



**Consumer  
Focus**  
Campaigning for a fair deal

# **Consumer Focus response to the Financial Services Authority Mortgage Market Review**

**January 2010**

## About Consumer Focus

Consumer Focus is the statutory organisation campaigning for a fair deal for consumers in England, Wales, Scotland, and, for postal services, in Northern Ireland. We are the voice of the consumer, and work to secure a fair deal on their behalf. We were created through the merger of three consumer organisations – Energywatch, Postwatch and the National Consumer Council (including the Welsh and Scottish Consumer Councils). The new approach allows for more joined-up consumer advocacy, with a single organisation speaking with a powerful voice and able to more readily bring cross-sector expertise to issues of concern.

## Response to the FSA Mortgage Market Review

### Introduction

We agree that the existing regulatory framework was inadequate to constrain irresponsible lending and borrowing behaviour, leading to unsustainable growth and contributing to the eventual collapse of the mortgage market. This has led to many consumers being at risk of repossession and homelessness. It is essential to put in place measures now that will prevent the re-emergence of previous high-risk lending practices

### Prudential reform

We believe prudential reform (in the form of financial controls) to be an important aspect of a well-regulated mortgage market. However, in this response we have confined our comments mainly to issues which impact directly on the consumer experience. Nonetheless, should it be decided that no additional prudential measures are required in relation to mortgage lending, then this decision must remain under review. If there is any indication that the overall prudential reforms are insufficient to maintain the stability of the mortgage market, then additional measures in this regard should be considered immediately.

In view of the problems there have been in the mortgage market with high risk lenders and the particular mortgage arrears issues of 'non-banks' (para 3.48), we do not see the case for non-banks continuing to have less onerous capital resource requirements than deposit-taking banks and building societies.

We agree with the view that prudential reform alone will be insufficient to inhibit irresponsible lending behaviour and that conduct of business reform is also necessary.

## Conduct of business reform

### Introduction

As stated above, it is evident that the existing regulatory framework has not been sufficient to constrain high-risk lending and borrowing and reform is necessary.

### Product regulation

Many financial products are complex. The provision of information is not sufficient to ensure that consumers are able to make the right borrowing decisions. Prudential regulation did not prevent the proliferation of high-risk products in the mortgage market. We agree therefore that the target regulation of products is an appropriate measure.

### Loan-to-value (LTV), loan-to-income (LTI) or debt-to-income (DTI) ratios

We do not have our own data in this area and are prepared to accept that the case may not be clear on imposing caps on LTI or LTV ratios. Nonetheless we agree that this issue should be fully investigated and should be kept under review as a possible tool for use in the future. Furthermore, although caps may not be imposed, lenders should be expected to exercise appropriate care when lending at higher ratios. The lender must ensure that the lending decision is based on an assessment of the affordability of the loan to the borrower.

While the view of a capped DTI ratio may be that it is too blunt an instrument to impose on the mortgage market, it is telling that a very large proportion (88 per cent) of repossessed properties in the FSA's internal study referred to in the Discussion Paper (DP) had either been remortgaged or had a subsequent charge or charging order applied to them. This indicates that there is a case for lenders to be particularly vigilant when making lending decisions on second or subsequent mortgages.

Our own research into the problems that consumers were having managing their debt in the recession found that mortgage holders who had bought their homes under right-to-buy were more likely to have second mortgages secured on their property and that they were more likely to be struggling with keeping up with their mortgage payments<sup>1</sup>.

### Prohibiting loans to borrowers exhibiting certain multiple high-risk characteristics

There is a case for prohibiting a 'toxic mix' of products, exhibiting a combination of high risk factors. In addition to the combination illustrated in exhibit 4.12, possibilities could include a combination of low income mortgage, high loan to income ratio and high debt to income ratio or alternatively low income mortgage, remortgage and impaired credit history. It is important that the analysis of transactional data is carried out to determine whether and, if so, which different combinations result in greater arrears/repossession rates. Clearly once this analysis has been carried out, we will be in a better position to see which factors should be considered part of a potential 'toxic' combination.

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<sup>1</sup> Consumer Focus, Right-to-Buy homeowners struggle to keep their homes: Managing debt in the financial crisis (July 2009).

## Non-income verified mortgages

We agree that the data shows that default rates are most closely correlated to the category of mortgage. The level of default in relation to non-income verified mortgages is sufficient to justify very specific action in relation to those types of mortgage and we agree that income verification should be required in every case. This would act to reduce irresponsible lending and borrowing. It is evident that the assessment of affordability must also be an important part of the lending process.

## Sales regulation

### Affordability assessments

We agree that affordability checks must be strengthened and welcome the proposals in this regard. We agree that lenders should be ultimately responsible for the assessment of affordability – clarity about where the responsibility for this lies is crucial in ensuring that it gets done. It appears that the previous requirements meant that neither lender nor intermediary took responsibility for assessing affordability, both having assumed that the other had undertaken this. It is important that placing the ultimate responsibility for the assessment of affordability on the lender does not however mean that the requirements on intermediaries with regard to assessing affordability are any less stringent.

We support fully the proposal that all lenders should be required to assess consumer's expenditure when considering affordability, and lending decisions should be based on consumer's available disposable income. We are concerned that references to 'simple metrics' may imply obviating the need for full affordability checks. Previous experience has shown the ability of the market to misinterpret and misapply short cuts of this nature – for example the blurring of fast-track and self-certification that is mentioned in the DP.

We agree that loans should be made with regard to the consumer's borrowing capacity. There is a strong case for prohibiting sales to consumers with a negative, zero or low (below the lender's set minimum mortgage level) borrowing capacity. We support mortgages not being granted at, or increased to, a level above the consumer's borrowing capacity. We also agree that the current and expected value of the property should not be part of the assessment of affordability and nor should reliance be placed on future events in assessing affordability.

Clearly, there are limitations to the assessment of affordability that the lender can make, but we feel it is an essential step in improving responsible lending and borrowing in the mortgage market. The potential benefits in terms of reducing the risk of a repeat of a mortgage debt crisis in the future are substantial. It is important to recognise that consumers who are very keen to own their own homes may minimise their expenditure and we agree that, even though they may be reliant on the consumer for information, the lender should subject that information to scrutiny and check that it is plausible.

As identified in the DP, a phenomenon in the mortgage market in the lead-up to the crisis was a number of products with a low initial interest rate that rose substantially after the first or second year, at which point the mortgage became unaffordable. Affordability assessments should be based on the long-term affordability of the mortgage rather than an initial discounted period. The consumer should be involved in making realistic predictions about changes that may have an impact on their ability to meet their mortgage payments in the long term (eg starting a family or being on a fixed-term employment contract).

## Interest-only mortgages

The increasingly high proportion of interest-only mortgages sold in the lead-up to the crisis is a cause for concern. This is particularly so when coupled with the fact that the vast majority had no repayment vehicle identified and the higher arrears rates of lenders with greater numbers of interest-only mortgages. The evidence suggests that many of those with these types of mortgages have taken them out solely on the basis of affordability and will not be in a position to pay off the mortgages through a repayment vehicle at the end. Thus they will have to sell their homes to repay their mortgages.

Assessing the affordability of interest-only mortgages on a capital repayment basis should restrict the numbers who take out mortgages of this nature purely due to reasons of affordability. Nonetheless, given the associated problems, now that it seems these mortgages are largely being sold without endowments (which in any event have been shown not to be a reliable form of repayment vehicle for many), there may be a case for these types of mortgages being seen as inappropriate for residential purchases.

## Equity withdrawal

This is evidently a relatively new – though rapidly expanding – phenomenon in the mortgage market. Without more information and analysis, it is difficult to comment on the appropriateness of a limit on the amount of equity a consumer can withdraw from their home. We would certainly like to see more investigation into this area and whether equity withdrawal is being used as a way of masking problems with indebtedness which then spiral into greater arrears/repossession rates amongst consumers using this product.

## Distribution and advice

### Advised and non-advised sales

We agree that the distinction between advised and non-advised mortgage sales is not recognised or understood by many consumers. We are not confident that retaining the distinction and hence less stringent regulatory requirements on non-advised sales will be sufficient to protect consumers. The DP states that a substantial proportion of consumers want non-advised sales, but, because of the blurring between advised and non-advised sales, we cannot be certain that all the consumers who have had a non-advised sale have actively chosen it.

### Advised sales – assessment of affordability

The level of advised sales is high – as many as 91 per cent of intermediated mortgage sales. Despite the high number of advised sales, the crisis in the mortgage market still occurred. Therefore we doubt that the current suitability requirements will be sufficient to ensure consumer protection, even with the enhancements proposed.

We can see that the assessment of affordability by both the lender and intermediary could lead to unnecessary duplication. However, we feel that it is important for the intermediary to also carry out an assessment of affordability when considering the suitability of a product for a consumer. The process and content of affordability assessments will clearly determine the effectiveness of the assessment process and therefore it will be essential to have consumer input into any working groups on how affordability assessments should work in practice.

## Suitability letters

We consider that suitability letters will provide a useful record of the advice given to the consumer and may improve the quality of advice. They may not change borrowing behaviour on the part of consumers, but these other benefits are sufficient for us to support this being introduced as a compulsory measure.

## Approved Person Regime

We agree with the extension of the Approved Person Regime to all individual mortgage intermediaries.

## Retail Distribution Review (RDR) read across

We can see that there may be a case for certain elements of the RDR to be read across to mortgage regulation.

## Remuneration

We are concerned that commission has typically been higher for self-certified and credit-impaired loans that are seen as higher risk mortgage products. This encouraged sales for these types of loans, which helped boost the pre-crisis boom for these products. While self-certified products may no longer be permitted under these proposals, the power for commission to distort sales advice to consumers causes us considerable unease and we do feel that there remains a case for restricting commission on mortgage products.

## Professionalism

It is important that mortgage advisers maintain high professional standards. A Professional Standards Board may help achieve this. It is a concern that many firms do not meet the required standards in Training and Competence (T&C). Prompt action should be taken to remedy the situation accompanied by sanctions for non-compliance. The individual registration of advisers would be a positive step and could be a basis to distinguish truly independent advisers from those that work on commission.

## Service labelling

We agree that the intermediary service labels are confusing and should be simplified. It would seem simpler to call intermediaries who are not independent 'not independent', rather than 'restricted (limited panel)' intermediaries.

## Disclosure and changing consumer behaviour

### Disclosure

We accept that the Initial Disclosure Document (IDD) may not have had the desired effect or served its intended purpose. Our concern is that disclosure to consumers should be clear and accurate and communicated to them in a way that they readily understand. Thus we agree that there should be a duty to disclose key messages (it will be important to detail what the key messages must include), both orally and in writing.

We also agree that the Key Facts Information (KFI) should be retained. It is notable that this has not become a tool for consumers to shop around and demonstrates that disclosure is unlikely to result in active consumer behaviour in relation to decisions of this nature. Nonetheless, its usefulness to consumers as a record of the transaction means that we consider it should continue to be a requirement.

Furthermore, the evidence that consumers remember and rely more on what they are told in discussions means that we support certain key elements of disclosure to be carried out orally as well as in writing. This could be particularly important for consumers with poor literacy levels or more limited understanding of English.

### **Changing consumer behaviour**

We accept that the desire to own their home may lead individuals to be less cautious when making decisions in relation to taking on mortgage debt. The overstating of income in self-certification mortgages seems likely to be an example of this. The lack of caution on the part of borrowers coupled with the willingness of lenders to engage in high-risk lending contributed to the financial crisis. We agree that this lack of caution or self-protection on the part of consumers means that there is justification for intervention in relation to mortgage products and in respect of preventing individuals from taking on unsustainable levels of debt.

### **Financial capability**

We support financial capability initiatives, but these cannot be a substitute for adequate consumer protection or the availability of advice when a person is experiencing mortgage difficulties or facing repossession.

## **Arrears and repossessions**

We are very concerned by the findings that the FSA's approach to date in this area has not sufficiently protected consumers in arrears and facing repossession. We agree that this demonstrates a much more robust and interventionist approach is needed and look forward to commenting on the strengthened rules in this area.

### **Mortgage arrears and forbearance**

We support measures that will help borrowers to stay in their homes by making mandatory the tools that firms must employ to help consumers in arrears.

It should be noted that in England and Wales the pre-action behaviour of lenders intending to take court action is governed by the pre-action protocol in the Civil Procedure Rules. Scotland does not have a pre-action protocol, but the Home Owner and Debtor Protection (Scotland) Bill will introduce statutory pre-action requirements. A lender seeking possession will be required to demonstrate that they have considered all reasonable alternatives to repossession.

## Arrears charging practice

We are very concerned about disproportionate arrears charges which can greatly increase the indebtedness of consumers who already struggling to meet their payments. Therefore we welcome the banning of monthly mortgage arrears charges while a consumer is keeping to an arrangement to pay their arrears. We also agree that Early Redemption Charges should only apply to the outstanding loan and not any arrears fees or charges. We will be interested to see the outcome of the investigation into arrears fees and charges and the proposals in relation to arrears charges that are made as a result of that investigation.

## Unfair charging practices and price regulation

### Unfair charges

We welcome the recognition of the limitations of disclosure and transparency in influencing consumer behaviour and the need for more interventionist measures of consumer protection. We are not in a position to comment on whether mortgage market fees and charges are excessive in all areas, although in certain areas such as arrears fees, we suspect that these exceed underlying costs. Nonetheless, we agree that this is an issue of considerable concern and that it is important for the FSA to develop a better understanding of charging and pricing structures in order to assess whether, and the extent to which, excessive charging is taking place.

Rolling up intermediary fees and mortgage charges into the loan will tend to mask those fees and charges from the consumer. However, banning such practices could lead to the borrower not being able to take out the loan at all, due to not being able to find the money to pay the fees and charges up front.

## Scope extensions

The separate regulatory regimes for first and second charge lending can be confusing for consumers. A single regulator would also be in a position to maintain a full overview of both types of lending and the interaction between the two. It is important that all secured lending is subject to the same stringent regulatory requirements and that the potential for differences between the regulatory frameworks to be exploited should be eliminated.

We support the regulation of the buy-to-let market by the FSA. Concerns about the level of repossessions of buy-to-let properties and tenants being evicted at very short notice as a result have led to Government proposals to give tenants two months' notice of eviction. Research has shown that landlords that are recent entrants to the buy-to-let market are particularly struggling in the recession<sup>2</sup>. These problems seem likely to be due at least in part to the recent poor lending practices in this area. Thus there is a strong case for regulation of this market.

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<sup>2</sup> 52 per cent of landlords with five or fewer years' experience 'were struggling or falling behind financially'. Shelter and the Money Advice Trust, Taking the strain: the private rented sector in the recession (November 2009)

## Other matters for discussion

### Protecting consumers when mortgage books are sold on

We would be in favour of the extension of FSA regulation to the acquisition of mortgage books. Thus borrowers would remain protected when mortgage books were sold on to firms which may not themselves be engaging in regulated activity (such as hedge funds or private equity firms).

### Data requirements from lenders

We agree that it is important for data to be collected on a basis that would enable arrears and repossession matters back to the original mortgage transaction and also to any subsequent re-mortgages. We have identified the lack of available data as an issue in relation to tracking any particular difficulties suffered by those who have bought their home under right-to-buy.

### Definitional issues

We support standardised definitions for terms such as 'sub-prime'. We feel it would be important for these definitions to be consulted on, in order to achieve general consensus and understanding. For example, we would consider 'sub-prime' to include lending that was wider than lending to credit-impaired individuals only. 'Sub-prime' for us describes a type of higher-cost mortgage product made available to borrowers who are viewed as 'high risk' by the credit industry. This includes not only those with an impaired credit history, but also for other reasons such as low income (including benefit recipients) or uncertain or unstable employment status.

### Fees and charges

In view of the FSA's concerns expressed around fees and charging, there is a strong case for the improvement of the data collected from lenders in this area and for that data to be made publicly available. All lenders should be required to:

- outline all the fees and charges on their mortgage products
- state how much is charged and how the charge is calculated
- say what charges are for and when they apply
- update the FSA when changes to these are made.

In assessing the feasibility of improved data collection the importance of improved scrutiny of this aspect of the mortgage market should be given the same degree of consideration as the potential cost.

### Financial crime

We do not have any comments to make in relation to financial crime.

### Equity release

We are not in a position to comment specifically on the equity release market. Others with more specialist knowledge of this area will be better placed to do so. Nonetheless, we are concerned that problems have been highlighted in this market previously, not least by the FSA's own thematic reviews, and this is a potentially vulnerable client group.

An additional requirement could be that the borrower must have received independent advice prior to entering the transaction. If a decision is made at this time not to impose additional requirements in relation to equity release lending then this should remain under review. In order to ensure that if any additional measures are required they are introduced in a timely and effective manner, it will be important for this sector of the market to be properly monitored.

## Right-to-buy (RTB)

As stated above, research commissioned by Consumer Focus in Spring 2009 found that RTB homeowners with mortgages were twice as likely as non-RTB mortgage holders to be struggling with their mortgage payments<sup>3</sup>. This finding is supported by the previous concerns raised by the Citizens Advice about the difficulties being experienced by RTB homeowners in managing mortgage debt and the particular vulnerabilities of this client group. Furthermore, as the DP states, the evidence suggests that non-affordability has been a particular issue for RTB homeowners.

We welcome the suitability and affordability proposals in this paper. We believe they will go some way towards addressing the problems that have occurred in relation to RTB. Nonetheless, there have been past problems of sales of unsuitable and/or unaffordable products to this group of consumers and it is a particularly vulnerable client group. There is a risk of a very high level of detriment to the consumer. Therefore we feel that there should be particular scrutiny of affordability and suitability in relation to this group of consumers and evidence of that process of scrutiny prior to the grant of a mortgage. In addition, before the sale can proceed, there should be a requirement that the borrower has received independent advice on the full financial and legal implications of the transaction.

In terms of the small size of the RTB market, the reduction in the number of transactions was contributed to by the increase of the minimum time period before a tenant became eligible. Since January 2005, tenants must have at least five years' tenancy to exercise RTB (an increase from two years' tenancy). Thus, a new and growing tranche of tenants will now become eligible to exercise RTB and, once a recovery begins, the activity in this sector is likely to increase once more. The level of consumer detriment which may result in this segment of the market without additional protection may not be as limited as the DP suggests.

It should be noted that the situation in Scotland with RTB is different to England and Wales. Under proposals within the newly introduced Housing (Scotland) Bill, new council house and housing association tenants will no longer have the Right to Buy.

## Next steps

We welcome many of the proposals set out in the DP. However, the extent to which these proposals will be effective will depend on how they are implemented and enforced. We would be keen to see the FSA's proposals on how it will ensure that the measures set out in the DP are followed by lenders and how it will act in the case of non-compliance.

We would be very keen to meet with the FSA to discuss the DP and our comments further.

We look forward to receiving the Feedback Statement in March 2010 and responding to further consultation papers on the very important issues raised in the DP.

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<sup>3</sup> As note 1 above

## **Consumer Focus response to the Financial Services Authority Mortgage Market Review**

Written by: Marie Burton, Consumer Focus

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### **Consumer Focus**

4th Floor  
Artillery House  
Artillery Row  
London SW1P 1RT

Tel: 020 7799 7900

Fax: 020 7799 7901

Media Team: 020 7799 8004 / 8005 / 8006