

Financial Services Consumer Panel

AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Dear Lynda Blackwell

FSA Discussion Paper 09/3: Mortgage Market Review

This is the Financial Services Consumer Panel's response to the FSA's discussion paper on the mortgage market. Overleaf, the Panel has provided both an introduction to its views and responses to the questions posed in the discussion paper.

Yours sincerely

Adam Phillips
Chairman of the Financial Services Consumer Panel

DP 09/03 – Mortgage Market Review

Introduction

This is the response of the Financial Services Consumer Panel to the Discussion Paper DP 09/03 – Mortgage Market Review. This Discussion Paper is the first comprehensive review of the regulation of this market since the FSA became responsible for its regulation in 2005. The Panel welcomes the FSA's attempt to identify and address weaknesses in the functioning of this market which have become more apparent during the last business cycle and which need further regulatory intervention.

Mortgage debt accounts for four-fifths of outstanding UK lending to individuals and housing associations, with the decision to take out a mortgage being one of the most important decisions taken by private individuals. The Panel believes that in a well functioning mortgage market, consumers should be able to shop around for affordable mortgage products that meet their individual needs. The total cost of a mortgage should be easily comparable across the market, with lenders competing for consumers' business on price and level of customer service. Intermediaries and lenders should be complying with FSA rules and principles, with those falling short being named, thus offering those firms treating their customers fairly a business advantage. And finally for any customers experiencing financial difficulty, firms should be treating them positively and sympathetically, with a solution to managing the mortgage arrears being developed on an individual basis.

To a large extent this has been happening, but nevertheless there have been significant failures, as the paper points out, which have created considerable detriment and costs both for consumers and the industry.

The Panel has set out its detailed response to the questions posed in the Discussion Paper overleaf, but would like to draw particular attention to two issues:

- The Panel's support for mandatory verification of an applicant's income in view of the detriment created by an unfettered self-cert sector. However, with the self-employed in mind, we recognise the need for lenders to be flexible about what forms of independent income verification should be used, with lenders being astute and pragmatic when assessing applications; and secondly
- The Panel's belief that advisors have a responsibility to provide suitable advice, which would include checking affordability, yet it is the lender who must decide whether to advance the loan and the lender who is ultimately accountable for assessing affordability.

We welcome the FSA's in-depth research and analysis of the market and look forward to responding to the FSA's additional research and consultation papers over the coming months.

**Financial Services Consumer Panel's response to DP 09/03:
'Mortgage Market Review'**

Q1. Do you agree that the prudential reforms will ensure that banks and building societies are adequately capitalised for the risks inherent in mortgage lending and should support a more stable mortgage market through the economic cycle?

Although this subject is not within our particular expertise, the Panel agrees that banks and building societies should be adequately capitalised. We note Mervyn King's reference in a recent speech¹ to an "Achilles heel" in the setting of prudential ratios, namely that the riskiness of lenders' activities can change suddenly and radically as market sentiments shift. If King's view is correct, there can be no guarantee that more exacting prudential requirements will "ensure" stability in the mortgage market, as proposed in the question. From a consumers' perspective, it is also important that prudential ratios are not set at a level, or in a manner, that undermines competition in the mortgage market.

Q2. Do you agree with our analysis of the implications of applying higher capital requirements to high-risk loans (on top of the prudential reforms) and that to do so would not be likely to protect borrowers from the risks of taking on such loans?

The FSA's analysis highlights uncertainties regarding the impact of higher capital requirements but does not provide a fully argued case against. Proof of uncertainty does not constitute proof that the option would be ineffective. We believe further analysis and evidence would be required to support the proposition in the question.

Q3. Do you agree that more direct intervention through business model analysis; applying asset limits; or increased prudential requirements is required to deal with the consumer and systemic risks posed by non-deposit taking lenders?

The Panel supports greater analysis of firms' business models by the FSA, but it does not believe the FSA's analysis yet provides a fully convincing case for the rest of these proposals. Although high-risk mortgages have led to a disproportionate rate of default and distress especially for disadvantaged consumers, the Panel believes such problems may be better tackled in the future at the point of sale. The extension of the regulatory boundary to fully encompass non-banks, could lead to disintermediation to other lenders, possibly outside of the UK, which could be more difficult to track and police. The Panel would like to see evidence of the rate of innovation in the mortgage market and an analysis of the extent to which non-banks have acted as a positive innovative spur.

¹ Speech to the Scottish Business Organisations in Edinburgh 20 October 2009:
<http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf>

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

Cross-border leakage of mortgage loan supply is an important concern. The current passporting arrangements effectively limit the powers of host regulators in several key areas and we believe the FSA needs to give further thought to the risks to consumers that could arise from a potential 'migration' of borrowers to lenders whose compliance costs are significantly less than those of UK incorporated firms.

Q.5 Do you agree with our analysis that, on the grounds of consumer protection, there is no case for prohibiting the sale of loans above certain LTV, LTI or DTI thresholds?

The Panel believes that simple LTV, LTI and DTI limits are too blunt an assessment tool; however the Panel is not suggesting the FSA rules out using such tools, if another housing market bubble began to develop.

In addition, the Panel believes the requirements to assess affordability should, if correctly implemented, offer proportionate consumer protection and therefore these tools are not necessary.

Q6. Do you consider that the FSA should prohibit the sale of mortgages to borrowers with multiple high-risk characteristics? If yes, what particular combinations of risk factors should the FSA consider prohibiting and why?

The Panel does not believe the FSA should ban the sale of mortgages to those with multiple high-risk characteristics. With the requirements in place to verify an applicant's income and affordability, it would be a decision by the firm whether or not it would be appropriate to lend money in those circumstances. We would expect the FSA's monitoring of firms' business models to uncover any questionable lending practices.

Q7. Do you consider that requiring verification of income by the lender for all mortgage applications is a viable option, and one which is sufficient to ensure responsible and sustainable levels of mortgage lending?

The Panel does not want to see a return to the types of problems, and consumer detriment, created by self-certified mortgages. It believes that all mortgage applicants should have their income verified, but lenders should be flexible about the form that independent verification can take, for example when verifying the income of the self-employed. With the self-employed particularly in mind, lenders must also become more astute in assessing applications. On this basis, mandatory verification of income is a viable option that should go some way to ensuring responsible lending at a sustainable level.

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

The Panel believes that the lender, rather than the intermediary, should be held ultimately accountable for checking the customer's ability to repay. [MCOB 11.3.1, for example, should be amended to refer specifically to a 'lender' rather than, as it does currently, to a 'firm'.] However, we note that in order to provide appropriate advice to clients, advisors must establish affordability during the sales process and that advisers are responsible for the advice they give.

Q9. Do you agree with our proposal to require lenders to assess affordability based on;
(i) the borrowers free disposable income;
(ii) a consumers borrowing capacity;
(iii) the plausibility of the information obtained; and
(iv) a capital repayment basis?

The Panel agrees that lenders should be rigorously assessing a customer's ability to repay a mortgage. This will protect consumers, specifically those who are vulnerable, from entering contracts that are unaffordable. However the Panel believes that the level of prescription proposed could inhibit the development of a flexible but responsible market.

A mandatory requirement to assess affordability on the basis of the specified areas could have unintended consequences for potential borrowers. Instead the Panel believes the FSA should set out the proposed criteria as a guideline to assessing affordability, with lenders being obliged to explain to the FSA when asked why the criteria were not applied in particular cases.

We would expect the FSA to be monitoring lenders' behaviour through supervisory visits and thematic work and to challenge those firms who are lending consistently to consumers outside of the usual affordability criteria.

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

The Panel welcomes the FSA's focus on affordability, but also believes the FSA must become more effective in supervision and enforcement of the rules than in recent times. The Panel would urge the FSA to step up its monitoring of the mortgage market and to take more effective and timely intervention.

As the Panel outlined in the Consumer Panel's response to HM-Treasury's White Paper on reforming financial services, it believes the FSA should have a greater appetite to take enforcement action to punish poor behaviour and encourage firms to comply with rules. When the FSA is taking enforcement action, the Panel believes consumers have the right to know that the FSA is concerned about a firm's behaviour so that they might be better informed and can take appropriate action.

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

The FSA should be actively looking-out for industry work-arounds in this sector. With this in mind, the Panel welcomes the HM-Treasury consultation proposing the extension of the FSA's regulatory remit to buy-to-let and second-charge mortgages and also the management of mortgage contracts which have been sold on by lenders. The Panel will be responding to the Treasury's consultation paper.

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

The FSA's research on this issue is at early stage, but it does raise some consumer protection concerns. The Panel would welcome a discussion with the FSA on this important issue once this further research has been completed.

Q13. Do you agree that we need to strengthen the selling standards for non-advised (information-only) sales to ensure consumers are only entering into contracts which are both affordable and appropriate?

The FSA acknowledges that in reality, many consumers do not fully understand the difference between advised and non-advised sales. However, there are some consumers who are sufficiently knowledgeable to use intermediaries to provide information on products that are available and then make their own choices. The Panel welcomes the FSA's proposal to retain non-advised sales (to be called information-only sales), but require a basic standardised affordability and appropriateness test. We believe this is an appropriate solution to tackle the areas of significant consumer detriment, while not forcing any consumers who are financially knowledgeable to take advice.

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

The Consumer Panel does not believe new measures are required, but the FSA should be enforcing existing measures. We believe the requirement to provide a suitability letter will help improve sale standards; lenders will have to clearly set out exactly why the particular mortgage is suitable and the consumer has a clear record of what was said during the sales process.

As outlined in response to question ten, the Panel would urge the FSA to step up its monitoring of the mortgage market and to take more effective and timely intervention. The FSA should have a greater appetite, than evidenced in the past, to take enforcement action to punish poor behaviour and encourage firms to comply with rules.

Q 15. To what extent should intermediaries retain responsibility for assessing a consumer's ability to repay? How could this work in practice?

The Panel agrees with the FSA's proposals and reasoning. In order to provide appropriate advice to their clients, intermediaries should be establishing affordability during the sales process; however the Panel believes it is the lender who must decide whether to advance the loan and the lender who is ultimately accountable for assessing affordability.

Q16. Do you agree that suitability letters should be introduced as a compulsory standard?

The Panel supports the reintroduction of suitability letters as a useful tool for both consumers and firms. The Panel understands the use of suitability letters was a common practice before the FSA took over mortgage regulation and replaced it with a prescribed disclosure document.

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

The Panel agrees with the FSA proposals to extend the Approved Persons Regime to all mortgage intermediaries and it will be responding to the consultation paper.

Q.18 Do you agree with our conclusion not to read across the adviser charging element of the RDR proposals into the mortgage market.

The FSA's analysis suggests commission-based remuneration does cause detriment in the UK market. However it argues that other factors, such as irresponsible lending and borrowing, cause proportionately greater detriment and that removing commission-bias would not be an appropriate response. It argues further that product and provider bias only occurs in niche market segments (e.g. self-cert and sub prime). One of its key points is that fees, if introduced, could still be a percentage of a loan, so the incentive to encourage larger loans would still be prevalent.

The Panel would welcome further analysis of the implications of introducing fees. Fundamentally, we have a concern that commission-based charging introduces practices which cause consumer detriment (e.g. churning larger unaffordable loans). The Panel acknowledges the considerable work the FSA has undertaken in this area and the strong arguments it presents. However, we believe upfront fees (e.g. based on time spent) might encourage greater competition and be more transparent for the consumer.

At the very least we ask the FSA to review the commission situation at regular intervals, particularly in a post-RDR world.

Q19. Are there any other considerations that are relevant to the assessment of the issues and risks posed by the current remuneration model within the mortgage market, which are not identified within the DP?

The Consumer Panel has no further comment.

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

The Consumer Panel does not believe there needs to be a Professional Standards Board (PSB), however all advisors should be members of a professional body.

Q21. Do you agree that simplified scope of service labelling, limited to 'independent' or 'restricted advice' and also describing a non-advised service as 'information-only', will result in better consumer understanding of the services on offer?

The Consumer Panel agrees that limiting the descriptions of advice and describing non-advised sales as 'information-only' will offer a clearer understanding of what services are being provided.

Q22. Do you agree with the proposals to:
i) remove the requirement for the IDD and replace with disclosure of key messages;
ii) retain use of the KFI; and
iii) require elements of disclosure to be carried out on an oral basis?

The Consumer Panel's own work and research confirms that consumers are often overloaded with information when purchasing financial products. More often or not, the critical messages are hidden in the detail with consumers not recognising, let alone understanding, what has been written.

The Panel believes that the problems experienced in the sector with poor oral disclosure occurred because the details of the discussions were not recorded. We believe some of these problems could be mitigated with the introduction of a suitability letter because lenders will have to clearly set out exactly why the particular mortgage is suitable and the consumer will also have a clear record of what was said during the sales process.

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

The Panel believes most people do act rationally when they seek a mortgage; a consumer would like the most money they could afford to enable them to buy a property, however they may not be fully aware of the costs of owning a property or the potential risks they face in the longer term. Problems can arise if intermediaries and lenders focus on maximising their income, rather than treating their customers fairly and on offering loans to the customer that are likely to be affordable. Regulatory emphasis should centre on ensuring firms treat their customers fairly and on the consumer outcome.

Q24. Do you agree that the FSA has a role in preventing the extension of credit to individuals who are unable to afford such high levels of debt?

The FSA has a statutory objective to secure the appropriate degree of protection for consumers and this would quite clearly include placing safe-guards to ensure firms do not lend irresponsibly, especially to vulnerable consumers. Consumers should be made well aware of the implications of entering a mortgage contract and understand what would be an affordable mortgage agreement in their circumstances.

The Panel supports the requirements for lenders to assess affordability and verify income of mortgage applicants. It believes these measures will help protect consumers by ensuring firms take into account the consumer's circumstances when agreeing a mortgage. The Panel would expect that the FSA's monitoring of compliance with MCOBS, as well as analysing firms' business models would uncover any questionable lending practices.

Bearing in mind the role of the proposed Consumer Financial Education Body (CFEB) and it taking over responsible for consumers' financial education, the Panel believes CFEB must aspire to have an influential role in enabling consumers to be better informed about borrowing. The FSA and CFEB must be clear on their future respective roles in providing consumers with such information.

Q25. Do you have any comments on the financial capability initiatives designed to support the overall mortgage reform?

We are supportive of the FSA leadership on financial capability, the national Money Guidance service and moves to maximise the role of intermediaries in this area. However, key questions remain regarding delivery, resources, capacity and relationship with the new consumer education authority - how can the FSA communicate key consumer messages if the brand 'money made clear' moves to the new authority? These are issues the Consumer Panel is taking forward with the FSA.

In terms of court process mentioned in the discussion paper, the Panel would recommend considering the proposals outlined in the 'Home Owner and Debtor Scotland Bill'. The Bill proposes enhanced access to advice and in-court advice for home owners faced with repossessions.

Q26. Do you have comments on our proposals to strengthen our approach to firms' arrears management practices?

The Panel is supportive of the FSA's proposals to strengthen its approach to firms' arrears management practices. This is an area with significant risk of detriment and hardship for consumers, especially in the current economic climate, and it is very disappointing that the unfair treatment of consumers has persisted so widely within the mortgage market. Strong and decisive action by the FSA is required to remind firms of their duty to treat customers fairly and signal the FSA's commitment to identify and take action against firms who are non-compliant.

The Panel will be responding to the FSA's consultation paper on the handling of mortgage arrears.

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

The Panel would welcome discussing these issues with the FSA once the FSA has published its research into charging practices in the mortgage industry.

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

The social and economic effects would be disproportionate to the regulatory objective. Many consumers would simply borrow cash on their credit card to fund this additional up-front burden, with the consequence that they would face far higher interest rates than those applied to their mortgage itself. First time buyers would be particularly hard hit as they would have to raise genuine fresh capital in addition to the deposit, legal fees, etc, and could not factor this into their overall financial picture in the way that can be done by anyone who is also selling an existing property.

The Panel strongly believes that all charges and costs must be clearly disclosed to consumers to enable them to understand the total cost and also to be able to compare policies.

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

We agree with the proposal, but would not comment on the costs issue as this is not a question for the Consumer Panel.

Q30. Do you agree the FSA should standardise some existing industry definitions such as 'sub prime'? And if yes, are there any existing definition issues other than sub prime?'

The Panel agrees with the FSA that a standard definition would be very useful. We are not aware of other similar issues.

Q31. What are the potential compliance costs if the FSA collected better data on fees and charges directly from lenders on an on-going basis as part of regulatory reporting?

This is not an issue the Consumer Panel can comment on.

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

We particularly support the proposal to extend the approved persons regime to individual intermediaries, while recognising that the FSA will be unable to regulate members of certain professional bodies. We suggest a 'task force' approach combining the FSA and relevant bodies representing, for example, valuers, estate agents, and relevant intermediaries.

We support the other proposed measures, with the proviso that regulation of buy-to-let needs further study since the real problems appear to have arisen through investment schemes and so-called 'educational' firms that offer costly seminars on how to profit from this sector, and which are themselves linked to developers and agents who would be outside the FSA's remit. A more holistic approach is needed.

[ends]