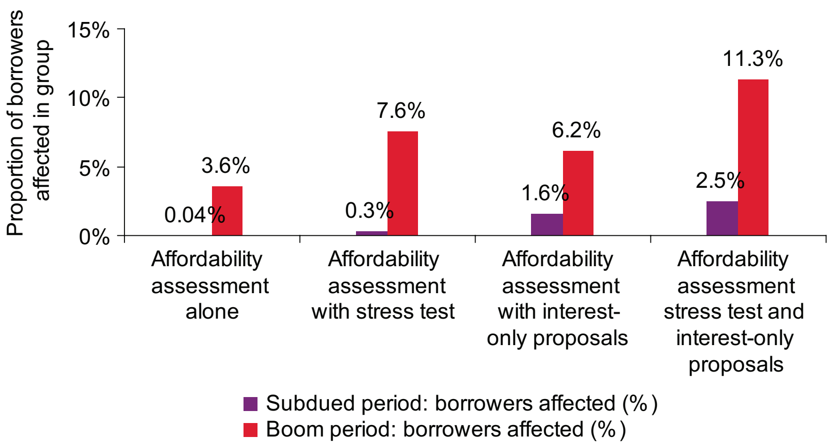
106. Here we would particularly value industry views on our estimates for the impacts of the interest-only proposals.

> Q101: **Do you have any comments on our estimates for the impacts of the interest-only proposals? Do you have any data and/or analyses that could be informative about these impacts?**

D. Combined impact of the responsible lending requirements on borrowers

107. Figure A4.23 presents our estimates of the combined impact on borrowers of the three responsible lending requirement together. As with the interest rate stress test and the interest-only proposals individually, we have used the DSR to estimate the combined impact i.e. we have estimated the proportion of borrowers who would have had their DSR pushed above 45% by the interest rate stress test and the interest-only proposals together.

Figure A4.23 – Proportion of borrowers affected by the responsible lending requirements.



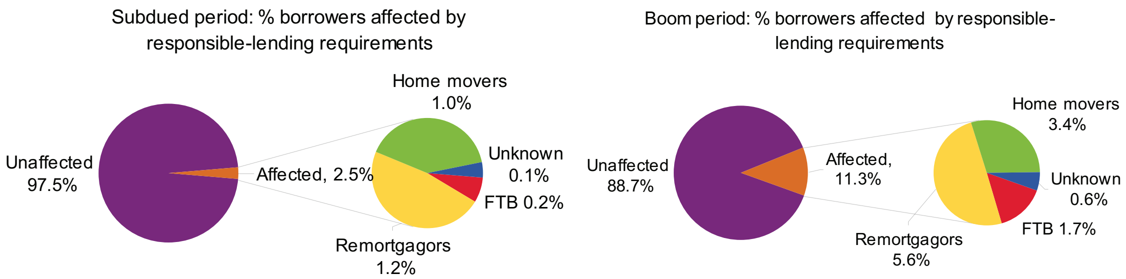
108. The combined impact of the three responsible lending requirements is – for our central estimate – that 2.5% of borrowers would have been affected in the subdued period. Using our range of DSR thresholds (50% and 40% respectively) we estimate that the combined impact would have been between 1.7% and 3.7% in the subdued period. In the boom period our central estimate for the borrowers affected is 11.3%, while our estimate for the range is between 7.8% and 17%.

109. The incremental impact of the interest rate stress test and interest-only proposals together (2.5% in subdued, 7.7 % in boom) is greater than the sum of their individual incremental impacts (1.8% in subdued, 6.6% in boom). This is due to the interest-only and interest rate stress tests proposals acting together to affect borrowers who would not be affected by either of the two proposals alone. For example, an interest-only borrower may pass an affordability assessment with the interest rate stress test, and may also pass an affordability assessment with the interest-only proposals, but not pass an affordability assessment where both the interest rate stress test and the interest-only proposals are applied.

110. These results also allow us to calculate the incremental impact of the interest-only proposals had these been added to the affordability assessment and the interest rate stress test in our sample period. It would have led to an additional 2.2% of borrowers being affected in the subdued period and an additional 3.7% being affected in the boom period.

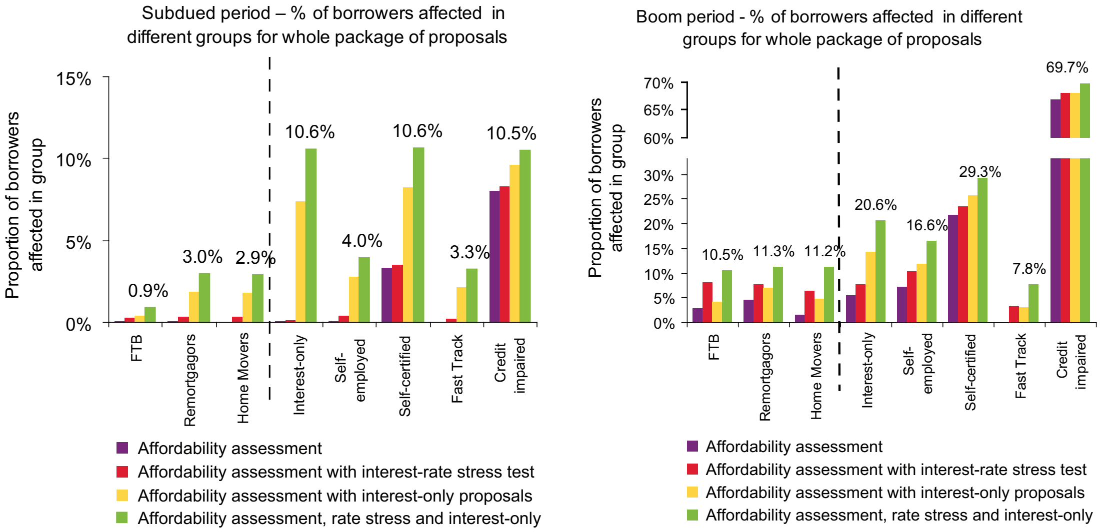
111. Figure A4.24 breaks down the combined impact of the responsible lending requirements between FTBs, remortgagors and home-movers (see Figure A4.7). In line with the previous break downs, remortgagors account for most of the impact, particularly in the boom period. Home-movers are also a significant part of the impact, while FTBs account for relatively little of the impact in both periods.

Figure A4.24 – Breakdown of borrowers affected by the responsible lending requirements



112. Figure A4.25 presents the proportion of borrowers that would have been affected in both the subdued and boom periods by the three responsible lending proposals together.

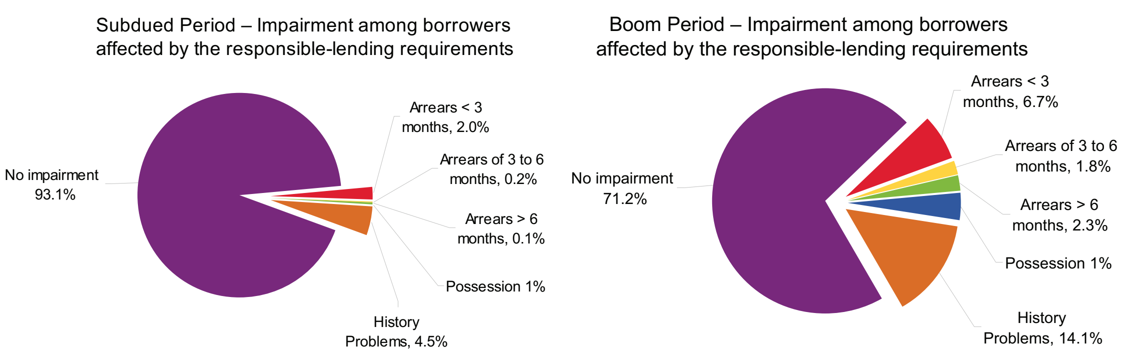
Figure A4.25 – Proportions affected in different borrower groups



113. In the subdued period, borrowers in all groups are highly unlikely to be affected. Even in the most affected groups, interest-only, self-certified and credit-impaired borrowers, only about 10% would be affected. In contrast, impacts in the boom period are much more significant. The higher risk groups, credit-impaired and self-certified borrowers, would be particularly affected, as would interest-only borrowers, which is intuitive given the interest-only requirements.

114. To complete our presentation of the impacts of the responsible lending requirements, we show the proportion of affected borrowers that our data set tells us experienced impairment. This gives us an indication of whether the responsible lending requirements, as modelled here, would have targeted those who actually faced some difficulties with their mortgage payments. Figure A4.26 presents this breakdown for both periods.

Figure A4.26 – Affected split by impairment experienced



115. These pie charts show that in the subdued period very few (~7%) of the borrowers who are modelled as affected by the responsible lending requirements actually faced mortgage impairment. In contrast, in the boom period, about 30% of the borrowers who are modelled as affected actually faced impairment in some form. Although, this may be appear to be a low 'hit rate', in the well-being section we use our estimates of the well-being effects to estimate that over the sample period the responsible lending requirements would be net-beneficial in well-being terms. The overall result is helped by the fact that the number of borrowers modelled as affected in the boom period, which enjoyed a higher hit rate, is much greater than the number affected in the subdued period when the hit rate was lower.

116. There are also two important caveats that are relevant to interpreting the impairment charts above:

- In the subdued period, mortgages have had relatively little time to go into impairment. Due to this, Figure A4.26 for the subdued period is likely to understate the impairment borrowers affected by the MMR might expect without the MMR.
- As mentioned earlier, our DSR method for modelling the interest rate stress test and the interest-only proposal picks out borrowers with higher-DSR mortgages as being the ones affected although – because of the weak association between DSR and impairment in our data – these borrowers do not tend to have correspondingly high levels of impairment. As a result, Figure A.26 is likely to understate the impairment that affected borrowers could expect to face without the responsible lending requirements.

117. Taken together, the two caveats suggest that in practice the MMR may well capture more high-impairment-risk borrowers than is indicated in Figure A4.26.

118. Here we would particularly value industry views on our estimates of the combined impact of the responsible lending requirements.

Q102: Do you have any comments on our estimates of the combined impacts of the responsible lending requirements? Do you have any data and/or analyses that could be informative about these impacts?

E. Other lending provisions

119. In this section we discuss the impacts of two further lending provisions. These are:

- the income verification proposal;
- the proposed transitional arrangements.

The impact of the income verification proposal

120. So far we have not explicitly discussed the income verification proposal which will require that income be verified by lenders or intermediaries. This will end self-certified borrowing.

121. In deciding how to model the income verification proposal, we considered simply assuming that none of the self-certified and fast-track mortgages in our data would have taken place under the MMR. However, we decided against this approach because:

- Most self-certified and fast-track borrowers are able to provide evidence of income but have not done so, for reasons such as convenience or speed. For example, they will have bank accounts or tax returns which would enable them to certify their income. In view of this we expect that only a small group of borrowers would have been significantly delayed in or prevented from borrowing by the income verification proposal.
- Some lenders that did not verify income had weaker underwriting standards, thus the impact of the income verification proposal should then be partly captured in the impacts presented for the other responsible lending requirements above since these seek to impose minimum underwriting risk standards.
- Self-certified borrowers who overstated income are likely to be higher risk and captured by our underwriting risk approach.

122. For all of these reasons, we assumed instead that self-certified borrowers who could afford their mortgage would have been able to have their income verified, while those self-certified borrowers who could not afford their mortgage, for example because they were using self-certification to inflate reported income, would be captured by our underwriting measure as a predictor of higher levels of subsequent impairment. This approach may not, of course, be entirely realistic, but we considered that it would give a much fairer view of the impacts than simply assuming self-certified borrowers would have been prevented from borrowing.

123. Given this, the impacts presented for the affordability rule with the interest rate stress and interest-only proposals should be read as including the income verification proposals.

Transitional arrangements

124. The impacts of the affordability proposals will also depend on the transitional arrangements to be put in place to allow lenders to waive the MMR responsible lending requirements for borrowers that want to remortgage, but do not meet the MMR responsible lending requirements. The transitional arrangements apply when borrowers do not increase the mortgage amount and have a good payment history. The intention of the transitional arrangements is to help existing borrowers who may become ‘trapped’ with their lender due to the new MMR rules because they are not able to re-mortgage.

125. As discussed in Chapter 3 of the CP, the transitional arrangements are ‘enabling’ provisions, which allow lenders to waive the new lending standards if they choose to do so. In practice

this means that lenders will only make re-mortgage offers to borrowers where this is compatible with the lender's risk appetite. This also means that it is not straightforward to quantify how many borrowers will benefit from the transitional arrangements. It will depend on:

a. Market conditions – transitional arrangements are unlikely to have an impact under current market conditions because of tight lending standards in the market and low interest rates. The impact when the market recovers in the future is unclear because of the interaction with capital requirements and the 'enabling' nature of the transitional arrangements.

b. The extent to which competition between lenders will enable remortgagors not meeting the new MMR responsible lending requirements to switch to another lender.

126. The main benefit of the transitional arrangements will be that some existing borrowers will be able to re-mortgage when otherwise the new MMR rules would have unfairly (since the proposals are being introduced after they have committed to a mortgage) prevented them from doing so. This will reduce the impact of the MMR, and as a result **both** its costs and benefits. However, as the arrangements are transitional these mitigating effects will be transitory. One potential cost is that these borrowers could become concentrated in a small number of lenders, whose failure would then be costly for these borrowers.

127. In conclusion, because of the conditions for borrowers to be eligible and the fact that lenders may choose not to offer loans under the transitional arrangements, we expect the impacts of the transitionals to be small. We do not think that adjusting our analysis to take the transitionals explicitly into account would have led to material changes to our estimated impacts of the responsible lending proposals.

F. Other issues relevant to the impacts of the responsible lending requirements and the other lending provisions

128. In this section we discuss two issues that are relevant to the impacts that the responsible lending requirements will have. These are:

- how future impacts may differ from the historical impacts presented above; and
- how the impacts depend on the effectiveness of the requirements.

How future MMR impacts may differ from the impacts above

129. Our analysis of lending impacts was historical; we modelled the impact of the MMR affordability proposals had they been in place from 2005 to 2010. A natural question is whether these impacts are a fair indication of the future impacts of the MMR. Here there are two issues to consider. First, whether future market conditions will be drastically

different from those of the time period we have used. Second, whether other regulatory changes will affect the impacts of the MMR. Also, future regulatory changes may change future market conditions.

130. On market conditions, the period 2005 to 2010 included a pre-crisis period where lending standards were very relaxed, and a subsequent period with drastic tightening of lending standards. The first part of the period (2005 to 2007) was also one where wholesale funding was readily available and cheap. The crisis has shown serious problems with certain wholesale funding markets i.e. where apparently low risk mortgage-backed securities turned out to be much higher risk than they appeared to be when they were first sold. The securitisation markets may well be markedly different in future periods, perhaps with mortgage lenders finding it more expensive to fund mortgage lending from wholesale markets. If this is correct, then lending criteria are likely to be more restrained or margins higher in a future boom period than was the case in 2005 to 2007. If so, the MMR would be likely to have more moderate impacts in boom periods than presented here.

131. There has been a wide range of regulatory changes introduced since the crisis. The most significant have been changes to improve micro and macro prudential regulation. In microprudential regulation, the ongoing introduction of the 'Basel III' policies to strengthen systemically important financial institutions has already led banks to increase their capital levels significantly. Independently of the MMR, this will lead deposit-taking mortgage lenders to moderate their lending. Given the improved risk-weighted capital regime, lending is also likely to fall more for higher-risk borrowers. For this reason, we expect these changes to lead to lower lending impacts of the MMR, relative to the historical estimates presented in the previous sections.

132. Similarly, there have been important macroprudential regulatory changes. The creation of the Financial Policy Committee (FPC), which has been given the task of managing financial stability, is likely to affect the mortgage market in the future. As financial stability is largely determined by booms and busts in the housing market, the FPC is likely to introduce policies to prevent the housing market from overheating. These will also reduce lending to higher-risk borrowers, further reducing the impacts the MMR would have in practice.[31]

133. Taken together, these changes make it likely that lending in future boom periods will be constrained as compared with the last boom. The incremental impacts of the MMR <u>itself</u> are expected to be reduced accordingly.

The effectiveness of the proposed requirements (possibility of gaming)

134. As with any regulation, the effectiveness of the MMR proposals and the size of the impacts it has on lending, will depend on firms' incentives to comply with it. This depends on the substance of the regulation, how it will affect market conditions (including, for example,

31 This and the Basel III changes may suggest that MMR is not required because other ongoing regulatory changes would be sufficient to prevent unaffordable borrowing. It is our view that this is not so and that there is a strong case for the MMR. See Chapter 8 in the CP for the detailed discussion of the impact of Basel III.

firms' ability to pass the incremental costs on to their customers), and the supervisory, and enforcement mechanisms put in place to ensure compliance.

135. Oxera's analysis from CP10/16 indicates that the then proposed rules did not materially change the incentives of lenders, those of intermediaries or the dynamics of competition. Lenders will 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 with the most relaxed lending criteria. Lenders also still have an incentive to offer mortgages to those who would fail any fully-compliant affordability test if it is still profitable to sell mortgages to these borrowers as a group, taking into account any regulatory costs that might result from making these non-compliant loans.

136. The extent of non-compliance will depend 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 the potential consequences of non-compliance to lenders. 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.

G. Quantity of lending impacts and their macroeconomic effects

137. As we have shown in our analysis above, the proportion of borrowers affected by the MMR responsible lending requirements is potentially significant, particularly during a boom period in the housing market. Given this, an important question is what impact this would have on the value of lending and what macroeconomic impacts, costs and benefits this may bring about. In this section we present how we estimate our lending impact and what those estimates are. We then discuss the macroeconomic impacts arising from these lending impacts.

Impacts on lending

138. To estimate the impacts of the MMR on lending it is important to distinguish the different impacts it will have on FTBs, home-movers and remortgagors.

- *First-time buyers (FTBs)* are different from home-movers and remortgagors because they do not have an existing mortgage. FTBs may either get a smaller mortgage or delay their property purchase. If a FTB has to get a smaller mortgage because of the MMR then they will only reduce what they can borrow up to a point where they can no longer buy a suitable property for them. Beyond this point, they will not take out a mortgage. For those FTBs who do not take out a mortgage because of the MMR, the amount they would have borrowed without the MMR is the reduction in lending.

- *Home movers* may be unable to move or only be able to move to a less desired property. Those that do not move will keep their existing mortgages. In this case the impact on lending is the lost additional lending (i.e. the difference between a new mortgage not granted and the existing mortgage).
- *Remortgagors* who are unable to remortgage under the MMR will keep their existing mortgage. Where such a borrower wanted to remortgage for a better price deal only, there is no impact on the overall amount of lending. Where the borrower wanted to withdraw equity, the impact on lending is the lost additional lending.

139. For FTBs, we calculated by how much they would need to reduce their mortgage by to make it compliant with the responsible lending requirements.[32] If this reduction was greater than 30%, it was assumed that the FTB would not accept the mortgage because it would no longer meet their needs. This 30% level was chosen, in the absence of relevant data, using a judgement about what might be the maximum reduction a FTB could on average accept without pulling out of home purchase altogether.[33] In this context, we note that one of the results of our macroeconomic analysis is that the cumulative reduction in demand for housing resulting from the MMR is not so large as to have very significant impacts on house prices.

140. For home-movers and remortgagors, we first estimated the average additional lending for these borrowers, that is the additional lending taken on by a home-mover when they move their home, or by a remortgagor when they switch mortgages.[34] We then assumed that home-movers or remortgagors affected by the MMR would have either kept their current mortgage or obtained a mortgage of the same size as their current mortgage. So our estimate of the impact on lending from affected remortgagors or home-movers is the lost average additional lending from this type of borrower.[35]

141. Figure A4.27 presents the lending impacts for the different responsible lending requirements; it also reproduces the corresponding affected borrowers for comparison.

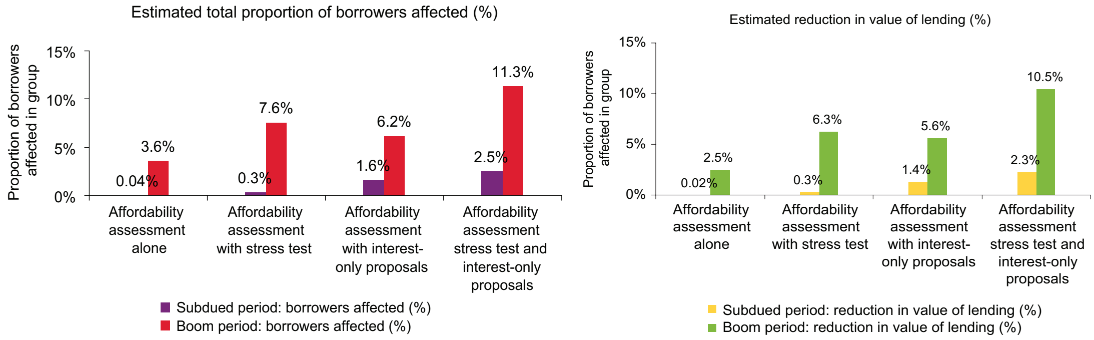
32 To calculate the reduction we used an average underwriting-risk score vs. DSR relationship to calculate by how much a FTB would have to reduce a mortgage to become compliant with the affordability assessment (i.e. to reduce their underwriting risk score to the 0.4 threshold). For the interest rate stress and the interest-only proposals we calculated how much their mortgage would have to shrink for the DSR to be within the threshold (45%).

33 Though the choice of 30% maximum reduction was based on a judgement, we thought this was a better choice than making an extreme assumption, e.g. that a first-time buyer with any reduction would not take out their mortgage, or that a first-time buyer could reduce mortgage by any amount, as these alternatives are clearly highly unrealistic and would lead to significant overestimation or underestimation of the impacts on lending from affected first-time buyers.

34 For home-movers, this average additional lending figure was estimated at 40%. This is based on comparing the average size of mortgages for all borrowers in 2005 with the average mortgage size of home-movers in 2010, both as recorded in the PSD. This five-year gap was chosen because it is the closest we could get to the average life of a mortgage (which is about six years) in our data. For remortgagors, our average additional lending figure estimate was 20%, based on our Mortgage Lenders and Administrator's Return (MLAR) data which provide information on flows of new mortgage lending.

35 This overestimates the impacts on lending from these borrowers somewhat, since it excludes the additional lending that would still go through when home-movers and remortgagors obtain a smaller mortgage under the MMR than they would like, but which is greater than their current mortgage. Nevertheless, we chose this approach because it was simpler than the alternatives, which would have required complex modelling and numerous judgements that would have not had a firm basis in data available to us.

Figure A4.27 – Borrower and lending impacts of the responsible lending requirements



142. The lending impacts mirror the borrower impacts, but are slightly lower. This is to be expected given the simple method used to calculate the lending impacts. For home movers and remortgagors impacted by the MMR, we deduct all of the additional lending that would have been made to these borrowers without the MMR. Therefore, in these cases, the lending impacts are similar to the borrower impacts. The lower figures for lending impacts compared to borrower impacts come from some FTBs obtaining smaller mortgages under the MMR.

143. The lending impacts for the responsible lending requirements together are a 2.5% reduction in lending in the subdued period and 10.5% in the boom period. When averaged to construct an estimate for the lending impact over the cycle (which we use for our macroeconomic analysis) we obtain a reduction in lending of 8.7%.[36]

144. Tables A4.4 and A4.5 provide further information on the lending impacts. In particular, they show how many mortgages would have been reduced in size and how many would have been delayed by the responsible lending requirements. We do not know the duration of these delays and treat them as indefinite. So we may be overestimating the costs of the MMR. The results in Table A4.5 are used in our well-being analysis section.

Table A4.4 – Number of mortgages reduced or delayed for FTBs, home-movers and remortgagors

		FTB	Home Movers	Remortgagors
Subdued period	Reduced in size	3300	-*	-*
	Delayed	1600	15900	17700
Boom period	Reduced in size	89000	-*	-*
	Delayed	55000	201000	349000

* As explained in paragraph A4.132, we model all affected home-movers and remortgagors as being delayed in their borrowing.
Note: Numbers in the table have been rounded.

36 The lending impact over the cycle is close to the boom period impact, as the average is weighted and lending levels were high in the boom period compared to the subdued period.

Table A4.5 – Number of mortgages reduced or delayed for impaired vs. not-impaired

		Impaired	Not impaired
Subdued period	Reduced in size	200	3100
	Delayed	2500	32800
Boom period	Reduced in size	17000	72000
	Delayed	183000	422000
Sample period (boom and subdued)	Reduced in size	17200	75100
	Delayed	185500	454800
	TOTAL (to nearest 1000)	203000	530000

Numbers have been rounded

145. Here we would particularly value industry views on our estimates for the lending impacts of the responsible lending requirements.

Q103: Do you have any comments on our estimates for the lending impacts of the responsible lending requirements? Do you have any data and/or analyses that could be informative towards estimating these impacts?

Macroeconomic effects

146. We use the National Institute for Economic and Social Research's (NIESR) NiGEM model to calculate the macroeconomic impacts of the MMR. We assess the macroeconomic impacts relative to a base case which takes account of changes to prudential regulation. This separates the impacts of the MMR from the impacts of prudential regulation.[37]

147. The base case assumes that growth recovers in 2013 to a rate of 2½% with inflation of 2% and nominal house price growth of 3½%. Lending growth recovers slowly to an annual growth of 4½% by 2018 and household liabilities as a percentage of GDP rise steadily from 85% to 90% between 2017 and 2025. We accept that short-run economic projections have become gloomier since we did our modelling but these make little difference to the long-run projections.

148. As explained in paragraph A4.143, we estimate the impact of the MMR on mortgage lending to be a decrease of 8.7% over the cycle. We have therefore analysed the macroeconomic impact of this reduction in mortgage lending compared to the base case.

149. The main effect of the MMR on the macroeconomy arises as banks redirect funds away from mortgage lending to corporate lending and to other household lending. This has short-term and long-term impacts on GDP:

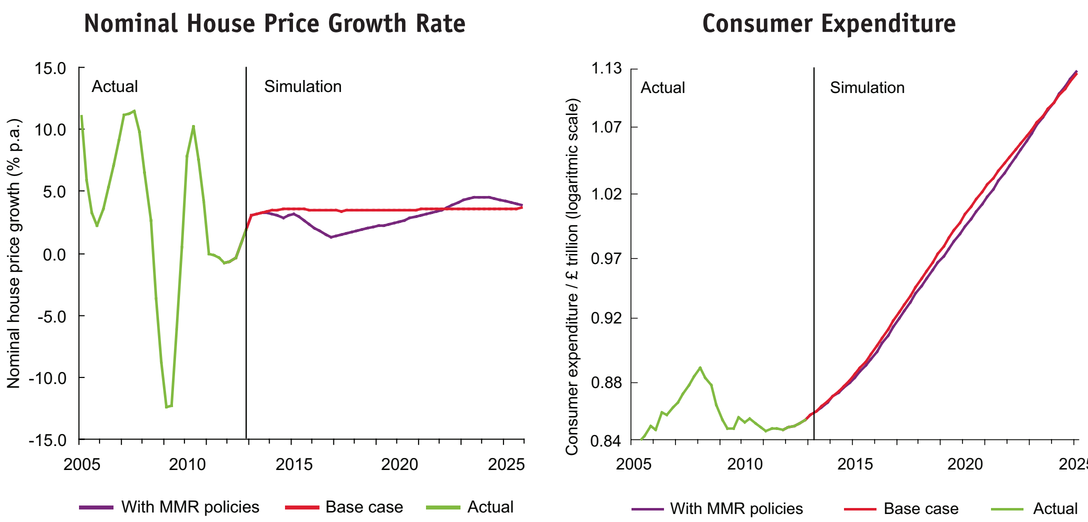
37 The base case includes the Basel III proposals following the 16 December 2010 agreements.

- In the short term there is a small negative effect on GDP through lower demand for housing and lower household consumption.
- In the long term the redirection to corporate lending has a positive impact on GDP through an increase in investment.

150. In the short term the reduction in lending to households[38] reduces the demand for housing. Lower demand for housing lowers house price growth, reducing households' expectations of capital gains from investing in owning a home. Table A4.6 shows annual house price growth. In the short to medium term (up to about eight years after implementation of the MMR) house price growth will be lower relative to house price growth without the MMR. House price growth decreases by a maximum of about 2% per annum about four years after implementation. Overall, if house price growth would have been 34% over the years 2014 to 2022 without the MMR, we estimate that it would be 23% with the MMR.

151. In response to the expected reduction in investment returns, households increase their savings and reduce general spending levels. Households rapidly implement the changes to their savings decision and this has an immediate impact on aggregate consumer expenditure; this is shown in Table A4.6.

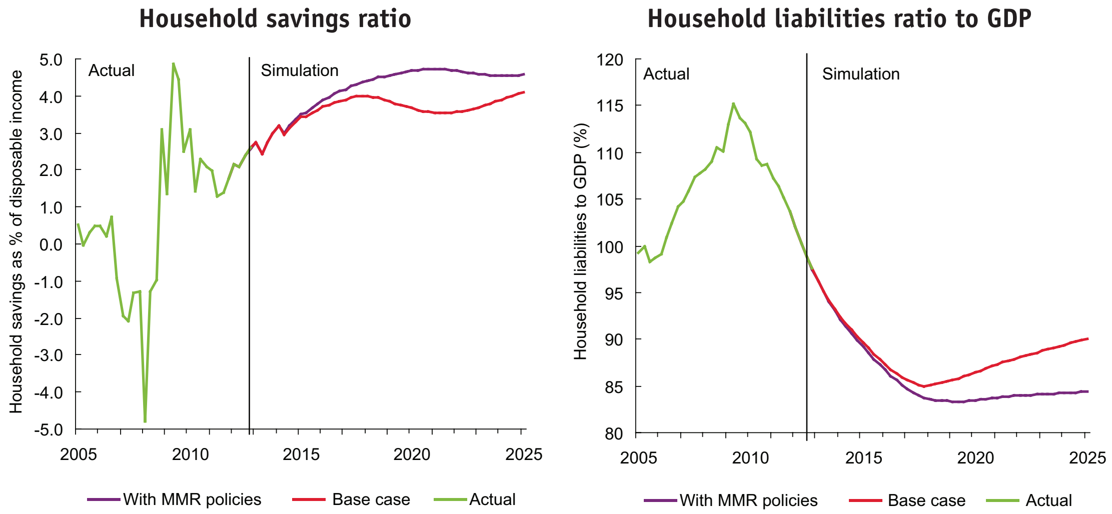
Table A4.6 – Macroeconomics effects of MMR (1)



152. Reduced levels of consumer activity lead to a higher savings ratio and lower household liabilities. Table A4.7 shows these effects. As this is likely to have a dampening effect on inflation in the long run, it is assumed in the NiGEM model that the Bank of England's bank rate (and so interest rates generally in the economy) is lower than it would otherwise be over that period. This offsets to some extent the short-term reduction in consumer expenditure.

38 We have applied the average reduction of mortgage lending over the whole business cycle (i.e. 8.7%) to this base case scenario.

Table A4.7 – Macroeconomic effects of MMR (2)



153. As mortgage lending is reduced, banks find themselves with a surplus of funds (liabilities) that they need to repay or reinvest in other sectors. Banks redirect some of these funds to other sectors, primarily as unsecured loans to households and corporate lending. Lending to these sectors is also supported by the lower bank rate. The additional lending to the corporate sector increases business investment which, over time, adds to productive capacity in the economy and increases GDP. In the longer term, the addition to the economy's productive capacity more than offsets the initial negative impact of the MMR on consumption.

154. We estimate the long-term impact on GDP to be an annualised increase of approximately £1/3bn per year. In the short-term there will be a small fall. The maximum fall is approximately £3bn or 0.2% of GDP seven years after implementation of the MMR.

155. The impact of the MMR on the UK economy is small but depends to some extent on the assumptions we make about prevailing conditions in the economy and the mortgage market as the policy is introduced. We measure the macroeconomic impacts of the MMR relative to a base case which assumes slow economic recovery emerging in 2013 and the return of relatively benign macroeconomic conditions by 2014.

156. For as long as the economy continues scarcely to grow, with subdued conditions persisting in the housing market, the macroeconomic impact of the MMR is likely to be trivial. On the other hand, if the MMR is implemented in boom conditions the impact will be larger because a relatively large amount of household lending is curtailed in the first instance.

H. Well-being impacts

157. The MMR will have impacts on consumer well-being. In this section we present our estimates of the well-being effects due to the responsible lending requirements.

158. It is important to be clear about what we mean by well-being to avoid confusion with the economic concept of welfare. These are different concepts:

- In classical economics, *welfare* is concerned with consumers obtaining what they most prefer. Welfare benefits arise when consumers obtain a more-preferred option; welfare costs arise when consumers are constrained to accept a less-preferred option. Regulation can improve consumer welfare by providing important information that consumers otherwise lack, enabling them to make choices more in line with their preferences (taking into account both quality and price).
- *Well-being* is concerned with consumers' psychological state. It is typically measured on the basis of reports by the consumers themselves. For example, consumers who have a mortgage that they can easily afford are likely to have greater well-being than consumers who have fallen behind with their mortgage payments.

159. The evaluation of the responsible-lending requirements will differ depending on the concept used. If one evaluates using welfare then the responsible lending requirements will be more net beneficial the more they help consumers to obtain, and the less they hinder consumers from obtaining, what they prefer.

160. In contrast, with well-being, the responsible lending requirements will be more net beneficial the more they lead to consumers reporting increased satisfaction. For example, this may happen because consumers avoid mortgage payment problems (the main driver of psychological distress in our analysis). On the other hand, to the extent that the MMR prevents consumers from living in, for example, a larger property or an owned rather than rented property, it will reduce well-being.[39]

161. In the next subsection we briefly discuss the welfare effects of the responsible lending requirements. We also briefly explain why we have not estimated these and adopted instead an alternative approach that estimates well-being. The subsequent sections set out our analysis of these well-being impacts.

The responsible lending requirements and welfare

162. Before presenting our estimates of the well-being impacts of the responsible lending requirements, we first briefly consider in qualitative terms what welfare impacts (in the classical economic sense) the MMR responsible lending requirements might have.

39 These two concepts may overlap more or less depending on the borrower. Where borrowers tend to prefer mortgages that maximise their psychological well-being, the more the well-being and welfare evaluations would be similar. However, for some borrowers welfare and well-being may diverge. Risk-loving borrowers, for example, may truly prefer to take out high-risk mortgages although they may experience significant psychological distress from subsequent payment problems. Similarly, some risk-averse borrowers may prefer more affordable mortgages than the ones they obtain even when these mortgages are already affordable and unlikely to lead to psychological distress.

163. Since a well-functioning mortgage market should ensure that consumers obtain what they prefer, welfare benefits will arise in relation to the mortgage market from the responsible lending requirements to the extent that they reduce the market failures discussed in Chapter A3. In particular, welfare benefits will arise to the extent that the responsible lending requirements help borrowers who, because of information asymmetries (e.g. being less informed than lenders about their true risk of impairment) or behavioural biases (e.g. over-optimism, overly discounting the future), borrow more than they (on reflection) would ideally like. For these borrowers, the responsible lending requirements should improve their welfare if they are pushed to choose a more affordable mortgage (or to delay borrowing) and this better reflects the preferences they would have if they were well-informed and/or not subject to behavioural biases. Part of the reason for expecting the responsible lending requirements to be welfare-enhancing then is that we expect that most borrowers would prefer to borrow affordably, i.e. to limit the risk of impairment that they take on, and that the responsible lending requirements will help many borrowers to do this better.

164. In contrast there is no market failure when borrowers choose their preferred mortgage when they operate in an informed way that reflects their self-interest. Any constraint imposed on their choice by the responsible lending requirements is likely to be welfare-destructive.

165. Indirect welfare costs and benefits will also arise from the impacts the responsible lending requirements will have on borrowers generally (e.g. from the higher prices that result when compliance costs are passed through to consumers, or the impacts on households from the macroeconomic impacts of the responsible lending requirements).

166. In this case, the conventional approach to measuring impacts on welfare would require estimation of the demand and supply for mortgages to enable us to isolate the welfare effect from restricting mortgage demand as a result of the MMR. However, this approach is not ideal because a key market failure in the mortgage market is that some borrowers choose what they do not truly prefer because of behavioural biases, and this would be reflected in the demand curves.

167. To allow for behavioural biases we would need the borrower's 'true preference' demand curve, which is not manifested in the data we have. Conversely, if we were simply to model welfare effects using the observed demand curve we would be likely to underestimate significantly the benefits of the MMR (since we would capture constraints on rational consumers, but not the benefits to consumers subject to behavioural biases).

168. Because of this difficulty, we decided instead to analyse the impacts of the MMR on well-being. This approach allows us to use available data. It also captures benefits to individuals that would be difficult to capture with the classical welfare approach, for example, the benefit from reduced psychological detriment from reduced arrears.

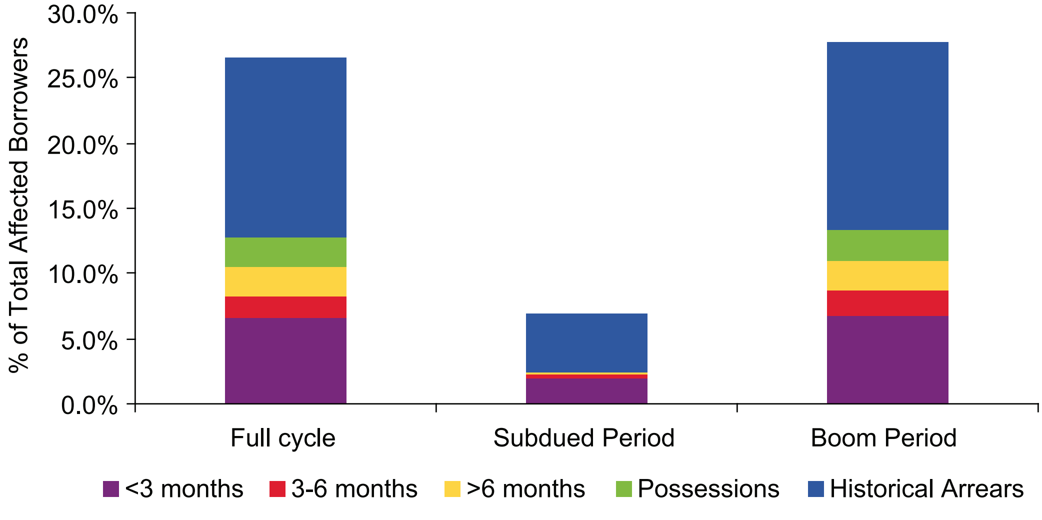
The responsible lending requirements and well-being

169. Restricting access to mortgages which are assessed as being unaffordable will have both positive and negative effects on well-being.

170. The positive effect is that some people will avoid repayment difficulties, arrears, or repossessions on the mortgages they would otherwise have taken out. There are differing degrees of stress which we need to take into account, and these are associated with different levels of mortgage impairment. From our data, we can identify borrowers currently in arrears and/or who have been repossessed. We can also identify those who have been in arrears in the past but who have since moved out of arrears: these are called 'historical arrears'.

171. Figure A4.28 presents a breakdown of these different types of mortgage impairment for all mortgages in our data set. The relative proportion of impairment types is quite stable across the boom and subdued periods. In both periods the largest share of impairment is historical arrears.[40] Arrears with duration shorter than three months are the second largest category.

Figure A4.28 – Cascade of harm for borrowers affected by responsible lending requirements



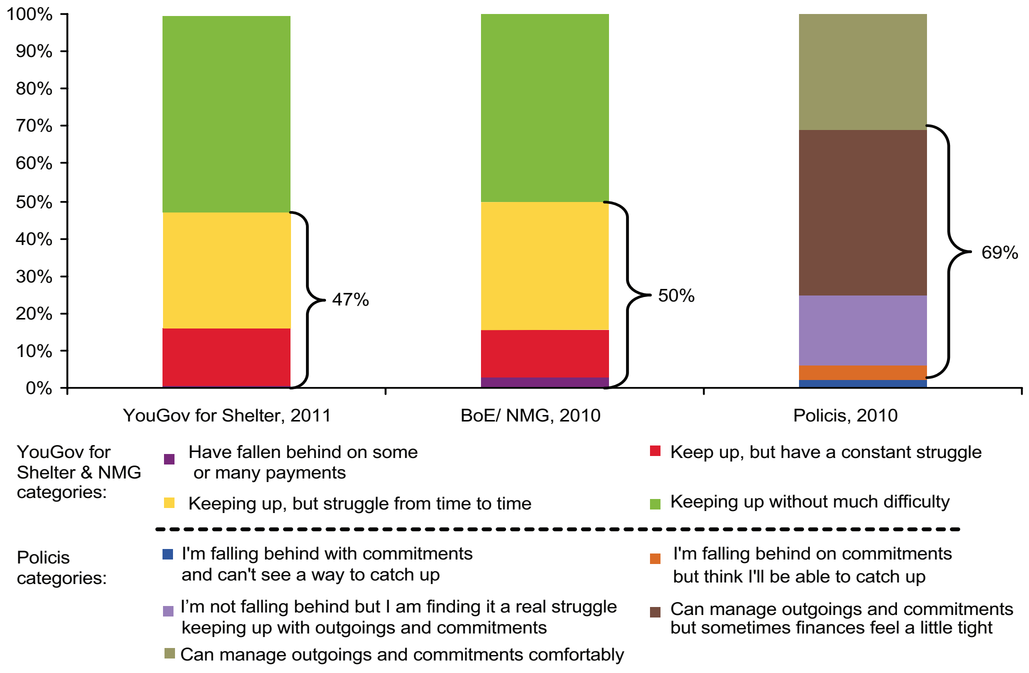
Source: PSD

172. The breakdown of mortgage impairment above does not include those borrowers who have had payment difficulties but did not fail to make their payments as they fell due, as such payment difficulties are not recorded in our data set. However, the 2011 *Annual Housing Survey* by YouGov for Shelter indicates, for example, that in the past year 47% of borrowers have been struggling to pay their mortgages at least from time to time, with

40 The way historical arrears are reported in the dataset is such that their duration is unknown. It is known that contracts showing historical arrears were either in arrears that have subsequently been cleared or were subject to some form of forbearance.

16% constantly struggling or falling behind[41]. Figure A4.29 presents the results of three surveys on mortgage payment problems.

Figure A4.29 – Extent to which mortgage borrowers are struggling with their payments



Source: BoE/NMG, Policis, YouGov online surveys for Shelter (GB representative, 2,065 responders, April 2011), FSA analysis

173. A <u>negative effect</u> of the MMR is that some people who in practice would have been able to afford the mortgage they would have taken out if the MMR had not been in place, some of whom will be prevented from taking their desired mortgage as a result of failing the affordability assessment required by the MMR. Moreover, some of these would have been willing and able to deal with high repayment burdens without much stress.

174. Our previous analysis in sections A, B and C (i.e. the impacts of the affordability assessment, interest rate stress test, and interest-only proposals) gives us an estimate of the proportion of borrowers whose access to mortgages would be restricted by the MMR. Here we also identify from the PSD how many of the borrowers who would have been affected by the MMR actually experienced some type of mortgage impairment. We identify that over our sample period up to about 30% of the borrowers identified as impacted by the affordability assessment through our methodology experienced impairment. The other 70% did not. The fact that only a minority of borrowers who would have been affected experienced impairment is in large part due to the nature of the mortgage market over our sample

41 Consumers who actually fall behind in their payments are likely to be captured in our PSD.

period, when the level of impairment was low. Almost any quantitative rule – unless it could target those borrowers who would face impairment very precisely – would be likely to affect more borrowers who do not become impaired than borrowers who do.

175. This means that from our data set we have a balance between:

- the c.200,000 consumers who in the sample period experienced different degrees of impairment but who would have been protected from the distress arising from this had the MMR been in place; and
- the c.530,000 consumers who would have been affected by the MMR but who did not experience impairment. Of these about 75,000 would obtain a smaller mortgage while the rest would be pushed to delay their borrowing.[42]

176. Deciding what relative weight to put on these positives and negatives is inherently highly uncertain. To a significant extent, therefore, the decision on whether to proceed with the approved rules has to be based on social and political judgements rather than any precise quantification. However, we think it important to attempt to quantify this trade-off as best possible. We have done this by developing an analysis of borrowers' psychological well-being, based on extensive survey data reported by consumers. We use this to estimate:

- the well-being benefit of the MMR in preventing the emotional distress from unaffordable lending;
- the well-being cost to those borrowers whose home-ownership will be delayed; and
- the well-being cost to those borrowers who will get a smaller mortgage.

177. We apply these well-being costs and benefits to the borrowers affected by the MMR identified in our previous analysis and thereby estimate the aggregate well-being impact of the MMR.

178. The Executive and Board of the FSA have reached the judgement that the benefits enjoyed by the c.30% of affected borrowers who would otherwise get into payment difficulties outweigh the costs suffered by the 70% affected who would not have got into payment difficulties. This reflects the strong evidence of very significant stress caused by arrears and repossessions. In response to the consultation, we would welcome views from interested parties on whether this balance between winners and losers is acceptable.

Q104: Do you have any views on whether this balance between winners and losers is acceptable, given the importance of the protection obtained by the winners?

42 We do not know for how long borrowing would be delayed and this is an important caveat to our analysis. In our analysis, we do not treat any of those who do not borrow as borrowing later. It is therefore likely that over the long run we are over-estimating the impacts of the MMR on lending volumes in the market. The benefits of preventing borrowing when it is unaffordable are, however, unaffected by this.

179. No amount of quantification would remove the need to make such a judgement. We illustrate, however, our quantification of the trade-off. This should not be interpreted as providing a precise measure of well-being effects, but rather as supporting some reasonable assumptions about the relative weight attached to different positive and negative effects, and illustrating that such relative weights might support different judgements.

1. Methodology

180. To estimate these well-being impacts we use an empirical framework that is well-established in the academic literature to study the determinants of reported well-being.[43]

181. The data we use is collected within the British Households Panel Survey (BHPS). This data provides information on individuals and households from 1991 to 2008. The sample was chosen in 1991 to provide a representative picture of the population of Great Britain living in private households. One of the major advantages of the BHPS is that the annual questionnaire contains a wide range of information on reported psychological well-being, household income and finances, savings behaviour, job and employer characteristics, housing tenure and conditions, household composition, education profiles and other relevant factors.

182. The aim of our analysis is to measure by how much, on average, the level of well-being reported by interviewed households in the BHPS changes (increases or decreases) as a consequence of:

- being a tenant rather than being an owner with a mortgage of a given property;
- living in a less desirable property; and
- experiencing mortgage payment problems and/or mortgage arrears (and, ideally, repossession).

183. In our analysis the level of well-being reported by households is modelled in terms of:

- reported problems with mortgage payments;
- reported arrears events;
- reported level of satisfaction with the property;
- reported tenure (either tenancy or ownership with mortgage);
- reported number of problems encountered with material conditions of the property;
- a set of individual specific economic, financial and personal and household related characteristics; and
- the specific year in which the well-being interviews take place.

43 Our approach is based on Taylor et al. (2006): The Psychological Costs of Unsustainable Housing Commitments. Other academic works, focusing on different determinants of reported well-being, share the same econometric framework.

184. Our analysis controls for financial and household-related characteristics to avoid misleading well-being estimates.[44] For example, it would be erroneous to assume that households' well-being, overall, is only affected by housing-finance related factors. Obviously the level of well-being reported every year by individuals is affected by their level of income, their financial conditions, their job market status, by whether they are married, single or divorced, the number of children they have, etc. We also include a year-specific factor so that the variations in reported well-being due to year-specific historical events and factors are not misinterpreted as actually being driven and determined by the housing-related factors of interest to us.

185. We define and construct each relevant variable for our analysis following the information provided in the BHPS:

- Psychological well-being index: this is our measure of household psychological wellbeing. This index is the GHQ12 score in the BHPS, a measure of psychological distress that is widely recognised as being reliable.[45]
- Payment problems: in each year, each head of household is asked: In the last 12 months, would you say you have had any difficulties paying for your accommodation? In the BHPS, payment problems include all instances of arrears. We subtract the number of households who are in arrears from this measure to calculate the number of households who have payment problems only. So by "payment problems" we mean payment problems not amounting to arrears.
- Arrears: in each year, each head of household is asked: In the last 12 months, have you ever found yourself more than two months behind with your rent/mortgage?[46] This allows us to identify the occurrence of arrears in mortgage payments.
- Repossession: the BHPS asks those heads of household that have declared changes in their address from the previous year their reason for doing so. This allows us to identify those who have experienced repossession.
- Tenure premium: each head of household is asked, every year, if the occupied accommodation is rented, owned with a mortgage or owned outright.
- Satisfaction with accommodation: in each year heads of households are asked to report how satisfied they are with the accommodation they are currently occupying. This information is used to construct an index of satisfaction with the property.
- Other characteristics: information contained in several BHPS questions is used to construct variables that may also affect well-being. These are: age, monthly income, position in income distribution, savings behaviour, employment status, self-employment,

44 The data available to us and the way in which the data are generated limit the extent to which we can control for certain factors.
45 This measure provides the total score (0-36) reported by each respondent over 12 well-being questions, each scaled from 0 to 3, running from Not at all/Much less than usual (coded 0) to Much more than usual / Better than usual. Added together they create an index of mental distress raging from 0 to 36, high scores representing low feelings of well being (high distress) and vice-versa.
46 So, for example, if a borrower is two months and a day late in a payment, they would count as being in arrears.

part-time employment, duration of employment, duration of unemployment, marital condition (separated, divorced, widowed), number of children, type of accommodation (detached, semi-detached, terraced flat etc.), mortgage payments amount, and number of technical problems associated with the accommodation.

186. Since we are dealing with self-reported well-being indicators we use specific estimation techniques[47] to take account of unobservable individual characteristics that might be affecting reported well-being, e.g. constant characteristics such as individual personality traits. Our estimated well-being impacts therefore show how much better-off or worse-off individuals are as a result of housing-related events, relative to their usual (average) well-being. The estimated well-being coefficients, which are statistically significant, represent the well-being gain/loss that, averaging over the years included in the sample (1996 to 2008) and over the households selected in the BHPS, is found to be associated with being a renter instead of an owner, being in arrears instead of not being in arrears, etc. We see different results for those who suffer payment problems not amounting to arrears and for those who suffer arrears, and for those who are restricted from owning and for those who would get a smaller mortgage.

187. Our well-being analysis is static and uses an approach well-established in the academic literature. Our estimates are therefore point-in time estimates of the relevant event (e.g. being homeowner, being in arrears, etc). This analysis does not tell us how well-being varies over time; as a result we might be overestimating or underestimating the well-being costs and benefits.[48]

2. Results

188. The main results of our regression analysis, which is based on the BHPS survey, are:

- For remortgagors and home movers affected by the MMR who experience payment problems (not amounting to arrears) we observe a well-being gain approximately three times larger than the well-being loss they suffer from forgoing improved quality of their properties. The impact on their net well-being is therefore positive.
- For FTBs affected by the MMR who experience arrears we observe a well-being gain approximately over three times larger than the well-being loss they suffer from not being home owners. The impact on their net well being is therefore positive.

47 As in Taylor M., Pevalin D. and J. Todd (2006), 'The Psychological Costs of Unsustainable Housing Commitments', *ISER Working Paper*, we use what is called a Fixed Effects Within-Group Panel Estimator which redefines variables as the differences from their individual-specific means.

48 The academic literature on well-being shows that individuals tend to become used to being in a particular state, so for events that last for a long period there is a reduced impact on well-being as the event continues. For home ownership, which is a long term event, this implies that being deprived of (or delayed in acquiring) home ownership would not have a much greater well-being impact over time relative to the short-term impact of becoming a home owner. Similarly with arrears – the first exposure to arrears would have a large negative impact on well-being, but subsequent spells should have less dramatic effects. On the academic literature on adaptation dynamics in well-being see the literature pioneered by Amartya Sen, 1999: Development as Freedom, Oxford, Oxford University Press. For a more recent contribution on adaptation and life events see: Clark, A. E., Diener, E., Georgellis, Y. and Lucas, R. E., 2008, Lags and Leads in life satisfaction: a test of the baseline hypothesis, The Economic Journal 118 (June), F222-F243

- For remortgagors and home movers affected by the MMR who experience arrears we observe a well-being gain approximately six times larger than the well-being loss they suffer from forgoing improved quality of their properties. The impact on their net well being is therefore positive.
- For those FTBs who would have been delayed in purchasing their own home by the MMR but who in practice did not report any form of mortgage payment problem we observe a well-being loss approximately twice the size of the well-being loss of remortgagors and home-movers who are affected by the MMR and do not experience any payment problems. This is because the detriment associated with being prevented from becoming a home owner for the first time is found to be larger than the detriment associated with being prevented from remortgaging or moving to a better property.
- The regression is not statistically significant for repossession (and we ignore the results). This is likely to be due to the very small number of repossessed borrowers in the BHPS, which makes estimation difficult. So, again, we may be under-estimating benefits.

189. The main message these results suggest is that the distress households suffer from payment problems and impairment is much greater than the satisfaction from becoming a home owner or owning a better property. This means that the MMR can be beneficial in terms of net well-being even if the majority of people affected by it would not have experienced payment difficulties, arrears or repossession.

190. Table A4.8 presents the well-being weights we obtain from our analysis. We apply these weights to the different types of borrowers affected by the MMR over our sample period to estimate the total well-being costs and benefits.

Table A4.8 – Well-being costs and benefits over the sample period (2005-07 and 2009-10) in well-being units.

	FTB delayed mortgage			FTB reduced mortgage size			Home movers/Remortgagors		
	Number of borrowers	Well-being weight*	Total well-being impact	Number of borrowers	Well-being weight*	Total well-being impact	Number of borrowers	Well-being weight*	Total well-being impact
Well-being benefits									
Avoiding Short Term Arrears (less than 3 months)**	1800	0.5	900	2700	0.87	2000	38000	0.87	33000
Avoiding Long Term Arrears (over three months)	12000	1.8	22000	11000	2.17	24000	137000	2.17	297000
Total by borrower type	–	–	22900	–	–	26000	–	–	330000

	FTB delayed mortgage			FTB reduced mortgage size			Home movers/Remortgagors		
	Number of borrowers	Well-being weight*	Total well-being impact	Number of borrowers	Well-being weight*	Total well-being impact	Number of borrowers	Well-being weight*	Total well-being impact
Well-being costs									
Delayed in buying/ remortgaging a property & would not have fallen into arrears	18000	-0.8	-14000	–	–	–	436000	-0.43	-187000
Having to buy a smaller/ lower quality property & would not have fallen into arrears	–	–	–	64000	-0.43	-28000	11000	-0.43	-5000
Total by borrower type	–	–	-14000	–	–	-28000	–	–	-192000

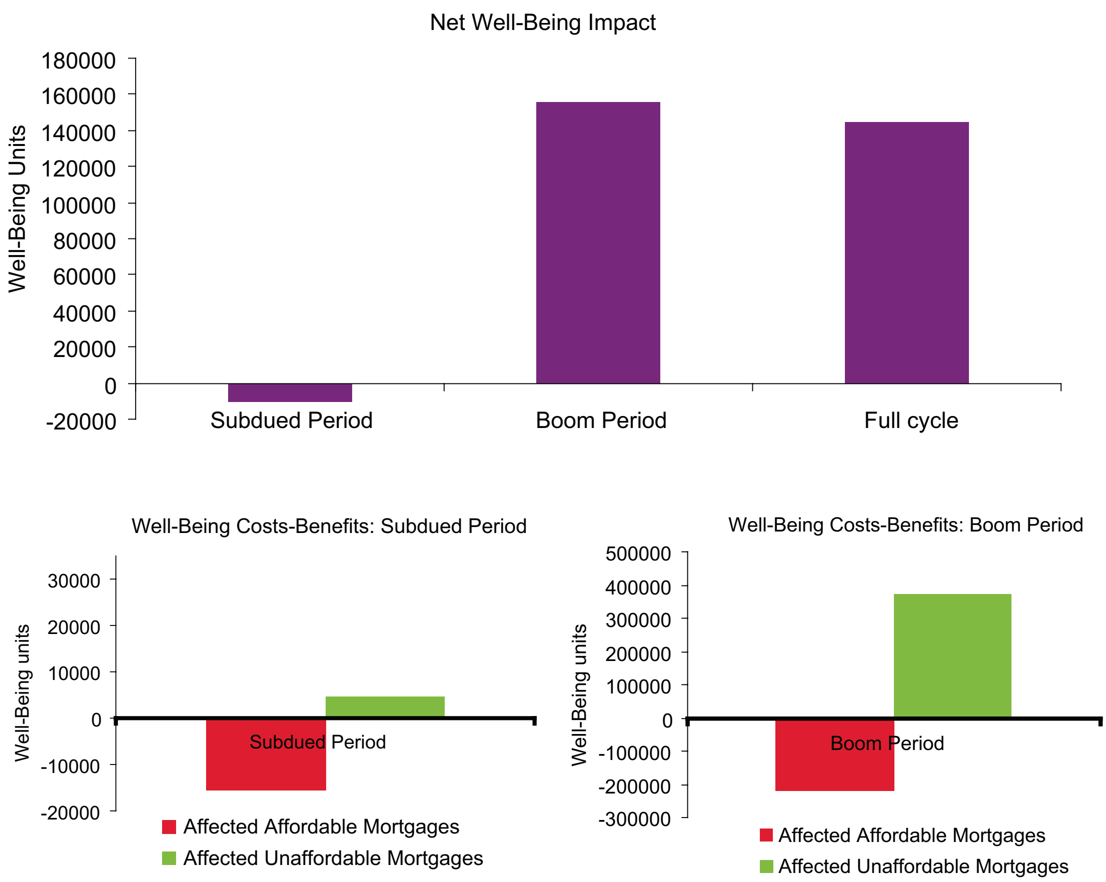
* The well-being weights applied to those borrowers who benefit from the MMR are net of any well-being loss they also experience e.g. from delaying home ownership or from foregoing a better quality property.

** We apply the well-being benefit of avoiding payment problems (that are not arrears) derived form the BHPS to those borrowers in the PSD who are late in their mortgage payments for less than three months.

***Numbers have been rounded.

191. In Figure 4.30 we show the costs and benefits in well-being units separately for the subdued and boom periods. Over the whole sample period, we estimate a net well-being benefit from the responsible lending requirements. The requirements are net-beneficial during the boom period, and slightly net-costly in the subdued period. However, it is likely that we have underestimated the benefits for the subdued period. This is because this period includes mortgages originated in 2009 and 2010 and impairment tends to take at least two years to materialise. As a result, impairment is materially under-recorded in this period.

Figure A4.30 – Well-being costs and benefits expressed in well-being units



192. Since our estimates of well-being are point-in time they do not strictly tell us how well-being varies with time. The academic literature on well-being shows, however, that individuals tend to become used to being in a particular state, so for events that last for a long period there is a reduced impact on well-being as the event continues. For home ownership, which is a long term event, this implies that being deprived of home-ownership would not have the massive well-being impacts that might first be expected. Similarly with arrears – the first exposure to arrears would have a large negative impact on well-being, but subsequent spells should have less dramatic effects. For these reasons the fact that our well-being impacts do not vary with duration may not be significant, although there is a risk we might be either over or underestimating the well-being costs and benefits.

193. We have also attempted to monetise the well-being impacts because our estimates of the other cost and benefits of the MMR are expressed in monetary terms (which, unlike our well-being estimates, capture the value of actual economic resources absorbed and saved by the MMR). Monetization of well-being impacts is notoriously problematic. Many studies find the income equivalents of the well-being impacts of the analysed events to be unexpectedly large. We seek to avoid this problem as follows.

194. We observe from our analysis that the distress households suffer from arrears is broadly of similar scale to the distress of being unemployed, which is more easily monetized, at least in part. So we use the income people lose while unemployed as a rough indication of the 'financial equivalent' cost of the distress associated with payment difficulties, arrears and possession. As an example, we report what would be the average monetary equivalent of the distress associated with arrears for households belonging to the Credit-Hungry and Bread-Line Experian consumer categories. This suggests the following monetized well-being impacts[49]:

- The positive impact on FTBs who are delayed from entering the mortgage market and would have experienced payment problems ranges between £1,500, (if in arrears for less than three months) and £8,000 (if in arrears for one year). For remortgagors the positive impacts range from £2,500 (if in arrears less than three months) and £14,000 (if in arrears for one year). The positive impact on these borrowers is net of any loss they also experience e.g. from delaying home ownership or from foregoing a better quality property.
- The negative impact for FTBs who are delayed from entering the mortgage market and who would not have experienced payment problems ranges between £2,000 and £6,000. The negative impact for remortgagors who would not have experienced payment problems ranges between £1,000 and £3,000.
- 'Home movers' are assigned similar monetary impact ranges as remortgagors.

195. When we apply these monetised well-being benefits to all the borrowers affected, positively or negatively, by the MMR over the sample period, the average net well-being benefit per borrower is around £350.

I. Reduction in costs of arrears and repossession for consumers

196. Consumers, who would have otherwise taken on an unaffordable mortgage avoid detriment because they do not incur arrears charges and repossession costs that could have arisen from this mortgage.

197. For those mortgages that were identified as unaffordable, we estimate a reduction in the number of arrears of about 170,000 and a reduction in the number of repossessions of about 27,000 over the boom period (2005 to 2007). For the subdued period (2009 to 2010) we estimate a reduction in the number of arrears of about 4,500 and a negligible number of repossessions.[50]

49 We note that these monetary estimates of net benefits are likely to be lower than the true net benefits as the estimates do not capture all dimensions of the reduction in well-being.

50 This is a potentially substantial underestimation of the number of borrowers that would benefit in the subdued period. The underestimation arises because we use data on actual impairment of mortgages at the end of 2010. Mortgage impairment (especially repossessions) takes time to materialise. For the subdued period we have data on whether the mortgage has gone into impairment for between 3 months and 2 years after origination. For many mortgages, impairment will materialise only after that.

198. From the review of tariffs of arrears charges, we estimate the average cost per case in *arrears* is between £300 and £350, depending on the duration of arrears. Based on this, the expected benefit from saved resource costs due to avoided arrears charges is around £60m over the boom period (2005 to 2007) and about £1m over the subdued period (2009/10).

199. From the review of tariffs of arrears charges, enforcement cases and relevant literature we estimate the costs of *repossession*, including the costs of court proceedings and a possible discount due to a fire-sale of the property, to be between £30,000 and £35,000 per case. This is based on a 20% discount on the property's value. The resource costs of the court proceedings are very small relative to the discounts. We therefore treat these costs as if they were part of the transfer, although this leads to a slight understatement of economic benefits.

200. The fire-sale discounts are a transfer from the repossessed borrower to the buyer of the repossessed house, so reducing them per se is neither an economic cost nor an economic benefit. As these transfers are from the repossessed borrowers to the property purchasers, however, reducing them is likely to be regarded as socially beneficial. We expect these transfers to be reduced by around £900m over the boom period (2005 – 2007) and around £1m over the subdued period (2009/10).

A5

Costs and benefits resulting from non-bank prudential proposals

1. In addition to the proposals on the conduct of lenders and intermediaries, we are proposing changes to the capital requirements and a high-level liquidity management requirement for lenders that do not take deposits. These firms are commonly referred to as non-banks. These proposals will change the MIPRU[51] part of the Handbook, and are presented and discussed in Chapter 9 of the Consultation Paper.

2. In this section of the CBA we report our estimates of the costs and our analysis of the benefits associated with these proposed changes in prudential rules for non-banks.

3. Our analysis of the costs is divided into two sections to reflect the two types of expected incremental compliance costs:

   - *Capital compliance costs*: the costs a firm would incur if it has to raise additional and/ or better quality capital; and
   - *Non-capital compliance costs*: the additional costs arising from setting up and maintaining the necessary systems and controls to introduce and maintain the proposed capital and liquidity regimes.

4. We also expect the proposed changes in the prudential regime to affect the quality and variety of mortgage lending and competition. These impacts are discussed in Chapter A6.

51 MIPRU is the Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries. In this chapter we also refer to BIPRU, the Prudential Sourcebook for Banks, Building Societies and Investment firms.

The types of non-banks subject to the new prudential requirements

5. Not all FSA-regulated non-banks will be subject to the new MIPRU prudential regime, namely:

- non-banks that are solo-consolidated subsidiaries of banking or building society groups will be excluded from the new requirements[52]; and
- non-banks in run-off will not be affected because the new requirements will only apply to the new lending undertaken by firms.

6. All other types of FSA-regulated non-banks will be subject to the proposed prudential requirements and may incur incremental compliance costs. These are stand-alone firms, non-banks that are part of non-BIPRU groups, and non-banks that are subsidiaries of BIPRU firms but are not solo-consolidated.

7. Table A5.1 shows the number and size of the FSA-regulated non-bank-lenders broken down by the different categories of firms.

Table A5.1 – FSA-regulated non-banks by type (Q1 2011*).

Types of FSA-regulated non-banks		Number of firms**	Total assets (£bn)
Subject to the proposed prudential regime	Stand-alone	41	1.8
	Part of non-BIPRU groups	25	12.4
	Non solo-consolidated subsidiaries of BIPRU groups	16	83.5
Not subject to the proposed prudential regime	Solo consolidated subsidiaries of BIPRU groups	33	69.4

* Source: Mortgage Lenders & Administrators Return (MLAR)
** Including firms in run-off

52 Solo consolidation is a method of allowing a regulated firm to treat a subsidiary as an operating division. The result is that, for the purposes of solo capital requirements, the regulated firm and its subsidiary are treated as one entity. The benefit for the regulated firm is that, rather than fully deducting its investment in these subsidiaries (which would be required under the normal application of solo capital rules), the subsidiaries' assets are risk weighted as if they were the regulated firm's own assets.

Capital compliance costs

Current and proposed capital requirements

8. Before estimating the capital compliance costs, we first compare the proposed capital requirements with those currently in MIPRU. This comparison is set out in Table A5.2.

Table A5.2 – Current and proposed capital requirements

	Current capital requirements[53]	Proposed capital requirements
Minimum capital requirement	The higher of: £100,000 and 1 per cent of tangible assets plus total undrawn commitments.	The higher of: £100,000 and the sum of a) 8 per cent of risk-weighted assets (RWAs) derived from the following: the standardised credit risk requirement (BIPRU Chapter 3) applied to assets relating to lending activities and exposures to collective investment undertakings[54] entered into on or after the implementation date of the rules; and the standardised securitisation requirement (BIPRU Chapter 9) applied to securitisation positions originated on or after the implementation date of the rules. b) 1 per cent of all other relevant tangible assets (including loans and securitisation positions entered into before the implementation date of the new rules).[55]
Quality of capital	No restrictions on the proportions of different forms of capital resources, such as subordinated loans, that can be held to meet the capital requirement.	At least 20 per cent of capital is in the form of share capital and reserves after the deduction of intangible assets.

9. As table A5.2 shows, the minimum capital requirement of £100,000 remains unchanged. This means that those small non-banks that currently have a capital requirement of £100,000 and

53 See MIPRU Chapter 4.
54 Exposures to collective investment schemes (CIS) are included to prevent regulatory arbitrage. If this was not done and CIS were subject to the current 1% requirement, non-banks could hold their assets in purpose-built CIS to avoid the new requirements.
55 For a detailed discussion of the cut-off between past and future lending and the treatment of loan books acquired, increases in existing mortgages, loans that are renewed with different terms, the capitalisation of interest and loans renewed with a different underlying security, please see Chapter 9 of the Consultation Paper.

for whom the proposed risk-weighted calculation would also imply a capital requirement of less than £100,000 would not face an increase in the required level of capital.

10. Capital requirements are likely to increase for all non-banks not subject to the minimum capital requirement of £100,000. The proposed capital charges are sensitive to the relative riskiness of a non-bank's exposures. So the magnitude of the capital increase will depend on the individual non-bank's balance sheet assets and business model. Firms will try to pass through the cost increases to borrowers. Depending on whether this is successful, their business models may need to change.

11. The quality of capital requirements will increase for all non-banks, including those small non-banks that do not face an increase in the required level of capital. We discuss below to what extent non-banks already meet these requirements and therefore to what extent the quality of capital will change.

12. To estimate the incremental capital costs given the data limitations we faced, we have simplified the proposed rules by constructing four generic types of balance sheet assets.[56] These four assets reflect the structure of the available returns data as reported in the Mortgage Lenders and Administrators Return (MLAR). This simplified risk-weighted approach is set out in Table A5.3. We then use these risk weights and non-banks' MLARs to calculate minimum capital requirements that would have applied historically to non-banks.

Table A5.3 – Risk weights applied to asset types

<table>
<tr><th>Type of capital requirement</th><th colspan="5">Type of on-balance sheet asset</th><th colspan="2">Simplified capital requirements</th></tr>
<tr><td rowspan="10">Credit risk</td><td rowspan="10">Loan assets</td><td rowspan="9">Regulated and unregulated residential mortgages to individuals</td><td rowspan="3">Not past due**</td><td colspan="2">Part of the loan:</td><td>Risk-weight</td><td>Capital charge*</td></tr>
<tr><td colspan="2">below 80% LTV</td><td>35%</td><td>2.8%</td></tr>
<tr><td colspan="2">above 80% LTV</td><td>75%</td><td>6.0%</td></tr>
<tr><td rowspan="6">Past due**</td><td>Part of the loan:</td><td>Provisions against the component:</td><td></td><td></td></tr>
<tr><td rowspan="2">below 80% LTV</td><td><20%</td><td>100%</td><td>8%</td></tr>
<tr><td>>=20%</td><td>50%</td><td>4%</td></tr>
<tr><td rowspan="2">above 80% LTV</td><td><20%</td><td>150%</td><td>12%</td></tr>
<tr><td>>=20%</td><td>100%</td><td>8%</td></tr>
<tr></tr>
<tr><td colspan="4">Other loans</td><td>100%</td><td>8%</td></tr>
<tr><td>Securitisation risk</td><td colspan="5">Retained securitised positions</td><td>1250%</td><td>100%</td></tr>
<tr><td>Other assets</td><td colspan="5">Assets not subject to the securitisation and credit risk requirements</td><td>N/A</td><td>1%</td></tr>
</table>

* Capital charge is calculated as 8% of risk-weighted assets

** Exposures of all types which have not been repaid 90 days after the due payment date are treated as past due under the standardised approach to credit risk

56 We follow explanatory notes published by the FSA on the standardised approach to credit risk under BIPRU 3 (www.fsa.gov.uk/pubs/international/bipru3.pdf) and the standardised approach to securitisation risk under BIPRU 9 (www.fsa.gov.uk/pubs/international/bipru9.pdf).

13. From Table A5.3 we can see that the relative impact on capital requirements will be much higher for non-banks that securitise loans and retain securitisation positions on their balance sheet, than for non-banks that do not.[57] For non-banks that do not securitise the originated loans, the increase in the capital requirement will be driven mainly by the proportion of lending with high loan-to-value ratios, as well as the proportion of loans in arrears. We estimate that capital requirements are likely to increase from the current 1% level to between 2.6% and 5.5% depending on the type of assets on the balance sheet.

14. The increase in capital requirements for securitising non-banks may be much greater depending on the nature of any retained positions, because of the significant increase in the capital charge for certain retained securitisation positions relative to the existing MIPRU requirement. Moreover, in the context of the amendments made to the Capital Requirements Directive (Article 122a), we would expect many non-banks in future to retain a net economic interest of at least 5% in the securitisations they originate, since these changes prohibit EU credit institutions from investing in securitisation positions unless the originator or original lender, such as a non-bank, has retained a net economic interest of at least 5%.[58] If non-banks did not do this, they would significantly reduce the potential investor base for their securitisations.[59]

15. Assuming then that a non-bank securitising residential mortgages retains a 5% net economic interest via retention of the first loss tranche (the most capital intensive retention method), we estimate that they would incur a capital charge for the retained securitisation positions of between 56% and 100%. This is a significant increase from the current 20% requirement.[60]

16. The range of potential capital requirement post securitisation has an upper bound set by the pre-securitisation capital requirement: the capital requirement for retained securitisation positions cannot exceed that for the whole pool of assets had they not been securitised. When this cap does not apply, a firm retaining 5% net economic interest via an unrated first loss tranche subject to the highest 1250% risk-weight would incur a 100% capital charge for the retained securitisation positions (i.e., 8% of risk-weighted assets). In other words, the capital charge for the firm retaining a 5% net economic interest is 5% of the underlying assets. However, the firm would be subject to a lower capital requirement whenever the overall risk-weight for the underlying pool of assets was below 62.5% because this would bring the cap into play.[61] Under BIPRU 3, the lowest risk-weight of 35% is for performing residential mortgages with LTVs below 80%. When this risk weight

57 We apply the maximum 1250% risk weight to the retained securitisation positions to provide an upper bound cost estimate. This risk weight would apply, for example, where non-banks hold the first-loss piece of the securitisation. As a result, we overestimate the capital charge where retained securitisations would have been subject to lower risk-weights. It is also the case that under the proposed rules the capital charge cannot exceed that which would apply for the whole pool of assets underlying the securities. Our analysis will therefore overstate the capital impact where this ceiling applies.

58 See Chapter 9 of this Consultation Paper.

59 It would be possible for a non-bank to originate a transaction and not retain a 5% net economic interest, so our cost estimates will represent upper bound total costs and actual costs could be lower if retention did not occur.

60 Under the current rules, a firm retaining 5% net economic interest in the securitisation positions would incur a capital charge of 1 per cent of the value of securitised exposures. This would be equivalent to a capital charge of 20% applied to the retained securitised exposures (calculated as 1% over 5%).

61 This is because the capital requirement for a pool of assets with an overall risk weight of 62.5% is 5% of assets.

is applicable, firms retaining 5% net economic interest would face a capital requirement equivalent to 56% of the retained positions (for example, 100 x 35% risk weight x 8% capital requirement = 2.8; 2.8% is 56% of the retained net economic interest of 5%).

17. We apply these simplified capital charges to historical MLAR data, including the pre-crisis period, to estimate the capital compliance costs had the new MIPRU regime been in place over the period.

Estimated capital compliance cost

18. We estimate capital compliance costs in two steps. First we estimate whether non-banks active in the market from 2006 to 2011 would have had capital shortfalls under the proposed regime (assuming requirements applied to all lending). We then estimate the range of costs the industry could have incurred to meet the new requirements had they been in place during these years.

19. We have adopted this historical approach because capital compliance cost estimates based on the most recent balance sheets would underestimate overall costs. The current non-bank lending market remains very subdued because of the illiquid securitisation markets since the crisis. The estimates presented here will represent future impacts to the extent that future non-bank activities in less subdued periods mirror those observed in the historical period of our data.

20. This approach is also a simplification because it assumes that firms react only by increasing capital levels and not adjusting their lending risk appetite or the composition of their balance sheet or prices. This is unrealistic, particularly given that the proposed risk-weighted capital regime is being introduced to incentivise better risk-management in lending. In practice, we would expect non-banks to adapt their risk appetites and balance sheets in response to the proposed changes and to reduce their capital requirements in doing so. Thus, the approach taken here would be expected to somewhat overestimate the impact of the new capital requirements.

21. Non-banks may also want to offset the impact of increased capital requirements by increasing prices. Our research on the impact of prudential requirements for banks has shown that retail borrowers are relatively insensitive to the price of credit. If this were also to apply in the context of non-bank mortgage lending, non-banks would be able to pass on at least some of their cost increases to borrowers without significantly reducing demand for their mortgage products.

22. It is proposed that the rules in this CP will apply only to new lending. Capital compliance costs will rise as old lending matures and new lending is taken on. If the cost of capital were constant through time, the ongoing costs incurred during the transition period would be proportional to the amount of new lending on the balance sheet.

23. Our analysis does not, however, take the transition period into account and assumes that the new regime applies to all assets on the balance sheet and therefore gives only an upper bound for the ongoing capital compliance costs in the short to medium term as new lending accumulates and old lending matures. Our estimates do, however, represent the ongoing cost that would be incurred once all lending on the balance sheet has been originated under the new regime.

24. We divide non-banks into three categories on the basis of the type and extent of capital compliance costs they would be expected to incur. Table A5.4 sets out these categories.

Table A5.4 – Types of non-banks and capital compliance costs

<table>
<tr><th></th><th>Type of non-bank</th><th colspan="2">Description of capital compliance costs</th></tr>
<tr><td>A</td><td>Solo-consolidated non-banks which are part of BIPRU groups</td><td colspan="2">Not subject to the proposed rules.</td></tr>
<tr><td>B</td><td>Part of BIPRU group (but not solo-consolidated)</td><td colspan="2">Capital requirements will increase and restrictions on quality of capital will apply.

Impacts may be low because the BIPRU group is already subject to risk-weighted capital requirements which include the non-bank's assets, so the group will already have some group capital available to help meet the proposed non-bank requirements. The extent to which they already have such capital depends on the extent to which the BIPRU requirement for the assets in the non-bank subsidiary is as high as the new non-banks requirement.</td></tr>
<tr><td rowspan="2">C</td><td rowspan="2">Not part of BIPRU group (i.e., stand-alone or part of a non-BIPRU group)</td><td>C1: small non-banks subject to the minimum £100,000 requirement under both current and proposed rules.</td><td>The same capital requirement, but may need to raise higher quality capital to meet it due to the new restrictions on quality of capital.</td></tr>
<tr><td>C2: larger non-banks with capital requirements exceeding £100,000.</td><td>Capital requirements will increase, and firms may incur costs from raising more and higher-quality capital.</td></tr>
</table>

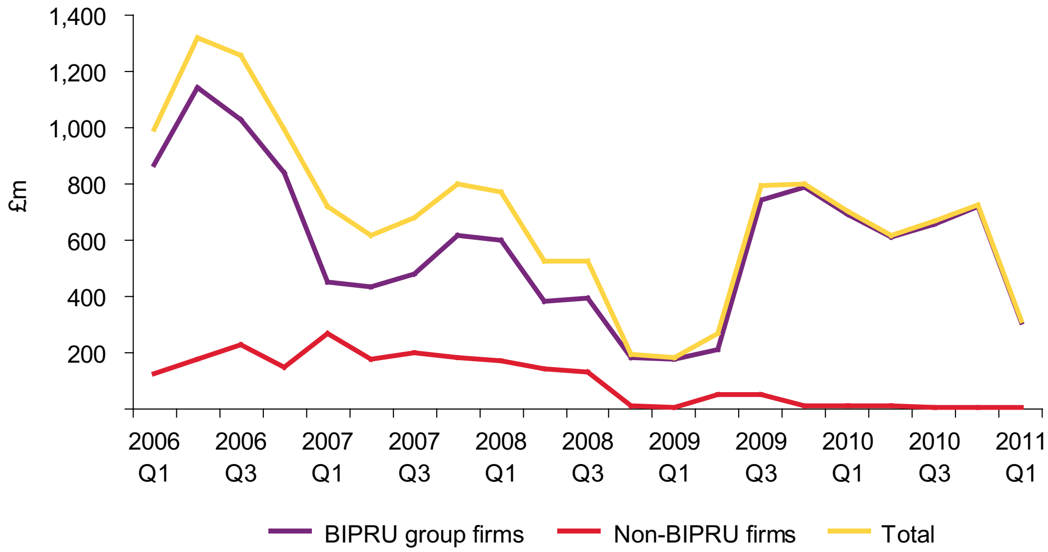
25. The impact on non-banks that are part of BIPRU groups but are not solo-consolidated (B) will vary depending on the capital held in the non-bank and in the group. Where the BIPRU group has capital available in the group, it may move this capital to the non-bank to help meet the requirements. However, excess capital in regulated firms is often held for the purposes of buffer management and so is not available for deployment in other ways. So non-banks in this category (or their parent) will often have to raise some capital to meet the proposed capital requirements. Given these uncertainties, in our analysis we assume that these non-banks (or their parent) will raise capital to make up the difference between the current and the new capital requirements. Clearly, this is an upper-bound estimate.

26. The impacts for group C1 in the table above (small non-banks that are not part of BIPRU groups and that do not exceed the minimum £100,000 requirement) will be of minimal significance. This is because most of these firms are financed through equity and so would not need to increase the quality of the capital they hold.

27. We expect the impact to be the greatest on the larger non-banks that are not part of BIPRU groups (group C2 in the table above). These may need to raise additional capital.

28. Figure A5.1 sets out the estimated total capital shortfall for the period of time for which we have data available for all non-banks which report on the MLAR. This is presented in monetary terms. As a proportion of total assets, the capital shortfall ranged on average between 1% and 3% of the firm's total assets.

Figure A5.1 – Capital needed to meet the proposed capital requirements, assuming compliance with the current capital requirements, 2006 Q1 – 2011 Q1



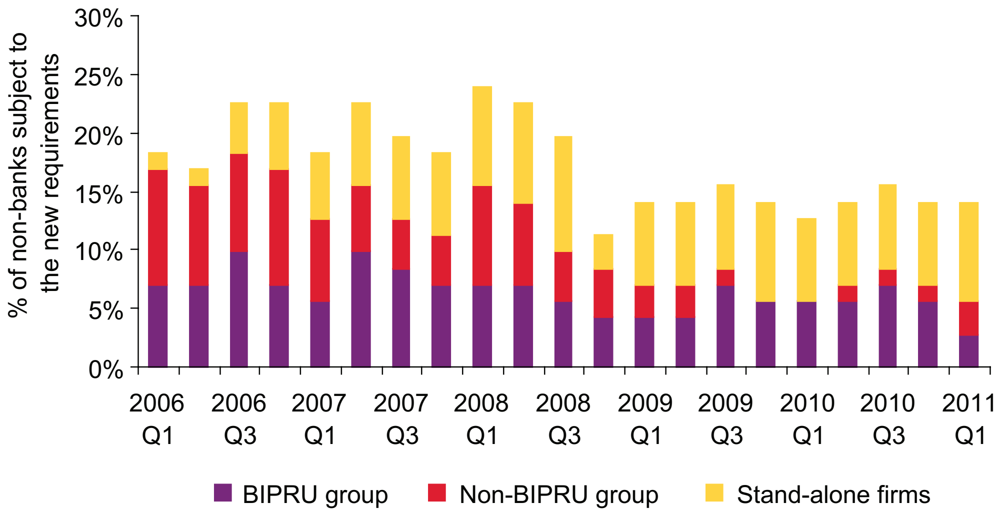
29. From these capital shortfall estimates, we construct a simple estimate of the increase in costs to firms. Our analysis of the ratio of shareholder funds to total regulatory capital shows that most firms already have sufficient share capital and reserves to meet the new quality of capital requirements. Therefore, for firms which do not need to raise any additional amount of capital, we assume that the new quality of capital requirements bring no costs. However, we assume that firms which do need to raise an additional amount of capital will raise this amount at the average minimum quality permitted by the new rules.

30. Therefore, assuming a cost of equity of 20% and a cost of debt of 8%[62] and assuming that regulatory capital is 20% equity and 80% debt (the minimum equity proportion required by the new regime), we apply a weighted average cost of capital of about 9%.

31. On this basis, larger non-compliant non-banks that are not subsidiaries of BIPRU groups (type C2 in the table above) would have incurred a yearly cost ranging between £0.30m and £24.1m in our estimation period. BIPRU subsidiaries (that are not solo-consolidated, type B in table above) would have incurred a yearly cost between £15.7m and £102.7m in our estimation period. Most of these costs would have been incurred by a single non-bank. Total capital compliance costs for all affected non-banks could therefore range between £16m to £126.8m per year.[63]

32. Figure A5.2 reports the proportion of non-banks that would have had to increase their capital holdings.

Figure A5.2 – Estimates for the proportion of non-bank lenders that would have had to increase capital resources (by group membership), excluding lenders not compliant witth the current rules, 2006 Q1 – 2011 Q1



33. As described throughout this chapter the MLAR data has limitations and we had to make some simplifying assumptions. So these cost estimates have uncertainties attached to them. Also we had to use historical data and report the impacts based on the period from 2006 to 2011, which is not reflective of current market conditions. Therefore the cost estimates provided here are likely to be overestimates. They should be interpreted as indicating the likely range of the costs that non-banks may face rather than as precise estimates.

62 These parameters were derived from cost of capital analyses we have carried out for banks, with some simple corrections (i.e. rounding up) to allow for the higher cost of capital of non-banks relative to banks.

63 Our data does not allow us to identify capital buffers of non-banks. We therefore assume that non-banks have no capital buffers, which is a simplifying assumption. If non-banks were to hold an additional 10% of the requirement as a buffer, then costs would also increase by approximately 10%.

Impacts on niche markets

34. We do not expect the impacts to be significant for firms active in niche product markets (i.e. bridging finance, home purchase plans and equity-release markets). Our MLAR data show that in every quarter between 2006 and 2011 only one to three firms would have experienced a capital shortfall. Almost all niche providers would not have experienced a shortfall at any point. Because of this, we expect the impact on niche markets to be of minimal significance.

Non-capital compliance costs

35. There will be systems implications for affected firms (all non-banks). Under the current rules it has been possible to calculate capital charges at an aggregate level for all mortgages. However, under the new regime it may be necessary to calculate individual capital charges for each mortgage, based on its latest LTV and arrears status.

36. Compliance costs were calculated from responses to a survey sent to non-banks and from compliance cost estimates from the CRD when Basel II was implemented.[64] We sent a survey to a population of 25 firms, of which 15 responded. We asked questions regarding both one-off and ongoing costs. We are grateful to the firms who participated in the survey. Using these responses and also the compliance cost estimates from the CRD, we estimate one-off costs of up to £2m and annual ongoing costs of up to £500,000 a year for all affected non-banks taken together.

37. The non-capital compliance costs are considerably lower than the incremental capital costs for firms that will have to hold increased capital, although unlike the capital compliance costs, we would expect some non-capital compliance costs to be incurred by all firms.

Liquidity requirements

38. We do not expect firms to incur material incremental compliance costs due to the proposed liquidity requirements.

39. The systems, strategies, policies and processes for managing liquidity risk are not different from those that financial firms should have in place for managing other types of risks. Examples include basis risk tracker, pipeline data, contractual maturity analysis and FX risk profiling. Although firms may incur some costs from revising these policies and processes to accommodate the new liquidity requirement, we do not expect these costs to be material. Also, we do not expect firms to incur material incremental software or hardware costs, since firms should already have software and hardware in place to monitor risks and these can be used to meet the proposed liquidity requirements.

64 See the compliance cost section of CP 06/3.

40. In principle, a firm could incur costs if it did not have the expected systems and processes in place. However, based on our consultation with industry participants, we are not aware of any such firms.

Benefits of the prudential regulation on non-banks

41. There are two main ways we expect benefits to arise from the proposed prudential regime for non-banks:

- Reducing the difference in prudential regulation between BIPRU mortgage lenders and non-banks reduces the possibility of regulatory arbitrage and contributes to a more appropriate pricing of risk, avoiding overly relaxed lending standards for high-risk borrowers, and reducing incentives for other (BIPRU) mortgage lenders to follow suit.[65]
- Higher capital requirements on non-banks should help to reduce their vulnerability to unexpected losses.

42. Non-banks act as intermediaries between the wholesale funding markets and residential mortgage lending. Under normal market conditions (i.e. unless wholesale funding markets are completely illiquid), higher capital requirements on non-banks should help to reduce the vulnerability of non-banks to funding shocks.

Regulatory arbitrage

43. Current capital requirements for regulated and unregulated mortgage activities are much lower for MIPRU firms than for BIPRU firms. The gap between current MIPRU and BIPRU capital requirements will widen even further with the introduction of Basel III. This will increase incentives to use MIPRU-regulated firms as a way to reduce the burden from capital regulations for BIPRU-regulated firms, without correspondingly reducing the risk they face.

44. Whether these regulatory opportunities exist depends on the details of the institutional and economic relationships between the BIPRU firm and the non-bank. However, there is unlikely to be much opportunity for regulatory arbitrage where the non-bank is a subsidiary of the BIPRU firm that is subject to group-consolidated supervision, since such a firm will need to hold BIPRU-compliant capital that takes the non-bank subsidiary into account.

45. However, there may be ways in which a BIPRU firm could fund mortgage lending carried out by a non-bank that is not a subsidiary, but where it maintains the economic interest in the mortgages originated by the non-bank. In such a case, the lower capital requirements applicable to the non-bank could allow risk to be borne by the BIPRU firm that is not adequately reflected in the capital it holds.

65 However, the increase in capital requirements may also have competition impacts by creating barriers for non-banks to enter or re-enter the market. This is discussed in further detail in the competition analysis in Chapter A6.

46. Reducing the difference between BIPRU and MIPRU helps to reduce the likelihood that BIPRU firms will explore and construct methods to reduce the costs associated with the BIPRU regime. This will have benefits by increasing in practice the effectiveness of the strengthened BIPRU regime being introduced with Basel III.

Improved risk pricing

47. Current MIPRU capital requirements for non-banks are not reflective of the riskiness of the lending and securitising activities they undertake. Bringing MIPRU closer to BIPRU requirements for securitisation and credit risk helps to address this, since it introduces risk-weights which are sensitive to credit risk and thus higher for high-risk lending. In addition, while the quality of underwriting will be determined by the accuracy of lenders' models and policies, introducing this requirement should increase the buffer to deal with unforeseen risks.

A6

Other impacts, costs and benefits

1. In addition to the impacts on lending, the macroeconomic effects, the changes in well-being and the costs for non-banks that we have discussed in the sections above there are other costs that arise from the proposals contained in this CP.

2. Here we discuss the impacts of the MMR that are not directly associated with changes in the quantity of lending or with the costs of capital requirements for non-banks. More specifically, this section covers the impacts on:

- Costs to the FSA;
- Compliance costs;
- Variety and quality of lending; and
- Competition.

A. Costs to the FSA

3. The proposed new rules may not generate the need for significantly more supervisory resource. The way we assess compliance by lenders and mortgage intermediaries with Conduct of Business Rules includes file reviews and this will not change under the MMR. We will need to intensify our supervisory focus on mortgages if and when the market starts to recover significantly and reprioritise how we allocate resources to meet any new emerging risks. While this reprioritisation would lead to some specific opportunity costs, it is in keeping with our risk-based resource allocation and the costs would likely arise whether or not the MMR is in place. The opportunity costs of any post-implementation review of the MMR would, however, be incremental, even though it would similarly be subject to prioritisation and resourced from within existing numbers.

4. The MMR proposals should also help supervisors to achieve efficiencies. Subject to satisfactory standards of record keeping, the new rules will provide supervisors with clearer and less ambiguous evidence of compliance or non-compliance than has been the case in the past, which should make reviews less time-consuming.

5. It is likely that the FSA will incur a small training cost. We will need to bring supervisors up to speed with the new requirements, which in turn will necessitate some focused training.

6. So we do not expect material incremental costs to arise for the FSA.

B. Compliance costs

7. When we published CP10/16 and CP10/28, we relied on two separate pieces of work from consultancy firm Oxera to estimate compliance costs for firms.[66] Their identification and analysis of the compliance (and indirect) costs were informed by interviews with the industry and through surveys of lenders and intermediaries. In November 2010 Oxera produced an additional report for the Council of Mortgage Lenders (CML)[67] which contained updated estimates of some of the compliance costs associated with the responsible lending proposals.

8. We welcome Oxera's additional effort to improve the accuracy of their estimates and, whenever appropriate, we rely on the figures that Oxera produced for the CML to describe the compliance costs of the proposals contained in this CP.

9. For those proposals that were not assessed by Oxera either in the reports for the FSA or in the one for the CML, we have relied on internal FSA data and on a survey of lenders active in the bridging loans market that we have carried out.

10. Here, we do not present the details of how Oxera calculated compliance costs as the interested reader can find more information in the relevant reports and in the CBAs in our consultations, CP10/16 and CP10/28.

11. The total incremental compliance costs arising from the proposals discussed in this CP are estimated to be in the range of £40m to £65m for one-off costs, and in the range of £47m to £170m a year for ongoing costs. They are summarised in Table A6.1.

66 The Oxera reports for the FSA are available here: www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf and here: www.fsa.gov.uk/pubs/policy/oxera_report_mmr.pdf.
67 The Oxera report for the CML is available here: www.cml.org.uk/cml/filegrab/oxera-full-report.pdf?ref=7432

Table A6.1 – Incremental compliance costs, industry total

	One-off cost	Ongoing cost per year
Income verification	Minimal	£7.1m – £10.3m
Affordability	£3m – £15m	£4.8m – £14.3m
Interest-only	£14.7m	£16.7m
Arrears charges	Minimal	Minimal
Distribution and Disclosure	£22m – £33m	£2m
Non-bank lenders Capital compliance costs	Minimal	£16m – £126.8m (expected to be at lower end of this range, see Chapter A5 for details)
Non-bank lenders Non capital compliance costs	Up to £2m	Up to £0.5m for systems costs
Niche markets	Up to £0.5m	Minimal
Total	**£40m – £65m**	**£47m – £170m**

Source: Oxera analysis of survey data and FSA data

12. In the remainder of this section we describe the various components of the estimates of compliance costs.

Income verification compliance costs

13. The proposals on income verification are very similar to those we published in CP10/16. We therefore rely on the updated estimates that Oxera produced for the CML to determine the compliance costs associated with them.

14. In the original report for the FSA, Oxera had estimated the one-off costs of the verification proposals to be minimal. At the time, we commented that this assessment may have been in part due to firms lacking details on income verification proposals before the CP was published. However, Oxera confirmed the fact that these costs are minimal in the report for the CML, when draft rules were available. So we can be more confident that one-off costs will indeed be minimal.

15. According to the Oxera reports, 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.

16. Based on the responses received in the survey of 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. These estimates have been confirmed by Oxera in its report for the CML.

17. However, Oxera felt its initial assumptions on the percentage of mortgage applications that required further investigation were not accurate and increased these percentages in the report for the CML. They therefore estimated that annual ongoing costs of the income verification proposals will be between £7.1m and £10.3m.

Affordability compliance costs

18. Oxera did not change its estimates of compliance costs on the affordability proposals in the report for the CML. They are therefore unchanged from those we published in CP10/16 and are summarised in Table A6.2.

Table A6.2 – 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 year	£3.5-13.1m

Source: Oxera analysis based on survey data

19. However, following feedback received on CP10/16 we have made amendments to our responsible lending proposals, as outlined in this paper. The revised proposals are in general no more onerous than those in CP10/16. In many cases, such as in relation to the assessment of affordability, they are higher level and less prescriptive in comparison with the ones addressed in the CBA published in CP10/16. Also, we are not proceeding with several of the proposals, such as the maximum 25 year term for assessing affordability, and the impaired credit buffer. So the above costs are likely to overestimate somewhat the true costs.

Other affordability-related costs

20. In addition to the main proposals on income verification and affordability we are consulting on proposals on record keeping, debt consolidation for impaired credit borrowers and monitoring of lenders' responsible lending policies.

21. We are proposing to increase record keeping requirements to three years. Our discussions with the industry indicated that no incremental costs would arise from this proposal as firms already keep records for more than three years. We are also proposing that where a lender uses the transitional arrangements to enter into a mortgage with a customer of another lender, they should keep a record of term, repayment method, parties to the mortgage, and outstanding balance at the beginning of the new mortgage, so they can pass it on to the next lender if the borrower wishes to take advantage of these arrangements again. Since it may be several years before the borrower remortgages elsewhere, we are proposing to extend the record keeping requirements to cover the life of the mortgage, just in these cases i.e. the cases in which remortgaging has occurred under the transitional arrangements. However, we do not believe that this will impose additional compliance costs as firms will already keep this information. Similarly, we are also proposing firms keep a

record of the check of the repayment strategy, that they undertake during the life of the mortgage, for interest-only mortgages for the remainder of the term. We do not consider that this will result in additional compliance costs.

22. In cases where an impaired credit consumer wishes to remortgage to consolidate debts we are proposing additional measures to protect consumers. We are consulting on two options. The first option will require lenders to take reasonable steps to ensure that the debts are repaid. The second option is for the lender to assume that the debts remain outstanding following the mortgage advance, by including them as 'committed expenditure' in the affordability assessment. We expect the one-off costs of these proposals to be minimal, as they largely follow existing good practice or procedures within firms. However, there are likely to be some ongoing costs for the first option, which we estimate to be £60 per case. We therefore estimate that annual ongoing costs will be £770,000. We do not expect there to be additional costs for the second option as cases will follow the standard procedure for mortgage processing, with the debts to be consolidated just added as committed expenditure, rather than being ignored for the purposes of assessing affordability.

23. We are also proposing to strengthen our requirements on monitoring lenders' policies. We do not expect this to lead to additional costs, as the requirements largely reflect good practice in the market. The proposal for an annual review by internal audit of compliance with the lender's responsible lending policy may impose additional costs, particularly for smaller firms that outsource their audit function. The time taken to complete the audit will vary according to the size of the firm, but on average we have assumed that the extra work involved would take two auditors an average of two weeks to complete. Based on the average number of lenders active in the market, we estimate that the annual ongoing costs will be around £400,000.

24. So we estimate that overall ongoing costs for the affordability proposals are in the range between £4.8m and £14.3m.

Arrears charges compliance costs

25. Our assessment of the compliance costs arising from changes in the calculations of arrears charges has not altered.

26. We are slightly changing our proposals on the number of times lenders can request a payment. We propose to allow lenders to request payments from borrowers up to twice per month. The proposal evaluated by Oxera last year was to allow them to request payments as many times as they like and charge only twice per month. Oxera estimated that a small number of lenders may need to incur a one-off cost of up to £60,000, and ongoing costs in the thousands of pounds per year to develop and maintain a new system to make sure that only two payment requests are charged. We believe, following limited enquiries, that the cost to build a system that requests a payment no more than twice per month would be similar. On this basis, the Oxera estimate is still reliable.

27. We are also making small amendments to MCOB 13.3.4 by introducing a time limit of 15 business days for providing borrowers in arrears with a statement of the shortfall charges. MCOB 13.4.1R and 13.5.1R already require a firm to produce similar information and we therefore estimate the incremental costs to be of minimal significance.

Interest-only compliance costs

28. In CP10/16 we asked for feedback on several questions on interest-only mortgages to help inform our thinking. We did not include any cost estimates as we made no firm proposals. Oxera did ask some questions in their survey in relation to our high level thinking at the time on interest-only, but few lenders responded. So we do not use the data gathered by Oxera as it could be misleading to use its estimates in this case.

29. During the policy development process, the CML made a number of suggestions on the regulation of interest-only mortgages and, following a request from the FSA, provided estimates obtained from lenders of compliance costs associated with such suggestions.

30. The proposals we are consulting on in this CP are sufficiently similar to those suggested by the CML to warrant the use of their estimates as a reasonable approximation of the compliance costs, given that our proposals centre on lenders:

- having a clear policy on acceptable repayment strategies for interest-only mortgages;
- assessing the repayment strategy before entering into a mortgage; and
- checking on the status of the repayment strategy at least once during the term.

31. Compliance costs estimates for interest-only proposals are reported in Table A6.3 below.

Table A6.3 – Total costs of the interest-only proposals

	One-off	Ongoing per year
Development of policy on acceptable repayment methods	£0.6m	£0.8m
Validating repayment method at point of sale	£8.7m	£10.0m
Re-validating repayment method before the end of the mortgage term	£5.4m	£5.9m
Total	**£14.7m**	**£16.7m**

Source: CML

32. Overall one-off costs are estimated to be about £15m while annual ongoing costs are approximately £16.7m. As can be seen from the table it is the requirement to assess the repayment strategy at the point of sale and check its status during the term that is responsible for the majority of costs.

Distribution and disclosure compliance costs

33. The compliance costs associated with the proposals on distribution and disclosure in CP10/28 were estimated in the CBA published within that paper. While many of the proposals being discussed in this CP are the same as those in CP10/28, some differ, particularly in the areas of sales standards and scope of service disclosure.

34. The proposed amendment to sales standards should not result in changes in compliance costs as, even under the proposals discussed in CP10/28, the difference between 'advised' and 'non advised' sales was minimal. There we proposed that all consumers be taken through the same process regardless of whether they were receiving advice or just information. In this CP we are proposing to require firms to provide advice in all sales where there is a dialogue between the consumer and the firm (i.e. telephone sales, face-to-face, social media etc). As we recognise that there are some sophisticated consumers in the market, we are proposing to allow high net worth and professional individuals to opt out of receiving advice and to purchase on an execution-only basis. However, we are also proposing that some vulnerable consumers must receive advice regardless of whether the sale involves a dialogue. These include debt-consolidating consumers and consumers purchasing sale and rent back, equity release or right-to-buy products.

35. In addition, where a sale involves no dialogue between the consumer and the firm (i.e. postal or purely online sales) we will allow consumers to purchase without advice i.e. on an execution-only basis. So firms may save some of the costs associated with a full appropriateness and suitability assessment proposed in CP10/28 for certain customer and sale types.

36. For scope of service disclosure, we are no longer proposing to read-across the 'independent' and 'restricted' labels developed for the RDR to the mortgage market. Instead we propose to require firms to explain to consumers whether their service is limited in any way (and if so, how). This includes firms noting where they will not consider 'direct-only' deals for the consumer (similar to the proposal outlined in CP10/28).

37. We have also changed our proposal on the medium in which information on scope of service and remuneration must be given. We will still require the messages be given in a clear and prominent manner, but we will not require them to be given in a durable medium (with the exception of sales falling under the Distance Marketing Directive).

38. When Oxera calculated the impact of a change of scope of service labels, it took account of the costs that would be incurred by firms if they had to change their existing disclosure documents and marketing materials to reflect the new labels. Our revised disclosure proposals will not require firms to give the altered description of their service in a durable medium, and will not be prescriptive about the exact terms used by firms to describe their service in any written material they choose to give. So, many firms will not be compelled to create new documents and incur these costs as a result of the proposals (providing their existing materials remain accurate).

39. The cost estimate Oxera provided for replacing the Initial Disclosure Document (IDD) was based on an estimate for changing the document from one form to another. As a result of firms no longer having to give the messages on scope and remuneration in a durable medium, we will not be compelling firms to incur this cost either.

40. For firms whose initial contact with the consumer does not involve spoken interaction, the main costs are likely to be incurred by electronic disclosure of the required messages. These disclosure costs were included in the estimate provided in CP10/28.

41. It is difficult to estimate with precision what impact altering the disclosure proposals will have on Oxera's cost estimates. It is likely that the costs will be reduced, as a result of firms not being compelled to change or produce new written material. We have therefore reduced the cost estimates provided by Oxera by excluding the costs on scope of service labelling in comparisons to the costs we published in CP10/28.

42. As a consequence of our interest-only proposals, we are amending an existing rule in relation to the disclosure of the repayment strategy on the offer document. We currently require the lender to state the repayment vehicle in the offer document only where the lender knows what it is. Under our interest-only proposals lenders will always know what the repayment strategy is, and therefore will always need to disclose it in the offer. However, we are proposing that they may state this in the illustration part of the offer, or the wider offer document, and therefore we do not expect that this will impose material costs on firms.

43. Finally, for borrowers who use the transitional arrangements we will require lenders to make clear that the mortgage is being offered as an exceptional arrangement outside normal lending criteria, on the basis that the borrower has demonstrated that they can afford the mortgage by keeping their existing mortgage payments up to date for at least the last 12 months. We do not believe that this will add material costs for lenders.

Table A6.4 – Total costs of the distribution and disclosure proposals

Proposal	One off (£m)	Ongoing (£m)
Sales standard	£0.8m	£1m
Professionalism	£17m – £28m	–
Labelling	–	–
Ban automatic roll up fees	£2m	–
Changes to service and product disclosure requirements	£1.7m	£0.7m
Changes to record-keeping requirements	–	£0.3m
Total	**£22m -£33m**	**£2m**

Source: Oxera analysis of survey data

Niche markets compliance costs

44. This CP contains a number of proposals dealing with specific niche markets or market segments which, while they share most of the relevant characteristics of the standard mortgage market, are sufficiently different to warrant a different regulatory treatment. When calculating industry-wide costs in its original reports, Oxera included all first charge residential mortgage loans. Therefore, for most of the proposals the compliance costs have already been captured in the estimates reported in the tables above.[68] For the few proposals in niche markets that could result in incremental costs materialising we report our estimates below.

Bridging loans

45. Some respondents to CP10/28 pointed out that Oxera's survey did not include firms that specialise in bridging finance. As explained above, Oxera's costs were calculated on the basis of the entire first-charge residential mortgage market, which includes bridging loans. However, in order to check that bridging firms are not disproportionately affected by the MMR proposals we have surveyed such firms and asked questions to establish compliance and indirect costs.

46. The population of firms exclusively involved in these loans is quite small (approximately 20 firms) and, in total, we received seven responses to our survey. The estimates are therefore subject to considerable uncertainty. However, the costs per firm or per loan are similar to those that Oxera calculated for the main market, which is reassuring. On the basis of the survey results, we estimate that one-off costs associated with affordability proposals are in the region of £140,000 while ongoing costs are £36,000 a year. With regard to distribution and disclosure proposals, one-off costs are estimated to be of minimal significance and ongoing costs in the range of £0 to £16 per sale, depending on the complexity of the assessment of the borrowers' ability to repay. However, for the reasons explained above, these costs are not additional to those already reported in this analysis.

47. There is one area where costs are additional to those estimated by Oxera and that is the requirement for firms to obtain the borrower's explicit consent before extending the term of an existing bridging loan. Before the loan is extended we will also require the lender to carry out a further assessment (in addition to that carried out at the outset) of the borrower's ability to repay. In CP10/28 we did not include an estimate of the costs associated with this proposal as it had not been developed. On the basis of the survey result we estimate compliance costs to be £50 per loan that is 'rolled over'. These costs are necessary to check, where applicable, that the loan is still affordable, that the customer's repayment strategy remains plausible and to require the customer to positively elect to extend the loan.

68 We stress that we have not reduced the compliance cost estimates to take into account the cost savings associated with the removal of some obligations in niche markets.

High net worth individuals and business loans

48. In general, no incremental costs arise from these proposals as they reduce the burden on firms if borrowers have certain characteristics. An exception could be that sellers of business loans will now be subject to the Training and Competence Sourcebook (TC) – although they will not be required to hold a relevant qualification. However, our existing Senior Management Arrangement and Systems and Controls (SYSC) provisions include high-level competence requirements that apply to all firms. For example, SYSC 15.1 requires a firm to employ personnel with the relevant skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. So the costs associated with this new requirement should be of minimal significance.

Equity release (lifetime mortgages and home reversion plans) and home purchase plans

49. The costs related to lifetime mortgages were included in the analysis conducted for CP10/16 as they are classified as regulated mortgage contracts. Home reversion plans and home purchase plans[69] were not included. This is because lifetime mortgages account for approximately 95% of equity release and the total number of home reversion and home purchase plans sales is approximately 1,000 per year. In CP10/28 we specifically stated that compliance costs for all of these niche markets were not included in the published estimates.

50. Given the very limited size of the equity release and home purchase plans markets, compared with the overall mortgage market and with the lifetime mortgages market, it would not have been proportionate to conduct a fully fledged survey to estimate the compliance costs specifically for them. We decided instead to rely on the estimates that Oxera produced for the main market and apply them to these niche markets using a combination of firm size and market size.

51. On this basis, we estimate that applying the responsible lending proposals will result in overall one-off costs of approximately £10,000 and overall annual ongoing costs of approximately £20,000 for the equity release and home purchase plan markets. The corresponding figures for distribution and disclosure proposals are one-off costs between £0.27m and £0.35m and annual ongoing costs of £15,000.

52. Overall, the compliance costs (both one-off and ongoing) associated with the proposals on niche markets are therefore small and likely to be within the margin of error of the estimates for the overall market.

69 Equity release products allow older homeowners to release the equity tied up in their home. Home purchase plans are contracts that a number of scholars of Islamic law consider acceptable.

C. Variety and quality of mortgage lending

53. The MMR proposals will also affect the variety and quality of mortgage lending. We consider these effects here.

Responsible lending proposals

54. *Variety of mortgage products* – The income verification requirement and the affordability assessment are likely to result in a reduction in the types of mortgage available in 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 (e.g. the self-employed, applicants with non-standard characteristics such as a lack of regular income or temporarily low income, etc.) who were relying on and able to afford the products that will cease to be offered or will be significantly constrained. 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 their preferred mortgages.

55. *Quality of lending* – The impacts on the quality of lending are closely linked to the impacts on the quantity of lending and the associated welfare impacts. First, the responsible lending proposals should improve mortgage quality (the match) for certain borrowers. Unaffordable mortgages will be reduced in size to become affordable. For example, mortgages that would otherwise have been based on inflated reporting of income will be set up on the basis of more accurate information, improving their quality for both lender and borrower. Associated with this quality change is a reduction in the quantity of lending, being to a significant extent 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. A detailed discussion of these issues is included in several parts of this CBA, for example in the introductory section which provides an overview of the impacts of the MMR on an economy-wide level and on consumers, as well as in the sections on well-being and macroeconomic impacts.

Benefits of the proposals on arrears charges

56. Our rules already require lenders to set arrears charges that are a reasonable estimate of the additional administration costs faced by the lender in relation to requesting payment of arrears. We now propose to limit the number of times missed payment fees can be requested and charged to a maximum of two per month. As the unit cost cannot increase (because it has to be cost reflective), this change, if considered alone, will lead to an overall reduction in borrowers' charges. This would be a transfer from lenders to borrowers not an outright social cost or benefit.

57. The proposal to widen the arrears charges rules to apply to all payment difficulties (and not only to arrears, as defined in MCOB) ensures that firms will not be able to arbitrage the rules by front-loading charges onto the first two months, when the MCOB definition of arrears

and therefore the protection described in the previous paragraph does not apply. Borrowers who have payment difficulties not amounting to MCOB arrears would benefit from a similar transfer as borrowers in arrears: lenders will not be in a position to increase charges above the administrative cost and will only be able to request payments twice a month.

58. By removing the possibility for lenders to withdraw a concessionary rate to a borrower who has payment difficulties, some borrowers may benefit from reduced payments. However, given that very few instances of this practice have been identified in the market, the overall benefit is likely to be minimal.

Distribution and disclosure proposals

59. The impacts on variety and quality of lending associated with the sales standards and disclosure proposals were assessed by Oxera in conjunction with their analysis of the responsible lending proposals discussed in CP10/16. These results are still valid.

60. *Variety of mortgage products and processes* – The only potential impact identified on the variety of products and processes is the unavailability of execution-only sales for certain vulnerable consumers (equity release, sale and rent back, right to buy and those debt-consolidating consumers). Some consumers (high net worth individuals and professionals) will be able to opt not to receive advice if there is a dialogue between the borrower and the firm. All other consumers will be able to use online and postal sales if they have identified the product they specifically need. Furthermore, all consumers (with the exception of sale and rent back consumers) will be able to reject the advice after it has been given and buy on an execution-only basis. Given this, we expect the overall effect from the restriction of mortgage products and processes to be small.

61. *Quality of mortgage lending* – Benefits from the distribution and disclosure proposals will materialise from a mitigation of the market failures set out in Chapter A3 above, which should increase the suitability of mortgages offered and accepted by consumers. This will benefit consumers who avoid detriment they would otherwise have suffered from having mortgages that were less well-suited to their needs and circumstances.

62. In particular, the sales standards, professionalism and disclosure proposals are expected to address market failures and bring about benefits in the following ways:

a) The proposals on sales standards, by requiring advice to be provided wherever there is dialogue between the consumer and the firms, aim to mitigate the risks that consumers do not understand the service they are receiving and end up with products that are not appropriate for them i.e. products will be properly assessed against the borrowers needs and circumstances.

b) The proposals on professionalism will improve the quality, role and expertise of mortgage sellers and are also tailored to changes we are proposing in sales standards. They should ensure that all sellers have the requisite understanding of the various characteristics of the products they discuss with consumers, so they are in a position to understand whether or not a specific mortgage product meets their client's requirements.

c) To address the information asymmetries and how consumers make their mortgage decisions, it is important to give consumers the information they need when choosing a firm or product (or deciding whether to accept an adviser's recommendation). Re-focusing our disclosure requirements on the key messages about the service the seller is providing should help to increase the effectiveness of the disclosure and improve consumers' understanding of the products and services they are receiving.

d) Allowing consumers a choice in whether their mortgage fees are rolled-up into the loan is in principle beneficial. It should mean that consumers who can finance their mortgage fees more cheaply, for example by paying them from a current account of low-yielding deposit account, will do so, while customers who want to roll up their mortgage fees will continue to do so. We can provide an estimate for the expected benefit per impacted mortgage. By using £920 as the average mortgage fee, 4.5% as the average rate on a mortgage[70], 3.5% as the discount rate and assuming that the mortgage lasts for 25 years, the benefit of banning automatic roll-up of fees per affected mortgage is estimated to be approximately £100.[71] This is determined by the difference between the mortgage rate (the cost of rolling up the fee) and the discount rate (the cost of paying the fee up front). To calculate an overall figure for the benefits from this, we would need to know how many consumers are currently obliged to roll-up fees and would choose not to. Internal research showed that the percentage of loans where fees are rolled up varies considerably between lenders and that few of them do automatically roll-up such fees. In addition, it is likely that most consumers who choose to roll-up fees do so for good reasons (e.g. because the cost of other types of credit is higher) and would still do so even if our new rules will be implemented. These issues make the number of consumers who would benefit difficult to estimate.

e) The record-keeping changes should strengthen the internal and external monitoring of sales processes, which should in turn strengthen the incentives of non-advised sellers to provide appropriate mortgage products and thus further improve sales processes.

D. Competition impacts

63. The mortgage market is currently undergoing a period of transformation. Some of the changes observed over the past few years may be temporary, reflecting the current state of

70 These figures are taken from *Moneyfacts Treasury Reports, Mortgage Trends*, (October 2010).
71 However, this figure may underestimate the true benefit since we would expect the people who do roll-up fees to be of higher risk profile than average borrowers and thus more likely to pay a higher interest rate and a higher fee than the average mortgagee.

the economy. Other changes may shift the structure of the market over the long term and could affect long-term competition in the market. This uncertainty should be borne in mind when reading this section.

64. In this section we assess the total and individual impact on competition of the main MMR proposals, namely the ones on responsible lending, non-bank lenders, niche markets, distribution and disclosure.

Responsible lending

65. Although we expect there to be some impacts on 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 and 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 and do not place any market participant at a competitive disadvantage. The Oxera analysis shows that the level of compliance costs varies with the size of the firm. For instance the one off costs for the affordability assessment were estimated to be £700,000 for large lenders and £25,000 for small and medium sized lenders.[72] Similarly, the costs that we reported above incurred by bridging firms, that are considerably smaller than the non-bridging firms, confirm that the overall compliance costs are approximately proportional to firm size. Overall therefore, no category of firms should be disproportionately hit by these proposals.

66. We note that most high-risk lenders have already ceased most or all of their new business activity. It is possible that these lenders would have re-entered the market during the next boom period. Our analysis of arrears arising from the most recent boom suggests that such re-entry would be harmful for many of the consumers who would borrow from these lenders.

67. Borrowers will generally face added transaction costs (e.g. added search time, processing time for mortgage applications and 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.

68. Oxera reported that firms are not planning to change the product focus of their business in response to the proposals and do not envisage any shift in their customer focus in response to the proposals. Oxera also found little evidence of any plans for greater consolidation in the market as a result of the responsible lending proposals and no firms indicated being likely to acquire other distributors.

69. By giving lenders the responsibility to verify income and assess affordability, lenders might be expected to become more involved in the application process. This could lead them to prefer direct sales over introduced sales. Furthermore, in recent years, there already appears to be a trend towards the use of direct sales forces, irrespectively of the proposed rules.

72 See page 16 of the Oxera report: www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf.

Oxera's analysis suggests that this trend may be strengthened as a result of the proposed rules. Lenders are likely to reduce the number of intermediaries they work with and rely more on their direct sales forces. This might disadvantage smaller lenders, although they would still be in a position to use intermediaries to screen initial applications on their behalf if they find this beneficial, as long as they retain ultimate responsibility to verify income and assess affordability. Each intermediary is still likely to have access to a sufficient number of mortgage lenders. Borrowers may face higher search costs to access intermediaries if the number of intermediaries is reduced.

70. While the reduction in the number of relationships between lenders and intermediaries should not significantly affect the degree of competition between lenders, the 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 help their customers (in particular those who are less likely to pass a standard affordability test because of their specific personal circumstances) in identifying lenders that would be willing to lend to them, and help them prepare the relevant evidence required for income verification. This is, though, unlikely to be substantially different to what intermediaries are doing in the subdued market conditions we are experiencing at the moment, where lenders are less willing to lend to some categories of borrowers.

71. The income verification requirement could give deposit-takers a small 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). 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 in many cases already being used as a source for verifying income by both deposit-takers and non deposit-takers and that the cost of verifying income using payslips or other means is small.

Non-bank lenders

72. Non-bank lenders will be affected by all the proposals discussed in this CP. However, there are some specific changes in prudential rules that only apply to them.

73. In the years preceding the crisis, non-deposit taking mortgage lenders focused specifically on niche markets and higher-risk borrowers. The MMR proposals could have material impacts on competition for non-bank lenders. These lenders have largely exited the market as a result of the current downturn. However, the introduction of a higher capital requirement for non-deposit-taking lenders could impose additional barriers to entry for these or similar lenders and prevent a significant number of these firms from re-entering the market in the next upswing of the economic cycle. This would result in a reduction in the offering of these loans insofar as they would not comply with the proposed responsible-lending rules.

74. Some non-bank mortgage lenders will not be affected by the MMR proposals as they are not regulated by us, for example firms engaged in buy-to-let and second charge mortgage lending.

75. Among those who are engaged in regulated activities, many non-bank mortgage lenders are subsidiaries of large banks and building societies. They mostly operate under the BIPRU regime as part of a larger group with appropriate capital requirements applied. So, they will not be affected by the new capital requirements for non-banks. However, they will be captured by the other proposals discussed in this CP.

76. A few lenders that are not subsidiaries of a large bank are engaged in both regulated and unregulated mortgage lending. The new capital requirements will be applied to the consolidated balance sheet of non-deposit taking lenders (i.e. regulated and unregulated mortgages) but only on new lending. Depending on whether the new capital requirements are binding, some of these lenders may decide to break their business into two parts. One part will focus solely on regulated lending (e.g. impaired credit borrowers) with the new prudential requirements applied, while the second part will focus on unregulated mortgage lending (e.g. buy-to-let) with the existing prudential regime applied. Our analysis suggests that the costs of this restructuring are not prohibitively high and all firms will be able to continue mortgage lending in relevant markets, although some efficiency from economies of scale and scope could be lost as a result of the restructuring.

77. Firms that are not subsidiaries of a large bank and whose business is focused solely on regulated mortgage lending (including ones falling into this category after the restructuring described above) are the ones that could be affected by the new capital requirements. See Chapter A5 of this CBA for our estimate of capital compliance costs for non-bank lenders. A more stringent capital requirement for these non-bank lenders is likely to impose additional costs on doing business and make entry into this market more difficult. Some of the affected firms may decide to exit the market or not (re)-enter the market during the next upswing, thus lessening the efficiency of competition in this segment of the market and resulting in reduced mortgage supply to non-bank lender customers and higher prices.

78. It is challenging to single out and assess the impact of the non-bank lender proposals on the mortgage market because it will largely overlap with the responsible lending proposals. The affordability assessment and income verification proposals aim to reduce unaffordable lending in the mortgage market. As a result, some potential borrowers will not be able to pass the new affordability and income verification tests and will either be significantly constrained or prevented from taking a mortgage. This is a desired effect of the proposal for borrowers who would not have been able to repay the mortgage had their application been approved. From our analysis, we know that a large proportion of unaffordable mortgages were advanced by non-bank lenders to high-risk borrowers. So we expect that the responsible lending proposals are likely to reduce the demand for mortgages from these

high risk borrowers. Thus some non-bank lenders that specialised in high risk borrowing and have exited the market or some new entrants may not (re-)enter because the responsible lending proposals would not allow them to offer their products.

Sales standards and disclosure proposals

79. Overall, the impacts of the sales standards and disclosure proposals on the functioning of competition and on market structure are unlikely to be material. This was assessed by Oxera in conjunction with its analysis of the responsible lending proposals.

80. No detrimental effects on competition were found as the overall changes to the sales process are small. However, the requirement for some sellers to disclose cases in which they do not consider direct-only products for consumers may incentivise some consumers to move from intermediaries to direct-only sales. This might have competition impacts through increased shopping around by consumers and increased price competition.

81. We expect the professionalism requirements to impose direct costs on some individuals who are not currently required to hold a qualification, but these requirements are unlikely to have material impacts on competition. In theory, the additional one-off costs could act to increase barriers to entry for those individuals and have market impacts as a result. However, our evidence from discussions with the industry is that most lenders already require their sellers to hold a relevant qualification.

Transitional arrangements

82. As described in Chapter 3 of the Consultation Paper there will be transitional arrangements for the MMR responsible lending proposals. Without such an arrangement, some existing mortgage borrowers would not pass typical new affordability and income verification tests when seeking to re-mortgage. This would create “mortgage prisoners”, which would diminish the competitiveness of the mortgage deal they obtain (from their existing lender or from other lenders). This issue would 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.

A7

Background: developments to our lending impact analysis since CP10/16

1. As explained in Chapter A4, the methodology we used in our CBA to measure the quality of underwriting for the affordability assessment was chosen after attempts to construct mortgage affordability measures using the debt service ratio (DSR) and expenditure data. These attempts tried to measure affordability from its determinants at origination i.e. the borrower's income, mortgage characteristics and expenses. In CP10/16, for example, we used the DSR, the ratio of the monthly mortgage payment to free disposable income. However, subsequent analyses using more recent data indicated that the DSR did not adequately discriminate between affordable and unaffordable mortgages for the mortgages that are likely to be impacted by the affordability rule. We then explored using expenditure data to construct a better measure of affordability. This chapter describes these analyses in more depth. It should be noted that, as much of the analysis presented here was conducted on an earlier dataset in which impairment did not include historical payment problems, impairment levels here are generally lower than those presented elsewhere in this CBA.

Measuring affordability of mortgages for the CBA

2. The proposed affordability rule aims to ensure lenders carry out realistic affordability assessments that produce an acceptable quality of mortgage underwriting. The aim is not to stop borrowers with particular characteristics from borrowing or to ban certain types of mortgage products. As long as a borrower has sufficient income after basic expenses and existing credit commitments to meet their (stressed) mortgage payments then they should not be prevented from borrowing by the MMR affordability rule.

3. Mortgage impairment (arrears or repossession) may indicate a mortgage that was unaffordable at origination and which should not have been granted or granted at a smaller size. However, not all impairment indicates an unaffordable mortgage at origination. Life events (e.g. divorce, having children, illness, unemployment etc.) can lead borrowers to struggle with a mortgage that was affordable at origination. For the purposes of the affordability rule, impairment only indicates unaffordability at origination when the quality of underwriting was poor i.e. it was foreseeable to the lender from the income, basic expenses and credit commitments that the borrower would be unlikely to make all their mortgage payments.

4. To estimate the impacts of the affordability rule on lending, we modelled which mortgages will be impacted and how. This required us to identify whether a mortgage was or was not affordable at origination (in the sense targeted by the affordability rule). We did this by:

a) constructing a measure of the risk at origination that a mortgage would go into impairment; and

b) from this, identifying the risk from poor quality underwriting by lenders (i.e. not from life events, or borrower or product characteristics.

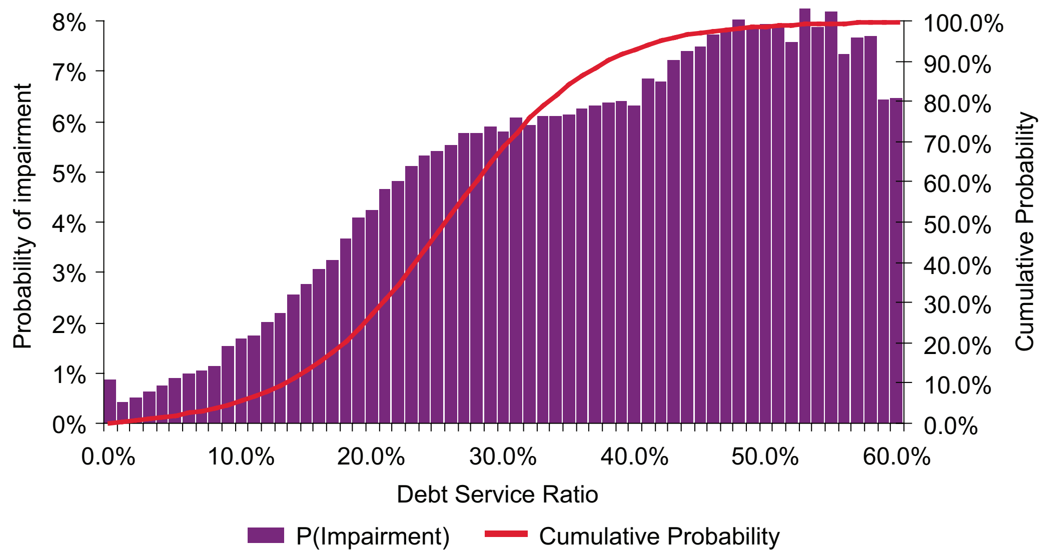
5. For a) the challenge was to identify data available at origination that was the best indicator of subsequent mortgage payment problems. In CP10/16 we used the debt service ratio (DSR) as our measure of affordability. We did not attempt step b) because the affordability rule proposed then was not framed in terms of quality of underwriting. This clarification of the policy has also arisen in response to feedback and analysis since CP10/16.[73]

6. Our rationale for using the DSR in CP10/16 as an ex-ante measure of mortgage affordability was straightforward. DSR is the proportion of income (after tax and national insurance) at origination that a borrower is dedicating to their mortgage payment. Thus, a high DSR indicates that a borrower will have little income left after paying his mortgage and tax, and so is more likely (all else being equal) to have problems paying for his mortgage when he experiences financial pressure. For that reason, a higher DSR generally indicates a less affordable mortgage.

7. Figure A7.1 below shows such a relationship between DSR and probability of impairment for the Product Sales Data (PSD) used in CP10/16.

73 See Chapter 3 in the CP for further discussion of how policy thinking on the MMR affordability rule has evolved.

Figure A7.1 – Probability of mortgage impairment vs DSR (PSD 2005-09)



8. Using DSR as a measure of affordability had the advantage of simplicity and, as shown in Figure A7.1, presented a relationship that suggested it might be a useful measure of affordability.

9. However, DSR had some important limitations as an affordability measure:

- DSR does not take borrower expenditure into account. As a result, it is not entirely satisfactory for assessing the impacts of an affordability rule that requires lenders to use expenditure data in their lending decision. Because of this, we made a commitment in CP10/16 to explore refinements using expenditure data.

- There are other factors (besides expenditure) that are important to affordability but were not adequately taken into account using a DSR threshold for affordability. For example, borrowers with higher income are likely to be able to afford a mortgage with a higher DSR than lower income borrowers (as the proportion of their income devoted to essential, non-discretionary expenses would be expected to be lower than that for lower income borrowers. Because of this, they will have larger proportions of income to divert to their mortgage if they need to).

10. To overcome these limitations, we have explored ways to improve our measure of affordability since CP10/16 was published, both to refine the design of the affordability rule and to improve the estimates of its impacts in the CBA.

11. In particular, we explored:

- possible improvements to the DSR affordability measure; and

- using expenditure data to improve the measure of affordability (following up on the commitment we made in CP10/16).

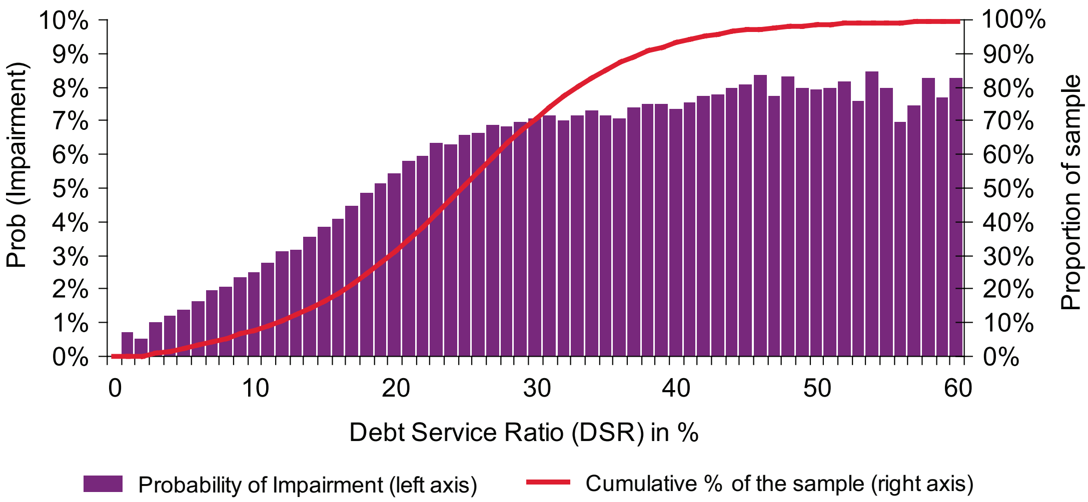
12. We present a summary of some the key results of these explorations below.

Constructing a better DSR measure of ex-ante affordability

13. Since CP10/16 we have, in conjunction with the Council of Mortgage Lenders (CML), obtained additional mortgage data from lenders and obtained more recent data from the Product Sales Data (PSD). Using these additional data, we re-analysed the DSR measure of affordability.

14. Figure A7.2 presents the graph of probability of impairment against DSR for the enhanced data set.

Figure A7.2 – Probability of mortgage impairment and DSR (PSD 2005-10)



15. Figure A7.2 shows that for DSRs between 0% and 25%, a region containing over half of the borrowers, probability of impairment rises at an almost constant rate. This is in line with what one might expect, i.e. impairment increases as leverage increases, reflecting the fact that the more leveraged a borrower is at origination the less likely he will be able to meet his mortgage payments in the face of subsequent economic shocks and life-events. However, borrowers in this low DSR range are of little interest for the MMR, since they are almost certainly borrowing responsibly and would be unlikely to be impacted by any reasonable affordability rule.

16. DSRs between 25% and 45% are in a range where leverage might be high enough to indicate unaffordability. About 45% of the mortgages lie in this DSR range. However, in this region, impairment risk does not significantly increase with mortgage leverage, which is counterintuitive. It suggests confounding factors are at play. For example, it may be that borrowers in this DSR range are dominated by home-movers, who are onto their second or third move, have stable jobs and experience of managing credit and debt (so that for them a higher DSR is positively correlated with a greater ability to handle payment problems risk).

17. The region where DSR is above 45% contains a small proportion of the borrowers (less than 5%) but it is likely to contain a significant amount of the unaffordable borrowing the MMR aims to target. However, for the highest DSR values, beyond 45%, risk of payment problems is flat. This is likely to be due to the region being dominated by a small number of higher wealth and higher income individuals who can borrow affordably at high DSRs.

18. The insensitivity of impairment to DSR for high DSRs that we observe in Figure A7.2 may be a consequence of the period of abnormally low interest rates that were prevalent over the last few years. Interest rates fell rapidly following the onset of the crisis and this may have helped to cushion borrowers from economic shocks that would otherwise have led them into mortgage impairment. It may be that during more normal interest rate environments, we would observe a sensitivity of impairment risk to DSR at high DSR levels. We also note that it is conventional for official policy makers to cut interest rates in times of increasing economic difficulty.

19. As a next step, therefore, we investigated additional factors that might help to improve a DSR measure of affordability. Two factors we considered were income and loan-to-value (LTV), both factors that can play an important role in whether a mortgage with high DSR goes into impairment. High income borrowers are likely to have greater levels of discretionary expenditure that they can redirect to mortgage payments if required, while borrowers who take out mortgages with lower LTVs are more likely to have wealth to fall back on for meeting mortgage payments.

20. To explore possible improvements to DSR using income data, we segmented our mortgage data by income decile and plotted the DSR relationship with impairment for each decile. This showed, as one might expect, that the lower income groups tended to have higher DSRs on average. At any given DSR, the lower the income decile, the higher the probability of impairment. Figures A7.3 and A7.4 present the DSR-impairment relationship for the second lowest and second highest income deciles. They are representative of the complete set of DSR-impairment graphs by income decile.

Figure A7.3 – Probability of impairment and DSR (2nd lowest income decile)

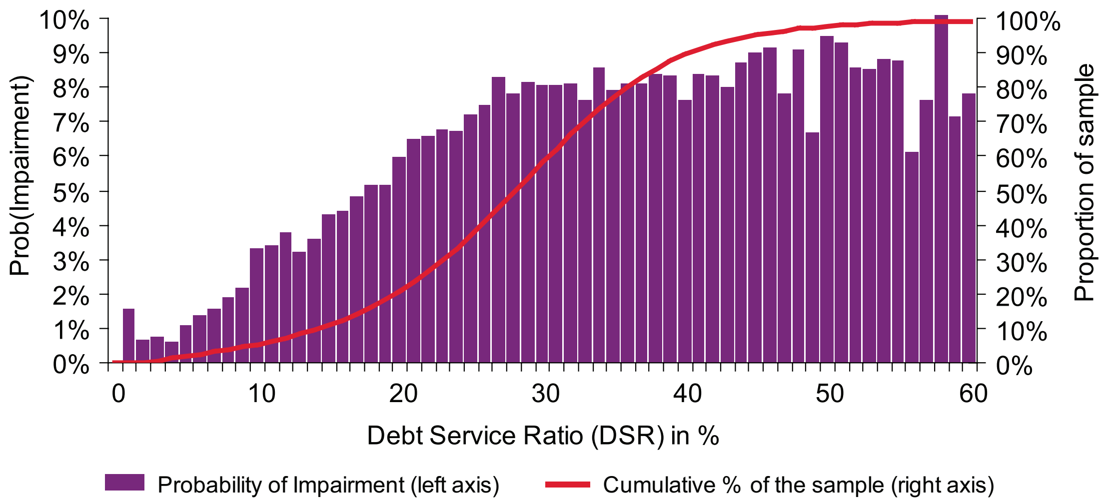
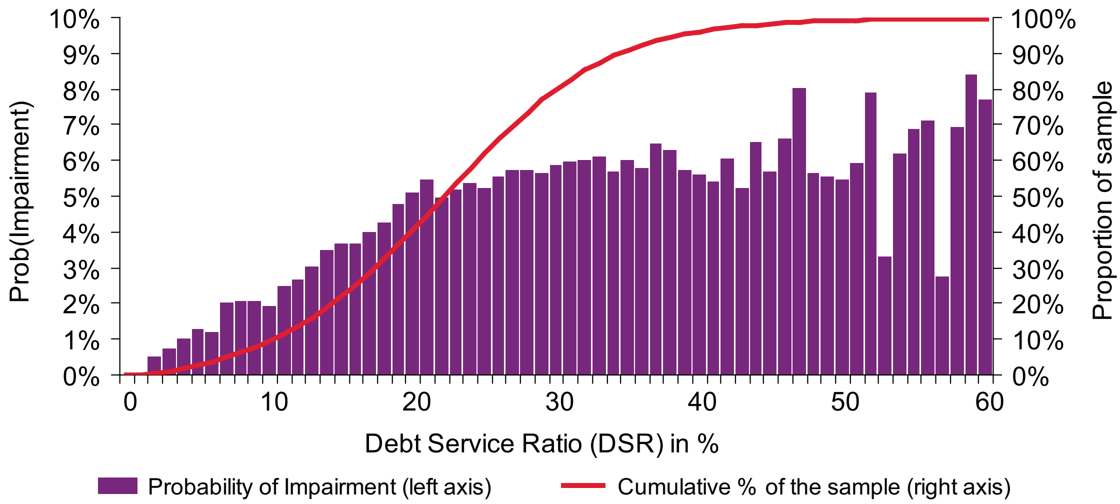


Figure A7.4 – Probability of impairment and DSR (2nd highest income decile)



21. The sensitivity of probability of impairment to income decile suggests an income-decile-sensitive DSR as a possible measure of affordability. However, as shown in Figures A7.3 and A7.4 above, the probability of impairment remains insensitive to DSR in the higher DSR region for a given income decile. Thus, the problem encountered with the simple DSR measure remains i.e. for higher DSR mortgages, even when one conditions on income, a higher DSR does not appear to be a strong indicator that a mortgage is more likely to face impairment.

22. We also investigated how the DSR-impairment relationship varied for different income and different LTV levels. This was done by segmenting the mortgage data into Low (less than 50%), Medium (50-75%) and High (75%+) LTV bands. The DSR-impairment relationship was then plotted by income-decile and LTV band. Figures A7.5 to A7.7 present this relationship, taking the fifth income decile as an example (which is representative of the pattern observed for other income deciles).

Figure A7.5 – Probability of impairment & DSR (Low LTV, 5th income decile)

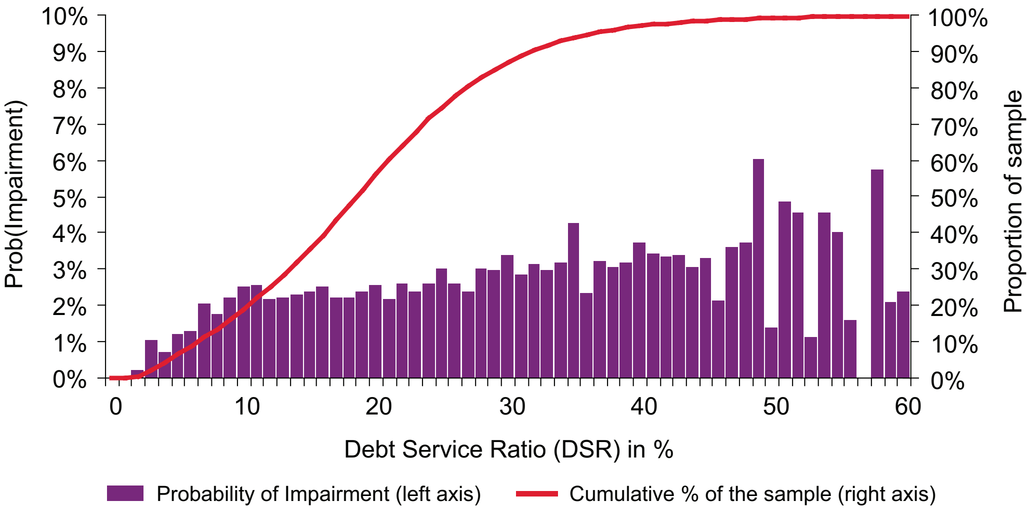


Figure A7.6 – Probability of impairment & DSR (Medium LTV, 5th income decile)

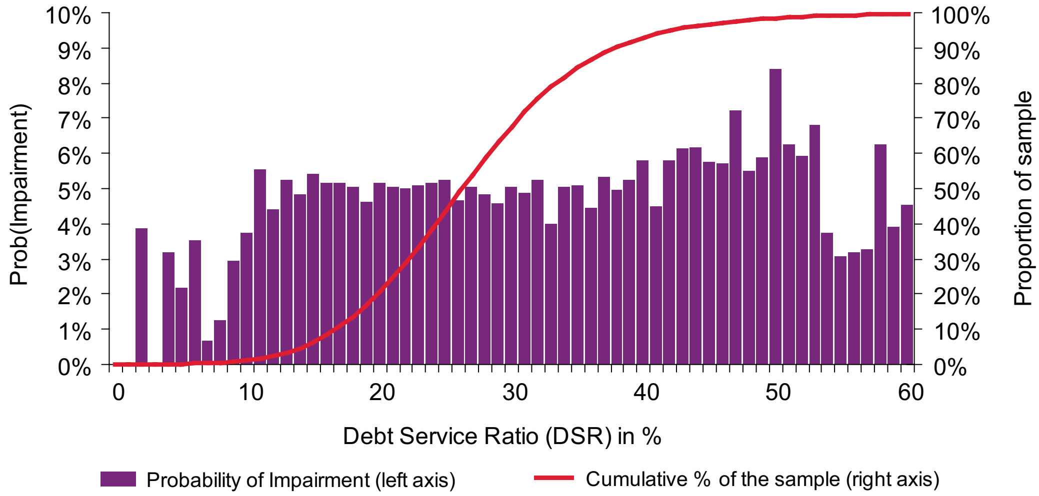
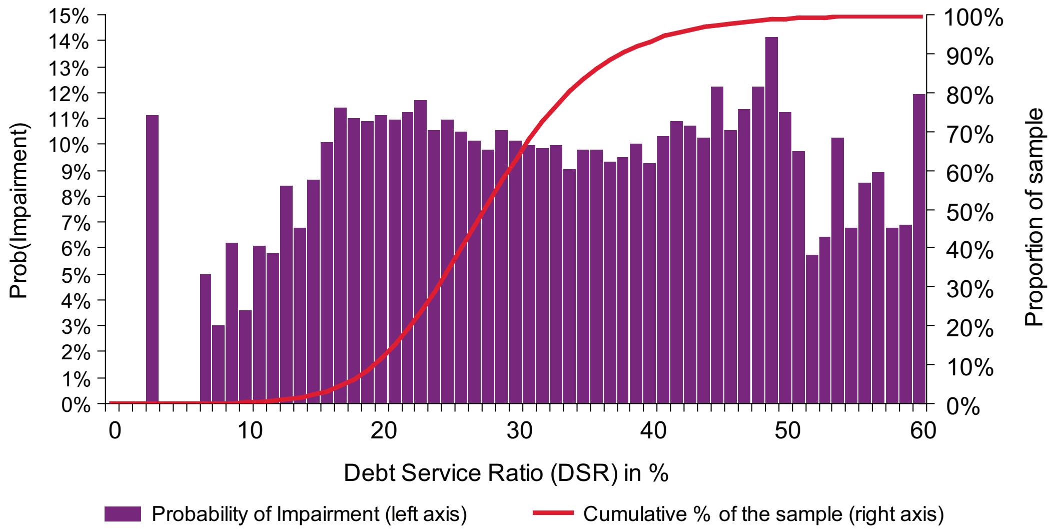


Figure A7.7 – Probability of impairment & DSR (High LTV, 5th income decile)



23. These results showed that for a fixed income and DSR level a higher LTV is associated with a higher probability of impairment. However, as with income, conditioning on LTV band did not bring out a dependence of impairment risk on DSR in the higher DSR regions.

24. The difficulty in finding a useful DSR-related measure of affordability might well have been due to the problem, mentioned in CP10/16 and above, that DSR does not take into account the expenditure details of the borrower. This was the next avenue we explored i.e. using expenditure data to construct a better ex-ante measure of mortgage affordability.

Constructing a better measure of ex-ante affordability using expenditure data

25. A problem with a DSR-based measure is that it is not informed by expenditure. Borrowers have 'non-essential' expenditure they will reduce in order to make a mortgage payment and 'essential' expenditure that they will not, and possibly cannot, reduce. If a borrower is pushed to a point where his expenditure is purely essential then any shock that reduces income or increases essential expenditure will push him to miss a mortgage payment (ignoring any savings or wealth the borrower may have).[74]

26. Given the difficulties with DSR, we considered two expenditure-to-income ratios for measuring affordability:

- *Total expenditure ratio*: This is the ratio of total expenditure and mortgage payment to net income (i.e. income after tax and national insurance).

74 Although borrower wealth is another important factor, we have not incorporated it into our attempts to construct a measure of affordability because we did not have appropriate data available to us.

- *Essential expenditure ratio*: This is the ratio of essential expenditure and mortgage payment to net income.

27. To assess affordability with an expenditure approach – regardless whether this is based on total or essential expenditure – requires expenditure data for borrowers. The PSD does not include data on borrower expenditure. Constructing an expenditure measure of affordability from the PSD thus requires attributing expenditure for each borrower in the PSD. The level of expenditure of a borrower also crucially depends on their household size, as household size is a key driver of expenditure. Unfortunately, household size data is also not included in the PSD.

28. To construct expenditure ratios, we therefore needed to map external data about expenditure and household size to the PSD. To understand the serious difficulties associated with this approach, it is important to describe the necessary steps we used to match expenditure data to the PSD.

- As household expenditure data is not reported in the PSD, the data for household expenditure was constructed using data reported from the Living Cost and Food (LCF) survey, collected by the Office for National Statistics.[75]
- Within the LCF, total expenditure is organised into 13 broad expenditure categories, which contain 484 detailed expenditure categories. We used this data to construct a measure of total household expenditure.
- The next step was to identify the key drivers of total or essential household expenditure. This was done by running a regression analysis based on the LCF dataset.[76]
- We then used the regression model to estimate the expenditure of the borrower households in the PSD.
- The crucial missing variable in the PSD was the lack of information about household size. To resolve this, we introduced Experian data on consumer types. This data on consumer types is based on post codes and also provided data about the probability of a household having children. Using the post code as the link, we used this to construct an estimate of the household size of the borrower in the PSD.

29. As this brief overview should make clear, the step of estimating expenditure for borrowers in the PSD was complex since it required linking data from several different data sources, which had been collected from different populations and for different purposes. This necessarily placed strong limits on the precision of the claims that could be made from the resulting matched data. However, in spite of these limitations we carried out the analysis to

75 The LCF provides a comprehensive breakdown of total expenditure for a representative sample of approximately 5,000 UK households every year. (We used five years of data from 2004 to 2008 in our analysis here.)

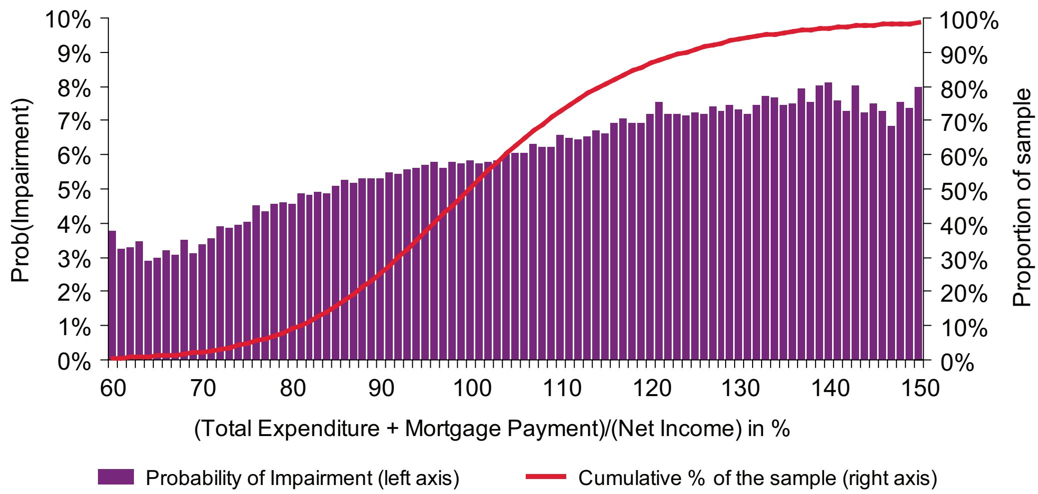
76 The regression analysis suggested the following drivers of household expenditure: disposable income, household size (i.e. it is also strongly related to the presence of children), the age of the head of the household (expenditure is greatest for households with a middle-aged household head) and geographical region.

explore the feasibility and possible benefits of incorporating external expenditure data in the measurement of mortgage affordability.

Total Expenditure Affordability Measure

30. We constructed a measure of total expenditure for borrowers in the PSD and used it to calculate the ratio of total expenditure and mortgage payments to net income, which was plotted against probability of impairment, as shown in Figure A7.8.

Figure A7.8 – Impairment and Total expenditure (based on LCF survey)



31. The graph shows probabilities of mortgage impairment almost continuously rising with the increasing total expenditure to income ratios. However, the gradient is not steep. In addition, Figure A7.8 reports very high expenditure to net income ratios. Indeed, the data reports that more than half of borrowers had total expenditure well in excess of net income. This is likely to be partly due to borrowers relying on previous savings or other wealth for expenditure. It may also be partly due to equity withdrawal, meaning mortgage lending that directly fed expenditure. However, it is extremely unlikely that these would fully account for such high ratios. The source of these high figures is likely in significant part to be nothing more than weakness in the method used to estimate expenditure data from the PSD using external expenditure data.

32. Even ignoring the very high total expenditure ratios, the data shows again a similar result to that observed with DSR: probability of impairment is not very sensitive to the total expenditure ratio, which also makes it a weak candidate for measuring ex-ante affordability.

Essential Expenditure Affordability Measures

33. A total expenditure ratio might mislead us because spending by better-off households might have a substantial discretionary element. This suggests an improved affordability measure, a ratio of essential expenditure plus mortgage payment to net income.

34. The preferred approach for measuring essential expenditure would be to use data that report household expenses for different categories of goods through time (with the expenditure on goods that remains stable indicating expenditure that is essential). Unfortunately, the available household expenditure data was not at a level of detail to enable this to be done.

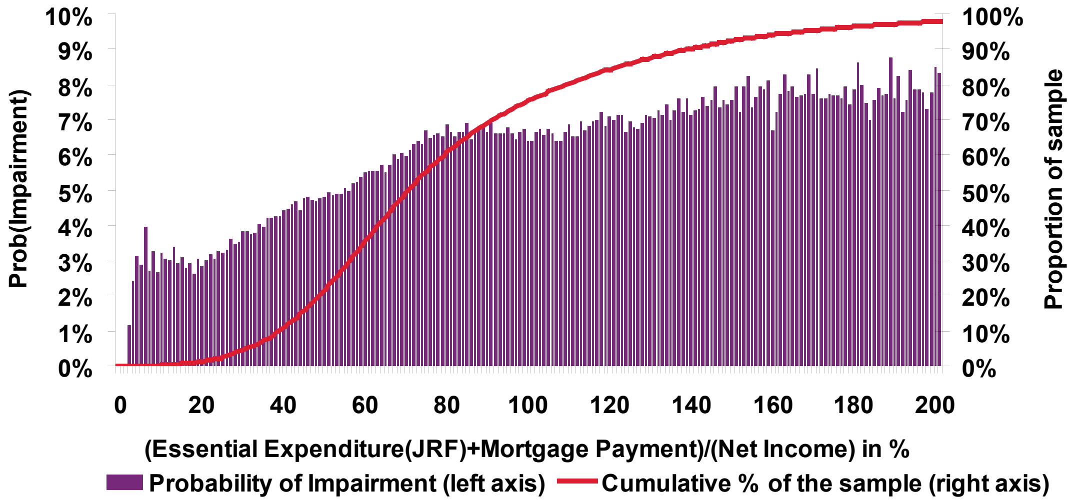
35. A second approach is to classify expenditures as essential and non-essential using external estimates for expenditure or income that is considered essential. There are several estimates available, for example, benchmark figures used by the Insolvency Service, trigger figures used in the Common Financial Statements,[77] the level of welfare benefits or the minimum income standards estimated by the Joseph Rowntree Foundation (JRF). The following exhibits present a range of different essential expenditure estimates using several data sources:

- Essential expenditure based on Joseph Rowntree Foundation (JRF) estimates.
- Essential expenditure directly based on Insolvency Service benchmark estimates (these estimates only vary with household type, not with household income).
- Essential expenditure based on Insolvency Service benchmark estimates amended to make the estimate sensitive to household income.

36. Figure A7.9 shows the ratio of essential expenditure plus mortgage payments plus a 5% contingency buffer to net income.

77 'The Common Financial Statement (CFS) is a budgeting tool that can be used by advice agencies and other third party organisations to make debt repayment offers to creditors on behalf of clients. It provides a detailed budgeting format to provide an accurate overview of a person's income, expenditure, assets and liabilities.' Quoted from www.moneyadvicetrust.org/section.asp?sid=14, accessed 5th October 2011.

Figure A7.9 – Mortgage payment problems and household expenditure – Essential expenditure based on Joseph Rowntree foundation estimates



37. In Figure A7.9 we observe that probabilities of mortgage payment problems are continuously rising up to a ratio of 80%. This covers approximately 60% of borrowers. The graph is relatively flat afterwards. Comparing Figures A7.8 and A7.9, we also see that the total expenditure ratio is greater for most groups than the corresponding essential expenditure ratio based on the JRF data.

38. Using Joseph Rowntree Foundation estimates to proxy essential expenditure may introduce an upward bias, especially for low income groups, since the JRF estimates are minimum income standards for an acceptable standard of living. For some groups, these are extremely high.[78] Because of this, other external measures for essential expenditure were also considered. However, as shown in Table A7.1 , external estimates vary widely.

Table A7.1 – External estimates of monthly (essential) expenditure (2010)

Household type	JRF[a]	Insolvency service estimates[b]	Trigger figure estimates[c]	Benefits[d]
Single	678	461	532	284
Couple (no children)	1,075	893	896	445
Couple (2 children)	1,627	1,070	1,321	1,020

a) Minimum Income Standard estimates – developed by the Joseph Rowntree foundation (JRF) –- exclude rent, council tax, water rates and childcare costs.

b) Insolvency estimates exclude rent but include other housing costs (i.e. water, electricity)

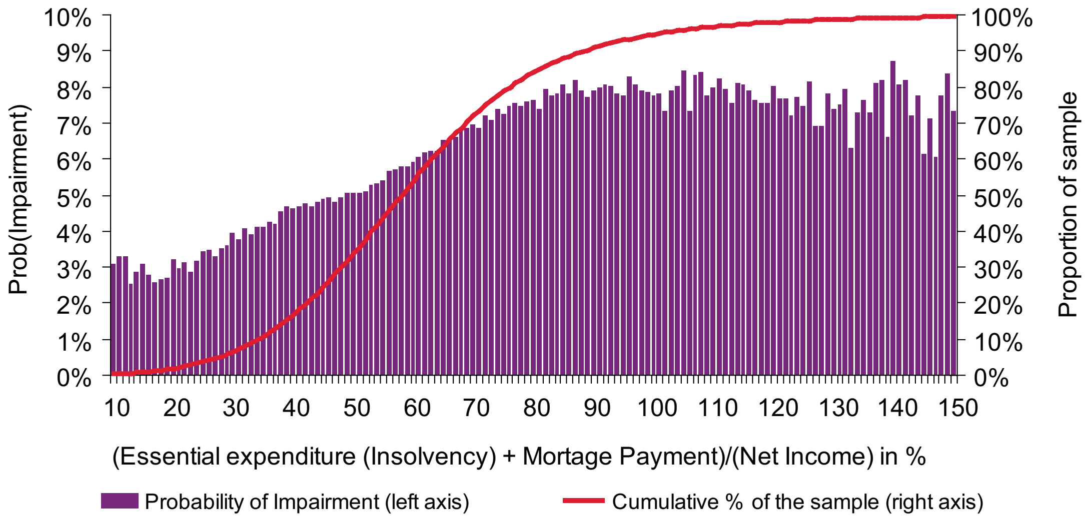
c) Trigger figures are used in the Common Financial Statements. Trigger figure estimates exclude rent, water, electricity and council tax.

d) Calculated including Jobseekers' Allowance, Child Benefit and maximum Child Tax Credit available for non-working parents with 2 children (> 1 yr old).

78 For example, based on JRF data, the essential and contingency expenditure estimate for a couple with one child is approximately £25,000. This compares with an average UK gross (pre-tax) individual income of £26,500 in 2010.

39. Continuing our analysis of expenditure ratios we also considered an essential expenditure ratio based on Insolvency Service estimates. Figure A7.10 below presents the relationship of this expenditure ratio with impairment.

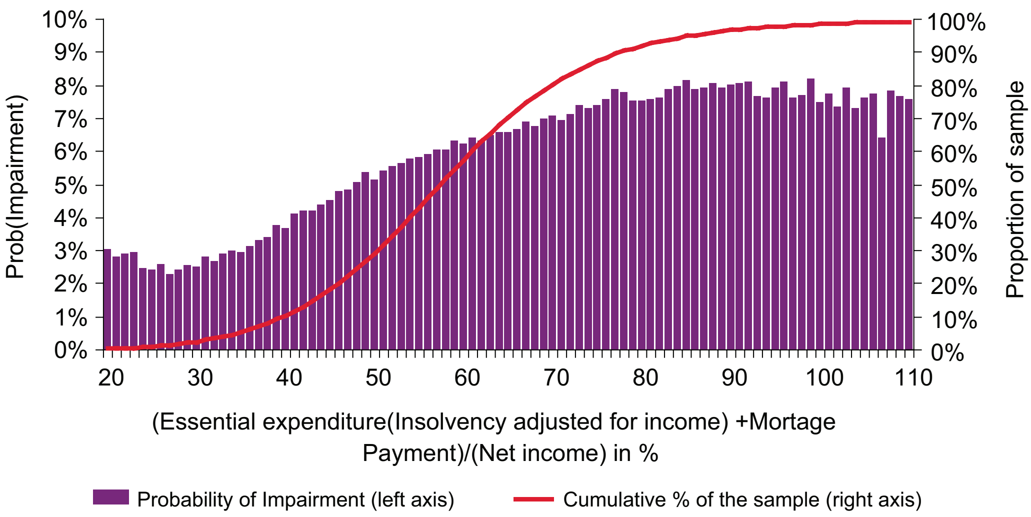
Figure A7.10 – Probability of impairment and household expenditure – Essential expenditure based on Insolvency Service estimates (non-income sensitive)



40. Relative to the previous expenditure estimates, the average ratios of expenditure to net income in Figure A7.10 are more in line with what one would expect, i.e. expenditure is lower than net income in over 90% of cases. However, the numbers are likely to be an underestimate, since approximately 85% of borrowers have more than 20% of their income available for discretionary expenditure, which seems not to reflect economic reality. The source of this bias is likely due to the characteristics of the Insolvency Service estimates. For example, the Insolvency Service estimates are based on only five data points from 2010 and we had to make assumptions about essential expenditure to make inferences for other household types. In spite of this, the graph itself has the most promising shape as it is rising until a ratio of expenditure / income of approximately 90%, which covers nearly 90% of borrowers.

41. We further adjusted the Insolvency Service measure to make it income-sensitive by mapping it (using the assumptions underpinning the Insolvency Service measure) to the Living Costs and Food Survey. The resulting graph is presented in Figure A7.11.

Figure A7.11 – Probability of impairment and household expenditure – Essential expenditure based on Insolvency Service estimates (income sensitive)



42. The results and data limitations are similar to those in Figures A7.9 and A7.10. We observe increasing probabilities of payment problems with increasing expenditure / income ratios until this ratio reaches approximately 75%. This covers 90% of borrowers. However, the expenditure estimates are now even lower than in Figure A7.10. More than 90% of borrowers now have more than 20% of income left for discretionary expenditure. Introducing income sensitivity to the Insolvency Service measure may therefore reinforce the downward bias in the Insolvency Service expenditure estimates. As with the other expenditure measures, and the DSR measures, impairment remains relatively insensitive to the essential expenditure ratio for less affordable mortgages on the right of the graph. Again, this is a disappointing result, since it shows that we have yet to find a measure of initial affordability that is a strong indicator of later mortgage performance problems.

Conclusions from our attempts to improve the affordability measure

43. Since CP10/16 we have improved our mortgage data and explored external expenditure data. This was done to improve our understanding of the drivers of mortgage impairment and with the aim of constructing an improved measure of ex-ante affordability. The key conclusions of this analysis are:

- DSR by itself is not a strong predictor of impairment for the data we have in the area of high risk mortgages. Conditioning on income and LTV did not help significantly;
- Supplementing the PSD with expenditure data from external sources is complex and because of data limitations can only be carried out to a limited level of precision. The

total expenditure ratio we constructed using the LCF data did not resolve the problems observed with the DSR.

- Constructing an affordability measure based on essential expenditure is theoretically more attractive. However, this introduced further data difficulties, in particular identifying which expenditure is essential. As with our analysis of total expenditure, our results did not suggest that an improved measure of affordability could be constructed using essential expenditure.

44. As described in Chapter A4 we have developed an alternative approach based on the quality of underwriting to estimate the impacts of the affordability assessment. This aimed at identifying mortgages that were poorly underwritten (i.e. based on weak assessments of credit and other factors), as these are the mortgages most likely to be affected by our proposals. We have based our estimated impacts of the affordability assessment on this approach.

45. However, we have encountered difficulties in using this approach based on the quality of underwriting to estimate the impacts of the interest rate stress test and the interest-only proposals (see Chapter A4). We therefore decided to use an approach based on DSR to estimate the incremental impact of the interest rate stress test and interest-only proposals. We chose DSR – despite the difficulties attached to it – because it is the only mortgage-expense related variable available to us.

Annex 2
Equality impact assessment

Introduction

1. We are required under the Equality Act 2010 to 'have due regard' to the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions.

2. As part of this, we conduct an equality impact assessment (EIA) to ensure that the equality and diversity implications of any new policy proposals are considered.

3. In this chapter we set out the results of our initial assessments of the MMR proposals. Because of the extensive nature of the MMR, we have broken our analysis down into separate EIAs for the proposals relating to:

- responsible lending (including the interest-only proposals and transitional arrangements);
- sales standards and disclosure;
- arrears management;
- the prudential regime for non-deposit taking lenders (non-banks); and
- the niche markets.

4. Our initial assessments suggest that our proposals do not result in direct discrimination for any of the groups with protected characteristics i.e. age, disability, gender, pregnancy and maternity, race, religion and belief, sexual orientation and transgender. However, our analysis and the feedback we have received so far has indicated that some of our proposals could give rise to indirect discrimination against some of these groups.

5. In this chapter, we discuss the potential impact of our proposals in relation to each of the protected characteristics. The EIA process is ongoing and will not be completed until we confirm our final policy position. Through this consultation, we are seeking additional input from all stakeholders to help us further investigate and establish the extent of any potential impacts of our proposals.

Initial assessments

6. Our initial assessment of the impact of our proposals takes account of the feedback we have received to questions already asked on this topic in previous consultations.

7. In CP10/16[1] (Responsible Lending) we asked:

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

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

8. In CP10/28[2] (Distribution and Disclosure) we asked:

> ***Q12:*** *Do you think that these distribution proposals will impact any groups with protected characteristics?*

> ***Q17:*** *Do you think these disclosure proposals will impact any groups with protected characteristics?*

9. Most respondents to these questions did not think that any of our proposals would have a negative impact on any groups with protected characteristics. However, there were some specific issues identified, which we discuss further below.

Age

10. A number of respondents raised concerns that the proposed tighter rules around **lending into retirement** and **interest-only** borrowing could mean that older consumers find it more difficult to obtain the levels of borrowing they want and this could limit their options.

11. Our proposals do not stop older consumers from taking out mortgages. What matters is that the consumer can afford the mortgage, even if their income reduces due to retirement. But we do share the concern that these proposals could be considered to disproportionately affect older consumers, which could be considered to be indirect discrimination.

12. On the other hand, the benefits these proposals could bring may outweigh any potential detriment. This was highlighted in the responses we received from consumer groups. They felt that these proposals could benefit older consumers, by preventing them from taking out

1 CP10/16, *Mortgage Market Review: Responsible Lending,* (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf
2 CP10/28, *Mortgage Market Review: Distribution & Disclosure,* (November 2010): www.fsa.gov.uk/pubs/cp/cp10_28.pdf

mortgages that they could not afford after retirement and by ensuring that they have a means to repay the capital element of an interest-only mortgage at the end of the term.

13. There is a similar concern about younger consumers who have not been in work for long and who may therefore find it difficult to provide the required history to enable a lender to **verify income**. Of course, this will not prevent them from getting a mortgage, though it may cause delay. The benefit of that delay is that the consumer does not take out a mortgage they cannot afford. So, again, it is a question of weighing up the potential benefits the proposal will bring against any potential detriment.

14. A few respondents felt that our proposal to require all **equity release sales to be advised** may cause some older, financially capable consumers who do not want advice to feel that they are being compelled to undertake a lengthier and unnecessary sales process. Again, this raises a question about the degree to which the benefit of this proposal might outweigh any potential detriment. Given the complex nature of these products it is important to ensure that the consumer's needs and circumstances are fully considered. The main trade association representing the equity release market already requires its members to ensure that their customers get advice from a qualified advisor which means that most of the market is already advised.

15. One trade body and a consultancy firm raised concerns about our proposal to require **all intermediaries to obtain a qualification**. They believed this proposal could particularly impact on older intermediaries who may be less able to take and pass exams at their stage in life, which may affect their employability. This proposal could also affect younger, less experienced intermediaries, or young people attempting to become advisers.

16. In our view, this proposal is justified on the basis that anyone who sells mortgages (irrespective of age or experience) should be appropriately qualified. Consumers receiving advice from any intermediary are entitled to expect that they have attained and maintained an appropriate level of knowledge. Moreover, any potential impact is mitigated by the fact that we already encourage qualification providers to offer alternatives to examinations for those advisers who are unable to sit a written examination.

17. At present, we do not think any further action is needed to address any of the above issues but we continue to look into them and would welcome feedback.

Q105: **Do you have any comments on the age-related issues discussed above?**

Q106: **Are there any other age-related impacts from our proposals not highlighted above? If yes, please provide details.**

Disability

18. A number of respondents believed that, because of uncertainties about the future of state benefits (including Support for Mortgage Interest and Disability Living Allowance), and the irregular nature of employment for some long-term disabled consumers, consumers with a disability might struggle to provide the necessary **evidence of income**.

19. In addition, there is a concern that the tighter requirements around **interest-only** loans may have an impact, especially for long-term disabled consumers who require interest-only mortgages in order to access shared ownership schemes or the Housing Option for People with Long-Term Disabilities scheme.

20. Our intention has always been to ensure that the changes we propose to our responsible lending rules leave sufficient room for lenders to be able to take account of an individual's circumstances. As we are not being prescriptive about the type of income or method of repayment that lenders can accept, we do not believe that our proposals will have a negative impact on the long-term disabled. But, again, we would welcome further feedback on this.

21. Some respondents have expressed concerns that our proposals to **disclose certain key messages** orally or in writing may not be accessible to those with sight or hearing problems. But lenders and intermediaries who deliver the key messages are subject to equalities legislation and should already have in place the means to ensure their services are accessible to all.

22. The proposed **transitional arrangements** set out in Chapter 3 (which are designed to help existing mortgage borrowers who cannot meet the proposed new affordability requirements) allow additional money to be borrowed only for the purposes of property repairs. This could mean that those consumers who become disabled or whose condition worsens may be unable to obtain additional funds in order to make the necessary alterations to their property to allow them to continue living there comfortably.

23. We have considered whether we should add an additional exception to the transitional arrangements to provide for this. However, we are concerned about the practical difficulties in identifying and confirming that this exception applies and the resulting potential for abuse. We also believe that there may be other more appropriate means of raising the necessary funds (e.g. government grants).

24. The final issue relates to disabled intermediaries being unable to sit examinations and obtain the necessary **qualifications**. However, qualification and training providers are obliged to meet the provisions of the Disability Discrimination Act and the Equality Act, including providing alternative means for studying and taking assessments. Given this, we do not think this issue needs any further investigation.

25. We continue to consider the issues raised above and the impact of these proposals on consumers with a disability and would welcome feedback on this.

Q107: Do you have any comments on the disability-related issues discussed above?

Q108: Are there any other disability-related impacts from our proposals not highlighted above? If yes, please provide details.

Gender

26. The only issue raised in feedback on gender was that women make up more of the temporary work force in the UK and so could be disproportionately affected by our **income verification** proposals.

27. As previously noted, however, we are not being prescriptive about the type of income lenders can accept. All income is capable of being proven in some way, so we do not think this issue needs any further investigation at this time. We would welcome feedback on this particular issue though, and we continue to investigate what other gender-related impacts our proposals could have.

Q109: Do you have any comments on the gender-related issue discussed above?

Q110: Are there any other gender-related impacts from our proposals not highlighted above? If yes, please provide details.

Pregnancy and maternity

28. Some respondents considered that pregnancy or career breaks to take care of children may mean that women are unfairly disadvantaged by the need to provide **evidence of income** and this could result in underwriting decisions that breach sex discrimination legislation.

29. We agree this is a potential area of concern. What we are proposing is that consumers – no matter who – take out mortgages that they can afford. Firms are already subject to sex discrimination legislation and should not have underwriting processes in place which discriminate against pregnant women or those on maternity leave.

30. We will continue to assess the impact of our responsible lending proposals in relation to pregnancy and maternity.

Q111: Do you have any comments on the pregnancy and maternity-related issue discussed above?

Q112: Are there any other pregnancy and maternity-related impacts from our proposals not highlighted above? If yes, please provide details.

Race

31. We have not identified any concerns that specifically relate to race but will continue to consider race issues within our assessments.

Q113: Are there any race-related impacts from our proposals that we should consider? If yes, please provide details.

Religion or belief

32. A few respondents felt that care will need to be taken with Home Purchase Plans (HPPs) sold to Islamic consumers, to ensure appropriate account is taken of their differences from regulated mortgage contracts and to ensure that they are covered by appropriate rules.

33. We already apply an element of tailoring of our mainstream rules to the HPP market in order to take account of the different product characteristics. We will continue to apply this tailored approach in relation to our revised sales standards rules and so we do not propose to investigate this further unless new evidence comes to light (details of our proposed approach to HPPs can be found in Chapter 10).

34. The final issue raised on religion and belief relates to the proposal to remove the requirement to present the Initial Disclosure Document (IDD), which means that the Islamic law compliance statement will not be given for HPPs. However, where intermediaries and providers deem this important, they can continue to include this statement in their initial disclosure.

Q114: Do you have any comments on the religion-related issues discussed above?

Q115: Are there any other religion-related impacts from our proposals not highlighted above? If yes, please provide details.

Sexual orientation

35. We have not identified any concerns that specifically relate to sexual orientation but will continue to ensure we consider sexual orientation issues within our assessments.

Q116: Are there any sexual orientation-related impacts from our proposals that we should consider? If yes, please provide details.

Transgender

36. We have not identified any concerns that specifically relate to transgender, but will continue to ensure we consider transgender issues within our assessments.

Q117: Are there any transgender-related impacts from our proposals that we should consider? If yes, please provide details.

The self-employed or those with irregular income who could belong to any protected group

37. While being self-employed and/or having an irregular income is not in itself a protected characteristic, respondents have suggested that some groups with protected characteristics may contain a higher than average proportion of consumers who are self-employed, or have irregular income. This could lead them to being disproportionately affected by our **affordability** and **interest-only** proposals.

38. As we have previously noted, the aim of these proposals is to ensure no-one is granted a mortgage they cannot afford, whether or not they belong to one of the groups with protected characteristics. What matters is that the consumer can afford the mortgage and, where it is an interest-only mortgage, has a credible strategy for repaying the capital element.

39. We will, however, continue to analyse the impact of these proposals in this context.

Next steps

40. We have not identified any equality or diversity issues arising from our proposals on arrears management and the prudential regime for non-banks. However, we continue to investigate the potential impact of all the MMR proposals on groups with protected characteristics and would welcome feedback in relation to all aspects of our proposals.

41. One difficulty we have encountered relates to data on protected characteristics. While we have been able to obtain limited data from our Product Sales Data (PSD) on, for example, age, it has proved difficult to find reliable data. To properly investigate the true extent to which any groups with protected characteristics may be affected, we would like to obtain more detailed information and supporting data on their mortgage needs and habits. So we would particularly welcome help in securing or accessing the necessary data to enable us to do this.

Q118: Do you have access to, or know of, any statistics regarding the mortgage needs and habits of groups with protected characteristics that could help us with our analysis? If yes, please provide details.

42. On the basis of current information, there is insufficient evidence of discrimination to justify amending or altering any of our policy proposals. The potential impacts on groups with protected characteristics we have discussed above are all likely to be justified in terms of our overall policy aims. But our analysis continues.

43. During the consultation period, we propose to engage with special interest groups for all protected characteristics to get their views and input, and to access any relevant data they hold.

44. Finally, it is important that the analysis and assessments we are undertaking in respect of our statutory obligations are not misinterpreted or used in any way as a pretext for firms' non-compliance with their own equality and diversity obligations. Firms have obligations to ensure for themselves that their systems and processes do not operate against groups of consumers with protected characteristics and our work should not be seen as a substitute for that.

Annex 3

Compatibility statement

Introduction

1. In this section we set out our views on how the proposals and draft rules in this Consultation Paper (CP) are compatible with our general duties under Section 2 of the Financial Services and Markets Act 2000 (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

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

Market confidence

3. We believe that our proposals will improve the quality of lending and sales standards across the market. In turn, we would expect this to lead to a higher level of consumer confidence when borrowing and higher market confidence more generally about the quality of mortgages underwritten.

Consumer protection

4. Some consumers have suffered significant detriment stemming from a mortgage that is unaffordable. Our draft rules ensure that this detriment is addressed. In addition, our draft rules on arrears charges should prevent those consumers having payment difficulties from being unfairly charged for costs that do not stem directly from the costs to the firm of administering their accounts.

5. Our draft rules on advice and execution-only sales will ensure that all consumers get mortgages that are suitable for them and, in particular, that vulnerable groups of consumers always get advice. In addition, our draft rules on disclosure requirements will ensure that consumers have a proper understanding up front of the costs of a firm's service and whether there are any limitations on the mortgages on offer through that firm.

6. Finally, the draft rules extending our proposals to the niche markets will ensure similar levels of consumer protection in these markets.

Reducing Financial Crime

7. We expect the draft rules requiring that income is verified in every case to help minimise the risk of mortgage fraud. Similarly, we would expect the draft rules strengthening professional standards and regulatory accountability of firms and individuals involved in selling mortgages to reduce the opportunities for financial crime.

Financial Stability

8. Our draft rules on responsible lending should help lead to a reduction in unaffordable borrowing. This reduction in the volume of unsustainable borrowing will also contribute to greater financial stability.

9. Our proposed new prudential rules for non-deposit taking lenders (non-banks) should improve non-banks' risk management, reduce the size of losses associated with default, limit opportunities for regulatory arbitrage and so contribute to greater financial stability.

Compatibility with the principles of good regulation

10. Section 2(3) of FSMA requires that, in carrying out our general functions, we have regard to the principles of good regulation. The proposals set out in this consultation fulfil all seven of our principles of good regulation.

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

11. As explained in the cost benefit analysis (CBA) in Annex 1, we anticipate that the proposals in this CP will introduce efficiencies in the supervision of firms. Subject to satisfactory standards of record keeping, the new approach provides supervisors with clearer and less ambiguous evidence of compliance or non-compliance than has been the case in the past and could help make firm reviews less time-consuming. In line with our approach elsewhere, we will use our risk-based resource allocation to prioritise any post-implementation review of the MMR.

The responsibility of those who manage the affairs of authorised persons

12. Our proposals to enhance sales standards across the market puts responsibility on firms and their management to ensure that consumers are only presented with mortgages that meet their particular needs and circumstances. Our responsible lending proposals clarify and strengthen the principle that ultimate responsibility for assessing affordability rests with the lender. Our proposals also require that the lender's responsible lending policy is approved by it's Board. In addition, our proposed package of prudential measures for non-banks will improve the firm's risk management and limit opportunities for regulatory arbitrage.

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

13. The proportionality of our approach is addressed in the CBA at Annex 1. Our conclusion is that the costs of our proposals are proportionate to the benefits both in terms of the reduced detriment arising from inappropriate products and unaffordable loans for consumers, and the macroeconomic impact of more sustainable lending.

The desirability of facilitating innovation

14. Our responsible lending proposals will constrain unaffordable lending, with an impact on innovation by firms that have moved higher up the risk curve. However, we believe that the draft rules will allow for innovation within firms. For example, firms will continue to create on-line business models and firms will also be responsible for determining how best to verify income and robustly assess affordability.

Promoting public awareness

15. As well as imposing new obligations on firms, the proposed changes to the sales process and the requirements on income verification and affordability assessments will have the effect of highlighting to consumers the importance of fully considering their purchasing decision. Alongside this, we will be working with the Money Advice Service 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.

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

16. 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, and 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.

17. We have also engaged closely with the Financial Stability Board's work on mortgage underwriting. Our proposals should allow the UK to demonstrate how it embodies the key elements of the sound mortgage underwriting principles that are being developed at an international level. This should assist in maintaining wider confidence in the standards in the UK market and therefore support its competitive position.

The need to minimise the adverse effects on competition

18. As explained in the CBA in Annex 1, our proposals may have a material impact on competition for non-bank lenders. However, it is challenging to single out and assess the impact of these proposals because it will largely overlap with the responsible lending proposals. Our analysis shows that a large proportion of unaffordable loans were advanced by non-bank lenders and it is expected that the responsible lending proposals are likely to reduce the availability of these loans. Thus this may prevent some non-bank lenders that have exited or some new firms from (re)-entering the market.

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

19. Our proposals draw on a comprehensive evidence base, and follow from extensive engagement with those interested in the mortgage market. We have taken account of the feedback to CP10/16[3] and CP10/28[4] in our further policy development.

20. We believe the proposals described in this CP represent the most appropriate and proportionate approach to ensuring that lending and borrowing is sustainable and affordable. As noted in CP10/16, we believe that imposing lending thresholds could unfairly penalise those consumers able to repay and preventing the sales of products with combinations of high-risk characteristics could unfairly deny consumers a mortgage without assessing their ability to pay. In our view, what matters is a proper assessment of affordability at an individual level.

21. We also explain in Chapter 8 why we believe that prudential reform would not of itself be an effective mechanism for deterring the high-risk lending the MMR is designed to target and therefore why conduct reform is needed in addition to prudential reform.

3 CP10/16, *Mortgage Market Review: Responsible Lending,* (July 2010): www.fsa.gov.uk/pubs/cp/cp10_16.pdf
4 CP10/28, *Mortgage Market Review: Distribution & Disclosure,* (November 2010): www.fsa.gov.uk/pubs/cp/cp10_28.pdf

Annex 4

List of questions

Chapter 1

No questions

Chapter 2

No questions

Chapter 3

Q1: **Do you agree that lenders should detail how they incorporate anti-fraud controls into their affordability assessments in their responsible lending policy?**

Q2: **Do you have any comments on our income proposals?**

Q3: **Do you agree with this approach to expenditure? Do you have any comments on the categories of expenditure? Do you have any practical concerns about implementing this approach?**

Q4: **Do you have any comments on our proposed approach to assessing affordability against future interest rate increases?**

Q5: **Do you agree with our assumption that 90% of lenders already apply a stress-test?**

Q6: **Do you think that lenders are currently applying a stress test of a similar degree to the test we propose?**

Q7: **Do you have any comments on our proposal to drop the requirement that affordability should be assessed on a maximum term of 25 years?**

Q8: **Do you have any comments on our proposals to protect credit-impaired consumers?**

Q9: **Do you think that our proposed enhanced sales standards will provide adequate protection for right-to-buy consumers? Are further measures required?**

Q10: **Do you think income multiples could work under our proposed rules? If not, why?**

Q11: **Do you have any comments on our proposal to require lenders to take into account information about future changes to income and expenditure?**

Q12: **Do you agree, that to ensure these proposals work, we should define a credit-impaired consumer? Do you agree with our proposed definition?**

Q13: **Which option do you prefer? Option 1, where the lender would be required to take reasonable steps to ensure that debts to be consolidated are repaid? Or option 2 where the lender would be required to assume that debts to be consolidated remain outstanding for purposes of assessing affordability? If you disagree with both options, what do you suggest as an alternative?**

Q14: Do you agree with our proposals to strengthen lender's systems and controls around responsible lending?

Q15: Do you have any comments on our proposed transitional arrangements? Do you think they will be sufficient to address risks to consumers? Will they create any additional risks to consumers?

Q16: Do you think that there is sufficient protection for mortgage borrowers who are 'trapped' with their current lender? If not, what additional protection do you suggest?

Q17: Do you think the eligibility requirements are appropriate? Should we allow these transitional arrangements to be used where the new monthly payment is higher?

Q18: Should we allow the transitional arrangements to be used where there is a material change to the mortgage, such as the removal of a borrower following a divorce? How could gaming be prevented?

Q19: Do you think these arrangements will be practical to implement? How could they be improved or simplified?

Q20: Do you agree that the draft rules on responsible lending in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012*, at Appendix 1, reflect the stated policy intention?

Chapter 4

Q21: What is your view on our approach to assessing affordability for interest-only mortgages?

Q22: Do you agree that we should apply a consistent approach to regulating interest-only across the board and that we should not adapt our approach according to different consumer types?

Q23: Do you agree with our non-prescriptive approach to repayment strategies, or do you have any comments on this approach?

Q24: Do you agree that lenders should be free to set their own appropriate controls around repayment strategies?

Q25: What is your view of our proposals for lenders' interest-only policies?

Q26: What are your views on our approach to requiring lenders to assess the repayment strategy prior to entering into the mortgage?

Q27: What is you view of our proposals for the ongoing management of interest-only loans? Do you foresee any practical issues?

Q28: Do you have any comments on the proposed changes to the glossary term, or the consequential changes?

Q29: Do you have any comments on the draft interest-only rules set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1? Do you think the rules reflect the stated policy intention?

Chapter 5

Q30: Do you have any comments on our proposed approach to intermediaries' role in assessing affordability?

Q31: (i) Do you have any comments on our proposed approach which allows high net worth consumers and mortgage professionals to opt-out of receiving advice and purchase on an execution-only basis?

(ii) Do you have any comments on our proposed definition of a 'mortgage professional'? (A question about the definition of a high net worth consumer is at the end of paragraph 10.83 in Chapter 10.)

(iii) Is there anything we can do to mitigate the risk of intermediaries using these exceptions to circumvent the rules?

(iv) Are there any other consumer types you think should be able to purchase on an execution-only basis in an interactive sale?

Q32: Do you have any comments on our proposed approach which allows consumers to opt-out of advice when purchasing products online or by post and allows them to purchase on an execution-only basis?

Q33: (i) We are proposing that consumers who are vulnerable (i.e. equity release, Sale and Rent Back or right-to-buy consumers and those who are consolidating debt) should always be advised and therefore will not be able to purchase their mortgage through a non-interactive process. Do you have any comments on this approach?

(ii) What are your views on our proposal to allow high net worth consumers and mortgage professionals to opt-out of receiving advice irrespective of whether they are considered to be vulnerable?

(iii) Are there any other consumer types you think should always receive advice?

Q34: **Do you agree that, except in the case of Sale and Rent Back, we should allow consumers to reject advice and proceed on an execution-only basis?**

Q35: **(i) We are proposing that intermediaries monitor their execution-only business. Do you have any comments on our proposed approach to monitoring?**

(ii) Are there any other steps we should take to ensure that consumers are protected when purchasing on a non-interactive basis, e.g. should we place any other limitations on the types of consumers who are able to purchase online?

Q36: **Do you agree that we should be specific about the appropriate method of disclosing service fees that are not simple flat fees?**

Q37: **Do you have any comments about our revised approach to the requirements for the messages on product range and remuneration to be given 'clearly and prominently'?**

Q38: **Do you consider that the combined IDD template remains useful with respect to mortgage service disclosure?**

Q39: **Do you agree that we should not apply the 'independent' and 'restricted' labels to the mortgage market, but instead require intermediaries to explain to the consumer in clear and straightforward terms any limitations to their service?**

Q40: **Do you have any views about our updated proposals for product disclosure?**

Q41: Do you have any comments on the draft rules on distribution and disclosure as set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1?

Chapter 6

Q42: Do you have any comments on the proposed policy approach on the calculation of payment shortfall charges?

Q43: Do you have any comments on the proposed policy approach on direct debit payments?

Q44: Do you have any comments on the proposal to extend the application of MCOB 12.4 and 13.3 rules to include payment shortfalls?

Q45: Do you have any comments on the proposal to replace MCOB 12.4.1 R (2) with a rule permitting firms to remove concessionary rates where there is a material breach of contract unrelated to payment shortfall?

Q46: Do you have any comments on the draft rules on arrears management as set out in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1?

Chapter 7

No questions

Chapter 8

Q47: **Do you agree that the new prudential requirements are unsuited to meeting the objectives of the MMR, specifically deterring high-risk lending?**

Chapter 9

Q48: **Do you have any comments on the proposed risk-based capital requirement?**

Q49: **Do you have any comments on the proposed restriction in the eligible capital calculation?**

Q50: **Do you have any comments on this proposed liquidity regime?**

Q51: **Do you have any comments on the proposed scope and application of the regime?**

Q52: **Do you have any comments on the draft rules set out in the draft *Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (Non-Bank Lenders) Instrument 2012* at Appendix 1? Do you think the rules reflect the stated policy intention?**

Chapter 10

Q53: **Do you have any comments on our views, summarised in the table at the end of this chapter, about the MMR proposals which are either not applicable or where a straight read-across to the equity release market is appropriate?**

Q54: What are your views on our proposal to treat the equity release market as a single market for regulatory purposes?

Q55: Do you have any comments on the tailoring we propose in relation to execution-only sales following rejected advice and scope of service?

Q56: Is any other tailoring required for the equity release market? If yes, please explain.

Q57: Overall, do you have any other comments on our proposed read-across of the MMR to the equity release market?

Q58: Do you have any comments on our views, summarised in the table at the end of this chapter, about those mainstream MMR proposals which are either not applicable or where a straight read-across to the Home Purchase Plan market is appropriate?

Q59 Do you have any comments on the tailoring we propose in relation to execution-only Home Purchase Plan sales following rejected advice and enhancing sales standards?

Q60: Is any other tailoring required for the Home Purchase Plan market? If yes, please explain.

Q61: Overall, do you have any other comments on our proposed read-across of the MMR to the Home Purchase Plan market?

Q62: Do you have any comments on our views, summarised in the table at the end of this chapter, about those mainstream MMR proposals which are either not applicable or where a straight read-across to the Sale and Rent Back market is appropriate?

Q63: Do you have any comments on the tailoring we propose in relation to not allowing Sale and Rent Back consumers to reject advice?

Q64: Is any other tailoring required for the Sale and Rent Back market? If yes, please explain.

Q65: Overall, do you have any other comments on our proposed read-across of the MMR to the Sale and Rent Back market?

Q66: Do you have any comments on our proposal to define a bridging loan as a regulated mortgage contract with a term of 12 months or less?

Q67: Do you have any comments on how the affordability proposals should be applied to consumers taking out bridging finance?

Q68: Do you have any comments on our proposed read-across of our interest-only proposals to bridging finance?

Q69: Do you have any comments on our proposal that lenders consider the repayment or exit strategy of the borrower, and have a clear lending policy that reflects this?

Q70: Do you have any comments on our proposals about extending bridging finance loans?

Q71: Are there any other factors that firms should consider in order to determine that a bridging loan is appropriate?

Q72: Do you have any comments on our proposal which requires that intermediaries who only offer bridging loans should describe the restriction on their service to the consumer?

Q73: **Do you have any comments on the proposed prudential regime for bridging lenders?**

Q74: **Do you agree with our views, summarised in the table at the end of this chapter, about the MMR proposals which are either not applicable or where a straight read-across to the bridging finance market is appropriate?**

Q75: **In addition to the proposed tailoring set out above, is any other tailoring required for the bridging finance market? If yes, please explain.**

Q76: **Overall, do you have any other comments on our proposed read-across of the MMR to the bridging finance market?**

Q77: **What are your views on our approach to high net worth consumers? Should we adopt a more free-market approach, recognising that for some consumers, regulation is not needed to protect them from the decisions they make?**

Q78: **Would an elective approach similar to that adopted in the investment market be appropriate?**

Q79: **Would it be appropriate for all mortgage rules to be forgone?**

Q80: **Would it be appropriate for all regulatory protections for high net worth to be forgone or should some, such as redress, for example, be retained?**

Q81: **What are your views on defining high net worth consumers – what do you consider the appropriate figures for income and assets?**

Q82: Do you agree that it is appropriate to extend the definition to include high net worth consumers acting as guarantors?

Q83: Do you have any comments on how the affordability proposals should be applied to high net worth consumers?

Q84: Do you have any comments on our proposal to extend the tailored disclosure rules to high net worth consumers?

Q85: Do you think that to achieve this, an elective approach similar to that adopted in the investment market would be appropriate?

Q86: Do you agree with our views summarised in the table at the end of this chapter about the MMR proposals which are either not applicable or where a straight read-across to high net worth lending is appropriate?

Q87: In addition to the proposed tailoring set out above, is any other tailoring required for high net worth lending? If yes, please explain.

Q88: Overall, do you have any other comments on our proposed read-across of the MMR to high net worth lending?

Q89: What are your views on our approach to business lending? Should we adopt a similar approach to that proposed for high net worth consumers, recognising that for some consumers, regulation is not needed to protect them from the decisions they make?

Q90: How would we draw a line between those business borrowers able to take the risk and those who are not?

Q91: How would we prevent this proposal from being exploited as a means of circumventing our affordability proposals?

Q92: Would it be appropriate for all mortgage rules to be forgone or should some, for example the arrears rules, be retained?

Q93: Do you have any comments on how the affordability proposals should be applied to business borrowers?

Q94: Do you have any comments on the proposed approach to professional standards in business lending?

Q95: Do you agree with our views summarised in the table at the end of this chapter about the MMR proposals which are either not applicable or where a straight read-across to business lending is appropriate?

Q96: In addition to the proposed tailoring set out above, is any other tailoring required for business lending? If yes, please explain.

Q97: Overall, do you have any other comments on our proposed read-across of the MMR to business lending?

Q98: Do you have any comments on the draft rules specific to niche mortgage markets in the draft *Mortgage Market Review (Conduct of Business) Instrument 2012* at Appendix 1? Do you think the rules reflect the stated policy intention?

Annex 1 CBA

Q99: Do you have any comments on our estimates for the impacts of the affordability assessment? Do you have any data and/or analyses that could be informative about these impacts?

Q100: Do you have any comments on our estimates for the impacts of the interest rate stress test? Do you have any data and/or analyses that could be informative about these impacts?

Q101: Do you have any comments on our estimates for the impacts of the interest-only proposals? Do you have any data and/or analyses that could be informative about these impacts?

Q102: Do you have any comments on our estimates of the combined impacts of the responsible lending requirements? Do you have any data and/or analyses that could be informative about these impacts?

Q103: Do you have any comments on our estimates for the lending impacts of the responsible lending requirements? Do you have any data and/or analyses that could be informative towards estimating these impacts?

Q104: Do you have any views on whether this balance between winners and losers is acceptable, given the importance of the protection obtained by the winners?

Annex 2 EIA

Q105: Do you have any comments on the age-related issues discussed above?

Q106: Are there any other age-related impacts from our proposals not highlighted above? If yes, please provide details.

Q107: Do you have any comments on the disability-related issues discussed above?

Q108: Are there any other disability-related impacts from our proposals not highlighted above? If yes, please provide details.

Q109: Do you have any comments on the gender-related issue discussed above?

Q110: Are there any other gender-related impacts from our proposals not highlighted above? If yes, please provide details.

Q111: Do you have any comments on the pregnancy and maternity-related issue discussed above?

Q112: Are there any other pregnancy and maternity-related impacts from our proposals not highlighted above? If yes, please provide details

Q113: Are there any race-related impacts from our proposals that we should consider? If yes, please provide details.

Q114: Do you have any comments on the religion-related issues discussed above?

Q115: Are there any other religion-related impacts from our proposals not highlighted above? If yes, please provide details.

Q116: Are there any sexual orientation-related impacts from our proposals that we should consider? If yes, please provide details.

Q117: Are there any transgender-related impacts from our proposals that we should consider? If yes, please provide details.

Q118: Do you have access to, or know of, any statistics regarding the mortgage needs and habits of groups with protected characteristics that could help us with our analysis? If yes, please provide details.

Annex 5

List of non-confidential respondents to CP10/16 and CP10/28

A Mortgage Now
Affinity Sutton
Age UK
Alison Stidolph
Angie Giacoppo
Anthony Sims
Arbuthnot Latham & Co Limited
Arron Bardoe
Association of Arrears Mediators
Association of Bridging Professionals
Association of Mortgage Intermediaries
Aviva UK Life
Bank of Ireland (UK) plc
Bath Building Society
Ben Bailey Homes
Bill Warren Compliance LLP
BM Samuels plc
Bovis Homes
Bridgewater Equity Release
British Bankers Association
Bromford Group
Bruce Packard
Building Societies Association
Cala Group
Callcredit
Cambridge Building Society
Carvill Group
Centre for Responsible Credit
Charles Church
Christopher Nicholson
Citizens Advice Bureau
Clive Brooks

Commercial First Mortgages Limited

Construction Employers Federation

Consumer Credit Counselling Service

Consumer Focus

Corinne Tuplin

Council of Mortgage Lenders

Countrywide Principal Services Ltd

Crest Nicholson

Cumberland Building Society

Danny Lovey

Darlington Building Society

David Harland

David Olivier

David Richie

Department for Communities and Local Government

Ed Lewis

Equifax

Equity Advice Line Ltd

Experian

Fairfield Finance

Finance & Leasing Association

Financial Services Consumer Panel

Furness Building Society

Galliford Try

Gary Frost

GE Money Home Lending

Genworth Financial

GMAC-RFC Limited

Goldsmith Mortgage Services

Graham Cox

Graham Edwards The Mortgage Shop Ltd

Headley Financial Services

Hearnden Associates

Home Builders Federation

Homes and Communities Agency

Homes for Scotland

Homes Mortgage Consultants Ltd

House Builders Association

Housing Rights Service

Hyde Group

Ian Gordon

Ian Rogers

Institute of Chartered Accountants in England and Wales

Intermediary Mortgage Lenders Association

Ipswich Building Society

J J Kelly

Jackson Cohen

JD Mortgage Services

Jeremy Kenyon

John Charcol

John Har-Ewen

John-Paul Rooney

Jon Vyse

Joseph & Hepple-Wilson
Just Retirement
KA Leason
Karen Stone
Keith Butler
Kevin White
Key Retirement Solutions
LaterLiving Ltd
Law Society
Leeds Building Society
London & Country Mortgages Limited
M Crosweller
Mactaggart & Mickel
Manchester Building Society
Mansfield Building Society
Mark Stone
Mark Thompson
Maureen Treadwell
McCarthy & Stone
Menelaus Analytics Ltd
Miller Homes Limited
Moat Homes Limited
Money Advice Trust
MortgageFinders Ltd
Mortgages Made Easy
Mortgages-Online
National Australia Group
National Counties Building Society
National Housing Federation
New Homes Marketing Board
Nicholas King Homes plc
Northern Rock Asset Management
Northern Rock plc
Norwest Consultants
Nottingham Building Society
Oakridge Financial Services plc
Openwork Limited
Orbit Group
Paul Kelly
Persimmon Homes
Peter Davies
Philip Shewan
Platform Mortgages
Priced Out
Property Match (UK)
Prudential
R S Mortgage Consultancy
Redrow Homes
Residential Landlords Association
Riccardo Tonelli
Rosaline Attardo
Royal Bank of Canada
Royal Institution of Chartered Surveyors
Rudolph Hucker

Scottish Building Society

Scottish Government

Shelter

SHIP

Skipton Building Society Group

Sovereign Housing Group

Stafford Railway Building Society

Stephen Atkins

Stephen Graham

Suresh Shah

Symphony Group

Taylor Wimpey plc

Teachers Building Society

The Association of Short Term Lenders

The Chartered Insurance Institute

The Co-operative Financial Services

The Mansfield Building Society

The Melia Partnership

The Mortgage Selector

The Office of Fair Trading

The Paragon Group of Companies plc

The Royal Bank of Scotland

The SJ Group Limited

Thomas Ross

Thornhill Financial Services

Tipton & Coseley Building Society

Tiuta plc

Towergate Financial/John Charcol

Trevor Passby

Tricon Limited

Welsh Assembly Government

Wentworth Financial

West Bromwich Building Society

Which?

White Horse Mortgage Services Limited

Willmott Dixon Homes

Yes Financial Services Ltd

Yorkshire Building Society

PART V
Appendices

Appendix 1

Draft Handbook text

Appendix 1: Draft Handbook text

Mortgage Market Review (Conduct of Business) Instrument 2012

MORTGAGE MARKET REVIEW (CONDUCT OF BUSINESS) INSTRUMENT 2012

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 modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended is amended in accordance with the Annexes to this instrument listed in column (2) below.

(1)	(2)
Glossary of definitions	Annex A
Training and Competence sourcebook (TC)	Annex B
Conduct of Business sourcebook (COBS)	Annex C
Mortgages and Home Finance: Conduct of Business sourcebook (MCOB)	Annex D
Professional Firms sourcebook (PROF)	Annex E

Amendments to material outside the Handbook

E. The Perimeter Guidance Manual (PERG) is amended in accordance with Annex F to this instrument. The general guidance in PERG does not form part of the Handbook.

Citation

F. This instrument may be cited as the Mortgage Market Review (Conduct of Business) Instrument 2012.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The new text is not underlined.

bridging loan	a *regulated mortgage contract* which has a term of twelve *months* or less.
credit-impaired customer	a *customer* who: (a) within the last two years has owed overdue payments, 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 (b) has been the subject of one or more county court judgments, with a total value greater than £500, within the last three years; or (c) has been subject to an individual voluntary arrangement or bankruptcy order which was in force at any time within the last three years.
direct deal	a *home finance transaction* that can only be obtained direct from a *home finance provider*, where that *home finance provider* is not the selling *firm*.
elective business customer	a *customer* who enters into a *home finance transaction* in order to fund his business activities, and has notified the *firm* in writing that, in relation to that *home finance transaction*, he agrees that *MCOB* will not apply to the services to be provided by the *firm*.
elective high net worth customer	a *high net worth customer* who has notified the *firm* in writing that, in relation to a *home finance transaction*, he agrees that, to the extent compatible with *EU* law, *MCOB* will not apply to the services to be provided by the *firm*.
execution-only sale	a *home finance transaction entered into* by a *firm* with, or *arranged* by a *firm* for, a *customer*, at the specific request of the *customer*, where the *firm* does not give

	advice on home finance transactions, or where the *customer* has rejected such *advice* given by the *firm*.
high net worth customer	in relation to a *home finance transaction*, a *customer* with an annual net income of no less than [£1,000,000] or net assets of no less than [£3,000,000], or whose obligations are guaranteed by a person with an income or assets of such amount.
high net worth illustration	an *illustration* for a *regulated mortgage contract* to a *high net worth customer*.
high net worth offer document	an *offer document* for a *regulated mortgage contract* to a *high net worth customer*.
initial contact	the first occasion when a *firm* is in contact with the *customer* and may perform any of the following in relation to a *home finance transaction*: (a) *advising* on the transaction; (b) *arranging (bringing about)* the transaction; or (c) *entering into* the transaction, when there is no *firm arranging (bringing about)* the transaction.
interest roll-up mortgage	an *interest-only mortgage* under which neither capital repayments, nor payment of any of the interest accruing under its terms, are required until it comes to an end, whether on expiry of the term (if any), discharge of the mortgage or the happening of some other event.
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.
professional customer	a *customer* who works or has recently worked in the home finance sector for at least one year in a professional position, which requires knowledge of the *home finance transactions* or home finance services envisaged, and who the *firm* reasonably believes to be capable of understanding the risks involved in the transaction or transactions contemplated.

Amend the following definitions as shown.

combined initial disclosure document	information about the *scope of advice* or *scope of basic advice* and the nature of the services offered by a *firm*

in relation to either:

(a) two or more of the following:

(~~a~~ i) *packaged products* or, for *basic advice*, *stakeholder products*;

(~~b~~ ii) *non-investment insurance contracts*;

(~~c~~ iii) ~~*regulated mortgage contracts*~~ *home finance products* (other than ~~*lifetime mortgages*~~ *regulated sale and rent back agreements*); or

~~(d) *home purchase plans*;~~

~~(e) *equity release transactions*;~~

(b) *home finance products* (other than *regulated sale and rent back agreements*) only;

which contains the keyfacts logo, headings and text in the order shown in, and in accordance with the notes in, *COBS* 6 Annex 2.

early repayment charge

(in *MCOB* and *BSOCS*) a charge levied by the *mortgage lender* on the *customer* in the event that the amount of the loan is repaid in full or in part before a date or event specified in the contract.

initial disclosure document

information about the *scope of advice* and the nature of the services offered by a *firm* in relation to~~:~~

~~(a) a *regulated mortgage contract* other than a lifetime mortgage as required by *MCOB* 4.4.1R(1) and set out in *MCOB* 4 Annex 1R;~~

~~(b) an *equity release transaction* as required by *MCOB* 4.4.1R(1) and set out in *MCOB* 8 Annex 1R;~~

~~(c) a *home purchase plan* as required by *MCOB* 4.4.1R(1) and set out in *MCOB* 4 Annex 1R; or~~

~~(d)~~ a *non-investment insurance contract* in accordance with *ICOBS* 4.5.1G and set out in *ICOBS* 4 Annex 1G.

repayment mortgage

a *regulated mortgage contract* under which the *customer* is obliged to make payments of interest and capital which are designed to repay the mortgage in full over the stated term.

repayment ~~vehicle~~ strategy

the means by which the *customer* ~~will~~ intends to repay the outstanding capital ~~due~~ and, where applicable, pay the interest accrued under the *regulated mortgage* *contract*, where all or part of that contract is an *interest-only mortgage*.

Annex B

Amendments to the Training and Competence sourcebook (TC)

In this Annex, underlining indicates new text.

TC Appendix 1

App 1.1 Activities and Products/Sectors to which TC applies subject to TC Appendices 2 and 3

App 1.1.1 R

<table>
<tr><th>Activity</th><th colspan="2">Products/Sectors</th><th>Is there an appropriate examination requirement?</th></tr>
<tr><td colspan="4">…</td></tr>
<tr><td colspan="4">Regulated mortgage activity and reversion activity carried on for a customer</td></tr>
<tr><td rowspan="3">Advising<u>; arranging (bringing about) or (for a mortgage lender or home reversion provider) an activity which would be arranging (bringing about) but for the exclusion in article 28A Regulated Activities Order (Arranging contracts to which the arranger is a party)</u></td><td>20</td><td>Regulated mortgage contracts for a non-business purpose</td><td>Yes</td></tr>
<tr><td><u>20A</u></td><td><u>Regulated mortgage contracts for a business purpose</u></td><td><u>No</u></td></tr>
<tr><td>21</td><td>Equity release transactions</td><td>Yes</td></tr>
</table>

Designing scripted questions for ~~non-advised~~ <u>execution-only</u> sales	<u>21 A</u>	<u>*Regulated mortgage contracts* for a non-business purpose</u>	<u>Yes</u>
	<u>21 B</u>	<u>*Regulated mortgage contracts* for a business purpose</u>	<u>No</u>
	22	*Equity release transactions*	Yes
Overseeing ~~non-advised~~ <u>execution-only</u> sales on a day-to-day basis	23	*Equity release transactions*	Yes
…			

…

Appendix 4E – Appropriate Qualification tables

…

Qualification table for: Advising a customer on <u>or arranging (bringing about)</u> a *regulated mortgage contract* (for a non-business purpose) - Activity number 20 in TC Appendix 1.1.1R<u>; and Designing scripted questions for use in execution-only sales to customers of *regulated mortgage contracts* for a non-business purpose - Activity number 21A in TC Appendix 1.1.1R</u>
…

Qualification table for: Advising a customer on <u>or arranging (bringing about)</u> *Equity release transactions* - Activity number 21 in TC Appendix 1.1.1R
…

…

Qualification table for : Overseeing ~~non-advised~~ <u>execution-only</u> sales on a day-to-day basis on *Equity release transactions* – Activity number 23 in TC Appendix 1.1.1R	
…	

TP 8 Transitional provisions relating to time limits for attaining qualifications

…		
8.2	R	An *employee* who is carrying on the activities specified in *TC* Appendix 1 of *arranging (bringing about) regulated mortgage contracts* or *home reversion plans* or (for a *mortgage lender* or *home reversion provider*) an activity which would be *arranging (bringing about)* but for the exclusion in article 28A *Regulated Activities Order* (Arranging contracts to which the arranger is a party) for a non-business purpose or designing scripted questions for execution-only sales of *regulated mortgage contracts* for a non-business purpose as at [*insert date final rules come into force*] will, for the purposes of *TC* 2.2A.1R, be regarded as carrying on such activities only with effect from that date; and, in relation to such an *employee*, a *firm* need not (in relation to such activities only) comply with *TC* 2.1.6R until [*insert date 30 months from date final rules come into force*]. TP 8.1 does not apply in respect of such an *employee*.

Annex C

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

6.2A Describing advice services

…

6.2A.4 G (1) A *firm* that provides both *independent advice* and *restricted advice* should not hold itself out as acting independently for its business as a whole. ~~However, a *firm* may hold itself out as acting independently in respect of its services for which it provides *independent advice* or advice which meets other independence requirements for particular *investments*. For example, a *firm* that provides *independent advice* on *regulated mortgage contracts* in accordance with *MCOB* but *restricted advice* on *retail investment products* will not be able to hold itself out as an independent financial adviser. However, it would be able to hold itself out as an adviser providing *independent advice* for *regulated mortgage contracts* provided it was made clear in accordance with the *fair, clear and not misleading rule* that it provided *restricted advice* for *retail investment products*.~~

<u>(1A)</u> <u>A *firm* that offers an unlimited range of *regulated mortgage contracts*, or gives *advice* in relation to *contracts of insurance* on the basis of a fair analysis, but offers *restricted advice* on *retail investment products* should not hold itself out as acting independently for its business as a whole, for example by holding itself out as an independent financial adviser. However, it may disclose that it offers an unlimited range for *regulated mortgage contracts* or gives *advice* in relation to *contracts of insurance* on the basis of a fair analysis provided it makes clear in accordance with the *fair, clear and not misleading rule* that it provides *restricted advice* for *retail investment products*.</u>

…

6 Annex 2 Combined initial disclosure document described in COBS 6.3, ICOBS 4.5~~, MCOB 4.4.1R(1)~~ and MCOB ~~4.10.2R(1)~~ <u>4.4A.20G</u>

….

2 Whose products do we offer? **[Note 4]** **[Note 4A]** **[Note 6]**

Home Finance Products [Note 13]

~~[Compliance with Islamic law [Note 18]~~

~~Our services are regularly checked by [name(s) of scholar(s)] to ensure compliance with Islamic law. Ask us if you want further information about the role of our scholar(s).]~~

[1] ~~[Lifetime]~~ [Mortgages] [Equity Release Products] [~~and~~ Islamic] [home ~~reversion schemes~~ purchase plans] [Note 13]

☐ ~~We offer [lifetime] [mortgages] [home reversion plans] [equity release products] from the whole market.~~

☐ ~~We [can] **[Note 7]** only offer [lifetime] [mortgages] [home reversion plans] [equity release products] from a limited number of [lenders / companies].~~

~~Ask us for a list of the [lenders / companies] we offer [lifetime] [mortgages] [home reversion plans] [equity release products] from. **[Note 14]**~~

☐ ~~We [can] **[Note 7]** only offer [a limited range of the] [a] [lifetime] [mortgage] [s] [home reversion plan] [s] [equity release products] from [a single lender / company] [name of single lender / company**]. [Note 11(1) and (3)][Note 16]**~~

~~[or]~~

~~We only offer our own [lifetime] [mortgages] [home reversions plan] [equity release products]. **[Note 11(2)]**~~

☐ ~~We do not offer [lifetime mortgages] [home reversion plans]. **[Note 12]**~~

~~[2] [Islamic Home Purchase Plans] [Note 19] [Note 13]~~

☐ ~~We offer Islamic home purchase plans from the whole market.~~

☐ ~~We [can] **[Note 7]** only offer Islamic home purchase plans from a limited number of providers.~~

~~Ask us for a list of the providers we offer Islamic home purchase plans from. **[Note 14]**~~

☐ ~~We [can] **[Note 7]** only offer [a limited range of the] [a] Islamic home purchase plan [s] from [a single provider] [name of single provider].~~ ~~**[Note 11(1) and (3)][Note 16]**~~

~~[or]~~

~~We only offer our own Islamic home purchase plans.~~ ~~**[Note 11(2)]**~~

Equity release products are either lifetime mortgages or home reversion plans. **[Note 5]**

We are not limited in the range of [mortgages] [equity release products] [Islamic] [home purchase plans] we will consider for you **[Note 7A]**

[Compliance with Islamic law [Note 18]

Our services are regularly checked by [name(s) of scholar(s)] to ensure compliance with Islamic law. Ask us if you want further information about the role of our scholar(s).]

3 Which service will we provide you with? **[Note 4]** **[Note 4A]** **[Note 6]** **[Note 6A]**

…

~~**[Home Finance Products] [Note 13]**~~

~~**[1] [Mortgages] [Equity Release Products] [Note 13]**~~

☐ ~~We will advise and make a recommendation for you on [lifetime mortgages] [home reversions] [equity release products] after we have assessed your needs.~~

☐ ~~You will not receive advice or a recommendation from us. We may ask some questions to narrow down the selection of [lifetime mortgages] [home reversions] [equity release products] that we will provide details on. You will then need to make your own choice about how to proceed.~~

~~**[2] [Islamic Home Purchase Plans] [Note 13]**~~

☐ ~~We will advise and make a recommendation for you after we have assessed your needs.~~

☐ ~~You will not receive advice or a recommendation from us. We may ask some questions to narrow down the selection of products that we will provide details on. You will then need to make your own choice about how to proceed.~~

4 What will you have to pay us for our services? [Note 4A] [Note 20A]

...

[Home Finance Products] [Note 13]

[1] [Mortgages] [Equity Release Products] [Islamic] [Home Purchase Plans] [Note 13]

☐ No fee. [We will be paid by commission from the [lender/~~company that buys your home~~provider].] **[Note 33]**

☐ A fee of £[ ] payable at the outset and £[ ] payable when you apply for a [lifetime] [mortgage] [home reversion plan] [equity release product] [Islamic] [home purchase plan]. [We will also be paid commission from the [lender/~~company that buys your home~~ provider.]]. **[Note 33] [Note 34]**

You will receive a ~~*key facts illustration*~~ keyfacts illustration when considering a particular [lifetime] [mortgage] [home reversion plan] [equity release product], which will tell you about any fees relating to it. **[Note 13] [Note 13A]**

Refund of fees [Note 32] [Note 13]

If we charge you a fee, and your [lifetime] [mortgage] [home reversion plan] [Islamic] [home purchase plan] does not go ahead, you will receive: **[Note 35]**

☐ A full refund [if the [lender/~~company~~provider] rejects your application]. **[Note 36]**

☐ A refund of £ [ ] [if your application falls through]. **[Note 36] [Note 37] [Note 38]**

☐ No refund [if you decide not to proceed]. **[Note 36]**

~~**[2] [Islamic Home Purchase Plans] [Note 13]**~~

☐ ~~No fee. [We will be paid by commission from the provider.] **[Note 33]**~~

☐ ~~A fee of £[ ] payable at the outset and £[ ] payable when you apply for an Islamic home purchase plan. [We will also be paid commission from the provider]. **[Note 18]**~~

~~**Refund of fees [Note 35]**~~
~~If we charge you a fee, and your Islamic home purchase plan does not go ahead, you will receive: **[Note 32]**~~

☐ ~~A full refund [if the provider] rejects your application]. **[Note 36]**~~

☐ ~~A refund of £ [ ] [if your application falls through]. **[Note 36] [Note 37] [Note 38]**~~

☐ ~~No refund [if you decide not to proceed]. **[Note 36]**~~

…

8 Are we covered by the Financial Services Compensation Scheme (FSCS)? [Note 4A] [Note 39] [Note 55] [Note 56]

…

~~**[Note 59] Message from the Financial Services Authority**~~

~~**Think carefully about this information before deciding whether you want to go ahead.**~~

~~**If you are at all unsure about which equity release product is right for you, you should ask your adviser to make a recommendation.**~~

...

Note 4 – a *firm* should describe the services that it expects to provide to the particular *client*. For services in relation to:

…

- ~~*equity release transactions* – the *firm* should select a maximum of two boxes within this section. *Firms* should not omit the boxes not selected.~~

- *home finance transactions* (other than *regulated sale and rent back agreements*) – where the *firm* will be providing services to a *consumer* by way of a *distance contract*, it should include in Section 3 a statement that explains whether or not the *consumer* will receive *advice* as part of the services. It should insert the appropriate heading above the statement in accordance with Note 13 (1).

Note 4A - If a *firm* is not offering all product types it should omit the headings and text relating to the product types it is not offering. For example, if it is completing the relevant sections of this template in relation to insurance and home finance products but not investment products, it should omit the heading "Investment" and the corresponding text.

Note 5 – a *firm* should include this sentence if, and only if, it offers *equity release transactions*.

…

Note 6A – If the *combined initial disclosure document* is used only in relation to *home finance transactions* (except where Section 3 is required to be used for *home finance transactions* as the *firm* is providing services by way of a *distance contract*: see Note 4), the *firm* should delete this heading and re-number the later sections accordingly.

Note 7 – insert "can" if the *firm's* range of products is determined by any contractual obligation. This does not apply where a *product provider*~~,~~ or *insurer*~~,~~ ~~*lender, home purchase provider*~~ or ~~*home reversion provider*~~ is selling its own products.

Note 7A - This sentence must only be used where there are no limitations in the product range that a *firm* will be providing to the *customer*. Otherwise, the *firm* must insert alternative text that describes in simple, clear terms the limits on its product range for the relevant market. If the *firm* is not considering products from a comprehensive range across the market and has not listed here the name of every lender/provider it offers products from, the text used must offer a list of these lenders/providers. Where the *firm* offers *equity release products*, it must state if it offers *home reversion plans* but not *lifetime mortgages*, or vice versa. The *firm* must also state that it will not consider *direct deals*, where that is the case. Depending on the *firm's* precise circumstances, the following examples may be appropriate:

- "We offer a comprehensive range of [mortgages] [equity release products] [Islamic] [home purchase plans] from across the market, but not deals that you can only obtain by going direct to a [lender/provider]."
- "We only offer products from [number] [lenders/providers]. We can provide you with a list of these."
- "We only offer some, but not all, of the [mortgages] [equity release products] [Islamic] [home purchase plans] from [number] [lenders/providers]. We can provide you with a list of these."
- "We only offer the [mortgages] [equity release products] [Islamic] [home purchase plans] from [name of lender(s)/provider(s)]."
- "We only offer some, but not all, of the [mortgages] [equity release products] [Islamic] [home purchase plans] from [name of lender(s)/provider(s)]."
- "We only offer lifetime mortgages from [name of lender(s)] and home reversion plans from [name of provider(s)]."
- "We only offer [lifetime mortgages/home reversion plans] but not [lifetime mortgages/home reversion plans]. We only offer [lifetime mortgages/home reversion plans] from [name of provider] and we only offer some, but not all, of their products."
- "We only sell bridging finance products from [name of lender(s)]. We do not offer products from across the mortgage market."

…

Note 11 – if the *firm* selects this box, it will be offering the products of one provider for a particular product type. It should therefore follow the format specified in (1) below except when offering its own products, in which case it should follow (2) instead. In the case of *non-investment insurance contracts*, where the *firm* is providing a service in relation to different types of insurance, this box covers the situation where it is offering a particular type of insurance from a single *insurance undertaking*.

(1) Insert the name of the provider, namely the *product provider* for *packaged products*~~,~~ and the *insurance undertaking(s)* for *non-investment insurance contracts*~~, the *lender* for *regulated mortgage contracts* and *regulated lifetime mortgage contracts* and the *home reversion provider* for *home reversion plans*~~. For example: “We can only offer products from [name of *product provider*]”. For *non-investment insurance contracts* the type of insurance offered should also be included. For example: “We only offer ABC’s household insurance and ABC’s motor insurance.” If the provider has only one product, the *firm* should amend the text to the singular – for example: “We can only offer a ~~mortgage~~ policy from [name of ~~lender~~ *insurance undertaking*]”. ~~If the *firm* does not offer all of the *home finance transactions* generally available from that provider, it should insert the words “a limited range of” as shown in the specimen.~~

(2) If the *firm* is a *product provider* offering only its own products, or is part of a *product provider* offering only the products sold under that part’s trading name, it should use this alternative text.

~~(3) If the *firm* offers *home reversion plans* from only one *reversion provider*, and *lifetime mortgages* from only one *lender*, which is different from the *reversion provider*, then the *firm* should identify the *lender* and the *reversion provider* and specify the type of *equity release transaction* to which they relate. For example, “We can only offer lifetime mortgages from ABC Mortgages Ltd and home reversion plans from ABC Reversions Ltd.”~~

~~**Note 12** – if the *firm* does not give *personal recommendations* advise or give personalised information on, both types of *equity release transactions*, then it should indicate to the *client* the sector that the *firm* does not cover. However, if the *firm’s* scope of service does not include *equity release transactions*, the last box (‘We do not offer [lifetime mortgages] [home reversion plans]’), should be omitted.~~

Note 13 – in describing the services and products provided, *firms* should omit the text in brackets that do not apply and ensure that they describe accurately their activities with respect of the services and products that they offer, as follows:

(1) Headings and sub-headings:

a. If the *firm* offers ~~both~~ a combination of *regulated mortgage contracts* ~~and~~, *home purchase plans* and *equity release products*, it should include the heading “Home Finance Products” in the *combined initial disclosure document* and describe the *regulated mortgage contracts*, ~~and~~ *home purchase plans* and *equity release transactions* (as applicable) that it offers under ~~two~~ separate sub-headings. The sub-headings (“Mortgages”, ~~and~~ “Home Purchase Plans” and

"Equity Release Products") should be numbered accordingly. If the *firm* only offers one of these ~~two~~ three products, then the heading "Home Finance Products" should be omitted and the heading will read "Mortgages", ~~or~~ "Home Purchase Plans" or "Equity Release Products", as appropriate.

b. If the *firm* offers *equity release transactions*, then the appropriate heading ~~"Home Finance Products" should be omitted and the~~ or sub-heading ~~will read~~ is "Equity Release Products" ~~(~~even if the *firm* offers ~~*equity release transactions* from only one sector)~~ only *lifetime mortgages* or only *home reversion plans*.

…

(2) Describing the products:

a. If a *firm* gives ~~*personal recommendations* or gives personalised information~~ *advice* on, or *arranges execution-only sales* in, lifetime mortgages, it should change "mortgage" to "lifetime mortgage"

b. If a *firm* gives ~~*personal recommendations* or gives personalised information~~ *advice* on, or *arranges execution-only sales* in, home reversion plans, it should use the text in brackets relating to home reversion plans.

c. If the *firm* gives ~~*personal recommendations* or gives personalised information~~ *advice* on, or *arranges execution-only sales* in, products from both equity release market sectors, then it should use the term 'equity release products' when referring to them collectively.

(3) Describing the provider: If a *firm* gives ~~*personal recommendations* or gives personalised information~~ *advice* on, or *arranges execution-only sales* in, *home purchase plans* or *home reversion plans*, it should change "mortgage" to "product" and "lender" to "company" or "provider", as appropriate.

(4) Home purchase plans: A *firm* that carries on *home purchase activities* may add the word "Islamic" to "home purchase plan(s)" if it holds out one or more *home purchase plans* within its product range as compliant with Islamic law. If "Islamic" is included, it should be included consistently throughout the document. However, a *firm* may omit the word "Islamic" in sections 5 and 8 even if it uses it elsewhere throughout the document. A *firm* that wishes to hold itself, its products or services out as compliant with religious or philosophical belief other than Islamic law may include an appropriate description in place of the references to "Islamic" and "Islamic law".

(5) A *firm* offering services in relation to loans for business purposes must use a description of its services which make that clear.

Note 13A – A *firm* must not include this paragraph if the only services to which the *combined initial disclosure document* relates are activities relating to *home purchase plans*. A *firm* may include a similar explanation regarding the financial information statement if the services they offer include activities relating to *home purchase plans*.

~~**Note 14** – for services provided in relation to *home finance transactions*, this sentence is required only where a *firm* selects this service option. It may also be omitted if a *firm* chooses to list all of the *lenders*, *home purchase providers* and *home reversion providers* it offers *home finance transactions* from in the previous line, so long as the *firm* offers all of the products generally available from each.~~

…

Note 16 – if the *firm* does not select this box, it should alter the wording to say "a single group of companies" for *packaged products*~~,~~ and "a single insurer" for *non-investment insurance contracts*~~, "a single lender" for *regulated mortgage contracts* or *lifetime mortgages* and "a single company" (or "a single provider") for *home purchase plans* and *home reversion plans*~~. For example: "We only offer the products from a single group of companies" should replace the text in the specimen *combined initial disclosure document*.

…

Note 18 – This subsection ~~is optional unless~~ may (at the *firm's* option) be used if, and only if, the *firm* holds ~~itself,~~ its ~~*regulated mortgage contract* or~~ *home purchase plan* products or services out as compliant with Islamic law ~~in the *combined initial disclosure document*~~. If a *firm* includes this section it should describe it as Section 2 and renumber subsequent sections accordingly.

A *firm* that wishes to hold itself, its ~~*regulated mortgage contract* or~~ *home purchase plan* products or services out as compliant with religious or philosophical beliefs other than Islamic law ~~in the *combined initial disclosure document*~~ may also use the subsection in accordance with this note and modify the wording in the section to the extent appropriate.

~~**Note 19** – A *firm* that carries on *home purchase activities* may omit the word "Islamic" from "Islamic home purchase plan(s)" if one or more *home purchase plans* within its scope of service is not held out as compliant with Islamic law. If "Islamic" is omitted, it should be omitted consistently throughout the document. However, a *firm* may omit the word "Islamic" in sections 5 and 8 without having to omit it throughout the document. A *firm* that wishes to hold itself, its products or services out as compliant with religious or philosophical belief other than Islamic law in the *combined disclosure document* may make appropriate amendments to references to "Islamic" and "Islamic law".~~

…

Note 34 – insert a plain language description of when any *fees* are payable for services relating to *home finance transactions*, and the amount ~~This description could include, for example, a cash amount, a percentage of the loan or reversion amount or the amount per hour, as appropriate. However, where a cash amount is not disclosed, one or more examples of the cash amount should be included~~. If a *firm* offers more than one pricing option in relation to *equity release transactions*, it should specify the pricing policy for each of them. For example, "A fee of £[XX] payable at the outset and £[YY] when you apply for a lifetime mortgage and £[ZZ] when you apply for a home reversion plan". If a *firm* does not charge a *fee*, the text for the second box should be abbreviated to 'A fee'. The fee must be described, where possible, as a cash sum, but where this is not possible:

- If the fee is a percentage of another sum which is not yet known (such as the amount to be borrowed), give the percentage and a representative illustrative example which gives an amount as a cash sum.

- If the fee will be one of a range of possible cash fees, provide a description of the fee in terms which include the maximum and minimum possible fees as cash sums, and what factors will determine where in the range the fee will be.

- If the fee will be one of a range of fees that are a percentage of another sum which is not yet known (such as the amount to be borrowed), give the minimum and maximum percentages and a representative illustrative example which gives an amount as a cash sum, and set out what factors will determine where in the range the fee will be.

- If the fee will be based on an hourly rate, but the number of hours to be spent on the *customer's* transaction is unknown, state the hourly rate in cash terms and set out what factors will determine how many hours it takes to provide the *firm's* services.

…

Note 39 – the *firm* may omit this section for services relating to *packaged products* if the *firm* has, on first contact with the *client*, provided the *client* with its *client agreement* which contains that information. This section may be omitted for services relating to *non-investment insurance contracts* if the information covered by this section is not required by *ICOBS* or is required by *ICOBS* but is provided to the *customer* by some other means. ~~This section may be omitted for services relating to *home finance transactions* in accordance with *MCOB* 4.4.1R(3).~~ If this section is omitted, the other sections of the *combined initial disclosure document* should be renumbered accordingly.

…

~~**Note 59** – this warning box should be added when the *firm* sells *lifetime mortgages* or home reversion plans or both.~~

Annex D

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.

Amend the following as shown.

1.2 General application: who? what?

1.2.1 R (1) This sourcebook applies to every *firm* that:

(a) carries on a *home finance activity* (subject to the business loan and loans to *high net worth customers* application provisions); or

…

Firm types and the home finance activities

1.2.2 G (1) This sourcebook applies to activities carried out in respect of ~~four types of product:~~ *regulated mortgage contracts* ~~(which includes *lifetime mortgages*)~~, *equity release transactions*, *home purchase plans*, ~~*home reversion plans*~~ and *regulated sale and rent back agreements*…

…

Business loans and loans to high net worth customers: application of MCOB

1.2.3 R In relation to a *regulated mortgage contract* for a business purpose

(1) *MCOB* applies if the *customer* is not a *large business customer* or an *elective business customer*; and

(2) if *MCOB* applies, a *firm* must either:

(a) comply with *MCOB* in full (disregarding the tailored provisions for *regulated mortgage contracts* for a business purpose in the remainder of *MCOB*); or

(b) comply with *MCOB* in full, but taking account of all those tailored provisions, including *MCOB* 1.2.7R.

1.2.3A R In relation to a *regulated mortgage contract* with a *high net worth customer*

(1) *MCOB* applies if the *customer* is not an *elective high net worth*

customer. If the *customer* is an *elective high net worth customer* then it applies only to the extent required to comply with *EU* law; and

(2) if *MCOB* applies, a *firm* must either:

(a) comply with *MCOB* in full (disregarding the tailored provisions for *regulated mortgage contracts* with *high net worth customers* in the remainder of *MCOB*); or

(b) subject to MCOB 1.2.9-AR, comply with *MCOB* in full, but taking account of all those tailored provisions, including *MCOB* 1.2.7R.

1.2.4 G For detail of the tailored provisions applying, see the section ~~on~~ '~~business~~ Business loans~~'~~ and loans to high net worth customers' set out in each relevant chapter.

…

Business loans and loans to high net worth customers: additional requirements if tailored route is used

1.2.7 R In relation to a *regulated mortgage contract* for a business purpose or with a *high net worth customer*, if a *firm* has opted for the tailored route, it must adopt the following modifications to the sourcebook:

(1) (except in relation to ~~sections 6 and 8 of any *initial disclosure document* or~~ sections 5 and 8 of any *combined initial disclosure document*) substitute an alternative description of the facility provided under the *regulated mortgage contract* for 'mortgage' where that term is used in any disclosure;

(2) substitute the term 'illustration' for ~~'key facts~~ 'keyfacts illustration' when opting to use the tailored business loans or loans to *high net worth customers* rules in *MCOB* 4.9, *MCOB* 5.7, *MCOB* 6.7 or *MCOB* 7.7; and

…

1.2.8 G (1) *Firms* are reminded of the requirement in *MCOB* 2.2.6R that any communication should be clear, fair and not misleading when substituting an alternative for the term 'mortgage' in accordance with *MCOB* 1.2.7R(1).

(2) Possible alternatives to the term 'mortgage' include, for example, 'secured ~~business~~ overdraft', 'secured loan' or 'secured business credit'.

1.2.9 G The disclosure *rules* in *MCOB* place particular emphasis on the description of borrowing. Where the *regulated mortgage contract* is for a business purpose or with a *high net worth customer*, a *firm* should reflect this emphasis in any disclosure by first describing any borrowing before addressing the other facilities provided under the *regulated mortgage contract*.

Requirement to obtain statement of high net worth before treating customer as high net worth customer

1.2.9-A R A *firm* may not apply, in relation to a *customer*, any of the tailored or other provisions for *regulated mortgage contracts* with *high net worth customers*, (including the provisions relating to *elective high net worth customers*), unless it has first obtained a written statement which:

(1) confirms that the *customer* satisfies the definition of *high net worth customer*;

(2) specifies the period for which it is valid, which includes the time when the *regulated mortgage contract* is *entered into*; and

(3) is signed by a suitably qualified professional adviser of the *customer* who is not an *associate* of the *firm* or of the *customer*.

1.2.9-B R A *firm* must keep the written statement in *MCOB* 1.2.9AR for not less than three years from the date on which it was obtained.

…

Authorised professional firms

1.2.10 R *MCOB* does not apply to an *authorised professional firm* with respect to its *non-mainstream regulated activities* except for:

…

(2) … ~~; and~~.

(3) ~~initial disclosure requirements but only as regards providing the information contained in section 7 (What to do if you have a complaint) and section 8 (Are we covered by the Financial Services Compensation Scheme?) of an *initial disclosure document* or *combined initial disclosure document* (see *MCOB* 4.4 and *MCOB* 4.10).~~ [deleted]

…

1.3 General application: where?

…

Distance contracts entered into from an establishment in another EEA State

1.3.4 R …

(2) The *rules* which do not apply are:

(a) initial disclosure requirements in *MCOB* ~~4.4~~ 4.4A (in respect of *regulated mortgage contracts*)…

…

(g) *MCOB* 8.3 (Application of rules in *MCOB* 4) to the extent that it applies *MCOB* ~~4.4~~ 4.4A to *MCOB* 4.6;

…

…

2.1 Application

Who?

…

2.1.2 R This table belongs to *MCOB* 2.1.1 R

(1) Category of firm	**(2) Applicable section**
mortgage lender ~~*mortgage administrator*~~ ~~*mortgage adviser*~~ ~~*mortgage arranger*~~	whole chapter except *MCOB* 2.2.6AR, *MCOB* 2.2.8AR, *MCOB* 2.2.8BG, *MCOB* 2.6A.1R to 2.6A18G and *MCOB* 2.8.6G
mortgage administrator *mortgage adviser* *mortgage arranger*	As for a *mortgage lender*, except that *MCOB* 2.6A.-1R does not apply.
home purchase provider	*MCOB* 2.1, *MCOB* 2.2.1G, *MCOB* 2.2.6R to *MCOB* 2.2.9G, *MCOB* 2.5~~,~~ to *MCOB* 2.6, *MCOB* 2.6A.1R to *MCOB* 2.6A.4G, *MCOB* 2.6A.7G to *MCOB* 2.6A.10G, *MCOB* 2.7.4R to *MCOB* 2.7.6R, *MCOB* 2.7A and *MCOB* 2.8.6G
…	
SRB administrator	*MCOB* 2.1, *MCOB* 2.2.1G, *MCOB* 2.2.2G, *MCOB* 2.2.3R, *MCOB* 2.2.6R, *MCOB* 2.2.7G, *MCOB* 2.2.8G, *MCOB* 2.5~~,~~ to *MCOB* 2.6, *MCOB* 2.6A.5BR(5), *MCOB* 2.6A.8R to *MCOB*

	2.6A.11G, *MCOB* 2.6A.17AR, *MCOB* 2.6A.18G, *MCOB* 2.7.1G to *MCOB* 2.7.5R, *MCOB* 2.7A, *MCOB* 2.8.1G to *MCOB* 2.8.5G.
…	

…

2.2 Communications

…

Related investment advice

2.2.5 G *Firms* are reminded that they should follow the relevant *rules* in *COBS* 6 and *COBS* 13 relating to advice and disclosure on *investments* if they are *advising* the *customer* on an *investment* such as an annuity associated with an *equity release transaction* or an *ISA* used as a *repayment* ~~*vehicle*~~ *strategy*.

…

2.5A The customer's best interests

2.5A.1 R A *firm* must act honestly, fairly and professionally in accordance with the best interests of its *customer*.

…

2.6A Protecting customer's interests: regulated mortgage contracts, home purchase plans, home reversion plans and regulated sale and rent back agreements

Protecting customer's interests: regulated mortgage contracts

2.6A-1 R A *mortgage lender* may only include, or rely on, a term in a *regulated mortgage contract* which permits it to change the rate of interest from a fixed, discounted or other concessionary rate to the *firm's* standard variable rate in the event of a breach of contract if each of the following conditions is met:

(1) the breach of contract is material;

(2) the breach of contract is unrelated to a *payment shortfall*; and

(3) that standard variable rate is not an interest rate created especially for *customers* who are (either at all, or in particular ways) in breach of contract.

...

Protecting customers' interests under regulated sale and rent back agreements:

security of tenure

2.6A.5B R (1) When ~~entering into a~~ *entering into a* *regulated sale and rent back agreement*, a *firm* must ensure that, under the terms of the *regulated sale and rent back agreement*:

...

(2) When ~~entering into a~~ *entering into a* *regulated sale and rent back agreement*, a *firm* must ensure that, under the terms of the *regulated sale and rent back agreement*, if the property is in England and Wales, the terms of the tenancy do not:

…

(3) When ~~entering into a~~ *entering into a* *regulated sale and rent back agreement*, a *firm* must ensure that, under the terms of the *regulated sale and rent back agreement*, if the property is in Scotland, the terms of the tenancy do not include:

…

(4) When ~~entering into a~~ *entering into a* *regulated sale and rent back agreement*, a *firm* must ensure that, under the terms of the *regulated sale and rent back agreement*, if the property is in Northern Ireland, the terms of the tenancy do not include:

…

…

3.8 Form and content of real time qualifying credit promotions

…

3.8.6 G Firms should note the additional disclosure requirements in *MCOB* ~~4.4.7R (Disclosure~~ 4.4A.17R (Additional disclosure where initial contact is by telephone), *MCOB* 4.4A.18R (Additional disclosure requirements where the services are to be provided to a consumer under a distance contract) and *MCOB* 4.5 (Additional disclosure for distance mortgage mediation contracts and distance home purchase mediation contracts with retail customers) in relation to telephone calls that may fall within the definition of a *financial promotion***.**

…

4.1 Application

Who?

…

4.1.2 R Table This table belongs to MCOB 4.1.1R

(1) Category of firm	(2) Applicable section
mortgage lender	except in relation to *lifetime mortgages*: *MCOB* 4.1 to *MCOB* ~~4.4~~ 4.4A, 4.6A, ~~and~~ *MCOB* ~~4.8~~ 4.8A in accordance with *MCOB* 4.1.2A R, ~~to~~ and *MCOB* 4.9
mortgage adviser	except in relation to *lifetime mortgages*: whole chapter except *MCOB* 10
mortgage arranger	except in relation to *lifetime mortgages*: whole chapter except *MCOB* ~~4.7~~ 4.7A and *MCOB* 4.10
home purchase provider	*MCOB* 4.1, *MCOB* 4.2 and *MCOB* 4.10 (except *MCOB* 4.10.5G to *MCOB* 4.10.7G). ~~*MCOB* 4.3,~~ *MCOB* ~~4.4~~ 4.4A and *MCOB* ~~4.8~~ 4.8A in accordance with *MCOB* 4.1.2BR and *MCOB* 4.10
home purchase adviser	*MCOB* 4.1, *MCOB* 4.2, *MCOB* 4.5, *MCOB* 4.6 and *MCOB* 4.10. ~~*MCOB* 4.3,~~ *MCOB* ~~4.4~~ 4.4A, *MCOB* ~~4.7~~ 4.7A and *MCOB* ~~4.8~~ 4.8A in accordance with *MCOB* 4.10
home purchase arranger	As for a *home purchase adviser* except ~~*MCOB* 4.10.5G to *MCOB* 4.10.7G~~ *MCOB* 4.10.5AR to *MCOB* 4.10.9AR, 4.10.13R and *MCOB* ~~4.7~~ 4.7A do not apply
~~*reversion*~~ *equity release provider* ~~*reversion*~~ *equity release adviser* ~~*reversion*~~ *equity release arranger*	See *MCOB* ~~8~~ 8.3 for the application of this chapter
…	

4.1.2A R *MCOB* 4.8A only applies to a *mortgage lender* in relation to *entering into a regulated mortgage contract* where there is no *firm* which is *arranging (bringing about)* the *regulated mortgage contract* to which *MCOB* 4.8A applies.

4.1.2B R *MCOB* 4.8A only applies to a *home purchase provider* (as provided in *MCOB* 4.10.9BR) in relation to *entering into a home purchase plan* where there is no *firm* which is *arranging (bringing about)* the *home purchase plan* to which *MCOB* 4.8A applies (as provided in *MCOB* 4.10.9BR).

4.1.2C G *MCOB* 4.1.2AR and *MCOB* 4.1.2BR mean that the provisions in *MCOB* 4.8A on *execution-only sales*, including the prohibition on entering into them in the circumstances specified in that section, only apply to sales by *mortgage lenders* or *home purchase providers* where there is no intermediary *firm* to which that section applies.

4.1.2D G *MCOB* 4.1.2AR and *MCOB* 4.1.2BR mean that the situations where *MCOB* 4.8A applies to a *mortgage lender* or *home purchase provider* include where a *mortgage intermediary* or *home purchase intermediary* has been involved in *arranging* a *regulated mortgage contract* or *home purchaser plan* but is no longer involved in the transaction.

What?

4.1.3 R This chapter applies if a *firm* in the course of carrying on a *home finance activity*~~:~~ *enters into*, *advises on* or *arranges a home finance transaction* or a variation of the terms of a *home finance transaction*.

~~(1) makes, or anticipates making, a *personal recommendation* about; or~~

~~(2) gives, or anticipates giving, personalised information relating to;~~

~~the *customer*~~

~~(3) entering into a *home finance transaction*; or~~

~~(4) varying the terms of a *home finance transaction* entered into by the *customer*.~~

…

4.1.6 G ~~*MCOB* 4.1.5 R means that this chapter, *MCOB* 4, deals with standard *regulated mortgage contracts*, *home purchase plans* and *regulated sale and rent back agreements* only and therefore *firms* should note that the scope of service *rules* in this chapter do not apply in respect of *equity release transactions*.~~ [deleted]

…

4.2 Purpose

4.2.1 G (1) This chapter amplifies *Principle* 6 (Customers' interests), *Principle* 7 (Communications with clients) and *Principle* 9 (Customers: relationships of trust).

(2) The purpose of this chapter is to ensure that:

(a) *customers* are adequately informed about the ~~nature of the service they may receive from a *firm* in relation to *home finance transactions*. In particular *firms* need to make clear to *customers* the scope~~ <u>range</u> of *home finance transactions* available from ~~them~~ <u>*firms* and the basis of their remuneration</u>; ~~and~~

(b) where *advice* is given, it is suitable for the *customer*~~. The steps *firms* need to take to ensure that the *customer* receives suitable *advice* will vary depending on the demands and needs of the *customer* and the type of *home finance transaction*.~~<u>;</u>

<u>(c) where there is spoken or other interactive dialogue between the *firm* and the *customer* during the sale, the *firm* provides advice in every case, except for *high net worth customers* and *professional customers*;</u>

<u>(d) when there is no spoken or other interactive dialogue between the *firm* and the *customer* during the sale, the *firm* is able to provide an execution-only service except for certain vulnerable *customers* (*customers* for *regulated sale and rent back* and *equity release transactions*; *customers* whose main purpose is debt consolidation; and *customers* who are using the transaction in order to exercise a statutory "right to buy") who are given advice in every case;</u>

<u>(e) *execution-only sales* are only provided where the *customer* has been warned about the implications of proceeding without *advice*, or where the *customer* has rejected *advice* which has been given, and has specifically instructed the *firm* that he wishes to do so; and</u>

<u>(f) except in the case of *regulated sale and rent back transactions*, *customers* have the right to reject *advice* and proceed on an execution-only basis.</u>

(3) This chapter also implements certain requirements of the *Distance Marketing Directive* in relation to *distance mortgage mediation contracts* and *distance home purchase mediation contracts*.

…

The existing section 4.3 is deleted in its entirety. The existing text is not struck through.

4.3 Scope of service provided <u>[deleted]</u>

MCOB 4.4 is deleted in its entirety and replaced with a new section MCOB 4.4A. The deleted text is not shown and the new text is not underlined.

4.4 Initial disclosure requirements [deleted]

4.4A Initial disclosure requirements

Description of a firm's services in all cases

4.4A.1 R Using the methods and at the times specified in this section, a *firm* must provide the *customer* with the following information:

(1) whether there are any limitations in the range of products that it will offer to the *customer*, and if so what those are; and

(2) the basis on which the *firm* will be remunerated.

4.4A.2 R (1) The limitations in *MCOB* 4.4A.1R include any limitations on the *regulated mortgage contracts* the *firm* will consider from within the relevant market. A *firm* which is offering services to a *customer* in respect of more than one type of relevant market must describe its services in relation to each such relevant market.

(2) For these purposes, there are two relevant markets for *regulated mortgage contracts* (apart from *lifetime mortgages*): one for *regulated mortgage contracts* that are not for a business purpose; and one for *regulated mortgage contracts* that are. A *firm* offering services in relation to loans for a business purpose must make that clear in its disclosure under *MCOB* 4.4A.1R(1).

(3) If a *firm* will not, as part of its services, consider *direct deals*, it need not treat that as a limitation in its product range, but the *firm* must tell the *customer* as part of the disclosure under *MCOB* 4.4A.1R(1) that it will not consider *direct deals*.

4.4A.3 G (1) A *firm* that only offers products from one part of a relevant market (for example, just *bridging loans*) should not disclose its service as unlimited.

(2) When considering whether there are any limitations in its product range across the relevant market, a *firm* need not take account of the existence of exclusive deals which a *mortgage lender* offers to be sold by one or a limited number of *mortgage intermediaries* only (and not generally by *mortgage intermediaries* across the relevant market).

4.4A.4 R (1) If a *firm* is not offering to the *customer* products from an unlimited range from across the relevant market, its disclosure on product range in

MCOB 4.4A.1R must either:

(a) list the names of all the *mortgage lenders* whose products it is offering; or

(b) inform the *customer* of the number of *mortgage lenders* whose products it is offering and that he has the right to request a list of those *mortgage lenders*

(2) If a *customer* requests the list in (1), the *firm* must provide it in a *durable medium* as soon as possible following the request and in any event within five *business days.* The list must also indicate whether the *firm* offers all of the products generally available from each *mortgage lender* on the list.

4.4A.5 G A *firm* may be able to describe its product range as unlimited even if it offers its *customers* only a selection of the *regulated mortgage contracts* available from the relevant market, or uses 'panels'. The *firm* would need to ensure that any panel, or selection of products, is sufficiently broad in its composition that it is representative of products from across the market; that it is reviewed regularly, and that its use does not materially disadvantage any *customer*. In such a case, a *firm* should ensure that its analysis of the market and of the available *regulated mortgage contracts* is kept adequately up to date. For example, a *firm* would need to update its selection of *regulated mortgage contracts* if it became aware that a *regulated mortgage contract* had become generally available offering an improved product feature, or a better interest rate, when compared with the *regulated mortgage contracts* currently in the *firm's* selection.

4.4A.6 G The disclosure required by *MCOB* 4.4A.1R(1), *MCOB* 4.4A.2R and *MCOB* 4.4A.4R(1) about limitations in product range and *direct deals* should be expressed in simple, clear terms. A *firm* may wish to consider using a sentence appropriate to the circumstances, along the following lines:

- "We are not limited in the range of mortgages we will consider for you."
- "We offer a comprehensive range of mortgages from across the market, but not deals that you can only obtain by going direct to a lender."
- "We only offer mortgages from [number] lender(s). We can provide you with a list of these."
- "We only offer mortgages from [name of lender(s)]."
- "We only offer some, but not all, of the mortgages from [number] lender(s). We can provide you with a list of these."
- "We only offer some, but not all, of the mortgages from [name of lender(s)]."

- "We only sell bridging finance products from [name of lender(s)]. We do not offer products from across the mortgage market."

4.4A.7 G (1) *Firms* are reminded that, in the light of the *rules* and *guidance* in *SYSC*, they should have adequate systems and controls in place to ensure that the disclosure they make to a *customer* about their service reflects the service the *customer* is actually offered.

(2) *Firms* are also reminded that *Principle* 7 (Communications with clients) and *MCOB* 2.2.6R (Clear, fair and not misleading communications) are also relevant to how they describe their services, including in any business name they adopt. For example, a *firm* should not call itself an "independent mortgage adviser" unless its product range across the relevant market is unlimited.

(3) A *firm* that offers a different service for different product types should not disclose that it offers one type of service for its business as a whole. For example, a *firm* that provides independent advice on retail investment products but only offers a limited range of *regulated mortgage contracts* should ensure it discloses to the *customer* that the service is different for the different products.

(4) There are additional *rules* about complying with *MCOB* 4.4A.1R(1) in relation to *home purchase plans* and *equity release transactions* at *MCOB* 4.10.3BR and *MCOB* 8.3.2BR.

4.4A.8 R (1) The information about the basis of remuneration required by *MCOB* 4.4A.1R(2) must include all relevant information, including the following details:

(a) any fees which the *firm* will charge to the *customer*;

(b) when any such fees will be payable and, if applicable, reimbursable; and

(c) whether the *firm* will receive commission from a third party and, if applicable, any arrangements for offsetting this against any fees charged.

(2) The details in (1)(a) must be expressed, where possible, as a specific cash sum, but the following *rules* apply where this is not possible:

(a) If the *firm* will charge a fee that is a percentage of another sum which is not yet known (such as, but not limited to, the amount to be borrowed), the *firm* must provide details of the percentage and a representative illustrative example which gives an amount as a cash sum.

(b) If the *firm* will charge one of a range of possible cash fees, the *firm* must provide a description of the fee in terms which include the maximum and minimum possible fees as cash sums, and what factors will determine where in the range the fee will be.

(c) If the *firm* will charge one of a range of fees that are a percentage of another sum which is not yet known (such as, but not limited to, the amount to be borrowed), the *firm* must provide details of the minimum and maximum percentages and a representative illustrative example which gives an amount as a cash sum, and set out what factors will determine where in the range the fee will be.

(d) If the *firm* will charge an amount based on an hourly rate, but the number of hours to be spent on the *customer's* transaction is unknown the *firm* must state the hourly rate in cash terms and set out what factors will determine how many hours it takes to provide the *firm's* services.

Method of providing initial disclosure in all cases

4.4A.9 R The information required by *MCOB* 4.4A.1R, *MCOB* 4.4A.2R, *MCOB* 4.4A.4R(1) and *MCOB* 4.4A.8R must be communicated clearly and prominently, and in doing so:

(1) if the *initial contact* includes spoken interaction, the information must be communicated orally; and

(2) if the *initial contact* does not include spoken interaction, the messages must appear separately from other messages in the communication.

If the *initial contact* is made by electronic means, the *firm* must ensure that the *customer* cannot progress to the next stage of the sale unless the information has been communicated to the *customer*.

4.4A.10 G (1) In order to comply with *MCOB* 4.4A.9R for an internet sale, a *firm* should display the required information on a screen which the *customer* must access as part of the sales process. It would not be sufficient for the information to be accessible only by giving the *customer* the option to click on a link or download a document. The messages could be displayed clearly on one of the initial pages which the *customer* accesses.

(2) In a postal sale, a *firm* may comply by setting out the messages in a clear covering letter.

(3) Where the *initial contact* is by email, SMS or instant messaging, the messages could be displayed clearly and prominently early on in the body of the email, SMS or instant messaging.

(4) For face-to-face and telephone contact, a *firm* should comply by building the messages into the initial oral discussion with the *customer*.

4.4A.11 G A *firm* may demonstrate compliance with *MCOB* 4.4.9R(1) by, for example, undertaking one or more of the following: building a requirement for oral communication of the relevant information into its training of staff as evidenced by its training and compliance manuals; inserting appropriate prompts into paper-based or automated sales systems; and having procedures in place to monitor compliance by staff with that *rule*. What is required in each case will depend on all the circumstances.

Timing of initial disclosure in all cases

4.4A.12 R The information required by *MCOB* 4.4A.1R, *MCOB* 4.4A.2R, *MCOB* 4.4A.4R(1) and *MCOB* 4.4A.8R must be provided during the course of the *initial contact*.

4.4A.13 G (1) In many cases, *MCOB* 4.4A.12R means that information will be given at the time of the first contact between the *firm* and the *customer*. However, there may be circumstances, for example in relation to a loan for a business purpose, where the possibility of the *customer* entering into, or varying the terms of, a *regulated mortgage contract* is only identified after preliminary discussions. The relevant disclosure is only required once this possibility is identified.

(2) *MCOB* 4.4A.12R does not require a *firm* to provide the information specified in that *rule* when a *customer* contacts a *firm* simply to arrange to receive services in relation to a *regulated mortgage contract* at a later time, such as when a *customer* books an appointment. In those cases, the initial disclosure should be made when the *firm* first makes contact with the *customer* with a view to actually carrying out the services. However, *firms* should note the additional disclosure requirements in *MCOB* 4.5 (Additional disclosure for distance mortgage mediation contracts with retail customers), and the need to ensure that the required information is provided in good time (see *MCOB* 4.5.3G(1)).

4.4A.14 G *Principle* 7 and *MCOB* 2.2.6R also mean that, if initial disclosure has been given but any of the information in it (for example the basis on which the *firm* will be remunerated) subsequently changes, the *firm* should bring this clearly to the *customer's* attention.

Instances where initial disclosure need not be given

4.4A.15 R The information requirements in *MCOB* 4.4A.1R, *MCOB* 4.4A.2R, *MCOB* 4.4A.4R(1) and *MCOB* 4.4A.8R do not apply where:

(1) the information has already been provided by the *firm* and the *firm* has good reason to believe that it is still accurate and appropriate for the *customer*; or

(2) the information has already been provided by the *firm* which first made contact with the *customer* in respect of the particular *regulated mortgage contract*, and the *firm* subsequently making contact with the *customer* does not expect to alter or replace the product range or basis

of remuneration described in that information.

4.4A.16 G A *mortgage lender* should provide the information in the provisions referred to in MCOB 4.4A.15R in a direct sale but need not do so where the sale is via a *mortgage intermediary*. If a number of different *firms* are involved in relation to the transaction, having regard to *MCOB* 2.5.4R(2), those *firms* should take reasonable steps to establish that the *customer* has been provided with the information as required by this section.

Additional disclosure where initial contact is by telephone

4.4A.17 R If the *initial contact* is by telephone, then the *firm* must also, before proceeding further, give the name of the *firm* and (if the call is initiated by or on behalf of the *firm*) the commercial purpose of the call.

Additional disclosure where the services are to be provided to a consumer under a distance contract

4.4A.18 R Where a *firm* provides services to a *consumer* by way of a *distance contract*, the *firm* must provide the *consumer* with the following information in a *durable medium* in good time before the *distance contract* has been agreed:

(1) the information which is required by *MCOB* 4.4A.1R to *MCOB* 4.4A.8R;

(2) whether or not the *firm* will be providing the *consumer* with *advice*;

(3) the name and the main business of the *firm*, the geographical address at which it is established and any other geographical address relevant for the *consumer's* relations with the *firm*;

(4) an appropriate statutory status disclosure statement (see *GEN* 4), a statement that the *firm* is on the *FSA Register* and its *FSA* registration number;

(5) the total price to be paid by the *consumer* to the *firm* for the financial service, including all related *fees*, charges and expenses, and all taxes paid through the *firm* or, when an exact price cannot be indicated, the basis for the calculation of the price enabling the *consumer* to verify it;

(6) the arrangements for payment and for performance;

(7) how to complain to the *firm*, whether complaints may subsequently be referred to the *Financial Ombudsman Service* and, if so, the methods for having access to it, together with equivalent information about any other applicable named complaints scheme;

(8) whether compensation may be available from the *compensation scheme*, or any other named compensation scheme, if the *firm* is unable to meet its liabilities, and information about any other applicable named

compensation scheme; and

(9) any other contractual terms and conditions of the *distance contract*.

4.4A.19 G (1) *MCOB* 4.4A.18R contains the additional disclosure requirements for *firms* providing *mortgage mediation activities* to a *consumer* by way of a *distance contract*. *MCOB* 4.5 and *MCOB* 4.6 contain further *rules* and *guidance* applicable where *firms* enter into a *distance contract* in respect of their *home finance mediation activities* independent of any contractual arrangement with a *consumer* relating to a particular *home finance transaction* or *transactions*.

(2) There is *guidance* on *distance contracts* and *consumers* at *MCOB* 1.3.5G and *MCOB* 1.3.6G.

4.4A.20 G If used in accordance with its notes and provided to the *customer* at the correct time, using a *combined initial disclosure document* in a *durable medium* may satisfy the requirements of *MCOB* 4.4A.18R, though *firms* should consider whether it contains all the contractual terms and conditions of the *distance contract*.

Uncertainty whether a mortgage is regulated

4.4A.21 R (1) If at the point that initial disclosure must be made in accordance with *MCOB* 4.4A.1R, *MCOB* 4.4A.2R, *MCOB* 4.4A.4R and *MCOB* 4.4A.8R a *firm* is uncertain whether the contract will be a *regulated mortgage contract*, the *firm* must:

(a) make the initial disclosure; or

(b) seek to obtain from the *customer* information that will enable the *firm* to ascertain whether the contract will be a *regulated mortgage contract*.

(2) Where (1)(b) applies, the initial disclosure must be made unless, on the basis of the information provided by the *customer*, the *firm* has reasonable evidence that the contract is not a *regulated mortgage contract*.

Appointed representatives

4.4A.22 R A *firm* may restrict the *home finance transactions* it authorises a particular *appointed representative* to sell. If it does so, the *firm* must ensure the *appointed representative* reflects this limited range in any disclosure given to the *customer* under *MCOB* 4.4A.

Record keeping

4.4A.23 G *Firms* are reminded of the general record-keeping requirements in *SYSC* 9. A *firm* should keep appropriate records of the disclosures required by this section.

Amend the following as shown.

4.5 Additional disclosure for distance mortgage mediation contracts, distance home purchase mediation contracts and distance regulated sale and rent back mediation contracts with retail customers

…

4.5.2 R If the ~~initial contact of a kind in *MCOB* 4.4.1R(1)~~ <u>*initial contact*</u> is with a *consumer* with a view to concluding a *distance mortgage mediation contract*…

After MCOB 4.6 insert the following new section. The text is not underlined.

4.6A Rolling-up of fees or charges into loan

4.6A.1 R A *mortgage lender* may not offer a *regulated mortgage contract* to a *customer* on the basis that fees or charges of any kind (receivable either by the *mortgage lender* or another party) are automatically added to the sum advanced.

4.6A.2 R A *firm* must not undertake any action that commits a *customer* to an application for a *regulated mortgage contract* where a fee or charge of any kind (receivable either by the *firm* or another party) is to be added to the sum advanced under the *regulated mortgage contract*, unless the *customer* has made a positive choice to add the fee or charge to the sum advanced.

MCOB 4.7 is deleted in its entirety and replaced with a new section MCOB 4.7A. The deleted text is not shown and the new text is not underlined.

4.7A Advised sales

4.7A.1 G (1) *MCOB* 4.7A sets out standards to be observed by *firms* when *advising on regulated mortgage contracts*.

(2) The *rules* at *MCOB* 4.8A, by forbidding *execution-only* sales to certain types of vulnerable *customer* unless *advice* has been given and rejected, require *firms* selling *regulated mortgage contracts* to these *customers* to provide *advice* to them.

(3) The *rules* at *MCOB* 4.8A also provide that *advice* must be given wherever the sales process involves spoken or other interactive dialogue (except for *high net worth customers* and *professional customers*) unless the *customer* elects not to receive *advice* and to proceed on an execution-only basis.

Suitability

4.7A.2 R If a *firm* gives *advice* to a *customer* to enter into a *regulated mortgage contract*, or to vary an existing *regulated mortgage contract*, , it must take reasonable steps to ensure that the *regulated mortgage contract* is, or after the variation will be, suitable for that *customer*.

4.7A.3 R In *MCOB* 4.7A, a reference to *advice* to enter into a *regulated mortgage contract* is to be read as including *advice* to vary an existing *regulated mortgage contract*.

4.7A.4 G In accordance with *Principle* 9, a *firm* should take reasonable steps to obtain from a *customer* all information likely to be relevant for the purposes of *MCOB* 4.7A.

4.7A.5 R For the purposes of *MCOB* 4.7A.2R:

(1) a *regulated mortgage contract* will not be suitable for a *customer* unless the *regulated mortgage contract* is appropriate to the needs and circumstances of the *customer*;

(2) a *firm* must base its determination of whether a *regulated mortgage contract* is appropriate to a *customer's* needs and circumstances on the facts disclosed by the *customer* and other relevant facts about the *customer* of which the *firm* is or should reasonably be aware;

(3) no *advice* must be given to a *customer* to enter into a *regulated mortgage contract* if no suitable one exists in the product range offered by the *firm*; and

(4) if a *mortgage lender* is dealing with an existing *customer* with a *payment shortfall* and has concluded that there is no suitable replacement *regulated mortgage contract*, the *firm* must nonetheless have regard to *MCOB* 13.3.

4.7A.6 R When a *firm* assesses whether the *regulated mortgage contract* is appropriate to the needs and circumstances of the *customer* for the purposes of *MCOB* 4.7A.5R(1), the factors it must consider include the following, insofar as relevant:

(1) whether the *customer's* requirements appear to be within the *mortgage lender's* known eligibility criteria for the *regulated mortgage contract*;

(2) whether it is appropriate for the *customer* to have an *interest-only mortgage*, a *repayment mortgage*, or a combination of the two;

(3) whether it is appropriate for the *customer* to take out a *regulated mortgage contract* for a particular term;

(4) whether it is appropriate for the *customer* to have stability in the

amount of required payments, especially having regard to the impact on the *customer* of significant interest rate changes in the future;

(5) whether it is appropriate for the *customer* to have their payments minimised at the outset;

(6) whether it is appropriate for the *customer* to make early repayments;

(7) whether it is appropriate for the *customer* to have any other features of a *regulated mortgage contract*;

(8) whether the *regulated mortgage contract* is appropriate, based on the information provided by the *customer* as to his credit profile; and

(9) whether it is appropriate for the *customer* to pay any fees or charges in relation to the *regulated mortgage contract* up front, rather than adding them to the sum advanced (see also *MCOB* 4.6A.2R).

4.7A.7 G *Firms* are reminded that the list in *MCOB* 4.7A.6R is not exhaustive. For certain *customers* there may be additional considerations to explore beyond those described in that rule; for example, in the case of a business loan or a *regulated mortgage contract* for a *high net worth customer*.

4.7A.8 G Examples of criteria in *MCOB* 4.7A.6R(1) are: the expected affordability criteria of the *mortgage lender*; and whether the *mortgage lender* will lend in respect of properties of a non-standard construction.

Interest-only

4.7A.9 R In relation to *MCOB* 4.7A.6R(2), where a *firm* has identified an *interest-only mortgage* as appropriate for a *customer*, the *firm* must ensure that the *customer* is aware that he will have to demonstrate to the *mortgage lender* that he has a clearly understood and credible *repayment strategy* in place, in order for the *mortgage lender* to be able to satisfy *MCOB* 11.6.24R(1).

4.7A.10 G *MCOB* 4.7A.9R does not require a *firm* to *advise* the *customer* on a credible *repayment strategy* or assess the adequacy of a *customer's* existing *repayment strategy*.

Bridging loans

4.7A.11 R When a *firm* <u>assesses</u> whether a *bridging loan* is appropriate to the needs and circumstances of the *customer* for the purposes of *MCOB* 4.7A.5R(1), the factors it must consider include, in addition to the factors listed at *MCOB* 4.7A.6R:

(1) whether it is appropriate for the *customer* to make regular payments; and

(2) whether it is appropriate for the *customer* to access finance quickly.

4.7A.12 R Where a *firm* has identified a *bridging loan* as appropriate for a *customer*, the *firm* must ensure that the *customer* is aware that he will have to demonstrate to the *mortgage lender* that he has a clearly understood and credible *repayment strategy* in place.

4.7A.13 R Where a *firm* is considering giving *advice* to a *customer* to enter into a *bridging loan*, the reasonable steps in *MCOB* 4.7A.2R include considering why it is not appropriate for the *customer* to take out a *regulated mortgage contract* which is not a *bridging loan*.

4.7A.14 E If a *firm advises* a *customer* to enter into a *regulated mortgage contract* with a term of a particular length so that *MCOB* 4.7A.11R to *MCOB* 4.7A.13R does not apply because the *regulated mortgage contract* does not fall within the definition of a *bridging loan*, that advice may be relied on as tending to show contravention of *MCOB* 2.5A.1R (The customer's best interests).

Debt consolidation

4.7A.15 R When a *firm advises* a *customer* in relation to entering into a *regulated mortgage contract* where the main purpose for doing so is the consolidation of existing debts by the *customer*, in addition to the factors at *MCOB* 4.7A.6R, it must also take account of the following, where relevant, in assessing whether the *regulated mortgage contract* is suitable for the *customer*:

(1) the costs associated with increasing the period over which a debt is to be repaid;

(2) whether it is appropriate for the *customer* to secure a previously unsecured loan; and

(3) where the *customer* is known to have payment difficulties, whether it would be appropriate for the *customer* to negotiate an arrangement with his creditors rather than to take out a *regulated mortgage contract*.

4.7A.16 E An attempt by the *firm* to misdescribe the *customer's* purpose or to encourage the *customer* to tailor the amount he wishes to borrow so that *MCOB* 4.7A.15R does not apply may be relied on as tending to show contravention of *MCOB* 2.5A.1R (The customer's best interests).

Further advances

4.7A.17 R Where the *customer* is looking to increase the borrowing secured on the property which is the subject of an existing *regulated mortgage contract*, unless the *firm* knows that the existing lender will not make a further advance to the *customer*, the *firm* must inform the *customer*, either orally or in writing, that it may be possible, and more appropriate, to do so rather than to enter into a *regulated mortgage contract* with another lender.

4.7A.18 G F*irms* are not under any obligation to explore whether a further advance with the existing lender is, in fact, more appropriate for the *customer*.

Other considerations when advising

4.7A.19 R When *advising* a *customer* on the suitability of a *regulated mortgage contract*, a *firm* must explain to the *customer* that the assessment of whether the *regulated mortgage contract* is appropriate to his needs and circumstances is based only on the *customer's* current circumstances and any reasonably foreseeable changes to those.

4.7A.20 G Different considerations apply when giving *advice* to a *customer* with a *payment shortfall*. For example, the circumstances of the *customer* may mean that, viewed as a new transaction, a *customer* should not be advised to enter into a *regulated mortgage contract*. In those cases, a *firm* may still be able to give *advice* to that *customer* where the *regulated mortgage contract* concerned is, in the circumstances, a more suitable one than the *customer's* existing *regulated mortgage contract*.

4.7A.21 G In complying with *MCOB* 4.7A.5R(1) a *firm* is not required to consider whether it would be preferable for the *customer* to:

(1) purchase a property by using his own resources, rather than by borrowing under a *regulated mortgage contract*; or

(2) rent a property, rather than purchase one; or

(3) delay entering into a *regulated mortgage contract* until a later date (on the grounds that property prices would have fallen in the intervening period, or that the interest rate in relation to the *regulated mortgage contract* may be lower, or both).

4.7A.22 G *MCOB* 4.7A.5R(3) means that where the *advice* is not provided on an unlimited range of products from across the relevant market, the assessment of suitability should not be limited to the types of *regulated mortgage contracts* which the *firm* offers. A *firm* cannot recommend the 'least worst' *regulated mortgage contract* where the *firm* does not have access to products appropriate to the *customer's* needs and circumstances. This means, for example, that a *firm* dealing solely in the credit-impaired market should not recommend one of these *regulated mortgage contracts* if approached for *advice* by a *customer* who is not a *credit-impaired customer*.

4.7A.23 G A *firm* may generally rely on any information provided by the *customer* for the purposes of *MCOB* 4.7A.5R(1) unless, taking a commonsense view of this information, it has reason to doubt it.

Rejected advice

4.7A.24 R If a *customer* has rejected the *advice* given by a *firm* and instead requested an *execution-only sale,* the *firm* may *enter into* or *arrange* that *execution-only sale* provided the conditions in *MCOB* 4.8A.10R are satisfied.

Record keeping

4.7A.25 R (1) A *firm* must make and retain a record:

(a) of the *customer* information, including that relating to the *customer's* needs and circumstances, that it has obtained for the purposes of *MCOB* 4.7A;

(b) that explains why the *firm* has concluded that any *advice* given to a *customer* complies with *MCOB* 4.7A.2R and satisfies the suitability requirement in *MCOB* 4.7A.5(1)R; and

(c) of the *customer's* positive choice in *MCOB* 4.6A.2R (Rolling up of fees or charges into loan) where applicable.

(2) The records in (1) must be retained for a minimum of three years from the date on which the *advice* was given or, in the case of (1)(d), the making of the choice.

MCOB 4.8 is deleted in its entirety and replaced with a new section MCOB 4.8A. The deleted text is not shown and the new text is not underlined.

4.8A Execution-only sales

Scope and application of this section

4.8A.1 G This section sets out the conditions which must be satisfied for a *firm* to *enter into* a *regulated mortgage contract* with a *customer*, or *arrange* such a transaction for a *customer*, without giving *advice*, or where the *advice* given by the *firm* has been rejected.

4.8A.2 G Where the *rules* in *MCOB* 4.8A apply to a *firm* they restrict *execution-only sales* to cases where:

(1) there is no spoken or other interactive dialogue between the *firm* and the *customer* during the sale; or

(2) if there is spoken or other interactive dialogue between the *firm* and the *customer* during the sale, the *customer* is a *high net worth customer* or a *professional customer* and has identified the product he wishes to purchase at the outset of the sale and positively elected to proceed with an *execution-only sale*; or

(3) the *customer* has rejected *advice,* identified the product he wishes to purchase and positively elected to proceed with an *execution-only*

sale;

and in each case certain conditions are satisfied.

4.8A.3 G Interactive dialogue includes SMS, mobile instant messaging, email and communication via social media sites.

The customer's best interests

4.8A.4 G *Firms* are reminded that *MCOB* 2.5A.1R (The customer's best interests) applies in all cases, including in relation to *execution-only sales*.

4.8A.5 R A *firm* must not encourage a *customer* to opt out of receiving *advice* on *regulated mortgage contracts* from, or reject *advice* given by, it or any *associate*.

4.8A.6 G *Firms* are not prohibited from *entering into* or *arranging execution-only sales* for *regulated mortgage contracts* for *customers* to whom they have provided product information, but *MCOB* 2.5A.1R and *MCOB* 4.8A.5R (The customer's best interests) mean the information they provide should be neutral and not prompt the *customer* to elect to enter into an *execution-only contract*.

Cases where execution-only sales are not permitted

4.8A.7 R A *firm* must not *enter into* or *arrange* an *execution-only sale* for a *regulated mortgage contract* if:

(1) the *customer* is intending to use it to exercise a statutory "right to buy" the *customer's* home; or

(2) the main purpose of the *customer's* entering into it is to raise funds for debt consolidation; or

(3) there is spoken or other interactive dialogue between the firm and the customer at any point, except where the *customer* is a *high net worth customer* or a *professional customer*;

unless the *customer* has received *advice* and the conditions set out in *MCOB* 4.7A.24R (Rejected advice) are satisfied.

4.8A.8 E An attempt by the *firm* to either:

(1) misdescribe the *customer's* purpose or characteristics; or

(2) encourage the *customer* to tailor the amount he wishes to borrow;

so that *MCOB* 4.8A.7R does not apply may be relied on as tending to show contravention of *MCOB* 2.5A.1R (The customer's best interests).

4.8A.9 G (1) If a *firm* wishes to be able to apply the exception in *MCOB* 4.8A.7R(3) for a *high net worth customer*, it should first consider the provision in *MCOB* 1.2.9-AR (Requirement to obtain statement of net worth before treating customer as high net worth customer).

(2) Where a *firm's* business model is such that it does not offer *advice on regulated mortgage contracts*, it should ensure that it does not *enter into execution-only sales* with (or *arrange* them for) *customers* falling within *MCOB* 4.8A.7R(1) and (2). Such a *firm* may wish to use filtering questions which the *customer* is required to answer before he is able to proceed.

The conditions for execution-only sales

4.8A.10 R A *firm* must not *enter into* or *arrange* an *execution-only sale* for a *regulated mortgage contract* unless:

(1) the *customer* has identified at the outset the *regulated mortgage contract* he wishes to purchase, specifying to the *firm* at least the following information:

(a) the name of the *mortgage lender*;

(b) the rate of interest;

(c) the interest rate type (that is, whether fixed, variable or some other type);

(d) the price or value of the property on which the *regulated mortgage contract* would be secured (estimated where necessary);

(e) the length of the term required by the *customer*;

(f) the sum the *customer* wishes to borrow; and

(g) whether the *customer* wants an *interest-only mortgage* or a *repayment mortgage*; and

(2) after providing the information in (1), the *customer* has been informed, clearly and prominently and in a *durable medium*:

(a) in any case falling within *MCOB* 4A.7.24 R (Rejected advice), that the *firm* considers the *regulated mortgage contract* unsuitable for the *customer*; or

(b) in any other case, that in the provision of its services for the *execution-only sale* the *firm* is not required to assess the suitability of that *regulated mortgage* contract;

and that therefore the *customer* will not benefit from the protection of the rules (in *MCOB* 4.7A) on assessing suitability. In any case where there is spoken dialogue between the *firm* and the *customer* at any point, the *firm* must also provide this information orally; and

(3) once the *customer* has been provided with the information in (2), in any case where there is spoken or other interactive dialogue between the *firm* and the *customer* at any point, he has confirmed, in writing, to the *firm* that he is aware of the consequences of losing the protections of the rules on assessing suitability and is making a positive election to proceed with an *execution-only sale*.

4.8A.11 R (1) Where the written confirmation in *MCOB* 4.8A.9R(3) is required, it must be in the same document as the information in *durable medium* in *MCOB* 4.8A.10R(2), which must be separate from any other information or contractual documentation.

(2) Where the information in *MCOB* 4.8A.10R(2) is given by electronic means, the *firm* must ensure that the *customer* cannot progress to the next stage of the sale unless the information has been communicated to the *customer*.

4.8A.12 R Where a sale is carried out entirely on the internet, a *firm* may permit the *customer* to input details about the matters specified in *MCOB* 4.8A.10R(1) in order to select from the *firm's* product range the *regulated mortgage contract* he wishes to purchase, provided it does not direct or encourage the *customer* towards the selection of any particular details.

4.8A.13 G If a *firm* intends (where permitted under this section) to operate a business model under which it will not give *advice*, it may wish to refer to *PERG* (particularly *PERG* 4.6) for guidance on the regulatory perimeter in relation to the *regulated activities* which constitute *advising on home finance transactions*.

Managing execution-only sales

4.8A.14 R A *firm* which intends to transact *execution-only sales* in *regulated mortgage contracts* must have in place and operate in accordance with a clearly defined policy which:

(1) sets out the amount of business the *firm* reasonably expects to transact by way of *execution-only sales*; and

(2) sets out its processes and procedures for ensuring compliance with the *rules* in *MCOB* 4.8A; in particular:

(a) how it will ensure in every case that, before proceeding with an *execution-only sale* it has obtained (where required) a voluntary and informed positive election from the *customer* in order to comply with *MCOB* 4.8A9R(3);

(b) how it will ensure in every case that it acts in compliance with *MCOB* 2.5A.1 R and *MCOB* 4.8A.4 R (The customer's best interests), including not encouraging a *customer* to enter into a *regulated mortgage contract* as an *execution-only sale*; and

(c) how it will identify whether a *customer* meets the definition of *high net worth customer* or *professional customer*, if it will offer *execution-only sales* to those *customers*; and

(3) includes the arrangements for monitoring and auditing compliance with the policy, processes and procedures.

Record keeping

4.8A.15 R (1) Whenever a *firm enters into* or *arranges* an *execution-only sale* for a *regulated mortgage contract,* it must make and maintain a record of:,

(a) the information provided by the *customer* which satisfies *MCOB* 4.8A.10R(1);

(b) the information in *durable medium* in *MCOB* 4.8A.10R(2);

(c) (where applicable) the confirmation by the *customer* in *MCOB* 4.8A.10R(3); and

(d) any *advice* from the *firm* which the *customer* rejected, including the reasons why it was rejected, before deciding to enter into an *execution-only sale*.

(2) The record in (1) must be retained for a minimum of three years from the date on which the *regulated mortgage contract* was *entered into* or *arranged*.

(3) A *firm* must keep an adequate and up to date record of the policy in *MCOB* 4.8A.14R, where such policy is required by that *rule*. 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.

4.9 Business loans and loans to high net worth customers

4.9.1 R ~~For the purposes of the *rules* in *MCOB* there is one market in *regulated mortgage contracts* for a business purpose. Within this market, a *firm* should describe its scope of service in accordance with *MCOB* 4.3.1R.~~ [deleted]

4.9.1A G *Firm*s are reminded that in accordance with *MCOB* 1.2.3R, they should ~~either~~ comply in full with *MCOB*, but in doing so may opt to take account of ~~or comply with~~ all tailored provisions in *MCOB* that relate to business loans or loans to *high net worth customers*, as the case may be. Therefore, a *firm* may only follow the tailored provisions in *MCOB* 4.9 in relation to one of these sectors if it also follows all other tailored provisions in *MCOB* that relate to that sector. In either case, the rest of *MCOB* applies in full.

4.9.2 G ~~Where a *personal recommendation* or personalised information is provided in connection with a *regulated mortgage contract* for a business purpose it is recognised that there may be additional considerations beyond those described in *MCOB* 4.7.11E as part of the assessment of whether the *regulated mortgage contract* is appropriate to the needs and circumstances of the *customer*.~~ [deleted]

Initial disclosure

4.9.3 G ~~As explained in *MCOB* 4.4.3G(1) the requirement to provide an initial disclosure document is only triggered where the *firm* has identified the possibility that it will be giving personalised information or *advice* to a *customer* on a *regulated mortgage contract* for a business purpose.~~ [deleted]

4.9.4 G (1) *Firms* are reminded that *MCOB* 1.2.7R enables them to substitute an alternative for 'mortgage' in the initial disclosure ~~document~~ in relation to a *regulated mortgage contract* for a business purpose or a *high net worth customer* (except in relation to ~~sections 6 and 8 of any *initial disclosure document* or~~ sections 5 and 8 of any *combined initial disclosure document*).

(2) *MCOB* 1.2.7R also means that a *firm* ~~must~~ should amend any *combined initial disclosure document* in relation to a *regulated mortgage contract* for a business purpose or a *high net worth customer* so that the final sentence of prescribed text in section 4 states: 'You will receive an illustration which will tell you about any fees relating to a particular [term used by the firm to describe the borrowing, for example "~~mortgage~~ secured overdraft"]'.

(3) Where the initial disclosure ~~document~~ in relation to a *regulated mortgage contract* for a business purpose or a *high net worth customer* makes reference to the permitted business of a *firm* (for example, sections ~~6~~ 5 and 8 of the ~~initial disclosure document~~ *combined initial disclosure document* may refer to a *firm advising* on or *arranging regulated mortgage contracts*) a *firm* can add text explaining the relevance of these descriptions. One approach may be to add an additional sentence such as: 'Secured overdrafts are referred to here as "mortgages" because they involve a charge being taken over your property'.

Non-advised sales

4.9.5 R ~~*MCOB* 4.8.1R does not apply in relation to a *regulated mortgage contract* for a business purpose.~~ [deleted]

…

4.10 Home purchase plans: sales standards

Scope of service provided

4.10.1 R ~~A firm must comply with the scope of service requirements at *MCOB* 4.3.1R and *MCOB* 4.3.2R (Providing services within and beyond scope), *MCOB* 4.3.4A R and 4.3.4AR (Whole of market and *MCOB* 4.3.10R (Appointed representatives).~~ <u>[deleted]</u>

Initial disclosure requirements

4.10.2 R (1) ~~A *firm* must, on first making contact with a *customer* when it anticipates giving personalised information or *advice* on *entering into* a new *home purchase plan*, ensure that the *customer* is, or has been, provided with an appropriate *initial disclosure document* or *combined initial disclosure document* in a *durable medium*.~~

(2) ~~If the initial contact in (1) is by telephone, a *firm* must:~~

~~(a)~~ ~~(if the call is with a view to concluding a *distance home purchase mediation contract*) give the following information before proceeding further:~~

~~(i)~~ ~~the name of the *firm* and (if initiated by the *firm*) the commercial purpose of the call;~~

~~(ii)~~ ~~the scope of the service provided by the *firm*; and~~

~~(iii)~~ ~~whether or not the *firm* will provide the *customer* with *advice* on those *home purchase plans* within its scope; and~~

~~(b)~~ ~~Ensure that the *customer* is, or has been, provided with such a document in a *durable medium* as soon as is practicable.~~

(3) ~~A *firm* must not use a *combined initial disclosure document* in relation to a combination of *home purchase plans* and *equity release transactions*.~~ <u>[deleted]</u>

4.10.3 G ~~In accordance with *Principle* 7, where a *firm* is likely to provide services in relation to both *regulated mortgage contracts* and *home purchase plans*, it should provide a combined *initial disclosure document* rather than two separate *initial disclosure documents*.~~ <u>[deleted]</u>

<u>4.10.3A</u> <u>R</u> <u>A *firm* must comply with the *rules in MCOB* 4.4A as if the references in those *rules* to *regulated mortgage contracts* and *mortgage lenders* were to, respectively, *home purchase plans* and *home purchase providers*.</u>

<u>4.10.3B</u> <u>R</u> <u>For the purposes of *MCOB* 4.4A.2R(1) there is one relevant market for *home purchase plans*.</u>

4.10.4 G The guidance on initial disclosure requirements ~~at *MCOB* 4.4.2G to *MCOB* 4.4.4G~~ <u>in *MCOB* 4.4A</u> may be relevant<u>; in this context, that *guidance* should</u>

be read using *home purchase plan* terminology instead of the equivalent *regulated mortgage contract* terminology, where appropriate.

Additional requirements for distance home purchase mediation contracts with retail customers

[**Note:** The rules regarding additional disclosure requirements for, and cancellation of, *distance home purchase mediation contracts* are set out in *MCOB* 4.5 and *MCOB* 4.6 respectively.]

Advised sales: suitability

4.10.5	G	~~In accordance with *Principle* 9, a *firm* should take reasonable steps to obtain from a *customer* all information likely to be relevant to ensuring the suitability of its advice.~~ [deleted]
4.10.5A	R	If a *firm* gives *advice* to a *customer* to enter into a *home purchase plan*, or to vary an existing *home purchase plan*, it must take reasonable steps to ensure that the *home purchase plan* is, or after the variation will be, suitable for that *customer*.
4.10.5B	R	In *MCOB* 4.10, a reference to *advice* to enter into a *home purchase plan* is to be read as including *advice* to vary an existing *home purchase plan*.
4.10.5C	G	In accordance with *Principle* 9, a *firm* should take reasonable steps to obtain from a *customer* all information likely to be relevant for the purposes of *MCOB* 4.10.5AR to *MCOB* 4.10.9AR.
4.10.5D	R	For the purposes of *MCOB* 4.10.5AR:

(1) a *home purchase plan* will not be suitable for a *customer* unless the *home purchase plan* is appropriate to the needs and circumstances of the *customer*;

(2) a *firm* must base its determination of whether a *home purchase plan* is appropriate to a *customer's* needs and circumstances on the facts disclosed by the *customer* and other relevant facts about the *customer* of which the *firm* is or should reasonably be aware;

(3) no *advice* must be given to a *customer* to enter into a *home purchase plan* if there is no *home purchase plan* which is suitable from the product range offered by the *firm*;

(4) if a *home purchase provider* is dealing with an existing *customer* in *arrears*, with a *payment shortfall* or otherwise in breach of their *home purchase plan* and has concluded that there is no suitable replacement *home purchase plan*, the *firm* must nonetheless have regard to *MCOB* 13.3; and

(5) the reasonable steps in that *rule* include considering why it is not appropriate for the *customer* to take out a *regulated mortgage*

contract.

4.10.6 R ~~A *firm*, before making a *personal recommendation* on a *home purchase plan*, must take reasonable steps to ensure that it is:~~

~~(1) affordable;~~

~~(2) appropriate to the *customer's* needs and circumstances.; and~~

~~(3) the most suitable of those *home purchase plans* that the *firm* has available to it within the scope of the service provided to the *customer*.~~ [deleted]

4.10.6A G *MCOB* 4.10.5DR(3) has the effect that a *firm* cannot recommend the 'least worst' *home purchase plan* where the *firm* does not have access to *home purchase plan* products appropriate to the *customer's* needs and circumstances.

4.10.7 G ~~The guidance on suitability at *MCOB* 4.7.8G to *MCOB* 4.7.10G and *MCOB* 4.7.16G may be relevant~~ *Firms* may wish to consider the following provisions:

(1) the *rule* at *MCOB* 4.7A.6R on the *customer's* needs and circumstances, as if it were *guidance* and to the extent applicable to *home purchase plans*; and

(2) the *guidance* at *MCOB* ~~4~~ 4.7A.1G(2), *MCOB* 4.7A.21G and *MCOB* 4.7A.23G (other considerations when advising);

in each case using *home purchase plan* terminology instead of the equivalent *regulated mortgage contract* terminology, where appropriate.

~~Non-advised sales~~

4.10.8 R ~~If a *firm arranges* a *home purchase plan* or a variation to an existing *home purchase plan* without giving a *personal recommendation*, it must ensure that the questions it asks about the *customer's* needs and circumstances are scripted in advance.~~ [deleted]

4.10.9 G ~~The guidance on non-advised sales at *MCOB* 4.8.2G and on scripted questions at *MCOB* 4.8.5G and *MCOB* 4.8.6G may be relevant.~~ [deleted]

Rejected recommendations

4.10.9A R If a *customer* has rejected the *advice* given by a *firm* and instead requested an *execution-only sale* of a *home purchase plan*, the *firm* may *enter into* or *arrange* that *execution-only sale* provided the conditions in *MCOB* 4.8A.10R (as applied in relation to *home purchase plans* by *MCOB* 4.10.9BR and modified for *home purchase plans* by *MCOB* 4.10.9CR) are satisfied.

Execution-only sales

4.10.9B R *MCOB* 4.8A applies to a *firm* as if the references in that section to *regulated mortgage contracts* and *mortgage lenders* were to, respectively, *home purchase plans* and *home purchase providers*, but *MCOB* 4.8A.10R(1) is modified in relation to *home purchase plans* as set out in *MCOB* 4.10.9DR.

4.10.9C G As provided in *MCOB* 4.1.2BR, *MCOB* 4.8A only applies to *home purchase providers* in relation to *entering into home purchase plans* where there is no *firm* which is *arranging* the transaction and to which *MCOB* 4.8A applies.

4.10.9D R (1) For *home purchase plans*, the following items of information replace those set out in *MCOB* 4.8A.10R(1):

(a) the name of the *home purchase provider*;

(b) the length of the term required by the *customer*; and

(c) the sum required from the *home purchase provider*.

(2) For *home purchase plans*, the information in (1) must be provided by the *customer* to the *firm* without any need for further discussion between the *firm* and the *customer*, in order for the condition in *MCOB* 4.8A.10R(1) to be satisfied.

Risks and features statement and tariff of charges

4.10.10 R A *firm* must, before ~~making a *personal recommendation* to~~ *advising* a *customer* ~~of, or when a *customer* requests or selects,~~ to enter into, or *entering* into or *arranging* a *home purchase plan* as an *execution-only sale*, ensure that the *customer* is, or has been, provided with an appropriate risks and features statement about that plan.

…

Record keeping

4.10.13 R (1) A *firm* must make and retain a record:

(a) of the *customer* information, including that relating to the *customer's* needs and circumstances that it has obtained for the purposes of *MCOB* 4.10.5DR;

(b) that explains why the *firm* has concluded that any *advice* given to a *customer* complies with *MCOB* 4.10.5AR and satisfies the suitability requirement in *MCOB* 4.10.5DR(1); and

(c) of any *advice* which the *customer* has rejected, including the reasons why they were rejected and details of the *home purchase plan* which the *customer* has proceeded with as an *execution-only sale*.

(2) The records in (1) must be retained for a minimum of three years from the date on which the *advice* was given.

4.10.14 G *Firms* should note the record-keeping requirements in *MCOB* 4.8A in relation to *execution-only sales* which are imposed in relation to *home purchase plans* by *MCOB* 4.10.9BR.

4.11 Sale and rent back: advising and selling standards

Initial disclosure requirements

4.11.1 R (1) A *regulated sale and rent back firm*~~, on first making contact with a potential *SRB agreement seller* for whom it might reasonably be expected to carry on any *regulated sale and rent back activity*,~~ must make the following disclosures to ~~him~~ a *customer*, both orally and in writing, during the *initial contact*:

…

~~Affordability and appropriateness~~ Advised sales

4.11.3 R A *regulated sale and rent back firm* must not permit a potential *SRB agreement seller* to become contractually committed to enter into a *regulated sale and rent back agreement* unless it has reasonable grounds to be satisfied that~~:~~ a *firm* with *permission* to *advise on regulated sale and rent back agreements* has *advised* the *customer* to enter into it.

~~(1) the *customer* can afford the payments he will be liable to make under the agreement; and~~

~~(2) the proposed *regulated sale and rent back agreement* is appropriate to the needs, objectives and circumstances of the *customer*.~~

Suitability

4.11.3A R A *firm* must take reasonable steps to ensure that it does not *advise* a *customer* to enter into a *regulated sale and rent back agreement* unless the *regulated sale and rent back agreement* is suitable for that *customer*.

4.11.3B G In accordance with *Principle* 9, a *firm* should take reasonable steps to obtain from a *customer* all information likely to be relevant for the purposes of *MCOB* 4.11.3AR.

4.11.3C R For the purposes of *MCOB* 4.11.3AR:

(1) a *regulated sale and rent back agreement* will not be suitable unless, having regard to the facts disclosed by the *customer* and other relevant facts about the *customer* of which the *firm* is or should reasonably be aware, the *firm* concludes on reasonable grounds that:

(a) the *customer* can afford the payments he will be liable to make under it; and

(b) the proposed *regulated sale and rent back agreement* is appropriate to the needs and circumstances of the *customer*;

(2) A *firm* must base its determination of whether a *customer* can afford the payments he will be liable to make under a *regulated sale and rent back agreement*, and whether it is appropriate to his needs and circumstances, on the facts disclosed by the *customer* and other relevant facts about the *customer* of which the *firm* is or should reasonably be aware.

(3) no *advice* must be given to a *customer* to enter into a *regulated sale and rent back agreement* if there is no *regulated sale and rent back agreement* which is suitable from within the product range offered by the *firm*.

4.11.4 E (1) In assessing whether a *customer* can afford to enter into a particular *regulated sale and rent back agreement*, a *firm* should use the following information:

(a) the rental payments that will be due under the tenancy agreement which confers the right of the *customer* (or trust beneficiary or related party) to continue residing in the property, stress tested to take account of possible future rental increases during the fixed term of the tenancy agreement by reference to the circumstances in which the agreement permits increases or changes to the initial rent;

(b) adequate information, obtained from the *customer* to establish his average income and expenditure calculated on a monthly basis, and any other resources that he has available, and verified by the firm using evidence provided by the *customer*;

(c) the *customer's* net disposable income, which a *firm* should establish using the information referred to in (b);

(d) the *customer's* entitlement to means-tested benefits and housing benefits; and

(e) the effect of any likely future change to the *customer's* income, expenditure or resources during the period of the *regulated sale and rent back agreement*.

(2) The *firm* should explain to the *customer* that it will base its assessment on whether he can afford to enter into the particular *regulated sale and rent back agreement* on the information he provides to the *firm* about his income, expenditure and resources.

(3) In assessing affordability under (1) the *firm*:

(a) must not rely to a material extent on the capital of, or income from, any lump sum the *customer* receives which represents the net sale proceeds of the property; and

(b) must disregard any discount or any future sum that may be payable to the *customer* under the terms of the *regulated sale and rent back agreement*.

(4) Contravention of (1), (2) or (3) may be relied upon as tending to show contravention of *MCOB* 4.11.3CR(1)(a).

4.11.4A R In assessing whether the *regulated sale and rent back agreement* is appropriate to the needs and circumstances of the *customer* for the purposes of *MCOB* 4.11.3C R(1) (b), as a minimum requirement a *firm* must consider the following list of factors:

(1) whether it is appropriate for the *customer* to sell his property for a price less than its value (as determined by the valuation which is required by *MCOB* 6.9.2R, including where applicable a valuation obtained by the *SRB agreement seller* as described in *MCOB* 6.9.2R (4)) (where this is proposed under the *regulated sale and rent back agreement*);

(2) whether it is appropriate for the *customer* because he is in financial difficulty;

(3) whether all other options have been explored and eliminated, including the *customer* speaking to his *home finance provider* and other creditors, getting debt advice, releasing the equity by other means and checking whether he is eligible for government or local authority help;

(4) whether it would be more appropriate for the *customer* to sell his home on the open market;

(5) whether the benefits to the *customer* in entering into the proposed *regulated sale and rent back agreement* outweigh any adverse effects it may have for him, including on his entitlement to means-tested benefits and housing benefits;

(6) the feasibility of the *customer* raising funds by alternative methods other than by a sale of his property; and

(7) if the *customer* is not under threat of repossession, why it is appropriate for the *customer* to take out a *regulated sale and rent back agreement* rather than to use an alternative method of finance.

4.11.4B E The following may be relied on as tending to show contravention of *MCOB* 2.5A.1R (The customer's best interests):

(1) an attempt by the *firm* to misdescribe the *customer's* reasons for

considering a *regulated sale and rent back agreement*; or

(2) an attempt to encourage a *customer* to enter into a *regulated sale and rent back agreement* involving a sale price for his property which is less than its value (as determined by the valuation which is required by *MCOB* 6.9.2R, including where applicable a valuation obtained by the *SRB agreement seller* as described in *MCOB* 6.9.2R(4)) if he is not under threat of repossession.

4.11.4C G *Firms* are reminded that the list in *MCOB* 4.11.4AR is not exhaustive. For certain *customers* there may be additional considerations to explore beyond those described in that rule.

4.11.5 E (1) ~~In assessing whether a particular *regulated sale and rent back agreement* is appropriate to the needs, objectives and circumstances of a potential *SRB agreement seller*, a *firm* should have due regard to the following:~~

~~(a) whether the benefits to the *customer* in entering into the proposed *regulated sale and rent back agreement* outweigh any adverse effects it may have for him, including on his entitlement to means-tested benefits and housing benefits; and~~

~~(b) the feasibility of the *customer* raising funds by alternative methods other than by a sale of his property.~~

(2) ~~Contravention of (1) may be relied upon as tending to show contravention of *MCOB* 4.11.3R(2).~~ [deleted]

…

4.11.7 G

…

(2) The *firm* should consider whether a *customer* ~~in *arrears*~~ with a *payment shortfall* under his *regulated mortgage contract* or *home purchase plan* has contacted his *mortgage lender* or *home purchase provider* to discuss possible forbearance options that may be available. Other possible alternative methods of raising funds will include the availability of local authority or other government rescue schemes that may apply in the *customer's* circumstances.

…

Record keeping

4.11.8 R (1) A *firm* must make and retain a record of the *customer* information that has been provided to it, including that relating to:

(a) the *customer's* income, expenditure and other resources that it has obtained from him for the purpose of assessing affordability, together with the stress testing of the rental payments;

(b) the *customer's* needs and individual circumstances that it has obtained from him for the purpose of assessing appropriateness; and

(c) the *customer's* entitlement to means-tested benefits and housing benefits, including any evidence provided by the *customer*, that it has obtained from him for the affordability and appropriateness assessment;

and which explains why the *firm* concluded that the *regulated sale and rent back agreement was suitable for* the *customer* ~~could afford, and why it was appropriate for him,~~ and why it *advised* him to enter into ~~the proposed *regulated sale and rent back agreement*~~ it.

(2) The record in (1) must be retained for a minimum of five years from the date on which the assessment of ~~affordability and appropriateness~~ suitability was made, or one year after the end of the fixed term of the tenancy agreement under the *regulated sale and rent back agreement*, if later.

Reliance on another firm

4.11.9 R A *firm* need not comply with the requirements imposed on a *regulated sale and rent back firm* in this section to the extent that it is satisfied on reasonable grounds that another *firm*, with the appropriate *permission* to do so, has already done so.

4.11.10 G The effect of *MCOB* 4.11.9R is that a *SRB agreement provider* is expected to ~~carry out its own assessments of affordability and appropriateness~~ *advise* in relation to a particular *regulated sale and rent back agreement,* unless it is reasonable for it to rely on another *firm* with *permission* to *advise on regulated sale and rent back agreements*, to have done so in relation to a particular transaction.

The following Annex is deleted in its entirety. The deleted text is not struck through.

4 Annex 1R Initial disclosure document [deleted]

Amend the following as shown.

5.1 Application

…

What?

5.1.3 R (1) This chapter applies if a *firm*:

(a) ~~makes a personal recommendation to~~ *advises* a *customer* to enter into, or *arranges* an *execution-only sale* in, a *home finance transaction*; or

(b) provides information to a *customer* that is specific to the amount to be provided on a particular *home finance transaction* , including information provided in response to a request from a *customer*; or

(c) provides the means for a *customer* to make an application to it;

in connection with entering into, or agreeing to enter into, a *home finance transaction* provided by a *home finance provider,* other than an *equity release transaction* or a variation to an existing *home finance transaction*.

…

5.2 Purpose

5.2.1 G …

(2) The purpose of *MCOB* 5 is to ensure that, before a *customer* submits an application for a particular *home finance transaction*, he is supplied with information that makes clear:

(a) (in relation to a *regulated mortgage contract*) its features, any *linked deposits*, any *linked borrowing* and any *tied products*; and

(b) the price that the *customer* will be required to pay under that *home finance transaction*, to enable the *customer* to ~~assess whether it is affordable to him~~ make a well-informed purchasing decision.

…

5.4 ~~Mortgage illustrations:~~ Information on regulated mortgage contracts: general

Clear, fair and not misleading

5.4.1 R A *firm* must be able to show that it has taken reasonable steps to ensure that any *illustration* it issues is clear, fair and not misleading.

Accuracy

5.4.2 R Except as provided in *MCOB* 5.5.1CR, ~~A~~an *illustration* on a particular *regulated mortgage contract* issued by, or on behalf of, a *mortgage lender*, must be an accurate reflection of the costs of the *regulated mortgage contract*.

5.4.3 R Except as provided in *MCOB* 5.5.1CR, ~~A~~ a *mortgage intermediary* must take reasonable steps to ensure that an *illustration* which it issues, or which is issued on its behalf, other than that provided by a *mortgage lender*:

(1) is accurate within the following tolerances:

(a) no more than one percent or £1, whichever is the greater, below the actual figures charged by the *mortgage lender* for the following:

(i) the *total amount payable* in Section 5 of the *illustration*;

(ii) the amount payable for every £1 borrowed in Section 5 of the *illustration*;

(iii) the amounts that the *customer* must pay by regular instalment in Section 6 of the *illustration* (or in Section 7 of the *illustration* for an interest rate with a floor or a ceiling); and

(iv) the amount by which the regular instalment (or the *total amount payable* for loans without a term or a regular repayment plan) would increase following a one percentage point increase in interest rates in Section 7;

(b) the *APR* in Section 5 of the *illustration* cannot be understated by more than 0.1%; and

(2) except in the case of conveyancing fees and insurance premiums (where estimates may be used), is accurate in respect of other figures quoted in the *illustration* including fees payable to the *mortgage lender* or *mortgage intermediary* in Section 8 of the *illustration* and cash examples of *early repayment charges*, calculated in accordance

with the rules in *MCOB 5.6.84 R* to *MCOB 5.6.88 R*, in Section 10.

…

~~Restriction on provision~~ Provision of information

5.4.13 R ~~A *firm* must not provide a *customer* with information that is specific to the amount that the *customer* wants to borrow on a particular *regulated mortgage contract* except in the following circumstances:~~

~~(1) when it is in the form of an *illustration*;~~

~~(2) when it is provided on screen, for example a computer screen;~~

~~(3) when supplementary information which is not contained within an *illustration* is provided after or at the same time as an *illustration*; or~~

~~(4) when it is provided orally, for example by telephone.~~ [deleted]

5.4.13A G When providing information on *regulated mortgage contracts*, *firms* should bear in mind that the information must be clear, fair and not misleading in accordance with *Principle* 7 and *MCOB* 2.2.6R; and must be given in accordance with *MCOB* 2.5A.1R (The customer's best interests).

5.4.14 R ~~Where *MCOB* 5.4.13R(2) applies:~~

~~(1) if the *customer* initiates the accessing of quotation information on screen (for example, by using the internet or interactive television), the following warning must be displayed prominently on each page on screen:'This information does not contain all of the details you need to choose a mortgage. Make sure that you read the separate key facts illustration before you make a decision.'; and~~

~~(2) a *firm* must not provide a customised print function where the information on the screen would not be in the form of an *illustration* if the information were printed in hard copy.~~ [deleted]

5.4.15 R ~~Where *MCOB* 5.4.13R(3) applies, supplementary information must only be provided when it does not significantly duplicate information provided in the *illustration*.~~ [deleted]

5.4.16 G *MCOB* ~~5.4.13R~~ 5 places no restrictions on the provision of information that is not specific to the amount the *customer* wants to borrow, for example, marketing literature including generic mortgage repayment tables or graphs illustrating the benefits of making a regular overpayment on a flexible mortgage. Such literature may, however, constitute a *financial promotion* and be subject to the provisions of *MCOB* 3 (Financial promotion).

5.4.17 G ~~Where *MCOB* 5.4.13R(2) and *MCOB* 5.4.13R(4) apply, *firms* should encourage the *customer* to obtain a copy of an *illustration* in a *durable medium*. This could be done, for example, if the information was contained on the *firm's* website, by a prompt which asked the *customer* whether he~~

~~wished to print off an *illustration*.~~ [deleted]

5.4.18 R (1) ~~Unless (2) applies, where *MCOB* 5.4.13R(2) or *MCOB* 5.4.13R(4) apply, a *firm* must provide the means for the *customer* to obtain an *illustration* as soon as practicable, through a delivery channel acceptable to the *customer*.~~ [deleted]

(2) ~~A *firm* does not need to provide an *illustration* if the *customer* refuses to disclose key information (for example, in a telephone conversation, his name or a communication address) or where the provision of an *illustration* is not appropriate, for example, because on the basis of discussions undertaken the *customer* is ineligible given the *mortgage lender's* lending criteria, or is not interested in pursuing the enquiry.~~ [deleted]

Messages to be given when providing information on regulated mortgage contracts

5.4.18A R (1) Except in the circumstances in (2), whenever a *firm* provides a *customer* with information specific to the amount that the *customer* wants to borrow on a particular *regulated mortgage contract* following an assessment of the *customer's* needs and circumstances in order to comply with *MCOB* 4.7A.2 R, it must give, clearly and prominently, the following information:

(a) the same information on the *firm's* product range as is required by *MCOB* 4.4A.1R(1), *MCOB* 4.4A.2R and *MCOB* 4.4A.4R(1); and

(b) that the *customer* has the right to request an *illustration* for any *regulated mortgage contract* which the *firm* is able to offer the *customer*.

(2) A firm need not give the information in (1) if it has previously given that information in compliance with this *rule* within the last ten *business days*.

Message to be given when customer requests an execution-only sale

5.4.18B R Whenever a *customer* provides a *firm* with the information in *MCOB* 4.8A.10R(1) the *firm* must inform the *customer*, clearly and prominently, unless the *firm* has previously given this information in compliance with this *rule* within the last ten *business days*, that the *customer* has the right to request an *illustration* for any *regulated mortgage contract* which the *firm* is able to offer the *customer*.

Guidance relevant to messages given to customer

5.4.18C G (1) In order to demonstrate compliance with *MCOB* 5.4.18AR(1), a *firm* may wish to consider, for example, doing one or more of the following: give the messages to the *customer* in a durable medium; build the requirements into the *firm's* training of staff, as evidenced by its training and compliance manuals; insert appropriate prompts into paper-based or automated sales systems; have procedures in place to monitor compliance by its staff with that *rule*. What is required in each case will depend on all the circumstances.

(2) The reference in the template *illustration* at *MCOB* 5 Annex 1R to the possibility of obtaining other *illustrations* is not sufficient to comply with the obligations in *MCOB* 5.4.18AR(1)(b) and *MCOB* 5.4.18B R. A *firm* may, however, satisfy those obligations in a number of ways; for example, by drawing the *customer's* attention to the right to request an *illustration* orally in a face-to-face meeting, or by referring to it in a letter or electronic communication or other written information.

…

Tied products

…

5.4.24 G The rules on the content of an *illustration* at *MCOB* 5.6 (Content of illustrations) mean that if the *regulated mortgage contract* requires the *customer* to take out a *tied product*, the *illustration* must include an accurate quotation or a reasonable estimate *of the payments the customer* would need to make for the *tied product* (see *MCOB* 5.6.52R(2) ~~on~~ where the *tied product* is a *repayment* ~~*vehicle*~~ *strategy* ~~that is a *tied product*~~ and *MCOB* 5.6.74R ~~on insurance that is a~~ where the *tied product* is insurance)…

…

5.5 Provision of illustrations

Timing

5.5.1 R (1) A *firm* must provide the *customer* with an *illustration* for a *regulated mortgage contract* before the *customer* submits an application for that particular *regulated mortgage contract* to a *mortgage lender*, unless an *illustration* for that particular *regulated mortgage contract* has already been provided.

(2) ~~A~~ Except in the circumstances in *MCOB* 5.5.1AR, a *firm* must provide the *customer* with an *illustration* for a *regulated mortgage contract* when any of the following occurs, unless an *illustration* for that *regulated mortgage contract* has already been provided:

(a) the *firm* ~~makes a *personal recommendation* to~~ *advises* the *customer* ~~in relation~~ to enter into ~~one or more~~ that *regulated mortgage contract*~~s~~, in which case an *illustration* must be provided at the point the ~~recommendation~~ *advice* is ~~made~~ given ~~(and *illustrations* for all recommended *regulated mortgage contracts* must be provided)~~, unless the *advice* is given by telephone, in which case the *firm* must provide an *illustration* within 5 *business days*; or

(b) ~~the *firm* provides written information that is specific to the amount that the *customer* wants to borrow on a particular *regulated mortgage contract*; or~~ [deleted]

(c) ~~the *customer* requests written information from the *firm* that is specific to the amount that the *customer* wants to borrow on a particular *regulated mortgage contract*, unless the *firm* does not wish to do business with the *customer*.~~ [deleted]

(d) the *customer* requests an *illustration* for that *regulated mortgage contract*, unless the *firm* is aware that it is unable to offer that *regulated mortgage contract* to him; or

(e) the *customer* has provided the *firm* with the information in *MCOB* 4.8A.10R(1) (The conditions for execution-only sales) in relation to that *regulated mortgage contract*.

(3) Subject to *MCOB* 5.5.4R, the *firm* may comply with (1) and (2) by providing an *offer document* containing an *illustration*, if this can be done as quickly as providing an *illustration*.

5.5.1A R A *firm* need not provide an *illustration*:

(1) in relation to a *direct deal*;

(2) if the *customer* refuses to disclose key information (for example, in a telephone conversation, his name or a communication address) or where the *customer* is not interested in pursuing the enquiry; or

(3) if the *firm* does not wish to do business with the *customer*.

5.5.1B R If the *firm* chooses not to give an *illustration* in the circumstances set out in *MCOB* 5.5.1AR(1), where it has given *advice* on a *direct deal*, the *firm* must give the *customer* a written record of the *advice*.

5.5.1C R If, notwithstanding *MCOB* 5.5.1AR(1), a *firm* chooses to give an *illustration* in relation to a *direct deal*, it need not comply with *MCOB* 5.4.2R or *MCOB* 5.4.3R (Accuracy).

5.5.1D G In the circumstances in *MCOB* 5.5.1CR, a *firm* remains subject to *MCOB* 5.4.1R (Clear, fair and not misleading).

5.5.1E G In the circumstances in *MCOB* 5.5.1AR(2), the *rule* in *MCOB* 5.5.1R(1) will mean that the *customer* may not make an application for a *regulated mortgage contract* as an *illustration* has not been provided.

…

5.5.4 R A *firm* must not ~~accept fees, commission a valuation, or~~ undertake any ~~other~~

action that commits the *customer* to an application (including accepting product-related fees in relation to the *regulated mortgage contract* concerned) until the *customer* has had the opportunity to consider an *illustration*.

…

5.5.6 G ~~Subject to *MCOB* 5.5.1R and *MCOB* 5.5.15R when an *illustration* is requested without delay, a *firm* may perform an internal credit score and obtain information on the *customer's* credit record from a credit reference agency (subject to the consent of the *customer*), in order to provide a *customer* with an approval in principle for a *regulated mortgage contract*, without having to provide an *illustration*.~~ [deleted]

…

~~No preference between repayment and interest-only~~

5.5.13 R ~~If the *customer* expresses no preference between a *repayment mortgage* and an *interest-only mortgage*, the *firm* must:~~

~~(1)~~ ~~provide an *illustration* for a *repayment mortgage* (except where the *firm* does not provide *repayment mortgages*, in which case it must provide only an *illustration* for an *interest-only mortgage*); and~~

~~(2)~~ ~~make the *customer* aware that it has provided the *illustration* on this basis.~~ [deleted]

Providing an illustration without delay in response to a customer request

5.5.14 G Where the *customer* requests ~~written information from the *firm* that is specific to the amount that the *customer* wants to borrow on~~ an *illustration* for a particular *regulated mortgage contract* ~~under~~ (see *MCOB* 5.5.1R(2)~~(c)~~(d)), the purpose of *MCOB* 5.5.15R , *MCOB* 5.5.16R and *MCOB* 5.5.17G is to ensure that the *customer* receives an *illustration* without unnecessary delay. These requirements do not restrict the information that the *firm* may obtain from the *customer* after it has provided the *customer* with an *illustration*.

5.5.15 R In meeting a request for an *illustration* ~~under~~ in accordance with *MCOB* 5.5.1R(2)~~(c)~~ (d), the *firm* must not delay the provision of the *illustration* by requesting information other than:

…

(7) any of the following information where it affects the availability of the *regulated mortgage contract* that the *customer* has requested information on or affects the information to be included in the illustration:

…

(c) ~~whether the *customer* needs to self-certify his income;~~ [deleted]

…

5.6 Content of illustrations

…

Content: required information

…

5.6.6 R As a minimum the *illustration* must be personalised to reflect the following requirements of the *customer*:

…

(4) the term of the *regulated mortgage contract* (where the *customer* is unable to suggest a date at which he expects to repay the loan, for example in the case of an open-ended ~~secured bridging loan~~ *bridging loan*, secured overdraft or *mortgage credit card*, then a term of 12 months must be assumed and this assumption stated); and

…

Section 5: "Overall cost of this mortgage"

5.6.31 R Under the section heading 'Overall cost of this mortgage' where the *regulated mortgage contract* has an agreed term for repayment and a regular payment plan (that is, it is not a revolving credit agreement such as a secured overdraft or *mortgage credit card*, or a *regulated mortgage contract* where all of the interest rolls up, such as an open-ended ~~bridging loan~~ *bridging loan*):

…

5.6.32 R Under the section heading 'Overall cost of this mortgage' where the *regulated mortgage contract* has no agreed term for repayment, (and a 12 month term has been assumed), or no regular payment plan, or both (for example, a revolving credit agreement such as a secured overdraft or *mortgage credit card* or a *regulated mortgage contract* where all the interest rolls up such as an open-ended ~~bridging loan~~ *bridging loan*):

…

(2) where all the interest on the *regulated mortgage contract* rolls up and is repaid as a lump sum at the end of the *regulated mortgage contract*, for example a ~~secured bridging loan~~ *bridging loan*, then the following text must follow the text in (1): 'It assumes that you pay back the total amount owing as a lump sum at the end of the mortgage term.';

…

…

Section 6: 'What you will need to pay each [insert frequency of payments from MCOB 5.6.40R]

5.6.39 R *MCOB* 5.6.40R to *MCOB* 5.6.57G do not apply to loans without a term or regular payment plan where some or all of the interest rolls up, for example ~~secured bridging loans~~ *bridging loans*, secured overdrafts or *mortgage credit cards*. In these cases, *MCOB* 5.6.134R to *MCOB* 5.6.138G apply.

…

5.6.52 R Where all or part of the *regulated mortgage contract* to which the *illustration* relates is an *interest-only mortgage*:

…

(2) if the *regulated mortgage contract* requires the *customer* to take out a ~~*repayment vehicle* that is a~~ *tied product* as a *repayment strategy* either through the *mortgage lender* or *mortgage intermediary* then:

…

(b) include an accurate quotation or a reasonable estimate of the payments the *customer* will need to make for ~~the *repayment vehicle*~~ that *tied product*; and

…

(3) if the *illustration* includes a quotation for the payments that would need to be made ~~into the *repayment vehicle*~~ by the *customer* for the *repayment strategy*:

…

(b) the *illustration* must provide a brief description only of the type of *repayment* ~~*vehicle*~~ *strategy* illustrated (full details of the *repayment* ~~*vehicle*~~ *strategy* may be provided separately);

…

(4) if a quotation for the *repayment* ~~*vehicle*~~ *strategy* is not provided in the *illustration*, the *illustration* must include a '?' sign in the column for payments alongside the following text…

(5) unless *MCOB* 5.6.55R applies, if a quotation for the *repayment* ~~*vehicle*~~ *strategy* has been included in the *illustration*, Section 6 must be extended to illustrate the monthly cost inclusive of the savings plan and must have the sub-heading 'What you will need to pay each [insert frequency of payments from *MCOB* 5.6.40R] including the cost of a savings plan to repay the capital' and must include:

…

(b) the sum of what the *customer* would need to pay in each instalment for the *regulated mortgage contract* and for the *repayment* ~~*vehicle*~~ <u>*strategy*</u> in the payments column. For example if payments are made monthly, this would be the amount that the *customer* would need to pay each month for the *regulated mortgage contract* and the *repayment* ~~*vehicle*~~ <u>*strategy*</u>…

…

Multi-part mortgages

…

5.6.56 R Where *MCOB* 5.6.55R applies and part of the *regulated mortgage contract* is an *interest-only mortgage*:

(1) if a quotation for the *repayment* ~~*vehicle*~~ <u>*strategy*</u> has been included in the *illustration* in accordance with *MCOB* 5.6.52R(3) then *MCOB* 5.6.52R(5) does not apply.

…

…

Section 7: 'Are you comfortable with the risks'?

5.6.58 R *MCOB* 5.6.59R to *MCOB* 5.6.65R do not apply to loans without a term or regular repayment plan where some or all of the interest rolls up, for example, ~~secured bridging loans~~ <u>*bridging loans*</u>, secured overdrafts or *mortgage credit cards*. In these cases *MCOB* 5.6.140R to *MCOB* 5.6.145R apply.

5.6.59 R Under the section heading 'Are you comfortable with the risks?':

(1) under the sub-heading 'What if interest rates go up?' the *illustration* must include the following:

…

(e)

…

(ii) where a *repayment* ~~*vehicle*~~ <u>*strategy*</u> has been included in the *illustration* in accordance with *MCOB* 5.6.52R(3), the payments quoted in (i) must include the cost of the *repayment* ~~*vehicle*~~ <u>*strategy*</u> and state that this is the case;

…

…

Alternative requirements for loans without a term or a regular repayment plan
Section 6: " What you will need to pay each [insert frequency of payments from MCOB 5.6.40R]"

5.6.133 R *MCOB* 5.6.134R to *MCOB* 5.6.138G apply only to loans without a term or regular payment plan where some or all of the interest rolls up, for example ~~secured bridging loans~~ *bridging loans*, secured overdrafts or *mortgage credit cards*.

5.6.134 R The heading for Section 6 of the *illustration* and the heading of the column on the right-hand side of this section must state the frequency with which payments must be made by the *customer*. (For example, if payments were to be made on a monthly basis, the heading for this section would be 'What you will need to pay each month' and the column would be headed 'Monthly payments'). Where no regular payments are required on the *regulated mortgage contract*, for example where all interest is rolled-up on a ~~secured bridging loan~~ *bridging loan*, then this section must be retained and the frequency of payments assumed must be 'monthly'.

5.6.135 R All the payments in Section 6 of the *illustration* must be calculated based on the frequency used for the purposes of the headings in *MCOB* 5.6.40R and must be shown in the column on the right-hand side of this section. If no payments are required, for example on a ~~secured bridging loan~~ *bridging loan* or secured overdraft, then this column should be marked on the *illustration* as nil.

5.6.136 R Section 6 of the *illustration* must contain the following information:

…

(3) where no payments are required (or no payments are allowed), for example a ~~secured bridging loan~~ *bridging loan* or secured overdraft, then section 6 of the *illustration* should state if no payments are required or no payments can be made; or

…

Section 7: "Are you comfortable with the risks?"

5.6.139 R *MCOB* 5.6.140R to *MCOB* 5.6.145R apply only to loans without a term or regular payment plan where some or all of the interest rolls up, for example ~~secured bridging loans~~ *bridging loans*, secured overdrafts or *mortgage credit cards*.

…

5.7 Business loans and loans to high net worth customers

5.7.1 R Where the *regulated mortgage contract* is for a business purpose or to a *high net worth customer*, a *firm* may choose to provide a *business illustration* or *high net worth illustration* (as applicable) (in compliance with *MCOB* 5.7.2R) instead of complying with *MCOB* 5.6.

5.7.1A G *Firms* are reminded that, in accordance with *MCOB* 1.2.3R, they should ~~either~~ comply in full with *MCOB*, but in doing so may opt to take account of ~~or comply with~~ all tailored provisions in *MCOB* that relate to business loans or loans to *high net worth customers*. Therefore, a *firm* may only follow the tailored provisions in *MCOB* 5.7 in relation to one of these sectors if it also follows all other tailored provisions in *MCOB* ~~if it also follows all other tailored provisions in *MCOB*~~ that relate to that sector. In either case, the rest of *MCOB* applies in full.

5.7.2 R A *business illustration* or *high net worth illustration* provided to a *customer* must:

…

(4) use font sizes and typefaces consistently throughout the *business illustration* or *high net worth illustration* which are sufficiently legible so that the *business illustration* or *high net worth illustration* can be easily read by a typical *customer*;

…

5.7.3 G …

(3) A *firm* may also choose to include other information beyond that required by *MCOB* 5.6. However, when adding additional material a *firm* should have regard to:

(a) the intended use of the *business illustration* or *high net worth illustration* as an aid to comparison by *customers*; and

(b) the requirement in *MCOB* 2.2.6R that any communication should be clear, fair and not misleading.

(4) The *business illustration* or *high net worth illustration* provided in accordance with *MCOB* 5.7.2R should be based upon the total borrowing that the *firm* is willing to provide under the *regulated mortgage contract*. This means that there is no requirement for a *firm* to provide a further *business illustration* or *high net worth illustration* (or *business offer document* or *high net worth offer document*) where a *customer* redraws against payments made under the *regulated mortgage contract*, providing this redrawing does not exceed the borrowing described in the original *business offer document* or *high net worth offer document*.

(5) *MCOB* 5.6.6R (4) requires that where the term of the *regulated mortgage contract* is open-ended, the *business illustration* or *high*

net worth illustration must be based on an assumed term of 12 months and that this assumption must be stated. This does not mean that a *firm* is limited in the actual term of the *regulated mortgage contract*. A *firm* is able to include in the *business illustration* or *high net worth illustration* an explanation that while a 12-month term has been assumed for the purpose of the *business illustration* or *high net worth illustration*, the *regulated mortgage contract* itself will be open-ended.

5.7.4 R Any *business illustration* or *high net worth illustration* provided by a *firm* must be limited to facilities provided under a *regulated mortgage contract*.

5.7.5 R *MCOB* 5.6.31R(2), *MCOB* 5.6.52R(1) and *MCOB* 5.6.52R(4) prescribe text that should be used to remind a *customer* with an *interest-only mortgage* that there is a need to separately arrange for the repayment of capital. The options for repayment of capital may be different where the *regulated mortgage contract* is for a business purpose or to a *high net worth customer*, and a *firm* must vary the prescribed wording in the *business illustration* or *high net worth illustration* to reflect this. One approach may be for the *firm* to revise the wording to reflect how the *customer* has said he will repay the capital.

5.7.6 R (1) When providing a *business illustration* or *high net worth illustration* in accordance with *MCOB* 5.7.2R a *firm* should describe facilities provided under the *regulated mortgage contract* that are not a loan within section 12 (Additional features) of the *business illustration* or *high net worth illustration*.

(2) In complying with (1), a *firm* should follow the requirements in *MCOB* 5.6.92R - *MCOB* 5.6.108G where these are relevant. Where the facility is of a type not considered in *MCOB* 5.6.92R - *MCOB* 5.6.108G the *firm* should provide in section 12:

(a) a brief description of the facility involved;

(b) the term of the facility if different from the term described elsewhere in the *business illustration* or *high net worth illustration*; and

(c) a summary of any charges, including any *early repayment charges*, which apply to the operation of the facility.

(3) Full information on any facility described in section 12 must be provided in supplementary materials that accompany the *business illustration* or *high net worth illustration*.

5.7.7 G (1) In accordance with *MCOB* 5.7.6R(1), where the *regulated mortgage contract* includes a loan, the facilities described in section 12 of the *business illustration* or *high net worth illustration* should include the existence of, and a simple explanation of, any all monies charge, any contingent liabilities such as guarantees and so on.

(2) Where the *regulated mortgage contract* includes more than one loan facility (such as a secured loan and a separate secured overdraft facility) the *business illustration* or *high net worth illustration* should be based upon the primary facility and describe any other loan within section 12.

5.8 Home purchase plans

…

Financial information statement: timing

5.8.1 R ~~A~~ Except in the circumstances in *MCOB* 5.8.1AR, a *firm* dealing directly with a *customer* must ensure that the *customer* is, or has been, provided with an appropriate financial information statement for a *home purchase plan* in a *durable medium*:

(1) before the *customer* submits an application for that particular plan to a *home purchase provider*; and

(2) without undue delay when any of the following occurs:

(a) the *firm* ~~makes a *personal recommendation* to~~ gives *advice* to the *customer* ~~to enter into a~~ in relation to one or more *home purchase plans*, in which case a financial information statement must be provided at the point the *advice* is given (and financial information statements for all recommended *home purchase plans* must be provided), ~~(~~unless the ~~*personal recommendation*~~ *advice* is ~~made~~ given by telephone, in which case ~~a *firm* must ensure the financial statement is or has been provided as soon as practicable after the telephone call)~~ the *firm* must provide a financial information statement within five *business days*; or

(b) ~~the *firm* provides written information that is specific to the amount of finance to be provided on a particular plan; or~~ [deleted]

(c) ~~the *customer* requests written information from the *firm* that is specific to the amount of finance to be provided on a particular plan, unless the *firm* does not wish to do business with the *customer*.~~ [deleted]

(d) the *customer* requests a financial information statement, unless the *firm* is aware that it is unable to offer that *home purchase plan* to him; or

(e) the *customer* has provided the *firm* with the information in *MCOB* 4.8A.10R(1) (The conditions for execution-only sales), as applied in relation to *home purchase plans* by *MCOB* 4.10.9BR and modified for *home purchase plans* by *MCOB* 4.10.9CR.

(3) A *firm* may comply with (1) and (2) by providing an *offer document* if this can be done as quickly as providing a financial information statement.

5.8.1A R A *firm* need not provide a financial information statement:

(1) in relation to a *direct deal*; or

(2) if the *customer* refuses to disclose key information (for example, in a telephone conversation, his name or a communication address) or where the *customer* is not interested in pursuing the enquiry; or

(3) if the *firm* does not wish to do business with the *customer*.

5.8.1B R If the *firm* chooses not to give a financial information statement in the circumstances set out in *MCOB* 5.8.1AR, where it has given *advice* on a *direct deal*, the *firm* must give the *customer* a written record of the *advice*.

…

Financial information statement: format

…

5.8.5 R A financial information statement, if not set out in a separate document, must be:

(1) in a prominent place within the ~~other~~ document and clearly identifiable as key information that the *customer* should read; and

(2) separate from the other content of the document in which it is included.

…

Message to be given when providing information on home purchase plans

5.8.12 R (1) Except in the circumstances in (2), whenever a *firm* provides a *customer* with information specific to the amount of finance to be provided on a particular *home purchase plan* following an assessment of the *customer's* needs and circumstances in order to comply with *MCOB* 4.10.5D R, it must give, clearly and prominently, the following information:

(a) the same information on the *firm's* product range as is required by *MCOB* 4.4.A1R(1), *MCOB* 4.4A.2R and *MCOB* 4.4A.4R (1) (as applied in relation to *home purchase plans* by *MCOB* 4.10.3AR); and

(b) that the *customer* has the right to request a financial information statement for any *home purchase plan* which the *firm* is able to offer the *customer*.

(2) A firm need not give the information in (1) if it has previously given that information in compliance with this *rule* within the last ten *business days*.

Message to be given when customer requests an execution-only sale

5.8.13 R Whenever a *customer* provides a *firm* with the information in *MCOB* 4.8A.10R(1) (as applied in relation to *home purchase plans* by *MCOB* 4.10.9BR and modified for *home purchase plans* by *MCOB* 4.10.9CR) the *firm* must inform the *customer*, clearly and prominently, unless the *firm* has previously given this information in compliance with this *rule* within the last ten *business days*, that the *customer* has the right to request a financial information statement for any *home purchase plan* which the *firm* is able to offer the *customer*.

…

6.4 Mortgages: content of the offer document

…

Modifications to the illustration

6.4.4 R The *illustration* provided as part of the *offer document* in accordance with *MCOB* 6.4.1R(1) must meet the requirements of *MCOB* 5.6 (Content of illustrations) with the following modifications:

…

(7) *MCOB* 5.6.52 R to *MCOB* 5.6.53 G is replaced by the following: Where all or part of the *regulated mortgage contract* is an *interest-only mortgage*, the *illustration* in the *offer document* must:

(a) clearly state that the payments on the *regulated mortgage contract* cover only interest, and not the capital borrowed; and

(b) ~~state the *repayment vehicle* the *customer* intends to use where the *firm* knows details of the specific *repayment vehicle* from the application by the *customer*; if the *firm* does not know how the *customer* intends to repay the capital borrowed, the *firm* must clearly state that the *repayment vehicle* is unknown, and must provide the *customer* with a clear reminder of the need to put suitable arrangements in place; and~~ [deleted]

(c) include a statement reminding the *customer* to check regularly the performance of any *investment* used as a *repayment* ~~*vehicle*~~ *strategy*, to see whether it is likely to be adequate to repay the capital and, where applicable, pay the interest accrued at the end of the term of the *regulated mortgage contract*;

(7A) The *illustration* may state the *repayment strategy* the *customer* intends to use.

…

Other information contained in the offer

…

6.4.11A R If the *illustration* provided by the *firm* to the *customer* does not state the *repayment strategy* the *customer* intends to use, as permitted by *MCOB* 6.4.4R(7A), that information must be included in the *offer document*.

…

6.7 Business loans and loans to high net worth customers

6.7.1 R (1) Where the *regulated mortgage contract* is for a business purpose or to a *high net worth customer*, a *firm* may choose to provide a *customer* with a *business offer document* or *high net worth offer document* (as applicable) instead of the *offer document* referred to in *MCOB* 6.4.1R.

(2) If a *firm* provides a *customer* with a *business offer document* or *high net worth offer document* in accordance with (1), it must ensure that:

(a) an updated *business illustration* or *high net worth illustration* (as applicable), as required by *MCOB* 5.7 (~~Pre-application disclosure for business~~ Business loans and loans to high net worth customers), forms part of the *business offer document* or *high net worth offer document*; and

(b) subject to the tailoring required by *MCOB* 5.7 (~~Pre-application disclosure for business~~ Business loans and loans to high net worth customers), the *business offer document* complies with *MCOB* 6.4 (Mortgages: ~~Content~~ content of the offer document).

6.7.1A G *Firms* are reminded that in accordance with *MCOB* 1.2.3R and *MCOB* 1.2.3AR, they should ~~either~~ comply in full with *MCOB*, but in doing so may opt to take account of ~~or comply with~~ all tailored provisions in *MCOB* that relate to business loans or loans to *high net worth customers* (as applicable). Therefore, a *firm* may only follow the tailored provisions in relation to one of these sectors if it also follows all other tailored provisions in *MCOB* that relate to that sector. In either case, the rest of *MCOB* applies in full.

6.7.2 G *MCOB* 6.7.1R(2) means, for example, that the required text in *MCOB* 6.4.4R(7) should be replaced by text that satisfies the requirements for *business illustrations* or *high net worth illustrations* in *MCOB* 5.7.5R.

6.7.3 G A *firm* may supplement the first paragraph of text prescribed in *MCOB* 6.4.4R(5)(a) to clarify that, while the *regulated mortgage contract* is not binding until the relevant mortgage document has been signed and funds have been released, the *business offer document* <u>or *high net worth offer document*</u> may form part of a wider set of negotiated facilities and that the *customer* is separately bound by these.

...

6.9 Regulated sale and rent back agreements

Process for concluding regulated sale and rent back agreements

6.9.1 R A *SRB agreement provider* must not ~~enter into a~~ <u>*enter into a*</u> *regulated sale and rent back agreement* unless it follows the process outlined in this section.

Valuation of the property

6.9.2 R (1) A *SRB agreement provider* intending to ~~enter into a~~ <u>*enter into a*</u> specific *regulated sale and rent back agreement* with a *SRB agreement seller* and before it complies with the other requirements in this section, must ensure that the property is properly valued by a valuer: …

…

…

7.4 Mortgages: disclosure at the start of the contract

Disclosure requirements

7.4.1 R (Subject to *MCOB* 7.7.5R) a *firm* that *enters into a regulated mortgage contract* with a *customer* must provide the *customer* with the following information before the *customer* makes the first payment under that *regulated mortgage contract*:

…

(4) confirmation of whether, in connection with the *regulated mortgage contract*, insurance or *investments* (such as a *repayment* ~~*vehicle*~~ <u>*strategy*</u>, term assurance, buildings and contents insurance or payment protection insurance) have been purchased through the *firm*;

…

(8) if all or part of the *regulated mortgage contract* is an *interest-only mortgage*, a reminder to the *customer* to check that a *repayment* ~~*vehicle*~~ <u>*strategy*</u> is in place, if the *repayment* ~~*vehicle*~~ <u>*strategy*</u> is not provided by the *firm*;

(9) what to do if the *customer* falls into ~~*arrears*~~ a *payment shortfall*, explaining the benefit of making early contact with the *firm*, providing the address and telephone number of a contact point for the *firm* and drawing the *customer's* attention to the *arrears* charges set out in the *tariff of charges*.

…

7.5 Mortgages: statements

…

Annual statement: content

7.5.3 R The statement required by *MCOB* 7.5.1R must contain the following:

(1) except in the case of *mortgage credit cards*, information on the type of *regulated mortgage contract*, including:

…

(b) a prominent reminder, where all of the *regulated mortgage contract* is an *interest-only mortgage*, that:

(i) the *customer's* payments to the *firm* do not include ~~the~~ any costs of ~~any~~ the *repayment* ~~*vehicle*~~ *strategy* (if that is the case); and…

…

(c) a prominent reminder, where only part of the *regulated mortgage contract* is an *interest-only mortgage*, that:

(i) the *customer's* payments to the *firm* do not include ~~the~~ any costs of ~~any~~ the *repayment* ~~*vehicle*~~ *strategy* (if that is the case); and…

…

(4) information at the date the statement is issued on:

…

(e) the cost of redeeming the *regulated mortgage contract* (this must be shown as the sum of *MCOB* 7.5.3R(4)(a) and *MCOB* 7.5.3R(4)(d) plus any *linked borrowing* that cannot be retained (including the outstanding balances) plus any other charges that can be quantified at the date the statement is issued); if additional charges are payable that cannot be quantified at the point that the statement is issued (for example if the *customer* is in ~~*arrears*~~ arrears) a warning must be included to that effect; and

…

7.5.4 R ~~In the limited circumstances where it would be unlikely for~~ Where payments are not being made for a *repayment* ~~*vehicle*~~ ~~to be set up~~ *strategy* ~~for an~~ ~~*interest-only mortgage*~~ (for example, for a ~~short term bridging loan~~ *bridging loan*) *MCOB* 7.5.3R(1)(b)(ii) or *MCOB* 7.5.3R(1)(c)(ii) is replaced with the following: "As all or part of your mortgage is an interest-only mortgage, it assumes that you pay back the total amount borrowed on an interest-only basis as a lump sum at the end of the mortgage term."

...

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* 13.5.1R (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.

…

7.6 Mortgages: event-driven information

…

Further advances

7.6.7 R Before a *customer* submits an application to a *firm* for a further advance on an existing *regulated mortgage contract* or for a further advance that is a new *regulated mortgage contract*, if the further advance requires the approval of the *mortgage lender*, the *firm* must provide the *customer* with an illustration that complies with the requirements of *MCOB* 5 (Pre-application disclosure) and *MCOB* 7.6.9R to *MCOB* 7.6.17R for the further advance, unless an illustration has already been provided or the *regulated mortgage contract* is for a business purpose and the *firm* has chosen to comply with the tailored provisions for *regulated mortgage contracts* for a business purpose (see *MCOB* 7.7 (Business loans and loans to high net worth customers)).

…

7.6.9 R The *illustration* provided in accordance with *MCOB* 7.6.7R must:

…

(4) include a clear statement, where all or part of the *regulated mortgage contract* is an *interest-only mortgage* and the amount paid in each instalment does not include the cost of a *repayment* ~~*vehicle*~~ *strategy*, to indicate that these payments do not include the cost of any savings plan or other investment.

…

7.7 Business loans <u>and loans to high net worth customers</u>

Further advances

7.7.1 R (1) Where, in relation to a *regulated mortgage contract* for a business purpose <u>or to a *high net worth customer*</u>, a *customer* either:

(a) seeks an immediate increase in the borrowing provided under the *regulated mortgage contract*; or

(b) overdraws on the borrowing under the *regulated mortgage contract*;

the further advance rules in *MCOB* 7.6.7R to *MCOB* 7.6.17R do not apply.

(2) Where (1) applies, the *firm* must within five *business days* provide the *customer* with either:

(a) a *business illustration* <u>or *high net worth illustration* (as applicable)</u> for the new total borrowing; or

…

7.7.1A G *Firms* are reminded that in accordance with *MCOB* 1.2.3R, they should ~~either~~ comply in full with *MCOB*<u>, but in doing so may opt to take account of</u> ~~or comply with~~ all tailored provisions in *MCOB* that relate to business loans <u>or loans to *high net worth customers*</u>. Therefore, a firm may only follow the tailored provisions <u>in relation to one of these sectors</u> if it also follows all other tailored provisions in *MCOB* <u>that relate to that sector. In either case, the rest of *MCOB* applies in full.</u>

…

7.7.3 R Where a *customer* applies for a further advance that is a *regulated mortgage contract* for a business purpose <u>or to a *high net worth customer*</u> and *MCOB* 7.7.1R does not apply:

(1) the *business illustration* <u>or *high net worth illustration*</u> must be based upon the total borrowing; and

(2) *MCOB* 7.6.9R to *MCOB* 7.6.10G and *MCOB* 7.6.12G do not apply.

Arrangements to repay capital

7.7.4 R Where *MCOB* 7.6.28R(5) applies, a *firm* may omit the final sentence of the required text where it is aware, in the context of an *interest-only mortgage*, that the *customer's* intention is not to use a savings plan as a *repayment* ~~*vehicle*~~ <u>*strategy*</u>.

Disclosure

7.7.5 R *MCOB* 7.4 (Disclosure at the start of the contract) does not apply in relation to a *regulated mortgage contract* that is for a business purpose or a *high net worth customer*.

…

7.8 Home purchase plans

...

Annual statement – additional content for customers 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)).

...

8.1 Application

Who?

8.1.1 R This chapter applies to a *firm* in a category listed in column (1) of the table in *MCOB 8.1.2 R* in accordance with column (2) of that table.

8.1.2 R This table belongs to MCOB 8.1.1R

(1) Category of firm	**(2) Applicable section**
equity release provider	whole chapter except *MCOB* 8.5A and *MCOB* 8.7, *MCOB* 8.6A in accordance with *MCOB* 8.1.2AR
equity release adviser	whole chapter ~~except *MCOB* 8.6~~. *MCOB* 8.7 does not apply in relation to a *lifetime mortgage*
equity release arranger	whole chapter except *MCOB* 8.5A. *MCOB* 8.7 does not apply in relation to a *lifetime mortgage*

8.1.2A R *MCOB* 8.6A only applies to an *equity release provider* in relation to *entering into an equity release transaction* where there is no *firm* which is *arranging (bringing about)* the *equity release transaction* to which *MCOB* 8.6A applies.

8.1.2B G *MCOB* 8.1.2AR means that the situations where *MCOB* 8.6A applies to an *equity release provider* include where an *equity release intermediary* has been involved in *arranging (bringing about) an equity release transaction* but is no longer involved in the transaction.

What?

8.1.3 R (1) This chapter applies to a *firm* which in the course of carrying on an *equity release activity*~~:~~ *enters into*, *advises on* or *arranges* an *equity release transaction* or a variation of the terms of an *equity release transaction*.

~~(a) makes, or anticipates making, a *personal recommendation* about; or~~

~~(b) gives, or anticipates giving, personalised information relating to;~~

~~the *customer*:~~

~~(c) entering into an *equity release transaction*; or~~

~~(d) varying the terms of an *equity release transaction* entered into by the *customer* .~~

(2) In respect of *arranging* or *advising on a home reversion plan* for a *customer* who is acting in his capacity as an *unauthorised reversion provider*, only *MCOB* 8.1, *MCOB* 8.2 and *MCOB* 8.7 apply.

…

8.1.5 G ~~If a *firm* is an *authorised professional firm*, *MCOB* 1.2.10R(3) has the effect that when the *firm* conducts *non-mainstream regulated activities* with a customer, *MCOB* 4.4 (Initial disclosure requirements) (as modified by *MCOB* 8) applies. The *firm* is only required to provide the initial disclosure information in section 7 (What to do if you have a complaint) and section 8 (Are we covered by the Financial Services Compensation Scheme (FSCS)?) of the *initial disclosure document* or *combined initial disclosure document*.~~ [deleted]

8.2 Purpose

8.2.1 G ~~The purpose of this chapter for *equity release transactions* is the same as that for *regulated mortgage contracts* and *home purchase plans* in *MCOB* 4.~~ [deleted]

8.2.2 G (1) This chapter amplifies *Principle* 6 (Customers' interests), *Principle* 7 (Communications with clients) and *Principle* 9 (Customers: relationships of trust).

(2) The purpose of this chapter is to ensure that:

(a) *customers* are adequately informed about the nature of the service they may receive from a *firm* in relation to *equity release transactions*. In particular *firms* need to make clear to *customers* the range of *equity release transactions* available from them and the basis of the *firm's* remuneration;

(b) where *advice* is given, it is suitable for the *customer*;

(c) *customers* for *equity release* transactions receive *advice* in all cases;

(d) *execution-only sales* are only provided where the *customer* has rejected *advice* which has been given, has been warned about the implications of proceeding and has specifically instructed the *firm* that he wishes to do so.

(3) This chapter also implements certain requirements of the *Distance Marketing Directive* in relation to *distance mortgage mediation contracts*.

8.3 Application of rules in MCOB 4

8.3.1 R (1) (a) *MCOB* 4.1 to *MCOB* 4.6A ~~and *MCOB 4.8*~~ (with the modifications stated in *MCOB* 8.3.~~3~~2BR ~~and~~ to *MCOB* 8.3.4R) apply to a *firm* where the *home finance transaction* is a *lifetime mortgage*.

(b) *MCOB* 4.1 to *MCOB* 4.4A ~~and *MCOB* 4.8~~ (with the modifications stated in *MCOB* 8.3.~~3~~2BR ~~and~~ to *MCOB* 8.3.4R) apply to a *firm* where the *home finance transaction* is a *home reversion plan*, except for those provisions that by their nature are only relevant to *regulated mortgage contracts*.

…

8.3.2 R ~~In applying initial disclosure requirements to *equity release transactions*, the market for *equity release transactions* should be treated as one single market with two separate sectors. References to the 'whole market' must be read as references to the whole market for *equity release transactions*. This is unless the *firm* only gives personalised information or *advice* to *customers* on products in one market sector, in which case references to the 'whole market' must be read as references to the whole market for *lifetime mortgages* or *home reversion plans* as the case may be.~~ [deleted]

8.3.2A G ~~The effect of the *rules* on independence is that a *firm* that sells *lifetime mortgages* and *home reversion plans* from the whole market and enables the *customer* to pay a fee for the provision of the service, can hold itself out as being 'independent' for the equity release market (see *MCOB 4.3.7 R*). If the *firm* offers a service on this basis for only one of these market sectors, then it can only describe itself as 'independent' for that sector.~~ [deleted]

8.3.2B R For the purposes of *MCOB* 4.4A.2R(1) there is one relevant market for *equity release transactions*. Accordingly, a *firm* offering a *customer* only *lifetime mortgages* or only *home reversion plans* must include in its disclosure under *MCOB* 4.4A.1R(1) that it is limited in that regard in the range of products that it can offer to the *customer*.

8.3.2C G In the light of *MCOB* 8.3.2BR, a *firm* may wish to consider using a sentence appropriate to the circumstances, along the following lines:

- "We offer a comprehensive range of equity release products from across the market."
- "I sell home reversion plans only and not lifetime mortgages, though I will consider all home reversion plans available in the market."

8.3.3 R Table of modified cross-references to other rules: This table belongs to MCOB 8.3.1R.

Subject	Rule or guidance	Reference in rule or guidance	To be read as a reference to:
~~Advice or information from the whole market~~	~~*MCOB* 4.3.4R(2)~~	~~*MCOB* 4.7.2R~~	~~*MCOB* 8.5.2R~~
~~Initial disclosure requirement (for *equity release transactions* only)~~	~~*MCOB* 4.4.1R(1)(c) and (3)~~	~~*MCOB* 4 Ann 1R~~	~~MCOB 8 Ann 1R~~
~~Initial disclosure requirements~~	~~*MCOB* 4.4.3G~~	~~*MCOB* 4~~	~~*MCOB* 4 as modified by *MCOB* 8~~
~~Initial disclosure requirements where initial contact is by telephone (for *equity release transactions* only)~~	~~*MCOB* 4.4.7R(2)~~	~~*MCOB* 4 Ann 1R~~	~~*MCOB* 8 Ann 1R~~
Additional disclosure for *distance mortgage mediation contracts*	*MCOB* 4.5	*MCOB* 4	*MCOB* 4 as modified by *MCOB* 8
~~Non-advised sales~~	~~*MCOB* 4.8.6G~~	~~*MCOB* 4.7~~	~~*MCOB* 8.5~~

8.3.4 R Table of rules in MCOB 4 replaced by rules in MCOB 8: This table belongs to MCOB 8.3.1 R.

Subject	Rule(s)	Rule(s) replaced by
Advised sales	*MCOB* 4.7A	*MCOB* 8.5A

…

MCOB 8.5 is deleted in its entirety and replaced with a new section MCOB 8.5A. The deleted text is not shown and the new text is not underlined.

8.5A Advised sales

8.5A.1 G (1) *MCOB* 8.5A sets out standards to be observed by *firms* when *advising on equity release transactions*.

(2) The *rules* at *MCOB* 8.6A require *firms* selling *equity release transactions* to provide *advice* to the *customer*, subject to the *customer's* right to reject *advice* which has been given and to proceed on an execution-only basis.

Suitability

8.5A.2 R If a *firm* gives *advice* to a *customer* to enter into an *equity release transaction*, or to vary an existing *equity release transaction*, it must take reasonable steps to ensure that the *equity release transaction* is, or after the variation will be, suitable for that *customer*.

8.5A.3 R In *MCOB* 8.5A, a reference to *advice* to enter into an *equity release transaction* is to be read as including *advice* to vary an existing *equity release transaction*.

8.5A.4 G In accordance with *Principle* 9, a *firm* should take reasonable steps to obtain from a *customer* all information likely to be relevant for the purposes of *MCOB* 8.5A.

8.5A.5 R For the purposes of *MCOB* 8.5A.2R:

(1) an *equity release transaction* will not be suitable for a *customer* unless the *equity release transaction* is appropriate to the needs and circumstances of the *customer*;

(2) a *firm* must base its determination of whether an *equity release transaction* is appropriate to a *customer's* needs and circumstances on the facts disclosed by the *customer* and other relevant facts about the *customer* of which the *firm* is or should reasonably be aware;

(3) no *advice* must be given to a *customer* to enter into an *equity release transaction* if there is no *equity release transaction* which is suitable from the product range offered by the *firm*;

(4) if a *mortgage lender* is dealing with an existing *customer* with a *payment shortfall* and has concluded that there is no *equity release transaction* which satisfies the requirements of *MCOB* 8.5A.2R, the

firm must nonetheless have regard to *MCOB* 13.3.

8.5A.6 R When a *firm* assesses whether the *equity release transaction* is appropriate to the needs and circumstances of the *customer* for the purposes of *MCOB* 8.5A.5R(1), the factors it must consider include the following:

(1) whether the benefits to the *customer* outweigh any adverse effect on:

(a) the *customer's* entitlement (if any) to means-tested benefits; and

(b) the *customer's* tax position (for example the loss of an Age Allowance);

(2) alternative methods of raising the required funds such as, in particular:

(a) (where relevant) a local authority (or other) grant; or

(b) taking a further advance under an existing *regulated mortgage contract* (including a *lifetime mortgage*), or a new *regulated mortgage contract* (including a *lifetime mortgage*) to replace an existing one, or an additional release under an existing *home reversion plan*;

(3) whether the *customer's* requirements appear to be within the *equity release provider's* known eligibility criteria for the *equity release transaction*;

(4) the *customer's* preferences for his estate (for example, whether the *customer* wishes to be certain of leaving a bequest to his family or others);

(5) the *customer's* health and life expectancy;

(6) the *customer's* future plans and needs (for example, whether the *customer* is likely to need to raise further funds or is likely to move house);

(7) whether the *customer* has a preference or need for stability in the amount of payments (where payments are required) especially having regard to the impact on the *customer* of significant interest rate changes in the future;

(8) whether the *customer* has a preference or need for any other features of an *equity release transaction*; and

(9) for *lifetime mortgages* only, whether it is more appropriate for the *customer* to pay any fees or charges in relation to the *lifetime mortgage* up front, rather than adding them to the sum advanced (see also *MCOB* 4.6A).

8.5A.7 G Examples of eligibility criteria in *MCOB* 8.5A.6R(3) are: the amount that the *customer* wishes to borrow or to release; the loan-to-value ratio; the age of the *customer*; the value of the property which would be the subject of the *equity release transaction*.

The customer's needs and circumstances: means-tested benefits, customer's tax position and alternative methods of finance

8.5A.8 R In considering the factor at *MCOB* 8.5A.6R(1), where a *firm* has insufficient knowledge of means-tested benefits and tax allowances to reach a conclusion, the *firm* must refer a *customer* to an appropriate source or sources such as the Pension Service, HM Revenue and Customs or Citizens Advice Bureau (or other similar agency) to establish the required information.

8.5A.9 E (1) In considering the factor at *MCOB* 8.5A.6R(2)(a), a *firm* should:

(a) establish, on the basis of information given by the *customer* about his needs and objectives, whether these appear to be within the general scope of a local authority (or other) grant (for example where the *customer* requires funds for essential repairs to his property); and

(b) refer a *customer* to an appropriate source such as his local authority or Citizens Advice Bureau (or other similar agency) to identify whether such a grant is available to him.

(2) Compliance with (1) may be relied upon as tending to show compliance with *MCOB* 8.5A.6R(2)(a).

8.5A.10 R If for any reason a *customer*:

(1) declines to seek further information on means-tested benefits, tax allowances or the scope for local authority (or other) grants; or

(2) rejects the conclusion of a *firm* that alternative methods of raising the required funds are more suitable;

a *firm* can *advise* the *customer* (in accordance with the remaining requirements of this chapter) to enter into an *equity release transaction* where there is an *equity release transaction* (or more than one *equity release transaction*) that is appropriate to the needs and circumstances of the *customer*, but must confirm to the *customer*, in a *durable medium*, the basis on which the *advice* has been given.

Debt consolidation

8.5A.11 R In relation to *MCOB* 8.5A.5R(1), when a *firm advises* a *customer* in relation to entering into an *equity release transaction* where the main purpose for doing so is the consolidation of existing debts by the *customer*, it must also take account of the following in assessing whether the *equity release transaction* is suitable for the *customer*:

(1) the costs associated with increasing the period over which a debt is to be repaid;

(2) whether it is appropriate for the *customer* to secure a previously unsecured loan; and

(3) where the *customer* is known to have payment difficulties, whether it would be more appropriate for the *customer* to negotiate an arrangement with his creditors than to enter into an *equity release transaction*.

8.5A.12 E An attempt by the *firm* to misdescribe the *customer's* purpose or to encourage the *customer* to tailor the amount he wishes to borrow so that *MCOB* 8.5A.11R does not apply may be relied on as tending to show contravention of *MCOB* 2.5A.1R (The customer's best interests).

Further advances

8.5A.13 R Where the *customer* is looking to increase the borrowing secured on the property which is the subject of an existing *regulated mortgage contract*, a *firm* must inform the *customer* (either orally or in writing) that it may be possible, and more appropriate, for the *customer* to take a further advance with the existing lender rather than entering into an *equity release transaction* with another provider.

8.5A.14 G *MCOB* 8.5A.13R does not mean that *firms* are under any obligation to explore whether a further advance with the existing lender is, in fact, more appropriate for the *customer*.

Other considerations when advising

8.5A.15 R When *advising* a *customer* on the suitability of an *equity release transaction*, a *firm* must explain to the *customer* that the assessment of whether the *equity release transaction* is appropriate to his needs and circumstances is based on the *customer's* current circumstances, which may change in the future.

8.5A.16 G *MCOB* 8.5A.5R(3) explains that different considerations apply when dealing with a *customer* with a *payment shortfall*. For example, the circumstances of the *customer* may mean that, viewed as a new transaction, a *firm* could not *advise* the *customer* to enter into an *equity release transaction* in compliance with *MCOB* 8.5A.3R. In such cases, a *firm* may still be able to *advise* the *customer* to enter into an *equity release transaction* where it is more suitable than the *customer's* existing *home finance transaction*.

8.5A.17 G *MCOB* 8.5A.5R(2) means that where the *advice* provided is based on a selection of *equity release transactions* from a single or limited number of providers, the assessment of suitability should not be limited to the types of *equity release transactions* which the *firm* offers. A *firm* cannot recommend the 'least worst' *equity release transaction* where the *firm* does not have access to products appropriate to the *customer's* needs and circumstances. This means, for example, that if a *firm* only has access to lump sum *equity release transactions* it should not recommend or arrange one of these if approached by a *customer* requiring regular payments.

8.5A.18 G *MCOB* 8.5A.5R(1) does not require a *firm* to provide *advice on investments*. Whether such *advice* should be given will depend upon the individual needs and circumstances of the *customer*. *MCOB* 8 does not restrict the ability of an adviser to refer the *customer* to another source of *investment advice* (for example, where the adviser is not qualified to provide *advice* on *investments*).

Record keeping

8.5A.19 R (1) A *firm* must make and retain a record:

(a) of the *customer* information, including that relating to the *customer's* needs and circumstances and the *customer's* apparent satisfaction of the *equity release provider's* known eligibility criteria, that it has obtained for the purposes of *MCOB* 8.5A;

(b) that explains why the *firm* has concluded that any *advice* given to a *customer* complies with *MCOB* 8.5A.2R and satisfies the suitability requirement in *MCOB* 8.5A.5R(1);

(c) of any *advice* which the *customer* has rejected, including the reasons why they were rejected and details of the *equity release transaction* which the *customer* has proceeded with as an *execution-only sale*; and

(d) where applicable, of the *customer's* positive choice in *MCOB* 4.6A.2R (Rolling up of fees or charges into loan).

(2) The records in (1) must be retained for a minimum of three years from the date on which the *advice* was given or, in the case of (1)(d), the making of the choice.

MCOB 8.6 is deleted in its entirety and replaced with a new section MCOB 8.6A. The deleted text is not shown and the new text is not underlined.

8.6A Execution-only sales

Scope and application of this section

8.6A.1 G (1) *MCOB* 8.6A provides that a *firm* may only *enter into an equity release transaction* with a *customer*, or *arrange* such a transaction for a *customer*, as an *execution-only sale* if the *customer* has rejected *advice*, identified the product he wishes to purchase and positively elected to proceed with an *execution-only sale*.

(2) The aim of *MCOB* 8.6A is to ensure that, in all sales of *equity release transactions*, there is one *firm* which *advises* the *customer* on the *equity release transaction* and, where applicable, is responsible for ensuring that the conditions for an *execution-only sale* are satisfied. So, as provided in *MCOB* 8.1.2AR, *MCOB* 8.6A only applies to *equity release providers* in relation to *entering into equity release transactions* where there is no *firm* which is *arranging* the transaction and to which *MCOB* 8.6A applies.

The customer's best interests

8.6A.2 G *Firms* are reminded that *MCOB* 2.5A.1R (The customer's best interests) applies in all cases, including in relation to *execution-only sales*.

8.6A.3 R A *firm* must not encourage a *customer* to reject *advice* received by him on *equity release transactions*.

The conditions for execution-only sales

8.6A.4 R A *firm* must not *enter into* or *arrange* an *execution-only sale* for a *equity release transaction* unless:

(1) the *customer* has rejected the *advice* given by the *firm* and instead requested an *execution-only sale* of an *equity release transaction*;

(2) the *customer* has identified at the outset which particular *equity release transaction* he wishes to purchase, specifying to the *firm* at least the required information;

(3) after providing the required information in (2), the *customer* has been informed, clearly and prominently and in a *durable medium*, that in the provision of its services for the *execution-only sale* the *firm* is not required to assess the suitability of that *equity release transaction* and that therefore the *customer* will not benefit from the protection of the rules (in *MCOB* 8.5A) on assessing suitability. In any case where there is spoken dialogue between the *firm* and the *customer* at any point, the *firm* must also provide this information orally; and

(4) after the *customer* has been provided with the information in (3), in any case where there is spoken or other interactive dialogue between the *firm* and the *customer* at any point, the *customer* has confirmed in writing to the *firm* that he is aware of the consequences of losing the protections of the rules on assessing suitability and is making a positive election to proceed with an *execution-only sale*.

8.6A.5 R The required information in *MCOB* 8.6A.4R(2) is:

(1) for a *lifetime mortgage*:

(a) the name of the *mortgage lender*;

(b) the rate of interest;

(c) the interest rate type;

(d) the price or value of the property on which the *lifetime mortgage* would be secured (estimated where necessary); and

(e) the sum the *customer* wishes to borrow under it, either immediately or in the future (including the amount of any lump sum, any regular drawdown or flexible facility or any combination of amounts the *customer* wishes to apply for);

(2) for a *home reversion plan*:

(a) the name of the *equity release provider*;

(b) any initial lump sum required and any lump sum required in the future;

(c) the price or value of the property to which the *home reversion plan* would relate (estimated where necessary); and

(d) in the case of a *home reversion plan* which is not a full reversion, the amount or percentage of the value of the property that the *customer* wishes to retain.

8.6A.6 R (1) Where the written confirmation in *MCOB* 8.6A.4R(4) is required, it must be in the same document as the information in *durable medium* in *MCOB* 8.6A.4R(3), which must be separate to any other information and contractual documentation given to the *customer*.

(2) Where the information in *MCOB* 8.6A.4R(3) is given by electronic means, the *firm* must ensure that the *customer* cannot progress to the next stage of the sale unless the information has been communicated to the *customer*.

Record keeping

8.6A.7 R (1) Whenever a *firm enters into* or *arranges* an *execution-only sale* for an *equity release transaction*, it must make and maintain a record of the required information provided by the *customer* which satisfies *MCOB* 8.6A.4R(2), the information in *durable medium* in *MCOB* 8.6A.4R(3) and (where applicable) the confirmation by the *customer* in *MCOB* 8.6A.4R(4).

(2) The record in (1) (a) must be retained for a minimum of three years from the date on which the *equity release transactions* was *entered into* or *arranged*.

The following Annex is deleted in its entirety. The deleted text is not shown struck through.

8 Annex 1R: Initial Disclosure Document [deleted]

Amend the following as shown.

9.3 Pre-application disclosure

…

9.3.2 R **Table of modified cross-references to other rules.**

This table belongs to *MCOB* 9.3.1R.

Subject	Rule or guidance	Reference in rule or guidance	To be read as a reference to:
…			
Messages to be given when providing information on *equity release transactions*	*MCOB* 5.4.18AR	*MCOB* 4.7A.2R	*MCOB* 8.5A.2R
…			

9.3.3 R **Table of rules in *MCOB* 5 replaced by rules in *MCOB* 9: This table belongs to *MCOB* 9.3.1R**

Subject	Rule(s) or guidance	Rule(s) or guidance replaced by:
…		
~~Information that is not an *illustration*~~	~~*MCOB* 5.4.14R~~	~~*MCOB* 9.3.11R~~
…		

9.3.4 R **Table of rules in *MCOB* 5 which do not apply to *MCOB* 9: This table belongs to *MCOB* 9.3.1R.**

Subject	Rule(s)
~~Illustrations for repayment mortgages and interest-only mortgages~~	~~*MCOB* 5.5.13R~~
Business loans and loans to high net worth customers	*MCOB* 5.7

…

9.3.11 R ~~Where a *firm* provides a *customer* with information specific to an *equity release transaction* on a screen:~~

~~(1)~~ ~~if the *customer* initiates the accessing of quotation information on screen (for example, by using the internet or interactive television), the following warning must be displayed equally prominently on each page on screen: This information does not contain all of the details you need to choose an equity release product . Make sure that you read the separate key facts illustration before you make a decision.~~

~~(2)~~ ~~a *firm* must not provide a customised print function where the information on the screen would not be in the form of an *illustration* if the information were printed in hard copy.~~ [deleted]

9.3.12 R In meeting a request for ~~written information specific to the *customer's* requirements on~~ an *illustration* in relation to a particular *equity release transaction* (see *MCOB* 5.5.1R(2)~~(c)~~(d)), the *firm* must not delay the provision of the *illustration* by requesting information other than:

…

…

9.7 Disclosure at the start of the contract: lifetime mortgages

…

Disclosure requirements where interest payments are required

9.7.2 R A *firm* that *enters into* a *lifetime mortgage* with a *customer* where interest payments are required (whether or not they will be collected by deduction from the income from an annuity or other linked *investment* product) must provide the *customer* with the following information before the *customer* makes the first payment under the contract:

…

(9) if it is possible for ~~*arrears*~~ a *payment shortfall* to occur, what to do if the *customer* ~~falls into *arrears*~~ has a *payment shortfall*, explaining the benefit of making early contact with the *firm*, providing the name, address and telephone of a contact point with the *firm*, and drawing the *customer's* attention to the *arrears* charges set out in the tariff of charges;

…

Disclosure requirements where a lump sum payment is made to the customer and interest is rolled up

9.7.8 R Where the *lifetime mortgage* provides for a lump sum payment to be made to the *customer*, and all or part of the interest will be rolled up during the life of the mortgage, the *firm* must provide the *customer* with the following information before the *customer* makes the first payment under the contract, or if no payment are required from the *customer*, within seven days of completion of the mortgage:

…

(2) If payments are required from the customer:

…

(d) what to do if the *customer* ~~falls into *arrears*~~ has a *payment shortfall*, explaining the benefit of making early contact with the *firm*, providing the name, address and telephone of a contact point with the *firm*, and drawing the *customer's* attention to the *arrears* charges set out in the tariff of charges;

…

MCOB 11.1, 11.2 and 11.3 are deleted in their entirety and replaced with new sections MCOB 11.4 et seq. The deleted text is not shown and the new text is not underlined.

11 Responsible lending, and responsible financing of home purchase plans

11.1 Application [deleted]

11.2 Purpose [deleted]

11.3 Responsible lending, and responsible financing of home purchase plans [deleted]

11.4 Application

Who?

11.4.1 R This chapter applies to a *firm* in a category listed in column (1) of the table in *MCOB* 11.4.2R in accordance with column (2) of that table.

11.4.2 R This table belongs to *MCOB* 11.4.1R

(1) Category of firm	(2) Applicable section
mortgage lender	Whole chapter
home purchase	Whole chapter except *MCOB* 11.6.1 G (2), *MCOB* 11.6.3R (3) and (4), *MCOB* 11.6.16 R, *MCOB* 11.6.17G, *MCOB* 11.6.18 R (2) and (9),

provider	*MCOB* 11.6.23 G to *MCOB* 11.6.41 G, *MCOB* 11.6.42 R(3) and (4) and *MCOB* 11.7.4 R

What?

11.4.3 R This chapter applies:

(1) if a *firm enters into a regulated mortgage contract* or *home purchase plan* with a *customer*; or

(2) if a *firm* makes a further advance or varies an existing *regulated mortgage contract* or *home purchase plan* to make a further advance to a *customer*; and

(3) throughout the term of any *regulated mortgage contract* or *home purchase plan* which a *firm* has *entered into*.

11.4.4 R In this chapter, references to making a further advance are to each of the methods of making a further advance in *MCOB* 11.4.3R(2).

11.5 Purpose

11.5.1 G (1) This chapter requires a *firm* to treat *customers* fairly by assessing, before deciding to:

(a) *enter into a regulated mortgage contract* or *home purchase plan*; or

(b) make a further advance on a *regulated mortgage contract* or *home purchase plan*;

whether the *customer* will be able to repay the sums borrowed and interest (in the case of a *regulated mortgage contract*) or pay the sums due (in the case of a *home purchase plan*).

(2) 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).

(3) This chapter sets out some limited exceptions to the requirement to assess the *customer's* ability to repay (or pay), including transitional arrangements in relation to *customers* with existing *regulated mortgage contracts* or *home purchase plans* which satisfy certain conditions.

(4) This chapter also applies in relation to extending the term of a *bridging loan*.

11.6 Responsible lending and financing

Contents of this section

11.6.1 G (1) This section sets out *rules* and *guidance* for lenders and providers under *regulated mortgage contracts* and *home purchase plans*, in relation to the assessment of affordability for the *customer* of these products. It also contains (at *MCOB* 11.6.23G to *MCOB* 11.6.35G) additional *rules*, with accompanying *guidance*, in relation to *regulated mortgage contract*s which are *interest-only mortgages*. These *rules*:

(a) restrict the circumstances in which *interest-only mortgages* may be entered into, and impose additional requirements on *mortgage lenders* in those limited cases where they are permitted; and

(b) provide for an exception to the requirement to assess affordability in relation to those *interest-only mortgages* which are *interest roll-up mortgages*, and restrict the circumstances in which *interest roll-up mortgages* may be used (see *MCOB* 11.6.39R to *MCOB* 11.6.41G).

(2) This section also contains (at *MCOB* 11.6.36E to *MCOB* 11.6.38R) special provisions for *mortgage lenders* in relation to *bridging loans*, including some which apply only where the *bridging loan* is an *interest-only mortgage*.

The assessment of affordability

11.6.2 R (1) Except as provided in *MCOB* 11.6.39R (Interest roll-up mortgages) and in *MCOB* 11.7 (Transitional arrangements):

(a) before:

(i) *entering into a regulated mortgage contract* or *home purchase plan*; or

(ii) making a further advance on a *regulated mortgage contract* or *home purchase plan*;

a *firm* must assess whether the *customer* will be able to pay the sums due; and

(b) the *firm* must not enter into the transaction in (a) unless it can demonstrate that the *regulated mortgage contract* or *home purchase plan* is (or, where applicable, following the further advance, remains) affordable for the *customer*.

(2) In *MCOB* 11.6, references to payment of sums due means:

(a) in the case of a *regulated mortgage contracts*, the making of the payments to repay the sums advanced and interest reasonably expected to be accrued under the *regulated mortgage contract*; and

(b) in the case of a *home purchase plan*¸ the payment of sums under the *home purchase plan*

in each case as they fall due.

11.6.3 R When assessing for the purposes of *MCOB* 11.6.2R whether a *customer* will be able to pay the sums due, a *firm*:

(1) 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) must take full account of:

(a) the income of the *customer*, net of income tax and national insurance; and, as a minimum

(b) (i) the *customer's* committed expenditure; and

(ii) the basic essential expenditure and basic quality-of-living costs of the *customer's* household;

(3) (if it is a *mortgage lender*) must assess affordability on the basis of both repayment of capital and payment of interest over the term, except where lending under an *interest-only mortgage* in accordance with *MCOB* 11.6.24R(1); and

(4) (if it is a *mortgage lender*) must take account of the impact of likely future interest rate increases on affordability, as set out in *MCOB* 11.6.16R.

11.6.4 R For the purposes of *MCOB* 11.6.2R, a *firm* must not rely on a general declaration of affordability by the *customer* or his representative.

Income multiples

11.6.5 G A *firm* may wish to impose a limit, expressed as a multiple of the *customer's* income, on the amount it is prepared to advance under a *regulated mortgage contract* or *home purchase plan*. Such an approach is not, of itself, inconsistent with *MCOB* 11.6.2R but, in accordance with the *rules* in this section, the *firm* must be able to demonstrate that the loan is affordable, having taken full account of the *customer's* income and expenditure, and (for a *mortgage lender*) the impact of future likely interest rate increases on affordability.

Income

11.6.6 R In taking account of the *customer's* income (in accordance with *MCOB* 11.6.3R(2)(a)) for the purposes of its assessment of whether the *customer* will be able to pay the sums due:

(1) a *firm* must obtain evidence of the income declared by the *customer* for the purpose of the *customer's* application for the *regulated mortgage contract*, *home purchase plan* or further advance. The evidence, whether document-based or derived through the use of automated systems, must be of a type and for a period which is adequate to support each element of income that the *firm* is taking into account; and

(2) a *firm* must not accept self-certification of income by the *customer*, and the source of the evidence in (1) must be independent of the *customer*.

11.6.7 G In relation to taking account of the *customer's* income for the purposes of its assessment of whether the *customer* will be able to pay the sums due:

(1) income may be derived from sources other than employment, or from more than one job;

(2) the evidence necessary to comply with *MCOB* 11.6.6R will vary according to factors such as the nature of the employment of the *customer*, his length of employment (for example, whether he is employed, self-employed, a contractor or retired) and, in particular, any elements of income that are not contractually guaranteed. For example: income from overtime working may be evidenced by payslips over a period of time or by checking the level of income regularly paid into a bank account;

(3) for self-employed *customers*, a *firm* may wish to consider using projections of future income, where these are sufficiently robust;

(4) a *firm* may use information it already holds about a *customer's* income, for example where the *customer* holds a current account with the *mortgage lender*;

(5) the source of evidence may be independent of the *customer* even where it is supplied by the *customer*; for example, in the form of payslips, bank statements or tax returns;

(6) a *firm* may use information provided to it by a *home finance intermediary* or other third party, including electronic sources of information, but the *firm* will retain responsibility for compliance with this chapter; and

(7) *mortgage lenders* and *home purchase providers* are reminded of their obligations under *SYSC* 8 in respect of outsourcing where

they choose to use a third party to verify income information.

Expenditure

11.6.8 R For the purposes of a *mortgage lender's* or *home purchase provider's* assessment of whether the *customer* will be able to pay the sums due:

(1) the committed expenditure of a *customer* in *MCOB* 11.6.3R(2)(b)(i) is his credit and other contractual commitments which will continue after the *regulated mortgage contract* or *home purchase plan* is entered into or the further advance is made;

(2) the basic essential expenditure of a *customer's* household in *MCOB* 11.6.3R(2)(b)(ii) comprises expenditure for: housekeeping (food and washing); gas, electricity and other heating; water; telephone; council tax; buildings insurance; ground rent and service charge for leasehold properties; and essential travel (including to work or school); and

(3) the basic quality-of-living costs of a *customer's* household in *MCOB* 11.6.3R(2)(b)(ii) is its basic quality-of-living costs (beyond that included in its basic essential expenditure).

11.6.9 G (1) Examples of committed expenditure are: credit commitments such as loans and credit cards; hire purchase agreements; child maintenance; alimony; and the cost of a *repayment strategy* where the *customer* has an *interest-only mortgage*; and

(2) Basic essential expenditure is expenditure which cannot realistically be reduced.

(3) Examples of basic quality-of-living costs (which can be reduced, but only with difficulty) are: clothing; household goods (such as furniture and appliances) and repairs; personal goods (such as toiletries); basic recreation (television, some allowance for basic recreational activities, some non-essential transport); and childcare.

11.6.10 R For the purposes of its assessment of whether the *customer* will be able to pay the sums due:

(1) a *firm* may generally rely on any evidence of income or information on expenditure provided by the *customer* unless, taking a common sense view, it has reason to doubt the evidence or information;

(2) in taking account of the *customer's* committed expenditure, a *firm* must take reasonable steps to obtain details of the *customer's* actual outstanding commitments; and

(3) in taking account of the basic essential expenditure and basic quality-of-living costs of a *customer's* household, a *firm* may obtain details of the actual expenditure. Alternatively, it may use statistical data or other modelled data appropriate to the composition of the *customer's* household, including the *customer*, dependent children and other dependents living in the household. If it uses statistical or other modelled data a *firm* must apply realistic assumptions to determine the level of expenditure of the *customer's* household.

11.6.11 G (1) Examples of evidence of income in *MCOB* 11.6.10R(1) are payslips and bank statements.

(2) If a *firm* obtains details of the *customer's* credit commitments from the *customer*, it should corroborate the information, for example by making a credit reference agency search or checking credit card or bank statements.

(3) Where the *customer's* credit or contractual commitments are due to end shortly after the *regulated mortgage contract* or *home purchase plan* has been entered into or the further advance has been made, a *firm* should take a common sense approach to deciding whether to include those commitments in its assessment of whether the *customer* will be able to pay the sums due, according to such factors as the remaining term of the commitment and the magnitude of payments required under it.

Future changes to income and expenditure

11.6.12 R If a *firm* is, or should reasonably be aware from information obtained during the application process, that there will, or may, be future changes to the income and expenditure of the *customer* during the term of the *regulated mortgage contract* or *home purchase plan*, the *firm* must take them into account when assessing whether the *customer* will be able to pay the sums due for the purposes of *MCOB* 11.6.2R.

11.6.13 G (1) Examples of future changes to income and expenditure in *MCOB* 11.6.12R are: reductions in income that may come about following the *customer's* retirement; where it is known that the *customer* is being made redundant; or where the *firm* is aware of another loan commitment that will become due during the term of the *regulated mortgage contract* or *home purchase plan*, such as an equity loan to assist in property purchase.

(2) If the term of a *regulated mortgage contract* or *home purchase plan* would extend beyond the date on which the *customer* reaches state pension age, a *firm* should take a prudent and proportionate approach to assessing the *customer's* income beyond that date. The degree of scrutiny to be adopted may vary according to the period of time remaining to retirement when the assessment is made. The closer the *customer* is to retiring, the more robust the evidence of

the level of income in retirement should be. For example, where retirement is many years in the future, it may be sufficient merely to confirm the existence of some pension provision for the *customer* by requesting evidence such as a pension statement; where the *customer* is close to retirement, the more robust steps may involve considering projections provided on pension statements.

(3) Where an additional loan commitment is expected to become due during the term of the *regulated mortgage contract* or *home purchase plan*, the *mortgage lender* should assess whether the *regulated mortgage contract* or *home purchase plan* will remain affordable when the loan commitment becomes due, unless there is an appropriate repayment strategy in place to repay that loan, such as through the sale of the property which is the subject of the *regulated mortgage contract* or *home purchase plan*.

Debt consolidation and credit-impaired consumers

11.6.14 R (1) This *rule* applies where:

(a) a purpose of a *regulated mortgage contract, home purchase plan* or further advance is debt consolidation; and

(b) the *customer* is a *credit-impaired customer*.

[(2) *Option 1* Where each of the conditions in (1) is satisfied and, if the debts which are to be repaid using the sums raised by the *regulated mortgage contract*, *home purchase plan* or further advance were not repaid, the transaction would not be affordable for the *customer,* the *firm* must take reasonable steps to ensure that, on completion of the transaction, those debts are actually repaid.]

[(2) *Option 2* Where each of the conditions in (1) is satisfied, the *firm* must assume that the *customer's* existing debts which are to be repaid using the sums raised by the *regulated mortgage contract*, *home purchase plan* or further advance will not in fact be repaid and, accordingly, include them as committed expenditure in the affordability assessment for the *customer*.]

11.6.15 G [The requirement in *MCOB* 11.6.14R(2) [*Option 1*] for reasonable steps may be satisfied by the *mortgage lender's*, or *home purchase provider's*, repaying the committed expenditure directly to the creditors concerned as a condition of granting the *regulated mortgage contract*, *home purchase plan* or further advance.]

Considering the effect of future interest rate rises

11.6.16 R (1) Under *MCOB* 11.6.3R(4), in taking account of likely future interest rate increases for the purposes of its assessment of whether the *customer* will be able to pay the sums due, a *mortgage lender* must consider the likely future interest rates over a minimum period of five years from the beginning of the term of the *regulated mortgage contract* or further advance, unless the interest rate under the *regulated mortgage contract* is fixed for a period of five years or more from that time, or for the duration of the *regulated mortgage contract* or further advance, if less than five years.

(2) A *mortgage lender* must be able to justify the basis it uses for determining likely future interest rates for the purposes of this *rule* by reference to market expectations.

(3) For the purposes of this *rule*, even if the basis used by the *mortgage lender* in (2) indicates that interest rates are likely to fall, or to rise by less than 1%, during the first five years of the *regulated mortgage contract* or further advance, a *mortgage lender* must assume that interest rates will rise by a minimum of 1% over that period.

11.6.17 G In relation to *MCOB* 11.6.16R(2):

(1) an example of market expectations is the forward sterling rate published on the Bank of England website. A *mortgage lender* should not use its own forecast; and

(2) a *mortgage lender* should not link its determination to market expectations without considering the likely effect of rate changes in accordance with the market expectations on the specific *regulated mortgage contract* in question.

Responsible lending or financing policy

11.6.18 R A *firm* must put in place, and operate in accordance with, a written policy, approved by its Board, setting out the factors it will take into account in assessing a *customer's* ability to pay the sums due. The policy must address the following matters:

(1) how income and expenditure is to be assessed, including:

(a) details of the types of income which are acceptable;

(b) the proportion of different income streams which is acceptable;

(c) how variations in income over time, of which the *firm* is aware, are to be considered;

(d) what is acceptable evidence of income (including the time period to be covered by the evidence); and

(e) how committed and basic expenditure is taken into account when assessing affordability;

(2) how future interest rates are taken into account when assessing affordability;

(3) the calculations used to determine whether the *regulated mortgage contract* or *home purchase plan* is affordable;

(4) how the *mortgage lender's* or *home purchase provider's* anti-fraud controls are incorporated into affordability assessments;

(5) how the *mortgage lender's* or *home purchase provider's* method of calculating the size of the advance for each *customer*, based on a consideration of the *customer's* income and expenditure, is to be monitored, including the timing of reviews and key performance indicators to be used;

(6) the actions to be taken if the *mortgage lender's* or *home purchase provider's* calculation method, referred to in (5), does not perform as expected;

(7) how regular audits of compliance with the *mortgage lender's* or *home purchase provider's* responsible lending or financing policy established in accordance with this *rule* are to be undertaken (as required by *MCOB* 11.6.22R);

(8) how the record keeping requirements in *MCOB* 11.6.42R are to be met;

(9) (if applicable) the matters required by *MCOB* 11.6.33R (Interest-only policy); and

(10) (if applicable) how the *firm* will apply the *rules* in *MCOB* 11.7 (Transitional arrangements).

11.6.19 G Examples of different income streams in *MCOB* 11.6.18R(1)(b) are: income derived from sources other than employment; income from more than one job; and elements of income that are not contractually guaranteed.

Monitoring

11.6.20 R A *firm* must put in place, and be able to demonstrate that it has, robust systems and controls in place to monitor the effectiveness of its affordability assessments, including in preventing payment difficulties.

11.6.21 G The monitoring in *MCOB* 11.6.20R should:

(1) include use of management information and key performance indicators to review and (where appropriate) adjust and improve

the *mortgage lender's* or *home purchase provider's* method of calculating the size of the advance for each *customer*, based on a consideration of the *customer's* income and expenditure; and

(2) take place on a regular basis. However, a *firm* should put in place key performance indicators that trigger more frequent reviews; for example, if the incidence of *customers* being in *arrears*, or of early *arrears*, is higher than expected.

11.6.22 R A *firm* must ensure that its compliance with the responsible lending or financing policy required by *MCOB* 11.6.18R is reviewed at least once per calendar year by its internal audit function or a comparable independent auditing unit external to the *firm*.

Interest-only mortgages

11.6.23 G The rules in this part (*MCOB* 11.6.24R to *MCOB* 11.6.32R) provide that *interest-only mortgages* may be *entered into* by *mortgage lenders* in limited circumstances.

Entering into interest-only mortgages

11.6.24 R (1) A *mortgage lender* may only *enter into* an *interest-only mortgage*, or switch a *repayment mortgage* onto an interest-only basis for all or part of its term, if:

(a) it has evidence that the *customer* will have in place a clearly understood and credible *repayment strategy*; and

(b) as far as it is reasonably able to assess, the *repayment strategy* has the potential to repay the capital borrowed and any interest reasonably expected to be accrued under the *interest-only mortgage*.

(2) In *MCOB* 11.6, a reference to an *interest-only mortgage* is to be read as including any *regulated mortgage contract* which includes an interest-only period or where part of the sum is advanced on an interest-only basis.

(3) A *mortgage lender* must not accept speculative *repayment strategies* for the purposes of (1).

11.6.25 G *Firms* are reminded that:

(1) *interest-only mortgages* include those where some, but not all, interest is payable at the end of the term. Accordingly, the requirement in *MCOB* 11.6.24R(1)(b) applies equally to such *interest-only mortgages* as it does to those where all of the interest is accrued until the end of the term; and

(2) a *lifetime mortgage* is a type of *interest-only mortgage*, as full repayment of capital and interest is not required over the term.

Accordingly, the requirements in the *Handbook* (including in *MCOB* 11.6 and *MCOB* 11.7) which apply to *interest-only mortgages* apply to *lifetime mortgages*, unless specifically disapplied. Depending always on its terms, a *lifetime mortgage* may also be an *interest roll-up mortgage,* as noted in *MCOB* 11.6.41G.

11.6.26	R	*MCOB* 11.6.24R(1) does not prevent a *mortgage lender*, when appropriate, from making a temporary concession, by which he accepts payment of interest only, with a *customer* who is in *arrears* or has a *payment shortfall*, or is at risk of *arrears* or a *payment shortfall*, on a *regulated mortgage contract*.
11.6.27	G	*Firms* are reminded that whether it is appropriate to take the action contemplated by *MCOB* 11.6.26R will depend on all the circumstances of the particular case and must be considered having regard to, among other things, *Principle* 6 and the *rules* in *MCOB* 13.
11.6.28	G	The following *repayment strategies* may, subject to the circumstances of the *customer,* be acceptable for the purposes of *MCOB* 11.6.24R(1): (1) regular savings into an investment product; (2) the periodic repayment of capital from irregular sources of income (such as bonuses or some sources of income from self-employment); and (3) the sale of assets such as another property or other land owned by the *customer*.
11.6.29	E	Acceptance by a *mortgage lender* of any of the following *repayment strategies* for the purposes of *MCOB* 11.6.24R(1) may be relied upon as tending to show contravention of that *rule*: (1) an expectation on the part of the *customer* that the value of the property which is the subject of the *regulated mortgage contract* will increase over its term sufficiently to enable the *customer* to sell the property to repay the capital borrowed and, where applicable, pay the interest accrued under the *interest-only mortgage*; (2) an intention on the part of the *customer* to utilise an expected, but uncertain, inheritance to repay the capital borrowed and, where applicable, pay the interest accrued under the *interest-only mortgage*; and (3) the sale of the property which is the subject of the *regulated mortgage contract*, where the *mortgage lender* does not consider whether the property will have the potential to provide sufficient funds for the *customer* to repay the capital borrowed and, where applicable, the interest accrued under the *interest-*

only mortgage, and allow the *customer* to purchase a cheaper property to reside in or execute any other associated strategy.

The above list is not exhaustive.

11.6.30 G In complying with *MCOB* 11.6.24R(1), where a *customer's repayment strategy* is the sale of the property which is the subject of the *regulated mortgage contract*, a *mortgage lender* may wish to consider, as part of its assessment of that *repayment strategy*, factors such as the equity in the property when considered in relation to the level of property prices in the relevant area or, for a *lifetime mortgage*, the borrower's life expectancy.

Assessing affordability under an interest-only mortgage

11.6.31 R For the purposes of *MCOB* 11.6.2R, where a *mortgage lender* is lending under an *interest-only mortgage* in accordance with *MCOB* 11.6.24R(1), it may assess affordability on the basis of payment of interest only over the term (plus repayment of such capital as may be due to be repaid over the term). If it does so, it must consider as part of the *customer's* committed expenditure under *MCOB* 11.6.3R(2)(b)(i) the cost to the *customer* of the *repayment strategy*.

Review during the term of interest-only mortgages

11.6.32 R (1) This *rule* applies in relation to all *interest-only mortgages* which a *mortgage lender enters into* on or after [*insert date Instrument comes into effect*] except:

(a) *lifetime mortgages*; and

(b) any other case where the repayment of capital borrowed and, if applicable, interest accrued, is certain.

(2) Except as set out in (3), a *mortgage lender* must carry out a review (as a minimum, once) during the term of the mortgage, in which contact is made with the *customer*, to check that the *customer's repayment strategy* is still in place, and that it is still reasonable to expect that the *repayment strategy* has the potential to repay the capital borrowed and, where applicable, pay the interest reasonably expected to be accrued under the *interest-only mortgage*. The review must be carried out at a stage of the term when, if the *repayment strategy* is not in place, or not adequate, there is likely to be sufficient time prior to the end of the term for the *customer* to take appropriate steps to remedy the situation.

(3) The review in (2) is not required in any case where, despite reasonable efforts to contact the *customer*, the *mortgage lender* has been unable to do so.

(4) Following the review in (1), where appropriate the *mortgage lender* must take reasonable steps to discuss with the *customer* what may be done to address the situation.

Interest-only policy

11.6.33 R A *mortgage lender* which *enters into interest-only mortgages* (unless they are only *lifetime mortgages*) must include in the policy which is required by *MCOB* 11.6.18R (Responsible lending and financing policy) a policy on *interest-only mortgages*, setting out its processes and procedures for ensuring compliance with *MCOB* 11.6.24R(1) and for safeguarding the interests of *customers* during the term of *interest-only mortgages*. This policy must include:

(1) details of the *mortgage lender's* plans for lending by way of *interest-only mortgages*, including its planned volumes of lending on that basis over a specified period, and provision for reviewing the actual volumes of lending on that basis, including the timing and method of review;

(2) specification of the types of *repayment strategy* which will be considered acceptable, and the evidential requirements and other controls which will be applied to ensure that only such types will be accepted, including the controls to be applied where the *repayment strategy* is the sale of the property which is the subject of the *regulated mortgage contract*;

(3) the procedures for checking the existence and adequacy of the *repayment strategy* in line with the policy, including questions to be asked of the *customer*;

(4) the arrangements for monitoring and auditing compliance with the policy, processes and procedures; and

(5) the process for the review required by *MCOB* 11.6.32R which, as a minimum:

(a) prescribes the timing of the review;

(b) prescribes the content of the review, including the questions to be asked of the customer and the actions to be taken if the *customer* proves difficult to contact or otherwise does not co-operate with the review;

(c) sets out how it is to be decided whether the *customer's repayment strategy* meets the criteria in *MCOB* 11.6.32R(1); and

(d) sets out the actions which will be appropriate to be considered during the discussions in *MCOB* 11.6.32R(2), depending on the circumstances of the *customer*.

11.6.34 G (1) The controls in *MCOB* 11.6.33R(2) may include, where appropriate: maximum loan to value limits; minimum equity requirements; regional factors such as property prices; or other eligibility requirements.

(2) The policy and procedures for safeguarding the interests of a *customer* under an *interest-only mortgage* should not permit the *mortgage lender* to change the *interest-only mortgage* to a *repayment mortgage*, extend the term or otherwise change the features of the *interest-only mortgage* unless to do so is compatible with the duties of the *mortgage lender* under *Principle* 6 and any other applicable *rules* and regulations. A *mortgage lender* should also have regard to the *Unfair Terms Regulations* when drafting the provisions of *regulated mortgage contracts* in relation to changes to their features.

11.6.35 G *MCOB* 11.6.33R sets out requirements for *mortgage lenders* to have appropriate procedures for managing *interest-only mortgages* in order to safeguard the interests of *customers*. *Firms* are reminded of the *rules* and *guidance* in *SYSC* (notably *SYSC* 7.1) relating to systems and controls for the management of risks to which *firms* themselves are exposed. *Firms* will need to consider whether their systems and controls are adequate in relation to the management of risks arising from *interest-only mortgages*.

Assessing the customer's repayment strategy for bridging loans

11.6.36 E For a *bridging loan* which is an *interest-only mortgage*, acceptance by a *mortgage lender* as a *repayment strategy* for the purposes of *MCOB* 11.6.24R(1) of an expectation that, by entering into the *bridging loan*, the *customer's* credit status will be sufficiently improved to enable him to refinance to a longer-term *regulated mortgage contract* (except where the *mortgage lender* has evidence of a guaranteed offer for such a longer-term contract) may be relied upon as tending to show contravention of that *rule*.

11.6.37 G For a *bridging loan* which is an *interest-only mortgage*, in complying with *MCOB* 11.6.24R(1):

(1) where the *customer's repayment strategy* is the sale of his existing home, the *mortgage lender* may wish to consider asking for it to be supported by an independent valuation of that property, as a condition of accepting that *repayment strategy*; and

(2) where the *customer's repayment strategy* is the replacement of the *bridging loan* with a mainstream *regulated mortgage* contract, the *mortgage lender* should not accept that *repayment strategy* unless it is reasonably satisfied that a mainstream *mortgage lender* will be willing to enter into a *regulated mortgage contract* with the *customer*. A *firm* may wish to

consider requesting evidence of a guaranteed offer or agreement in principle, once the existing term of the *bridging loan* has expired, or obtain the necessary income and expenditure information, in order to be so satisfied.

Extending the term of a bridging loan

11.6.38 R (1) When considering extending the term of a *bridging loan*, a *mortgage lender* must comply with *MCOB* 11.6.2R as if the *bridging loan* were a new loan.

(2) Where *MCOB* 11.6.2R does not apply in relation to extending the term of a *bridging loan* (because the *bridging loan* is an *interest roll-up mortgage*, and therefore *MCOB* 11.6.39R applies), the *mortgage lender* must consider with the *customer*, before he commits himself to extend the term, the impact of the extension on the *customer's* remaining equity in the property which is the subject of the *bridging loan*.

(3) A *firm* must not agree to extend the term of a *bridging loan* unless the *customer* has made a positive choice to do so.

Interest roll-up mortgages

11.6.39 R The requirements in *MCOB* 11.6.2R do not apply in relation to an *interest roll-up mortgage*.

11.6.40 R A *mortgage lender* may not *enter into* an *interest roll-up mortgage*, or vary an existing *regulated mortgage contract* so that it becomes an *interest roll-up mortgage*, unless it is:

(1) a *lifetime mortgage*; or

(2) a *bridging loan*; or

(3) a loan to a *high net worth customer*; or

(4) a loan for business purposes.

11.6.41 G *Firms* are reminded that an *interest roll-up mortgage* is a type of *interest-only mortgage*, where no payments of interest or capital are required until the mortgage comes to an end. Depending always on their terms, it is possible to structure the types of product set out in *MCOB* 11.6.40R(1) to (4) as an *interest roll-up mortgage*. Where that is the case, *MCOB* 11.6.2R will not apply in relation to them, but *MCOB* 11.6 23G to *MCOB* 11.6.35R will apply to all *interest roll-up mortgages*, to the extent they are permitted by *MCOB* 11.6.40R.

Record-keeping

11.6.42 R (1) A *firm* must make, in paper or electronic form, an adequate record of the steps it takes to comply with the *rules* in this chapter in relation to each *customer*.

(2) The record in (1) must include the information taken into account in each affordability assessment, so that it is possible to understand from the record the basis of the *mortgage lender's* or *home purchase provider's* lending or financing decision, including:

(a) the *customer's* income, including, where relevant, a breakdown of the different income types;

(b) the *customer's* committed expenditure;

(c) the basic essential expenditure and basic quality-of-living costs of the *customer's* household (whether actual expenditure for that household or assumed expenditure from statistical or other modelled data, including information to show why the assumed data is appropriate to that *customer's* household);

(d) the evidence relied on to assess income and expenditure;

(e) the rate or assumptions used to test affordability against likely future interest rate rises;

(f) the repayment type and term of the *regulated mortgage contract*, or the term of the *home purchase plan*; and

(g) the calculation used to determine whether the *regulated mortgage contract*, *home purchase plan* is (or, where applicable, following the further advance, remains) affordable for the *customer*.

(3) In relation to *interest-only mortgages*, the record in (1) must include:

(a) the reasons for each decision to offer an *interest-only mortgage* to a *customer*;

(b) the evidence of the *customer's repayment strategy* and its cost; and

(c) the outcome of each review required by *MCOB* 11.6.32R (whether conducted once during the term of the *interest-only mortgage* or more frequently).

(4) In relation to the extension of the term of a *bridging loan* which is an *interest-only mortgage*, the record in (1) must include:

(a) the *customer's* positive choice to extend the term;

(b) the reasons for the decision to extend the term;

(c) the evidence of the *customer's repayment strategy* and its cost; and

(d) the outcome of each review required by *MCOB* 11.6.32R, where applicable (whether conducted once during the term of the *bridging loan* or more frequently).

(5) A *firm* must retain the records required by (1) to (4) as follows:

(a) the records required by (1) to (3)(b) and (4)(a) to (c): for three years from the date at which the *regulated mortgage contract* or *home purchase plan* is entered into or the further advance is provided;

(b) the records required by (3)(c) and (4) (d): for the remainder of the term of the *interest-only mortgage*, or three years, whichever is longer.

(6) Where a *firm* enters into a *regulated mortgage contract* or *home purchase plan* under *MCOB* 11.7 (Transitional arrangements), it must keep, for the term of the contract or plan, a record of:

(a) the evidence of the *customer's* payment history for the purposes of *MCOB* 11.7.1R(3);

(b) the following details in relation to the new *regulated mortgage contract* or *home purchase plan*, at the point when it is entered into:

(i) the term;

(ii) the repayment method;

(iii) the parties to the *regulated mortgage contract* or *home purchase plan*; and

(iv) the outstanding balance; and

(c) the cost of the repairs or maintenance work to the property, where relevant.

(7) A *firm* must make, and keep up to date, an adequate record of the policy required by *MCOB* 11.6.18R. When the policy is changed, a record of the previous policy must be retained for three years from the date of change.

11.A.3.43 G For the purposes of *MCOB* 11.6.42R(2)(g), if it is not practicable for the *firm* to record on the *customer's* file full details of the calculation method applied, it should record clearly which version of that method was applied in order that the file can be reviewed in conjunction with the applicable version of the method, so that it is possible to reconstruct the lending decision.

11.7 Transitional arrangements

11.7.1 R When considering *entering into* a *regulated mortgage contract* or *home purchase plan*, a *firm* need not apply the *rules* in *MCOB* 11.6.2R to *MCOB* 11.6.17R inclusive if it has established, acting reasonably, that the following conditions are satisfied:

(1) the *customer* has an existing *regulated mortgage contract* or *home purchase plan* which was in existence prior to [*insert date Instrument comes into force*], or an existing *regulated mortgage contract* or *home purchase plan* which was entered into in reliance on, and in compliance with, this section 11.7;

(2) subject to *MCOB* 11.7.3R, the proposed *regulated mortgage contract* or *home purchase plan* would not:

(a) involve the *customer* taking on additional borrowing or payment obligations beyond the amount currently outstanding under the existing *regulated mortgage contract* or *home purchase plan*; or

(b) oblige the *customer* to make monthly payments greater than those due under the existing *regulated mortgage contract* or *home purchase plan*.

(3) the *firm* has obtained evidence which demonstrates that the *customer* has not been in *arrears* or had a *payment shortfall*, under the existing *regulated mortgage contract* or *home purchase plan*, for the last year;

(4) the *firm* is not aware of any information which means that the *customer* will not, or is unlikely to, be able to make payments under the proposed *regulated mortgage contract* or *home purchase plan*;

(5) the *customer* has not, after [*insert date Instrument comes into force*] increased the size of the advance under the existing *regulated mortgage contract* or *home purchase plan* other than to finance any relevant product fee or arrangement fee in relation to, or the cost of essential repairs or maintenance to the property which is the subject of, that *regulated mortgage contract* or *home purchase plan*;

(6) the proposed *regulated mortgage contract* or *home purchase plan* would not involve the removal of a borrower or *home purchaser* who is a party to the existing *regulated mortgage contract* or *home purchase plan*, or the adding of a new borrower or *home*

purchaser; and

(7) the term of the proposed *regulated mortgage contract* or *home purchase plan* will not extend beyond the term of the existing *regulated mortgage contract* or *home purchase plan*, and the other terms and conditions of the proposed *regulated mortgage contract* or *home purchase plan* will not involve any material changes from those of the existing *regulated mortgage contract* or *home purchase plan*.

11.7.2 G The evidence in *MCOB* 11.7.1R(3) may be from the *firm's* own records, where it is the *customer's* current *mortgage lender* or *home purchase provider*, or from external sources (such as a mortgage reference or credit reference), in other cases.

11.7.3 R The condition in *MCOB* 11.7.1R(2) does not apply:

(1) to the extent that additional borrowing or payment obligations or greater monthly payments are required to finance any product fee or arrangement fee for the proposed *regulated mortgage contract* or *home purchase plan*; or

(2) if each of the following conditions is satisfied:

(a) the *firm* is the *mortgage lender* or *home purchase provider* under the existing *regulated mortgage contract* or *home purchase plan* in *MCOB* 11.7.1R(1);

(b) the value of the property which is the subject of the *regulated mortgage contract* or *home purchase plan* is at risk if repairs or maintenance work to the property are not carried out;

(c) the funds generated by the additional borrowing are to be used to carry out the repairs or maintenance work; and

(d) the *firm* has obtained evidence which demonstrates that the additional borrowing is no more than the cost of the repairs or maintenance work.

11.7.4 R (1) When considering *entering into* an *interest-only mortgage*, a *mortgage lender* need not apply the *rules* in *MCOB* 11.6.24R(1), *MCOB* 11.6.32R, *MCOB* 11.6.33R and *MCOB* 11.6.42R(3) if the conditions in *MCOB* 11.7.1R are satisfied, and if it has established, acting reasonably, that the existing *regulated mortgage contract* in *MCOB* 11.7.1R(1) is an *interest-only mortgage*.

(2) Where only part of the sum advanced under the existing *regulated mortgage contract* is on an interest-only basis, (1) applies, but only to that part.

11.7.5 R Before *entering into* a *regulated mortgage contract* or *home purchase plan* in reliance on this section (*MCOB* 11.7), a *firm* must communicate to the *customer*, clearly and prominently in a *durable medium*, that the new *regulated mortgage contract* or *home purchase plan* is being offered as an exceptional arrangement outside normal lending (or financing) criteria, on the basis that the *customer* has demonstrated that he can afford it by keeping up the payments under his existing *regulated mortgage contract* or *home purchase plan* for at least the last year.

11.7.6 G A *firm* may satisfy the requirement in *MCOB* 11.7.5R by disclosing the information in the *offer document*.

11.7.7 G In accordance with its obligation under *Principle* 6 to treat its *customers* fairly:

(1) a *firm* should not treat a *customer* with whom it enters into a *regulated mortgage contract* or *home purchase plan* pursuant to this section 11.7 less favourably than it would treat other *customers* with similar characteristics, for example by offering less favourable interest rates or other terms; and

(2) where a *customer* is unable to move an existing *regulated mortgage contract* or *home purchase plan* to a new *mortgage lender* or *home purchase provider*, the existing *mortgage lender* or *home purchase provider* should not take advantage of the *customer's* situation in the way it treats the *customer* (for example, by engaging in practices such as charging a high interest rate to a *customer* in this situation).

Amend the following as shown.

12.1 Application

...

What?

...

12.1.4 R The ~~arrears~~ <u>*payment shortfall*</u> 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*~~ <u>*payment shortfall*</u> charges under this chapter.

...

12.4 ~~Arrears~~ <u>Payment shortfall</u> 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 <u>or charges</u> for ~~arrears~~ <u>a *payment shortfall*</u> on a *customer* ~~except where that~~ <u>unless the *firm* is able objectively to justify that the</u> charge is <u>equal to or lower than</u> a reasonable ~~estimate~~ <u>calculation</u> of the cost of the additional administration required as a result of the *customer* ~~being in *arrears*~~ <u>having a *payment shortfall*</u>.

(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*.~~ <u>[deleted]</u>

12.4.1A E The imposition of a charge for ~~*arrears*~~ <u>a *payment shortfall*</u> 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~~ <u>*payment shortfall*</u> 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~~ <u>*payment shortfall*</u> (excluding any interest or charges on that balance).

12.4.2 G <u>For each type of *payment shortfall* charge (for example, a monthly *arrears* management charge),</u> ~~A~~ <u>a</u> *firm* may calculate the same level of ~~arrears charges~~ <u>additional administration costs and *payment shortfall* charges</u> for all *regulated mortgage contracts* where the *customer* is in ~~*arrears*~~ <u>*payment shortfall*</u>, rather than <u>performing a calculation</u> on the basis of the individual *regulated mortgage contract* with the particular *customer*.

12.4.3 G *Firms* are also subject to requirements on information provision and standards relating to *arrears* and *repossessions* (see *MCOB* 13 (Arrears and repossessions)).

<u>12.4.4 R In calculating the cost of the additional administration required as a result of a *customer* having a *payment shortfall*, a *firm* must not take into account:</u>

(1) the following types of costs:

(a) funding or capital;

(b) general bank charges that are not incurred as a result of a *customer* having a *payment shortfall*;

(c) unrecovered fees;

(d) advertising costs; and

(e) regulatory fines;

(2) the costs of preparing financial reports for the *firm* unless there is an objectively justifiable reason to do so and the costs relate solely to the analysis and management of accounts in *payment shortfall*;

(3) executive staff costs unless there is an objectively justifiable reason to do so and the costs relate to the day-to-day management of customers in *payment shortfall.*

12.4.5 R In *MCOB* 12.4, 'executive staff' means the staff or business owners responsible for the management of the *firm's* business.

12.4.6 G

(1) For some *firms*, their executive staff will be the executive board members.

(2) Executive staff costs relating to company strategy, including *payment shortfall* strategy, should not be included as costs relating to the day-to-day management of *customers* in *payment shortfall.*

(3) General financial reporting costs, including all legal and regulatory reporting costs, should not be included as costs relating solely to the analysis and management of accounts in *payment shortfall.*

12.4.7 G In calculating the cost of the additional administration required as a result of a *customer* having a *payment shortfall*, the *firm*:

(1) may, where appropriate, take into account the following types of costs:

(a) providing information or documents;

(b) non-executive staff costs;

(c) premises costs;

(d) human resources costs; and

(e) information technology costs; and

(2) should consider the extent to which the cost of the additional administration is shared with the rest of its business.

(3) should, where a type of cost is absent from the lists in (1) and at *MCOB* 12.4.4R(1), before taking it into account, consider whether it is appropriate to do so.

12.4.8 R A *firm* must not impose a charge for a *payment shortfall* that is calculated as a proportion of the outstanding loan.

…

12.6 Business loans and loans to high net worth customers

12.6.1 G *Firms* are reminded that, in relation to a *regulated mortgage contract* for a business purpose or to a *high net worth customer* in circumstances where *MCOB* 7.7.1R applies, if there is a new *early repayment charge* or a change to the existing *early repayment charge*, *MCOB* 7.7.1R(2) requires a *firm* to notify the *customer* within five *business days* of the maximum amount payable as an *early repayment charge*.

12.6.2 G *Firms* are also reminded that in accordance with *MCOB* 1.2.3R, they should ~~either~~ comply in full with *MCOB*, but in doing so may opt to take account of ~~or comply with~~ all tailored provisions in *MCOB* that relate to business loans or loans to *high net worth customers*.

...

13 Arrears, payment shortfalls and repossessions: regulated mortgage contracts and home purchase plans

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~~ with a payment shortfall: 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 attempt to process more than two direct debit 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, on at least one occasion in each of two consecutive months, due to insufficient funds, the *firm* must:

(a) consider whether the method of payment remains suitable for the *customer*;

(b) make reasonable efforts to contact the *customer* to discuss whether the method of payment remains suitable for the *customer*; and

(c) 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(2)(c) does not prevent a *firm* from attempting to process up to two direct debit requests in any one calendar month provided the *firm* has made reasonable efforts to contact the *customer* and the *customer* has failed to respond.

...

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~~ *payment shortfall* as if it was part of the original amount provided (but a *firm* must not automatically capitalise a ~~payment shortfall~~ *payment shortfall*); 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~~ *payment shortfall* 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~~ *payment shortfall* 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 repayments are arranged over the remaining term.

...

Record keeping: ~~arrears~~ payment shortfalls and 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*~~ has a *payment shortfall* 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*~~ having a *payment shortfall*;

(2) in relation to correspondence issued to a *customer* ~~in *arrears*~~ with a *payment shortfall*, 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 in relation to a loan for a business purpose;

(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 the information in *MCOB* 13.4.1R when a ~~payment shortfall~~ *payment shortfall* occurs but before the

customer's account falls into *arrears*, it need not repeat the provision of the information in *MCOB* 13.4.1R 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* 13.4.1R), the *arrears* have been cleared and the *customer's* account falls into *arrears* on a subsequent occasion a *firm* must either:

(1) …

(2) provide, as soon as possible, and in any event within 15 *business days* of becoming aware of the further *arrears*, 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* 13.5.1R, in which case the annual statement will need to be supplemented to include the actual ~~payment shortfall~~ *payment shortfall*.

...

13.7 Business loans <u>and loans to high net worth customers</u>

13.7.1 R Where the *regulated mortgage contract* is for a business purpose <u>or to a *high net worth customer*</u>, a *firm* may as an alternative to *MCOB* 13.4.1R(1) provide the following information in a *durable medium* instead of the *Money Advice Service* information sheet "Problems paying your mortgage":

(1) details of the consequences if the ~~payment shortfall~~ <u>*payment shortfall*</u> is not cleared;

(2) a description of the options available to the *customer* for clearing the ~~payment shortfall~~ <u>*payment shortfall*</u>; and

(3) <u>(in the case only of loans for a business purpose)</u> details of sources of fee-free advice for business *customers*.

13.7.2 G *Firms* are reminded that in accordance with *MCOB* 1.2.3R, they should ~~either~~ comply in full with *MCOB*<u>, but in doing so may opt to take account of</u> ~~or comply with~~ all tailored provisions in *MCOB* that relate to business loans <u>or loans to *high net worth customers*</u>. Therefore, a *firm* may only follow the <u>relevant</u> tailored provisions in *MCOB* 13.7, if it also follows all other <u>relevant</u> tailored provisions in *MCOB*. <u>In either case, the rest of *MCOB* applies in full.</u>

…

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 1.2.9-BR	*A high net worth customer*	Written statement confirming the *customer* is a *high net worth customer*	When it is obtained	Three years
…				
<u>*MCOB* 4.4A.23G</u>	<u>Disclosures</u>	<u>Appropriate records of disclosures required by section 4.4A</u>	<u>When disclosure made</u>	<u>As required by *SYSC* 9</u>
~~*MCOB* 4.7.17R (1)(a)~~	~~Suitability~~	~~Details of the customer information obtained, including the *customer's* needs and circumstances,~~	~~When the *personal recommendation* is made~~	~~Three years~~

		~~for the purpose of assessing the suitability of a *regulated mortgage contract*~~		
~~*MCOB* 4.7.17R (1)(b)~~	~~Suitability~~	~~An explanation of the reasons why the *firm* believes the *personal recommendation* complies with the suitability requirements in *MCOB 4.7.4 R (1)*~~	~~When the *personal recommendation* is made~~	~~Three years~~
~~*MCOB* 4.7.17R (1)(b)~~	~~Suitability~~	~~An explanation of the reasons why a *personal recommendation* has been made on a basis other than that described in *MCOB 4.7.13 E (1)*~~	~~When the *personal recommendation* is made~~	~~Three years~~
~~*MCOB* 4.8.7R~~	~~Scripted questions~~	~~A record of the scripted questions used in non-advised sales~~	~~The date on which the scripted questions are first used~~	~~One year from the date on which the scripted questions are superseded by a more up-to-date record~~
MCOB 4.6.11R	Notice of cancellation	A record of the fact that notice has been given (including the original notice instructions and a copy of any receipt of notice issued)	When the *firm* first becomes aware that notice has been served	Three years
<u>*MCOB* 4.7A.25R (1) (a)</u>	<u>Suitability of *regulated mortgage contracts*</u>	<u>*Customer* information obtained for the purposes of assessing suitability of a *regulated mortgage contract*</u>	<u>When advice given</u>	<u>Three years</u>
<u>*MCOB* 4.7A.25R (1) (b)</u>	<u>Suitability of *regulated mortgage contracts*</u>	<u>An explanation of why the *firm* has concluded its *advice* is suitable</u>	<u>When advice given</u>	<u>Three years</u>
<u>*MCOB* 4.7A.25R (1) (c)</u>	<u>Rolling-up of fees or charges into</u>	<u>The *customer's* positive choice to add fees or charges to the</u>	<u>When choice made</u>	<u>Three years</u>

	loan	sum advanced		
MCOB 4.8A.15R (1) (a)	*Execution-only sales* of *regulated mortgage contracts*	Information provided by the *customer* about the *regulated mortgage contract* he wishes to purchase.	The date a *regulated mortgage contract* was *entered into* or *arranged*	Three years
MCOB 4.8A.15R (1) (b)	*Execution-only sales* of *regulated mortgage contracts*	The warning to the *customer* in a *durable medium* regarding his lack of protection of the rules on assessing suitability	The date a *regulated mortgage contract* was *entered into* or *arranged*	Three years
MCOB 4.8A.15R (1) (c)	*Execution-only sales* of *regulated mortgage contracts*	The *customer's* confirmation of his positive election to proceed with an *execution-only sale*	The date a *regulated mortgage contract* was *entered into* or *arranged*	Three years
MCOB 4.8A.15R (1) (d)	*Execution-only sales* of *regulated mortgage contracts*	Details of *advice* rejected.	The date a *regulated mortgage contract* was *entered into* or *arranged*	Three years
MCOB 4.8A.15R (3)	*Execution-only sales* of *regulated mortgage contracts*	The *firm's* policy for managing *execution-only sales*	When the policy is made	One year from when the policy is changed
MCOB 4.10.9BR	*Execution-only sales* of *home purchase plans*	Information provided by the *customer* about the *home purchase plan* he wishes to purchase; the warning to the *customer* in a *durable medium* regarding his lack of protection of the rules on assessing suitability; the *customer's* confirmation of his positive election to proceed with an *execution-only sale*. The *firm's* policy for managing *execution-only sales*	The date a *home purchase plan* was *entered into* or *arranged* When the policy is made	Three years One year from when the policy is changed
MCOB 4.10.13R(1) (a)	*Suitability* of *home purchase*	*Customer* information obtained for the purposes of	When advice given	Three years

	<u>*plans*</u>	<u>assessing suitability of a *home purchase plan*</u>		
<u>*MCOB* 4.10.13 R (1) (b)</u>	<u>*Suitability* of *home purchase plans*</u>	<u>An explanation of why the *firm* has concluded its *advice* is suitable</u>	<u>When advice given</u>	<u>Three years</u>
<u>*MCOB* 4.10.13R(1) (c)</u>	<u>*Advice* on *home purchase plans*</u>	<u>Any *advice* rejected, including the reasons rejected and details of any *home purchase plan* the *customer* has proceeded with as an *execution-only sale*</u>	<u>When advice given</u>	<u>Three years</u>
…				
MCOB 4.11.8R	*Customer* information on which an assessment of the ~~affordability and appropriateness~~ <u>suitability and basis of *advice*</u> for a *regulated sale and rent back agreement* was based	*Customer* information on his income, expenditure, resources, needs, objectives and individual circumstances	The date on which the *firm* ~~reached a conclusion on affordability and appropriateness~~ <u>assessed suitability</u>	Five years, or one year after the end of the fixed term of the tenancy agreement, if later
…				
~~*MCOB* 8.5.22R(1) (a)~~	~~Suitability~~	~~Details of the customer information obtained, including the *customer's* needs and circumstances, for the purpose of assessing the suitability of a *equity release transaction*~~	~~When the *personal recommendation* is made~~	~~Three years~~
~~*MCOB* 8.5.22R(1) (b)~~	~~Suitability~~	~~An explanation of the reasons why the *firm* believes the *personal recommendation* complies with suitability requirements in *MCOB* 8.5.4R(1)~~	~~When the *personal recommendation* is made~~	~~Three years~~

~~*MCOB* 8.5.22R(1)(b)~~	~~Suitability~~	~~An explanation of the reasons why a *personal recommendation* has been made on a basis other than that described in *MCOB* 8.5.17E(1)~~	~~When the *personal recommendation* is made~~	~~Three years~~
~~*MCOB* 8.3.1R (1)~~	~~Scripted questions~~	~~A record of the scripted questions used in non-advised sales~~	~~The date on which the scripted questions are first used~~	~~One year from the date on which the scripted questions are superseded by a more up-to-date record~~
MCOB 8.3.1R(1)	Notice of cancellation	A record of the fact that notice has been given (including the original notice instructions and a copy of any receipt of notice issued)	When the *firm* first becomes aware that notice has been served	Three years
MCOB 8.5A.19R (1)(a)	Suitability of *equity release transactions*	*Customer* information obtained for the purposes of assessing suitability of an *equity release transaction*	When advice given	Three years
MCOB 8.5A.19R (1)(b)	Suitability of *equity release transactions*	An explanation of why the *firm* has concluded its *advice* is suitable	When advice given	Three years
MCOB 8.5A.19R (1)(c)	*Advice* on *equity release transactions*	Any *advice* rejected, including the reasons rejected and details of any *regulated mortgage contract* the *customer* has proceeded with as an *execution-only sale*	When advice given	Three years
MCOB 8.5A.19R (1)(d)	Rolling-up of fees or charges into loan	The *customer's* positive choice to add fees or charges to the sum advanced	When choice made	Three years
MCOB 8.6A.7R	*Execution-only sales* of *equity release*	Information provided by the *customer* about the *equity release transaction*	The date a *home purchase plan* was *entered into* or	Three years

	transactions	he wishes to purchase; the warning to the *customer* in a *durable medium* regarding his lack of protection of the rules on assessing suitability; the *customer's* confirmation of his positive election to proceed with an *execution-only sale*.	*arranged*	
…				
~~*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* 11.3.4R(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~~	~~The date on which the policy is set~~	~~One year from the date on which the policy is replaced~~
MCOB 11.6.42R(1) to (4)	Responsible lending and financing	Steps taken to comply with rules including: information taken into account in each affordability assessment; in relation to *interest-only mortgages*, the reasons for the offer decision, evidence relating to the *customer's* repayment strategy and the outcome of each mid-term review; information relating to the extension of the term of *bridging loans* which are *interest-only mortgages*	When *regulated mortgage contract* or *home purchase plan* is entered into or further advance provided, or the mid-term review takes place	Three years from the date of the contract, plan or advance; except records relating to a mid-term review of an interest-only mortgage: for the term of the mortgage or three years, whichever is longer

MCOB 11.6.42R(6)(a)	Transitional arrange-ments	Evidence of the *customer's* payment history	When *regulated mortgage contract* or *home purchase plan* is entered into	For the term of the *regulated mortgage contract* or *home purchase plan*
MCOB 11.6.42R(6)(b)	Transitional arrange-ments	The required details of the *new regulated mortgage contract* or *home purchase plan* at the point when it is entered into	When *regulated mortgage contract* or *home purchase plan* is entered into	For the term of the *regulated mortgage contract* or *home purchase plan*
MCOB 11.6.42R(6)(b)	Transitional arrange-ments	The cost of repairs or maintenance work to the property	When *regulated mortgage contract* or *home purchase plan* is entered into	For the term of the *regulated mortgage contract* or *home purchase plan*
MCOB 11.6.42R(7)	Responsible lending and financing policy	The *firm's* policy, setting out the factors it will take into account in assessing a *customer's* ability to pay the sums due	When the policy is made	Three years from the date the policy is changed
MCOB 13.3.9R	Dealings with *customers* ~~in *arrears*~~ with a *payment shortfall*, *or* with a ~~*mortgage*~~ *sale 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

Annex E

Amendments to the Professional Firms sourcebook (PROF)

In this Annex, striking through indicates deleted text.

5.3 Reference to other sourcebooks or manuals

…

Mortgages: Conduct of business sourcebook

…

5.3.8 *MCOB* 1.2.10R provides that *MCOB* does not apply to an *authorised professional firm* with respect to its *non-mainstream regulated activities* except for *MCOB* 2.2 (Clear, fair and not misleading communication), *MCOB* 3 (Financial promotion) ~~and to a limited extent *MCOB* 4.4 (Initial disclosure requirements)~~.

Annex F

Amendments to the Perimeter Guidance manual (PERG)

In this Annex, underlining indicates new text and striking through indicates deleted text.

4.4 What is a regulated mortgage contract?

…

Type of lending

4.4.11 G The definition of *regulated mortgage contract* also covers a variety of types of product. Apart from the normal mortgage loan for the purchase of property, the definition also includes other types of secured loan, such as secured overdraft facility, a ~~secured bridging loan~~ *bridging loan*, a secured credit card facility, and so-called 'equity release loans' (defined as *regulated lifetime mortgage contracts* in this *guidance*) under which the borrower (usually an older person) takes out a loan where repayment of the capital (and in some cases the interest) is not required until the property is sold, usually on the death of the borrower.

Appendix 1: Draft Handbook text

Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries Instrument 2012

PRUDENTIAL SOURCEBOOK FOR MORTGAGE AND HOME FINANCE FIRMS, AND INSURANCE INTERMEDIARIES (NON-BANK LENDERS) INSTRUMENT 2012

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 purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [ ].

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex [x] to this instrument

E. The Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU) is amended in accordance with the Annex [x] to this instrument.

Citation

F. This instrument may be cited as the Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (Non-Bank Lenders) Instrument 2012.

By order of the Board
[*Date*]

Annex x

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

exposure

…

(2) (in accordance with Article 77 of the *Banking Consolidation Directive* and for the purposes of the calculation of the *credit risk capital component* and the *counterparty risk capital component* (including *BIPRU* 3 (Standardised credit risk), *BIPRU* 4 (The IRB approach), *BIPRU* 5 (Credit risk mitigation), ~~and~~ *BIPRU* 9 (Securitisation)) or for the purposes of the calculation of the credit risk capital requirement in *MIPRU* 4.2 (Capital resources requirement) an asset or off-balance sheet item.

…

risk weight

(in relation to an *exposure*) a degree of risk expressed as a percentage assigned to that *exposure* in accordance with:

(a) whichever is applicable of the *standardised approach* to credit risk and the *IRB approach*, including (in relation to a *securitisation position*) under *BIPRU* 9 (Securitisation); or

(b) (for a *firm* to which *MIPRU* 4 applies), *MIPRU* 4.2A.10R to *MIPRU* 4.2A.13R.

risk weighted exposure amount

(in relation to an *exposure*) the value of an *exposure* for the purposes of the calculation of (in the case of a *BIPRU firm*) the *credit risk capital component* or (in the case of a *firm* to which *MIPRU* 4 applies) the credit risk capital requirement under *MIPRU* 4.2A.4R, in both cases after application of a *risk weight*.

securitisation

…

(2) (in accordance with Article 4(36) of the *Banking Consolidation Directive* (Definitions), ~~and~~ in *BIPRU* and *MIPRU* 4) a transaction or scheme whereby the credit risk associated with an *exposure* or pool of *exposures* is *tranched* having the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the *exposure* or pool of *exposures*; and

(b) the subordination of *tranches* determines the distribution of *losses* during the ongoing life of the transaction or scheme.

sponsor …

(2) (in *BIPRU*), in accordance with Article 4(42) of the *Banking Consolidation Directive* (Definitions) and in *MIPRU* 4 and in relation to a *securitisation* within the meaning of paragraph (2) of the definition of securitisation~~)~~, an *undertaking* other than an *originator* that establishes and manages an *asset backed commercial paper programme* or other *securitisation* scheme that purchases *exposures* from third party entities.

Annex x

Amendments to the Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

4.2 Capital Resources Requirement

Applicable guidance within BIPRU

4.2.-1 G Unless otherwise specified, where *MIPRU* 4.2 to *MIPRU* 4.2D refers to a *guidance* provision contained in *BIPRU*, a *firm* should regard that *guidance* provision as applying to it in the same way that that provision applies to a *BIPRU firm*.

General solvency requirement

4.2.1 R A *firm* must at all times ensure that it is able to meet its liabilities as they fall due.

4.2.1A G Specific liquidity requirements for a *firm* carrying on any *home financing* or *home finance administration* connected to *regulated mortgage contracts* are set out in *MIPRU* 4.2D.

…

4.2.10 R Table: Application of capital resources requirements

	Regulated activities	**Provisions**
1.	(a) *insurance mediation activity*; or (b) *home finance mediation activity* (or both); and no other *regulated activity*.	*MIPRU* 4.2.11R
2.	(a) *home financing* not connected to *regulated mortgage contracts*; or (b) *home financing* and *home finance administration* (not connected to *regulated mortgage contracts*); and no other *regulated activity*.	*MIPRU* 4.2.12R to *MIPRU* 4.2.17E
…		
6.	~~Any combination of *regulated*~~	~~*MIPRU* 4.2.22R~~ [deleted]

	~~*activities* not within rows 1 to 5.~~	
7.	(a) *home financing* connected to *regulated mortgage contracts*; or (b) *home financing* and *home finance administration* connected to *regulated mortgage contracts*; and no other *regulated activity*.	*MIPRU* 4.2.23R
8.	any combination of *regulated activities* not within rows 1 to 7.	*MIPRU* 4.2.22R

4.2.10A G *MIPRU* 4.2.12R to *MIPRU* 4.2.23R have the effect that a *firm* carrying on any *home financing* or *home finance administration* which is connected to *regulated mortgage contracts* will be subject to different capital requirements to a *firm* that carries on those activities without connection to *regulated mortgage contracts*. To identify which of the *rules* in *MIPRU* 4.2.12R to *MIPRU* 4.2.23R is applicable, a *firm* should consider which *regulated activities* it performs as part of its *home financing* and *home finance administration* activities and determine whether any of those *regulated activities* (no matter what proportion) are connected to *regulated mortgage contracts*.

…

Capital resources requirement: home financing and home finance administration not connected to regulated mortgage contracts ~~(but not home finance administration only)~~

4.2.12 R (1) The capital resources requirement for a *firm* carrying on only *home financing* which is not connected to *regulated mortgage contracts*, or *home financing* and *home finance administration* which is not connected to *regulated mortgage contracts* (and no other *regulated activity*) is the higher of:

(a) £100,000; and

(b) 1% of:

(i) its total assets plus total undrawn commitments and unreleased amounts under the *home reversion plan*; less

(ii) excluded loans or amounts plus intangible assets (see Note 1 in the table in *MIPRU* 4.4.4R).

…

…

Capital resources requirement: home finance administration only

4.2.18 R The capital resources requirement for a *firm* carrying on *home finance administration* only, which has all or part of the *home finance transactions* that it administers on its balance sheet, is: ~~the amount which is applied to a *firm* carrying on *home financing* or *home financing* and *home finance administration* (and no other *regulated activity*) (see *MIPRU* 4.2.12R)~~

(1) in the case of a *firm* carrying on only *home finance administration* which is not connected to *regulated mortgage contracts*, the amount which is applied to a *firm* under *MIPRU* 4.2.12R; or

(2) in the case of a *firm* carrying on any *home finance administration* which is connected to *regulated mortgage contracts*, the amount which is applied to a *firm* under *MIPRU* 4.2.23R.

…

Capital resources requirement: insurance mediation activity and home financing or home finance administration

4.2.20 R The capital resources requirement for a *firm* carrying on *insurance mediation activity* and *home financing* or *home finance administration* is the sum of ~~the requirements which are applied to the *firm* by~~:

(1) the capital resources requirement ~~*rule*~~ for a *firm* carrying on *insurance mediation activity* or *home finance mediation activity* (and no other *regulated activity*) (see *MIPRU* 4.2.11R); and

(2) (a) in the case of a *firm* carrying on *home financing* which is not connected to *regulated mortgage contracts*, or *home finance administration* which is not connected to *regulated mortgage contracts*, the ~~capital resources requirement *rule* for a *firm* carrying on *home financing* or *home financing* and *home finance administration* (and no other *regulated activity*) (see~~ amount which is applied to a *firm* under *MIPRU* 4.2.12R~~)~~; or

(aa) in the case of a *firm* carrying on any *home financing* which is connected to *regulated mortgage contracts* or any *home finance administration* that it administers on its balance sheet which is connected to *regulated mortgage contracts*, the amount which is applied to a *firm* under *MIPRU* 4.2.23R; or

(b) ~~if, in addition to its *insurance mediation activity*, the *firm* carries~~ in the case of a *firm* carrying on *home finance administration* with all the ~~assets~~ *home finance transactions* that it administers off balance sheet, the ~~capital resources *rule* for such~~ amount which is applied to a *firm* ~~(see~~ under *MIPRU* 4.2.19R~~)~~.

Capital resources requirement: home finance mediation activity and home financing or home finance administration

4.2.21 R (1) If a *firm* carrying on *home finance mediation activity* and *home financing* or *home finance administration* does not hold *client money* or other *client* assets in relation to its *home finance mediation activity*, the capital resources requirement is ~~the amount applied to a *firm*, according to the activities carried on by the *firm*, by~~:

(a) in the case of a *firm* carrying on *home financing* which is not connected to *regulated mortgage contracts* or *home finance administration* which is not connected to *regulated mortgage contracts*, the ~~capital resources requirement *rule* for a *firm* carrying on *home financing* or *home financing* and *home finance administrator* (and no other *regulated activity*) (see~~ amount applied to a *firm* under *MIPRU* 4.2.12R~~)~~; or

(aa) in the case of a *firm* carrying on any *home financing* which is connected to *regulated mortgage contracts* or any *home finance administration* that it administers on its balance sheet which is connected to *regulated mortgage contracts*, the amount applied to a *firm* under *MIPRU* 4.2.23R; or

(b) ~~if, in addition to its *home finance mediation activity*, the *firm* carries~~ in the case of a *firm* carrying on *home finance administration* with all the ~~assets~~ *home finance transactions* that it administers off balance sheet, the amount applied to a *firm* under ~~capital resources *rule* for such a *firm* (see~~ *MIPRU* 4.2.19R~~)~~.

…

Capital resources requirement: other combination of activities

4.2.22 R The capital resources requirement for a *firm* carrying on any ~~other~~ combination of *regulated activities* which is not set out in *MIPRU* 4.2.10R to *MIPRU* 4.2.21R and *MIPRU* 4.2.23R is: ~~the amount which is applied to a *firm* carrying on *insurance mediation activity* and *home financing* or *home finance administration* (see *MIPRU* 4.2.20R)~~

(1) if the combination of *regulated activities* includes carrying on any *home financing* connected to *regulated mortgage contracts* or *home finance administration* connected to *regulated mortgage contracts*, the sum of the amounts which are applied to a *firm* under:

(a) *MIPRU* 4.2.20R(1); and

(b) *MIPRU* 4.2.23R; or

(2) in all other cases, the sum of the amounts which are applied to a *firm* under:

(a) *MIPRU* 4.2.20R(1); and

(b) *MIPRU* 4.2.12R.

Capital resources requirement: home financing and home finance administration connected to regulated mortgage contracts

4.2.23 R The capital resources requirement for a *firm* carrying on any *home financing* which is connected to *regulated mortgage contracts*, or *home financing* and *home finance administration* which is connected to *regulated mortgage contracts* (and no other *regulated activity*), is the higher of:

(1) £100,000; and

(2) the sum of:

(a) the credit risk capital requirement calculated in accordance with *MIPRU* 4.2A; and

(b) 1% of:

(i) its total assets plus total undrawn commitments and unreleased amounts under the *home reversion plan*; less

(ii) intangible assets (see Note 1 in the table in *MIPRU* 4.4.4R) plus loans, *securitisation positions* and *CIU* positions excluded from *MIPRU* 4.2A.4R.

After MIPRU 4.2 insert the following new sections. The text is not underlined.

4.2A Credit risk capital requirement

Application

4.2A.1 R This section applies to a *firm* that is required to calculate its credit risk capital requirement in accordance with *MIPRU* 4.2.23R.

Purpose

4.2A.2 G The purpose of *MIPRU* 4.2A is to:

(1) set out how a *firm* should calculate its credit risk capital requirement;

(2) set out how a *firm* should calculate its *risk weighted exposure amounts* for *exposures* on its balance sheet; and

(3) identify which provisions of *BIPRU* 3 will apply to a *firm*, in addition to the provisions of *MIPRU* 4.2A, to enable it to make those calculations.

4.2A.3 G A *firm* should refer to *BIPRU* 5 (as amended by *MIPRU* 4.2C.3R) with regard to the effect of *credit risk mitigation* on the calculation of *risk weighted exposure amounts*.

Calculation of credit risk

4.2A.4 R The credit risk capital requirement of a *firm* is 8% of the total of its *risk weighted exposure amounts* for *exposures* that:

(1) are on its balance sheet; and

(2) derive from:

(a) a loan entered into; or

(b) a *securitisation position* originated; or

(c) a *CIU* position entered into;

on or after [date to be confirmed]; and

(3) have not been deducted from the *firm's* capital resources under *MIPRU* 4.4.4R;

calculated in accordance with *MIPRU* 4.2A.

4.2A.5 R Any arrangements entered into on or after [date to be confirmed] which increase the amount of a loan already advanced or change the security to a loan already advanced or change the contractual terms (other than if the *firm* is exercising forbearance) of a loan already advanced will be subject to the credit risk capital requirement under *MIPRU* 4.2A.4R(2)(a).

4.2A.6 R The *exposure* value of an asset item must be its balance sheet value.

4.2A.7 R When calculating *risk weighted exposure amounts*, a *firm* must comply with *BIPRU* 3.2.3R, *BIPRU* 3.2.9R to *BIPRU* 3.2.19G, and *BIPRU* 3.2.38R in the same way that these provisions apply to a *BIPRU firm*, except to the extent that a provision is modified or excluded in the table in *MIPRU* 4.2A.8R.

4.2A.8 R This table belongs to MIPRU 4.2A.7R

***BIPRU* provision**	**Adjustment**
All provisions of *BIPRU* 3.2	A reference to a provision of *BIPRU* 3, *BIPRU* 5 or *BIPRU* 9 must be read in conjunction with *MIPRU* 4.2A.8R, *MIPRU* 4.2B.3R and *MIPRU* 4.2C.3R
All provisions of *BIPRU* 3.2	All references to *capital resources* in *BIPRU* 3.2 are replaced with references to capital resources calculated under *MIPRU* 4.4

BIPRU 3.2.14G	The last two sentences do not apply
BIPRU 3.2.38R	The references to *BIPRU* 14, *BIPRU* 13.3.13R and *BIPRU* 13.8.8R (Exposure to a central counterparty) do not apply

4.2A.9 R For the purposes of applying a *risk weight*, the *exposure* value must be multiplied by the *risk weight* determined in accordance with *MIPRU* 4.2A.10R, *MIPRU* 4.2A.11R, *MIPRU* 4.2A.12R or *MIPRU* 4.2A.13R.

4.2A.10 R To calculate *risk weighted exposure amounts* on *exposures* secured by mortgages on residential property, *risk weights* must be applied to all such *exposures*, unless deducted from capital resources calculated under *MIPRU* 4.4, in accordance with *BIPRU* 3.4.56R to *BIPRU* 3.4.88G.

4.2A.11 R To calculate *risk weighted exposure amounts* on *exposures* in *CIUs*, *risk weights* must be applied to all such *exposures*, unless deducted from capital resources under *MIPRU* 4.4, in accordance with *BIPRU* 3.4.114R to *BIPRU* 3.4.125R.

4.2A.12 R *Risk weighted exposure amounts* for *securitised exposures* must be calculated in accordance with *MIPRU* 4.2B.

4.2A.13 R To calculate *risk weighted exposure amounts* on *exposures* other than those provided for in *MIPRU* 4.2A.10R to *MIPRU* 4.2A.12R, *risk weights* must be applied to all such *exposures*, unless deducted from capital resources calculated under *MIPRU* 4.4, in accordance with *BIPRU* 3.5.5G as though that provision were a *rule*.

4.2A.14 G Rather than *risk weighting exposures* individually under *MIPRU* 4.2A.13R, a *firm* should apply a single *risk weight* to all *exposures* in each *exposure* class.

4.2A.15 R If a *firm* calculates *risk weighted exposure amounts* under *MIPRU* 4.2A.13R and is directed by *BIPRU* 3.5.5G to the "normal *rules*", it must, in the calculation of those *risk weighted exposure amounts*, comply with *BIPRU* 3.4 in the same way that that section applies to a *BIPRU firm*.

4.2A.16 R *Exposures* must be assigned a *risk weight* of 100% if *MIPRU* 4.2A.10R to *MIPRU* 4.2A.13R do not set out a calculation for *risk weighted exposure amounts* applicable to that *exposure*.

4.2A.17 R A *firm* must apply *BIPRU* 3.4.96R to *BIPRU* 3.4.102R to all past items due.

4.2A.18 G A *firm* may apply *BIPRU* 3.5.6G and *BIPRU* 3.5.7G to *exposures*. *MIPRU* 4.2C sets out the amendments to the *BIPRU* 5 *rules* referenced within these provisions.

4.2B Securitisation

Application

4.2B.1 R This section applies to a *firm* that is required to calculate the credit risk capital requirement under *MIPRU* 4.2.23R.

Purpose

4.2B.2 G The purpose of *MIPRU* 4.2B is to set out:

(1) how a *firm* that is required to calculate the credit risk capital requirement under *MIPRU* 4.2.23R should calculate the *risk weighted exposure amounts* for *securitisation positions*; and

(2) the requirements that investors, *originators* and *sponsors* of *securitisations* on the balance sheet will have to meet (*BIPRU* 9.3.1AR and *BIPRU* 9.3.15R to *BIPRU* 9.3.20R).

Calculation of risk weighted exposure amount for securitisation positions

4.2B.3 R To calculate the *risk weighted exposure amount* for *securitisation positions*, a *firm* must comply with *BIPRU* 9 in the same way that that section applies to a *BIPRU firm*, except to the extent that a provision of *BIPRU* 9 is modified or excluded in the table in *MIPRU* 4.2B.4R.

4.2B.4 R This table belongs to *MIPRU* 4.2B.3R

***BIPRU* provision**	**Adjustment**
All sections of *BIPRU* 9	All references to *capital resources* in *BIPRU* 9 are replaced with references to capital resources calculated under *MIPRU* 4.4
All sections of *BIPRU* 9	A reference to a provision of *BIPRU* 3, *BIPRU* 5 or *BIPRU* 9 must be read in conjunction with *MIPRU* 4.2A.8R, *MIPRU* 4.2B.4R and *MIPRU* 4.2C.4R
BIPRU 9.1.1R	This *rule* does not apply
BIPRU 9.1.2G	This provision does not apply
BIPRU 9.1.8AG(3)	The words “and these should be taken into account under the *overall Pillar 2 rule*” do not apply
BIPRU 9.1.9G	This provision does not apply
BIPRU 9.1.10G	This provision does not apply
BIPRU 9.2	This section does not apply

BIPRU 9.3.7R to *BIPRU* 9.3.14R	These *rules* do not apply
BIPRU 9.3.15R	The first sentence of this *rule* is amended to read as follows: “A *firm*, whether acting as *sponsor* or *originator*, must apply the same sound and well defined criteria used for credit granting in respect of *exposures* held on its balance sheet to *exposures* to be securitised.”
BIPRU 9.3.16R	This *rule* is amended to read as follows: “A *firm* must apply the same standards of analysis to *exposures* under *BIPRU* 9.3.15R regardless of whether it has purchased or originated those *exposures*.”
BIPRU 9.3.17R	Where a *firm* is an *originator*, it must comply with this *rule* as it applies to a *credit institution*
BIPRU 9.3.18R	Where a *firm* is an *originator* or *sponsor* of a *securitisation*, it must comply with this *rule* in the same way that it applies to a *credit institution*
BIPRU 9.3.19R	Where a *firm* is an *originator* or *sponsor* of a *securitisation*, it must comply with this *rule* in the same way that it applies to a *credit institution*
BIPRU 9.3.21G	This provision does not apply
BIPRU 9.3.22G	This provision does not apply
BIPRU 9.4.1R	This *rule* is amended to read as follows: “The *originator* of a *traditional securitisation* may exclude *securitised exposures* from the calculation of *risk weighted exposure amounts* and *expected loss* amounts if significant credit risk associated with the *securitised exposures* has been transferred to third parties and the transfer complies with the conditions in *BIPRU* 9.4.2R to *BIPRU* 9.4.10R.”
BIPRU 9.4.11R to *BIPRU* 9.4.18G	These provisions do not apply
BIPRU 9.5.1R(1)	This *rule* is amended to read as follows: “An *originator* of a *synthetic securitisation* may calculate *risk weighted exposure amounts*, and, as relevant, *expected loss* amounts, for the *securitised exposures* in accordance with *BIPRU* 9.5.3R and *BIPRU* 9.5.4R, if significant credit risk has been transferred to third parties, either through funded or unfunded credit protection, and the transfer complies with the

	conditions in (2) – (5)."
BIPRU 9.5.1R(3)	The reference to *BIPRU* 4.10 (Credit risk mitigation under the IRB approach) does not apply
BIPRU 9.5.1R(6)	This *rule* does not apply
BIPRU 9.5.1R(7)	This *rule* does not apply
BIPRU 9.5.1AG to *BIPRU* 9.5.1FG	These provisions do not apply
BIPRU 9.5.3R(1)	The reference to *BIPRU* 9.9 to *BIPRU* 9.14 is replaced by a reference to *BIPRU* 9.9 to *BIPRU* 9.11 The reference to *BIPRU* 3 is replaced by a reference to *MIPRU* 4.2A The reference to *BIPRU* 4 (IRB approach) does not apply
BIPRU 9.5.3R(2)	This *rule* does not apply
BIPRU 9.5.4R	The reference to *BIPRU* 9.9 to *BIPRU* 9.14 is replaced by a reference to *BIPRU* 9.9 to *BIPRU* 9.11
BIPRU 9.5.7R	The reference to *BIPRU* 4.10 (Credit risk mitigation under the IRB approach) does not apply
BIPRU 9.5.8R	The reference to *BIPRU* 9.9 to *BIPRU* 9.14 is replaced by a reference to *BIPRU* 9.9 to *BIPRU* 9.11
BIPRU 9.6.8G	This provision does not apply
BIPRU 9.7.3G	This provision does not apply
BIPRU 9.8.1R	The reference to *BIPRU* 9 is replaced with a reference to *MIPRU* 4.2B
BIPRU 9.8.2R	The reference to *BIPRU* 9 is replaced with a reference to *MIPRU* 4.2B
BIPRU 9.8.7R	The references to *BIPRU* 4.10 (Credit risk mitigation under the IRB approach) do not apply
BIPRU 9.9.1R	The reference to *BIPRU* 9.9 to *BIPRU* 9.14 is replaced by a reference to *BIPRU* 9.9 to *BIPRU* 9.11
BIPRU 9.9.2R	The reference to *BIPRU* 9.9 to *BIPRU* 9.14 is replaced by a reference to *BIPRU* 9.9 to *BIPRU* 9.11
BIPRU 9.9.4R(2)	This *rule* does not apply

BIPRU 9.9.5R	This *rule* does not apply
BIPRU 9.9.6R	The reference to *BIPRU* 9.14 does not apply
BIPRU 9.9.7R	The reference to *BIPRU* 4.10 (Credit risk mitigation under the IRB approach) and the reference to *BIPRU* 9.14 do not apply
BIPRU 9.9.9R	The words "subject to the provisions of *GENPRU* that deal with the deduction of *securitisation positions* at stage M in the relevant *capital resources table*" do not apply
BIPRU 9.10.1R	The references to the *IRB approach* do not apply
BIPRU 9.10.2R	This *rule* does not apply
BIPRU 9.10.3R	The reference to *BIPRU* 9.12.8R does not apply
BIPRU 9.10.4R to 9.10.7R	These *rules* do not apply
BIPRU 9.12	This section does not apply
BIPRU 9.13	This section does not apply
BIPRU 9.14	This section does not apply
BIPRU 9.15	This section does not apply

4.2B.5 G Subject to *BIPRU* 9.3.6G, for the purposes of *BIPRU* 9.4.1R and *BIPRU* 9.5.1R the transfer of credit risk to third parties should only be considered significant if the proportion of risk transferred is broadly commensurate with, or exceeds the proportion by which *risk weighted exposure amounts* are reduced.

4.2B.6 G For measuring the reduction in risk and *risk weighted exposure amounts*, an *originator* should assess the *securitisation positions* it holds against the underlying *exposures* as if they had never been *securitised.*

4.2B.7 G An *originator* should use an appropriate method, consistent with its own internal processes, to assess whether the risk transferred is significant.

4.2B.8 G If the result of:

(1) applying a *risk weight* of 1250% to all positions that an *originator* holds in the *securitisation*; or

(2) deducting all those positions from capital resources;

is a reduction in the *originator's* capital requirement compared to the capital requirements that would apply had it not transferred the *securitised* *exposures*, then the *originator* may treat the risk transferred as significant for the purposes of *BIPRU* 9.4.1R and *BIPRU* 9.5.1R.

4.2C Credit risk mitigation

Application

4.2C.1 R This section applies to a *firm* to which *MIPRU* 4.2.23R applies where that *firm* wishes to apply *credit risk mitigation* to the calculation of its *risk weighted exposure amounts* under *MIPRU* 4.2A.

Purpose

4.2C.2 G The purpose of *MIPRU* 4.2C is to set out which provisions of *BIPRU* 5 a *firm* should comply with in the recognition of *credit risk mitigation* in the calculation of *risk weighted exposure amounts* for the purposes of the calculation of the credit risk capital requirement under *MIPRU* 4.2.23R.

General

4.2C.3 R A *firm* that wishes to recognise *credit risk mitigation* in the calculation of *risk weighted exposure amounts*, must comply with *BIPRU* 5 in the same way that that section applies to a *BIPRU firm*, except to the extent that a provision of *BIPRU* 5 is modified or excluded in the table in *MIPRU* 4.2C.4R.

4.2C.4 R This table belongs to *MIPRU* 4.2C.3R

***BIPRU* provision**	**Adjustment**
All provisions of *BIPRU* 5	A reference to a provision of *BIPRU* 3, *BIPRU* 5 or *BIPRU* 9 must be read in conjunction with *MIPRU* 4.2A.8R, *MIPRU* 4.2B.4R and *MIPRU* 4.2C.4R
BIPRU 5.1	This section does not apply
BIPRU 5.3.2R	The words “without prejudice to *BIPRU* 5.6.1R” do not apply
BIPRU 5.4.1R	This rule does not apply
BIPRU 5.4.8R	This rule does not apply
BIPRU 5.4.16R	This rule does not apply
BIPRU 5.4.18R	The second sentence of this *rule* does not apply The words “*BIPRU* 5.4.19R to *BIPRU* 5.4.21R” are replaced with the words “*BIPRU* 5.4.21R”
BIPRU 5.4.19R	This *rule* does not apply
BIPRU 5.4.20R	This *rule* does not apply

BIPRU 5.4.22R	The reference to *BIPRU* 5.4.20R does not apply
BIPRU 5.4.23R to *BIPRU* 5.4.66R	These provisions do not apply. A *firm* must only use the *financial collateral simple method*
BIPRU 5.6	This section does not apply
BIPRU 5.7.4R	This *rule* does not apply
BIPRU 5.7.12R	This *rule* does not apply
BIPRU 5.7.19R	This *rule* does not apply
BIPRU 5.7.23R	The words "*BIPRU* 3.2.20R to *BIPRU* 3.2.26R" are replaced with the words "*MIPRU* 4.2A.8R to *MIPRU* 4.2A.11R and *MIPRU* 4.2A.14R"
BIPRU 5.7.23R(3)	The first clause of this *rule* is amended to read as follows: "E is the *exposure* value according to *MIPRU* 4.2A.5R and *BIPRU* 3.2.3R;" The second clause of this *rule* does not apply
BIPRU 5.7.24R	The words "*BIPRU* 3.2.20R to *BIPRU* 3.2.26R" are replaced with the words "*MIPRU* 4.2A.8R to *MIPRU* 4.2A.11R and *MIPRU* 4.2A.14R".
BIPRU 5.7.24R(1)	This *rule* is amended to read as follows: "E is the *exposure* value according to *MIPRU* 4.2A.5R and *BIPRU* 3.2.3R."
BIPRU 5.7.27R	The references to *BIPRU* 4.10R and the *IRB approach* do not apply
BIPRU 5.8.8R and *BIPRU* 5.8.9R	These *rules* do not apply

4.2D Liquidity resources requirements

Application

4.2D.1 R This section applies to a *firm* carrying on any *home financing* or *home finance administration* connected to *regulated mortgage contracts*, unless as at [date to be confirmed] its *Part IV permission* was and continues to remain subject to a restriction preventing it from undertaking new *home financing* or *home finance administration* connected to *regulated mortgage contracts.*

Adequacy of liquidity resources

4.2D.2 R A *firm* must at all times maintain liquidity resources which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

4.2D.3 G In assessing the adequacy of liquidity resources, a *firm* should have regard to the overall character of the resources available to it, which enable it to meet its liabilities as they fall due. A *firm* should ensure that:

(1) it holds sufficient assets which are marketable, or otherwise realisable;

(2) it is able to generate funds from those assets in a timely manner; and

(3) it maintains a prudent funding profile in which its assets are of appropriate maturities, taking into account the expected timing of its liabilities.

Systems and controls requirements

4.2D.4 R A *firm* must have in place robust strategies, policies, processes and systems that enable it to identify, measure, manage and monitor *liquidity risk* over the appropriate set of time horizons for its business activities, to ensure that it maintains adequate levels of liquidity resources. These strategies, policies, processes, and systems must be appropriate to the *firm's* business lines, currencies in which it operates, and its *group* companies and must include adequate allocation mechanisms of liquidity costs, benefits and risks.

4.2D.5 R The strategies, policies, processes and systems referred to in *MIPRU* 4.2D.4R must be proportionate to the nature, scale and complexity of the *firm's* activities and the risk profile of the *firm*.

4.2D.6 R A *firm* must have in place reliable management information systems to provide its *governing body*, *senior managers* and other appropriate personnel with timely and forward-looking information on the liquidity position of the *firm*.

4.2D.7 R A *firm* must ensure that its *governing body* reviews regularly (and not less frequently than annually) the continued adequacy of any strategies, policies, processes and systems in place in accordance with *MIPRU* 4.2D.4R

Stress testing and contingency funding plans

4.2D.8 R A *firm* must consider alternative scenarios in which its liquidity position could be impacted. The consideration of alternative scenarios must include and deal with off-balance sheet items and other contingent liabilities, including those of *securitisation special purpose entities* (*SSPEs*) or other special purpose entities, in relation to which the *firm* acts as *sponsor* or provides material liquidity support. These scenarios must be incorporated into the stress testing under *MIPRU* 4.2D.9R.

4.2D.9 R In order to ensure compliance with *MIPRU* 4.2D.2R, a *firm* must:

(1) conduct on a regular basis appropriate stress tests so as to:

(a) identify sources of potential liquidity strain; and

(b) ensure that the risks of current liquidity exposures can be adequately managed; and

(2) analyse the separate and combined impact of possible future liquidity stresses on its:

(a) cash flows;

(b) liquidity position; and

(c) solvency; and

(3) keep a written record of all stress tests and their results.

4.2D.10 R A *firm* must ensure that its *governing body* reviews regularly the stresses and scenarios tested and the assumptions underlying the funding position of the *firm* to ensure that their nature and severity remain appropriate and relevant to it.

4.2D.11 G For the purpose of *MIPRU* 4.2D.10R a review should take into account:

(1) changes in market conditions;

(2) changes in funding sources and inflows;

(3) changes in the nature, scale or complexity of the *firm's* business model and activities; and

(4) the *firm's* practical experience in periods of stress.

4.2D.12 R A *firm* must adjust its strategies, internal policies and limits on liquidity risk, taking into account the outcome of the alternative scenarios referred to in *MIPRU* 4.2D.8R.

4.2D.13 R (1) A *firm* must have in place contingency funding plans setting out adequate strategies and proper implementation measures in order to address potential liquidity shortfalls.

(2) The contingency funding plans must be:

(a) in writing;

(b) approved by the *firm's governing body*;

(c) regularly tested; and

(d) updated on the basis of the outcome of the stress tests, testing alternative scenarios set out in *MIPRU* 4.2D.8R.

4.2D.14 G A contingency funding plan sets out a *firm's* strategies for managing liquidity shortfalls in emergency situations. Its aim should be to ensure that, in each of the stresses set out in *MIPRU* 4.2D.11R, it would have sufficient liquidity resources to ensure that it can meet its liabilities as they fall due.

Amend the following as shown.

4.4 Calculation of capital resources

The calculation of a firm's capital resources

4.4.1 R …

(3) Subject to (4), if a *firm* carries on *home financing* or *home finance administration* that is connected to *regulated mortgage contracts*, at least 20% of its capital resources must be accounted for by items of capital in lines 1 to 5 of the table at *MIPRU* 4.4.2R (Items which are eligible to contribute to the capital resources of a firm).

(4) A *firm* is not required to meet the requirements in (3) if as at [date to be confirmed] its *Part IV permission* was and continues to remain subject to a restriction preventing it from undertaking new *home financing* or *home finance administration* connected to *regulated mortgage contracts*.

…

4.4.8 R (1) This rule applies to a *firm* which:

(a) carries on:

(i) *insurance mediation activity*; or

(ii) *home finance mediation activity* (or both); and

~~(b)~~ in relation to those activities, holds *client money* or other *client* assets; or

~~but is not carrying on *home financing* or *home finance administration*.~~

(b) carries on *home financing* or *home finance administration* connected to *regulated mortgage contracts* (or both) unless as at [date to be confirmed] its *Part IV permission* was and continues to remain subject to a restriction preventing it from undertaking new *home financing* or *home finance administration* connected to *regulated mortgage contracts*.

PUB REF: 002655

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: www.fsa.gov.uk