improving living in scotland

CONSULTATION PAPER – 10/16
FSA MORTGAGE MARKET REVIEW: RESPONSIBLE LENDING

NOVEMBER 2010

Homes for Scotland is the representative body of the Scottish homebuilding industry, with over 200 full and associate members. Its members build around 95% of all new homes for sale built each year, as well as a significant proportion of the affordable housing output annually. Homes for Scotland makes policy submissions on National and Local Government policy issues affecting the industry, and its views are endorsed by the relevant local committees and advisory groups consisting of key representatives drawn from within our members.

We support the work of the FSA in ensuring the prudential stability of the financial system and restoring much needed confidence in financial markets. We found much of the ethos of the consultation sensible, removing elements of unsustainable lending without restricting vital access to suitably sized loans. Some of the proposals however have implications which go too far, and must be given further consideration to ensure stronger protection does not dampen sustainable economic growth or prevent customers from accessing much needed new homes.

We remain unconvinced that the regulatory reform strikes the right balance and are seriously concerned that the proposals for regulation will ensure the protection of the minority at the expense of the majority. It is difficult for us to see from the information presented why regulation on some of the specific criteria is required at all. For years, lenders and borrowers have been able to reach agreement on appropriateness, risk and return on mortgage choices without FSA intervention and for the bulk of Scottish households the deals struck have provided a successful, sustainable avenue for home ownership.

We note with serious alarm the results of the independent consumer research carried out by Policis (4 November 2010) that finds that of the 11 million current mortgage holders, around half would not be able to have the level of mortgage borrowing they currently have and around a fifth would not be allowed any borrowing at all if the proposals had been in place. These findings are staggering and show just how high an impact these proposals could have on the UK's housing system. It is clear that some perspective is required in this debate.

1. Do you agree with our proposals for income verification?

We accept fully that there is no reason why an employed applicant would be unable to confirm income and would suggest that in all cases those employed must submit evidence accordingly. We also accept that even where income flow is non-regular, in the case of self-employed or contract workers, that it does not imply that it is 'non-

verifiable'. What we do not accept is complete removal of opportunity for genuine applicants to access home ownership.

If self-certification products are completely removed from the market (acknowledging that the number left on the market is already extremely low) there must be guidance to lenders to ensure those able to verify even the most irregular income are not turned away, or left to pick up the most expensive or poorest products on the market. For example if a self employed customer is asked to provide three years income for verification and earned £15k in year one, £20k in year two and £25k in year three, it must be clear to lenders what income they can lend on.

We note that you do not intend to prescribe the sources that lenders use to verify income and support this flexibility for lenders.

2. Do you agree with our approach to assessing income?

We support the decision not to prevent lenders from taking into account other legitimate sources of income such as pensions, alimony, maintenance payments and state benefits when assessing affordability.

We accept that the FSA does not propose to set limits on how lenders take into account additional income such as overtime, commission or bonuses but that they will require lenders to consider the variability of income over time in their assessment. We already believe this to be standard practice in the financial industry at present and do not fully appreciate the need for the FSA to regulate.

3. Do you agree with our approach to assessing expenditure? Do you foresee any practical issues?

We accept that it is a sensible approach for lenders to assess the level of a customer's expenditure in determining the affordability of a mortgage product to ensure that lending decisions are based on a customer's free disposable income. We further accept the 'best practice' industry model provided with three layers of deductions: committed expenditure (Income tax, NI, debt, bills and other commitments), personal expenditure (food, drinks, goods and services, transport, recreation etc) and contingency expenditure (to allow for any missed or understated expenses). As far as we understand the use of 'income multiples' as the sole approach to determining mortgage borrowing is no longer applied anyway, again leaving us unsure why there is a need for regulation.

We accept your definition of an affordable mortgage as 'when the level and terms allow the customer to meet current and future payment obligations in full, without recourse to further debt relief or rescheduling, avoiding accumulation of arrears, while allowing an acceptable level of consumption'. We also believe however that a balance needs to be struck between a borrower's responsibility to ensure they do not over extend their use of credit with the level of proposed regulation forcing lender's to take a view on ongoing affordability throughout the 25 year term of the mortgage. We fear that excessive regulation will reduce the number of lenders competing in the mortgage marketplace even further, thereby increasing the barriers to home-ownership.

Moving on to the use of robust expenditure models, we are pleased to note that lenders will be able to choose to use statistical data to develop assessment models rather than

gathering comprehensive expenditure from each of its customers. This should assist with processing without adding costs and delays to the banks or more importantly to customers.

4. Should lenders be required to ensure that credit commitments being cleared by debt consolidation are repaid as expected? Would there be significant additional costs in implementing this for further advances?

We accept that where an applicant states that credit commitments are to be repaid prior to or on completion of the mortgage it would be preferable to confirm that this has actually been done. It makes sense to do this through direct transfer where possible. It could be argued however that some responsibility should be left to the customer themselves.

5. Do you agree with our approach to calculating free disposable income?

We have serious concern surrounding the proposed rules on 'free disposable income' contained within the draft instrument (Appendix 1 – part 1). 11.3.12 states that 'the customer's free disposable income is the amount (if any) remaining when the customer's expenditure has been deducted from the customer's income. A regulated mortgage contract or home purchase plan is not affordable for a customer if it is foreseeable that, at any time during the term of the regulated mortgage contract or home purchase plan, the payments to be made under it by the customer for a particular month will be equal to or more than the customer's free disposable income over the same interval.

This rule leaves the lenders to judge whether the customer is likely to spend too much on Christmas presents in December or whether they are likely to book a summer holiday on credit. If common high spending occasions such as these are not listed under the customer's personal expenditure does this mean that the bank must consider adding an allowance for missed or understated expenditure and reduce the amount the customer can borrow further? Furthermore it is difficult to envisage how lenders could practically take into account unforeseeable life-changes such as redundancy, divorce or serious illness, or for that matter planned life-changes such as travel or pregnancy. As stated in our response to question 3 above, we feel that taking a view of spending over the full term of the mortgage is simply unrealistic. We understand that the OFT has recently published guidance on unsecure lending, taking a more realistic stance and requiring lenders only to take into account income and expenditure that is known at the time of assessment and not to engage in 'crystal ball gazing and/or speculation'.

Referring back to the FSA's definition of when a mortgage is affordable (as referred to in question 3 above) we read this as the customer being able to afford their monthly mortgage repayment without recourse to further debt, which is sensible. The affordability of a mortgage should not be based on a prediction of whether a customer is likely to have an overindulgent month anytime during the lifetime of the mortgage. Additional expenditure would not be committed and is highly unlikely to affect whether or not a customer makes their mortgage payment.

The recently published research by Policis (4 November 2010) finds that policy concerns on affordability do not recognise the reality of the flex in customer's budgets and their ability to prioritise mortgage payments with 9 out of 10 of those who have experienced reduced incomes through the recession adapting their budgets without significant strain

on their finances. The research also found that while credit has had a role to play in balancing budgets, savings have been far more important in supporting financial resilience, both overall and for those on reduced incomes. The FSA must take a realistic view on lifestyles when considering this rule or access to mortgages in the UK will become impossible for a high proportion of households.

In addition to this, we also strongly disagree with the assumption that future reductions in expenditure should not be a factor in assessing affordability of a mortgage. We note with interest the sweeping statement contained within the consultation that reductions in personal expenditure can be 'shortlived as best intentions can be overtaken by the demands of real life'. We feel that without inclusion of an assumption for future reductions in expenditure after the customer takes on the commitment of a mortgage the approach is fundamentally flawed.

The impact of regulating this approach will be enormous, particularly for those currently on the lower rungs of the housing ladder. Using first time buyers as the prime example, how can their current personal finances be used to assess whether they can afford a mortgage? Buying a home indicates a change in lifestyle, it is most often the accepted case that a change in spending patterns must follow. How would purchasers currently living at home with no rent or bills to pay prove that they can afford a mortgage? Even if their disposable income is currently <u>all</u> spent on recreational activities, can we assume this means that they will not be able to make significant lifestyle changes and as a result meet the mortgage payments that they have committed to? In our response to the FSA Mortgage Market Review Discussion Paper (09/03) we queried whether there was actually an evidence base to prove a correlation between spending patterns pre and post home purchase that would give rise to this concern. The content of the current Mortgage Market Review does nothing to address our question.

This circumstance is true not only for first time buyers but for those trading up. Again a change in lifestyle is a choice for home purchasers, who may wish to spend more on their home as their life changes, when they reprioritise spending and 'settle down'. The Free Disposable Income table must include not only a contingency expenditure for underestimates in spending (as with layer 3) but a percentage allowance for cuts in spending that can be predicted to come when the home is purchased. We would urge the FSA to give the affordability calculations more thought before prescribing these assumptions.

6. Do you agree that affordability should generally be calculated on a capital and interest basis?

We accept that a customer's borrowing capacity should be assessed on a capital repayment mortgage (even if applying for interest only) for <u>first time</u> mortgages. We fear that if this is applied to <u>all</u> mortgages (whether the customer is a first time buyer, trading up or remortgaging) then the result could be a high number of 'mortgage prisoners' who are unable to move because they would be assessed as unable to afford the payments of their arranged investment vehicle (which we assume would be classed as 'Committed expenditure' alongside insurance premiums and pensions) on top of the capital and interest repayment. We could not support anything that restricts movement in the housing market and look forward to learning how the FSA is proposing to cater for these households during the period of transition.

7. Do you agree that affordability should be assessed on a maximum term of 25 years?

We have serious concerns about this proposal.

Without justification, which was missing from the MMR Discussion Paper (09/3) and is still missing from this formal consultation, we find it extremely hard to understand why this clause would be included. The FSA explains that there is a correlation between the mortgage term and the LTV with a high proportion of customers with high loan to values with terms longer than 25 years. Yet, if those people were assessed accordingly to gain access to those funds and are maintaining their mortgage payments, we fail to see what is wrong with this situation.

The 25 year term appears to be completely arbitrary, with no justification for its selection and we would suggest the selection of this term by the FSA as over 25 years out of date! Demographics have changed dramatically over the past few decades, changing the time and circumstances in life when a home is purchased. We are also expected to be living and working longer, leaving less urgency for the mortgage to be repaid in a short time. As far as we understand a customer can never be forced to change the term of their mortgage, therefore if they sign up for a 40 year mortgage why would they need to prove they could afford the payments for a 25 year mortgage?

As we understand it, allowing customers to borrow over a typical maximum term of 40 years will generally allow the customer to borrow around 20% more than if they were restricted to pay over 25 years. If the customer can demonstrate income sufficient to cover the mortgage over 40 years, even if that income was from a retirement pension, then why include a maximum 25 year cap in the affordability assessments?

Including this rule will without doubt have an impact on the ability of customers to access adequate mortgage finance. Furthermore, this impact will unquestionably have a disproportionate effect on first time buyers, where customers are lucky enough to have a large enough deposit, the reduction in mortgage offer by 20% could easily be the difference between gaining access to owner occupation or not.

We recognise that significant increased mortgage terms may not be in customer's interest and that should be balanced not only with affordability but future house price trends. We would not be in favour of extending mortgage terms in the UK to fifty plus years as seen in other countries for example. We do believe however that the term of a mortgage should be dictated by the lender's criteria and not part of the FSA regulations.

8. Do you agree with our approach to testing affordability against future interest rate increases, based on swap rates or any other appropriate guideline rate? Can you foresee any practical issues in the FSA setting a guideline margin for firms to use?

We accept that the affordability assessment should include a stress test for increases in interest rates and agree that this must not be set too low or unreasonably high to unnecessarily restrict affordability. We are particularly pleased that the FSA has decided against the inflexible flat rate of 2% above the lenders standard variable rate that was suggested previously. The approach that is now proposed – with the FSA publishing a guideline margin for lenders on a quarterly basis – seems much more sensible. In terms

of linking this guideline margin to ‘swap rates’, we accept this approach as a useful indication of how rates may move over any given period. Given that ‘swap rates’ are determined by financial institutions there may actually be no point in regulating the guideline margin, or reviewing and publishing results on a quarterly basis which assumes a high resource commitment from the FSA, and instead leave it to lenders to establish their own stress test for affordability models.

9. Do you agree with our proposal to impose an additional buffer on the calculation of free disposable income to protect credit impaired borrowers? What would be an appropriate basis for that buffer and how should it be set?

Having been concerned that ‘credit impaired’ would include customers with as little as a missed credit card payment against their name, we are pleased to see the inclusion of a definition of ‘credit impaired borrowers’ by the FSA. The definition contained in Appendix 1: part 1: Annex A seems sensible. Having said that, we do not believe there is a need for the FSA to regulate to introduce an additional buffer for ‘credit impaired borrowers’.

As you point out, credit impaired borrowers already generally face higher interest rates than those with a good credit history, and under the proposed affordability assessments this would automatically add a buffer to their lending capacity. This automatically eliminates the need for an additional buffer through regulation. Furthermore, lenders own credit search models are likely to make it more difficult for credit impaired borrowers to access mortgages, i.e. they are likely to require a larger deposit than those with a good credit history. The inclusion of yet another barrier for credit impaired borrowers would be viewed by us as overkill.

10. Do you agree with our approach to lending into retirement?

We agree that there should be no restrictions on lending into retirement. We accept that *current* income should be verified for mortgage applications and this should also be true if that income is to be from pension payments. This would allow customers who are retired to apply for mortgages whether they are remortgaging (to raise funds to gift their grandchildren with their own mortgage deposit!) or moving home later in life.

We find it difficult to see, however, how future pension income could be verified without costly, resource intensive human intervention and, even with this intervention, how future payments from pension schemes could be calculated and verified. This, as you acknowledge, would not be a foolproof response and would always involve an element of risk. Given the lender’s difficulty in assessing the customer’s ability to repay from their pension, we would therefore suggest that this is a matter for the lender’s criteria and not for regulation by the FSA. We would also suggest that where an applicant states their intention to work beyond the age at which the customer might be expected to retire, this circumstance is also for the lender’s criteria to deal with and should not be regulated.

The implementation of regulation to enforce this change in criteria would restrict those nearing retirement and will undoubtedly have an impact on younger customers looking to take their mortgage over a longer period to ease affordability. It must be remembered that demographics are changing at a fast rate (i.e. firstly, the average age of an unassisted first time buyer in Scotland is now 37 meaning that even a traditional 25 year mortgage would already take the applicant to 62; and secondly the retirement age in the

UK is rising). Surely it is better for lender's to reflect this demographic evolution through review of their own criteria rather than having to wait for changes in regulation.

It should also be pointed out that the FSA document provides absolutely no evidence to suggest why lending into retirement should be included within the consultation proposals at all.

11. Are there specific atypical lending circumstances which you think merit an alternative approach to the assessment of affordability rather than being addressed through the possibility of rule modifications or waivers?

We have identified two atypical lending circumstances which we believe merit an alternative approach:

Firstly, automated accelerated approval models where the borrower is known to the lending institution and is requesting very low loan to value borrowing do not require the same level or depth of affordability assessment. The distinction between automated accelerated approval models and self-certification mortgages must be recognised.

Secondly, Government-backed/funded Shared Equity Models are viewed completely separately and must be considered differently. We were disappointed not to see any acknowledgment of these schemes in the consultation proposals given the concerns raised in our response to the Mortgage Market Review Discussion Paper (09/03).

12. Do you agree with this approach to lifetime mortgages?

No comment.

13. Do you agree with this approach to ensuring affordability for home purchase plans?

No comment.

14. In addition to the questions above, do you have any other comments on our approach to responsible lending? Do you have any comments on the draft rules as set out in Appendix 1 Part 1?

No further comment.

15. Do you think our income verification proposals will impact any groups with protected characteristics (e.g. race, religion)?

No comment

16 – 23. Interest only

N/A. Deadline for comments closed 30 September 2010.

24. Do you have comments not made previously in response to DP09/03 on the case for not banning loans above defined LTI, LTV or DTI rations?

No further comment, we are pleased that the FSA do not intend to regulate against high LTI, LTV or DTI rations.

25. Do you agree that we should not ban loans to borrowers with multiple high-risk characteristics but instead rely on robust affordability assessment requirements (including additional checks when the borrower is credit-impaired)?

We agree that loans to borrowers with multiple high-risk characteristics should not be banned but still do not fully understand why the robust affordability assessment can not be left to the lender rather than regulated for.

26 – 32. Arrears charges

No comment

Responsible borrowing, better informed purchasing

Although no direct questions are asked in this section, we thought it was important to acknowledge our support for the information awareness campaigns and access points to ensure our customers are better informed. It has never been more important to provide information for prospective home purchasers and for them to understand where they stand as potential customers in the mortgage process.

The assessment of personal affordability as proposed assumes a rigorous, time consuming and potentially expensive process which will significantly slow down the pace with which a mortgage lending approval can be sought by a customer. This has stark impacts for the new build market, going far beyond the scope of the FSA. It is crucial that if a customer wishes to find out quickly what size of mortgage they are likely to qualify for there should be a simple reliable calculation or method that they can follow – i.e. online tools based on the Free Disposable Income table.

From our own member's perspective, this would reduce the number of people reserving new homes without ensuring they have the lending capacity to complete the purchase.

33 – 34. Non-deposit taking lenders

N/A. Deadline for comments closed 30 September 2010.

35. Do you have any comments on the cost benefit analysis for our proposals on responsible lending & arrears charges?

We note that it is estimated that up to 4.1% of borrowers would have been excluded from the mortgage market had these proposals been in place from 2005 to 2009, and that up to 17% of borrowers would have had to reduce the amount borrowed to pass the affordability tests and obtain a mortgage. We assume the worst of this impact would have been made between 2005 and 2008 and would be surprised if any impact was made between 2008 and 2009. The reaction of the mortgage market to the downturn

has been to self-regulate and protect itself against high risk lending. We are far from supportive of the over protective reaction from lending institutions, but their actions do demonstrate the naturally occurring adjustments to affordability models that have taken place without the need for FSA intervention.

The cost benefit analysis finds that if the proposed changes were to be introduced, it would be less difficult for lenders to adapt their practices during a 'trough' in the business cycle i.e. during the downturn. The 'transitional measures' section of the main consultation document however states that final implementation dates will depend on how quickly the market recovers which indicates to us that no new proposals will be introduced during the downturn. Further clarification is therefore required on the timings of any changes.

We are pleased that you are separately considering transitional measures to help mitigate any adverse effects on existing borrowers. We would certainly not want any new regulation to slow movement in the already painfully slow and constrained mortgage market or to create an increase in the number of existing 'mortgage prisoners'.

36. Do you have any comments on the high-level cost benefit analysis on our current position on interest only mortgages and non-banks?

N/A. Deadline for comments closed 30 September 2010.

37. Do you have any comments on the compatibility statement?

N/A