

# eacg Response to the Mortgage Market Review

Lynda Blackwell,  
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Financial Services Authority,  
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LONDON,  
E14 5HS.

January 2010

Dear Ms Blackwell,

## **DP09/03- MORTGAGE MARKET REVIEW**

The ea Consulting Group (eaCG) has been closely involved with Retail Distribution Review. We now welcome this opportunity to respond to the above discussion paper impacting on another key and closely related market sector. eaCG has extensive experience of the UK mortgage scene including assignments undertaken for a range of leading high street banks and building societies.

Whilst the responses to the specific questions raised in DP09/03 are to be found in the appendix, we believe it appropriate to outline below our initial thoughts over the new proposals to regulate the mortgage market.

Overall, the DP represents a thorough review of the mortgage market and is to be commended to all interested parties. We do, however, have a number of concerns. Firstly, the consumer must always appreciate and be aware that any "adviser" is in effect a salesperson and it remains appropriate that the principle of *caveat emptor* should apply. Whilst every effort should be made to protect those individuals who are financially naive, equally, if appropriately advised, they must retain personal responsibility for any action taken.

Any casual reader of DP09/03 might be led to believe that the mortgage market is characterized by malpractice and yet we know for the vast majority of mortgage customers there has been no consumer detriment. We must seek an appropriate and proportionate regime. Where serious criminal activity has occurred amongst so-called professional advisers then the law of the land should apply hefty penalties to those convicted thereby discouraging others similarly tempted by the prospect of wealth creation.

A market in which house prices are stagnating (or falling should supply exceed demand) will fundamentally affect the mindset of both lenders and borrowers. All things being equal, both should adopt a more conservative approach. The proposals in the Mortgage Market Review (MMR) must be valid for all economic conditions.

We must also recognize that fast rising house prices in the past fuelled by easy access to mortgage finance have, with hindsight, been a major cause of social problems in the current downturn.

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Lenders have played their part but equally government policy created an economy driven by consumer credit with no saving for a rainy day. Whilst on one hand promoting savings (eg pensions, stakeholder regime) the government has conversely been very dependent on VAT receipts requiring a spend-spend culture to finance public service reforms. The regulator with the Bank of England must ensure that such market conditions contrary to longer term economic viability cannot be created in the future.

Enhanced prudential controls should also dictate that mortgage products are accurately risk-priced, discouraging fringe buyers. We must not forget that a buyer desperate to obtain a mortgage for a new property will often be blinded to warnings and details of charges irrespective of whether delivered orally or on paper or both. In such circumstances, few will shop around but summary documentation in a format permitting easy price comparison should be made available in case of need.

Going forward we must ensure that a consumer seeking a mortgage (or in difficulties with the repayment of their mortgage) is appropriately advised. The MMR is to be commended for its common-sense approach to *appropriateness* and *affordability* with the lender assuming responsibility for the latter. Adviser asymmetry however must be anticipated as financial capability remains in its infancy in the UK and will do so for many years to come. The information provided should be sufficient for the average consumer for a particular type of product to make an informed choice (eg right-to-buy situations are different to mainstream mortgage sales processes).

With regard to nomenclature, eaCG greatly dislikes, like many commentators, the use of 'restricted' for non-independent advice. Despite claims that the term adds clarity this appears far from true with elementary testing confirming that few individuals share a common understanding on its precise regulatory meaning. As with the RDR proposals, eaCG believes that the consumer gains a far better understanding of the advice offer available if the depolarization terms are adopted (ie single tied or multi-tied advice). We do, however, fully accept that 'non-advised' is a confusing term for consumers and 'information only' should be adopted where no advice is provided.

There is a fear of the UK enduring a double dose of new mortgage regulation should the EU introduce a similar but non-complementary Mortgage Directive or one governing product disclosure. In the absence of any major consumer detriment in the UK it is imperative that any of the MMR proposals finally implemented do not conflict with any likely EU legislation on the subject. The FSA priority must be in influencing the relevant EU officials to ensure that the UK is not disadvantaged by a second wave of unnecessary mortgage legislation tinkering with the MCOBS rulebook.

If further clarification is required on any point please contact me.

Yours faithfully,

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Appendix

## RESPONSES TO QUESTIONS RAISED IN DP09/03 MORTGAGE MARKET REVIEW:

### **Q1: 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?**

The various prudential reforms should protect the tax payer from a repeat of the recent funding difficulties experienced in the banking sector when wholesale funds all but dried up ultimately driving banks/building societies into new ownership or nationalization. The requirement to hold higher levels of capital against a stressed economic scenario should ensure the greater stability and therefore viability of banks/mortgage lenders although debate will ensue about the appropriate level and definition of capital (eg gilts) especially during any upturn. With the introduction of overt counter-cyclicality it is conceivable that a stable market will only be achieved by higher capital standards that will result in far more expensive products restricting the demand for residential mortgages. Depending upon market supply, rented accommodation may prove more attractive in the longer run. The demand for buy-to-let mortgages is expected to remain low for the foreseeable future as question marks remain over the use of property as a pension asset.

### **Q2: 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?**

The FSA is correct to conclude that the impact of additional capital on higher risk loans is at best 'uncertain'. It is a strange policy that effectively protects a less well off consumer by making a non-mainstream product even more expensive. It is always an irony that individuals who can easily cover capital repayments and interest enjoy finer interest rates than those with more limited incomes. Such additional interest charges may well make a lending decision marginal. As recognized, applying additional (higher) capital requirements will not protect borrowers from applying for 'riskier' loans as the drive for home purchase for a young family will be a very powerful driver. Borrowers must, however, retain their own personal responsibility for entering into any lending agreement.

### **Q3: 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?**

YES: Overall, it is believed that non-deposit taker lenders have been favoured by lighter regulation in the past (MIPRU) and far less demanding capital requirements. Focusing generally on higher risk lending they have also displayed poor commitment to the mortgage sector during the economic cycle. Although the CP09/17 reforms already propose the use of board approved 'asset limits' on higher risk lending it is appropriate for the FSA to demand increased prudential standards specifically for non-deposit taking lenders. Any player in the mortgage sector must show long term commitment to their customers and, as currently structured, non-deposit lenders pose a systemic risk floating in and out of the market as they are permitted to do as economic conditions fluctuate. Prudential regulation should monitor and control such forays.

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## **Q4: Are there any other considerations that are relevant to the issue of how prudential requirements influence mortgage market outcomes?**

DP09/03 contains an accurate portrayal of the likely impact of prudential standards on mortgage market 'outcomes'. Ultimately, mortgages are just one of a number of lending products offered by banks and building societies and capital provision is essentially treated at a macro rather than sector level. The motives behind prudential regulation are different to that of conduct of business and it is the latter that will largely control a satisfactory 'outcome'.

## **Q5: 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?**

YES: The analysis provided in DP09/03 supports the conclusion that loans should not be limited by thresholds (eg LTV). Clearly, a mortgage commitment is just one of a number of repayments that an individual must pay and levels of overall indebtedness will vary from family to family. Ideally, mortgage support should be dependent upon a straight affordability calculation.

## **Q6: 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?**

NO: Affordability is the key criteria and lenders should always be cognizant of a potential 'toxic' mix (i.e. high LTV, credit-impaired, unstable income) and treat any application on its individual merits. Potential borrowers must be made aware of the risks involved in obtaining a mortgage as part of the advice process. Outright bans on the sale of mortgages to groups with specific higher risk characteristics should not be necessary. Apart from social issues, prohibition might lead would-be borrowers into the hands of less scrupulous lenders with punitive rates of interest.

The FSA is over stepping the mark in its assertion that '.....we believe that prohibiting such sales might help to protect consumers from the consequences of imprudent borrowing and might help to protect lenders against the consequences of imprudent lending' [Section 4.45]. Borrowers at the margins will endure a famine in mortgage finance irrespective of any regulatory thresholds and specific figures or matrices are too inflexible for those just on the wrong side of the line.

## **Q7: 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?**

YES: Income verification is an obvious route to limit excessive earnings claims. Although it may be more difficult for the self-employed to provide accurate income figures this is not an insurmountable problem. Income verification should be adopted as it will lead to more appropriate levels of mortgage support across the industry especially at a time when house price inflation is low (or indeed negative).

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## **Q8: Do you agree with our proposal to require lenders to take ultimate responsibility for affordability?**

YES: This clear requirement will be welcomed by all parties. Whilst intermediaries should ensure themselves that any new mortgage commitment is affordable ultimately the lender must be satisfied that an application meets their own specific criteria confirming repayment capability.

## **Q9: 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?**

A long period of escalating house prices encouraged lenders to act like pawnbrokers fundamentally looking at the value of the underlying asset (and then anticipating further inflation) with mortgage limits set by earnings multiples. However, as recognized in the DP text most lenders now adopt an affordability assessment model in order to calculate a consumer's free disposable income and repayment capability. The FSA rightly identifies affordability as a cornerstone of the MMR as in limiting mortgage funding it effectively provides consumer protection.

Clearly, any assessment of affordability must take into account income and expenditure and the ability to service any new mortgage alongside any existing commitments. If the information available conflicts with existing knowledge or is contrary to the conclusions drawn from interrogating the customer's bank statements the lender must be placed on enquiry. If a consumer is unable to substantiate an income claim the figures involved cannot form any part of an affordability calculation. Written evidence must confirm figures in any application and ideally all white/black information should be shared with credit reference agencies. The latter is seen as key in combating mortgage fraud.

Whilst in the majority of situations calculating affordability on a capital repayment basis is entirely appropriate there may be circumstances when it is not (ie maturing policy, asset sale, trust income etc). The new proposals should retain some flexibility if lenders wish to offer interest-only mortgages and the consumer has an instrument to repay the debt.

## **Q10: Is the increased focus on affordability the right way to ensure sustainability of lending and consumer protection?**

YES: Proof of affordability is a relatively straightforward action that can protect the consumer from the excesses witnessed in the marketplace in recent years. Lenders have already adapted to new economic circumstances and with funding difficulties we have witnessed a wave of building society mergers. With more benign market conditions, we agree with the FSA that affordability is the key lever in delivering a viable mortgage industry more closely allied to the needs of the consumer. *Caveat emptor* should still apply. The latest MMR proposals must create an advice process highlighting all the relevant information so that an appropriate and informed choice can be made.

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## **Q11: Are there any additional policy levers we should use to curtail income inflation and related mortgage fraud?**

NO: Major mortgage fraud should be treated as a serious criminal matter and the prospect of prosecution and imprisonment should discourage offenders.

## **Q12: Do you think that the FSA should limit the amount of equity a consumer can withdraw from their home?**

NO: Consumers should be free to withdraw equity from their main home. Should we be entering a period of low house inflation then it is likely that equity withdrawal will be less popular than in the past. Affordability assessments should ensure that the repayment capability of an applicant is not adversely impacted by such equity release. Capital gains tax will, of course, apply where a second home is involved.

## **Q13: 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?**

It is very important that any non-advised/information-only sales process is proportionate whilst meeting the needs of its main users. We are not convinced that major changes are required. For a mainstream mortgage product 'appropriateness' is a given for an individual seeking to purchase a property over a longer term. We should be mindful, however, that if consumers are denied access to mortgage funds because of income verification requirements they may well seek an information-only sale despite the financial risks involved. Closing this loophole will add a level of complexity and cost to situations where formal advice is not given. Consumers that do not heed financial warnings must accept their own culpability should things go wrong. The FSA proposals must ensure that these warnings are given and understood. First and foremost, a consumer should always be recommended at the outset to take advice.

## **Q14: What measures should the FSA take to ensure sales standards in advised sales meet the needs of the market and appropriately protect consumers?**

As recognized by the DP09/03 text, the existing suitability requirements have proved effective in the advised sales process in handling the potential areas of consumer detriment. The new proposals do include one major initiative refocusing the existing sales rules on providing adequate explanations rather than on straight fact finding. This change reflects article 5.6 of the new Consumer Credit Directive due to become effective in June 2010. Consistency of regulation in similar fields is to be commended and, with obvious benefits to the consumer, eaCG supports this development.

Of the other suggestions, greater stress testing to cover upward movement in rates has some merit although the consumer's free income will also indicate what buffer is available. To avoid a myriad of rates for use in such exercises, the FSA or Bank of England may wish to publish a rate at least annually that indicates what they believe to be the upper limit that might be seen for standard mortgage finance. Commonsense dictates that niche products should only be made available for their target audience and warnings specific to the newly retired are also appropriate.

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## **Q15: To what extent should intermediaries retain responsibility for assessing a consumer's ability to repay? How could this work in practice?**

Mortgage intermediaries should, irrespective of the responsibilities of the lender, always undertake a full income and expenditure breakdown to ensure they are satisfied their client has the repayment capability for the mortgage sought. This breakdown (and any other supporting information e.g. bank statements) duly signed by all parties as accurate must be passed onto the lender.

## **Q16: Do you agree that suitability letters should be introduced as a compulsory standard?**

Suitability letters should be optional for any mainstream mortgage product. Their adoption should, however, be compulsory for the rarer products such as 'right to buy' mortgages where a suitability letter might serve as an ongoing reference document for individuals more likely to be financially naïve. All intermediaries must retain full and accurate records of the customer's needs, circumstances and any recommendations.

## **Q17: What are the implications of applying the Approved Person's regime to all individual mortgage intermediaries?**

We recognize that there will be benefits in applying the Approved Person's regime to mortgage intermediaries although it is disappointing that economically this move is driven primarily by fighting financial crime rather than by the delivery of higher industry standards. Set-up costs for lenders accurately calculated, in addition to FSA expenditure, must be a major consideration in deciding whether to proceed. This is no simple exercise. Handling new adviser applications to an acceptable standard will require time and thought and the cost of covering ongoing clerical maintenance of the personal details of the mortgage intermediaries should also not be overlooked. On balance, subject to a full CBA, this proposal is supported as we seek a professional body of mortgage advisers.

## **Q18: Do you agree with our conclusion not to read across the adviser charging element of the RDR proposals into the mortgage market?**

YES: Adviser charging is not appropriate for the mortgage market as there is no historic evidence of commission bias even in niche markets. The existing rules, of course, require advisers to recommend a suitable and affordable mortgage regardless of the commission payable.

Greater clarity is, however, required over the representation of interest rates and all associated charges so that ready comparisons of total costs might be made.

## **Q19: 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?**

NO: DP09/03 fairly represents the issues posed by the current remuneration model.

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## **Q20: To what extent should the proposals for a PSB as outlined in the RDR be extended to the mortgage market?**

We see value in establishing a PSB for the mortgage market. The RDR has established the need to rebuild customer trust in the investment industry by focusing on professional qualifications, a new code of ethics and a Professional Standards Board. The discerning mortgage consumer of the 21st century will similarly expect a professional adviser with a code of ethics to be monitored by such a governing body. There will always be a need to provide both high quality and unbiased advice. Consumers should be encouraged to seek out mortgage advisers that conform to the new code and who are subject to a PSB.

## **Q21: 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?**

NO: Although we have no objection to the adoption of the term 'information-only' for non-advised sales, the use of 'restricted' is very confusing and gives no clarity. In the minds of the consumer just what exactly is being "restricted"? Empirical research shows that this new term is regularly misunderstood most inferring that advice was only available on a limited range of products and not a restriction on the number of product providers.

eaCG firmly believes that the consumer will be better informed if the post-depolarisation terms of 'single-tied' or 'multi-tied' are applied in addition to 'independent' as complete clarity is given on the nature of the offer available.

## **Q22: 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?**

Disclosure is a key topic. Understanding essential information is vital for effective consumer protection. However, in considering the MMR proposals we must also be mindful of new EU developments in this sphere and delay change until clarity is available.

Although experience says that the typical consumer will rarely read the sales advice material in any detail (and few will shop around) we can but hope that the mortgage hunter of the future will be more discerning and financially more capable. One advantage of a period of low house inflation is that the rush to enter the housing market at any cost whilst prices are rising should be replaced by a more measured approach to mortgage finance. For many, a drop in house prices after a long bull market will prove a salutary lesson and many are questioning their current pension strategy based on property assets.

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Any regular user of financial products will be more than a little amused by the seemingly frequent changes in disclosure regimes (e.g. menu) and the assumed advantages of common display standards for investments, mortgages and insurance are fast disappearing. It is debatable if the disclosure of key messages will be any more successful than the current IDD. Oral disclosure may well be more effective but is difficult to police and most consumers will recall little of the information delivered even in the short term. The decision to retain the KFI is therefore a good one.

To meet the needs of a range of consumers the new EU disclosure regime must be short and succinct focusing on the truly key information (e.g. features, rates and risks). It should be delivered orally but confirmed in documentation for later reference preferably as an addendum to a personalised 'terms of reference' letter. We should not forget that insurance is often purchased at the same time (and on occasion investments too) and disclosure documentation should be compatible.

## **Q23: Do you agree that the limitations on the rationality of consumer behaviour in the mortgage market support the case for greater regulatory intrusion?**

NO: The fundamental cause of irrational consumer behaviour has been removed by a housing market no longer characterized by fast rising prices and the urge to 'get on the band wagon' at all costs. It is believed that similar occurrences in the future can be avoided primarily by new prudential standards and in insisting on income verification for all applicants. Increased capital requirements should make new mortgages relatively more expensive and there are likely to be fewer lenders in the marketplace. The house price spiral will not therefore be fed by a supply of ready and cheap mortgage finance.

It is vitally important that the new mortgage regime protects the borrower whilst being proportionate to the likelihood of consumer detriment. For the vast majority of mortgage holders the market operates effectively and to the satisfaction of all parties.

We support the FSA's policy, in accordance with its statutory objectives, that it should help consumers to understand their current responsibilities as well as what they can do to protect their own best interests.

## **Q24: 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?**

YES & NO: Commonsense dictates that individuals who have an inadequate repayment capability should not be permitted to take on new levels of debt. The FSA role should be in identifying such situations in general whilst individual lending decisions must be taken by the lender based on the merits of an individual case. There will always be examples where the background circumstances are unusual and a hard and fast ruling by the FSA risks inflexibility. Ultimately, and appropriately, it should be down to the lender to sanction or decline a mortgage application.

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## **Q25: Do you have any comments on the financial capability initiatives designed to support the overall mortgage market reform?**

The FSA's overall vision of *'better informed, educated and more confident consumers, who are able to take greater responsibility for their financial affairs and play a more active role in the market for financial services'* is fully supported. The suggested initiatives (Money Guidance, Court Process and Triggers for arrears) appear sound and should over time become a critical component of mortgage market reform.

## **Q26: Do you have any comments on our proposals to strengthen our approach to firms' arrears management practices?**

The FSA's proposals are fully supported. The measures suggested are proportionate and sadly reflect known activities in this vulnerable market sector and where consumer protection going forward is all important.

## **Q27: Do you consider that the mortgage market fees and charges reflect the underlying costs or are consumers paying excessive charges?**

A review of fees and charges across the marketplace indicates wide variations suggesting that the costs incurred may well include some punitive element. Obviously, some additional costs must be involved to monitor such situations but these should not be excessive but simply reflect the expenditure incurred. Although the industry norm, it does make no sense to inflict additional charges on borrowers who are least able to repay them.

## **Q28: What would be the impact of consumers not being allowed to roll up intermediary fees and product charges into the mortgage loan?**

At a time when borrowers are being expected to save a relatively large stake in any house purchase it is thought that any decision not to permit fees/charges to be added to the mortgage would be contrary to the interests of most consumers. This is especially so for lower income groups. Whilst the proposal will focus consumer attention on the charges involved the downside is likely to be more severe day-to-day financial problems.

## **Q29: Do you agree that the FSA should collect data to enable us to track arrears and repossessions cases back to the original product transaction on a permanent basis? What would be the costs imposed on the market?**

Although we do not have access to any detailed costing information it is our opinion that this measure is unlikely to be justified on CBA grounds. Empirical information can be collected when a mortgage defaults at far lower cost. The benefits to be gained by tracking on a permanent basis are limited although no doubt the figures could produce an impressive array of statistics.

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## **Q30: Do you agree the FSA should standardise some existing industry definitions such as subprime? And if yes, are there any existing definition issues other than subprime?**

For ease of general understanding, a precise nomenclature is always important along with the use of common definitions. In addition to 'subprime' consideration should be given to providing official definitions for all mortgage products to establish their clear regulatory identity (eg a mainstream mortgage, right-to-buy).

## **Q31: 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?**

This question will be answered and costed by our appropriate clients. It is difficult to see that the acquiral of this information on a regular basis and its perceived uses will justify the set-up expenditure.

## **Q32: Are there any additional measures that you feel the FSA could take to reduce the risk of financial crime?**

Greater penalties are required to discourage financial crime. The risk must always outweigh any potential fraudulent benefits. The FSA must be seen to be an enforcement regime where the protagonists fear the action of the regulator and police prosecution.

## **Q33: 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**

YES: Overall, the ideas put forward in DP09/03 should have a positive impact on the equity release and right to buy market. As specialized markets, the FSA must ensure that the law of unintended consequences does not apply.