Key Points from the Mortgage Market Review – Responsible Lending CP10/16

1) Changes to the FSA

The impact of moving the prudential supervision to a new subsidiary of the Bank of England and the conduct of business activities to a new Consumer Protection and Markets Authority will not impact the FSA's programme and work will continue unchanged.

2) Secured Lending

There is still an intent to move second charge lending from the OFT to the FSA. The timescale has not yet been announced but there will be a separate consultation on the proposed transfer and new rules in due course.

3) Buy to Let

The FSA still believe that parts of the Buy To Let market should be regulated. The Treasury (under the old Government) agreed with this proposal in principle. They are considering how regulation would work best since the original proposals raised considerable issues that need to be addressed to avoid the net being cast too widely and in inappropriate ways. More will follow on from this in due course.

4) Buying Regulated Loan Books

The regulation of 'buying mortgage books' is still also on the agenda – i.e. to have some controls over non-regulated firms buying regulated loans and not being subject to FSA supervision.

5) Affordability Proposals:

a. ALL loans must have verification of income from a source independent of the borrower. This is regardless of whether interest is retained/rolled up or not.

b. There is no prescription as to what lenders accept as evidence of income providing it is from an independent source (e.g. pay slips, accounts, p60).

c. Non acceptable verification includes a statement of affordability by the applicant or a third party including an accountant (a letter confirming income from an accountant would be acceptable evidence of income if the lender chooses to accept this).

d. Lenders will be expected to consider the variability of income e.g. for bonus, overtime, self employed which may impact the period over which income is verified.

e. Affordability must be assessed by assessment of income and expenditure and lending can only take place where affordability has been demonstrated.

f. Expenditure can be assessed by a line by line check of all expenditure or use statistical data systems or their own expenditure models. If not using the line by line approach firms must take into account committed and personal expenditure and have a process for identifying and assessing outliers (e.g. unusually high expenditure).

g. Lenders must take steps to identify and collect information on all outstanding credit commitments – secured and unsecured.

h. Whilst it is up to lenders to assess the risk posed by the individuals circumstances they would expect firms to consider factors such as credit history, employment status and employment history.

i. Affordability assessments must be based on a capital and interest basis even for interest only loans

j. The maximum term for the assessment is 25 years even if the mortgage is for a longer term

k. Affordability tests also require stress testing against an increase in interest rates by a margin to be set and published by the FSA. The proposal is to set this with reference to forward swap rates – firms would be able to use their own margin if higher than the FSA's.

l. Borrowers with impaired credit should have a 'buffer' applied to their calculation of free disposable income – effectively reducing their borrowing power. The FSA are seeking comments as to what this buffer should be.

m. Feedback is being sought on how to tighten up on interest only loans with no repayment vehicles in place (aimed at the long term market). Their view is that loans with no repayment vehicle in place should not be allowed and that lenders should monitor the existence/performance of the repayment vehicle throughout the life of the mortgage.

n. Where existing loans are to be repaid from the loan proceeds and thus ignored in the affordability calculations lenders must take steps to ensure this takes place – e.g. repaying direct or via solicitors at completion.

o. Firms can consider applying for a waiver where they wish to operate a different affordability structure e.g. for high net worth customers where repayment is agreed on an individual basis or interest rolled up.

p. The FSA are also seeking feedback on other models where the affordability proposals may cause problems.

q. The FSA recognise that the new proposals could cause difficulty for existing borrowers such as the newly self employed and those already on an interest only mortgage that may wish to remortgage. They have not therefore set a final implementation date and are considering transitional measures to mitigate adverse effects.

r. The FSA also recognise that the income verification rules may impact some groups due to their race or religion and are seeking comments on this.

6) Arrears

a. Arrears charges must not reflect more than the firms underlying costs and this is to be extended to all charges related to payment shortfalls.

b. A maximum of one charge per month (at the underlying cost) for missed payments – e.g. bounced debits

c. Firms should not 'gold plate' their arrears costs and should therefore ensure that appropriate grade staff are dealing with arrears cases

d. The FSA consider charging for executive costs are too remote from the arrears handling to be included as a proportion of overheads/costs. There may be some specific exemptions to be put forward for firms where the Directors are actually involved in the case due to their size or the nature of the case.

e. The funding cost incurred as a result of the arrears is not an administrative cost and cannot be added in to the arrears calculation.

f. The FSA will accept calculating costs of arrears as an average for all borrowers as opposed to individually costing each arrears case due to the cost of the latter approach.

g. Regular reviews of costs/cost estimates must be ascertained to ensure that the charges were/remain reasonable.

h. Using a percentage of the outstanding debt as a basis of the charge is not an acceptable approach.

i. Quarterly or annualised arrears charges are not an appropriate basis for a borrower who is only in arrears for a short period of time

7) Missed Payment Fees

a. The FSA wish to limit the number of times a firm charges a fee for presenting the same debit or for a bounced cheque to once per month and limit the amount if times the debit can be presented to twice in a month unless they waive any fee.

b. Firms will have to consider if it is appropriate to continue with debits as a payment system for cases where the debit repeatedly fails and suspend this method whilst they investigate.

8) Payment Shortfall

a. The FSA propose applying the arrears rules to all payment shortfalls (i.e. where the borrower pays less than the full amount) to avoid a technical loophole being exploited by some firms.

b. The current rules refer to arrears as being a shortfall in two or more payments. The FSA have proposed to insert a definition of payment shortfall into MCOB to ensure total clarity in their expectation.

9) Third Party Administrators

The FSA are still reviewing the use of, costings, charges and performance of outsourcing arrears handling to third parties and a further consultation and proposals will be published in due course covering this aspect.

10) Non Deposit Taking Lenders

The FSA are inviting comments as to how they might apply a prudential regime to non-bank lenders including changes in the capital adequacy requirements.
There is a wide scale discussion of options in the CP and it is vital firms understand the potential impact of this which could have impacts in both liquidity and structure (e.g. limiting use of subordinated debt for funding and meeting capital requirements) as well as administrative costs.

The key options being considered are:

a. More risk based capital requirement consisting of:

    i. A securitisation requirement

    ii. A standard credit risk requirement

    iii. Other assets requirements

b. Restrictions on quality of capital

c. A tailored liquidity requirement

11) Sale of property as exit.

The FSA do not like this method (mainly concerned at the long term market using the growth in equity to redeem the mortgage). They are considering being prescriptive about when this method could be used and are seeking comments on the following:

a. Setting a maximum LTV or amount of equity in the property at outset for which this method could be used (and if so where to set the mark)

b. Set limits on the type of customer, e.g. by setting a minimum income level (and where to set it)

c. Requiring lenders to assess the plausibility of exit on a case by case basis (but they aren't happy with past performance in this area)

d. Banning the sale of property as a repayment method for interest only cases although this could be disadvantageous to those for whom it would be appropriate.

12) Interest only

There are a number of groups for whom the FSA consider interest only may be appropriate:

a. Those with investment properties or second homes that could be sold to repay the capital without risking their main home

b. First time buyers who could afford a repayment mortgage but want to spend some of their income on home set up costs and then start repaying the loan

c. Older consumers with lots of equity in their property who will repay by selling (either on death as in lifetime mortgages) or by downsizing

d. High net worth borrowers who have the means to repay through realising assets

e. Financially capable borrowers who have made firm arrangements to repay through investments.

The FSA are inviting feedback on this and any other grouping that could benefit from interest only.

Summary

There are a lot of issues which could impact lenders and it is important that a strong response is made to ensure that the FSA understand the potential impact on your lenders business. If you need any assistance or advice in respect of these proposals or responding to them please get in touch with Ray Cohen - 020 8550 0613