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Dear CEO

Second charge lenders and responsible lending

I am asking you as a CEO of a firm that enters into regulated second charge mortgage contracts to review your mortgage lending processes and confirm to the FCA, by 1 May 2018, that your firm is lending responsibly and that your processes, systems and controls ensure this.

Why we are asking you to do this

In March 2016 the implementation of the Mortgage Credit Directive (MCD) moved second charge mortgage regulation from our consumer credit regime into our mortgage regime. To help us understand how second charge lenders had interpreted and implemented the new regime, we recently reviewed how they have adapted to the responsible lending requirements contained in Chapter 11 & Chapter 11A of the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) and, where relevant, how firms are complying with the Senior Management Arrangements, Systems and Controls (SYSC) module of the FCA Handbook. These rules are intended to prevent a return to poor lending practices seen during the run up to the financial crisis, by putting consideration of affordability for the borrower at the heart of any lending decision. We identified significant issues with how responsibly second charge lenders were lending.

Our methodology

To conduct this review, we looked at firms' lending processes and the areas of firms' systems and controls that could affect their ability to lend responsibly.

We reviewed lending policy documents and individual lending files to assess whether firms could show that they were lending in line with our rules. This included identifying whether the reasons behind firms' lending decisions were sufficiently clear and documented and whether firms' affordability calculations were using plausible income figures and taking sufficient account of borrowers' expenditure. We also considered firms' arrangements to protect themselves from being used as a vehicle to perpetrate financial crime (e.g. firms' oversight and quality assurance arrangements).

Our findings

We identified significant concerns and found a number of poor practices that led us to conclude that second charge lenders might not always be lending responsibly, leading to potential customer harm, particularly in the following areas:

Overall affordability assessment

Before becoming subject to our mortgage regime second charge lenders had their own methods of assessing the credit risks associated with individual loan applications. Since March 2016, all new regulated mortgage applications became subject to the affordability requirements. These are set out in our MCOB rules, which require that a firm must determine that a customer will be able to pay the sums due before entering into or agreeing to vary a regulated mortgage contract, by performing an income and expenditure assessment. Furthermore, firms are also required to show that the new loan is affordable when taking account of the impact of likely future interest rate increases[1]. In coming to a view as to likely future interest rates, lenders must have regard to market expectations and to the Bank of England Financial Policy Committee recommendation on appropriate stress tests.

Our review found that all firms in our sample had attempted to adapt their pre-existing practices by adding an affordability calculation aimed at complying with MCOB. However, we found examples where firms were not basing lending decisions on income and expenditure assessments. It is not sufficient to base a lending decision solely on equity, debt to income ratios or income multiples[2].

MCOB allows lenders to generally rely on any evidence of income or information on expenditure provided by the customer unless, taking a common sense view, it has reason to doubt the evidence or information. How your firm meets these requirements is a matter for the firm's senior management to decide upon. We found that income and expenditure calculations sometimes produced disposable income figures that didn't seem plausible when taking into account an applicant's credit profile. For example, it doesn't appear logical that a customer who has large volumes of unsecured debts should have a large disposable income. We found that the disposable income figures given were rarely challenged or reviewed and often contained this type of inconsistency. In the absence of due diligence around the quality and plausibility of this evidence, we could form the view that a firm is not lending responsibly.

Furthermore, we found that it was very difficult in some cases to follow how a firm had carried out affordability stress testing. This was particularly noticeable where a loan had been approved outside a firm's lending policy. Our record keeping requirements[3] necessitate that the basis of the lender's decision is understandable, including how it had arrived at its final affordability calculation[4].

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[1] MCOB 11.6.18R
[2] MCOB 11.6.5R(1)
[3] MCOB 11.6.60R
[4] MCOB 11.6.60R(2)(g)

Please consider whether your firm's affordability calculation is now at the heart of each lending decision and that the calculation itself takes into due consideration the credit profile of an applicant.

Income assessment

Generally, income assessment for customers in employment was reasonably well handled. In most cases, firms were capable of demonstrating that they had obtained enough evidence to meet the requirements of our rules[5].

However, we found that income assessment for self-employed customers was often very poorly handled. In some cases, we were unable to identify where an underwriter had obtained the figures used for net income. We also found evidence that lenders were not always taking account of tax and national insurance deductions[6] and were relying on calculations contained within accountants' certificates and other documents that did not appear to be plausible or realistic[7].

Please review your firm's methods of calculating net income to ensure that it focuses on obtaining a robust figure.

Expenditure assessment

Expenditure assessment is an important part of the overall affordability calculation. Most firms use some form of statistical modelling to calculate basic essential expenditure and basic quality of living costs. Firms must be able to show that the data they have used are likely to produce a realistic representation of the customer's monthly expenditure. We found that firms are not always using realistic assumptions, a practice that was particularly evident when customers were consolidating a number of debts, for example consolidating credit card accounts and overdrafts which were consistently near to or at their limit.

Furthermore, there was often a lack of transparency around what figures had been used to assess expenditure. A number of firms used Office of National Statistics (ONS) data, but it was sometimes unclear when the figures used had been last updated or reviewed. There was a lack of controls in place to identify where the use of modelling statistics had produced a figure that was not plausible or appropriate to the customer's profile and needed to be considered individually[8]. This was most obvious in the figures used for housekeeping (food and washing), essential travel costs, as well as a number of areas of the basic quality of living costs.

Please ensure that where your firm uses modelling data that it is producing realistic results. If your firm uses modelling or statistical data, please consider whether your firm's assumptions about basic essential expenditure and the basic quality of living costs capture sufficient detail to consistently produce reliable results.

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[5] MCOB 11.6.8R(1)
[6] MCOB 11.6.5R(2)(a)
[7] MCOB 11.6.12R(1)
[8] SYSC 3.1.1R

Oversight arrangements

The systems and controls a firm has in place to monitor its day to day business activities are a major factor in providing its Board with comfort that business is being carried out in line with its own internal policies and controls, as well as any relevant external regulations or requirements.

During this review, we found that some firms' quality assurance and oversight arrangements were not fully capable of identifying unaffordable loans and associated risk. We identified a number of issues which firms were unaware of and that they should have identified with more robust oversight.

Some of the oversight arrangements we saw appeared to be overly operationally focused; for example, establishing whether documents had been sent out or received, without monitoring the effectiveness of the firm's affordability assessment[9].

Please consider whether your oversight arrangements are focused on reducing the risks within your business that could result in customer harm and are fully capable of meeting regulatory requirements.

Financial crime

SYSC[10] requires that a firm should take reasonable care to establish and maintain effective systems and controls to counter it being used as a vehicle for financial crime. Our review found that second charge lenders appear too ready to accept supporting documents at face value, without carrying out further due diligence or authenticity checks. This could lead to them being implicated in financial crime.

We identified instances in which firms were vulnerable to fraud by accepting evidence of income that could easily be manipulated by the customer. We found that some lenders were accepting what appeared to be Self-Assessment 302 (SA302) documents but which were screenshots of income tax calculations lifted from the HMRC website. However, the content of these screenshots could subsequently be amended when the applicant proceeded to the next stage and completed the tax return.

You should be aware that where the FCA identifies that a firm's systems and controls have failed to such an extent that it is unable to protect itself from becoming a party to financial crime, we will consider taking action against the firm and its senior management.

As a result of these findings please consider whether the firm needs to carry out a review of the arrangements it has in place to protect itself from becoming a party to financial crime.

Action you should take

As the CEO of an FCA-regulated firm, we are expecting you to conduct a review to assess whether your procedures and systems and controls are suitable to ensure that your firm is

[9] MCOB 11.6.22R
[10] SYSC 3.2.6R

lending responsibly. Please make certain that you would be able to evidence this review and the firm's compliance with regulatory requirements, if asked to do so.

When reviewing, please consider the findings from our thematic review of responsible lending undertaken in 2016, which can be found in TR16/4 Embedding the Mortgage Market Review: Responsible Lending Review.

We expect to receive written confirmation that this review has been completed no later than 1 May 2018 to MMFlexibleFirms@fca.org.uk. If you are unable to meet this deadline please tell us, using the same email address, confirming when you will complete your review.

Yours sincerely

Jonathan Davidson
Director of Supervision - Retail & Authorisations