Mortgage Market Review

Response by the Council of Mortgage Lenders to the Financial Service Authority’s Discussion Paper 09/3
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Introduction

1. The Council of Mortgage Lenders is the representative trade body for the first charge mortgage lenders in the UK, with banks, building societies and other non-bank or specialist lenders in membership. The Mortgage Market Review (MMR) is timely, following on from the comprehensive market analysis in the Turner Review. We have been working very closely with the FSA on mortgage market issues in particular, following the credit crunch and the impact of the closure of some funding markets on market competition.

2. In anticipation of the MMR, the CML carried out a widespread pre-consultation with members in spring and summer 2009, summarising the key outcomes in a pre-submission published in September 2009. The Executive Summary of that submission is attached to this response for ease of reference (Annex 1). Following the publication of the MMR discussion paper in October 2009 we have undertaken a broad ranging consultation with members, which has formed the basis of our response.

Executive Summary

3. The key messages of this response are as follows:

- The FSA recognises that the UK mortgage market has worked well for the vast majority of consumers. Therefore, any new regulatory measures should be proportionate and targeted to the mortgage market problems, not “blunt tools” which will undermine the market for current and future borrowers.

- This is particularly important given that the mortgage market has not been functioning properly from a business or consumer perspective since the financial market crisis of 2007. Our response sets out the structural changes which have taken place in the industry which have led to:
  - Rationed mortgage funds at higher cost.
  - Excluded potential borrowers.
  - Higher mortgage pricing reflecting higher risks.
  - Muted competition, with only a few very large lending organisations actively lending.

- We support the FSA’s aim to reverse this trend to put in place a sustainable, flexible and competitive mortgage market which works better for all participants. However, we need to develop a shared vision of what such a market would look like. We have real concerns that the MMR proposals will not achieve these outcomes, and may accentuate negative trends seen in the last two years.

- We welcome the FSA’s reform agenda to enhance its own supervision of firms, and make itself an effective regulator in the mortgage market. We do not necessarily need more MCOB rules. The “new” FSA is re-shaping the financial services market as a whole, and the MMR is but one important piece of the jigsaw.

- If the FSA does its job properly, it will be able to act more decisively to ensure outlier firms have sustainable business models and do not present systemic risks. Its past supervisory failures have accentuated recent mortgage market problems.

- The FSA highlights the ‘major economic distress’ experienced by some borrowers as a reason for intervention. This distress can arise from a number of factors, including multiple credit use (not driven by the mortgage alone); ill-timed investment in residential property; changes in financial circumstances during a recession; irrational borrowing or irresponsible lending. Only some of these factors can be addressed by the MMR.

- Arrears should not be automatically equated with detriment as appears to underlie many of the FSA’s proposals in the DP.

- The CML believes the MMR measures should not proceed until an appropriate cost benefit analysis (CBA) of market impact, based on analysis of the market data, is carried out.
There are real and tangible market risks which the FSA needs to avoid:

- Underestimating the very major impact of prudential reforms on the mortgage market. The absence of an analysis of the impact of these prudential initiatives means there is a threat that additional conduct of business regulatory layers are added on to mortgage lending which are not necessary.
- Basing the CBA of the MMR on what a market which has "recovered" looks like, rather than the real market we have in 2010 is wrong. The CBA in the DP cannot be relied upon as a justification for any of the MMR measures being implemented now.
- Significant macroeconomic implications which could negatively affect GDP growth, general living standards, and a range of businesses dependent on the mortgage market.
- Non-trivial incremental compliance costs because the measures are not targeted or proportionate.
- Transition risks for firms and existing borrowers.
- Political intervention deflecting the FSA’s focus, if proposals are pursued to change current regulatory structures after the General Election.
- Premature regulatory action in advance of a clear picture emerging on possible European regulatory initiatives.

We support much of the FSA’s analysis of the cause of market problems, but believe further analysis, with industry expert support, is needed before implementing changes in the following areas:

- The actual causes of detriment which justify regulatory intervention using the transactional data and arrears and possessions data.
- Income verification and affordability proposals.
- What comprises higher risk lending?
- Non-bank measures and what comprises higher risk lenders?
- Transitional issues.
- The nature, role and responsibilities of third party administrators.
- The nature of future regulation of mortgage book purchasers, second charge lending and buy-to-let loans.
- Future data provision by lenders and definitional issues.

We support in principle the next steps of consultation on arrears and possessions, but are concerned about early consultation on expanding the approved persons’ regime to lenders. We need further clarification around the functions that the FSA intends to capture in lenders’ offices, and the subsequent impact on any cost benefit analysis to date.

Aside from these planned changes being implemented, with full regard paid to cost benefit analysis, we believe that the FSA should take no other action to implement any structural changes in the conduct of business regulation of the mortgage market in 2010. It should instead allow for the current recovery in the economy, and an analysis of the impact of prudential reforms in the UK and globally to be progressed first.

On chapter 3, on prudential reform, we agree changes under negotiation internationally will have a very major impact on the UK mortgage market. We believe that these measures, with the FSA’s new intensive and intrusive regulatory approach, remove the need for many of the conduct of business measures outlined in the discussion paper.

On chapter 4, on conduct of business regulation, we agree that there is no case for prohibiting the sale of loans above certain LTV, LTI or DTI thresholds.

We have provided evidence that arrears’ levels where fast track processing has been used do not justify a requirement of income verification in all cases.

We have demonstrated that self-certification products and the fast track process are entirely different, and should be recognised as such in the FSA’s regulatory treatment.
• We have put forward a strawman proposal to ensure proper use of fast track by the industry in the future. We recognise that this should be a risk-based approach to underwriting, for low risk customers, and not a proposition that should be directly marketed to borrowers.

• We do not believe that a product ban would represent a proportionate regulatory response.

• We recognise that self-certification is a higher risk product, that it has been abused in the past, and is not a mass market product. We warn against banning self-certification without a clear understanding of how borrowers with complex incomes and the self-employed would not be excluded from the market.

• We agree that lenders should ultimately be responsible for affordability, but the FSA and the industry needs to do further work on the rights and responsibilities of lenders and mortgage intermediaries to ensure that the proposed changes to the sales process will not introduce unintended and unwelcome cost or other disadvantages for consumers.

• The FSA should not prescribe a single affordability model to be used by all lenders.

• On chapter 5, on distribution and advice, we propose that all independent intermediary sales should be advised. We also agree with the strengthening of non-advised sales processes through lenders to enhance consumer protection, subject to the detail of the proposed ‘appropriateness’ test. The lender will already be responsible for assessing affordability.

• On chapter 6, on disclosure and changing consumer behaviour, we propose increased use of money guidance, in a non-sales environment, for higher risk borrowers as a pre-application stage for certain categories of higher risk mortgage, and a more targeted regulatory approach to avoiding irrational borrowing.

• On chapter 7, on arrears and possessions, we support targeted strengthening of the rules on firms’ arrears management practices.

• On chapter 8, on unfair charging practices and price regulation, we warn against the FSA becoming a price regulator and reaffirm that firms are not exploiting customers through profiteering.

• On chapter 9, on scope extensions, we support measures to widen the FSA’s scope other than in relation to buy-to-let lending, which must be carefully considered. The discussion paper and the recent HMT consultation do not put forward a convincing case for why consumer-focused regulation should apply to a commercial investment decision.

• On chapter 10, on other matters for discussion, we support increased data collection and standard definitions to ensure better regulatory reporting and management information in the future.

• In conclusion, we are content that the FSA has made the correct diagnosis of the global and UK problems. We need to ensure the regulatory treatment revives the mortgage market, but many pitfalls remain in the way ahead for the FSA, the industry and consumers.
Background

4. Changes in the structure and regulation of the UK mortgage market are necessary – the systemic impacts in the last 30 months demand a regulatory response (globally as well as in our national market). We support much of the analysis of market problems for firms, as well as analysis of the causes of consumer detriment suffered by a minority of borrowers.

5. In this response to Discussion Paper 09/3 (DP), we reaffirm our support for a range of measures where past regulation, business performance or consumer behaviour has led to unsustainable outcomes.

6. The FSA was right to issue a DP rather than to launch specific proposals for change immediately. More analysis is needed of the cumulative impact of the range of prudential and conduct of business (COB) measures to ensure that any unintended consequences for the industry or consumers are minimised. There should be an extended consultation process that extends well beyond the short-term before the full panoply of changes envisaged by the MMR are introduced.

7. For the most part, more regulatory changes in current mortgage market conditions could undermine competition and choice for consumers, but not enhance financial stability in the market.

8. Therefore, the FSA should proceed with caution. Further consultation is under way on some arrears and possessions measures (which in principle we support) and approved persons (which we support in principle in relation to mortgage intermediaries).

9. In this response, we give our own overview of the current mortgage market, to compare and contrast with the introductory comments in the DP. We also reiterate what we see as the key risks that the FSA needs to manage. We comment on the ongoing market analysis which the FSA plans.

10. Only by fully reviewing the real evidence, rather than political or public perception, will the FSA be able to ensure targeted regulatory interventions rather than using market wide ‘blunt’ tools (such as product bans). Further in depth discussions with market experts are necessary before any conclusions can be reached on the impact of many of the new regulatory proposals, so it would be wrong to give conclusive answers to some of the questions in the DP.

11. Nevertheless, we also comment on the next steps, and reiterate the importance of carefully planned transition arrangements based on robust cost benefit analysis of any new COB measures. Our initial answers to each of the 33 questions posed in the DP are in Annex 2 to this response.

Market Overview – the changed structure of the FSA and the industry

12. What is the current state of the UK mortgage market? In our view, it is not functioning properly, neither producing a stable environment for market participants, nor sustainable benefits of effective competition and choice for customers. Moreover, the reasons for this cannot necessarily be addressed by regulatory reform.

13. The Turner Review report rehearsed the recent systemic crises globally, and the particular impacts on the UK. The FSA has already fundamentally changed its regulatory approach to ensure more effective supervision of firms, tighter prudential requirements, and more proactive intervention into business models which could have adverse systemic implications. For the mortgage market, it is also perhaps worth repeating the scale of change since early 2007 for banks, building societies and specialist mortgage lenders (and indeed mortgage intermediaries).

(a) Reforming the FSA

14. The evolution of the mortgage market will be shaped by the way in which the FSA approaches its regulatory functions (and whether a new government changes the regulatory structure).

15. Some issues, we believe, can be managed at an individual firm level by strong supervisory activity based on the right prudential controls (and we have seen various examples from the FSA since 2007). We accept that other issues may be more relevant across the industry and require more
detailed conduct of business rules, which is where, over the longer term, the MMR has more relevance.

16. Will the FSA be more effective as a regulator in the future than in the recent past? On this aspect – vital to market confidence – we are optimistic. What has the FSA been doing to address the failings identified in its report on Northern Rock? The FSA has an impressive, far reaching, aggressive retail agenda.

17. First, we now have an intensive and intrusive regulator. We welcome this. If it had focussed on the few outliers before, in the way in which it will propose to do in the future, we may not be in the current market situation. When referring to ‘outliers’ in this response, we do so non-discriminatory. This term will apply to different products or firms depending on the circumstances. More generally, we do not believe that it is possible to categorise firms as ‘outliers’ or ‘high-risk lenders’ on the basis of firm type or size. Discussion must remain focussed on higher-risk lending.

18. Second, the FSA has embarked on a substantial supervisory enhancement programme. If the extra costs are matched by market experience and anticipation of problems in advance, the risk of systemic problems will be diminished.

19. Third, it has set up a conduct risk division. This is very important, as it will give a clear steer to the industry on the core problems to be addressed annually, and get industry buy-in to the FSA’s supervisory focus.

20. Fourth, it has, and continues, to enhance stress testing required of firms. Those who do not pass have had higher capital requirements imposed, or been closed down if diversified risks have not been sufficiently well managed. Has the balance been right, or has the FSA accelerated consolidation with a too risk adverse attitude? Bearing in mind past supervisory failures, ‘safe rather than sorry’ is the current FSA approach.

21. Fifth, the FSA has toughened its approvals process for senior management. Sixth, the FSA has embraced the need to widen its scope – sale and leaseback companies so far, and authorising purchasers of mortgage books and second charge lending to come (and possibly buy-to-let lending).

22. The “new” FSA is re-shaping the financial services market as a whole, and the mortgage market is but one important piece of the jigsaw. The MMR therefore needs to be seen in this wider regulatory context, both to understand the FSA’s rationale for current proposals and to recognise that its potential costs and benefits cannot be seen in isolation (see key market risks below).

23. Finally, we would also encourage the FSA to think carefully about the rules and powers that it currently has at its disposal in the current mortgage regulatory regime. We believe that MCOB is, by and large, fit for purpose, and backed by more intensive supervision and an increasing willingness to take action where rules have been broken, significant change to the rules should not be necessary. Effective supervision is more important than more rules.

(b) Banks

24. If we look at the largest ten bank lenders in 2006 –
   • we have seen two nationalised – Northern Rock and Bradford & Bingley;
   • we have seen two merge – HBOS and Alliance & Leicester;
   • we have seen two given comprehensive government support – Lloyds and RBS;
   • we have seen one withdraw from the UK intermediary market – the Bank of Ireland group; and
   • we have also seen the sale of Standard Life Bank – a relatively new entrant which for a period was a strong competitor to the largest lenders – to Barclays.

25. The scale of change to the banking market has been broader and more severe for all concerned – the government, taxpayers, the banks themselves and borrowers – than previously
imaginable. We are only part way through the adjustment process, with Northern Rock splitting into two businesses at the beginning of this year, and further divestments planned in Lloyds/RBS to enhance competition in lending markets.

26. Despite this series of changes, the banking sector has been a comparative winner in the UK mortgage market. Leading banks have largely been able to meet lending commitments to government and, in a substantially smaller market, taken market share from building societies and specialist lenders. Indeed, there is a real risk that market consolidation will accelerate this trend with 5 - 6 lenders representing 80% or more of market activity year by year.

(c) Building societies

27. And what about the building society sector? Initially, it was suggested by some commentators that societies did not follow the high-risk strategies of other lenders and would be largely unaffected by the closure of funding markets and the credit crunch. This proved to be wrong, as a series of societies have been downgraded by credit rating agencies; several societies have had to be rescued by merger, by government intervention, or input of new forms of capital. Lending volumes have been very modest for the sector as a whole. Building societies have collectively been comparative losers in the current UK mortgage and savings markets.

28. On top of the changes seen to date – the sector is in a process of transition –

- higher, and thus less profitable, liquidity requirements;
- changes to capital treatment;
- new lending limits based on the risk management skills of individual societies;
- the ongoing margin squeeze caused by a low interest rate environment; and
- additional cost pressures – including contributions to the Financial Services Compensation Scheme.

29. These sectoral pressures will heighten in 2010, so the process of consolidation will continue (Yorkshire BS and Chelsea BS are due to merge on 1 April); and other societies may leave the sector (as Britannia BS did by merging with Cooperative Bank).

30. Overall, we estimate that building societies’ market share (excluding any subsidiaries) fell from 17.0% at the end of 2008 to 15.4% at the end of 2009, with actual balances £6 – £7 billion lower (the Britannia/Co-op merger in August 2009 making it hard to make precise year-by-year comparisons). This picture will not reverse while societies have limited access to new funding, and are under considerable pressure from the banks in their efforts to retain current retail savings (with regular monthly outflows reported through 2009).

31. The FSA risks accelerating potentially unnecessary consolidation in this sector by its approach on a specialist building society sourcebook, with longer term competition implications. We believe that, in the current market conditions, it is premature to issue the sourcebook in early 2010 as planned with so many other changes to societies’ businesses under way.

32. It would be better to defer implementation until broader changes under the MMR are settled. We do not view the need for sectoral change to be as urgent as perceived by the FSA (which is understandably trying to avoid further events as at the Dunfermline and West Bromwich Building Societies). Supervisory action in relation to individual societies, if necessary, should still be able to be taken based on the current regulatory structure and the FSA’s intensive supervisory approach without the need for underpinning by a sourcebook.

(d) Non-deposit taking lenders

33. The non-deposit taking, specialist lenders have also been comparative losers. They have been affected in different ways again, depending on their niche focus – buy-to-let lenders and equity release firms have largely fared better than sub-prime lenders. Virtually all have had funding closed
as the securitisation markets have been inaccessible and they have not been able to access any of the various government special funding schemes. The impacts have been varied –

- Some non-banks have gone into administration.
- The majority of sub-prime lenders face backbook issues. Whilst the recession has impacted adversely on the whole of the market, it has affected this type of borrower more acutely, impacting arrears and possessions levels.
- A number of firms are facing enforcement action by the FSA.
- Some have tried to exit the market by selling their mortgage books to non-FSA authorised firms, such as hedge funds and venture capital companies.

34. As described in the DP, all of these issues raise questions about –

- the sustainability of the sub-prime business model;
- these firms demonstrating that customers are, and have been, treated fairly; and
- ensuring appropriate prudential and conduct of business measures are in place in the future.

35. Conversely, for buy-to-let and equity release lenders, the principal problem has not been the performance of past business but the ability to fund new loans (despite pent up demand). The relevance of these niche non-deposit takers will depend on how, and when, the securitisation market reopens, and what additional prudential measures are implemented by the FSA.

36. In our view, a diverse market with different types of lenders – funded by retail and wholesale markets, both large and small in business scale, is more likely to offer the sustainable and competitive benefits that regulators and consumers will want in the long term.

37. In 2007, the CML had 160 members. In 2010 we will have around 110 members representing approximately 95% of the market as a result of non renewals due to cost pressures and market exits (previously 98% market coverage). These figures encapsulate the scale of market change in the lending industry in the last few years.

(e) Mortgage intermediaries

38. Dramatic changes have taken places in all lending sectors – more changes will arise in the next 12 months. And it is not simply in the lending market that there has been dramatic change. Exhibit 5.2 shows the shrinkage of the number of mortgage intermediaries – now half of the level seen in 2007, and with low numbers of housing transactions and diminishing remortgage opportunities, this trend will not reverse any time soon.
(f) Other contextual pressures

39. We also know that the European Commission and UK authorities will continue to progress prudential reforms of banks and other lending businesses, and the Commission will potentially develop broader mortgage specific proposals to enhance consumer protection across Europe (which will not necessarily complement proposed MMR measures in the UK).

40. We know that whichever government is in power after a General Election will need to address the fiscal deficit, which will have unknown impacts on consumer sentiment, investor appetite for the residential mortgage market, and the speed and shape of the economic recovery in the UK.

41. There is a prospect of rising interest rates if inflationary pressures start to present themselves as a consequence of the quantitative easing programme and the recovery of the economy over time (although the CML’s view is that interest rates are unlikely to move significantly in 2010).

42. Therefore, these broader contextual issues underpin why, in a changing market, the FSA should not rush through regulatory changes in the immediate future - 2010 and 2011 - if conditions are not right.

43. In overview, from being seen as one of the most competitive and complete mortgage markets in the world, we have moved to –

- rationed mortgage funds at higher cost;
- excluded potential borrowers;
- higher mortgage pricing reflecting higher risks; and
- muted competition, with a few very large lending organisations active in the market.

44. If the FSA is to achieve its long term aims for the mortgage market, the challenge for the MMR is to reverse this trend – many of the proposed measures risk accentuating the recent trends making a flexible and sustainable mortgage market for consumers less likely.
Key market risks

(a) The cumulative cost of prudential reform

45. The key market risk is identified in paragraph 2 of the high level cost benefit analysis (CBA) in annex 2 to the DP. “In our analysis we have taken into account the fundamental prudential reform already under way and developments under the Turner Review. But the impacts of these prudential initiatives are not within the scope of this CBA.”

46. This recognises that the MMR is only one piece of a bigger jigsaw. The impact on the mortgage market cannot be accurately assessed based on the analysis in the DP, as it does not reflect the cumulative impact of regulatory changes.

(b) The cost benefit analysis of mortgage reforms

47. The DP also recognises that “the mortgage market has worked well for many consumers – the vast majority of mortgage borrowers will come through this recession meeting their mortgage payments and keeping their homes. But it has been a cause of major economic distress for others” (see Foreword). There is a risk that the MMR and other prudential proposals could undermine the former benefits of home ownership, without delivering effective and targeted solutions to the latter economic distress.

48. Section 1 of the CBA (paragraph 6) sets out in Box 1 a summary of findings on the nature of competition and market failures. It highlights some of the transformation over the past two years – such as the reduction in the number of active market participants – It concludes “Some of the changes observed…may be temporary, reflecting the current state of the economy, but others may reflect structural shifts that over the long term could give rise to more serious competitive concerns.” We agree with this competition concern, and this is a real and tangible risk with more market consolidation anticipated.

49. Section 2 of the CBA (paragraph 21) confirms that the FSA has analysed the benefits of the proposals on the basis that the market has “recovered”. We are not sure what form this market looks like in the FSA’s vision, and we need to develop a shared view of what a sustainable and competitive market looks like.

50. However, this approach to the CBA seems unduly optimistic, and forward thinking, as recovery is some years ahead. Structural changes in the market over the last two years may mean ‘recovery’ is elusive and in the longer term (2012 onwards) at best. Therefore, fundamentally, we see a key risk that the high level CBA of the MMR is based on the wrong premise and cannot be relied upon.

51. Paragraphs 22 to 26 of section 2 of the CBA describe the risks more fully. “First, the package of the proposals could lead to a reduction in unaffordable mortgage sales… or could limit access to the mortgage market for suitable individuals who could have entered the market” (paragraph 22). Financial exclusion is a real risk, yet we are unconvinced that the proposals will ensure a demonstrably more sustainable market for all consumers.

(c) Macroeconomic implications of market reforms

52. Second, depending on the specific requirements, the proposals could have significant macroeconomic implications (paragraph 23 of the CBA). If calibrated too stringently, the proposals could negatively affect GDP growth and general living standards, with effects on:

- Demand for housing, rental properties and future home-ownership rates.
- Supply of housing and the prospects for homebuilders and related industries.
- Lenders’ portfolios and profitability.
- Fiscal policy.
• Monetary policy.
• Pension policy (see paragraph 23 of the CBA).

53. We agree that this list of potential effects are real, and present tangible risks now if the wrong regulatory measures are implemented, at the wrong time, or in the wrong way.

(d) Non-trivial incremental compliance costs

54. There are a number of other key risks that could be triggered if corrective measures are not properly targeted or implemented. For instance, there is also a key risk of “non-trivial” incremental compliance costs of firms putting a heightened onus on effective supervision and enforcement by the FSA (paragraph 24). Most worrying is whether the proposals will actually be effective if there is a possibility of gaming any imposed limits (paragraph 25)? The FSA may only be able to partially mitigate the risk, and we believe gaming is a real and tangible risk in advance of the FSA’s scope being extended to cover second charge mortgages.

(e) Managing the transition to a new regulatory regime

55. In addition to all of the above risks, but equally important, are the transitional and timing issues for mortgage regulatory changes (paragraphs 37 to 40 of the CBA). The proposals are designed to have a positive effect over the economic cycle. However, we are not yet out of recession, with a rationed funding environment and market consolidation in lenders and products.

56. Therefore, we believe there is no urgency to implement structural measures, and indeed real and tangible risks of making substantive changes in current market conditions. We welcome the FSA’s explicit recognition of this risk (paragraph 37). “There is a careful balance that needs to be drawn here to introduce changes at the right time” (paragraph 38).

57. This is a vital and sensitive balancing act.

(f) Political risk

58. Finally, there are short term political risks if, as a result of a change in government, the functions of the FSA are changed more fundamentally by a move to the Bank of England, and a new Consumer Protection Authority is set up. This would, at best, be a distraction at the time when crucial decisions are being taken which will affect the mortgage market in the long term. At worst, the FSA’s eye could be taken off the ball again just as market conditions start to change for the better, reversing some of the positive regulatory progress which has been made in the last two years.

Future analysis

59. We have been impressed by the FSA’s determination to take an evidence-based, considered approach to regulatory changes. There is much to be resolved in international interventions on prudential reforms before an analysis of mortgage market specific measures can be taken.

(a) FSA aims for the MMR

60. The FSA has set out a range of areas where further analysis is under way. So, it is worth reiterating the final paragraph of the Foreword, with our comments in italics, and the summary aims of the review (paragraphs 1.2 and 1.3).

61. “Overall, the package of proposals discussed in this paper represents a very significant shift in the FSA’s strategic direction (we support a change in supervisory approach). We are not seeking to pre-empt the outcomes of the debate: the aim is to stimulate a wide-ranging discussion (this is a vital pre-requisite, and as described in this response in some areas the FSA seems too wedded to regulatory changes which we do not believe will improve market outcomes. However, a mature and evidence-based debate is welcome.). What matters is that collectively we deliver the right outcomes for the market. (Yes). But where we are confident in our position and where we gain support, we intend to move quickly (yes, in principle, but the details of each proposal needs an effective CBA and these are limited measures where early action is appropriate).”
The FSA’s aims for the mortgage market are worth stating in full. It is an ambitious agenda, with plenty of scope for falling short of the objective of a sustainable market for all participants.

Paragraph 1.2 states –

“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:

- 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.”

Jon Pain at the CML annual conference on 13 November 2009 summarised as follows-

“We don’t want to have a market where it will always be difficult for a first-time buyer to get a good mortgage deal. We don’t want niche markets to disappear for good. And we don’t want to have only six lenders of scale. But equally, and more importantly, we don’t want the irrational exuberance of the years up to mid-2007 to come back. We must not forget the lessons of the past. The reforms we propose to put in place will ensure that when confidence returns it does so in a sustainable way.” (emphasis added).

So, the FSA is primarily interested in stability and sustainability in its aims. This may or may not lead to the return of the level of competition, completeness of market, or mortgage choice for consumers that we have had in the past. We think a balance needs to be drawn, and the net impact of the accumulation of current proposals is, on balance, an over intervention in the market which will undermine the stated aims.

(b) Evidence based, further analysis of market impacts

Further analysis is needed in conjunction with practitioners in FSA led expert groups on –

- income verification and affordability;
- what comprises higher risk lending and how effective pricing, underwriting and monitoring can ensure its continuation;
- non-bank measures and what comprises higher risk lenders;
- transitional issues;
• the nature, role and responsibilities of third party administrators;

• the nature of regulation of purchasers of mortgage books, second charge lending and buy-to-let loans;

• future data provision by lenders and definitional issues; and

• unless otherwise defined through a robust cost benefit analysis, the approved persons regime.

This is a comprehensive workload which needs a focus on detailed market impacts.

(c) Arrears and possessions analysis

68. We are concerned that substantive interventions to conduct of business regulations should be based on real evidence of detriment and an effective CBA. We do not believe ‘arrears’ automatically equates to consumer detriment. In fact, most arrears are caused by changes in financial circumstance, not the original lending decisions.

69. In December 2009 ‘Turning the Tide?’ a joint publication by Advice UK, Shelter and the Citizens Advice Bureau outlined the reasons for arrears for 452 borrowers (see the table below). All respondents were asked to provide the three main causes for falling behind on their mortgage payments; the top five reasons given all relate to either a loss of income or change in circumstances, such as illness and divorce. Only 10% cited over-commitment as a reason.

70. Given the FSA’s own analysis in the MMR that 88% of a sample of borrowers that had been repossessed had additional secured borrowing, it is likely that this over-commitment came after the initial mortgage decision was made. Therefore, arrears may give rise to economic stress, but only in a minority of cases is this due to the original borrowing or lending decision.

71. Therefore, new COB measures will not influence future arrears levels, except at the margin, and trying to “stop” future arrears, because the FSA treat it as evidence of consumer detriment, is not itself a justification for regulatory intervention in the market. Mortgage arrears do not automatically equate to detriment – the financial and social dynamics in the home ownership market are more complicated.

72. Home ownership is by far the majority tenure at nearly 70%, having extended into aspirational borrowers whose income is more marginal or subject to fluctuation. Therefore, over the economic cycle, there will always be a level of arrears to be managed. The key issue is how to maximise efforts to minimise possessions – and great strides have been made by the industry, borrowers, debt advisers, the government and regulators over the recessionary period.
(d) Other unintended impacts on existing borrowers

73. Further analysis is needed on the impact on existing borrowers who are, or may be, locked in to their current deals as a result of market changes or proposed regulatory interventions such as product bans.

74. A number of asset management companies, not active in new lending, will remain major features of the market for years to come, and it is a key transitional priority that the FSA should be able to supervise these firms effectively, particularly where they have high risk borrowers unable to move.

(e) Developing a shared vision on what a sustainable and competitive market looks like

75. Further analysis and discussion is also needed on what is a ‘sustainable’ market for consumers, and what is an appropriate level of competition amongst lenders? Initially, the government spoke about returning to lending levels seen in 2007. It is now apparent that the mid “noughties” were abnormal years. Future lending is more likely to be in the region of £0 - £50 billion net lending and £125 - £175 billion gross lending – substantially smaller than before.

76. The FSA seems to assume that, on an economic recovery, the market will revert to 2007 conditions. It will not – too many market participants have already departed, and will depart the market before a recovery, and an intensive and intrusive regulator is unlikely to repeat the mistakes of the past.

77. So, although the FSA states its aims for the review, it is not clear what it thinks the market will be, or how it should look in the future. It needs to give further insight on how the FSA, and the tripartite authorities collectively, want to influence market participants to avoid the wrong consumer outcomes.

Next steps

78. The broader steps towards prudential reforms will continue, which will have a major impact on the mortgage market, and will require careful review in the context of the MMR.
The FSA is determined to implement its sourcebook for building societies. We believe this is fundamentally flawed in timing terms, and will have negative impacts. However, we await the FSA’s feedback statement to review how it justifies premature action targeted at one sector in the mortgage market.

Further consultation is under way on some arrears and possessions measures (which in principle we support) and approved persons (which we support in principle in relation to mortgage intermediaries).

We are unconvinced that any further regulatory measures will be appropriate in 2010, bearing in mind our view of the market conditions in the next 12 months.

We believe extension of the FSA’s scope to cover all secured loans is urgent and a prerequisite if the MMR aims are actually to be delivered for the reasons set out in the answers to the DP in Annex 2. But, we anticipate that legislative constraints will mean that these necessary reforms will only happen in the medium term, not in 2010.

Conclusion

The MMR will set the structure and nature of the UK mortgage market for years to come. Its importance cannot be overstated, as are the real and tangible risks of European measures undermining national market proposals. The CML, as the mortgage lending industry’s representative voice, is prioritising its resources to help the FSA in the next vital months.

So far, so good. The FSA has made a correct diagnosis of the problems globally, and in the UK. We must now, collectively, ensure that the proposed treatment is able to revive the mortgage market to deliver the MMR aims. However, many pitfalls remain in the way ahead for the FSA, industry and consumers.

28 January 2010
Annex 1 – Executive summary of pre-submission (September 2009)

85. Mortgages now and into the future will necessarily be more expensive compared to before the credit crunch with –

- Less generous lending criteria, reflecting a more restricted availability of funds.
- Higher pricing reflecting higher risks.
- More differentiation between different borrower groups in pricing, so higher risk first time buyers will pay more.
- A more intrusive (and costly) supervisory approach by the FSA.

86. As we go through this adjustment to new pricing for the future, lenders have been accused of profiteering. In fact, it reflects a necessary adjustment in the market which will not be reversed, and will likely be accentuated, by the outcomes of the Turner and mortgage market reviews.

87. The CML supports the FSA’s three key outcomes of the mortgage market review but believes it will be challenging to achieve them for reasons explained in this response.

88. The mortgage industry recognises the need for a review, but any changes should be targeted carefully. We believe that the mortgage conduct of business (MCOB) rules overseen by the FSA have largely fulfilled their purpose and do not need substantive amendment if enhanced supervision of firms is effective (although some improvements could undoubtedly be made to learn from practical experience since 2004).

89. The market is no longer as highly competitive as the number of active lenders and intermediaries has reduced substantially. Mortgage rationing has directly affected the number and types of mortgage products available in the market.

90. A vibrant and competitive market is one that consists of a range of different business models, which caters for a wide range of customers, and is free to innovate and adapt to changing circumstances. Structuring regulation in the wrong way can undermine all of these features.

91. It is important to focus on both responsible lending and borrowing, and there is a real risk that European Commission proposals may diverge from, rather than complement, national measures in the UK.

92. The review should look at the future treatment of higher risk mortgages, but we are not persuaded that the FSA should assume that banning particular product features, such as high loan to value, or prescribing sales requirements, such as income verification rather than self-certification, adequately addresses potential consumer detriment. These approaches to product regulation risk being blunt tools to address past problems no longer prevalent in the market.

93. As the FSA is aware, structural changes to capital and liquidity approaches will have a significant impact in the mortgage area of firms’ business. It is therefore important that the cumulative impact of these proposed changes, and any measures to regulate lending, are not too onerous or out of proportion to the risks of consumer detriment or business sustainability.

94. It is arguable that the overall effect of the measures suggested for building societies in the FSA’s specialist sourcebook consultation recently would substantially undermine the mortgage market if applied generally, and societies’ competitiveness if applied in isolation.

95. There are a number of areas where regulation of the intermediary sector could be improved to encourage better behaviours across this distribution channel. However, the changes in the market have shrunk the sources of advice to consumers and new regulatory measures are unlikely to reverse this trend.

96. Detailed consideration will need to be given to whether the retail distribution review for investment advisers should be read across in part or in whole to mortgage advisers.
97. There is a strong case to extend the FSA's scope to cover secured loans, if the FSA can demonstrate that its enhanced supervision programme is properly embedded. The case for regulation of buy-to-let is less straightforward due to the nature of this commercial market.
Annex 2 – Answers to the specific questions in DP 09/3

Chapter 3: Prudential Reform

Question 1: Do you agree that the prudential reforms will ensure that banks and building societies are adequately capitalised for the risks inherent in mortgage lending and should support a more stable mortgage market through the economic cycle?

98. The mortgage market experience, following the closure of global funding markets and subsequent global recession, has demonstrated unequivocally the need for prudential reform for banks, building societies and non-bank lenders.

99. International reform is under way and, as recognised in paragraph 3.2 of the DP, “in aggregate, these changes to the overall prudential framework will have a very major impact on the UK mortgage market.”

100. However, our concern, outlined in this response, is that no one has yet been able to demonstrate a clear understanding or analysis of the cumulative impact of prudential reform of capital and liquidity standards (Paragraph 3.3 mentions liquidity policy). Yet a very significant number of prudential reforms are being implemented or proposed at national, EU and global levels, not always in a co-ordinated fashion. It is right, therefore, that we should not have additional measures specific to mortgage lending by banks and building societies in isolation.

101. There is a real risk that the individual measures, if implemented too soon, or without further analysis of the market impact, could end up with unintended, detrimental consequences. For the same reason, we urge caution about layering additional conduct of business rules without compelling evidence that potential benefits will be delivered at a proportionate cost.

102. If self-correction in the market, changes in consumer behaviour based on recent experience, and wider prudential reform will diminish systemic risks in the mortgage market, it is right to take a considered approach over a prolonged period before rushing in regulatory changes in response to past detriment in the mortgage market.

103. So, in summary, the prudential reforms will ensure that banks and building societies are adequately capitalised and support a more stable mortgage market, but it is difficult to assess what the size and competitive structure of the market will be. As the FSA is aware, there is a need for more analysis on the cumulative impact of proposed changes (see Discussion Paper 09/4 on the Turner Review Conference).

Question 2: Do you agree with our analysis of the implications of applying higher capital requirements to high-risk loans (on top of the prudential reforms) and that to do so would not be likely to protect borrowers from the risks of taking on such loans?

104. We are not convinced that past experience of poor borrowing/lending decisions justify additional prudential policy changes to achieve conduct of business objectives (see paragraph 3.34 of the DP). We believe that the substantially higher capital and liquidity requirements (see paragraph 3.40) will, in themselves, deliver the policy objective of ensuring higher-risk lending is properly priced (and this higher price will make it less attractive to borrowers) and backed by appropriate capital.

105. However, this needs further analysis. The FSA sets out four concerns in paragraph 3.38 that prudential levers are unlikely to be fully effective or appropriately targeted. First, the extent to which higher requirements feed through to higher product prices and lower volumes of higher risk lending depends on the price elasticity of consumer demand.

106. Second, the risk that borrowers paying a higher price are more likely to be pushed into arrears by an adverse income shock. Third, the extent to which higher costs will be passed through from lender to borrower is uncertain (and cannot be guaranteed). Fourth, the impact of higher capital requirements is affected by the level of excess capital lenders hold over the regulatory minimum.

107. These concerns require further analysis, and have theoretical validity, but we do not believe they pose real market risks in the foreseeable future.
108. The financial crisis has left a legacy of rationed wholesale funding and heightened appreciation of risk in mortgage lending, legacies which we believe will have a long lasting impact on the market. In a long-term rationed funding environment, we will have limited competition in the market led primarily by the lenders who have historically not focussed on higher-risk lending. With heightened concern about risk amongst both lenders and wholesale debt investors, it is highly likely that there will be much less product choice or funding available to prospective higher-risk borrowers.

109. The extra sensitivity of capital to risk in Basel 2 and the retention requirements for securitisation already contained in the Capital Requirements Directive 2 will reinforce this outcome without any additional measures.

110. So, we conclude that the risks are not as high as the FSA suggest, and concur that additional prudential measures for higher-risk mortgages are not necessary. This is the same conclusion as the FSA, but for different reasons.

Question 3: Do you agree that more direct intervention through business model analysis; applying asset limits; or increased prudential requirements is required to deal with the consumer and systemic risks posed by non-deposit taking lenders?

111. We agree that, while non-banks are not all the same or follow the same business focus, events have shown the need for more direct intervention into riskier business models which can have systemic consequences or increase volatility through economic cycles.

112. We support the FSA being a more intensive and intrusive regulator, in principle. However, the regulatory focus should be on non-compliant lenders and genuinely outlying products rather than on the generality of the market, and the approach must deliver regulatory certainty so firms can invest for the future with confidence. It is right that the FSA should –

- use its authorisation process to grant permissions and impose limits on concentration of risk, with conditions that it can keep under regular review with the individual firm;
- use its new approach to permissions to vary and regularly review existing permissions of firms where evidence shows they are outliers; and
- ensure an enhanced supervisory approach (more intrusive supervision for higher risk firms, particularly new ones without a track record).

113. We should also emphasise that a tailored approach is vital, rather than that all non-deposit taking lenders are treated the same. As reflected in Exhibit 3.2 in paragraph 3.46, as some non-deposit taking lenders targeted higher risk business, they had a much higher arrears rates. But as noted earlier, we do not subscribe to the view that arrears automatically equals detriment.
However, other non-bank lenders were more equivalent to banks and building societies in their business focus and experience, and have demonstrated the sustainability of their business model by surviving the financial crisis without any government assistance.

We believe that prudential action against outlier firms would substantially address the systemic impact of –

- higher-risk lending;
- improper pricing for risk; or
- lending which relied on equity in the property.

These have all, rightly, been identified as features at the heart of recent market problems for a minority of lenders (now largely out of business) and borrowers acting irrationally in their use of credit. They are also issues which the FSA can take into account when assessing potential new entrants’ business models.

Paragraph 3.50 suggests that the pro-cyclical entry and exit of non-banks produces market sustainability issues. We agree, and believe this reinforces the need for the FSA to distinguish in its supervisory oversight between non-banks that have a long term commitment to UK mortgage lending and those that enter the market on an opportunistic basis.

While non-banks only comprise a minority of the market, they have had systemic impacts on the competitive positions taken by some banks, building societies and their subsidiaries. However, once again, it is right to emphasise that this generalisation does not apply uniformly across the market. Some non-banks acted responsibly, managed their specialist lending well, and maintained profitable performance through the recession.
119. We believe an expert group, with CML participation, should be set up to explore more fully the potential solutions set out in paragraphs 3.52 to 3.55, informed by the analysis of arrears and possessions data which the CML has provided to the FSA (paragraph 3.55).

120. With funding markets still largely closed, and the mortgage market still not functioning as the downturn in the economy persists, we do not see the collective capacity of non-banks to be a significant competitive feature (with significant market share) in the market in the next few years.

121. However, we hope that some will become active players again. We understand that the FSA has received applications from other potential new, non-bank entrants, who should be allowed to compete as well, subject to the FSA’s analysis of their business models and imposition of appropriate prudential controls.

122. It is important that regulators appreciate the importance of the re-emergence of a secondary mortgage market, not only to maintain competition in the mortgage market, but also to provide a mechanism by which risk can be transferred to investors rather than left with government. This is particularly pertinent for the UK given our recent experience, where both retail deposits and senior unsecured bank debt investors have been comprehensively protected from losses by the government.

123. If there was one outstanding cause of the crisis in UK banking, it was not insufficient capital or poor quality mortgage lending in the UK, but the vulnerability of our banks’ funding structures. A clear strategy to encourage the development of more sustainable funding models going forward should be a priority for the government, together with the Bank of England and FSA.

Question 4: Are there any other considerations that are relevant to the issue of how prudential requirements influence mortgage market outcomes?

124. We believe that the cumulative impact of proposed prudential requirements announced to date could have an adverse impact in the mortgage market. We see this as a high risk.

125. The FSA should seek to ensure a diverse market place of banks, large and small, building societies and other specialist lenders.

126. This is not the market in place at the beginning of 2010, so the FSA’s actions should not drive consolidation (as we believe will happen from the original building societies sourcebook proposals) nor exclusion from the market (by the FSA refusing to authorise new non-bank entrants).

127. In 2010, we shall see progress towards divestments in the nationalised and partly government-owned banks. This will provide the potential for more competition, and potentially on advantageous terms compared to other existing market players.

128. This could have negative impacts, as well as positive, and so the prudential requirements on these ‘new’ entrants will need to be carefully balanced between promoting economic activity without undermining longer-term market competition.

Chapter 4: Conduct of Business Reform

Question 5: Do you agree with our analysis that, on the grounds of consumer protection, there is no case for prohibiting the sale of loans above certain LTV, LTI or DTI thresholds?

129. We agree with the FSA analysis that, on the grounds of consumer protection, there is no case for prohibiting the sale of loans above certain LTV, LTI or DTI thresholds. We applaud the FSA’s willingness not to bow to political and other pressure to appear ‘populist’ when the evidence for change is not compelling. LTV and LTI caps would be a blunt tool (paragraph 4.39).

130. And for this reason, we have also looked at the FSA’s proposals on non-income verified lending, where the current approach would be another ‘blunt tool’ likely to have as many damaging impacts as potential benefits.
Question 6: Do you consider that the FSA should prohibit the sale of mortgages to borrowers with multiple high-risk characteristics? If yes, what particular combinations of risk factors should the FSA consider prohibiting and why?

131. The market recognises the case for change. If caps on LTVs/LTIs and general product bans (such as self-certification) are blunt tools, how should the FSA address the problem? We believe the answer is more intrusive, targeted and tailored regulation of higher-risk lending, not the generality of the lending market.

132. Exhibits 4.12 and 4.13 list a number of higher risk borrower and product types. On closer inspection, the majority of these are linked to either the income verification or affordability assessment processes, which are discussed in detail in the DP. It is therefore likely that these higher risk combinations will face closer scrutiny under a new regime. This would, of course, include the highlighted ‘toxic’ combination of high LTV, self-cert and sub-prime characteristics (see paragraph 4.40).

**Exhibit 4.12:**

**High-risk products/borrower types**

<table>
<thead>
<tr>
<th>What are high-risk products/borrower types?</th>
<th>Why are we concerned?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest-only mortgage</td>
<td>A consumer may take an interest-only mortgage because s/he cannot afford a repayment mortgage</td>
</tr>
<tr>
<td>Offset mortgage</td>
<td>Debt can increase above affordable levels through an overdraft facility</td>
</tr>
<tr>
<td>Income non-verified mortgage</td>
<td>Income can be overstated</td>
</tr>
<tr>
<td>Low income mortgage</td>
<td>Income may not be enough to service a mortgage, particularly if consumer’s circumstances change for worse</td>
</tr>
<tr>
<td>High LTV mortgage</td>
<td>Consumers have higher debt in relation to income (note that LTI is not a good measure of general affordability and should be viewed alongside absolute income)</td>
</tr>
<tr>
<td>Remortgage with extra money raised</td>
<td>Consumer increases level of debt, potentially because s/he experiences financial problems</td>
</tr>
<tr>
<td>Mortgage term post-retirement</td>
<td>Income may not be sufficient for mortgage servicing after consumer retires</td>
</tr>
<tr>
<td>Unstable income</td>
<td>Future income can be unstable or uncertain</td>
</tr>
<tr>
<td>High LTV mortgage (90%+)</td>
<td>Consumers have small deposit in relation to loan size which may indicate inability or unwillingness to save</td>
</tr>
<tr>
<td>Impaired credit history mortgage</td>
<td>Consumers have previously defaulted on their financial commitments</td>
</tr>
</tbody>
</table>
However, like the FSA, we believe it is premature to answer this question about prohibiting the sale of certain mortgage product higher risk characteristics without analysis of the data.

We look forward to working closely with the FSA on its review of what has caused borrowers to go into arrears. We believe the vast majority relate to changes in circumstances, particularly in the current recession. Some of these risks may be mitigated by the borrower taking out insurance, such as mortgage payment protection insurance.

However, for a small minority of borrowers who are over extended in credit use, this will have been abetted by products for debt consolidation (where the borrower has continued to use other credit facilities as well) (see also the arrears and possessions analysis section above).

Multiple debt cases are at the heart of the problem of irresponsible borrowing, (the DP says in 88% of possession cases), and it is not clear to us that prohibiting certain mortgage loans would, on its own, stop irrational behaviour by the small minority.

We believe it is also important for the FSA and the industry to discuss what characteristics are truly ‘high risk’ and to whom. It is important to look at the product and borrower types, and take account of what a future home-ownership market should look like (in conjunction with the government).

To date, the aim has been to help borrowers, even marginal ones, to achieve their aspiration to become a homeowner. If the FSA takes a purist line on some of the borrower types, it will:

- limit the size and diversity of the future mortgage market; and
- permanently exclude some consumers who may aspire to become homeowners from ever entering the market.

This is a sensitive political and social question which needs careful regulatory handling, if the MMR is not to fall into the trap of shaping the future mortgage market in unintended ways.
Question 7: Do you consider that requiring verification of income by the lender for all mortgage applications is a viable option, and one which is sufficient to ensure responsible and sustainable levels of mortgage lending?

140. As the FSA is aware, and contrary to paragraph 4.46 of the paper, the case for product regulation of non-income verified mortgages is neither clear nor non-controversial. In fact, the income verification and affordability provisions have created more heat (and we hope light) than any other part of the MMR paper.

141. It is right, first of all, to say that the FSA’s analysis is broadly right, and the actions of outliers in the industry in the past (in their abuse of the self-certification product and unclear and inappropriate description of the ‘fast track’ process) have given the FSA good reason to consider an outright ban.

142. The growth of these products, and failures in credit assessment and security measures by some lenders, has allowed mortgage fraud to proliferate. With a backdrop of rising house prices, it has allowed higher consumption by some borrowers and the growth of debt consolidation by borrowers with multiple debts, which impacted adversely on a minority of both lenders and borrowers. But, these past mistakes have been addressed.

143. A number of the outlier lenders have left the market. Borrowers may be behaving more rationally in their use of credit based on recent lending patterns. Product offerings have been dramatically changed so that self-cert products have disappeared, and the fast track process, and how it is used, has been tightened.

144. The market, in summary, has self-corrected (although Jon Pain in a speech to the CML annual conference on 13 November 2009 suggested that this was “somewhat of a mirage”). A key preliminary decision is therefore to decide which view is likely to be right, and how we can know if past mistakes have been resolved temporarily or permanently?

145. Having said the market has self-corrected, we think that it is important to clearly differentiate self-cert from fast track. Self-certified mortgages are a product offering to a customer where the lender will ask the borrower to disclose their income, but will not verify this. The lender should check the plausibility of the claim, but this is more of a ‘common sense’ check.

146. This product was originally intended for those borrowers with complex and uncertain incomes (most notably the self-employed). The uncertainty of this income, and the fact that the lender will not verify claims, mean this offering is higher risk. Consequently, the product should be priced accordingly and may have other restrictions around maximum LTV and the credit history of the applicant.

147. However, Fast track is an underwriting process used by lenders to improve efficiency of service to lower risk customers, reducing costs. A key element of this process is that lenders will verify income on a risk-based approach. However, there are a number of other checks and balances in the fast track process, including an affordability assessment that lenders will continue to carry out in all cases.

148. The DP states that the differences between fast track and self-cert have been blurred by lenders actively marketing fast track to brokers and consumers, whilst at the same time relaxing the underlying lending criteria.

149. In paragraph 4.54 of the DP it states that ‘Some market analysts now suggest that, like self-cert, fast tracking has become an adverse loan characteristic that produces arrears rates that are worse than those of income-verified product’. We understand that this statement is based on the Moody’s Investors Services 2009 report, What drives UK mortgage loans to default. But, using Moody’s own criterion for significance (a difference of 25% or more – section 3.2 first paragraph), Chart 5b of this report (reproduced below) suggests that Moody’s found no clear evidence that fast tracked mortgages below 85% LTV pose a significantly greater risk of default than similar cases where income has been verified.
We understand, however, that the FSA needs to be assured that fast track is distinct from self-cert and that any risks posed by this process are minimised going forward.

To aid the FSA in the process we have collected and analysed data from our members on the performance of self-cert, fast track and income verified mortgages and have reviewed a number of lenders fast track policies to formulate parameters that could be used going forward.

**Income non-verified (INV) lending: profile and performance**

Due to the urgent nature of the analysis this survey was conducted within a closed user group of members, rather than our wider membership. Consequently the results are based on a smaller sample than is typical for CML statistics. 11 firms, representing about 51% of regulated mortgage lending, responded to the survey. These firms undertook a representative sample of income non-verified lending (both “fast track” and self-certified) and income verified, which is fit for the purpose of looking at the profile and performance of portfolios. However, we do not attempt to use this for gauging the size of INV lending in total or of its constituent parts.

**Definitions for Income non-verified lending**

For the purposes of this return, we have used the following definitions:

- **Self-certified loans** - those explicitly sold and marketed as self-certified;

- **Non-marketed fast track loans** - those where borrower and/or intermediary understands that proof of income is required, but in practice the lender does not verify these details because other characteristics of the application (for example borrower credit score or loan-to-value) make the loan sufficiently low-risk that income verification is unnecessary. The important distinction is the decision not to verify income is not communicated to the borrower and/or broker;

- **Marketed fast track loans** – those which are not branded or marketed as "self-certified," but where there is a communicated undertaking to the borrower and/or broker that income details will not be checked. Such methods of communication could include (but are not limited to), specific marketing, notes within the application form, or a message on the sourcing engine in the course of entering prospective applicant details.

Among the reporting firms, INV lending in total represented 51% of outstanding regulated mortgage balances. This is broadly in line with separate data from our Regulated Mortgage Survey, which covers over 95% of regulated lending, giving us confidence that the smaller sample for this survey is robust enough for analysis.
155. Within the total, only 14% of INV loans were self-certified, and the remainder was non-marketed fast track lending. No firms reported any marketed fast track lending (although we accept that this has been a feature of the market).

156. The over 3 month arrears rate for the entire sample of both income verified and non income verified is 1.43%. This compares with an industry-wide rate of 2.40%. We do not make direct comparisons, as only regulated loans from a small number of firms are reported in this exercise. Instead, we look at the sample of lenders INV loan performance relative to that of its income-verified portfolio.

157. Within the sample, the arrears rate for INV lending was 1.54%, compared to 1.35% for its income-verified portfolio. However, within the INV portfolio there was a very clear delineation between the different types of loan. Self-certified loans had an overall arrears rate of 6.21% – over four times the higher than the rate for the entire sample of reported loans (verified and non-verified). But fast track loans had a much lower arrears rate – just 0.98%. This is, in fact, significantly lower than seen for the portfolio of verified loans from the reporting sample (1.35%).

158. A similar story is seen for possessions rates. Within the sample, the overall possessions rate (defined as all regulated loans taken into possession at any point from inception to 31 October 2009) was 0.09%. Within this, for self-certified loans the rate was over 4 times higher at 0.39%. But for fast track it was just 0.04% - less than half the overall sample possession rate or the rate for income verified loans (0.10%)

159. This sits well with the industry opinion that self-certification, as a specific loan product, differs fundamentally from fast track, which is purely an underwriting decision to improve efficiency in processing low-risk applications. But it is important to consider other factors which could also account for differing default rates. Self-certified lending is traditionally of particular use to self-employed borrowers. And it could be that the self-employed, who in general will have less certain or regular income streams than the employed, may also have a greater incidence of arrears and possessions.

160. In fact, the data from the sample bears this out. It also demonstrates the same clear differentiation between the performance of self-certified and fast track loans, relative to the income-verified portfolio, both for employed and self-employed (Charts 1 and 2).

**Chart 1: Percent of regulated mortgages over 3 months in arrear, by type of employment**

Source: CML Research
Notes: Data as at 31 October 2009.
Chart 2: Percent of regulated mortgages taken into possession, by type of employment

- Self-employed
- Employed

Source: CML Research

Notes:
Relates to all mortgages taken into possession at any point since origination, through to 31 October 2009.

161. As relatively new types of loan, it is also possible that the portfolios of self-certified and fast track lending may have a different seasoning, relative to each other and to income-verified lending. So it is also important to control for this, as variance in lending and borrower characteristics throughout the economic cycle will result in different performance for each vintage of loans.

162. Controlling for the seasoning of each book bears out the same result. For each year of origination, self-certified lending performs significantly worse than the sample average, but fast track has consistently lower arrears and possessions rates. And, with the exception of arrears rates in 2005, fast track also outperforms verified lending (Charts 3 and 4).

Chart 3: Percent of regulated mortgages over 3 months in arrear, by year of origination

Source: CML Research

Notes:
Data as at 31 October 2009.
Data for 2009 originations are omitted, as sample size is too small to make robust inference.
163. Although this survey was limited in its coverage, it nonetheless demonstrates that income non-verified as an umbrella term covers two very different types of loan – self-certified, which is higher risk lending (and should be priced, underwritten and monitored accordingly), and fast track, which in stark contrast is low risk, as demonstrated by its significantly better performance record. This needs to be borne in mind when considering INV loans in totality, and the appropriateness of the regulatory response.

CML proposals

164. We believe the following is a more balanced approach than an outright ban. Through the CML’s mortgage market review steering group, we have obtained a number of fast track policies from members. From this we have developed a high level ‘strawman’ industry definition of fast track:

- A credit score limitation (to exclude those with a history of adversity).
- LTV limits – <=75%.
- Buyer type rules – excluding buyers with no / limited mortgage experience.
- Income related rules – excluding complex income cases.
- Employment related rules – excluding self-employed.
- Random sampling – to enable testing of income verification processes

165. The difficulty in defining fast track is to ensure that lenders have flexibility to be able to innovate and change, whilst at the same time providing the FSA with certainty that past abuses will not re-emerge. This is, of course, innate in a rules-based regulatory approach.

166. This problem is perhaps even more pervasive when looking at self-cert. It is clear that self-cert grew beyond its initial and intended market and was abused by some. The CML’s position is that self-cert is not a mass-market product, but it remains legitimate if used properly. Not all self-cert books have ‘unacceptable’ arrears rate. From a regulatory perspective, we can see that it may be attractive to ban self-cert and the reputational harm that the product has suffered may make it an unviable offering in the future.

167. Therefore, if self-cert is not banned by the FSA, it is important to review when a customer would find it difficult to verify their income. We believe these are the most likely scenarios:

- Self-employed: early start-ups who have yet to submit formal accounts.
• Self-employed: whose income is highly variable.
• Self-employed: with audited accounts which exercise tax efficiencies.
• Sole traders and partnerships.
• Self-employed contractors.
• Persons with multiple and complex income streams.

168. In addition and, similarly to fast track, we believe it is necessary to define the parameters in which it would be acceptable to continue to serve self-employed borrowers and those with complex income streams, as part of an effective underwriting process. Our initial view of what the parameters might be are:

• Credit score driven policies, excluding applicants with an impaired credit history.
• LTV limits – <=75%.
• Self-employed/complex income only and a justifiable reason for self-certifying.
• Maximum loan size

169. Further discussion is necessary, but we believe a ban would have long-term negative impacts which are avoidable. A key element to this discussion will be scoping the detail of what the FSA means by income verification, as no clear definition is offered in the DP. The definition should be broad enough to allow the customer types above to be able to obtain a mortgage. A simple definition may be that the lender is required to obtain proof of income from the borrower and will verify this using a robust source.

170. However, on its own, we do not believe the FSA’s proposed ban would ensure responsible and sustainable levels of mortgage lending – this has more to do with risk-based pricing, effective credit underwriting, stable funding, and a benign economy than whether the customer verifies their income.

171. Income verification based on paper documents would be subject to fraud and manipulation. We would therefore oppose any requirement that specified a purely paper based approach to income verification. Lenders increasingly rely on electronic verification from their own data, credit reference agencies and we hope new sources such as the HMRC data. Affordability approaches are more relevant than income verification per se.

Question 8: Do you agree with our proposal to require lenders to take ultimate responsibility for affordability?

172. The simple answer is, yes, lenders are ultimately responsible for affordability. They always have been and the lenders that ignored this basic tenet have suffered most – and been fatally undermined – by the recessionary impacts. However, behind this question is the more thorny issue of how this question relates to future regulatory approaches on distribution by intermediaries.

173. If the FSA had fulfilled its supervisory approach better in the pre-2007 period, the levels of mortgage fraud could have been avoided by earlier, more effective action and deterrence.

174. If the lender is formally and ‘ultimately’ responsible, how far is it safe for any lender to accept the actions of any intermediary which is not its agent? We come back to this crucial issue in response to later questions in Chapter 5. By imposing a clearer regulatory risk by its new approach, that lenders will be held ‘accountable’ for the lending decisions they have taken, the FSA will fundamentally restructure the market.

175. The FSA needs to be explicit what it means by ‘accountable’, not least because new regulatory requirements will also introduce new Financial Ombudsman Service (FOS) complaint risks.
If this is taken to its ultimate extreme, this could effectively make secured lending unsecured, if there is a risk that mortgages become unenforceable.

176. Ultimately, customers themselves are best placed to know if they can afford a mortgage, whilst the lender’s role is to determine, from information provided by the consumer, that they can reasonably maintain their mortgage payments at that point in time, and in the future.

177. By making the lender ultimately responsible, without re-stating the need for consumer responsibility it will transfer the risk from consumers, who arguably will have more incentive to withhold or manipulate the information they provide rather than less.

Question 9: Do you agree with our proposal to require lenders to assess affordability based on; (i) the borrowers free disposable income; (ii) a consumers borrowing capacity; (iii) the plausibility of the information obtained; and (iv) a capital repayment basis?

178. Paragraphs 4.68 and 4.87 on ‘prescribing affordability assessments’ need careful consideration by the FSA and its expert group. We agree that as a result of the restructure of the market following the credit crunch, and the greater use of technological support, the use of affordability models is higher now than when the CML and Oxera researched the market in 2006 (paragraph 4.70).

179. The question to be answered is what is a ‘robust’ assessment of ‘both’ income and expenditure? And if the responsibility for affordability sits with lenders, is the FSA enshrining costly duplication, as the intermediary will also need to look at affordability to assess the suitability of the product, but the lender will have to revisit (and repeat) the process itself? Exhibit 5.4 sets out a balance of responsibilities between lenders and intermediaries for affordability assessments. We comment in detail in question 15 below.

180. We agree that the starting point should be an affordability requirement that should apply across the mortgage market (paragraph 4.73) but it would be premature to conclude on its precise form with regulator and industry discussions at an early stage. However, we believe that lenders should generally not rely solely on LTI ratios. From dialogue with our members, two main approaches to affordability assessment have emerged:

- A model-based approach where the lender will use various data sources (including ONS data) to assess if the applicant’s income and expenditure claims are reasonable. The model will take into account the geographical location, the size of the income, the size and nature of the property and the number of dependants amongst many other factors.

- A manual approach, where the lender will review the applicants’ income and expenditure claims and take a view as to whether they are reasonable.

181. For both approaches, the lender will always take into account other secured and unsecured debts from a credit search. Some lenders also have a maximum LTI and/or DTI limit that will be used as an additional check. Some lenders will use a blend of the two approaches.

182. However, we believe in principle that prescription based on an amended version of the left-hand column in Exhibit 4.16 (paragraph 4.77), rather than the right-hand column, (which is an example of the manual approach), would be appropriate to reflect ‘best practice’ in regulation.

183. We would caution against requiring too much detail of a borrower’s discretionary spending, as by its very nature it can alter significantly as circumstances dictate. We believe that it is more fundamental that the borrower understands the nature of the debt they are taking on, and the risks posed by that debt, in order for them to be able to assess and prioritise any changes to their discretionary spending that are necessary. Furthermore, assessments of expenditure with any accuracy are extremely problematic as the FSA acknowledges.

184. Fundamentally, lenders should be focussed on establishing whether a customer can afford to repay the mortgage, not whether the lender can validate and prove every item of expenditure.
185. We agree with the proposed approach to consumer’s borrowing capacity set out in paragraph 4.79. By prohibiting loans to individuals who have a negative, zero or low borrowing capacity, the FSA rather than the lender would be excluding that consumer from the market. If the FSA had taken other prudential measures against ‘equity lending’, we believe that lenders will, themselves, choose not to lend. So, a regulatory prescription as suggested in paragraphs 4.80/4.81 should not be necessary.

186. The fundamental weakness in reliance on the affordability of the mortgage to stop irresponsible borrowing is recognised in paragraph 4.82. An affordability assessment is only truly valid on the day that it is done. The FSA has little (indeed no) control over consumers’ expenditure and debt accumulation following the mortgage approval.

187. This is a strong reason why more focussed measures addressing directly those minority of consumers who do not act in their best interests is more appropriate than focussing on the lenders. We comment further on consumer measures later in this response.

188. The FSA states that “full reliance on consumer provided information can result in unaffordable mortgages”. It is also true that some consumers can commit financial crime, even with written information.

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**Exhibit 4.16:**

<table>
<thead>
<tr>
<th>Gross income (permissible items only)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax and NI</td>
</tr>
<tr>
<td>Servicing of existing secured and unsecured debt</td>
</tr>
<tr>
<td>Utility bills and other household bills</td>
</tr>
<tr>
<td>Council tax</td>
</tr>
<tr>
<td>Service charges or land rent</td>
</tr>
<tr>
<td>Shared ownership rent</td>
</tr>
<tr>
<td>Cost of investment vehicle to repay interest-only loan</td>
</tr>
<tr>
<td>Insurance premiums</td>
</tr>
<tr>
<td>Pension contributions</td>
</tr>
<tr>
<td>Nursery/college/school/university fees</td>
</tr>
<tr>
<td>Alimony and maintenance payments</td>
</tr>
<tr>
<td>TV licence and communication</td>
</tr>
<tr>
<td>Regular savings</td>
</tr>
<tr>
<td>Other existing commitments</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Personal expenditure (Layer 2) for applicant(s) and dependents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food and drinks</td>
</tr>
<tr>
<td>Alcohol and tobacco</td>
</tr>
<tr>
<td>Clothing and footwear</td>
</tr>
<tr>
<td>Household goods and services</td>
</tr>
<tr>
<td>Health and personal care</td>
</tr>
<tr>
<td>Transport</td>
</tr>
<tr>
<td>Recreation, culture, restaurants and hotels</td>
</tr>
<tr>
<td>Holidays</td>
</tr>
<tr>
<td>Other miscellaneous goods and services</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contingency expenditure (Layer 3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prudent allowance for any missed or understated expenses (non-zero level at lenders discretion)</td>
</tr>
</tbody>
</table>

= Free disposable income

Basis to be used by lenders to assess consumers borrowing capacity
However, reliance on generic information does not pass the test that a particular consumer can afford the particular loan for which the lender will be "accountable". So a key issue is to what extent income and expenditure information can or must be verified.

The FSA states that “…there is no good reason why all expenditure information should not undergo some kind of scrutiny” (paragraph 4.84). But, what does this mean? The word used in paragraph 4.87 is “plausible”.

The FSA seems to suggest “proxies” can be used, such as ONS family spending data, but will this give absolute protection to the lender against future consumer complaints or FSA intervention on the basis that the loan turned out to be “unaffordable”?

Sharing of data is key. In relation to income, it would be helpful if the government through its tax authorities could provide a service to lenders to help them confirm borrowers’ past income. The FSA aspires to “all credit information” being shared by lenders through credit reference agencies (paragraph 4.86). This is not a realistic aspiration as part of the MMR process or timetable.

The FSA recognises the cost to industry, but believe it is necessary “to ensure transparency and consistency of affordability assessment processes across lenders”. It goes on to say in paragraph 4.88 that “These changes will lead to a reduction in arrears and repossessions numbers as no mortgages will be sold that are unaffordable at the outset and this will reduce mortgage related losses for lenders.” We remain unconvinced that this is true except at the margins of outlier businesses, and has to be compared to the overall cost to the whole industry of change.

The final part of this question relates to the proposal to require interest-only mortgages to be assessed on a capital repayment basis. As this is currently in MCOB as guidance (MCOB 11.3.6G) most lenders will already assess affordability on a capital basis and the proposal to make this a requirement is unlikely to have a significant impact. However, there would need to be consideration of transitional issues for any customer who wished to remortgage and could not meet an affordability test on this basis.

A perennial concern amongst lenders is the regulatory uncertainty that surrounds the repayment vehicles used by consumers to repay the capital for an interest-only mortgage. Whilst it would be very difficult for lenders to do any more than is currently required in the regulation, the concern about the long term commitment of consumers to maintain a repayment vehicle is a thorny issue both for lenders and the regulator to consider.

This is especially relevant as borrowers who do not pay their mortgage at the end of the term are likely to be entering into the later stages of their working life, and lenders will have little option but to extend the term of the mortgage (potentially when a borrower is nearing retirement).

Lending into retirement is an area where views amongst lenders differ and further clarification may be beneficial. Whilst these issues are of concern, in the context of the mortgage market review and broader regulatory change, they are not the most pressing and should not be seen as an immediate priority.

So, in summary, there is an ongoing debate to be held on affordability assessments. It would, therefore, be premature to answer question nine affirmatively, but the industry recognises its fundamental regulatory, commercial (and social) responsibility to lend to borrowers who can afford to repay their loans.

**Question 10: Is the increased focus on affordability the right way to ensure sustainability of lending and consumer protection?**

No, as stated above, affordability is a key component but not a conclusive one ensuring sustainability of lending and consumer protection. Essentially, an affordability assessment is a snapshot of the applicant on that day, any number of unforeseen events (notably loss of income, change in family circumstances etc) could significantly change the balance.

The following table has been compiled by White Horse Mortgage Services (who provide debt counselling services to customers in arrears on behalf of lenders) following interviews with 21,500...
borrowers throughout 2009, to determine the primary reasons for falling into arrears. As with the findings in 'Turning the Tide', economic factors outside the borrowers control and changes in personal circumstances were given as the primary reasons for falling into arrears (76.88% of cases).

**White Horse Mortgage Services**

**The whole of the UK**

<table>
<thead>
<tr>
<th>Economic (Outside influence of borrower)</th>
<th>59.71 %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment Resolved</td>
<td>9.04 %</td>
</tr>
<tr>
<td>Unemployment Unresolved</td>
<td>13.76 %</td>
</tr>
<tr>
<td>Reduced Income Now Resolved</td>
<td>16.08 %</td>
</tr>
<tr>
<td>Reduced Income Unresolved</td>
<td>20.83 %</td>
</tr>
<tr>
<td><strong>Lifestyle (Under direct control of borrower)</strong></td>
<td>23.12 %</td>
</tr>
<tr>
<td>Over Indebtedness Now Resolved</td>
<td>2.11 %</td>
</tr>
<tr>
<td>Over Indebtedness Unresolved</td>
<td>3.23 %</td>
</tr>
<tr>
<td>Financial Mismangement</td>
<td>17.78 %</td>
</tr>
<tr>
<td><strong>Personal (Circumstances suffered by borrower)</strong></td>
<td>17.17 %</td>
</tr>
<tr>
<td>Relationship Breakdown</td>
<td>7.96 %</td>
</tr>
<tr>
<td>Ill Health - Recovered</td>
<td>4.02 %</td>
</tr>
<tr>
<td>Ill Health - Long Term</td>
<td>5.15 %</td>
</tr>
<tr>
<td>Other Reasons</td>
<td>0.04 %</td>
</tr>
</tbody>
</table>

Source: With kind permission of Whitehorse Mortgage Services Ltd, February 2010, Bulletin [pre-publication version]

201. Lenders maintain that the credit score is the most vital component of existing affordability determinations, which is not mentioned at all by the FSA in the DP.

**Question 11: Are there any additional policy levers we should use to curtail income inflation and related mortgage fraud?**

202. The range of measures already in place, in particular building on the Information from Lenders Scheme (IFL) set up by the FSA with CML support, are effectively addressing the financial crime risk at source. Given that this was launched in 2006, and revised in 2008, we believe that there is no reason why lenders should not be reporting cases to the FSA on a routine basis and suggest that reporting to the IFL is made mandatory.

203. Income inflation is seen by many as not being fraud and, if it is, it is a victimless crime that has no penalty. We strongly believe that more needs to be done to ensure that consumers are aware of the consequences of manipulating or providing false information to lenders. It should be made clear that if caught they will find it extremely difficult to obtain a mortgage (or any other credit) in the future, and that, under the Fraud Act 2007, it is a criminal offence.

204. A key element of this deterrent is that lenders share information with credit reference agencies and fraud tools and agencies such as National Hunter, National SIRA and CIFAS. We believe that the industry would benefit if there was a standard definition of mortgage fraud that would ensure consistent reporting. We are not convinced that this needs to be a regulatory definition, and may be something that the industry can develop in conjunction with the National Fraud Authority.

205. Finally, the HMRC has been running a pilot scheme offering a number of lenders the ability to check the validity of P60s and other official documents. This scheme ran for over a year and has recently been suspended, pending possible termination of the project. During the life of this pilot, lenders report that it has helped them detect and stop tens of millions of pounds worth of potential fraudulent applications. We believe that this service is essential and would be extremely disappointed to see it end, instead of being made available to the whole of the market on a permanent basis by the tax authorities.
Question 12: Do you think that the FSA should limit the amount of equity a consumer can withdraw from their home?

206. No, we do not think it is the FSA’s role to ‘nanny’ consumers by limiting the access to their own equity by preventing withdrawals by regulation. This would put the FSA in the place of the consumer. It is inconceivable that the regulator should impose its collective judgement on individuals, and would be perverse as the FSA itself says there is “no reason to suspect that equity withdrawal in itself is a problem” (paragraph 4.96). While a number of lenders do have LTV caps for customers who are remortgaging for debt consolidation purposes, ultimately the key determinant is whether the customer can afford the increased mortgage. Lenders would not want to see a limit enshrined in regulation.

207. We accept that further analysis and assessment needs to be undertaken, but this is not an acceptable ‘solution’ to a problem affecting a small minority of consumers at most.

Chapter 5: Distribution and Advice

Question 13: Do you agree that we need to strengthen the selling standards for non-advised (information-only) sales to ensure consumers are only entering into contracts which are both affordable and appropriate?

208. Yes, we agree that selling standards for non-advised sales need to be strengthened. In paragraph 5.7, the FSA concludes that there is little rationale for increasing capital resource requirements for mortgage intermediaries. Is it a shared conclusion reached with the Financial Ombudsman Service and the Financial Services Compensation Scheme based on their respective experience? We are prepared to accept this outcome, although intuitively, we do not believe it is right.

209. At the heart of this, we believe that a greater distinction needs to be drawn between advised and non-advised sales. We are concerned that, even with the best efforts of the industry, consumers may not be fully aware of the difference. One way to ensure effective differentiation is to allow non-advised (and advised) sales through lenders, but not to allow non-advised sales through intermediaries.

210. Paragraph 5.17 suggests 91% of introduced business is advised at present, and we believe extending this across the intermediary market would be a clear way of helping to avoid consumer confusion, and at a reasonable cost, bearing in mind intermediary firms will all provide advice in the majority of cases at present (paragraph 5.15). It may also worth clarifying what is meant by advice; at present it is narrowly focused on the product.

211. Also, if intermediaries do not have a non-advised option, it simplifies future relationships between intermediaries and lenders, if the income verification and affordability approach in the DP is introduced.

212. If consumers want a non-advised route, then money guidance would be a good protection against irresponsible borrowing (see below in this response). In addition, approaching a lender direct is an obvious option. The lender would in any event be responsible for affordability and so the regulatory issue would be what form an ‘appropriateness’ test should take.

213. There is a danger here that, without sufficient clarity, a consumer will confuse an appropriateness test with ‘suitability’ advice, further blurring the required distinction between advised and non-advised sales. We would be happy to discuss with the FSA how the appropriateness test might operate in practice.

214. Of course, we would wish to avoid this being a blunt tool which disadvantages intermediary firms who believe they can offer an information service by telephone or internet (but not face-to-face). Whether this is the right approach in the future to clarify relationships in the market depends on a considered CBA in the usual way.
However, fundamentally, we need to enshrine a compliance culture in smaller intermediary firms to ensure better consumer outcomes are routinely delivered in the future, or the structure of intermediary firms needs to change.

Question 14: What measures should the FSA take to ensure sales standards in advised sales meet the needs of the market and appropriately protect consumers?

We agree that additional measures are needed to ensure proper sales standards in advised sales (whether by intermediary or lender). We support stress testing to reflect upward movements in rates and long-term affordability. 2% has been suggested in the consumer borrowing capacity description, but is this sufficient with interest rates at the current historically low level (paragraphs 4.79 and 5.18)?

We agree that an explanation (based on the Mortgage Code’s ‘reason why’ letter) would be eminently sensible, as we said before MCOB was introduced in 2004 (see paragraph 5.18).

We would be happy to discuss lending into retirement with the FSA. We have not seen the scale of actual rather than theoretical consumer detriment. It is not a major area of mortgage complaints, so we remain to be convinced that further intervention is necessary or that it is a priority for the MMR (paragraph 5.18).

We accept there is a significant potential risk when niche products are sold beyond their target audience (eg, self-cert products). Product design should be clear to borrowers. Intermediaries should match product and customer, and explain their advice, so that it is immediately apparent if a product is not suitable – which would, of course, be included in the re-introduced suitability letter. The lender has a final role to play to ensure affordability.

Question 15: To what extent should intermediaries retain responsibility for assessing a consumer’s ability to repay? How could this work in practice?

As stated, the lender bearing ultimate responsibility for assessing and verifying affordability in every sale is accepted (paragraph 5.19). However, rather than removing uncertainty about the respective responsibilities of lenders and intermediaries, we believe it would create significant new practical issues between both parties and their ongoing relationship with the customer. Therefore, reluctantly, we have concluded that the industry needs to fill this gap by writing guidance on the rights and responsibilities of lenders and intermediaries to address this lacuna.

Not to pre-empt the output of this work, it is logical that if the adviser is responsible for suitability, they should be looking at the detail of the customer’s lifestyle, and their ability to adapt to change and shocks. To advise on suitability, it should be necessary to look in detail at the income and expenditure of the customer on an individual level. This complements the role of the lender which is to determine if the customer can reasonably afford the mortgage.

The DP sets out some of the practical issues for lenders and intermediaries and attempts to set out the balance of responsibilities in Exhibit 5.4 on paragraph 5.23. This demonstrates the complexity of what is proposed and the potential either to embody new regulatory risks for lenders (where the intermediary obtains and assesses documentation) or duplication of cost and wasted time for consumers (where the lender obtains the documentation as well as the intermediary adviser). Neither route described in Exhibit 5.4 is attractive.
Depending on how a lender is 'accountable' for the affordability decision, it may conclude that it has no option but to cease the current arrangements which, in most cases, have served customers well (paragraph 1.12). This would be a negative market impact.

We would not expect lenders to enter into agency relationships with intermediary advisers, so they would have no option but to do the checking themselves, duplicating work, increasing cost and extending the mortgage process. The only caveat to this would be a pragmatic approach being taken to the affordability assessment, and the extent to which individual borrower data is needed rather than generic information.

If an intermediary does not use individual data, it cannot assure the lender that the mortgage is affordable to that individual (and the lender will be held ‘accountable’). If generic information is used, it does not stop the irrational borrower who does not act in his best interests (in the FSA’s view).

The question asks to what extent intermediaries should retain responsibility for assessing a consumer’s ability to repay. The answer is the extent necessary to ensure the sale and advice is ‘suitable’ for that individual. The question also asks how could this work in practice? We are not sure it can, but this is where our work on rights and responsibilities and the FSA’s working group on income verification and affordability will need to complement each other.

**Question 16: Do you agree that suitability letters should be introduced as a compulsory standard?**

We agree in principle that suitability letters should be introduced as a compulsory standard when advice is given. It was a core, successful element of the predecessor Mortgage Code and should be implemented as soon as possible, for the reasons set out in paragraph 5.26. However, we would require clarification from the FSA as to whether the timing of its issue in the borrowing process might prevent it being used effectively in ‘shopping around’.
As a suitability letter would become a material document in the advice process, it would clearly become a fundamental part of any complaint considered by the FOS. Consequently, there is a real risk that the document could become generic, littered with caveats and, ultimately, not serve the purpose it is intended to achieve. Therefore, we would like to see clear guidance from the FSA, and essentially a buy-in from the FOS, about how the suitability letter would function.

**Question 17: What are the implications of applying the Approved Person’s regime to all individual mortgage intermediaries?**

Although the question specifically refers to mortgage intermediaries, it has become clear through discussions with the FSA and the publication of CP 10/2 that the intention is that it should extend to cover lender staff.

For mortgage intermediaries, particularly if mortgage advice is a compulsory requirement through this channel, we believe, in principle, the regulatory reasons for action are strong. However, we are unable to assess the potential costs against the real consumer and systemic benefits. Therefore, we would be happy to review this in the light of intermediary feedback to the FSA.

We would welcome the resumption of the FSA’s work looking at the potential implications for extending the approach to lenders. However, we first need the FSA to outline what roles would be covered by the proposal, as well as define ‘arranger’ and ‘adviser’. It is vital that roles such as collection staff are not caught up in this proposal.

Proposals that carry significant costs (paragraph 5.37) need particularly careful analysis against the likely benefits. We are concerned that the proposal to include lending staff as currently framed could place disproportionate administration burden not only on lenders - but also the regulator, with costs passed on to authorised firms. The FSA will need to provide definitive clarification of which roles it intends to capture within this proposal before we can scrutinise the cost benefit analysis outlined in the FSA’s recent consultation.

Whilst the burden of proof will rest with the individual, the majority of the processing work will be carried out by the lender and/or the FSA, as is the case at present. Lenders currently carry out their own checks on the information provided by an individual as part of the application to become an approved person.

As we understand, this often results in the FSA processing applications faster than the seven day Service Level Agreement – something that will be particularly important if the regime is extended to advisers and/or arrangers; a typically dynamic and high-churn workforce.

However, these turnaround times are likely to be compromised, not only by the increase in application volume, but by the number of en bloc applications that will need to be processed for existing lending staff. We understand that en bloc applications already present problems for lenders and the FSA, with turnaround stretching to months in some instances.

We would welcome a steer from the FSA whether it intends to streamline or standardise the process in light of the proposal (if it proceeds).

Responsible firms already do all they reasonably can to mitigate the reputational risk of employing somebody lacking honesty, integrity and propriety. Many lenders will already collect much of the information expected of an approved person as part of their recruitment process. As such, is the FSA able to put a value on: duplicating these requirements; and asking ‘additional’ requirements asked of lenders (which will differ depending on firms’ specific recruitment processes) as set out in the FIT section of the handbook?

Where the FSA is concerned with recruitment processes and suitability of staff within outlier firms, we would argue that regulatory intervention specifically targeted at those firms is more appropriate. There is a risk that, with little evidence put forward to support the rationale, widening the approved persons regime for all lenders may be over-engineering a solution to the FSA’s aims.

An alternative would be to require the relevant staff in the functions within lenders to be individually registered. This would enable the FSA (and firms) to track individuals if they move...
between lender and intermediary firms and more importantly it would enable the FSA to suspend or remove the registration if an individual has not acted appropriately.

**Question 18:** Do you agree with our conclusion not to read across the adviser charging element of the RDR proposals into the mortgage market?

240. We are prepared to accept the FSA’s conclusions that there should not be a read across on the adviser charging element of the RDR proposals into the mortgage market, although based on past surveys our members' views are mixed on this issue.

**Question 19:** Are there any other considerations that are relevant to the assessment of the issues and risks posed by the current remuneration model within the mortgage market, which are not identified within the DP?

241. Paragraph 5.44 points out that the income verification proposals are designed to address mis-selling of self-cert products. If some self-cert products for niche borrowers, eg, self-employed, do continue, we would need to review again how to avoid product bias.

242. We agree that the approach is targeted regulatory action in niche segments, as set out in paragraph 5.4.8.

**Question 20:** To what extent should the proposals for a PSB as outlined in the RDR be extended to the mortgage market?

243. As proponents of a compulsory qualification CEMAP, under the Mortgage Code, we are pleased that the FSA found no evidence of a lack of training and competence in the mortgage market (paragraph 5.51).

244. We have no additional comments at this stage on this, but we would see merit in the area of professionalism for there to be a read across from the investment market in the RDR to the mortgage market.

**Question 21:** Do you agree that simplified scope of service labelling, limited to ‘independent’ or ‘restricted advice’ and also describing a non-advised service as ‘information-only’, will result in better consumer understanding of the services on offer?

245. We have no particular views on the scope of service labelling at this stage, other than that consistency is needed between the mortgage market and others. We have concerns over consumer understanding of the term ‘restricted’ advice as it could be taken to mean that the knowledge or experience of the adviser is limited, rather than the number of products/providers they are able to advise upon.

246. However, in conclusion on this Chapter on distribution, it is right to warn against unintended consequences, if the cumulative impact of the various measures cause further consolidation in the mortgage intermediary sector. Our working hypothesis is that the two-thirds shrinkage already experienced in this sector will have got rid of the non-compliant firms and individuals already, so the regulatory aim must be to help the good firms that remain, not submerge them in further unnecessary layers of costs.

**Chapter 6: Disclosure and Changing Consumer Behaviour**

**Question 22:** Do you agree with the proposals to; (i) remove the requirement for the IDD and replace with disclosure of key messages; (ii) retain use of the KFI; and (iii) require elements of disclosure to be carried out on an oral basis?

247. We do not agree with the proposal to remove the IDD as the alternative of a free-form terms of business letter fulfils the same function, which would incur significant cost on the industry without any clear benefit to the customer. There is a case that the IDD could be used more effectively to demonstrate the benefits of different services (i.e. the benefit of an advised sale vs. non-advised).
248. We strongly support the retention of the KFI (despite its faults), and are particularly wary of the risk of European-led changes to the disclosure requirements. It is very likely that the KFI will need some changes as a result of the broader proposals in the MMR.

249. We oppose making any regulatory requirements on disclosure deliverable orally rather than in writing. It is a recipe for disaster unless combined with a highly expensive and disproportionate requirement to record all interviews. Although there is no current regulatory requirement for oral disclosure, generally the documents are not left static and lenders will require key elements to be discussed as part of the interview process.

250. We, therefore, await the outcome of the analysis of oral disclosure in the insurance market with some interest. Of course, the impact of oral disclosure on the risks for short-term insurance are very different to the long-term nature of mortgages.

Question 23: Do you agree that the limitations on the rationality of consumer behaviour in the mortgage market support the case for greater regulatory intrusion?

251. We believe that prudential reforms on top of market consolidation, self-correcting measures by lenders in a rationed mortgage market, largely address the issue of irresponsible lending (but could be complemented by measures for those firms engaging in higher risk lending or outliers who would naturally attract greater regulatory scrutiny). The issue of changing consumer behaviour is more thorny.

252. We have already suggested that the evidence shows consumer behavioural changes in the last two years both in relation to new secured and unsecured credit levels, and some repayment of existing debt. However, by their nature, irrational borrowers might, in the FSA view, revert to type when economic circumstances change.

253. In our view, most borrowers have acted rationally, taking advantage of relatively cheap finance against an asset that was increasing in value, and the mortgage market has served them well. Although it is clear, with hindsight, that borrowers' assumptions at that time were positive, it is not irrational for a consumer to have a positive outlook when taking on long term debt in a mortgage.

254. Indeed, if they did not have a positive attitude toward this risk, they would not take on a mortgage in the first place. However, a small minority borrow on multiple credit facilities and show 'addictive' behaviour patterns which flow much further (and indeed are more acute) in other credit markets, eg, borrowing on credit cards.

255. We believe it is important to distinguish between investment and borrowing decisions (relevant to buy-to-let regulation – see later). It is important to differentiate between 'good' consumption and, in the FSA's view, 'bad' consumption, eg, equity withdrawal to provide a deposit to a first-time buyer may be acceptable, whereas serial remortgaging for debt consolidation might not.

256. We fundamentally oppose the underlying purpose of the MMR, as we read it, which is to make the lender responsible if the loan goes wrong, and we believe the tenor of the document is to step back from the principle of 'caveat emptor' and retaining some consumer responsibility.

257. If consumer behaviour is to be changed, it should be through measures targeted at consumers, not lenders.

258. So, if there is a case for greater regulatory intrusion (and there is in the case of multiple debts by marginal, niche mortgage borrowers), how should the action be targeted?

259. The FSA doubts whether greater transparency or financial capability (in the short term) will provide an answer (paragraph 6.11). As structured, the FSA is right, but just as measures for higher risk lenders are probably necessary (see above), so measures for "higher risk consumers" need to be identified.

260. This would still be consistent with "helping consumers to understand their current responsibilities" (paragraph 6.15) and is explicitly not seeking to change the balance of responsibilities between lenders and consumers. In fact, we believe the MMR would do this by swinging the
pendulum of responsibility firmly towards the lender. So, in effect, the FSA is re-opening the debate about the appropriate balance of responsibilities (paragraph 6.15 is, therefore, wrong).

261. We also think that there should be a clear statement that consumers cannot expect to benefit from the protection of regulation, if it is found that they have not been truthful on their mortgage application.

**Question 24: Do you agree that the FSA has a role in preventing the extension of credit to individuals who are unable to afford such high levels of debt?**

262. We agree that the FSA, and the OFT, have a role in preventing the extension of credit to individuals who are unable to afford high levels of debt. Equally, they have a responsibility to target measures at higher risk consumers –

- who disregard their financial circumstances;
- who take an over-optimistic view of their future finances;
- who fail to disclose accurate background information (or actively lie); or
- who act on the spur of the moment without due consideration of their buying decisions (particularly in respect of other consumption when already committed to a mortgage).

263. Some innovative thinking is necessary by the regulator, not simply making business life more difficult for regulated firms simply because it is easier to introduce new rules.

264. For example, in the USA, FICO scores are used to educate consumers about their credit status and to inform firms about the relative risks of different individuals. We have discussed whether, and how, to introduce a similar approach in the UK with some credit reference agencies, but to date without success.

265. This may be something which the FSA could take a lead on to improve consumer knowledge of the impact of their own credit status, and how to improve their status (building on the Debt tool launched as part of the initial financial capability work on which the CML worked with the FSA).

**Question 25: Do you have any comments on the financial capability initiatives designed to support the overall mortgage market reform?**

266. Paragraph 6.17 has the kernel of the real answer to address ‘addictive’ consumer behaviour. “There is . . . evidence that targeted information and advice designed to reach the right people at the right time, improves outcomes for consumers”.

267. All the FSA and OFT need to do is identify the minority of “right people” who need help, and get to them at the ‘right time’ – i.e., before they are financially committed – put simply, prevention rather than cure through debt advice.

268. The FSA has identified three work streams but only one is at the ‘right time’ – money guidance. We agree that looking at triggers for arrears and the court process are relevant for the “right people”, but it is too late. And significant work has been done elsewhere on consumer messages on arrears and possessions, not least by the government and the industry themselves, so this should not be a primary focus of the financial capability work of the FSA.

269. So, the financial capability agenda of the future has to have twin tracks for the immediate future to resolve current problems but, as importantly, put in place long-term measures to change consumer behaviour by money guidance.

270. How could it work? Well, money guidance is already focussed on those who are “vulnerable to the consequences of poor financial decision making.” So, first identify the ‘right’ people – a small minority of borrowers. Then, get to them at the ‘right’ time.

271. If the aim is to make consumers stop and think before they buy, should the aim be to give money guidance outside of a sales environment, and removed from the adviser and lender? A dispassionate review of an individual’s financial circumstances, as a compulsory pre-application step
for higher risk borrowers (as defined). It could, for example, be used for first-time buyers (but not returners), impaired credit or multiple credit users, lending into retirement or equity release.

272. The Consumer Financial Education Body and other trusted advice services currently in place could fulfil the role independently.

273. In the United States, we understand pre-purchase counselling has been used in the past, but we have not seen evidence of its impact. However, a dispassionate, independent view could at least remove the consumer from the immediate pressure of a particular house purchase, or other purchase to extract equity from an existing property.

274. We think measures focussed on higher risk consumers, but not all borrowers, should be a key component of the MMR package to redress the pendulum of risk and responsibility swinging too far towards lenders as currently drafted.

Chapter 7: Arrears and Possessions

Question 26: Do you have any comments on our proposals to strengthen our approach to firms’ arrears management practices?

275. We have been highly proactive on arrears and possessions issues since before the recession, working in tandem with the FSA and government. Therefore, in principle, we are very supportive of the measures outlined – many reflect industry best practice guidance. A lot has been achieved so far to improve the structure of the market –

- The regulation of sale and leaseback companies.
- The prospective regulation of purchasers of distressed books.
- The introduction of earlier income support for mortgage interest.
- The retention of a high standard rate for charge for ISMI, substantially above the base rate so that more borrowers on higher interest rates could be protected from repossession.
- Increased funding for debt advice.
- Better targeted messages at an early stage to borrowers so that advice can be sought before arrears’ problems have built up.

276. These initiatives have been matched by lenders’ commitment to strengthen their own arrears management practices –

- Industry wide and individual moratoria against taking possession have been introduced to allow time for forbearance.
- Working with government to identify the percentage of borrowers who allow voluntary repossession to see if other measures can be taken.
- Improving communication to tenants affected by landlords not paying their mortgage.
- Using the receiver of rent rather than possession in rental cases where the rent would cover the mortgage payment.
- Monthly liaison with debt advice groups on emerging issues and future trends through the Home Finance Forum and other avenues.

277. So regulation is a backstop to a much wider array of activity to help borrowers through the economic downturn.
For firms who have treated their customers fairly, it is an important test of the FSA's effectiveness as a supervisor whether appropriate enforcement action is taken against outlier firms, whilst ensuring that it is consistent in its approach to considering customer fairness when addressing arrears handling practices.

While the specific practical proposals will need to be reviewed as part of the detailed consultation, moving more towards rules rather than guidance is accepted in principle. The precise proposals and the CBA on which they have been justified have only just been published. There is an inherent risk that moving from guidance to rules will require firms to give “advice”, whereas at present they do not. This would have serious systemic and financial implications for firms if it was an unintended consequence of the strengthening of current MCOB rules.

However, it is also clear to us that not all forbearance tools should be required, eg, potential membership of the government’s homeowner mortgage support scheme would be an unwelcome distraction to most lenders. And defining which arrangements should not be subject to ongoing arrears charges will not be straightforward, as we comment below in answer to the questions on future data collection.

We also agree that the terms of future securitisations should be sufficiently flexible to allow lenders to manage arrears with appropriate forbearance. However, any changes for the future should avoid unintended retrospective consequences on past issuance.

We will work with the FSA as its analysis of arrears charging practices evolves. It is right that the customers which create these costs should have to bear them (except where they are adhering to an agreed arrangement to repay arrears). However, the proposal to ban arrears charging if there is an agreed arrangement requires careful definition, and lenders should still be able to pass on fees which they have to pay to their outsourced service providers, which need to remain financially viable to provide cost-saving services, as well as third parties (e.g. debt counselling undertaken during the arrangement period).

We would caution the FSA against becoming a price regulator, either in the case of arrears charges or more widely. The profit mix of lenders vary and the regulator should not intervene on prices and the commercial nature of the market (and the OFT’s recent legal case on bank charges also provides relevant background to this debate).

An FSA “baseline” figure would contradict the principle that the charges should match the lenders’ costs. Indeed, setting a cap on many product fees would be inappropriate, as these are related to price of the product, as opposed to fees which are related to costs.

One of the lesser known, but vitally important, areas of the review relates to lenders’ relationships with third party administrators (TPA). We need to ensure clarity in the rules vis-à-vis outsourced arrangements as well as cases where TPAs are, or might become, the ‘lender’ responsible for decisions on interest rates, arrears policy, etc.

The TPA market is more complicated than described in the MMR paper, and the future regulatory direction needs more thought (despite the warning comments issued recently by the FSA). We have been pleased to facilitate informal discussions between TPAs and the FSA. We understand the FSA will be carrying out more visits which should help inform future policy and improve upon the current regime which has been described by the regulator itself as a “patchwork”. Primary regulatory compliance must remain with the lender, as currently outlined in the SYSC section of the Handbook.

These discussions need to continue to identify the right way forward (as part of the FSA review mentioned in paragraph 7.13). We would be happy to provide detailed comments as a supplement to this paper once the FSA's ongoing analysis has been progressed further. It is difficult to usefully comment in detail now based on the scarce references to TPAs in the DP.
Chapter 8: Unfair charging practices and price regulation

Question 27: Do you consider that the mortgage market fees and charges reflect the underlying costs or are consumers paying excessive charges?

288. It is understandable why the FSA should want a more “interventionist and robust” approach to monitoring and enforcing against “excessive” and “unfair charging practices”. Of course, what is ‘excessive’ or ‘unfair’ is often open to debate, as seen in the recent bank charges case in the Supreme Court.

289. The commercial attractiveness of any market is dependent on its financial return (up front costs, profit margin and subsequent fees for additional services). It is also increasingly dependent in the financial services sector –

- on the level of perceived regulatory risk;
- on the clarity or certainty of that risk remaining unchanged (subject to regulators and politicians changing the goalposts);
- on the perceived threat of intervention in relation to regulatory reviews or consumer complaints levels undermining the financial return expected from commercial business.

290. The more that regulators seek to box financial firms into a corner to reduce their scope for movement, let alone innovation, the more firms will have to price assuming the regulatory worse case outcome. Put simply, regulatory changes looking at price (and charging practices) affect attitudes about willingness to remain in particular markets, and at what price.

291. So, we believe the FSA should exercise caution in its work on charges and fees, if it is not going to lead to unintended consequences across the market. The FSA should not assume a higher price is ‘excessive’ because it is higher. The high fee/low rate trade off (and vice-versa) is an entirely suitable product choice for borrowers to be given. Market-wide interventions to address outlier charging practices carry more risks than benefits to consumers in our view.

292. We rebut the suggestion that lenders are ‘profiteering’ on their mortgage pricing, or asking consumers to pay excessive charges. As commercial companies, they are entitled to a fair return.

293. The fact that mortgages will be less widely available, and routinely more expensive in the future, is a consequence of a more rational market with higher regulatory risks and requirements that need to be met and reflected in the price.

Question 28: What would be the impact of consumers not being allowed to roll up intermediary fees and product charges into the mortgage loan?

294. We do not consider rolling up fees into the mortgage is a characteristic of a higher risk consumer acting irrationally. Consumers should already be making an informed choice in this regard, given that MCOB rules already require advisers to explain the implications of rolling fees into the mortgage.

295. We do not believe, therefore, that this is a proportionate response to the minority of customers who have got into difficulty and will instead limit consumer choice. The reality is that borrowers already have to provide a substantial deposit so fees and charges are a minor part of the overall entry cost.

296. Consumer behaviour would suggest some borrowers would otherwise take out a second loan to pay for fees if unable to roll them up into the mortgage loan, or perhaps be excluded from the mortgage market altogether (first time buyers, for example). We see no real value from this restriction for anyone in the market. We would be surprised if the FSA analysis (paragraph 8.8) suggests otherwise.
Chapter 9: Scope extensions

297. As the government is consulting on scope extensions, the FSA does not ask any questions in Chapter 9. The broad intention is to widen the FSA's regulatory scope, but not to have retrospective effect, so a key transitional issue will be how to manage parallel regulatory regimes with different consumer protection measures in place.

298. It is right for us to put on record that we support the FSA regulating second charge loans under MCOB (as amended) rather than Consumer Credit Act provisions (our policy position since 1999).

299. We are concerned about the impact on low cost home ownership schemes, particularly, shared equity, such as HomeBuy direct. Generally, local authorities and housing associations would be exempt thereby excluding purely government homebuy schemes but as drafted it is likely that private developers would be caught. The impact on LCHO needs to be properly considered before the FSA work through the technical detail of regulation.

300. We are unconvinced and unclear about the Treasury's arguments for regulating buy-to-let transactions. The aim is, first, consumer regulation. In which case, we would argue the decision to invest in property is the regulatory trigger, not the decision on how to finance the deal by a mortgage.

301. Both the Treasury and FSA fail to set out how they would regulate investment advice to consumers – property investment clubs – who arguably have been at the centre of many of the causes of detriment identified in recent years.

302. It should be noted that our comments throughout the paper are limited to the FSA's current scope of mortgage regulation and do not apply to any potential or future regime that could include buy-to-let mortgages.

303. There is a second regulatory purpose which is prudential to ensure BTL lenders do not represent any systemic risks. We believe that this is a relevant area to review further, rather than MCOB-like regulation of some consumer-led BTL transactions as we believe the FSA already has sufficient powers in the vast majority of cases.

304. As stated in paragraph 9.28, a key consideration will be defining the characteristics of such investors to ensure that regulation is not applied more widely than necessary.

305. Despite all the debate so far, we are yet to identify a viable definition that would achieve the stated regulatory aims.

306. Finally, whilst we see benefits for requiring all purchasers of mortgage books to be regulated, we do have concerns about how this may impact on current and future securitisation deals. Therefore the wording of the proposed legislation needs to be carefully considered to ensure that it covers only those mortgage book owners that have a material impact on borrowers.

Chapter 10: Other matters for discussion

Question 29: Do you agree that the FSA should collect data to enable us to track arrears and possessions cases back to the original product transaction on a permanent basis? What would be the costs imposed on the market?

307. As noted above, we agree and have lobbied for purchasers of mortgage books to be regulated to ensure consumer protection measures are in place across the market (paragraph 10.4). This is urgent as it leads directly into possible future trends in arrears and, more specifically, possessions, and whether consumers have appropriate forbearance and fair treatment in every case.

308. In order to track this, the FSA needs to enhance its data requirements from lenders (paragraph 10.5). We have, with industry support, been happy to track arrears/possessions cases back to the original product transaction on a voluntary basis.
We have committed to continue this voluntary initiative, and work closely with the FSA on its analysis of CML data, to ensure proper conclusions are reached on what further regulatory requirements might be necessary (paragraph 10.8).

We are happy to continue to do this until the FSA has authority to collect the data on a permanent basis. The costs imposed on the market would not be negligible, but small compared to the benefits of better decision making on targeted regulatory action as discussed in the answer to previous questions.

There is the potential for the FSA to adopt a less prescriptive approach to mortgage regulation by virtue of both its improved ability to identify and address outlier activity by firms, and more insightful MI reporting to boards and peer group benchmarking services across lenders that would support good practice. Some FSA action on data reporting might also help support investor confidence in the securitisation and covered bond markets.

Question 30: Do you agree the FSA should standardise some existing industry definitions such as sub-prime? And if yes, are there any existing definition issues other than sub-prime?

The CML has, over many years, strived to ensure lender reporting based on industry definitions on a consistent and standard basis. Progress has been faster in some areas than others, but we agree that FSA action could serve as a useful catalyst for imposing greater consistency of reporting, meaning and certainty.

With respect to sub-prime, our previous work on definitions and reporting has flagged that there is a very wide continuum of risk profiles, embracing myriad combinations of past arrears, default, IVA and bankruptcy circumstances, differentiated also according to number, magnitude and recency.

While it is possible to stratify these into broad clusters, the approach is necessarily somewhat arbitrary, and still potentially subject to variable interpretation across lenders. An important starting point would be for the FSA to decide on the period of time prior to a loan application for which adverse credit information is pertinent, and specifically what credit events would be relevant.

We have previously shared with the credit risk team of the FSA the definitions we have used in our closed user group reporting exercises and we would be happy to work with the FSA to develop these further.

However, these issues are also highly relevant to the work of credit reference agencies and rating agencies, and the FSA therefore needs to be careful to build a broad consensus in favour of change. This is unlikely to be a rapid process.

An intervening early step might be for the FSA to define what it regards as a prime mortgage, which would then at least allow stakeholders to introduce the notion of FSA-conforming mortgages, an approach analogous in some ways to that taken by the government sponsored enterprises in the US (Fannie Mae and Freddie Mac) and which has facilitated the development of significant standardised reporting.

Loan performance data already represents an important area of regulatory reporting and, understandably, this is likely to become progressively more important over the coming years. In this context, it would seem sensible for the FSA to ensure that reporting of arrears is as meaningful and consistent as possible - particularly if the FSA equates arrears with consumer detriment (which we believe is overly simplistic and simply wrong).

There are three aspects where FSA could consider better guidance (but it is not a CML proposal, and would require detailed discussions on the costs versus benefits of changes):

- Treatment of flexible mortgage terms, which give the borrower some automatic rights to take a payment holiday or draw down past capital payments. Both situations can facilitate a borrower facing financial difficulties concealing problems for a protracted period of time, in a way that is potentially unhelpful from the lender MI and regulatory reporting standpoints, and potentially also for subsequent forbearance strategies.
• Concessions and arrangements. Q3 MLAR reporting suggests that in about a third of arrears cases there is an agreement in place between the borrower and lender, but that the vast majority of these represent arrangements rather than concessions. This looks implausible, given our understanding that concessions relate to situations where less than full contractual payment is permissible for a short prescribed period, and that arrangements are situations where the borrower is repaying more than the normal contractual amount and so reducing past arrears. The FSA should strengthen its guidance in this area and also to ensure that firms are only reporting those agreements that are being adhered to by the borrower. This is also relevant to how easy it will be to implement the change being proposed in the forthcoming consultation paper on arrears and repossessions.

• Arrears capitalisation. Current FSA rules do not specify how or when firms should capitalise past arrears, although there is a requirement that loans that have been capitalised should continue to be reported according to their arrears status at the time of capitalisation until such time as the borrower has fully complied with the agreement underpinning the capitalisation for an unbroken period of six months.

**Question 31: What are the potential compliance costs if the FSA collected better data on fees and charges directly from lenders on an ongoing basis as part of regulatory reporting?**

320. Unless the FSA is planning to intervene in price setting or charging practices, it would not be appropriate or proportionate to routinely collect data on an ongoing basis. We have strongly cautioned against this regulatory route in our previous answers.

321. Of course, increased regulatory reporting is feasible (although, if it is to be consistent, some firms will face more costs of change than others). We would not wish to specify the potential compliance costs across the industry, as we are yet to see the benefit that will flow from such action as part of ongoing regulatory reporting.

**Question 32: Are there any additional measures that you feel the FSA could take to reduce the risk of financial crime?**

322. We have worked in close liaison with the FSA on financial crime issues, and believe the measures under way are comprehensive and will be effective in delivering a better framework for the future, as highlighted in answer to earlier questions. We would be happy to consider any measures proposed by other respondents, if the FSA believes they may be relevant.

**Question 33: Do you agree that the cumulative effect of the policy levers as outlined within our DP will have a positive effect on; (i) the equity release market; and/or (ii) the right to buy market?**

323. We found it interesting to juxtapose the comments in paragraph 9.18 on buy-to-let with paragraph 10.29 on equity release. The DP says the lack of funds makes the former unsustainable, but a similar conclusion is not reached on equity release (indeed the FSA says there is no evidence the market is unsustainable). Maybe it needs to take more account of the number of market participants that have exited as a result of no access to funding?

324. Having said this, we agree that, if funding returns, the equity release provisions in MCOB have largely worked, so we would hope this niche market will remain. However, with the prospects for funding uncertain, we are less sanguine than the FSA on the likely future for this market.

325. The measures put forward by the MMR paper and elsewhere will not have a positive effect on the equity release market, but it is difficult to judge to what extent it will accelerate further exits from the market by existing participants.

326. We believe that the policy measures are also, at best, neutral for the right-to-buy market. We certainly do not see the case for additional measures for these sales.

327. Finally, although no question is posed, we share the FSA’s concerns about the dependencies of some UK measures on possible EU policy developments. This should inevitably extend the
transitional period for any mortgage market changes in the UK so that a complementary approach can be taken here and across Europe.

28 January 2010