Consultation response

Mortgage Market Review: Proposed Package of Reforms

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Introduction

Every day Shelter advisers see the tragedy of people losing their homes. All too often, this could have been prevented by more responsible behaviour by mortgage lenders. Our research has shown the devastating effects of arrears and repossessions; including negative wellbeing impacts and stress for families,[1] wider damage to the housing market and increased costs to the state.

Shelter is also concerned about the families who are held-back by the lack of a decent, secure affordable home.[2] Rising house prices, fuelled by loose lending and a shortage of housing supply, have locked young people out of homeownership and stuck in the rented sector, where they currently have little stability or certainty.[3]

Loose credit is not the best way to help first time buyers - as they themselves recognise.[4] We need a less volatile market where house prices are not so drastically out of line with household incomes and new buyers don't have to over-leverage just to get a foot on the ladder. Market volatility also damages existing homeowners who find themselves trapped in negative equity. Responsible mortgage lending is a key tool to promote market stability, as recognised by both the OECD and the IMF,[5] and vitally important in the UK where we have one of the most persistently cyclical markets and highest mortgage debt to GDP ratios of advanced economies.

We welcome the latest draft of the FSA's proposals and we are keen that, given the long timescales and careful deliberation that has gone into the process so far, they are implemented swiftly to bring certainty to the mortgage market. We note that there have been a number of concessions to the industry to make the rules more flexible than in previous drafts. The rules must not be watered down any further and we expect the regulator to supervise the market and interrogate lender's policies much more closely than it did prior to the market collapse. Our response focuses on the conduct of business proposals and particularly on responsible lending.

Shelter's key recommendations are:

- The FSA should press ahead with implementation of its reforms and supervise the market closely thereafter
- There must be no further concessions to the industry on affordability assessments, income verification or interest rate stress testing
- Interest-only mortgages should only be given where there is a credible strategy to repay the capital sum.

Chapter 3: Responsible lending and borrowing

Q1: Do you agree that lenders should detail how they incorporate anti-fraud controls into their affordability assessments in their responsible lending policy?

We agree with this proposal.

Q2: Do you have any comments on our income proposals?

[1] Research conducted on behalf of Shelter by University College London shows that having your home repossessed is considered to be a more severe problem than a range of other social justice issues, including suffering a decline in health following medical negligence, being assaulted by a neighbour or being discriminated against because of disability.
[2] *Policy briefing: Held-back households - how the housing system squeezes people on low-middle incomes*, Shelter 2012
[3] *Policy briefing: Homes fit for families - the case for stable private renting*, Shelter 2012
[4] *Latest consumer and first time buyer attitudes to mortgage lending rules Do we need mortgage reform?,* Shelter 2011
[5] Including the chapters 'Housing and the Economy: Policies for Renovation' in Economic Policy Reforms 2011: Going for Growth, OECD 2011, and 'Housing Finance and Financial Stability—Back to Basics?' in Global Financial Stability Report, IMF 2011.

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Shelter has long argued that income should be verified on every mortgage loan. Lending people large sums of money secured on their home without even a basic check to see that they have sufficient income is clearly a risky strategy and the disproportionately high levels of arrears and repossessions in the self-certified market show this.

We strongly support the current proposal to make lenders responsible for verifying income in every case.

The rules are clear and the guidance allows lenders sufficient flexibility as to what sorts of evidence is acceptable for verification purposes, allowing for both automated processes and manual processes. We urge the FSA to check that automated processes, where they are used, are sufficiently robust. This is particularly important for lenders with high risk profiles.

Q3: Do you agree with this approach to expenditure? Do you have any comments on the categories of expenditure? Do you have any practical concerns about implementing this approach?

The proposed approach is a reasonable balance between considering borrowers' likely outgoings and undertaking an excessively onerous expenditure check. We would encourage all borrowers to go through a budget calculator independently and make an honest assessment of their financial situation before committing to a mortgage.

We do have some concerns that the lack of prescription here will result in inconsistency between lenders - this could deter borrowers from shopping around if they are concerned about having to complete multiple, costly expenditure checks, each with slightly different requirements.

The categories suggested cover the basic committed, essential and 'hard to reduce' costs that consumers spend their income on. We would expect lenders to use more detailed models in most cases. Upfront costs of moving home might also be factored in for first-time-buyers who may need to repair and refurbish their new home. It is also important to note that the cost of living can vary dramatically over time. For example, recent rail fare and petrol inflation mean that some consumers have had to unexpectedly re-order their budgets and cut back on spending in other areas. While we agree that neither the FSA nor lenders are best positioned to determine a minimum standard of living, we do believe that it is prudent for lenders to check that borrowers have some contingency funds available in the event that either mortgage or living costs rise and they can no longer afford repayments. This is particularly important for borrowers with little or no equity cushion and those who do not have any mortgage insurance.

We also have some concerns that childcare costs may not be properly accounted for if they are not included in the 'essential expenditure' category; childcare costs are very difficult for many families to avoid and can take up a large portion of family budgets.[6]

Q4: Do you have any comments on our proposed approach to assessing affordability against future interest rate increases?

We support the proposal to stress test affordability against future interest rate rises. However, we are not convinced that allowing lenders to choose the forward rate they assess against is the best way of doing this; at worst it could lead to inconsistencies within the market and stretching of affordability as a competitive tool. A minimum assumption of 1% rise or fall in rates is a fairly low base and we would expect the FSA to investigate any models that predicted less variation over a five year period.

Q7: Do you have any comments on our proposal to drop the requirement that affordability should be assessed on a maximum term of 25 years?

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[6] http://www.daycaretrust.org.uk/pages/childcare-costs-survey-2012.html

We agree that in light of later retirement ages and buyers generally purchasing at a later time in life, a maximum term limit of 25 years is unnecessary. However, we would be concerned if many firms started regularly assessing mortgage affordability over terms of over 35 or 40 years in order to artificially stretch affordability. We suggest that either the FSA sets a higher upper limit, or puts additional supervisory measures in place. It is also worth noting that working patterns are increasingly flexible - borrowers may not always be earning more at the end of their careers, for example if they switch to part-time work pre-retirement.

Q8: Do you have any comments on our proposals to protect credit-impaired consumers?

The evidence set out in the consultation about the disproportionately high levels of arrears and repossessions in the credit-impaired sector, and the very poor underwriting standards that were evident in the sector, suggest that robust action is needed to avoid further consumer detriment in this market. Shelter did not fully support the idea of a 'buffer' for credit impaired borrowers as we felt this would be unnecessary if the conduct rules were sufficiently strong to protect low-income borrowers from reckless lending. We support the measure to make advice mandatory for these borrowers and urge lenders to carry out detailed affordability assessments with credit-impaired customers.

Q9: Do you think that our proposed enhanced sales standards will provide adequate protection for right-to-buy consumers? Are further measures required?

Shelter sees many right-to-buy borrowers who end up in arrears or facing repossession. These clients are often older people or people with long term health issues, those who have over-committed to debt and had not realised or planned for the additional costs of service charges or repair and maintenance on their homes.

We urge the FSA to supervise this high-risk area extremely closely and to be alert to right-to-buy scams, working with consumer bodies, advice agencies and the OFT as needed.

Q10: Do you think income multiples could work under our proposed rules? If not, why?

We think that tailored affordability assessments are a better tool than income multiples, but see no reason why income multiples may not be used under the new framework if lenders choose to adopt them.

Q11: Do you have any comments on our proposal to require lenders to take into account information about future changes to income and expenditure?

It is reasonable that lenders take predictable future events into account, including retirement, when assessing affordability. In our previous responses we have highlighted cases of borrowers past or close to retirement age who were given large mortgages over long terms that they were clearly unable to repay. This type of poor practice should not be allowed to continue.

Q12: Do you agree, that to ensure these proposals work, we should define a credit-impaired consumer? Do you agree with our proposed definition?

We agree that the definition should be consistent with that found elsewhere in regulation.

Q13: Which option do you prefer? Option 1, where the lender would be required to take reasonable steps to ensure that debts to be consolidated are repaid? Or option 2 where the lender would be required to assume that debts to be consolidated remain outstanding for purposes of assessing affordability? If you disagree with both options, what do you suggest as an alternative?

We prefer Option 1, which would go further to ensure that a debt consolidation loan serves its purpose and actually pays off debt.

Q14: Do you agree with our proposals to strengthen lender's systems and controls around responsible lending?

Lenders must have a clear audit trail of their lending decisions. We would also favour a more transparent system where firms' responsible lending policies are made publicly available on request.

Q15: Do you have any comments on our proposed transitional arrangements? Do you think they will be sufficient to address risks to consumers? Will they create any additional risks to consumers?

Shelter shares concerns that some borrowers will be 'trapped' in their homes because they are unable to remortgage; this is a particular concern for those who need to move for work, families who are overcrowded and need a bigger place to live, and households in debt who would in normal market conditions remortgage to a better deal. While we would not wish to encourage lending to this group that is unaffordable or risky, we do agree that those who can afford it should be able to refinance if necessary. Therefore, we agree that the transitional arrangements, where customers who are not borrowing any additional sums can waive the new rules, are sensible.

Q20: Do you agree that the draft rules on responsible lending in the draft Mortgage Market Review (Conduct of Business) Instrument 2012, at Appendix 1, reflect the stated policy intention?

There are still some ambiguities within the draft MCOB rules, for example terms such as 'take reasonable steps to…' which lenders may interpret differently. While we accept that the rules need some flexibility in order to allow for different commercial procedures and practices, there is clearly a role for the FSA to closely supervise how lenders are interpreting the rules and how far this meets its stated policy aims.

Chapter 4: interest-only mortgages

Q21: What is your view on our approach to assessing affordability for interest-only mortgages?

We agree that interest-only can be riskier product than repayment mortgages if the borrower does not have sufficient means to repay the capital. The following case studies illustrate some of the problems Shelter sees from interest-only borrowers:

- An older couple that sought advice from Shelter were in difficulty with their endowment mortgage. The term had expired three years ago and the lender grated an extension. Although the interest payments were affordable, the couple still had no way of repaying the large capital sum outstanding and the lender was seeking the full amount and unable to negotiate further. The couple had no choice but to move, and fortunately were helped to secure a social tenancy nearby.
- A Shelter client and his wife, who has serious health problems, had bought a shared ownership property and eventually became the full owners. They had an interest-only mortgage with nearly £100,000 outstanding capital balance. The couple believed that they had taken out a lifetime mortgage, but were alarmed to learn that they had an interest-only mortgage that needed to be fully repaid in four years time. Although payments are affordable for now, the couple are not in work and may not be able to repay the capital sum off in the future unless they sell the property. They are pursuing a complaint with the Financial Ombudsman about potential mis-selling of the mortgage.
- A single woman who had stopped working due to mental health issues came to Shelter about problems with the interest-only mortgage she had taken out in 1988 for a shared ownership home. She was in arrears and had a large capital sum to repay, as well as charges on her home and unsecured debt. The lender had sought possession, but warrants for eviction had been suspended. The client is trying to sell her home to repay the capital sum.

We agree that lenders should generally assess on a capital and interest basis and only grant interest-only mortgages where there is a valid repayment method.

Q22: Do you agree that we should apply a consistent approach to regulating interest-only across the board and that we should not adapt our approach according to different consumer types?

We agree that this would make for a more straightforward regulatory rule.

Q23: Do you agree with our non-prescriptive approach to repayment strategies, or do you have any comments on this approach?

It is concerning that three quarters of the interest-only mortgages advanced in 2007 have no specified repayment vehicle. These mortgages could be a 'ticking time bomb' putting both borrowers and lenders at risk if the capital sum cannot be repaid. Relying on sale of property as a repayment strategy is not sound, partly because house prices are volatile and partly because few homeowners actually downsize after retirement. The draft regulations give lenders significant scope as to what they can assess as being valid repayment vehicles, and we are concerned that some lenders will be able to game this system. We favour a slightly more prescriptive approach where any method not on the regulators list must be highlighted to the FSA in advance.

Q24: Do you agree that lenders should be free to set their own appropriate controls around repayment strategies?

Yes, but these must be transparent and made available borrowers and advisers as well as to the regulator.

Q26: What are your views on our approach to requiring lenders to assess the repayment strategy prior to entering into the mortgage?

We agree that lenders should make some initial assessment of how realistic a repayment strategy is at the outset of a mortgage. While lenders cannot predict future trends or be held responsible for the performance of repayment vehicles, it is prudent that they should understand the risks and check the credibility of a borrower's plans.

Q27: What is you view of our proposals for the ongoing management of interest-only loans? Do you foresee any practical issues?

We do not agree that lenders should only be required to check a repayment strategy once over the course of a mortgage. This could mean just one check over a 25 year term. Checking on a more regular basis - at trigger points or every five years, for example, would be a helpful reminder to borrowers about their capital sum and give greater opportunity to take action if a repayment strategy is not performing. This need not be onerous for lenders - a letter to borrowers to remind them of the outstanding term and balance and a request for a statement on the status and performance of the repayment strategy may be adequate and provide the lender with an audit trail.

Chapter 5: distribution and disclosure

We do not have detailed comments on the distribution and disclosure policies and suggested channels set out by the FSA. Evidence of mortgage mis-selling does suggest that further regulation is needed to ensure that consumers know and understand the deal they are entering into and have appropriate means of redress if they are given misleading advice.

Q33: (i) We are proposing that consumers who are vulnerable (i.e. equity release, Home Purchase Plan, Sale and Rent Back or right-to-buy consumers and those who are consolidating debt) should always be advised and therefore will not be able to purchase their mortgage through a non-interactive process. Do you have any comments on this approach?

We agree that Sale and Rent Back, debt consolidation and right-to-buy customers should always be advised, given the strong evidence of consumer detriment in these sectors.

Chapter 6: Arrears management

Shelter sees many clients who are hit by high fees and charges that only make their debts worse, or are treated unfairly by lenders seeking to evict as quickly as possible. We support the action the FSA has taken to toughen rules on arrears charges throughout the downturn.

Q42: Do you have any comments on the proposed policy approach on the calculation of payment shortfall charges?

Fees should accurately reflect the costs incurred and this should be transparent.

Q43: Do you have any comments on the proposed policy approach on direct debit payments?

We agree with this proposal and have no additional comments further to those we made in response to CP 10/16.

Q44: Do you have any comments on the proposal to extend the application of MCOB 12.4 and 13.3 rules to include payment shortfalls?

We agree that the rules should cover all shortfalls and not just those that fall into the formal definition of 'arrears'.

Q45: Do you have any comments on the proposal to replace MCOB 12.4.1 R (2) with a rule permitting firms to remove concessionary rates where there is a material breach of contract unrelated to payment shortfall?

Yes; borrowers in financial difficulty will only find it harder to recover their position if their concessionary interest rates are removed.

Chapter 8: Impact of Basel III

Q47: Do you agree that the new prudential requirements are unsuited to meeting the objectives of the MMR, specifically deterring high-risk lending?

We support prudential reform as a way of making banking more stable and secure, ultimately to the benefit of consumers. We support the proposal for the Financial Policy Committee to use LTV and LTI caps as an economic stabilisation tool.

However, as we have outlined in previous consultations, we do not believe that prudential reform mitigates the need for conduct rules that govern the way lenders treat borrowers day to day.

Chapter 10: Tailoring for niche markets

Q62: Do you have any comments on our views, summarised in the table at the end of this chapter, about those mainstream MMR proposals which are either not applicable or where a straight read-across to the Sale and Rent Back market is appropriate?

We support the additional consumer protection measures for Sale and Rent Back customers given the evidence of serious consumer detriment in this market.

We do not have any particular evidence on high net worth borrowers, bridging finance, home purchase plans or business lending.

Annex 1: Cost Benefit Analysis

Q103: Do you have any comments on our estimates for the lending impacts of the responsible lending requirements? Do you have any data and/or analyses that could be informative towards estimating these impacts?

Q104: Do you have any views on whether this balance between winners and losers is acceptable, given the importance of the protection obtained by the winners?

We do not have any additional data, further to the survey evidence and case studies we have provided to the FSA, which could inform the cost benefit analysis. Overall, we think that the impact assessments for how many borrowers would be affected by the responsible lending measures are sound. We welcome the emphasis on wellbeing and the FSA's attempts to factor in the significant detriment caused to consumers who face arrears and repossession. Evidence suggests that losing a home is considered to be one of the most stressful legal problems a household can face.[7]

We have no comments on the equalities impact assessment.

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Until there's a home for everyone

In our affluent nation, tens of thousands of people wake up every day in housing that is run-down, overcrowded, or dangerous. Many others have lost their home altogether. The desperate lack of decent, affordable housing is robbing us of security, health, and a fair chance in life.

Shelter believes everyone should have a home.

More than one million people a year come to us for advice and support via our website, helplines and national network of services. We help people to find and keep a home in a place where they can thrive, and tackle the root causes of bad housing by campaigning for new laws, policies, and solutions.

We need your help to continue our work. Please support us.

Visit **shelter.org.uk** to join our campaign, find housing advice, or make a donation.

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[7] http://england.shelter.org.uk/__data/assets/pdf_file/0010/397459/Experiences_of_housing_problems_Research_Summary.pdf