Financial Conduct Authority

Thematic Review

TR16/4

Embedding the Mortgage Market Review: Responsible Lending Review

May 2016

Contents

Abbreviations used in this paper

AIV	Automated Income Verification
CfI	Call for Inputs (relating to competition in the mortgage sector)
FCA	Financial Conduct Authority
FLS	Funding for Lending scheme
FPC	Financial Policy Committee
FTB	First Time Buyers
HtB	Help to Buy scheme
LTI	Loan-to-Income ratio
LTV	Loan-to-Value ratio
MCD	Mortgage Credit Directive
MCOB	Mortgage and Home Finance – Conduct of Business sourcebook
MI	Management Information
MMR	Mortgage Market Review
NI	National Insurance
ONS	Office for National Statistics
PRA	Prudential Regulation Authority
PSD	Product Sales Data
QA	Quality Assurance
SYSC	Senior Management arrangements, systems and controls

1. Executive summary

Introduction

1.1 This report summarises the key findings of our market-wide thematic review of how firms are applying the responsible lending rules[1] we introduced in April 2014 following the Mortgage Market Review (MMR).

1.2 This review is the second of two market-wide thematic reviews examining the impact of the MMR.[2] It forms part of our wider programme of mortgages work that also includes the proposals outlined in the feedback statement of the mortgages Call for Input (CfI) which we have published alongside this report.[3]

1.3 The responsible lending rules set out to prevent a return to poor lending practices seen during the run up to the financial crisis, by putting affordability at the heart of the lending decision process. Our review assessed how our responsible lending rules had affected firms, consumer outcomes and competition in the marketplace using a range of tools. This included reviews of firms' lending policies, individual lending decisions, case-study lending scenarios, review of market data and on-site visits to firms. The scope of this review is restricted to residential first charge lending for new and existing borrowers.

1.4 In particular, our review was designed to examine:

- whether firms are lending responsibly
- how mortgage lenders across the market have interpreted and implemented our rules, and
- any root causes of good/poor consumer outcomes.

The review also considered:

- if there have been any unintended consequences of the rules, for example, whether particular groups of either new or existing customers are being denied access to affordable lending, and
- how the rules have impacted on aspects of competition.

1 www.handbook.fca.org.uk/handbook/MCOB/11/
2 Advice and Distribution Thematic Report (TR15/9) June 2015
3 www.fca.org.uk/news/fs16-03-competition-in-mortgages-sector

The Responsible Lending Review found:

1.5 Firms have recognised and positively engaged with the aim of our responsible lending rules. There was no evidence of previous poor practices like self-certification of income or interest-only lending without a credible repayment strategy. Where lending is affordable, we did not see evidence that the responsible lending rules have prevented creditworthy consumers obtaining loans.

1.6 All firms in the review have taken steps to follow our responsible lending requirements, but improvements can be made to some aspects of their affordability assessment process, monitoring and record keeping.

1.7 In nearly all of the lending decisions we reviewed the outcome appeared reasonable even if the approach taken by the firm was not completely clear.

1.8 Most lenders are using the flexibility afforded by our rules when dealing with their existing mortgage customers who want to make changes to their loan.[4] However, we are encouraging some firms to improve their decision-making process for these customers, because where firms are prepared to use flexibility in our rules, they are not always doing so early in the process. In particular, some firms could be more proactive and consistent in using exceptions to the responsible lending requirements for existing customers. Whether or not firms choose to apply the exceptions, firms should consider the fair treatment of customers when they want to make a change to their mortgage. In doing so, firms should ensure that customers do not face unreasonable barriers to changing product.[5]

1.9 We did not find evidence that the rules have prevented firms lending responsibly across particular groups, for example older borrowers and the self-employed except in one niche area of lending that we've taken steps to address.[6] We have come to this view based on:

- market data which shows there has been no obvious decline in lending to these customer groups post-MMR
- evidence from our review showing compliant lending to these groups.

1.10 However we are especially mindful that older consumers represent an increasing proportion of the UK population and it is important that the mortgage market continues to develop a range of products that can meet their needs. Lending to older borrowers will be included in our wider strategy work on the ageing population following our recent discussion paper.[7]

1.11 Our review of market data has shown that over a period where there have been a number of other interventions in the market,[8] the responsible lending rules do not appear to have made a material impact on lending volumes. Although, while the market is subdued any impacts are likely to be less visible. It is anticipated that the rules will have a greater impact as interest rates rise and affordability is stretched.

4 MCOB 11.6.3 and MCOB 11.7

5 TCF customer outcomes: www.the-fca.org.uk/fair-treatment-customers

6 We have published a modification by consent on our website. It applies to lifetime mortgages that let customers make regular payments but switch to rolling up interest at any point without the risk of repossession. It will make it more straightforward for firms to offer this type of product, which can be of benefit to customers who are concerned their equity may be eroded. We intend to consult on updating our Handbook to reflect this change in approach. There is evidence that this type of product made up approximately 15% of the lifetime mortgage market before the introduction of our MMR rules, and 5% after their introduction.

7 www.fca.org.uk/news/dp16-01-ageing-population

8 For example, the FPC's recommendation on loan to income ratios, and the government's Help to Buy scheme.

1.12 Our rules require firms to ensure that a loan is affordable, but we recognise that firms will have different risk appetites. Accordingly, we saw wide variations in what individual firms are willing to lend to identical customers.[9] However, it can be difficult for consumers (or intermediaries) to easily identify lenders prepared to lend a specific amount because of factors such as the inaccuracy of some online calculators.

1.13 As a result of this review and our other mortgage work we will continue to engage with the industry to address the issues identified. We are providing individual feedback to firms visited as part of our assessment, setting out any actions required as a result of our findings. Where appropriate, we will follow up as part of our ongoing supervision of these firms.

1.14 This report also responds to feedback on responsible lending provided by stakeholders as part of the CfI on competition in the mortgage sector.

Key messages for firms

Firms have recognised the aim of our responsible lending rules and have implemented them broadly in line with our expectations.

As firms continue to develop their processes, they must ensure that each aspect of their affordability assessment is adequate and appropriate to the circumstances of the customer.

- Income needs to be verified accurately.
- Where relying on modelled expenditure, firms need to assure themselves that the figures are based on realistic assumptions.
- When considering the effect of expected future interest rate changes, firms must have regard to both market expectations and any prevailing FPC recommendation, and to be able to clearly justify the basis used with reference to both.

Record keeping for lending decisions needs to improve.

- Firms need to ensure they can demonstrate how they assess affordability in each individual case.

Most firms are using the flexibility allowed by our rules when dealing with their own existing mortgage customers. Where it is firms' policy to use the flexibility, we want some firms to improve their decision-making process for these customers, because they are not always using that flexibility early in the process.

- We found that firms were prepared to apply exceptions to the affordability and interest-only requirements where our rules allow it.
- However, the processes for handling such cases were often time consuming. For example, some firms only consider using this flexibility after a customer has failed an affordability assessment. Firms should consider how they might improve processes and their impact on customers in these circumstances.

9 We used case study lending scenarios for this – asking firms to demonstrate whether they would approve or decline an example application, and how much they would be prepared to lend.

- Where a customer is unable to remortgage with another lender, the existing lender should not take advantage of the customer's situation to treat them any less favourably than it would treat other customers with similar characteristics.

Our rules do not prevent responsible lending to older borrowers and the self-employed.

- We recognise it is for individual firms to decide whether and to what extent they wish to operate in these markets, but our rules do not prevent lending responsibly to particular customer groups.

It would be helpful for lenders, intermediaries and consumers, if online calculators provided a more accurate guide to the amount they are likely to be able to lend.[10]

- We found some firms online calculators reflected firms' affordability assessments and gave a fairly accurate estimate.
- Others were based on simple multiples of income which may provide fairly inaccurate estimates.

Key messages for consumers

There are benefits to shopping around when looking for a mortgage, even at the basic level of identifying how much you can borrow.

- Our review found that how much you may be able to borrow can vary considerably from lender to lender.

If your current mortgage deal is coming to an end you should consider contacting your lender/mortgage broker.

- Customers looking to make a change to their mortgage and not borrowing more money may, in some circumstances, be able to move to better deals with their existing lender without passing an affordability assessment. They should discuss this with their lender or mortgage broker.

10 See Principle 7 and MCOB 3A.2.1R(1)

2.
Who is this report aimed at?

2.1 Firms

You should read this thematic report if you are:

- a lender or other home finance provider.

It may also be of interest if you are:

- a home finance administrator, or
- a firm that advises on or arranges mortgages or other home finance.

2.2 Consumers

This report may be of interest if you:

- have a mortgage or are planning to take one out.

This report will also be of interest if you are a body that represents consumers.

3.
The Mortgage Market Review – what it changed for lenders

3.1 Taking out a mortgage remains one of the most significant financial commitments that consumers have to make. We strengthened our responsible lending rules through the MMR with the aim of stopping a return to the poor lending practices seen before the financial crisis. The rules aim to prevent consumers taking on mortgages which are unaffordable, while not restricting access to mortgage finance for consumers who can demonstrate that they can afford the loan.

3.2 The responsible lending rules we introduced under the MMR set out the basic standards for assessing affordability as well as clarifying who is ultimately responsible. In summary, the key changes to the responsible lending rules require lenders to:

- assess affordability on the basis of a borrower's verified income, credit commitments, essential expenditure and basic quality of living costs
- take into account known or likely future changes to income and expenditure
- consider the effect of expected future interest rate rises
- not assess affordability on the basis of self-certified income or house price inflation, and
- only grant an interest-only mortgage where the customer has a credible repayment strategy.

3.3 We recognised that introducing these rules might impact some existing borrowers and make it harder for them to refinance or switch to a more competitive deal. To mitigate this, our rules do not require affordability assessment in certain circumstances where a lender's existing customer wants to make a change and isn't borrowing any more money.[11]

3.4 Lenders are required to keep an adequate record of the steps taken to comply with the responsible lending rules for the period that the mortgage remains with the lender.[12] This should include, as a minimum, a record of the key information taken in to account for each affordability assessment:

- information on income and expenditure used in each affordability assessment, including the evidence relied on
- the rate or assumptions used to test affordability against expected future interest rate rises
- the repayment type and term of the mortgage

11 MCOB 11.6.3R, MCOB 11.7
12 MCOB 11.6.60R

- evidence of a clearly understood and credible repayment strategy where there is any element of interest-only lending, and
- the calculation used to determine whether the loan is affordable.

4. Mortgage market

Our review of market data has shown that the responsible lending rules do not appear to have made a material impact on lending volumes. It is anticipated that the rules will have a greater impact as interest rates rise and affordability is stretched.

Background

4.1 To provide background to our review we considered how the mortgage market had developed in the period before, and immediately after the rules came in to effect. This was to provide insight and understanding of any impact the rules had on consumers.

4.2 It is important to note that even though the responsible lending rules were introduced on 26 April 2014, many firms had already adjusted their practices ahead of this date. It is also important to consider any changes in the wider context of other regulatory, economic and policy changes that occurred during this period and could have affected the market dynamics, such as government backed Help to Buy schemes (HtB), the FPC interest rate stress test and LTI recommendations.

4.3 We considered the volume and value of residential mortgages within the UK, using a combination of the following:

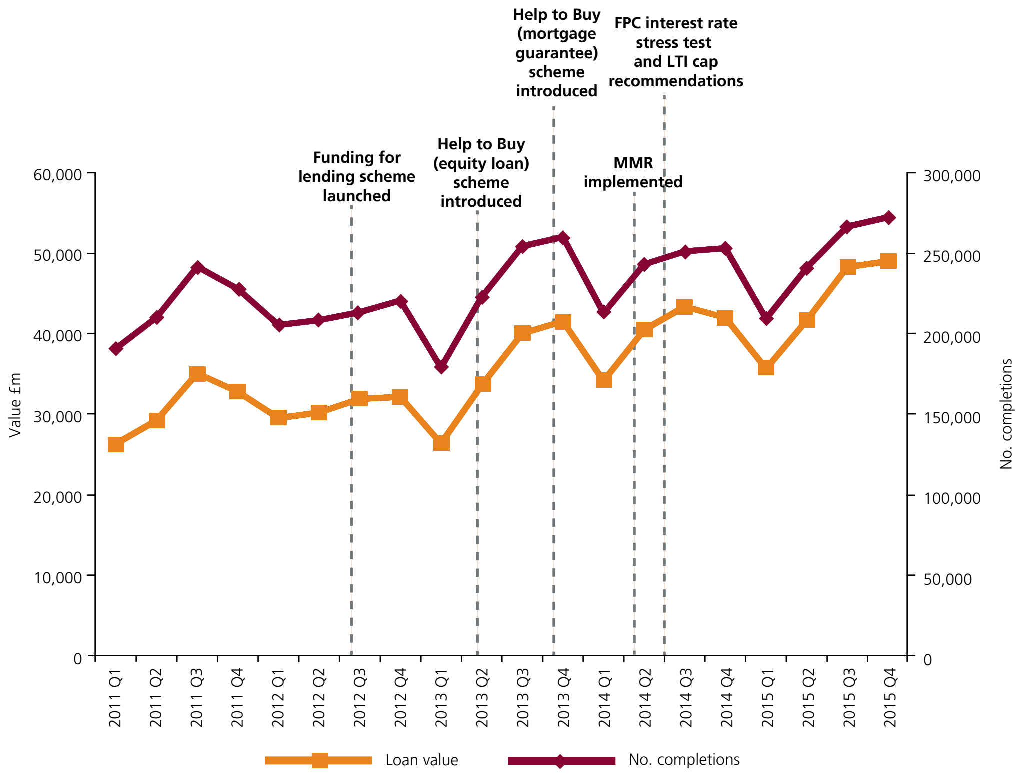
- FCA Product Sales Data (PSD) – transaction level data on regulated mortgage sales, submitted by lenders on a quarterly basis
- Transaction level credit reference data – collected by Experian on the regulated mortgage market.

Market data

4.4 Over a period where there have been a number of other interventions in the market[13] the responsible lending rules do not appear to have had a material impact on lending volumes. It is anticipated that the rules will have a greater impact as interest rates rise and affordability is stretched.

13 For example, FPC recommendations to cap at 15% the total number of residential mortgages available at or above 4.5 times income, and that firms assess whether the borrower could afford the mortgage if prevailing interest rate rises by three percentage points over the first five years of the loan.

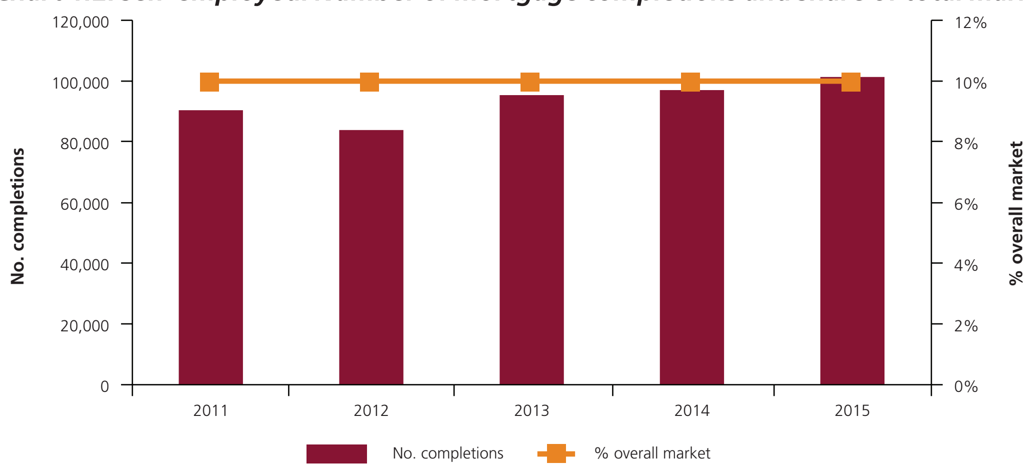
Chart 4.1: Total mortgage completions, by volume and value



Source: FCA, PSD

4.5 Our rules require firms to verify income as part of the affordability assessment. Although our rules do not differentiate between verifying the income of employed or self-employed borrowers, there were concerns raised at the time of implementation that the self-employed may find it more difficult to provide suitable evidence of earnings. The data shows that the proportion of customers taking out a mortgage who are self-employed has remained broadly unchanged.

Chart 4.2: self-employed: Number of mortgage completions and share of total market

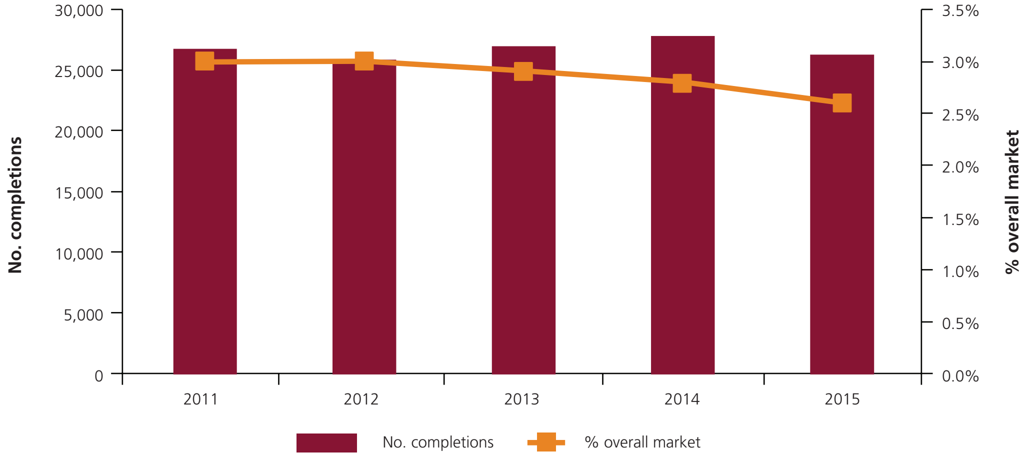


Source: PSD

4.6 Similarly, our rules do not prevent lending to older borrowers where the mortgage is affordable both now and in the future, accounting for known and likely changes to income and expenditure.

4.7 The number of customers taking out a mortgage after the age of 65 has not altered markedly since these changes to the affordability rules. There has been a slight structural change, however, meaning that a higher proportion of mortgages to this age group are now lifetime mortgages, although this is not necessarily as a result of MMR changes.

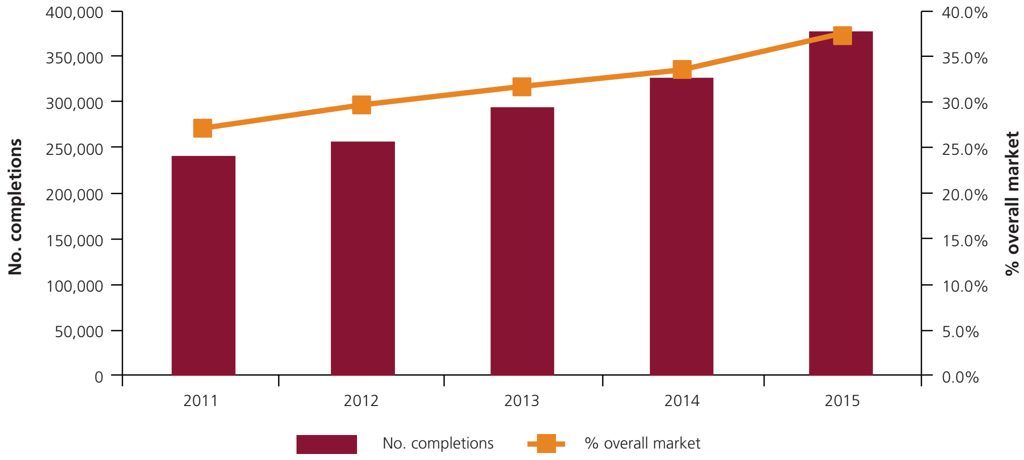
Chart 4.3: Customers aged 65 or over: Number of mortgage completions and share of total market



Source: PSD

4.8 The number of mortgages being arranged that are expected to mature after the customer has reached the age of 65 are increasing. This has been a growing trend for some time, including post MMR, and in part we believe this reflects recent changes such as the increase in state pension ages.

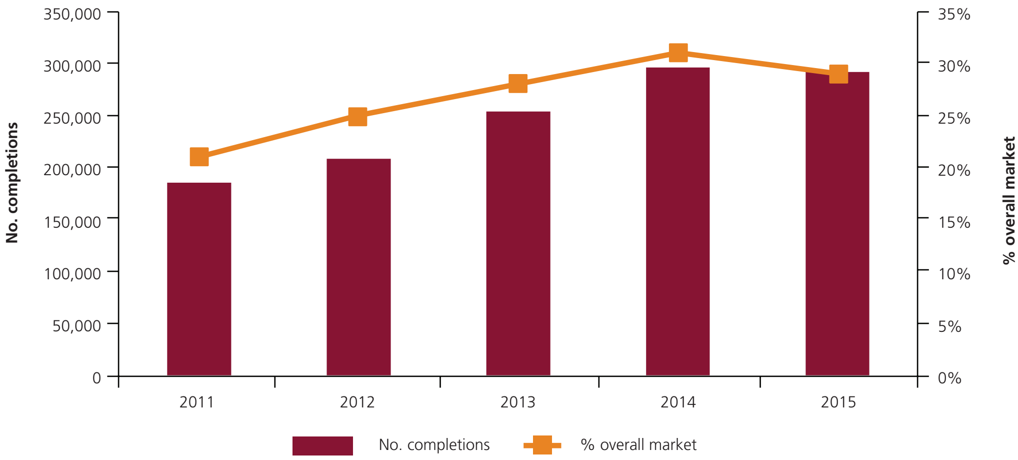
Chart 4.4: Customers aged 65 or over at maturity: Number of mortgage completions and share of total market



Source: PSD

4.9 First time buyers (FTB) have continued to access the market, with new lending volumes increasing over the period. This may be partly as a result of the HtB, which can be of particular assistance to customers with a limited deposit.

Chart 4.5: First time buyers: Number of mortgage completions and share of total market



Source: PSD

Characteristics of mortgage loans

4.10 According to data provided by Experian on mortgage loans in the period Q4 2012 to Q3 2014, the average term of new mortgages arranged increased by more than 16 months over the period as a whole (from 22.5 years to 23.8 years). A significant proportion of the increase in loan terms over the period is very likely to be associated with changes in key characteristics of borrowers. In particular, affordability pressures generally mean first time buyers tend to take out mortgages over longer terms to spread the cost over an extended period. The increased share of younger borrowers in the market would itself also be expected to result in an increase in average loan term.

5.
Assessing affordability: firm findings

Overall, we found that firms have implemented the responsible lending requirements within their lending policies, but there are still some areas for improvement in these policies and their application in practice. In nearly all of the lending decisions we reviewed the outcome appeared reasonable.

In all lending decisions assessed, attempts had been made to verify income. We did not see any instances of firms accepting self-certified income, a practice no longer permitted under the rules. Estimates made by firms about customer's expenditure appeared to take account of realistic assumptions.

Our review was carried out using:

- **Desk-based reviews** of lending policies and mortgage strategies, involving firms representing approximately 75% of post-April 2014 lending
- **Review of individual lending decisions** covering new lending, contract variations, remortgage and declined cases across mainstream mortgage lenders, and lifetime mortgages
- **Case study lending scenarios** To allow us to compare lending decisions, we asked firms to demonstrate whether they would approve or decline an example application, and how much they would be prepared to lend, depending on a series of tightly-defined customer circumstances
- **Visits to a selection of firms** to fill information gaps and deepen our understanding of particular areas.

Lenders approaches to assessing affordability – background

5.1 When assessing a mortgage application, lenders must ensure the customer is going to be able to afford the repayments.[14] To carry out this assessment, they need to obtain evidence of the customer's declared income.[15] They must also take into account:

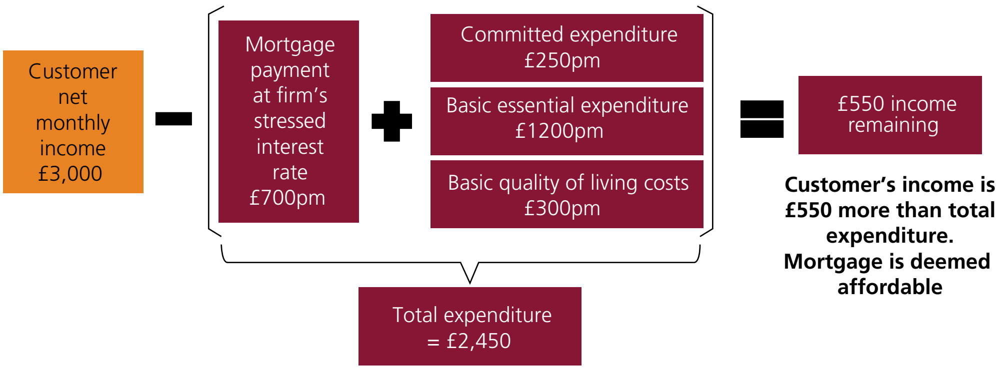
- committed expenditure (for example, outstanding loans and child maintenance)
- basic essential expenditure (for example, utilities and essential travel), and

14 MCOB 11.6.2R
15 MCOB 11.6.8R – 9G

- basic quality of living costs of the customer's household that would be hard to reduce (for example, clothing and household goods).[16]

Lenders must also take into account any known or likely future changes to that income or expenditure[17] and consider the impact of expected interest rate rises on the customer's mortgage payment.[18] See figure 5.1 for an example affordability assessment.

Figure 5.1: Example of simple affordability calculation



Source: FCA (not based on any single lender's calculation)

5.2 Larger lenders in particular, have automated elements of their lending decisions to speed up decision-making and lower costs. This automation appears to have made it more difficult for these firms to extract key figures from their systems relating to the individual customer decision. This can make it difficult for the firm to demonstrate how the overall lending decision was made in line with SYSC 9 and our record keeping requirements in MCOB 11.

5.3 In the vast majority of cases, lenders are verifying customer income by checking customers' payslips or self-employed earnings. Some larger lenders are using automated income verification (AIV) techniques on a limited basis. AIV uses the customer's current account turnover to estimate earnings.

5.4 The customer's household expenditure is generally calculated in one of two ways. Some lenders ask the customer to provide details of expected monthly spend on certain goods and services. Alternatively, and as permitted under our rules,[19] some firms rely on modelled household expenditure figures based on the customer's family structure, income and sometimes factoring other details, such as where the customer lives.

5.5 This modelling is generally based on available market data such as that collated by the Office for National Statistics (ONS), or the lender's own (for example, current account data). When using market data, the lender will use their own judgement on what expenditure items to include, along with any other interpretations of the base data. These judgements should be based on realistic assumptions. Where firms ask the customer to provide expenditure details, some are then cross-checking against market data to test plausibility and will use modelled data where they believe the customer's figure is unreasonably low.

5.6 To safeguard against the effects of expected interest rate rises, we require firms to assess affordability against a higher rate that might be payable within five years. In doing so, firms must

16 MCOB 11.6.10R – 13G
17 MCOB 11.6.14R – 15G
18 MCOB 11.6.18R – 19G
19 MCOB 11.6.12R (3)

have regard to market expectations and the FPC's prevailing recommendation on appropriate interest rate stress tests. We recognise that each firm can reach its own view on the stress rate used. However, lenders must be able to justify this.[20]

Firms' responsible lending policies

5.7 We found that responsible lending policies broadly reflected our requirements. Some policies were more detailed than others, and where there was less detail we saw evidence of this leading to inconsistencies in lending decisions. For example, for the same lender we saw different approaches in calculating how much non-guaranteed income is taken into account. Most lending policies either omitted, or gave little attention to, the records that should be kept following a lending decision.[21] This could have been a contributory factor to the lack of detail they were able to provide when we asked them to demonstrate lending decisions for our review.

Interest-only

5.8 Although many firms scaled back their interest-only lending before our rules came into effect in April 2014, the majority of firms are still offering interest-only mortgages, provided there is a credible repayment strategy. Where the customer is using the mortgaged property as the repayment strategy many lenders have introduced more stringent criteria, so as not to rely on house price inflation.

Older borrowers

5.9 The majority of firms' policies showed they were prepared to offer mortgages with terms that extend beyond a customer's expected retirement age. In particular, at the time of the review, we found that large lenders set their maximum age at 70 or 75. Our rules do not set any age limits and these policies are a reflection of lenders' current credit risk appetites and operational preferences.

5.10 Through our review of individual lending decisions we found that, in practice, lenders were following their policies and lending to older borrowers. Even where firms have maximum age criteria, we saw some firms making exceptions for existing customers where this was in their best interests. We found smaller building societies in our sample had more flexible underwriting standards which might allow customers exceeding other lenders maximum age limits to access the market.

5.11 We want to ensure that markets work well for consumers and we are especially mindful that older consumers represent an increasing proportion of the UK population. Older consumers are not a homogenous group (for example, they will differ in their asset wealth and income) and are best served by having a range of mortgage products and services available to them so they can find the option that best suits them. Lifetime mortgages can play an important part in serving some of these borrowers, and we are keen that our regulatory requirements do not place unintended barriers to growth and innovation.

5.12 Feedback from respondents to the competition CfI and our work on the review indicated that our responsible lending rules could have restricted development of those lifetime products that allow a customer to make regular payments but switch to interest roll-up at any point without risk of repossession.[22] To allow firms to more readily offer this type of product, which can be of benefit to consumers concerned about equity erosion, we have made available a modification

20 MCOB 11.6.18R (2)

21 MCOB 11.6.20R (8) and MCOB 11.6.60R

22 Evidence suggests this type of product constituted approximately 15% of the lifetime mortgage market before we introduced our MMR rules, and 5% afterwards.

by consent,[23] which is published on our website.[24] We intend to consult on updating our Handbook to reflect this change in approach.

5.13 We published a Discussion Paper on Ageing Population and Financial Services in February 2016.[25] Feedback and engagement associated with this paper, and our wider strategy on this, will include issues relating to lending to older borrowers.

Assessing income

All firms in our sample had processes in place to assess the customer's income. We saw no evidence that firms were intentionally exaggerating income, but did observe – particularly in more complex cases – that some firms struggled to assess income in line with their policy.

5.14 Most firms' policies clearly detailed the types of income accepted and their approach to assessing variable types of income. However, when putting into practice more complex elements of these policies, firms had difficulty assessing the eligible income for some borrowers.

Assessing income: employed

5.15 Although most firms are assessing income using payslips or P60s, we found that some larger lenders are using AIV. Although firms have expressed a clear appetite to extend use more widely, at this stage the model appears most suitable for customer groups with simple income arrangements.

5.16 For borrowers with more complex employed income, some lenders appeared to have difficulty separating different types of variable income (shift allowances, overtime etc.) from guaranteed income in order to verify it in line with their policy.

Evidence of income: employed

5.17 Some firms' lending policies require only one payslip as evidence of a customer's income. While this may be representative where the customer's income is consistent, we did see examples where it was relied on in relation to variable pay as well. Using one payslip captures earnings at a specific point in time. If used in isolation lenders need to satisfy themselves that they have considered income over an adequate period to assess affordability.

Example

Review of an individual lending decision shows a customer with three elements of monthly income earned through their full time job.

Income element 1 – Basic pay	= £2,000
Income element 2 – Shift allowance	= £500
Income element 3 – Overtime	= £500
Total	= £3,000

From one payslip it is unclear whether income elements 2 and 3 are ongoing permanent earnings or if they will vary from month to month. To ensure they grant an affordable mortgage, lenders should consider what evidence they might need to assess these additional elements of income.

23 These are offered where an unmodified rule would not meet the circumstances of a particular category of firm.
24 www.the-fca.org.uk/modification-consent-hybrid-lifetime-mortgage
25 www.fca.org.uk/news/dp16-01-ageing-population

Assessing income: self-employed

5.18 Most lenders had clearly laid out policies on how they assess self-employed earnings. The responsible lending requirements do not specify the period of time over which a lender must assess self-employed earnings, which is reflected by the differences we found in the policies we reviewed.

5.19 Assessing self-employed earnings can be more complex than employed earnings. When assessing income for self-employed customers, lenders in our sample typically reviewed the last two or three years of earnings.

5.20 The complexity of some self-employed earnings presented challenges for firms. In assessing self-employed earnings, firms either reviewed business accounts, or self-assessment returns (SA302) that have been accepted by the Inland Revenue. In assessing earnings some firms appeared to make deductions such as Tax and National Insurance (NI) where the evidence of income suggested deductions had already been made. In one instance the firm had failed to deduct any tax or NI from gross earnings.

5.21 Due to the more volatile nature of self-employed earnings there were often large differences in individual customer's annual earnings. We found that lenders often averaged amounts across these periods to provide a more moderated assessment of income.

Evidence of Income: self-employed

5.22 Lenders often use a combination of SA302s and business accounts as evidence of earnings. Lenders appear to have recognised the risk of using SA302s in isolation. These documents alone may not always be an accurate reflection of earnings as documents can be amended and reproduced at a later date.

Future changes

5.23 Firms must take account of any known or likely future changes to a customer's income and expenditure. During our review of lending decisions it was sometimes difficult to determine at what stage, and to what extent, the firm had gathered this information and taken it into account in their assessment.

> ***Example***
> Some firms did not ask customers to provide the ages of dependent children. This could be particularly important for cases where affordability is reliant on income (such as child benefit) that will end when the child reaches a certain age.

5.24 Where customers were borrowing into retirement we found that firms were asking for relevant information on the customer's post-retirement income, for example pension statements, projections and availability of other investment income.

Expenditure

> Expenditure estimates carried out by firms appeared to provide a realistic assessment of typical expenditure. However, in some cases customers would need to consider reducing non-essential spending in order to afford the mortgage.

5.25 In all new lending decisions assessed as part of the review, firms had taken in to account customer expenditure as part of their assessment. This included:

- committed expenditure
- basic essential expenditure
- basic quality of living costs, that are not easily reducible.

5.26 In lending decisions assessed as part of the review, we saw that committed expenditure was almost always taken in to account and appeared to have been corroborated through a credit reference agency.

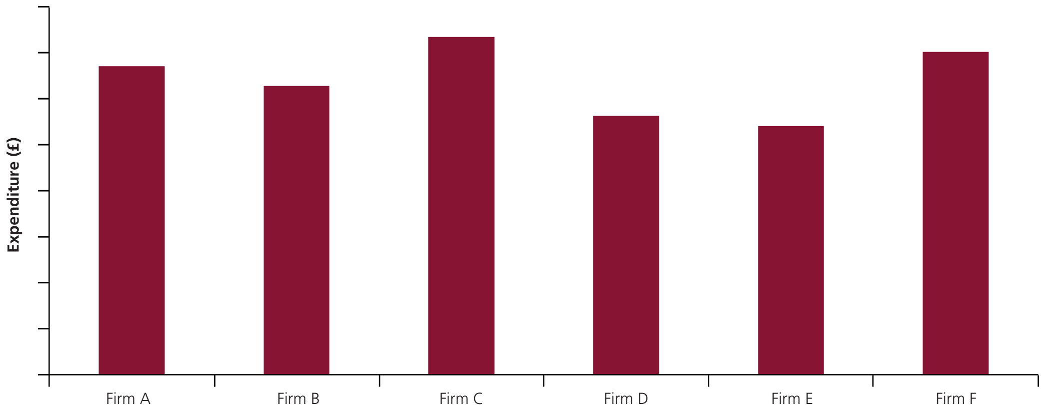
5.27 Other elements of expenditure were either collected directly from the customer (via the application form) or modelled through use of typical customer data. In broad terms, larger firms were more likely to use modelled data only, with smaller firms being more likely to ask the customer for expenditure details and then use market data where the customer's estimates looked unrealistically low.

5.28 We require firms to apply realistic assumptions when modelling expenditure and keep records of the rationale for those assumptions and how they have been applied in practice. Almost all firms that were modelling expenditure had chosen not to use every available element from their data source. Instead firms chose to remove or reduce some items of expenditure deemed unnecessary. Firms must ensure that they continue to make realistic assumptions when deciding which expenditure data to include. This risk could be particularly pertinent at times during the economic cycle when downward pressures can be exerted on lending criteria.

> ***Example***
> To help ensure expenditure figures were relevant to their customer base one firm cross-checked ONS data with income and expenditure details collected through interactions with arrears and interest-only maturity customers.

5.29 It is clear from firm feedback, that lenders have different thresholds for the standard of living they expect a customer to be able to maintain once they have paid their mortgage. This was illustrated through analysis of firms' responses to our case study lending scenarios. In the example shown in chart 5.1 below (a joint application with two dependants), Firm E assumed a monthly expenditure 36% lower than Firm C (both figures were modelled from ONS data). Across the firms in the sample it appeared that even where lower expenditure numbers were being used, they still appeared to use realistic assumptions in modelling typical essential expenditure for that type of customer.

Chart 5.1 – Expenditure numbers used by firms (all based on case study customers)



Interest rate stress test

All lenders were using an interest rate stress test as part of their affordability calculation. Lenders need to ensure that the rationale for the rate at which they stress test is credible and applied consistently across their lending decisions.

5.30 When deciding how to assess the effect of expected future interest rate rises on affordability, lenders must consider the likely future interest rates over a minimum period of five years. In coming to a view on likely future interest rates a lender must have regard to: market expectations and any prevailing FPC recommendation on appropriate interest rate stress tests. The lender must also be able to justify the basis for the stress test rate it uses with reference to both.

5.31 Our review found that most lenders took these requirements into account when justifying the basis used for their interest rate stress test. However, our review of individual lending decisions, found a small number of firms were not always consistently applying the rate as stated in their policy.

5.32 It is important that lenders account for expected future rate rises appropriately. Firms' rationale for interest stress rates must be realistic and appropriately thought through, with particular emphasis on considering the consequences on the borrower's ability to afford the mortgage if rates do rise.

5.33 Interest rate stress testing policies should be set using a robust governance process with the addition of appropriate oversight in place to ensure the agreed policy is executed consistently across all lending decisions.

Record keeping, monitoring and oversight

Many firms in the review were unable to adequately demonstrate how they made individual lending decisions. This could make it difficult for firms to be able to review their own lending decisions and ensure the accuracy of key systems they rely on.

5.34 Our record-keeping rule requires firms to make an accurate record of the steps they take to assess affordability. In our review of individual customer files, many firms were unable to demonstrate how the lending decision was reached. Those firms using automated decision systems involving complex lending calculators encountered more difficulty than those who have more manual processes.

5.35 The quality of files submitted to us presented a challenge in understanding how a firm was following both our rules and its own policy. For example, some files did not show which elements of the borrower's income were taken into account and how. We were able to overcome these issues in most cases by doing our own calculations. This raises concerns about firms' ability to accurately review their lending decisions. Firms need to be able to demonstrate how the decision was made, including each element set out in MCOB 11.6.60R. Figure 5.1 (see page 17) shows the type of calculation we would expect to be able to construct based on information provided by the firm.

5.36 In our visits to firms it became apparent that some firms that rely on automated systems are not carrying out end-to-end quality assessments of cases from application stage to lending decision to test compliance with our rules and the firm's own policy. Most firms' systems remove the ability for underwriters/quality assurance staff to view the internal workings of the system. This means the system outputs are not necessarily being questioned as part of the decision process. We accept that, in order to achieve the efficiencies in terms of cost and time, firms want to rely on their systems rather than manually check every decision. However, unless firms test the accuracy of the system outputs (for example, affordability calculations) at least on a sample basis, there is risk that a systemic problem could go undetected.

Example
Our review of one firm's individual lending decisions identified that they had failed to include one particular aspect within their affordability assessment for some customers.

This meant they were overstating the borrower's income for a particular customer group. This error had not been identified until we raised it with the firm.

5.37 The following sets out the areas where some firms did not provide adequate records:[26]

Income	Each element of income was not always supported with documentary evidence e.g. payslip. There was not always a record whether/ how they had taken account of known future changes to income.
Expenditure	Records did not contain enough information for us to see what they have taken into account. Records did not contain sufficient evidence to demonstrate they had taken in to account known future changes to expenditure.
Interest rate stress test	Lack of evidence to demonstrate whether an interest rate stress test had been applied.
Interest-only	Records did not set out the reason for the decision to offer an interest-only mortgage to a customer.
Affordability calculation	No record of or reference to the calculation used to determine whether the mortgage is affordable.
Affordability and interest-only transitional arrangements	There was often no record of the rationale for the decision to lend, including why the transaction is in the best interests of the customer.[27]

26 MCOB 11.6.60R
27 In accordance with MCOB 11.6.22R

5.38 Firms are required to have robust systems and controls to monitor the effectiveness of their affordability assessment.[28] We also found that lenders' Management Information (MI) was not always accurate or had key details missing. For example, in our selection of contract variation and declined cases, some firms were often unable to confirm the type of contract variations or reasons for declines. It was concerning that lenders did not have this information as it would help them understand whether they are lending responsibly and within their risk appetite.

Declined mortgages

5.39 In reviewing a small sample of customer files where new mortgages and existing mortgage contract variations had been declined, we found that firms had conducted affordability assessments in line with our rules. In some cases affordability was not the reason for declining a loan; a borrower's credit rating or the case being outside of the lender's risk appetite were also factors.

5.40 In general terms we have noted that the gap between mortgage applications and approvals did not widen with the introduction of the responsible lending rules. This confirms that the proportion of mortgages being declined has not changed significantly since lending standards tightened following the financial crisis. However, within the scope of this review we did not attempt to quantify the number of customers who enquired about obtaining a mortgage but did not apply for one.

New lending – variances in lending

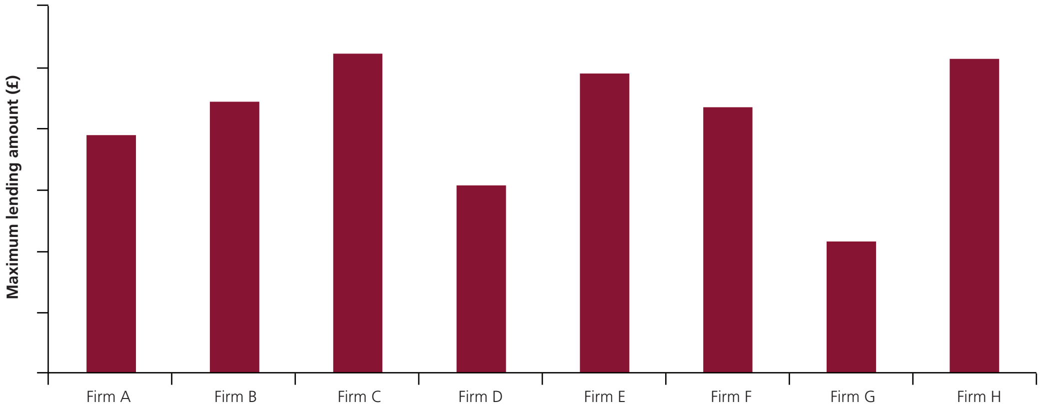
5.41 Within the framework of the responsible lending rules, firms will develop their own policies and processes based on their risk appetite. This means that some variance in the amount that different firms would lend to the same customer is to be expected and is not in itself a cause for concern as long as firms' approaches meet our requirements.

5.42 As part of our work reviewing new lending, and to help inform our findings, we provided a sample of firms with details of some case study lending scenarios. These comprised a range of different customer situations, and firms were asked to put each of the case studies through their affordability assessment as if they were genuine customers. Firms were then asked to provide details, based on the information provided, of the maximum amount they would be prepared to lend to that customer.

5.43 Through the responses received, we noted the range of maximum lending amounts varied considerably from lender to lender. Examples of this are shown in the chart 5.2.

28 MCOB 11.6.22R

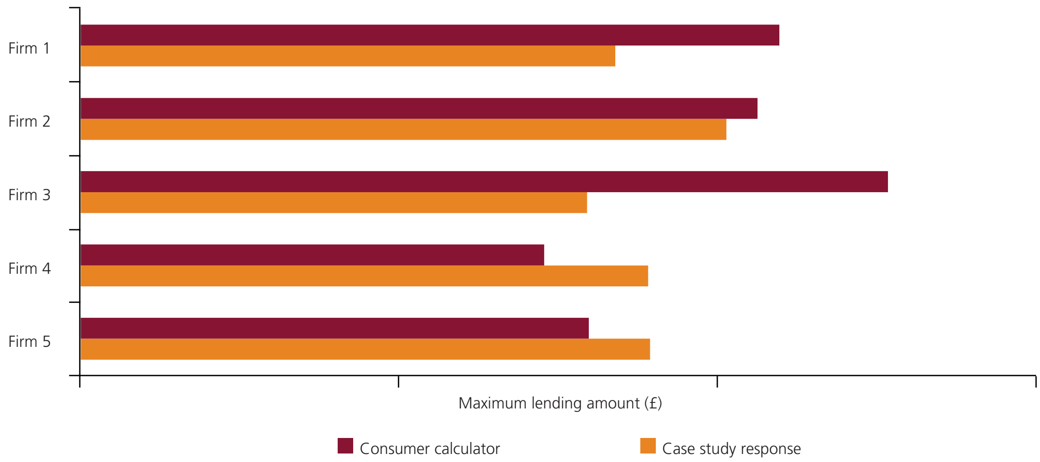
Chart 5.2 – Maximum lending amounts – response to case study lending scenario



5.44 The variance in the maximum amounts firms were prepared to lend were due in part to differences in how firms applied each element of the affordability assessment calculation. For example, some allowed for a higher level of expenditure, while others took into account a higher level of variable income.

5.45 We also entered details of each of the case study lending scenarios into firms' lending calculators that are available on their websites for use by customers. We were interested to see how closely the online calculator results corresponded with what firms told us they would lend having put the case study through its affordability assessment. As shown in Chart 5.3, some firms' calculators matched the amount the firm told us they would lend quite closely, whereas other calculators were far less accurate.

Chart 5.3 – Consumer calculator maximum lending amounts



5.46 From a consumer's perspective, being able to quickly identify how much you are likely to be able to borrow can be helpful when shopping around. Online calculators are one convenient source of this information and we found that most produced results that reflected firms' affordability assessments and, accounting for the limited information input about the customer, give a fairly accurate estimate. Others were less accurate and in some cases were still based on simple multiples of income which can provide inaccurate estimates for certain types of borrower. We also found that some firms provided useful help text on their calculators to give customers extra assistance. This can also help the customer get a more accurate guide to how much they can borrow, particularly for customers with more complex situations.

5.47 We would encourage firms to take reasonable steps to communicate with their customers in a way that is fair, clear and not misleading by checking whether their online calculators provide a realistic estimate.

Existing borrowers

Our rules allow firms not to conduct an affordability assessment in certain circumstances where the customer wants to make a change and is not borrowing any more money. Some lenders are using this flexibility provided by our rules when dealing with their own existing borrowers who wish to make changes to their mortgage contract. However, firms could improve their decision-making process for these customers because where firms are prepared to use the flexibility in our rules, they are not always doing so early in the process.

5.48 Our review assessed how lenders were treating their existing borrowers when they wanted to make a change to their mortgage. In particular, we considered the extent to which firms were using the flexibility in our rules.

5.49 Borrowers often want to make changes to their mortgage; this could be for a variety of reasons such as a product switch, an extension to their existing term or removing a party from the mortgage.

5.50 Our rules allow firms not to apply aspects of our responsible lending rules in certain circumstances where an existing mortgage customer wants to make a change to a mortgage and is not borrowing any more money.[29]

5.51 Before the introduction of the Mortgage Credit Directive (MCD) in March 2016, lenders could take on existing borrowers from other lenders (providing the original mortgage was taken out before 26 April 2014 and there was no increase in the amount outstanding) without applying aspects of an affordability assessment in appropriate cases. We found that no firms in our review actually took advantage of this option even though it was available during the period of the review.

5.52 However our review found the majority of lenders are using the flexibility afforded by our rules when dealing with their own borrowers who wish to make changes to their mortgage contract. Including, for example, those customers wishing to move to a lower cost contract.

5.53 We have seen that lenders deal with their existing borrowers in different ways. Some lenders have implemented processes that flag or re-route eligible customers to help ensure that flexibility offered by our rules is used at the earliest possible stage.

5.54 By contrast, other lenders conduct a full affordability assessment initially, even when not required to do so by our rules. However, if a case is declined, this is often reassessed by an underwriter, and this could result in the decision being overturned. In a limited number of cases we saw that customers had to appeal before the application was reassessed by an underwriter.

29 MCOB 11.6.3R and MCOB 11.7

Example
One lender talked us through the process they use to routinely review all declined cases for existing borrowers to make sure there was nothing they could have done to help that customer.

5.55 We found that most lenders offer to switch existing borrowers to new deals as initial discounted or fixed rates expire. Most lenders have such strategies to retain customers by informing them of the product options available in a timely fashion and making switching as straight forward as possible. Some lenders are being more innovative, with retention deal processes becoming digitalised.

6.
Interaction with the FCA's other mortgage work

6.1 As part of our wider programme of mortgages work we issued a call for inputs (CfI) on competition in the mortgage sector in October 2015. This asked for views on barriers to firms that wish to enter, compete or innovate in this market. Where we have identified relevant competition-related findings as part of our review of responsible lending this will be taken into account in our ongoing competition-focused work set out in the feedback statement.[30] As part of the CfI some stakeholders provided views relating directly to responsible lending. Below, we outline some of the main areas raised in this feedback, and our response to the issues raised.

Competition and responsible lending – issues raised

6.2 Several respondents expressed concern that our responsible lending requirements are restricting access to mortgage credit for some new and existing borrowers. However, respondents also recognised that there are other relevant factors that affect access to credit, such as lenders' risk appetites and changing demographics.

6.3 If a firm is or should reasonably be aware that there are likely to be future changes to the income or expenditure of the customer during the terms of the mortgage, our rules require the firm to take this into account when assessing affordability. Some respondents felt that this was an obstacle to lending to customers whose mortgage term extends beyond their likely retirement age. Lenders pointed to difficulties in accounting for known or likely changes to income and expenditure over the life of the loan, particularly where only a small portion of the term extends beyond retirement age. Indeed, two lenders questioned whether it is necessary to account for changes many years in the future, given that many customers remortgage well before the term end. Respondents felt that these issues were compounded by the combination of first time buyers entering the market in their 30s and increasing average terms.

6.4 More generally, respondents also expressed a perception that they could not take into account certain factors when conducting an affordability assessment, including bonuses, pay rises and income from sources other than employment, such as savings and investments. Some lenders also felt that our existing rules did not cater for particular borrower types such as older borrowers or the self-employed.

6.5 Two intermediary representatives felt that lenders should have made more use of transitional arrangements that, in certain circumstances, allowed them to take on other firms' customers without carrying out an affordability assessment and the FCA should have exerted more pressure on them to do so. These transitional arrangements have been removed as part of our implementation of MCD and both respondents asked whether a different (and less onerous) affordability assessment could be introduced, for instance by looking at a borrower's historic mortgage payments and servicing of other credit commitments

30 www.fca.org.uk/news/fs16-03-competition-in-mortgages-sector

6.6 Some respondents, including lenders and their representatives, recognised that firms' own risk appetites have resulted in a shift away from dealing with complex cases. A trade body felt that the risk of regulatory action in the future was a driving factor in firms' attitude to risk. For example, our rules allow a firm to not apply aspects of our affordability requirements where an existing customer wishes to vary their contract, is not borrowing more and there is no material impact on affordability. The trade body believes that some firms are taking a conservative view of what constitutes a material impact and so are not fully exploiting this flexibility. Several respondents commented that this approach posed risks to existing borrowers unable to move to a new deal. A consumer body felt that this could lead to firms overcharging existing customers.

Our response

6.7 Our rules are designed to stop a return to the poor lending practices seen before the crisis. The aim is to prevent consumers taking on unaffordable mortgages, including taking in to account reasonably foreseeable developments, while not restricting access to mortgage finance for consumers demonstrably able to afford the loan.

6.8 We believe that these policy objectives that underpin our responsible lending rules remain valid. We consider that evidencing a customer's income is critical to understanding whether the mortgage is affordable, so we do not propose to change this requirement on lenders. In addition, the MCD, as well as European Banking Authority guidelines on assessing creditworthiness, would restrict our ability to do so.

6.9 When we implemented the MCD responsible lending standards, we relied largely on existing rules, so as to minimise disruption in the market. This approach was supported by respondents to our consultation. As part of our implementation, we had to remove the transitional provision that, in certain circumstances, allowed lenders to take on other firms' customers without carrying out an affordability assessment. In theory we could introduce a different affordability assessment for these customers, but this would have to meet MCD standards, which require a thorough assessment of the customer's creditworthiness based on verified evidence of income and expenditure. As such, any differentiated approach would be very similar to our existing affordability regime. We believe that the cost of maintaining two different but very similar processes would be a disincentive to firms adopting such an approach.

6.10 Considering future changes to income and expenditure patterns is an essential part of the affordability assessment which firms undertake. However, we recognise that the extent to which firms can assess future changes in income will depend on the length of time before these changes happen and our guidance explicitly takes this into account.[31] For example, if the customer's retirement is many years in the future, the firm may decide it is sufficient to confirm the customer has pension provision by asking for evidence of a pension statement. If the customer is close to retirement, the firm may want to go into more detail and assess whether the expected pension will be enough to service the loan. This is an area where we have intentionally allowed firms to use their own judgement.

6.11 Similarly, our rules already allow firms to take into account a customer's retirement and investment income, as well as employment bonuses, when conducting an affordability assessment.

31 MCOB 11.6.15G

7. Next steps

7.1 We will continue to engage with the industry to address the issues identified. We are providing individual feedback to firms visited as part of our assessment, setting out any actions required, and where appropriate will follow up as part of our ongoing supervision of these firms.

7.2 Some of the firms we assessed had already identified issues with parts of their responsible lending policies and processes that might not currently be leading to the best experience and outcomes for customers, for example a lengthy appeals process where customers were originally declined. We welcome these efforts and recognise that some firms have learnt from their experiences since implementation and were improving processes at the time of our assessment.

7.3 We would encourage all lenders to consider the questions posed in Annex 2 as they review and further enhance their responsible lending policies and processes to ensure that they remain adequate and appropriate to the circumstances of the customer.

7.4 Firms should also consider the fair treatment of customers, including when they want to make a change to their mortgage. In doing so, firms should ensure that customers do not face unreasonable barriers to changing product.[32] Our rules allow firms to make changes to existing mortgages without conducting an affordability assessment, providing the customer is not borrowing any more money and other conditions are met. We would also remind firms that, where a customer is unable to remortgage with another lender, the existing lender should not take advantage of the customer's situation to treat them any less favourably than it would treat other customers with similar characteristics.[33]

32 TCF customer outcomes: www.the-fca.org.uk/fair-treatment-customers

33 See MCOB 11.8

Annex 1
Assessment methodology – how we carried out the review

The responsible lending review has been a substantive study involving firms that represent c.75% of the overall post MMR lending including large banks, new entrants, lifetime mortgage lenders and niche providers.

Scope

The scope of this review was restricted to residential first charge lending for new and existing borrowers.

The review was focused on understanding core market impacts. We therefore excluded the following products from this work:

- further advances (where an existing mortgage is in place)
- buy-to-let
- second charge lending and unregulated bridging finance

Furthermore we did not set out to examine the following themes:

- potential mortgage fraud
- the execution-only and advised sales processes, and
- any conditions that might have been included as part of any agreement to securitise any of the loans included as part of our file reviews and might have restricted a firm's ability to make amendments to a customer's existing mortgage.

Our review – how we carried it out

- **Desk-based reviews** of lending policies and mortgage strategies, across firms representing approximately 75% of post- April 2014 lending.
- **Review of individual lending decisions**, covering new lending, contract variations, remortgage and declined cases across mainstream mortgage lenders, and lifetime mortgages.

- **Case study lending scenarios.** To allow us to compare lending decisions, we asked firms to demonstrate whether they would approve or decline an example application, and how much they would be prepared to lend, depending on a series of tightly-defined customer circumstances.
- **Visits to a selection of firms** to fill information gaps and deepen our understanding of particular areas.

Annex 2
Considerations for firms

Following this review, we want firms to consider how the findings impact their lending policies and decisions. Although not an exhaustive list, or an indication of what we found in each firm, firms might find it helpful to ask themselves the following questions as they review and further enhance their approaches.

Q1: **How do you ensure that underwriters are able to accurately assess more complex incomes?**

Q2: **How do you ensure that expenditure modelling currently uses, and continues to use, realistic assumptions to determine the expenditure costs of borrowers?**

Q3: **How have you justified the interest rate stress test used in lending decisions?**

Q4: **Where relying on automated systems/processes what controls, testing, and periodic MI reviews do you have in place to ensure you are delivering the requirements of MCOB 11 and good outcomes for customers?**

Q5: **Does your record-keeping allow you to demonstrate how you have complied with our rules and how the lending decision was reached?**[34]

Q6: **How does your QA process ensure that the end to end affordability assessment is providing the right outcome for customers?**

Q7: **How have you ensured that customer journeys are appropriate for existing borrowers?**

34 MCOB 11.6.60R

Financial Conduct Authority

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