

FSA MORTGAGE CONFERENCE

Ensuring a sustainable mortgage market for the future

What issues can we learn from the past?

**Presentation by Michael Coogan, Director General
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Introduction

I am grateful to the FSA for arranging this mortgage conference in advance of its Discussion Paper in the autumn, and I am pleased to give an early indication of some of our views on the key issues.

The recently published Turner Review report thoughtfully describes the global banking crisis and the breadth of regulatory issues to be addressed in the UK and internationally. The mortgage market is a small but crucial part of the jigsaw. Recent market trends driven by the credit crunch and recession mean that what will be « normal » in the future will be very different to what we became used to in 2006 and 2007. Regulation will need to adapt accordingly to the new environment.

Today, I think it is important to unbundle the systemic banking issues relating to capital, accounting and liquidity (amongst other issues) from the mortgage-specific review. That is not to suggest the systemic issues are unimportant – they are absolutely crucial to the vibrancy of the mortgage market in the future.

I am here to talk in this session about what lessons we can learn from the past. I will also highlight some initial findings from a wide ranging consultation we have undertaken with members in recent weeks.

I know from my discussions with the industry that there is a recognition that there is a need for some change, but also a belief that the MCOB rules have largely fulfilled their purpose and do not need substantive amendment. Rather, it is by the application of the rules and principles, by better targeted supervision by the FSA, that we will achieve better consumer outcomes. So, my key message today is that we should not change the rules structure for its own sake – don't throw the baby out with the bathwater!

However, there are questions for the industry to answer and problems to address, and I believe some regulatory improvements can be made.

Past and current problems

Why is it even necessary to have a mortgage review now? I know that the answer is not simply that it has been on the FSA's «to do» list to review how MCOB has operated since 2004.

As the Turner Review report alludes, it is important for there to be a proper analysis of the areas of actual consumer detriment and their causes. I think solutions need to be focussed on the « real » problems in the mortgage market, not knee jerk reactions to ill-informed perceptions.

So will the current regulatory structure ensure that the mortgages of the future are appropriate in terms of risk versus price for the lender, and both suitable and affordable for the consumer? If not, what needs to be changed and why?

Has the growth of the remortgage market - churning by intermediaries matched by serial refinancing by some borrowers - been a sign of effective switching between providers (a good thing) or an example of the wrong types of behaviour (a bad thing)?

Has the increase in arrears and possessions in the last 18 months been a sign that lenders lent irresponsibly in the past, that customers over-extended themselves by borrowing irresponsibly, that lenders are taking possession too quickly and not treating their customers fairly now, or merely a reflection of higher unemployment feeding through into payment difficulties which can be expected in any economic cycle?

Have consumers taken sufficient responsibility for their own actions or have they relied too much on poor quality advice?

Has the government been right to promote a home ownership culture, creating an asset-owning democracy in the UK, or did this simply lead to more marginal borrowers taking out loans that inevitably they could not afford as soon as they faced a financial shock?

And, finally - the issue which I think will underpin the shape of the mortgage market in the future more than any other – what sources of funding will be available to meet consumer demand, and what can the FSA do to help market activity rather than hinder it? We have entered into a period of mortgage rationing for reasons that you will be familiar. Will this sustain, or shouldn't the FSA be seeking to re-open mortgage market activity to improve economic prospects, not closing the door to interested lenders by its prudential attitude?

So, I start with a series of questions which need to be considered carefully in the review.

FSA Business Plan

But, first, in its business plan, the FSA talked about reviewing the complete value chain – lenders, intermediaries and consumers. That is right.

I think, looking back, it is clear that a few lenders acted irresponsibly in their pricing of some mortgage products, relaxation of credit standards, or over reliance on the securitisation market. Those lenders are largely out of business as a result of their ill-judged commercial stance, relying too heavily on house price increases or customers refinancing to bail them out from bad lending decisions.

It is also clear to me that some of the behaviour of intermediaries has worsened the impacts on consumers. If we are to seek better and more sustainable consumer outcomes, we need to look very carefully at the structure of the intermediary sector and the future obligations on mortgage advisers.

Finally, if some consumers tend to borrow irresponsibly, they need to be stopped. If lenders' affordability models, or the quality of advice from intermediaries, does not ensure this outcome, there is a case to answer that marginal borrowers should be protected from themselves. But, how do we introduce protection for the few without reducing the choice of the many, and undermining the potential innovation and other benefits of competition which the generality of UK consumers would want to maintain ?

The business plan also recognises the need to engage with, and influence, the EU regulatory agenda. In case some of you have forgotten, the European Commission is holding a hearing in July on responsible lending, and plans to issue further proposals on managing arrears and possessions by the end of the year. It has a White Paper on mortgage credit which has been parked since the credit crunch, but could be revived once the Commission decides to pursue its consumer protection and integration agendas across Europe.

It is therefore absolutely vital that what the FSA does in this UK review runs with the grain on international issues, both in banking supervision more generally as well as mortgage regulation specifically.

CML consultation with members

I mentioned that in advance of this event we have been consulting widely with members. There have been four main themes that I would like briefly to touch upon in the next few minutes.

I should preface my comments by saying that we are at the start of the process, not the end. Therefore, my comments are not the final word, but the first contribution. I hope that it will help to focus the FSA and other stakeholders on some of the key issues that need to be addressed.

First, the FSA recognises the massive failure of supervision, and has introduced a supervisory enhancement programme, which it suggests will be in place by Q2 2009. It is clear from feedback from firms that there has been an increase in close and continuous supervision – intrusive and fact-finding on a range of fronts.

However, even now, feedback from our sector is that the quality of supervisors needs to be improved. The types of dialogue which supervisors and firms have are mixed, and we are some way from a relationship of mutual trust and understanding. A regulator seeking to instil 'fear' will fail again. What we need to have, but we do not yet consistently have in place, is proper informed debates between firms and supervisors, and appropriate prudential requirements to match business models and risks.

Second, distribution and the role of intermediaries. What types of poor behaviour have we seen, and what level of consumer detriment has arisen? Problems which have been encountered include customer churn, product and commission bias, facilitating fraud by misrepresenting borrowers' income, and poor quality advice. Some intermediaries have acted more like salesmen interested in maintaining their cash flow than advisers protecting their customers' interests.

It seems to me that, by their nature, large intermediary firms are less likely to exhibit these behaviours, but the long tail of small firms has been largely unsupervised since 2004, and some have taken advantage of that situation.

That cannot be a structure of distribution that can continue in the future if we are going to ensure good consumer outcomes. So, there is a need to look at a combination of enhanced intermediary authorisation requirements, higher capital and PI requirements for firms, enhanced training and qualification standards for advisers, and a review of the form of remuneration in our sector. Only with these measures may we sustainably improve the quality of advice in introduced mortgage cases across the market, and remove poor market behaviours.

We need a read-across from aspects of the retail distribution review into mortgages sooner rather than later.

While the intermediary sector, like the lending community, has shrunk substantially, we need to know that the structure that remains will be a robust one from a consumer perspective. I remain to be convinced that the right outcomes are being routinely achieved, and believe that, together with improvements within the FSA itself, this is a major area for the mortgage review to address.

Market expectations suggest that the majority of future business will continue to come from mortgage intermediaries, so this is something we cannot leave to chance.

Before I am accused of suggesting that lenders are entirely blameless, a number of the poor behaviours of intermediaries have been abetted by lenders in the way they have priced their products encouraging consumer churn, enhanced their commission for particular types of product, relaxed their credit standards for example in products without income verification, and not priced properly for the risk they were taking on. In an environment of scarce mortgage funds rather than an excess, this lax approach is not a problem likely to return in the foreseeable future.

But does this risk mean that to protect lenders from themselves, and to avoid 'toxic' products being misold, we need to ban high loan to value or loan to income products? We have asked members. The Turner Review rightly suggests that it needs to look at the evidence of customer defaults and bank losses to assess where the detriment has actually arisen, and it is also going to review international experience.

We know that in a number of countries there are LTV limits nearer 80%, some with enhanced government-backed insurance. However, we also know that the UK has developed better, more focussed mortgage products to meet consumers' needs at different times in their lives than in any other country around the world.

So, a balance will need to be drawn between reducing risk and volatility and reducing the availability of products which have proven themselves, such as higher loan to value products which have allowed people to become home owners, flexible mortgage products which enhance financial planning, offset products which encourage both saving and borrowing together, equity release products which help people enhance their income in old age, Islamic products etc.

So, I look forward to analysing the evidence of what the FSA believes are the real areas of consumer detriment to be addressed in the review.

If the problem is not the mortgage product, but the risk which the borrower has undertaken in a long term commitment, can it be addressed in another way? Some commentators have suggested that mortgage payment protection insurance should be made compulsory, because it would enable customers to manage the short-term difficulties of reduced income due to unemployment, sickness etc. That would seem to be a better approach than simply stopping customers transacting. Feedback from our members very clearly highlights the need for the FSA to take a closer prudential interest, and introduce higher capital requirements, for products which have inherently higher risks or concentrated business risks due to the scale of activity. A product ban is too blunt an instrument and would not achieve its objective.

Finally, we have consulted on whether to widen the FSA's regulatory scope. Some of you with good memories may recall that we suggested that secured second charge lending should be regulated by the FSA in 1999. Our view, and our members' view, remains clearly that that is the right direction of travel. However, I would add a caveat that the FSA needs to be able to manage these additional responsibilities, without taking its eye off the ball of delivering the enhanced supervision we all want to see in place first.

The more problematic area is regulation of buy-to-let. There is support in principle amongst members that buy-to-let should be regulated, but clear differences of view as to whether it should be by mortgage or investment conduct of business rules. There is a general recognition that a consumer as an amateur landlord has a different regulatory need to a professional landlord running a business. So a blanket approach would be disproportionate.

Conclusion

So what lessons can we learn from the past? First, the FSA spent too much time on the minutiae of consumer protection issues, and the treating customers fairly agenda, and insufficient time and rigour on prudential issues and systemic banking risks. We hope there will be a re-balancing of regulatory activity in the future, but recent feedback tells us that there are still too many small issues rather than big ticket risks which are being pursued by FSA staff in their various silos.

Second, in terms of supervision, we need enhanced supervision to embed itself, and until it does it seems a risk too far to extend the FSA's scope. But, the sense of direction from the industry is that there is a compelling case to widen the FSA's role to protect consumers taking out secured and buy-to-let loans.

Third, with a market influenced substantially by intermediary behaviour, we need to enshrine the compliance culture in small firms to ensure better consumer outcomes are routinely delivered in the future, or the structure of firms needs to change.

Finally, there is a case to be explored for banning particular types of high risk product, but our initial perception is that this particular risk can be addressed in other more targeted ways.

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