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Mortgage Market Review

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Summary

In 2005, soon after it had taken over responsibility for regulating the mortgage market, the Financial Services Authority (FSA) began a review of the mortgage market. The financial crisis which began in 2007, gave it a new focus and emphasis, reflecting the experience of lenders and lending practices exposed by that crisis.

When it was finally published in 2009, the review included 'tough' proposals that would limit over-lending and the likelihood of over - burdening mortgage holders with unsustainable debts. It has provoked a strong reaction from mortgage lenders and house builders who felt it had gone too far because, they claim, it will limit the number of mortgages which can be granted in future and thus deprive credit worthy individuals the chance to become homeowners. The FSA denied this and insisted that the benefits of the proposals far outweighed the costs of a, slightly, lower level of mortgage lending.

Since then the FSA has been replaced as the mortgage regulator by the Financial Conduct Authority (FCA) and it is the FCA which has overseen the introduction of the new rules in April 2014.

This note explains the background to the review and looks at the arguments over it and how it might affect potential borrowers.

1. The Financial crisis and mortgage lending.

The financial crisis, which began in 2007, exposed the underlying level of risk which many banks had taken on when they competed for a share of the mortgage market. In the years up to 2007, banks had been free to lend in the confident knowledge that rising house prices insulated them to a degree from lending losses and, anyway, the use of securitised mortgage instruments allowed them to pass on any risk attached to their lending decisions to third parties. The FSA summarised developments in the mortgage market in one of its Consultation Papers:

> Events in the financial market from late 2007 onwards inevitably affected our work and brought a much wider remit, extending it beyond a narrow conduct focus to the wider prudential and macroeconomic context. As we have said previously, the mortgage market worked well for many consumers. But it was also clear that the existing regulatory framework had been ineffective in constraining particularly risky lending and unaffordable borrowing. Circumstances led lenders to feel insulated from losses arising from poor lending, largely as a result of being able to pass risks onto others (e.g. by securitisation) and also by the widely held expectations of continuing growth in property values. This resulted in relaxed lending criteria and increased risk taking, and increased competition pushed lending further along the risk curve with a rash of new market entrants (often non-deposit taking lenders) adding to this.
>
> The continued boom in house prices and this ready availability of credit allowed many households to take on even more debt. This increase in mortgage borrowing included extended access to higher-risk groups, such as the credit impaired, who had previously been excluded. So far in this downturn we are seeing problems concentrated among such borrowers and characterised by apparently higher-risk lending practices.
>
> 1.4 With the Bank of England (BoE) Bank Rate at a historically low level the majority of borrowers currently enjoy lower mortgage rates. Together with the various government initiatives and improved lender forbearance, this disguises the full impact of unaffordable lending and the true extent of the vulnerability of many consumers to upward interest rate movement.[1]

The decline in house prices in the years after 2007 exposed the banks to capital losses and the 'freezing' of the mortgage securitisation market stopped them from passing on credit risk as they used to do. To an extent therefore some of the practices which the FSA sought to stop had already done so due to market conditions – but for how long?

On the other side of the lending equation, consumers, it was expected that a wave of housing repossessions would follow the crisis. That this did not happen to the extent predicted, may be due to measures introduced at the time of the crisis, especially record low interest rates introduced by the Bank of England since 2008 which significantly

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1 Financial Services Authority; Mortgage Market Review: Responsible Lending; CP 10/16 chap1

improved the affordability of mortgages. However, historically low interest rates as low as 0.5% could not be relied upon permanently and, the FSA argued, structural changes to the way mortgages were assessed and sold were necessary. Its response was the Mortgage Market Review (MMR).

2. The Mortgage Market Review

The FSA review of the mortgage market began in 2005 as a response to the new mortgage conduct of business rules introduced by it in 2004 when it assumed responsibility for mortgage business. It was therefore a review of the rules as much as a review of the market. This was changed by the financial crisis, particularly the collapse of Northern Rock in 2007 and the financial revelations which that and other bank collapses had revealed.

The post-crisis Review began in October 2009. The FSA press release announcing it is shown below:

> The Financial Services Authority (FSA) today sets out proposals for the major reforms required in the UK mortgage market to ensure that it works better for consumers and is sustainable for all market participants.
>
> The proposals, published in the mortgage market review discussion paper, reflect the FSA's changed approach to a more intrusive and interventionist style of regulation.
>
> The review's key features are:
>
> Imposing affordability tests for all mortgages and making lenders ultimately responsible for assessing a consumer's ability to pay;
>
> Banning 'self-cert' mortgages through required verification of borrowers' income;
>
> Banning the sale of products which contain certain 'toxic combinations' of characteristics that put borrowers at risk;
>
> Banning arrears charges when a borrower is already repaying and ensuring firms do not profit from people in arrears;
>
> Requiring all mortgage advisers to be personally accountable to the FSA;
>
> Calling for the FSA's scope to cover buy-to-let and all lending secured on a home.[2]

The Discussion document mentioned above set out the review's main aims:

> There are two broad aims of our review. The first is to have a mortgage market that is
>
> sustainable for all participants. This means:
>
> • lenders have sustainable business models which are adequately capitalised, while at the same time remain competitive, innovative and competent at what they do;
>
> • a regulatory regime that is predictable, clear and transparent – where regulation is not a source of volatility and minimises the pro-cyclical impacts on house prices, while helping to minimise mortgage fraud and other forms of financial crime; and
>
> • where the costs and risks of lending and borrowing are kept within the market and are not borne by wider society.
>
> The second broad aim is to have a flexible market that works better for consumers. This means that:

2 FSA Press Release 19 October 2009

> • it offers a range of products that meet the needs of different consumer types to allow individuals, who can afford it, the opportunity to buy their own home;
>
> • it is one where consumers clearly understand the costs and risks of mortgage borrowing;
>
> • consumers understand the implications and risks of considering property as an investment option rather than primarily as a home; and distribution helps to achieve good outcomes for consumers, and provides a professional service, with the number and complexity of products reflecting the needs of consumers, rather than firms, and where incentives in the distribution chain work for the consumer.[3]

The response to the discussion document was published in July 2010 – Mortgage Market Review: Responsible lending.[4] The FSA was doubtless unsurprised to find that large sections of the housing and mortgage market industry had reservations about the initial proposals. The FSA, however, stuck to its guns. The "proposals" mentioned in the October press release were now described as the "tough proposals" in the July press release which also now included evidence to support its stance:

> The tough new proposals, published in the consultation paper, form part of a major review by the FSA into the UK mortgage market and are based on detailed analysis of past lending decisions, looking at the causes of arrears and repossessions since 2005.
>
> The FSA found that:
>
> - 46% of households either had no money left, or had a shortfall after mortgage payments and living costs were deducted from their income;
> - Almost half of new mortgages between 2007 and the first quarter of 2010 were provided without a customer having to verify their income;
> - The share of interest-only mortgages has been increasing. At the peak of the market, over 30% of all mortgages were interest-only;
> - Many consumers with no repayment vehicle count on future house price rises or uncertain life events to repay their mortgage and some have no plan at all;
> - Borrowers with a credit-impaired history are particularly vulnerable.[5]

The particular targets of the FSA were interest - only mortgages and self-certificated mortgages and high loan-to-value loans.

The response of the Council of Mortgage Lenders (CML) and the house builders was very vigorous and negative. Whilst they supported the idea of sensible lending, who wouldn't, their main criticism was that the proposals would make it very hard for classes of individuals (the self-employed for example) to ever get a mortgage, and that the number of

3 FSA, Mortgage Market Review, DP 09/03, p7
4 FSA Mortgage Market Review: Responsible lending, CP10/16
5 FSA press release 13 July 2010

mortgage offers would decline substantially overall. The FSA denied this. In the July Consultation, it claimed that:

> Using two scenarios for the impacts of the proposals, we estimate that between 0.1% and 4.1% of borrowers would have been excluded from the mortgage market had the proposals been in place from 2005 to 2009, and that between 13% and 17% of borrowers would have had to reduce the amount borrowed to pass the affordability tests and obtain a mortgage. The total value of lending would have decreased by between 3.4% and 9.6%.[6]

In contrast to the FSA's claim that about 4% of mortgages would not have been approved, the CML claimed that:

> On 5 October, the CML published research looking at the impacts of the proposals on existing customers, concluding that 51% of transactions between 2005 and 2009 would not have been granted on the current terms.

This and other information about the CML response can be found on their website here.

Although the FSA is independent from government, the then Housing Minister, Grant Shapps, commented:

> The Housing Minister, Grant Shapps speaking at the National House-Building Council's annual lunch, said he himself would have failed to get a mortgage had new proposals for the mortgage market drawn up by the City watchdog been in effect when he bought his home.
>
> Mr Shapps said: "I think it was about the moment I realised that I wouldn't have a mortgage if the Mortgage Market Review (MMR) changes went through that I kind of thought that this might be going a step too far."
>
> He continued: "There is no point in closing the door after the horse has bolted. The whole problem with the mortgage market wasn't a pernickety thing about whether you could lend X or Y to a person, or what form you had to get a borrower to sign. It was because there was a lack of effective central regulation on how the banks were operating." He added that "What's required here is proper, sensible top-level regulation – not pernickety down-in-the-dirt what can you do what can't you do as a mortgage company."
>
> He told his audience that he hoped that the Financial Services Authority (FSA) "will be getting that message from you and everyone else. They are of course independent, but I think it's very important that we learn the lessons of the past without repeating them – which is what they are in danger of doing."[7]

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6 CP 10/16 Annex 1 A1 - 2

7 Reported 121Move.co website: http://www.121move.co.uk/news/01044/Housing-Minister-would-have-been-denied-a-mortgage

3. The proposed changes

Proposed changes to the conduct of business were set out in the 'Responsible Lending' document published in July 2010. The new rules come under several headings.

3.1 Affordability assessments

It is these proposals which caused the greatest comment and controversy. The key proposals are:

- All mortgages must be 'affordable'
- All mortgages to be assessed as if they were on capital and interest basis and for no longer than 25 years.
- All incomes must be verified and costs stress tested against interest rate rises.

The FSA propose:

> that lenders should assess the consumer's ability to repay for all mortgage applications, through an assessment of their income and expenditure, and to lend only where the mortgage is assessed as being affordable.
>
> To ensure that lenders base this assessment on accurate information, we propose that lenders must verify income for all mortgage applications. This proposal effectively bans self-certification and fast-track mortgages where income is not verified. We are not proposing to be prescriptive about the type of evidence that lenders can use to verify income, but the evidence must be from a source independent of the consumer and should be sufficient to enable the lender to assess the risks posed by the consumer's individual circumstances.
>
> [...]
>
> To prevent the stretching of affordability seen in the past, through the use of interest-only and the extending of mortgage terms, we are proposing that affordability assessments must normally be based on a capital and interest basis, even for interest-only mortgages; and on a maximum term of 25 years, even where the actual term is longer.
>
> We also propose that affordability assessments test mortgage payments against interest rate increases, to ensure that, as far as possible, assessments are robust. We are proposing that the FSA should publish a guideline margin for firms to test against. We have suggested that this margin is set with reference to forward swap rates, but invite views on this. Alternatively we propose that firms may use their own margin where it is higher than ours.
>
> To provide extra protections for impaired credit borrowers, who have been shown by our data to be at the highest risk of arrears and repossessions, we are proposing to apply a stricter affordability test. We are proposing that lenders apply a 'buffer' to their calculation of these borrowers' free disposable income and invite comment on an appropriate basis for that buffer.[8]

Whilst the CML did not dispute the undeniable wisdom of the objective that lenders 'lend only where the mortgage is assessed as being

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[8] FSA Mortgage Market Review: Responsible lending, CP10/16, p8

affordable' the practical implications of this proposal are far reaching. One area of conflict was the abolition of self –certificated loans.

The FSA expressed concern over 'self-cert' loans back in 2004. Then, the focus appears to have been the possibility of a self - cert loan being used as a vehicle for mortgage fraud. Typically, an applicant would inflate their earnings to take out a larger mortgage than they would otherwise be entitled to under the lenders criteria, thus exposing the institution to higher losses than it had provisioned for. It is true to say that the FSA has never been entirely happy with the self cert sector, and with reason. Advertisements for self cert mortgages at the time from some brokers appear incredibly casual and almost wholly dependent for their viability on an unending increase in house prices. Undoubtedly, too, self-cert mortgages facilitated mortgage fraud, indeed, many borrowers may have been unaware that what they were doing was fraud. Since it took responsibility for mortgage regulation in 2004, the FSA has been very vigorous in the prosecution of mortgage fraud, with many authorised persons being fined or dismissed from working in the industry.

In 2004, the CML responded to FSA fears as they were expressed then:

> Self-certification – or self-cert – mortgages allow borrowers to declare their own income, rather than providing documentary proof for the lender. These types of loan are helpful to people in a variety of circumstances:
>
> ● Many of those who are self-employed find they cannot take out conventional mortgages because their income comes from a complex variety of sources or they have not been trading long enough to meet lenders' requirements for proof of income.
>
> ● Even those in paid employment may find self-cert mortgages better suited to their needs in a variety of different circumstances, including if they have a low basic salary but high bonus payments or a regular second income that would not be taken into account with a more traditional mortgage.
>
> Changing lifestyles have helped drive the growth of self-cert mortgages. The number of people who are self-employed has grown and, among those who are employed, working patterns have become more flexible, with more people on short-term contracts or earning incomes that vary significantly from one period to another. These changes have required a re-think of traditional income criteria to allow a growing proportion of people continued access to home-ownership.
>
> Self-cert mortgages might be expected to be more expensive and risky than loans where the lender obtains verification of income from an employer. But niche lenders have been able to narrow the price gap between traditional mortgage products and those for borrowers who do not meet traditional lending criteria. And lenders can employ a range of techniques other than seeking documentary evidence of income from an employer to reduce the risks for both lenders and borrowers. The result is that many self-cert mortgages are attractively priced and there is a wide variety of choice of products to suit customers' needs. [9]

[9] Council of Mortgage Lenders News & Views 2/2004

Its central argument has not changed since, and arguably, since 2004, the nature of 'work' has evolved more towards the 'portfolio' of jobs with less long term tenure described above rather than the other way around. The CML's particular complaints about the proposed changes are shown below:

> To protect consumers in this way it requires the transfer of responsibility from the consumer to the lender. This is demonstrated in the FSA's definition of what is an affordable mortgage in its responsible lending proposals.
>
> *'A mortgage is affordable if its level and terms allow the consumer to meet current and future payment obligations in full without, recourse to further debt relief or rescheduling, avoiding accumulation of arrears while allowing an acceptable level of consumption'.*
>
> On face value this may seem like a sensible definition, but it requires lenders to make a judgement on the borrower's ability to make payments throughout the term of the mortgage.
>
> This is translated into the draft rules for lenders where it states that a mortgage is unaffordable if any particular month a borrower's expenditure exceeds their income. The lender has to take into account the variability of income (impacting self-employed borrowers) and expenditure over time. For credit-impaired borrowers, up to 20% of their income could be discounted for this equation, to provide a 'buffer' for un-disclosed debts.
>
> Equally, the FSA is proposing that the lender verifies future income where it is relied upon, where the mortgage extends into retirement this would necessarily capture income from pensions. If a borrower intends to continue to work beyond retirement age, the lender is required to make a decision if the borrower is reasonably capable of managing this.
>
> Furthermore, the lender is required to use a number of assumptions when assessing the affordability this includes assessing all mortgages on a capital repayment basis, on a maximum term of 25 years and to stress test against potential interest-rate rises.
>
> The overall outcome of these requirements is to create a number of layers of protection to ensure that the borrower can afford the mortgage in all foreseeable circumstances. For some of the requirements this is a straightforward calculation (e.g. capital repayment) for others it requires the lender to make a number of judgements on what events are likely to affect the borrower and allow for a sufficient reduction in lending to compensate.
>
> It is the layering of regulation that is likely to restrict access to the mortgage market for a significant number of current and future borrowers. This will be exacerbated with a conservative approach adopted by lenders, due to the additional regulatory risk that they face in complying with the proposed new rules. [10]

3.2 Product regulation

The FSA considered the case for imposing limits on loan-to-value and loan-to-income products. One mortgage product which came to

[10] Council of Mortgage Market Lenders, Mortgage Market Review, November 2010;

represent the worst excesses of pre-crisis lending was the Northern Rock 125% 'move together' mortgage which, post-crisis left many borrowers with negative equity and no real prospect of paying off their mortgage and moving to another borrower. After considering such restrictions, the FSA decided against them, preferring instead to rely on the 'affordability' criteria instead to control excessive loans:

> We have now completed further more detailed analysis of arrears and repossessions data. Consistent with our earlier analysis of PSD and arrears data published in DP09/3, we found that:
>
> a. LTV ratios are a relatively consistent predictor of default;
>
> b. LTI ratios are not a strong or consistent predictor of default; and
>
> c. DTI ratios could not be assessed as insufficient information was available on consumers' overall debts relative to incomes.
>
> 3.10 Further detailed analysis of this data, therefore, has not led us to change our views. We agree with respondents to the DP and do not propose to implement any ban of loans above defined LTI, LTV or DTI ratios on consumer protection grounds. We are, however, not ruling out implementing such thresholds on macro-prudential grounds.[11]

The FSA also considered mortgages that involved multiple, high-risk elements. This would include high loan-to-value loans to someone with a poor credit history for example. The FSA looked at various combinations of high risk elements and the likelihood that such combinations would lead to default:

Borrowers' risk characteristics	**% of borrowers in arrears or repossession**
Credit-impaired, LTV>=80, Self-employed, Debt consolidation	42.4
Credit-impaired, LTV>=80, Self-employed, Right-to-Buy	40.6
Credit-impaired, LTV>=80, Self-employed	38.4
Credit-impaired, LTV>=80, Right-to-Buy	35.9
Credit-impaired, LTV>=80, Debt consolidation	35.5
Credit-impaired, Self-employed, Debt consolidation	33.8
Credit-impaired, Self-employed	32.3
Credit-impaired, Self-employed, Right-to-Buy	32.0
Credit-impaired, Right-to-Buy	30.0
Credit-impaired, LTV>=80	29.3
Credit-impaired, Debt consolidation	26.7
Credit-impaired	21.2

Source: FSA Responsible Lending CP 10/16

The FSA thought that outright bans on some of these combinations would be too blunt an instrument, instead it suggested that in cases of mortgages to credit impaired borrowers "our preferred approach is to require borrowers who are credit-impaired to have an additional 'buffer' of protection against unforeseen circumstances". This requirement is mentioned in the piece by the CML shown above.

[11] FSA Mortgage Market Review: Responsible lending, CP10/16, p42

3.3 Arrears charges

The FSA believe that borrowers pay very little attention to prospective arrears charges when they take out a mortgage and hence firms have been free to charge pretty much what they wanted within existing FSA rules that the fees should be 'reasonable', in the event of default and late payment. These fees, the FSA found, were often unrelated to the costs involved. The FSA fined two lenders a total of £4 million for excessive charging.

The FSA considered setting baseline fees above which lenders could not charge, but given that different lenders incurred different costs they concluded that any baseline figure might easily be seen as a target level that lenders would raise their fees to. Instead the FSA published in the consultation details of its work on fee levels and going forward intends to be more watchful on what lenders charge:

Ultimately, individual firms must ensure their arrears fees are based on a reasonable estimate of their costs, as our rules already require. Instead of publishing baselines, we will be using the findings from our review to inform our more intrusive supervisory approach and we will continue to challenge individual firms on their arrears charges under MCOB 12.4. Firms that increase their arrears charges will be subject to particular scrutiny. We do not expect to see firms change their charging practices simply to align with the market averages we have published.[12]

The FSA promised however, to look at specific practices, such as multiple re-presenting of direct debits (if a company presents a direct debit for payment knowing that it won't be paid it could charge for each failed attempt) and setting charges as multiples of the amount outstanding.

3.4 Responsible borrowing, better informed purchasing

The FSA also looked at the issue of consumer knowledge and responsibility:

> Clearly, firms must give suitable advice and lenders must lend responsibly. But consumers also have an important role to play in the mortgage process – for irresponsible lending goes hand-in-hand with poorly informed or even irresponsible borrowing. We have a mortgage market where many consumers have regularly re-mortgaged, shopping around far more than seen in the investment market, for example. For many of these consumers, the market has worked well. But the level of mis-buying also highlights that some consumers are failing to properly engage and that we cannot rely on all consumers to be able to protect their own best interests.
>
> So, for example, we have seen:
>
> a. the misuse of self-certification, where some consumers were willing to overstate their income in order to obtain a mortgage;

[12] Ibid p51

b. some consumers opting for interest-only products because it was the only way they could afford the amount they wanted to borrow, while having no credible plan in place for repaying the capital; and

c. many consumers focused only on the short-term mortgage cost – seduced by an attractive initial rate but unclear about longer-term affordability.[13]

The main thrust of the FSA's response here was in the provision of better and more focussed advice to borrowers either through its website or by the work of the new Consumer Financial Education Body. Examples of the proposed initiatives can be found in chapter 5 of the Consultation.

[13] Ibid p57

4. Impact assessment

The FSA is required to undertake a formal impact assessment (IA) whenever it produces new measures. These normally involve the use of independent consultants, who are normally the same consultancy firm – Oxera. Because it is the area of greatest controversy, only that part of the IA dealing with the responsible lending proposals will be looked at.

The formal, cash costs, of administering the proposals were summarised as shown below:

> Costs to the FSA
>
> We estimate the one-off costs for implementing the proposals to be in the region of £275,000. Ongoing costs for our supervisory resources will remain uncertain until we consult on the rest of the MMR proposals. Firms affected by these proposals will also be subject to our more intensive approach to supervision. However, costs of this more intensive supervision do not arise directly from the responsible lending proposals and therefore fall outside the scope of this CBA.
>
> Compliance costs to firms
>
> 5. We commissioned Oxera to estimate the compliance costs to firms. We have published Oxera's report separately. Oxera has estimated the average total incremental costs per mortgage sale at between £3 and £12. This is due to incremental costs per sale of:
>
> • £4.50 for each mortgage sale for which income would be verified;
>
> • £18 for each mortgage sale for which income would be verified and where the income verification is complex; and
>
> • £17 for each mortgage sale for which affordability would be assessed.
>
> 6. Oxera estimated the total cost to industry of implementing the income and affordability requirements to be in the region of £3m to £15m. The total ongoing costs for the industry to maintain compliance with these requirements is estimated to be in the region of £5.8m to £20.3m per annum.[14]

It is the indirect costs of the proposals that are most contested. The FSA's (Oxera's) estimates are shown below:

> We also asked Oxera to analyse potential adverse effects on the mortgage market as a result of our proposals, including competition effects. Their main findings are:
>
> • there should not be material adverse impacts on competition in the mortgage market;
>
> • reductions in the variety of mortgage products and application processes are not expected to be detrimental for most consumers, with those affected likely to apply for alternative types of mortgages; and
>
> • the proposals are likely to reduce demand for mortgages since some categories of customers will not be able to pass the new

[14] Ibid A1-2

> affordability test. This is not expected to be detrimental for most consumers.
>
> Microeconomic benefits
>
> 8. The main benefit for consumers from the package of proposals stems from the reduction in costs of arrears and repossessions consumers would otherwise have incurred (which could be substantial given the arrears charges findings) and from the other associated losses to welfare that they avoid.
>
> 9. Using two scenarios for the impacts of the proposals, we estimate that between 0.1% and 4.1% of borrowers would have been excluded from the mortgage market had the proposals been in place from 2005 to 2009, and that between 13% and 17% of borrowers would have had to reduce the amount borrowed to pass the affordability tests and obtain a mortgage. The total value of lending would have decreased by between 3.4% and 9.6%.
>
> 10. We estimate this would have generated benefits to consumers in the region of between £475m and £520m for the four year period. This translates into a benefit per mortgage sale of between £60 and £70. This is largely a transfer from other parties, from firms through lost arrears revenue, and from those who would otherwise profit from sales of repossessed properties.
>
> Macroeconomic impacts
>
> 11. Given the importance of mortgage lending to the growth of housing and credit bubbles, and their contribution to financial crisis, we have carried out a preliminary analysis of the effects of the proposals on financial stability and the net effect on the macroeconomy. In doing so, we have taken account of the prudential reforms already underway as a result of the Turner Review. Our preliminary analysis suggests that the responsible lending proposals increase financial stability and generate a net long-term increase in economic growth of up to 0.1% per year.[15]
>
> These are substantial gains: small increases in the cost of each mortgage of up to £12 a transaction compared to gains of £60 to £70 a mortgage. 0.1% extra annual economic growth when GDP is touching £1.400 billion is a significant sum (in tax revenue terms roughly a 3p cut in corporation tax, or about 0.05% of government borrowing); cumulatively it would be an enormous addition to national wealth; within 20 years national income would be £2 billion higher! Indeed, even if the micro-economic cost-benefits were reversed, i.e. a £60 cost for a £12 benefit, one could make a good argument for the rule change.

So why the complaints from CML and others?

At its heart is a disagreement about the impact of the affordability test. Whereas the FSA think that only "0.1% and 4.1% of borrowers would have been excluded from the mortgage market" the CML think the figure is anything up to 30% depending on what assumptions are made.

The CML research was based on survey evidence of:

- 626 Renters including 356 who intending to buy within the next 5 years
- 461 Home Owners without a mortgage

[15] Ibid

- 2223 Home owners with a mortgage, including a nationally representative sample of 1546 mortgagors, with boosted samples of 373 self-employed and
- 350 first time buyers[16]

The survey asked both about attitudes to mortgages and home ownership intentions as well as about income and expenditure patterns. The results of the survey, in particular the income, expenditure and employment and debt data, were then tested against a 'central test' of affordability which followed FSA intended rule changes. The results are shown below:

Current borrowers who fail responsible lending test

Borrower	Unable to borrow at all %	Unable to borrow at all 000's	Constrained borrowing %	Constrained borrowing 000's	Average current borrowing	Average permitted borrowing post MMR	Difference reduction (av'ge)
No additional requirements other than income>expenditure	10%	1 196	16%	1 838	£98 017	£80 482	-18%
Add: disallow if income cannot be verified	14%	1 539	16%	1 779	£98 017	£75 737	-23%
Add: allow only 50% of non-basic income	15%	1 689	15%	1 764	£98 017	£74 367	-24%
Add: 10% of income for contingency expenditure	17%	1 928	20%	2 257	£98 017	£70 005	-29%
Add: 2% stress test	17%	1 928	24%	2 720	£98 017	£67 682	-31%
Add: assess interest-only on capital & repayment basis	17%	1 928	28%	3 228	£98 017	£64 334	-34%
Add: maximum 25 year term	17%	1 928	28%	3 243	£98 017	£64 279	-34%
Add: cap term at age 65	19%	2 212	30%	3 393	£98 017	£62 095	-37%

Source: POLICIS Research: New approaches to mortgage, market regulation, Technical appendix

These figures are quite striking. Even with no further adjustments for 'stress tests or impaired credit terms, there is a baseline 10% disallowed from borrowing anything. The consequential reductions in borrowing capacity are quite marked too. For example, the combination of imposing an end date at 65 and assessing all mortgages as capital repayment only, could severely reduce the ability of people wanting to borrow late in life, after divorce perhaps, who now rely on low outgoings, the promise of a pension lump sum and the flexibility to work beyond 65 to secure, perhaps a mixed interest and capital mortgage.

It is difficult to get to the bottom of such wider differences when two pieces of work are meant to be measuring the same thing but come up with significantly different answers. The CML in a response to the FSA Consultation in November 2010, attack the methodology used by Oxera:

> Our first response to the FSA's cost-benefit analysis (CBA) of the impacts of the rules was to test the methodology and scope of analysis undertaken. We noted that in paragraph 1 of annex 1 – part 1, the CBA to CP 10/16 it says that:
>
> 'We carried out a full cost-benefit analysis (CBA) of the proposed rules and guidance set out in this CP.'
>
> 47. We decided to replicate several key aspects of this work.
>
> 48. This work has highlighted that the FSA did not in fact analyse the data as fully as it could have to demonstrate the cumulative impacts of all the affordability rules – an inexplicable error - see *A CML evidence-based review of MMR proposals on responsible*

[16] Technical Appendix, to Policis Report New Approaches to Mortgage Market Regulation - The impact of the MMR and the risks and benefits for consumers, society and the wider economy

> *lending* (October 2010) in *Research appendix 1.* The impact on the market across 2005 – 2010 is substantially higher than the FSA has so far admitted.
>
> 49. We also found that the FSA seem to be using the Expenditure Survey in ways which were not intended by its authors, and over interpreting its implications when suggesting that 46% of households had either no money or had a shortfall (paragraph 2.6 of CP 10/16). In the introduction to this dataset, the Office for National Statistics (ONS) states:
>
> *'..... the survey is not designed to produce a balance sheet of income and expenditure either for individual households or groups of households.'*
>
> 50. Second, we noted that Oxera had published a report with CP 10/16 – *Assessment of compliance costs as a result of the MMR lending reforms (July 2010)* which had not taken into account the draft rules. Therefore, we asked Oxera to look at the rules which are, of course, the key elements when trying to assess either cost or benefits. Oxera has now confirmed our suspicion that the rules would increase implementation costs by comparison to the CBA, and would likely impact on lenders' behaviour because of a perceived higher regulatory risk.[17]

The very last point is certainly a factor not implicitly included in the FSA's study. To the extent that the FSA is now pursuing a more 'intrusive' and aggressive monitoring of the mortgage market, as it claims, one would expect mortgage lenders to be more wary of making loans anyway. Memories of the endowment mortgage mis-selling episode and the considerable sums that cost the industry, are still very fresh. The industry would not want to now see a wave of claims about irresponsible lending by every customer that subsequently could not afford to pay their mortgage. Every bankrupt borrower would be justifiably able to complain about his lender that 'they made this loan and I couldn't afford it". Hence, it may be significantly more cautious in future than the FSA expect.

Following the response to the original reforms published in July 2010, a long period of reflection and reconsideration ended with a new set of proposals published in December 2011.[18]

17 CML Mortgage Market Review: Responsible Lending :Response by the Council of Mortgage Lenders to the Financial Service Authority's Consultation Paper 10/16, 15 November 2010

18 FSA, Mortgage Market Review, CP11/31

5. The new proposals

The main concession made by the FSA in its final December 2011 proposals was that many of the new rules would apply to new mortgages and borrowers only. This would allow existing borrowers to remortgage more easily as, for example, fixed term mortgages came up for renewal. This would reduce the chance of 'mortgage prisoners – people who had been given a mortgage under the old rules, but who would not qualify for one under the new rules.

The FSA outlined the impact that they feel the new rules would bring:

> The estimated aggregate impacts set out in the cost benefit analysis in Annex 15 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.
>
> 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.[19]

The proposals are grouped under the same headings as the July proposals (see above). The following sections set out the key features of the new rules but do not repeat the extended justifications mentioned earlier.

5.1 Responsible lending

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.

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[19] FSA, Mortgage Market Review, CP11/31

• **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.[20]

Affordability assessment

The FSA explain what this will entail and its consequences:

> 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.[21]

The FSA acknowledged the concern expressed by some that these proposals meant that the self-employed would find it difficult to get a mortgage. But, they said:

> 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.[22]

The FSA has decided that it will not adopt the alternative method of assessing affordability, for example, imposing loan to value limits on loans.

The original proposals also included detailed requirements as to the assessment of a consumer's expenditure. However, these requirements have been 'softened' and replaced with a general requirement 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,

[20] Ibid p17
[21] Ibid p18
[22] Ibid p18

> basic recreation, and childcare. These are items which give consumers a basic quality of life beyond the bare necessities.[23]

Overall, "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".[24]

The interest rate stress test

The FSA has also changed its position on this aspect. Whereas the FSA thought that lenders should all use a set (by the FSA) interest rate increase to assess the robustness of the loan, now they are willing to let lenders derive their own tests albeit referenced over a medium term outlook against future expected interest rate expectations, such as that supplied by the Bank of England.

Interest only mortgages

This is the first time that that FSA has consulted on interest only mortgages. At its heart is the question of how to determine whether the borrower's repayment plans are credible. The FSA's view was that lenders should assess affordability on the basis of capital and interest repayment costs "unless there is a clearly understood and believable alternative source of capital repayment".[25] Expanding on its more relaxed view the FSA state:

> 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.
>
> 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.[26]

The FSA has also retracted two other of its original proposals and modified a third.

First, they no longer insist that mortgages should be considered over a period no longer than 25 years. They accepted arguments about the impact this could have on younger borrowers and the likely effect of longer working lifetimes.

Second, originally they had proposed adding in a 'buffer' to the affordability calculation. They accept now that this is now unnecessary, given the other proposals.

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23 Ibid p19
24 Ibid p20
25 Ibid p21
26 Ibid p26

Third, they now propose a more flexible requirement for lenders to meet with respect to lending for pensioners. Lenders will have to do less "crystal ball gazing" with respect to their younger borrowers' likely, or potential, pension income, but be more diligent if they are lending to older people.

The final new rules, reflecting the FSA's response to the October 2012 Consultation statement, were published in Mortgage Market Review – PS12/16. The detailed changes from the October proposals can be found in Annex 2 of this document. The main changes of policy are:

> **Advice** (Chapter 2): where we clarify what we understand by regulated advice and explain that we are changing our approach to contract variations by allowing them to be completed without the need for advice, provided there is no increase in the amount outstanding under the mortgage.
>
> - The **transitional rules** (Chapter 3): where we explain our changed approach in allowing lenders to make their own decisions about whether to make exceptions to the responsible lending rules provided there is no increase in the amount outstanding under the mortgage.
> - Our approach to **high net worth and business lending** (Chapter 4): where we explain our decision not to provide a complete carve-out from the MMR proposals but instead to provide a tailored, higher-level approach for both.
>
> **1.12** We have made one other substantive change which we explain in our response to Q14 in Annex 1. We are requiring lenders to keep **responsible lending records** for the period the mortgage remains with the lender, and not just for three years, as consulted on in CP11/31.[27]

In its introduction the FSA say that:

> Responses to our consultation have been positive overall, with the industry welcoming the less prescriptive approach we have taken to the responsible lending requirements and acknowledging that the latest package would help achieve the MMR's overall aim of ensuring continued access to the mortgage market for the vast majority of customers who can afford it, while addressing the tail of poor mortgage lending seen in the past.[28]

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27 Mortgage Market Review – PS12/16 p7
28 Mortgage Market Review – PS12/16 p6

6. Other proposals

Although it is the lending and affordability proposals that have created the greatest interest the proposals also include new rules regarding the sale and distribution of mortgages. The trickiest issue has been the FSA's original decision to maintain a distinction between advised and non-advised sales, where different rules and higher standards are required for the former. The issue is more complicated because the FSA wants to raise the standards of both channels and sought to impose higher standards of assessing affordability and verification particularly on the non-advised sales, done predominantly by independent financial advisers. However, the higher are the requirements on this group, the less justification there is for a distinction between advised and non-advised sales processes. The FSA also acknowledge that, despite all efforts, the general public

> 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.[29]

Accepting the comments made by the industry and the public lack of appreciation of the regulatory nuances behind their proposals the FSA have made a significant, in terms of rule changes, change to their proposals:

> 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.
>
> 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.[30]

Aside from the detailed new rules proposed by the FSA, the macro prudential regulator – the Financial Policy Committee (FPC) – also proposed new requirements, namely a limit on the loan to income ratio which institutions should observe.

At its June 2014 meeting the FPC recommended:

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[29] Ibid p28
[30] Ibid p29

> "The PRA and the FCA should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The recommendation should be implemented as soon as is practicable."

This measure has gone out for consultation until 31 August 2014.

7. Summary

A summary table of the changes made by the review is shown below:[31]

Table 1 – Summary of the MMR regulatory reform package

Mortgage Market Review

Key proposals consulted on and position unchanged

Responsible lending

Lender responsible for affordability checks.

Income to be verified in all cases.

As a minimum, committed and basic essential expenditure to be taken into account.

Stress testing against future interest rate increases.

Interest-only where credible repayment strategy.

Distribution

All interactive sales (e.g. face to face and telephone) advised, except where the customer is a mortgage professional, or high net worth mortgage customer, or business borrower, where execution-only optional.

Execution-only allowed for non-interactive sales (e.g. internet and postal).

Requirement on intermediaries to assess affordability removed.

Every seller required to hold a relevant mortgage qualification.

Firms must act in the customer's best interests.

Disclosure

IDD replaced with a requirement for firms to disclose 'key messages' to the customer.

The 'trigger points' for presentation of the KFI changed to reduce information overload for customers.

Arrears management

The number of times fees for missed payments can be charged limited.

The arrears charges and forbearance rules widened to cover all payment shortfalls.

The costs which can and cannot be recovered through arrears charges clarified.

Lenders prevented from removing concessionary rates because of payment problems.

Non-deposit taking mortgage lenders (non-banks)

Risk-based capital requirement.

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31 Mortgage Market Review – PS12/16 p11

Increase in quality of capital.

High-level systems and controls to manage liquidity risk.

Application on a solo-basis and not to firms in run-off.

Key proposals consulted on and position reconsidered

Responsible lending

Transitional arrangements (see Chapter 3).

Record-keeping requirements (see Q14 Annex 1).

Distribution

Need for advice in relation to post-contract variations (see Chapter 2).

High net worth mortgage customers and business lending

Tailored regulatory approach recognising particular lending characteristics (see Chapter 4).

8. Implementation

The new mortgage rules came into force in April 2014 under the new Financial Conduct Authority (FCA) which replaced the FSA. Formally they form part of the Handbook rules (MCOB-11.6).

The CML produced a short guide to the possible impact of the reforms on the customer – who is after all the supposed beneficiary of the new rules. Their short conclusion is that applying for a mortgage will be a lengthy process. They do not estimate the impact on fees and costs of mortgage arrangement however, if they are right about the time element it would suggest that fees will increase too.

They conclude:

> The overwhelming majority of lenders are on course to implement the new rules for mortgage lending at the end of April, as anticipated. Some have already begun to switch their systems over and are already applying some of the new rules in practice.
>
> Customers are therefore already beginning to see changes in the process of taking out – or even amending – a mortgage, and will definitely do so after 26 April. The changes are being introduced to reinforce consumer protection.
>
> Borrowers will see benefits from greater consistency in the approach to assessing whether the mortgage is affordable, and appropriate to individual needs and circumstances. But, as this article highlights, they will also see a process that is more intrusive and onerous than they may have experienced in the past.

The rest of the article (edited) is shown below:

> So, what are the key changes that mortgage customers will see as a result of the new mortgage rules?
>
> **Taking out a mortgage could take you longer than before.**
>
> One of the main effects of the new rules will be to reinforce a clear distinction between mortgages sold on an "advised" or on an "execution-only" basis, with the overwhelming majority of sales being advised. Indeed, some lenders – and most brokers – will only offer advised sales after 26 April.
>
> The new rules are very prescriptive about giving advice, and the process is likely to take longer than before. Some estimates of the length of the process have been published, but these vary from lender to lender.
>
> It has been estimated that an advised sale could take up to two hours – perhaps longer – to complete. Even if you are making a change to an existing mortgage, you will be affected by the new rules and may find that the process takes longer than before.
>
> It is possible, therefore, that some lenders will choose to split the sales process into two separate interview sessions.
>
> Mortgage interviews will be longer because firms will need to ask more questions to determine what mortgage product is suitable for you, taking into account your individual needs and circumstances. Questions that will be covered as part of the advice process include:
>
> - What length of mortgage term is suitable for you?

- Do you need the stability of fixed monthly interest payments, bearing in mind the potential impact on your finances of future changes in variable rates?
- Is a mortgage offering lower monthly repayments at the outset an appropriate option?
- Is it likely that you will make early repayments?
- Should you have a repayment mortgage, an interest-only loan, or a combination of the two?
- Is it appropriate for you to pay any fees or charges upfront, instead of adding them on to the mortgage?
- What other loan features might suit your circumstances?
- Is the mortgage suitable, based on the information you provide and your credit history?

You will need to provide more details about your income and expenditure. Be prepared!

One of the cornerstones of the new rules is that there must be a careful and detailed assessment of the affordability of the mortgage for you. This assessment has to focus not just on the affordability of initial payments, but future ones as well – in an environment in which interest rates may be higher, and allowing for changes in your circumstances that can be reasonably foreseen at the time you take out your mortgage.

The requirement to lend responsibly, and assess affordability, will mean that lenders must take into account your income, committed expenditure and other basic essential expenditure and costs reflecting your quality of living.

You can help yourself through this process by anticipating some of the questions the lender will ask and having to hand appropriate supporting evidence. Documents that may be needed to substantiate income from employment could include:

- payslips, from each job if you have more than one job;
- evidence of any overtime or bonus payments if these are not captured by payslips;
- bank statements, which will help confirm that income is paid regularly; and
- statements from your employer verifying any income that is not contractually guaranteed or which is irregular, including, for example, maternity pay.
- If you are self-employed, you may need:
- business plans and future projections of income;
- tax returns, and other details of tax paid;
- business accounts, preferably independently prepared or verified; and
- statements or other verification of income from an accountant or other professional adviser.

Finally, if you want the lender to take into account other forms of income, you may need things like:

- pension statements and projections;

- annuity records; and
- statements of income from investments or rental properties.

You should also expect the lender to ask about questions about any potential changes to your future income and expenditure – for example, forthcoming retirement or anticipated redundancy. As with other requests from the lender for information as part of the application process, it is important for you to answer as fully and openly as possible.

The new rules could affect how much you can borrow.

Lenders will have to ask detailed questions about your spending. They will take into account any expenditure to which you are already committed, and will need to know about credit card and loan repayments, hire purchase agreements and child maintenance or alimony payments. You will be asked to provide evidence to help the lender make a realistic assessment of your commitments.

Firms will also have to allow for spending on essential costs of living, including what you spend on utilities, council tax and telephones, ground rent, building and contents insurance, running a car, and other costs for traveling to work or school, including season tickets. They will also have to make a realistic estimate of other living costs, including clothing, household and personal goods, and recreation and childcare costs.

Another important commitment that lenders will need to take into account for interest-only borrowers is the cost of investments that form part of your strategy for repaying the mortgage at the end of its term.

The rules also require lenders to “stress test” affordability of mortgage payments against higher interest rates. Firms will therefore have to consider likely future interest rate movements over at least five years, based on market expectations (unless borrowers opt to fix their rate for at least this period). Even if rates were expected to fall, lenders would still be required to assess affordability on the basis that there is a rise of at least 1% over the first five years.

You will be able to transact on an "execution-only" basis – but there are strict rules to make sure that you understand the process.

Choosing the execution-only option means you will not receive advice from your lender or broker.

[…]In most execution-only transactions, there can be no discussion between you and the lender. Most sales of this type are likely to be online.

Some lenders, and most brokers, will only offer advised sales.

It will still be possible for you take out an interest-only mortgage – but this will remain a niche offering.

The number of new interest-only mortgages has already contracted sharply, and some lenders have already decided to withdraw completely from this section of the market.

Lenders continuing to offer interest-only mortgages will need to ensure that you have a credible strategy for repaying the loan when it matures. They may accept a range of different strategies

> from you for this, and they will ask for evidence to support your chosen strategy. Examples could include:
>
> Regular deposits into a savings plan, or an investment product like an ISA. However, there may be requirements to provide supporting statements and projections of returns.
>
> The use of bonus payments or other irregular sources of income, again supported by evidence that could include payslips or statements from an employer.
>
> The sale of assets, supported by a valuation or other proof of value and ownership.

The FCA accept that the application process will be longer than it was but, unrepentantly, argue that the logic of a system that ensures that people can pay back their debts is unassailable in the long run. They also stated (on various radio interviews) that they expect the normal rules of competition to iron out excessive procedures quite quickly – mortgage providers want to lend so will not 'gold plate' their procedures or put unnecessary obstacles in the way of lending. The FCA's webpage on the MMR can be found here.