Policy briefing

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FSA CP11/31 Mortgage Market Review: Final Consultation and Reform Package

Summary

The Financial Services Authority (FSA) has published proposals aimed at reforming mortgage market regulation. This follows earlier consultations and feedback statements through 2009-2010. Key proposals unveiled last month include:

- **Advised versus execution-only**: an advised sale will be defined as any sale that stems from any sort of consumer-seller interaction, in which case the seller will have to assess suitability. Execution-only will only be possible in limited situations, such as if there is no interaction, if the customer is high net worth, or in some situations if the customer does not wish to take the advice. The non-advised regime will be effectively scrapped.
- **Vulnerable customers:** the rules will be stricter for vulnerable applicants to protect them from unknowingly making unsustainable commitments. These will have to receive advice, and (in sale & rent-back situations) will have to take it.
- **Affordability assessment:** self-certification mortgages will be banned and income will have to be verified in every mortgage application. In assessing affordability, lenders will have to stress-test interest rate changes and consider major outgoings such as heating and council tax.
- **Interest-only mortgages**: would still be allowed but lenders will have to be stricter about assessing repayment vehicles. Relying on rising property values will be severely restricted.
- There will be a transition process and existing borrowers will be unaffected, and there will be flexibility to provide new mortgages to existing customers even if they fail the new affordability requirements.

Next Steps

- **Consultation closes:** 30 March 2012.
- **Rules embedded:** Feedback Statement and final rules are expected on or about Summer 2013.
- **Flexibility on implementation:** the FSA explained that they will "have regard to market conditions" and defer implementation if necessary. Alternatively, if there is widespread support for certain proposals, they might implement those earlier.

Background to the FSA Mortgage Market Review

On 19 December 2011, the FSA published its latest and possibly final consultation paper on its Mortgage Market Review (MMR), a review of the residential mortgage market by the regulator with the aim to create "a sustainable mortgage market that works better for all participants". This consultation paper, plus supporting data as well as links to previous papers, have all been published here: www.fsa.gov.uk/pages/Library/Policy/CP/2011/11_31.shtml

The MMR saw an initial discussion paper in October 2009 followed by a series of consultations through 2010:

- Arrears and Approved Persons: this consultation in January 2010 included proposals to bring those who advise on and oversee the sale of mortgages from both lenders and intermediaries. This was finalised in a Policy Statement published on 24 June 2010.
- Responsible Lending: this consultation was published in July proposed changes to solidify responsible lending provisions, including requiring lenders to conduct an affordability test on all applications and verify borrowers' income, as well as extra provisions for vulnerable consumers with an impaired credit history. This consultation closed on 16 November 2010.
- Distribution and Disclosure: published in November 2010, it proposed to introduce an "appropriateness test" to be undertaken by the distributor for all mortgages both advised and non-advised to ensure that the mortgage is appropriate to the customer's circumstances. It also suggested that all individuals selling mortgages (including in non-advised situations) meet the same qualification requirements of QCF Level 3.

Overview of CP11/31

Following these earlier consultations and policy statements and "extensive discussion and debate with market participants" that ensued, the FSA has now pulled it all together and consulted on the entire package of mortgage proposals. At the core of this are three principles of good mortgage underwriting:

- lenders should assess affordability;
- borrowers should not sign contracts which are only affordable on the assumption that low initial interest rates will last forever; and
- interest-only mortgages should be assessed on a repayment basis.

While some of the proposals set out in this paper have been previously consulted on, many are entirely new and reflect the regulator's revised thinking following discussions with industry and consumer groups:

Distribution and disclosure:

- **Intermediaries must check that the borrower meets the lender's eligibility criteria.** This was floated in the previous consultation.
- **All mortgage sales stemming from consumer-seller interaction would be seen as advised.** Otherwise they are execution-only.
- **Execution-only barred for certain types of "vulnerable" borrowers.** This includes equity release, sale & rent back, and debt consolidation (but not first-time buyers).
- The last two proposals reflect entirely new thinking by the regulator following previous debates about "appropriateness tests" set out in the last consultation. See the section below for further details.

Responsible lending:

- **Effective ban on self-certification:** lenders must verify income and be able to demonstrate affordability in terms of borrower's income and expenditure. Self employed borrowers: the regulator believes that income could be verified through evidence of taxable income, which businesses are required by law to provide to HMRC.
- **Mandatory interest rate stress tests:** the lender must also take account of the impact on mortgage payments of market expectations of future interest rate increases.
- Lenders will be allowed to waive some of these affordability requirements for existing borrowers for a transitional period.

Interest-only mortgages:

- Lenders must assess affordability on capital & interest basis.
- They must obtain evidence of a repayment strategy before signing off interest-only mortgages, and reasonably check that this strategy would work. They must also check on this "repayment strategy" at least once during the term.
- Where the repayment strategy requires the borrower to make regular payments from income, lenders must assess affordability taking the cost of the repayment strategy into account.

Arrears management:

- Further clarification provided on how firms should be calculating arrears charges.
- Limiting the number of times direct debits can be presented each month.
- Widening the arrears charges and forbearance rules to cover all payment shortfalls.
- Removal of the rule allowing firms to remove borrowers from concessionary interest rates if they go into payment shortfall.

Prudential reforms:

- Considers the reforms and key policy changes that will implemented under Basel III and concludes that they would not in themselves be an effective mechanism for deterring high-risk lending, hence the need for MMR.
- Non-deposit taking lenders: these institutions have a greater exposure to the higher-risk (non-conforming or sub-prime) market and therefore policies aimed at restricting this will have a greater effect.

Niche markets:

- **Equity release:** proposal to create a single equity release market comprised of lifetime mortgages and home reversions as substitutable products. Therefore under disclosure requirements, intermediaries offering just one of these would be classed as "restricted". Equity release customers would not be able to opt-out of receiving advice, but would not be obliged to take it.
- **Home purchase plans**: part of the appropriateness assessment for this type of product should be whether a conventional mortgage should also be considered.
- **Sale & rent-back:** because consumers of these types of products are vulnerable in that they are facing financial difficulties including repossession, they would not be able to opt out of receiving advice, and also not be able to press ahead on an execution-only basis if the advice was not to buy such a product.
- **Bridging finance**: the lender is not required to assess affordability for these products, but must assess whether the consumer has an appropriate repayment strategy, in line with the interest-only policy. Bridging finance would have maximum 12-month term to prevent gaming.

Distribution Requirements

The consultation sets out some significant changes to the distribution and disclosure rules, reflecting an evolution in the FSA's thinking even since consultation CP10/28 on this subject published last November. Key among the changes is its thinking on advice versus execution-only.

Advised, Non-Advised or Execution-Only

- **Existing confusion between advised/non-advised:** the regulator argues that much of the problem related to distribution stems from the confusion of what advised and non-advised actually means, and this is not helped by the definitions in the existing mortgage conduct of business rules:

  - "advised" means that the seller conducts a suitability and appropriateness assessment for the individual consumer;
  - "non-advised" requires the seller to ask the customer to seek advice if the seller suspects that the customer is making an inappropriate purchase; and
  - "execution-only" means purchasing the product without interaction.

- **Risk of mis-selling:** the root of the FSA's concern is that for "non-advised" mortgage sales (34% of all mortgage sales), the customer is able to buy a mortgage that is inappropriate without receiving any warning from the seller. Consumers could also confuse non-advised with execution only.
- **Scrap the proposal for "Appropriateness Test"**: the CP10/28 consultation suggested requiring the seller to check the appropriateness of non-advised as well as advised sales, and to disallow the sale if the test fails. This idea has now been dropped on the grounds that it would create an all-advised market in all but name, and only add to customer confusion.
- "**Clean up**" **the definition of advice:** instead of appropriateness tests, the regulator suggests that it would be easier to make the definition of advice more meaningful to consumers.
  - *Advice* as any situation where an *interactive dialogue* between the customer and the seller.
  - *Interactive dialogue* could include face-to-face, telephone or any other two-way interface including email, SMS, internet "live chat", etc. Includes any personalised question & answer.
  - Scrap the non-advised sales process: the regulator now asserts that it would be far more intuitive to customers to create a simpler "advised" versus "execution-only" choice.
  - Non-interactive purchases such as pure on-line or postal sales would be transacted on an execution-only basis.
- **Professional and High Net Worth can opt out of advice:** where professional customers are defined as someone who has worked in the financial services sector for at least one year in a professional capacity which requires knowledge of the transactions or services envisaged.
- **Advice required for certain types of products or consumers:** including equity release, right-to-buy, sale & rent-back, and customers consolidating debt. The view is that these customers are considered vulnerable.
- **Customers retain option to reject advice**: and opt for an execution-only purchase, this would apply to all customers except in sale & rent-back situations.

Professionalism

The proposals in this consultation have not changed significantly from CP10/28 in November 2010. All staff selling mortgages would be required to hold a "relevant professional qualification" at QCF Level 3.

- Other assessment methodologies would be allowed to achieve this.
- Existing people not at this level will have 30 months from the time the rules enter force. Now joiners joining at any time after the rules come into force will also have 30 months.
- The mortgage QCF Level 3 syllabus will be reviewed once the final MMR and implementation date is agreed, then it would be reviewed every 3 years.

Implications

- Advice defined as seller-customer interaction: could this lead to firms reducing their customer service availability for prospective buyers in effort to avoid giving advice?
- Categories where advice must be provided: it seems strange that first-time buyers are excluded from this list as these are also vulnerable to interest rate or payment shocks.

- The proposals could move more customers into direct rather than introduced sales. For example giving lenders responsibility for verifying income and assessing affordability would involve them in the application process more closely, thus reducing the benefit of introduced or intermediated sales.

European & International Activities

An important factor in the development of the MMR is the knowledge that this review is not going on isolation, with work going on at European and international levels. As regards the latter, the Financial Stability Board is taking the lead on improving international standards for mortgage underwriting, and is now consulting on a principles-based framework.

Whilst this international work is under way, a far greater implication to the MMR is the work at the European level. The European Commission (EC) has been undertaking its own review of the residential mortgage market across Europe and in March 2011, published a legislative proposal which is currently being debated in the Parliament and European Council. Critically, the proposed directive takes the form of a framework, intentionally allowing member states to tailor and enhance national regulation to more effectively serve the needs of their particular market.

The debate continues and the European Council has recently tabled a compromise proposal which seems closer to the FSA's approach, and it is difficult to determine when an agreement would be reached and what this would look like. However we can look at the areas of convergence and divergence:

Convergence/Compatibility	Divergence
• **General approach:** the proposed Directive generally adopts a higher-level approach than the MMR and is not intended to be a substitute for national policy makers developing the appropriate detailed framework. • **National market compatibility:** Member State markets remain very different in their character. • **Responsible lending:** the aims align closely with the MMR objectives. • **Affordability assessment:** there is considerable consistency in the preferred approach, both the FSA and EC seem to be after a robust assessment of the affordability of any new lending.	• **Scope:** the EC focus on secured residential lending, whereas the FSA prefer to go wider with all mass-market consumer borrowing towards residential property, including buy-to-let, bridging finance, credit union lending. • **Disclosure:** the EC and FSA seem to be in a different place regarding pre-contractual disclosure. Having learned the lessons from the existing regime since 2005 that relied to heavily on written disclosure, the FSA have re-aligned its approach; whereas the EC is opting for a much more detailed KFI-type European Standardised Information Sheet.

Market Reactions

The mortgage industry seems to support the FSA for listening to their concerns and creating a more balanced set of proposals. Obviously there will be mixed opinions on the details, especially the advised/execution-only distinctions.

Council of Mortgage Lenders (Paul Smee):

- Whilst there is much detail to be pored over, the FSA's new proposals seem to strike broadly the right balance.
- If lenders are to make their contribution to improving the supply of housing and to the wider agenda for economic growth, then they need a regulatory framework which also supports that objective.

Association of Mortgage Intermediaries (Robert Sinclair):

- They have brought responsible lending into a place that just about fits the current market. The FSA have taken away a lot of the nastiness and listened to the market, which has taken us to a place which is sensible.

Building Societies Association (Paul Broadhead):

- The devil is always in the detail but these proposals seem to represent a welcome shift in policy by the FSA.
- No-one is looking for a regime that permits lax lending practices, however the original proposals were in danger of locking credit worthy borrowers out of the market or imprisoning those with immaculate payment records, but non-standard profiles, in their current homes and loans.

Nationwide Building Society (Andrew Baddeley-Chappell):

- We welcome the review and the fact that the FSA has responded to the issues raised by borrowers and lenders. However, the current mortgage market is fragile and growth is relatively weak.
- With this in mind, we question whether now is the right time to ask the industry to divert its focus onto further regulatory changes.
- Even more regulation, expected from the EU, is likely to result in further changes to the regulatory framework. It would be far better for the UK and European regulation to happen at the same time.

Coreco Group, a firm of independent mortgage brokers/financial advisers (Andrew Montlake):

- We are especially pleased that the FSA has recognised proper advice should be the cornerstone of any mortgage proposal and that there is indeed a large degree of confusion from the general public over whether they are receiving advice or not.
- This is a brave and necessary step taken by the FSA which not only levels the playing field between Mortgage Brokers and direct lenders, but will improve the prospects for all consumers taking out the largest loan they are likely to obtain in their life.

Countrywide Estate Agents and Property Services Group (Grenville Turner):

- In an environment where lenders are already being extremely cautious with their lending criteria; by placing all affordability assessments at the doors of lenders risk teams this could create an even stricter lending environment.
- However, lenders now have an opportunity to adapt their verification procedures to ensure that self-employed customers, who traditionally used self-certified products are not left out in the cold.
- One of the measures that can be considered is assessing the spending patterns of the applicant rather than entirely focusing on income levels.

Yorkshire Building Society (Andy Caton)

- The move to require some borrowers to undertake an advised process appears to be a positive one, however we would like to see clarity on the definition of 'vulnerable' and 'high net worth' customers.
- It is also important that individuals are able to select an execution only service, whichever channel they choose to use.
- Finally, the industry must be given appropriate time to implement any new systems and processes and we would urge the FSA to consider this when setting any timetable for implementation.

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