



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus Response to FSA mortgage market review: Responsible lending consultation paper

November 2010

Introduction

Before commenting in detail on the proposals within this consultation paper, we wish to make clear our overall support for the 'more robust and interventionist approach' proposed by the FSA and the reforms that this paper sets out in relation to responsible lending. Many vulnerable consumers have suffered and continue to suffer as a result of the irresponsible lending practices which characterised the mortgage market during the lending boom. In 2009, 47,500 homes were repossessed by lenders, the highest figure since 1995. Many more homes are at risk of repossession and a rise in interest rates would put many more homeowners into this position. We have no desire to impose unnecessary limitations on people being able to take out mortgages, but we agree with the FSA that 'we want lenders to lend to people who can repay and consumers to take on mortgages that they can afford'.

About Consumer Focus

Consumer Focus is the statutory organisation campaigning for a fair deal for consumers in England, Wales, Scotland, and, for postal services, Northern Ireland. We are the voice of the consumer, and work to secure a fair deal on their behalf.

Specific questions

Chapter 2: Affordability assessments

Income verification

Q1 Do you agree with our proposals for income verification?

As we stated in our response to DP09/03, we are strongly in favour of income verification for all mortgages. The higher rates of default and repossession for self-certified mortgages justify the removal of these loans from the marketplace. Lenders may be exercising restraint at the moment, but we consider that this is largely because of the constraints of the current financial climate and, that unless additional measures are introduced now, lenders will return to previous risky practices when credit becomes more freely available.

Similarly, while, overall fast-track mortgages may be maintaining high standards at the moment, there is considerable risk of these standards being relaxed when the financial situation recovers, as this is what happened during the lending boom. We agree with the Financial Services Authority (FSA) that there is a real danger of fast-track mortgages being used as a substitute for self-certification when this is not longer available. We do not consider there to be justification for allowing fast-track mortgages to be exempt from income verification requirements, particularly as it should not be difficult for individuals to provide proof of income in these circumstances. With regard to self-employed individuals, we support the view that having to wait until a new business has a verifiable track record of income can be in the consumers' interests. However, lenders should not impose blanket bans on lending to consumers on the basis of their self-employed status alone. It will be important for lenders to take an intelligent approach with regard to the evidence that self-employed borrowers are required to provide and to assess each case in relation to the borrower's ability to repay the loan.

Assessment of income

Q2 Do you agree with our approach to assessing income?

Lenders should be assessing the loan on its long-term affordability for the consumer. Therefore we would expect lenders to be required to exercise particular caution when taking into account income such as overtime and commission and bonuses, which is subject to fluctuation or withdrawal at short notice. Lenders should also be required to assess whether it is appropriate to include payments that are reliant on third parties, eg child maintenance, as some consumers may be entitled to such payments, but may not actually receive them. The key factor here will be the credibility of the evidence used as a basis for assessing income.

Expenditure

Q3 Do you agree with our approach to assessing expenditure etc?

We consider that the assessment of affordability is key to responsible lending. Affordability must be seen in the context of the borrower's overall financial well-being. The borrower must be able to meet their current and future mortgage payments and their other financial commitments without going into debt or experiencing financial stress. The importance of this is underlined by a financial climate where house prices may fall and consumers would have no prospect of selling their property to clear their debts should the mortgage payments become unmanageable.

In terms of evidence of expenditure, we can appreciate there may be practical difficulties in terms of items of personal expenditure and a robust statistical model may be an adequate substitute in these circumstances. However, we are less convinced that evidence of committed expenditure should be provided by way of statistical modelling. This would be a very inexact approach to assessing individual circumstances. In many instances, it should be possible for consumers to provide evidence of expenditure. In situations where this was not possible, then, provided they were able to show that it was justified in the circumstances, lenders could fall back on statistical modelling. Statistical modelling could also be used to identify consumers who might be understating their expenditure and to trigger further enquiry.

We agree that for secured and unsecured credit commitments individually-based information should be used and believe that this approach should be extended to committed expenditure.

In relation to contingency expenditure, it is stated that this will be set according to the lender's discretion. We feel that there should be more direction from the FSA as to the minimum level of the allowance for missed or understated expenses.

Q4 Should lenders be required to ensure that credit commitments being cleared by debt consolidation are repaid as expected etc?

If the lender has not included an outstanding credit commitment in the assessment of affordability, on the basis that that loan will be repaid prior to or on completion of the mortgage, it would seem prudent for the mortgage lender to ensure that that loan is paid off, either by direct payment or via the solicitor involved in the transaction. We would not anticipate that this should add significant additional costs to the transaction.

Free disposable income

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

We are concerned that the free disposable income figure does not allow any contingency for dealing with unexpected expenses or building up a savings buffer against financial difficulties. It is based on the presumption that any income that is not used for expenditure is available for making mortgage payments. There should be some further allowance within the calculation for unexpected expenses or for saving towards a buffer, otherwise there will be no capacity for borrowers to build up their resistance to financial 'shocks', such as having to pay a repair bill for a boiler or to replace a fridge or washing machine.

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

We do.

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

We agree with this. However, consumers should not be precluded from taking out 30 year (or longer) mortgages if this is appropriate in their specific circumstances, particularly with regard to their age and financial situation. Conversely, for other consumers, particularly those approaching the end of their working life, a shorter term may be appropriate if they cannot show that their income will be able to sustain a mortgage into retirement (see below).

Q8 Do you agree with our approach to testing affordability against future interest rate increases etc?

We believe that it is important to test affordability against higher interest rates. At a time of low interest rates, testing affordability at 2% above the lender's standard variable rate (SVR) might seem appropriate, but we are concerned that interest rates are currently at a historically low level, which is unlikely to continue indefinitely. Therefore we agree with the more flexible and responsive approach proposed by the FSA in terms of setting a guide margin. If lenders are going to use their own tests, it will be important for the FSA to check that they are at least as robust as the FSA's guide margin.

Maximum borrowing capacity

Lenders must lend responsibly on a sustainable basis. If borrowers are to be able to borrow up to their maximum borrowing capacity, then it is essential that the calculation of affordability has capacity for consumers to build up a savings buffer against unforeseen expenses or financial shocks.

Credit impaired consumers

Q9 Do you agree with our proposal to impose an additional buffer on the calculation of free disposable income to protect credit-impaired borrowers etc?

The prevalence of credit-impaired borrowers among those experiencing arrears and repossession problems suggests that there needs to be additional safeguards in relation to these types of borrowers. We would support the introduction of a buffer into the affordability assessment for credit-impaired borrowers. If the borrower was able to show that an impaired credit history was as a result of a 'life event' beyond their control, such as divorce, illness or involuntary redundancy and their financial circumstances were now significantly improved, then it would be worth considering whether the buffer could be reduced by the lender. Where credit impairment was largely as a result of financial mismanagement, we would expect the buffer to be applied rigorously.

Foreseeable changes in circumstances

Retirement

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

We do. Older consumers must not be arbitrarily refused mortgages because of their age, but, as stated above is important that lenders carry out checks to assess as accurately as possible whether the borrower will be able to sustain the mortgage into retirement.

Q11 Are there specific atypical lending circumstances which you think merit an alternative approach to the assessment of affordability etc?

We are not aware of any.

Lifetime mortgages

Q12 Do you agree with this approach to lifetime mortgages?

We note that these requirements will not apply to lifetime mortgages where no regular mortgage payments are made. We are not in a position to comment specifically on lifetime mortgages, but we do consider that it is an area where there is significant scope for consumer detriment and which requires regulation and scrutiny.

Home purchase plans

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

We note that these requirements will apply to home purchase plans. We are not in a position to comment specifically on home purchase plans, but we are in favour of affordability being a factor in any decision regarding long-term financial commitments.

Transitional measures

We agree that it is important to introduce transitional measures that will mitigate any adverse effects on existing borrowers and look forward to commenting on the FSA's proposals later this year.

Equality and diversity issues

Q15 Do you think our income verification proposals will impact any group with protected characteristics (eg race, religion)?

As you have identified, the income verification requirements may have a disproportionate effect on groups that are more likely to be self-employed. According to recent research by the Runnymede Trust, 'rates of self-employment are particularly high among certain ethnic minority groups, for example Bangladeshi people'.¹

Interest only-mortgages

We have already submitted our comments on this aspect of the consultation.

¹ <http://www.runnymedetrust.org/news/229/272/Ethnic-Minorities-at-High-Risk-of-Poverty-in-Old-Age.html>

Chapter 3: Product regulation

We are pleased to note the FSA's intention to intervene in product development at an earlier stage than previously and before harm has crystallised.

Lending thresholds

Q24 Do you have any comments not made previously in response to DP09/03, on the case for not banning loans above defined LTI, LTV or DTI ratios?

We note that in relation to loan-to-value (LTV) ratios it is stated that, after detailed analysis, these are 'a relatively consistent predictor of default'. Therefore we question why no further action is being taken with regard to regulating this aspect of product design.

Loans with multiple high-risk characteristics

Q25 Do you agree that we should not ban loans to borrowers with multiple high-risk characteristics but instead rely on robust affordability requirements etc?

We agree that with the strict application of affordability requirements, including a buffer for the credit-impaired, the situation with regard to loans with high-risk characteristics should improve. Nonetheless, we feel that the FSA's own analysis of risk combinations shows a case for banning some of the most toxic combinations.

The arrears or repossession figure for loans without any of the factors categorised as high risk is 2.5 per cent of loans.

The proportion of loans in arrears or possession rises dramatically to 42.4 per cent where the loan has the four risk factors of: credit-impaired, 80 per cent or more LTV ratio, self employed and for debt consolidation. Where the mortgage was for a right-to-buy (RTB) property (as opposed to debt consolidation), at a LTV rate of 80 per cent or more and the borrower was credit-impaired and self-employed, then 40 per cent of borrowers were in arrears or repossession. This is despite the fact that all of these loans were income verified and should have been subject to a higher level of scrutiny with regard to affordability. These high-risk borrowers were nearly 20 times more likely to have payment difficulties than those not exhibiting any of these factors. In view of this we are concerned that the buffer will not be adequate to protect consumers against the repossession risk and we feel that further consideration should be given to banning these particularly high-risk combinations or, at the very least, to introducing more stringent safeguards.

Right-to-buy

In relation to RTB mortgage holders, our own research has shown that these consumers were struggling more than other mortgage holders to make their mortgage payments and they also had a higher level of indebtedness.² These consumers are more likely to be vulnerable than other purchasers. Furthermore, the potential for detriment to these consumers is particularly high, as they will have given up the security of a public sector tenancy upon exercising the RTB. The level of RTB borrowers in arrears or possession is 7.3 per cent, rising significantly to 30 per cent where the borrower is also credit-impaired.

² Consumer Focus, Right to Buy homeowners struggle to keep their homes: Managing debt in the financial crisis (July 2009)

Our findings around indebtedness and RTB mortgage holders suggest that a number of RTB borrowers are likely to fall into this category. We do not feel there should be a ban on all loans to RTB borrowers, but we will continue to call for additional safeguards in relation to consumers exercising the right-to-buy.

As well as particular scrutiny of the affordability and suitability of a mortgage product prior to making a loan to a RTB consumer, there should be a separate requirement for the borrower to receive detailed financial and legal advice on the consequences of the transaction. Where RTB borrowers also exhibit other high-risk characteristics, there is a case for those loans to be strictly regulated and possibly even banned.

Arrears charges

Q26 Do you have any comments on the above clarifications to MCOB 12.4.1 etc?

We are very concerned by the extent of bad practice uncovered by the FSA's review of arrears charging. Arrears fees can plunge consumers who are already struggling with repayments into even greater debt. In view of the poor practice around fee-charging, it is disappointing that the FSA does not feel it can set a baseline figure as a cap for fees, because lenders 'would put their fees up to the cap'. Presumably this would be regardless of their actual costs, which is how the fees are meant to be calculated and would therefore be in breach of the regulations.

In the absence of a baseline figure, it is essential that the FSA carries out its stated intention to take a more intrusive supervisory approach to this issue. This will include closely policing the calculation of fees. We appreciate that it may be impractical for the lender to ensure that the individual costs incurred and the fee charged match exactly in every case, but there must be a strong link between any amount that the borrower is charged and the costs incurred by the lender and it will be for the FSA to ensure that this is the case.

We consider that lenders should be encouraged to follow the good practice of certain lenders in keeping arrears fees deliberately low in order to assist borrowers in difficulty.

Limiting the number of time missed payment fees are charged

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

We agree that missed payments fees should be limited to no more than two. If Direct Debits have been refused for two months or more, the lender should not continue to present the Direct Debit, but should contact the borrower about arranging another form of payment. The lender should not continue to charge missed payment fees in these circumstances.

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

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?

The practice by some lenders of front-loading arrears charges to evade the arrears regulations is highly regrettable. Clearly, if this is the way firms are choosing to apply the rules to the detriment of consumers, the regulations around arrears charging must be changed to encompass all payment shortfalls.

Chapter 5: Responsible borrowing, better informed purchasing

We note with interest the measures being taken to improve consumer behaviour and financial capability in relation to mortgage borrowing. We agree that it is important to acknowledge that during the boom some consumers' desire to own their own home led them to make financially unsound decisions, which unsafe lending practices allowed them to do.

Nonetheless, it is important to recognise that consumers made these decisions within the context of a rental market where public sector housing is scarce and the private rental sector is often expensive, of variable quality and insecure. Our Consumer Conditions Survey 2009 showed a high level of dissatisfaction among consumers in the private rented market: nearly a quarter (24 per cent) of consumers rated their experience in the private rental sector between 0 and 5 (with 0 being very dissatisfied and 10 very satisfied). Overall renting a property privately was ranked 38th out of the 45 market sectors surveyed.³

Given the severely limited availability of other adequate housing options, it is not irrational that consumers felt pressured into stretching themselves financially in order to own their own homes and to sometimes make decisions which with hindsight seem unwise. This is why we support the measures which are being brought in now to reduce the risk of consumers being able to enter into unsustainable mortgage borrowing in the future.

Chapter 6: Non-deposit taking lenders

We have already submitted our response to this part of the consultation paper.

We hope that you find the comments in this response helpful. We would welcome the opportunity to discuss these issues further.

³ Report on the 2009 Consumer Conditions Survey: Market research survey conducted for Consumer Focus. Other market sectors included gas and electricity providers, internet service providers and personal banking. Each of the 45 markets had a sample of at least 500 consumer responses.



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