

DP 09/3 FSA MORTGAGE MARKET REVIEW

RESPONSE FROM THE BSA

INTRODUCTION

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 52 UK building societies. Mutual lenders and deposit takers have total assets of over £390 billion and, together with their subsidiaries, hold residential mortgages of almost £260 billion, 21% of the total outstanding in the UK. They hold over £250 billion of retail deposits, accounting for just under 23% of all such deposits in the UK. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches. Building societies alone account for about 32% of all cash ISA balances.
2. We welcome the opportunity to respond to the FSA discussion paper on the Mortgage Market Review, and congratulate the FSA for its constructive and consultative approach since publication of the DP. The review is being undertaken at a crucial time for both the building society sector and the mortgage market in general. We share the FSA's stated objectives of a mortgage market that is sustainable for all participants; and a flexible market that works better for consumers.
3. It is important that the Review recognises that in the context of the current financial crisis, the problems in the global and European and UK economies today are a result of liquidity and structural issues arising in global financial markets. They are not a product of a dysfunctional and irresponsible residential mortgage market in the UK and the FSA should be mindful that they are not focusing their attention on fixing the wrong problem.
4. Despite the economic slowdown, FSA arrears statistics show that the overwhelming majority of mortgage borrowers in the UK have been able to continue to make their mortgage repayments. Low interest rates have clearly helped. But it does demonstrate that in the UK, the vast majority of building societies and other mainstream lenders have lent responsibly and have been sympathetic to customers in difficulty.

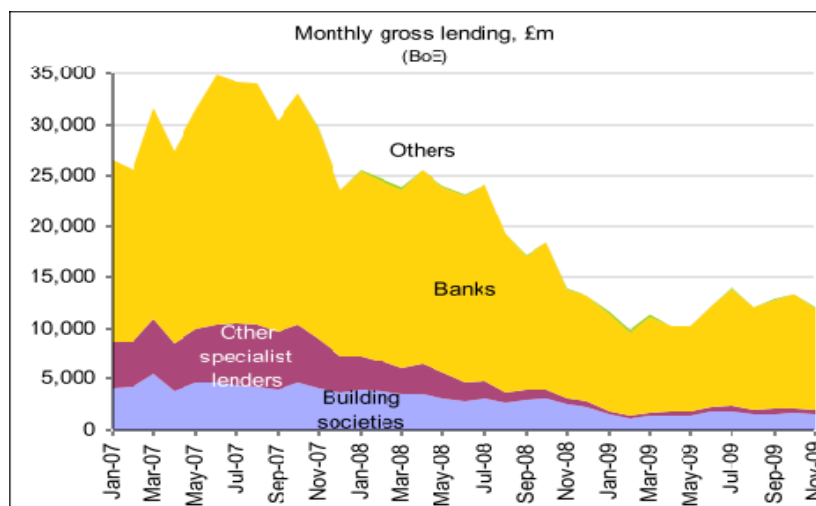
EXECUTIVE SUMMARY

5. The outcome of the Mortgage Market Review must be proportionate. Whilst many of the proposals are sensible, there is a theme throughout that leads to solutions that are rather disproportionate to some of the perceived failings. The FSA must focus its attention exclusively on those areas where the market has clearly failed and consumer detriment has occurred.
6. The BSA agrees with the FSA assertion that the mortgage market has worked well for the vast majority of consumers. We also agree that the existing supervisory regime has proved to be ineffective in constraining particularly risky lending and borrowing. It is in these areas that targeted change should be implemented.
7. The BSA welcomes steps already taken by the FSA to enhance its supervisory regime. We would recommend a full evaluation of the effectiveness of that regime. This would enable the FSA to make targeted conduct of business changes where there is continuing evidence of consumer detriment.

8. Due regard should be given to the cumulative impact of regulatory change being asked of lenders, in market conditions that are far from 'business as usual'. The FSA should consider carefully the implementation timeframe of any regulatory proposals to ensure that they are fully warranted and do not compromise the fragile market conditions that currently exist.

Current mortgage challenges

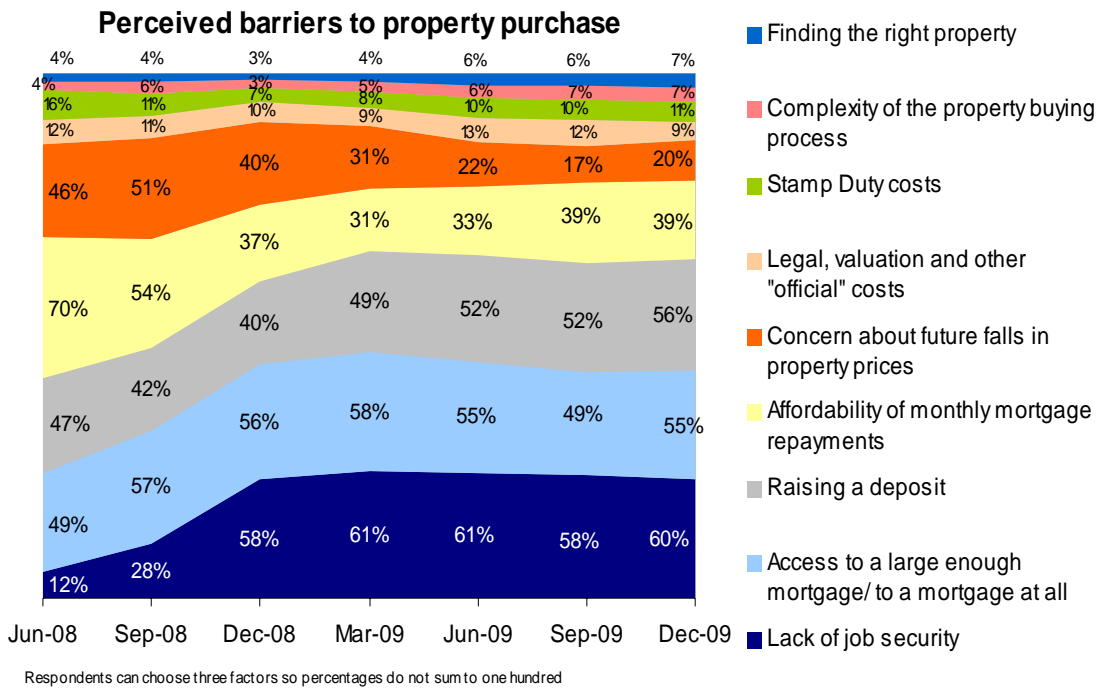
9. Building society gross lending in the mortgage market amounted to an estimated £18 billion¹ in 2009. This represents a decrease of 52% compared to 2008 and a decrease of 60% on 2006, the peak year for building society lending.
10. This decline in building society lending has been mirrored by a huge reduction in mortgage lending (in 2007 gross lending exceeded £360bn and net lending was in excess of £100bn, in 2009 gross lending was around £145bn and net lending was £11bn) overall.
11. Although all lenders have been affected by this change, lending has declined by a greater proportion at building societies (52%) than is the case at banks (see chart). For banks, the year on year (Jan – Nov 2008/2009) decline was 41%. Furthermore, year to date (Jan – Nov) in 2009 banks have accounted for 83% of all gross lending compared to an average share of 71% across 2007 and 2008.



12. During 2009 the vast majority of mortgage lending has been undertaken by the major high street banks, some of which the government has a stake in/is supporting or has fully nationalised. Often this lending has been in response to strict terms being attached in exchange for government support. Many of these institutions are also - by implication of the government action - deemed too big to fail.
13. In 2009, a declining housing market meant fewer buyers and a lower demand for mortgages. We expect continued uncertainty in the market this year, and with generally low levels of economic confidence job uncertainty remains high; this will affect the overall demand for mortgage finance.
14. The findings of the quarterly BSA Property Tracker² survey support this conclusion. The survey asks people what the biggest barriers to property purchase are, and it finds that a lack of job security has risen as a barrier from 12% of respondents to 60% between June 2008 and December 2009.

¹ Britannia left the building society sector in August 2009 and this accounts for some of the reduction.

² http://www.bsa.org.uk/mediacentre/press/property_tracker_dec09.htm



15. One of the key differentiators between building societies and other types of lender is the way that they fund their mortgage lending. Unlike many lenders (until 2007), building societies rely heavily on retail funding of their mortgage books.

16. Building societies find that they are currently subjected to unfair competition from state owned institutions. The recent propensity of the latter to offer uneconomic interest rates, coupled with the security of government backing distorts competition in the retail savings market at a time when the total size of the market is much contracted.

Specialist sourcebook for building societies

17. A further potential distortion in the market is the proposed FSA Specialist Sourcebook for Building Societies. We welcome the significant modification to move it away from being the rigid and stifling framework represented by the consultation draft. However, we remain convinced that conclusions on the lending elements of the sourcebook are premature and do not take account of the detailed research and analysis that was undertaken for the MMR. The lending elements of the sourcebook should be postponed and regulatory changes to lending practices should be proposed for the whole lending industry through the MMR.

18. We believe that if there are to be further restrictions on funding and lending limits these should not apply only to building societies. Recent institutional failures clearly demonstrate that on the whole other participants are arguably more in need of regulation in this area. Larger mortgage banks such as Bradford & Bingley, Northern Rock and HBOS relied heavily on short term wholesale funding, which resulted in (or at least substantially contributed to) their recent failures. Moreover, the quality of their lending appears to be lower than in the building society sector. Any limits should therefore be introduced across the whole mortgage lending sector, to apply irrespective of whether the lenders are building societies, specialist mortgage banks or mortgage lending divisions of complex banking groups.

Conduct of business reform

19. We do not agree with the premise that because some consumers have behaved recklessly that is in itself a strong enough reason for the FSA to impose greater regulatory intrusion. Furthermore, it is a dangerous and flawed strategy to make the lender fully responsible and accountable for a loan that ends in default, absolving the customer from their duties.

20. We believe that the verification of a borrower's income should be undertaken by the lender for virtually all mortgage applications.
21. A proportion of borrowers are unable to prove their income, but can demonstrate an ability and willingness to repay their mortgage. These borrowers should not be excluded from the market.
22. We recommend that 'fast track' systems remain valid internal processes as long as they are not marketed as a product.
23. We share the FSA's desire to ensure that all borrowers can afford the loan that they are taking out. However, we do not believe this is best achieved through prescribing affordability assessments.
24. We agree that there is no case for prohibiting the sale of loans above certain LTV, LTI or DTI thresholds on the grounds of either consumer protection or consumer choice.
25. Firms which wish to offer new products with multiple layers of risk should demonstrate to their supervisor that the product meets the needs of the particular customers.
26. The experience and knowledge of consumers entering into the buy to let market varies considerably. Typically, this is a commercial decision taken to invest in property over the medium to long term. As such it is not a matter of simply including these mortgages in the existing/proposed MCOB regime. Inclusion of buy to let in affordability, income and suitability requirements is less straightforward than in standard owner occupied mortgages.

Arrears and possessions

27. We do not agree that the poor practices of some lenders identified in the thematic reviews are indicative of the industry as a whole. We believe that in the main, the vast majority of customers are already treated fairly and are offered a range of solutions to help them manage their arrears under the existing MCOB rules.
28. Changing the use of forbearance tools from 'should be considered' to 'must be considered' may restrict lenders from providing flexible forbearance, based on the individual circumstances of the customer.
29. We strongly oppose the inclusion of specific references to Mortgage Rescue and Homeowner Mortgage Support (HMS) in MCOB 13. Not only are both schemes temporary measures due to end in 2011, but HMS is a voluntary scheme and must remain as such.

RESPONSES TO THE QUESTIONS RAISED IN THE DP

A: Prudential reform

- Generally, the BSA supports the use of prudential levers to ensure that all lenders are adequately capitalised. However, only deposit-takers will be subject to ever higher capital requirements and onerous stress-tests and resulting buffers, which will not affect wholesale-funded lenders. So building societies, which follow what is now regarded as the more prudent model of being predominantly funded by retail customer deposits, will be at a disadvantage.
- There are many prudential reforms affecting building societies, and each of these imposes both policy costs and administrative burdens. The FSA states in DP 09/4 that it intends to consider the *aggregate* impact of the policy cost of these reforms on buildings societies, as well as on the market generally. We also urge the FSA to be mindful of the aggregate administrative burden of several concurrent reforms, which – more so than policy costs - fall disproportionately on smaller building societies.
- The proposed Specialist Sourcebook for Building Societies is undergoing significant modification to move it away from being the rigid and stifling framework represented by the consultation draft. We continue to urge the FSA to ensure that the two projects are joined up and that the Sourcebook neither pre-empts, nor fails to take into account, the reforms being proposed for the whole lending industry through the MMR.

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?

30. We broadly agree, however, we are very concerned about the overall volume and impact of prudential reforms affecting building societies.

31. A key concern for building societies is that prudential reforms affecting the sector are already considerable and can harm the sector and mortgage lending. Prudential reforms include not only the extreme stress tests imposed during the banking crisis, the measures outlined in the Turner Review/DP 09/2³ / DP 09/4, the latest proposals in Strengthening Capital Standards 3 (CP 09/29), and Strengthening Liquidity Standards (CP 08/22 and PS 09/16)⁴, but also the proposed specialist sourcebook for building societies (CP 09/17)⁵.

32. The BSA remains concerned that, in aggregate, the prudential reforms are disproportionate to the problem they aim to solve and in danger of constituting a regulatory over-reaction. As outlined above, the prudential reform package is aimed at the banks, which caused the financial crisis, and affects building societies (which did not cause the crisis), but not wholesale funded-lenders (whose model was found particularly wanting in the crisis).

33. The timing and the content of the proposed specialist sourcebook for building societies published in July 2009 demonstrates that its proposals on lending were disconnected from, and pre-empted, the mortgage market review. Given the separate timeframes for these two projects and notwithstanding the substantial improvements FSA is conceding on the first draft of the sourcebook, we remain unconvinced that outcomes from these projects will be joined up.

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

³ The BSA's response to this is available at: http://www.bsa.org.uk/policy/response/global_banking_crisis_dp09_2.htm

⁴ The BSA's response to this is available at: http://www.bsa.org.uk/docs/policy/prudentialandfinreg/response_liquidity_0822.pdf

⁵ The BSA's response to this is available at: http://www.bsa.org.uk/policy/response/fsa_sourcebook_bsa_response.htm

so would not be likely to protect borrowers from the risks of taking on such loans?

34. We agree with the analysis in chapter 3.37-41. Imposing higher capital requirements to high-risk loans is unlikely to protect vulnerable borrowers who are unable to afford their loans. If mortgage lending is to be scrutinised more carefully as to affordability, a major risk element of these loans will already be mitigated, further undermining any case for additional capital requirements (on top of the prudential reforms).
35. However, such capital requirements may reduce the likelihood of building societies and banks lending to non-standard borrowers – for example, the self-employed who can typically afford to repay their loans. So, on a net basis, they may increase, not reduce, consumer detriment.
36. A simple curtailing of supposedly high risk loans will not improve nor benefit the mortgage market. Certain types, such as high LTV loans to first time buyers, when properly assessed and managed, benefit not just the borrower by reasonably providing them with the opportunity to gain a foothold in the housing market; or the lender by offering them the opportunity to provide products to a specific market, but also the economy as a whole which benefits greatly from the associated stimulus house buying brings.
37. Many small societies offer a more personalised underwriting approach that can cater for good-quality but unconventional loan applications that fall out of automated scorecards. The proliferation of cross-cutting limits and sub-limits in the specialist sourcebook already threatens this flexibility, undermining one of the natural advantages that smaller societies possess. Ever higher capital requirements could affect their ability to operate in the market altogether.

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?

38. We believe non-deposit taking lenders should be subject to asset limits or increased prudential requirements. That would bring them in line with building societies and other mortgage lenders.
39. We believe that any regulation on funding and lending limits should not be restricted only to building societies. Recent institutional failures clearly demonstrate that on the whole other participants are arguably more in need of regulation in this area. Larger mortgage banks such as Bradford & Bingley, Northern Rock and HBOS relied heavily on short term wholesale funding, which resulted in (or at least substantially contributed to) their recent failures. Moreover, the quality of their lending appears to be lower than in the building society sector. Any limits should therefore be introduced across the whole mortgage lending sector, to apply irrespective of whether the lenders are building societies, specialist mortgage banks or mortgage lending divisions of complex banking groups.
40. Specialist lenders have a role to play and provide much needed loans to individuals that fall out of the mainstream, therefore prudential requirements on such firms should not prevent entry into the market or drive them out of business altogether.

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

41. Building societies are facing an unparalleled stream of new and proposed regulation, both from the FSA and other parts of government. Societies must have an opportunity to assess the impact in total on their businesses.

42. The FSA has acknowledged the problem. DP 09/4 discusses the need for an impact assessment of the "whole package" of reform, in particular the cumulative effects of capital and liquidity reform.
43. This situation would be problematic enough in business-as-usual times but is more so in times of stress. If larger societies with larger staffs are badly affected, smaller ones are even more so. Many report that they have engaged extra staff and/or paid for external consultants to help them cope with the added regulation. These not inconsiderable costs come at times when there is huge pressure on margins; severe competition in the deposit market, some from nationalised and semi-nationalised banks, and low returns on liquidity resulting in lower profits in building societies; what profits there are have been eroded by contributions to the FSCS to bail out failed banks. This leads to less competition and choice in financial services due to societies restricted ability to compete.
44. We do not believe this is what the government wants and goes against the thrust of the recent *Reforming Financial Markets White Paper*⁶ which argues for a greater role for mutuals. Indeed, we pointed out in our response⁷ to the White Paper that there is an inherent, if unrecognised, conflict between tightening prudential regulation for the sake of financial stability, and encouraging competition, because prudential regulation generally benefits larger established firms at the expense of the smaller firms that are needed to provide competition.

B: Conduct of business reform

- **In the vast majority of cases a borrower should be able, and willing to provide verification of their income to a lender. Some borrowers are unable to prove their income in the traditional manner, but can demonstrate an ability and willingness to repay their mortgage. These borrowers should not be excluded from the market.**
- **Lenders should not advertise products stating that a borrower will not be required to provide income verification. However, this should not preclude lenders fast-tracking applications provided their own pre-defined underwriting criteria are met.**
- **Building societies share the FSA view that it is important to ensure that borrowers can afford the loan that they are taking out. However, we do not believe that this will be achieved through prescribing affordability assessments.**
- **Generally, we argue against product level regulation and we agree that there is no case for prohibiting the sale of loans above certain LTV, LTI or DTI thresholds.**
- **Firms which wish to offer new products with multiple layers of risk should demonstrate to their supervisor that the product meets the needs of the particular customers.**

Q5: 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?

45. We agree that there should not be any mandatory LTV, LTI or DTI thresholds from a conduct of business perspective.
46. However we do remain concerned that such limits may still be considered by the European Commission. We agree with the comments in the DP that any response at EU level needs to be necessary, proportionate and effective; we would therefore urge the FSA to continue its active engagement with the Commission. It would be better overall for the FSA to delay implementation of any changes until the likely impact of EU measures is clearer. We accept that in areas where there is real consumer detriment that there is a case for proceeding sooner.

⁶ http://www.hm-treasury.gov.uk/reforming_financial_markets.htm

⁷ The BSA's response to this is available at http://www.bsa.org.uk/policy/response/white_paper_bsaresponse.htm

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?

47. We understand the sentiment with regards to these products; however, we believe this would be problematic to implement and the rules would be subjective. Instead there should be an open dialogue between the lender and their supervisor about products with multiple risk layers.
48. Non prime products serve a section of the market and it is important that future regulation allows these products to remain. It is highly likely that there will be an increase in borrowers with credit impairment during, and following the recovery from the current depressed economic climate. Such potential borrowers should not be unduly excluded from the benefits of an upturn in economic activity.
49. However, we also recognise that the behaviour of a proportion of non prime customers is influenced by their attitude to debt, which is often very relaxed, rather than by circumstances outside of their control.
50. The arrears statistics do not provide sufficient detail to determine why certain products perform more poorly. Accordingly, where arrears occur it is not clear whether these are attributable to unsuitable products; to consumer behaviour, or to other factors related to the wider economy.
51. We therefore believe it will be difficult to agree which combinations should always be prohibited.
52. As an example, consider a credit impaired borrower, the extent of credit impairment can vary widely from a small £50 default on a mail order agreement to multiple defaults and county court judgements. At the extreme individual voluntary arrangements (IVA) and bankruptcy may also be a feature.
53. Consumers with credit impairment do not all behave the same. Example 1 below demonstrates how a difference in consumer behaviour can change the overall risk of an application.
54. Under blunt product regulation both customers in the example could potentially find themselves unable to access mortgage finance, despite Customer A using the equity to improve their financial situation and rehabilitate their record.
55. The BSA recommends that firms that wish to offer new products to a specific segment of the market, should be required to demonstrate to their supervisor that the product meets the needs of the particular customers and be in a position to justify the risk combinations within the product.
56. If the supervisor agrees that the product is suitable, the lender will be able to offer the product. This approach also links to other planned suggestions for monitoring, advice and the selling of products to the correct customer (Chapter 5 Advising and Selling Standards).
57. We understand, and agree that the FSA wish to ensure there is adequate protection in place for non prime customers, but we do not accept that product regulation is the way to ensure this. It remains our belief that a supervisory approach with the lender would result in more consistent outcomes ensuring that suitable products are provided to the right target customers.

Example 1

Customer A

LTV: 80%
Loan: £120,000
Credit history: 2 CCJs (£1,000)
Credit card default (£2,000)
Other unsecured debt (£5,000)

Purpose of loan: Debt consolidation

Behaviour post completion: All unsecured debts repaid, customer operates a small credit card with a limit of £500 the mortgage is up to date

Customer B

LTV: 80%
Loan: £120,000
Credit history: 2 CCJs (£1,000)
Credit card default (£2,000)
Other unsecured debt (£5,000)

Purpose of loan: Debt consolidation

Behaviour post completion: CCJs and defaults cleared, other unsecured debt increasing, currently 2 months in arrears with their mortgage.

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?

58. We believe that the verification of a borrower's income should be undertaken by the lender for virtually all mortgage applications. However, we believe it is important for lenders to be able to maximise process efficiencies and therefore where appropriate, retain the ability to expedite mortgage applications without fully verifying income in the traditional manner. Furthermore we recognise there is a proportion of borrowers who will be unable to prove their income, but can demonstrate an ability and willingness to repay their mortgage. These borrowers should not be excluded from the market and the lender should be able to offer mortgage finance in these situations.

59. We recognise that differences between 'self cert' and 'fast track' have been blurred by some lenders actively marketing their fast track procedures as a product. This has led to a very high proportion of applications being classed as non income verified and some of this lending could with hindsight be viewed as inappropriate. Whilst these practices have currently disappeared we agree that changes are required to ensure that past mistakes are not repeated.

60. We recommend that fast track remains as an internal underwriting process and is not marketed as a product feature. This means that the borrower will always expect to have to provide evidence of their income. However, if they meet the lender's pre-defined criteria, the lender may expedite the application without obtaining the documentary evidence. An example of an expedited criteria is below:

Example 2

A lender may expedite the underwriting process where an application has the following attributes:

- A credit score/history limitation (i.e. limiting those with an adverse credit history)
- A low LTV
- Not a first time buyer or have any other complicating feature

These rules would be supported by random sampling to enable testing of the income verification processes and to minimise the risk of 'gaming' by intermediaries.

61. Expedited underwriting processes play an important role in allowing lenders to increase their processing capacity quickly and efficiently to react to emerging market opportunities. To increase underwriting capacity without expedited processes could have a detrimental impact on the overall business, which for mutual lenders has a significant impact on members. It is worth noting that using an expedited process is in no way inferior or less prudent than a full status application.
62. We believe that an outright ban on non income verified loans would not be appropriate. There are situations where it may be difficult for a borrower to prove their current income accurately. For example, those working on a freelance basis such as journalists or independent consultants. The difficulty in being able to provide evidence of income to satisfy a stringent test is compounded for those who receive payment for their services irregularly. For example, a self-employed builder's monthly income will vary depending on his workload at the time, and moreover, there may be a lag between him doing the work and receiving payment showing a very high income in some months but possibly very little in others.
63. Furthermore placing a ban on non income verified loans may have a significant detrimental impact on existing borrowers who obtained their mortgage via a self cert loan. The vast majority of these borrowers are maintaining their mortgage payments and will need to refinance at some point in the future, restricting their access to mortgage finance could have unintended consequences such as preventing them from moving to a new part of the country for employment or business purposes, or leaving them paying a higher rate of interest.
64. In order to provide a flexible and considered approach for these borrowers, it is important that lenders are able to offer a mortgage with an income declaration from the borrower. The ability of the lender to offer this flexibility could be determined by defined criteria, such as:
- An excellent credit history and credit score
 - Low loan to value
 - Maximum loan size
 - The borrower has a complex income or employment situation
 - The borrower has a justifiable reason for being unable to evidence their income in the traditional manner
 - The lender must conduct a plausibility assessment of the income
65. It is vital that the FSA and industry continue to work in partnership through the FSA Expert Group to agree an appropriate and workable solution for income assessment. We strongly recommend that the expert group continues, with support from relevant trade associations until industry-wide agreement is reached.

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

66. We agree that lenders are ultimately responsible for affordability assessments. The vast majority of lenders have always taken this approach, and therefore this proposal is unlikely to make a difference to their current practice.
67. However, we would urge caution as to how this is formalised, to ensure that there is no unintended consequence, in particular, it should not be seen as absolving the consumer of their responsibilities as a borrower.
68. The role of the lender is to determine that the customer can maintain their mortgage payment at the point of application, based upon the information provided by the customer. The lender must not be held accountable for the loan becoming unaffordable in the future, for example if the customer was to lose their job and was unable to maintain the mortgage payments.
69. To make the lender responsible without any customer responsibility could, at the extreme, result in FOS determining that the loan is unenforceable. This would compromise the lender's security, effectively making secured lending unsecured. Moreover, it would fundamentally alter the foundations of the mortgage market and must be unequivocally avoided.
70. It is also important that the preliminary affordability assessment by the intermediary remains. Our response to question 15 provides a recommendation as to how this would add value to the process.

Q9: Do you agree with our proposal to require lenders to assess affordability based on:

- (i) The borrower's free disposable income;**
- (ii) A consumer's borrowing capacity;**
- (iii) The plausibility of the information obtained; and**
- (iv) A capital repayment basis?**

General comments

71. We share the FSA desire to ensure that all borrowers can afford the loan that they are taking out. However, we do not believe this is best achieved through FSA prescription of affordability assessments.
72. The purpose of an affordability assessment is to help inform the lender of the risk of possible default, and to help the borrower understand the impact of the mortgage on their financial commitments. Given the very disparate and often changing circumstances in individuals' lifestyles, a generic approach to assessing lifestyle needs and costs will be very misleading for lender and consumer alike.
73. This emphasises the need for a flexible approach to assessing affordability. As the FSA points out in the DP, an affordability assessment should help a lender to take into account differences in personal circumstances when assessing how much debt a borrower can afford to repay. Adopting a standardised model of affordability would prevent this outcome.
74. Many building societies already use affordability assessments similar to the one contained in the DP. However, even when using a detailed affordability assessment, they will not be relying on this solely when they make their final lending decision, but will make a considered decision using all of the information that they have available about the application.

(i) Free disposable income

75. We agree that consideration of a borrower's 'free disposable income' is a useful indicator of affordability; however, it is not the only indicator and should not be solely relied upon.

76. It may not be appropriate in all instances for an assessment of affordability to be based on free disposable income. It is unrealistic to expect lifestyles and financial priorities to remain unchanged over time. For example, a young and growing family purchasing a home will reasonably expect their outgoings and expenditure to increase in the short term. Furthermore, their expenditure may be erratic as they meet large one-off costs each time their family grows. This will differ from a family with older children no longer living at home which may have a much more stable expenditure pattern. Clearly there are many other events and circumstances that can affect the finances of a homeowner.
77. To help consumers better understand how free disposable income is calculated, they need to appreciate the difference between gross and net income. It may cause borrowers confusion if free disposable income is calculated using gross income (as suggested in paragraph 4.78 of the DP) as many people do not regard income tax and NI payments as expenditure as it is typically deducted at source. The situation is also further complicated if the borrower is in receipt of tax credits. We would therefore be wary of any tight definition of what free disposable income is or how it is calculated.

(ii) Consumer's borrowing capacity

78. We agree that individuals with a negative or zero borrowing capacity should not be provided with a mortgage. However, we would question whether an explicit ban is necessary and if a responsible lender would ever agree to a loan on this basis.
79. The proposed approach of calculating a borrowing capacity using term, interest rate and repayment type is already used by some lenders in a variety of ways, for these lenders, therefore, there would be little change.
80. However, this does not mean we agree that this approach is right for all and would urge caution in prohibiting lenders using a longer term than 25 years, especially for first time buyers for whom a longer term is realistic and can make a loan affordable.
81. We do agree that interest rates should be stress tested, but the rate used in this calculation requires further thought and it may be more appropriate for the lender to tailor the stress test to their product range. For example a stress test of $BBR + y\%$, is unlikely to be appropriate for a LIBOR based loan.

(iii) Plausibility of information obtained

82. As the FSA recognises, there are limitations to the proposed approach. There are significant limitations around the evidential requirements underpinning any assessment of affordability. As discussed earlier, past (or indeed current) spending behaviour may not be an effective indicator of future spending. Evidencing expenditure can be very difficult and it would be unreasonable on both lender and borrower to expect them to require this.
83. It is crucial that the lender does not become responsible for collecting and/or validating evidence of expenditure. As noted by the FSA, customers often underestimate their outgoings and some have little appreciation of what they actually spend. The burden of proof must remain solely with the borrower.
84. We also urge the FSA to consider the risk of some borrowers falsifying their expenditure details and supporting these with false documents.
85. However, we would expect a lender to take reasonable steps to ensure that the information they are provided with is realistic and plausible.
86. We agree that ONS data and other proxies can be useful in helping to check the plausibility of the information provided by a borrower. However, this data can only act as a guide.

(iv) Capital repayment

87. In principle we agree with this approach, but in order for this to be a practical and workable solution, there needs to be flexibility for some customers.

88. In particular we are concerned with how this would impact on customers with an interest only loan over a short term, as demonstrated in the example below:

Example 3	
Mortgage	£50,000
Term	5 years
Rate	4.95%
Monthly payment on interest only basis	£206.25
Monthly payment on capital and interest basis	£961.06

89. To overcome this issue, the lender must be given flexibility to assess the loan in these circumstances without using capital and repayment terms as the default option.

90. We are also concerned that a blunt approach may disadvantage consumers who do have suitable repayment vehicles in place and can evidence such. We do not believe it is fair to penalise these customers and instead the lender should be required to default to capital and interest only where no evidence of a repayment vehicle can be provided.

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

91. Affordability is a key aspect of the assessment process. However, it is one of several elements that make up the overall risk assessment. It will not, on its own ensure sustainable lending and consumer protection.

92. An affordability assessment will ensure that the mortgage is affordable only at the time it is taken out; it cannot cater for unforeseen circumstances, (such as job loss) nor can it protect consumers from the impacts of wider economic conditions.

93. The affordability assessment must therefore be taken in the context of other aspects of the risk assessment, such as the security, the loan, the economic environment and the lender's knowledge and experience.

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

94. In the context of the FSA proposals for more physical verification of income via payslips, bank statements etc, it is imperative that the supply of this information is credible and accurate. A tightening of requirements on income verification will see an increase in demand for false documents – primarily (though not exclusively) by perpetrators of financial crime. It is also important that lenders have access to appropriate third agencies to further verify an applicant's income.

95. The FSA should take a lead in securing regulation, or cessation of the trade in false "replica" payslips and other financial records which can currently be purchased legitimately via a number of internet based companies. It is known that false financial documentation has been used to indicate that an applicant's income is higher or more

regular than in reality⁸ – a risk both to the applicant and the lender, a form of mortgage fraud and a potential route for laundering the proceeds of crime.

96. The BSA and others, have raised this issue previously, but no action was taken as initially, there was a view that a false financial document had a use 'for recreational purposes'. The BSA produced strong evidence refuting this misinterpretation but, unfortunately, lack of police resources led to a planned multi-agency approach falling by the wayside.
97. It is now clear that only a tiny number of false documents are purchased for that purpose and that "recreational" replica documents could be clearly marked as being for that purpose without damaging their novelty value. We would favour either a total ban or some form of regulation whereby producers have to clearly identify on the slip itself that it is a replica produced at the request of the customer.
98. The capability to verify an applicant's stated income with relevant third parties is as important as production of the documents themselves in discouraging income inflation and spotting fraudulent applications. Building societies are therefore puzzled that HMRC has suspended its pilot Income Verification Scheme – a scheme allowing participating lenders to check whether HMRC documentation used to support a mortgage application was genuine. This additional source of independent verification of income was well-received and detected £16m of potential fraud in its first 6 months and its suspension now is obviously inconsistent with a greater focus on income verification at application stage. We would like the FSA to lobby HMRC to continue and expand the scheme, the BSA will also be doing so.
99. HMRC has a key role in helping lenders avoid being prey to fraudulent applicants. We would like to see initiatives such as HMRC's Document Verification Scheme continue and expanded to ensure that a borrower submits genuine information to lenders regarding their income.
100. Also, the FSA should encourage all current account providers to support lenders by providing a standard level of response on requests for checks on bank statements. Some banks are refusing to perform bank checks on documents and others are only offering a basic service e.g. confirmation of name and address details on a bank statement only, not key transactions such as salary payment. This inconsistency is hampering lenders' ability to properly verify applicants' income.

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

101. We do not believe that there should be a limit on the amount of equity that a consumer can withdraw from their home.
102. Limiting the amount of equity which can be withdrawn, effectively imposes LTV limits despite the FSA arguing that such limits are not appropriate. Limiting equity withdrawal is likely to drive customers to more expensive forms of credit, which may worsen their overall financial situation.
103. Subject to affordability constraints, homeowners should be able to withdraw as much of that equity as they wish and it is important that customers understand the implications of equity withdrawal and are appropriately informed of the risks involved.

C: Distribution and advice

⁸ <http://www.guardian.co.uk/money/2009/nov/15/fraud-borrowing-banks-payslips> and <http://www.guardian.co.uk/uk/2009/nov/15/id-theft-internet-fraud-mortgages>

- A suitability letter for non advised sales would not be appropriate. The FSA recognise that customer's choosing a non advised route wish to make decisions for themselves.
- Ensuring that mortgage products are sold to the customers that they are designed for is important and we support changes to the advised sale process to ensure this.
- Caution should be applied to any proposals to implement restrictive rules when lending into retirement.
- Intermediaries should be required to carry out affordability assessments, but this should focus on longer term financial planning and not just the required mortgage.
- In principle, we support the expansion of the approved persons regime for intermediaries.
- The current remuneration practices of lender commission payments in the form of procurement fees should remain.

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

104. We do not agree that changes are required to the non advised sale process. Customers who choose the non advised route do so as they wish to make those decisions for themselves, as recognised in the DP.

105. We understand the concerns that some consumers choose unsuitable products, but this is the responsibility of the consumer. Introducing a form of suitability test would blur the edges of advice and information. The DP recognises that some consumers are confused by the current definitions and a suitability check for non advised sales would only make this worse.

106. We believe that non advised sales should remain; the product choice should remain with the consumer. They should be provided with information to allow them to calculate whether the loan is affordable and suitable for them. We do not agree that this requirement should be placed upon the advisor in respect of non advised sales.

107. That said, we do need to ensure that there is a high standard of compliance within smaller intermediary firms, to ensure that customers are provided with the service which best meets their needs and is not based on which service is the most practical for the intermediary.

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

108. We agree with the comments in the DP that the existing suitability requirements are sufficient and we do not believe that fundamental changes are required to the advised sale practices.

109. Additional measures should be put in place to ensure that products are sold to their target audience. These measures should include a combination of rules and supervision, which leads to appropriate enforcement where there is evidence of non compliance. This is particularly important in the case of non prime or risk layered products as we suggest in our response to question 6.

110. We note the FSA concerns about lending into retirement, but we would urge caution with any plans to implement more restrictive rules in this area. The circumstances of each customer will vary, therefore the additional requirements, or any restrictions on lending need to be proportionate to the potential risk.

111. The following example highlights the potential issues if lenders were required to obtain evidence of income and assess affordability in retirement.

Example 4

Age:	45
Mortgage Term:	25 years
Loan amount	£150,000
Interest rate	4.99%
Current planned retirement age:	65
LTV	65%

Customer's intentions

The customer plans to sell the property and downsize before the end of the mortgage term. They have sufficient income to support the mortgage based on current earnings. Pension statements estimate insufficient earnings to support the loan into retirement.

Lender decision

As the customer cannot demonstrate the mortgage is affordable for the remaining 5 years of the term, the lender reduces the term to 20 years. This increases the monthly payments by £116 per month, which makes the loan unaffordable for the customer.

Impact on the customer

The customer has been unable to obtain the mortgage required on the basis of a pension statement, which is 20 years from maturity. This is despite the fact any number of life changing events could have occurred, which could have an impact on the customer (positively or negatively).

112. We agree that the customer should be notified of the risks involved and a warning statement as suggested in the DP may be a practical solution. We do not believe that the FSA needs to be prescriptive with its rules in this area.

Q15: To what extent should intermediaries retain responsibility for assessing a consumer's ability to repay. How could this work in practice?

113. The intermediary should continue to be required to conduct an affordability assessment and this should be in the form of a preliminary assessment, as per current requirements. We do not believe that fundamental changes are required to the existing rules, even if the lender is to become ultimately responsible for affordability.

114. As we have commented in response to Q14, we would urge caution with regards to additional requirements for lending into retirement.

115. We support the proposal that will ensure that products are sold to the target audience for which they were designed.

116. We support in principle the intermediary being required to stress the interest rate in order to focus on longer term affordability, as this approach would support the advice and recommendation given.

117. However, there are various fundamental life changing events which could have an impact on future affordability and we would urge the FSA to give consideration to the intermediary providing advice or more information in this area.

118. For example, intermediaries could be required to direct customers to the FSA *MoneyMadeClear* website for information on how to plan for future events, such as starting a family or loss of income and where appropriate the intermediary could provide further advice. This may allow the intermediary to add further value to the advice process,

ensuring that the borrower is aware of the importance of financial planning for the longer term. We believe that if executed properly, it would help to promote greater financial awareness and capability amongst consumers.

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

119. We agree that customers should be given details of the advice and recommendation they have received. However we do have concerns that a suitability letter would not achieve all the outcomes stated in the DP.

120. We do not believe that a suitability letter would encourage customers to shop around. By seeking advice and a recommendation from an advisor, the customer is far less likely to shop around and will be far more inclined to accept the advisor recommendation. We do not see how a suitability letter would, in the majority of instances, result in customers questioning the advice they have received and looking elsewhere.

121. We do agree that the letter is potentially a good way of both the customer and the intermediary keeping records of the transaction. The level of detail needs to be carefully considered to ensure the letter is useful for consumers and is not an excessive burden upon lenders.

122. The FSA also need to consider how prescriptive the letter will be. We would not support the same level of prescription currently in place for the KFI, regarding layout and formatting and clearly there will be costs associated with the introduction of the letters. The BSA would recommend that lenders, relevant trade associations, the FSA and FOS work together, to establish best practice in this area prior to any proposal to implement detailed rules.

Q17: What are the implications of applying the approved person's regime to all individual mortgage intermediaries?

123. We support in principle the move to make all mortgage intermediaries approved persons. However, the FSA should be mindful when constructing rules that they do not inadvertently capture administrative/back office functions where changes are temporarily made to the mortgage account. For example temporary term extension for borrowers in arrears.

124. There will be costs involved as noted in the DP and these will be dependent on how intrusive the regime will be.

125. An orderly transition to the regime will be of utmost importance to ensure there is minimal disruption, both for the intermediary, but also for consumers seeking advice. It is difficult to comment on the full implications without knowing the detail.

126. The key to ensuring the regime is effective, as with all other proposals in the DP, is ensuring that there is adequate supervision of and enforcement action against individuals who are non compliant. This is also likely to contribute to the ongoing costs associated with the regime.

127. An alternative would be to utilise aspects of the Professional Standards Board (PSB) to provide a register of advisors both at lenders and intermediary firms. This would allow individuals to be tracked, but would not necessarily be used to give an indication of their level of competency. However, it would allow firms to gather references from previous employers far more effectively and could be used to provide relevant information regarding individuals, without the need for an intrusive approved persons regime.

Q18: Do you agree with our conclusion not to read across the advisor charging element of the RDR?

128. We agree that the current practices of lender commission payments in the form of procuration fees should remain unchanged.
129. This process has functioned well for the vast majority of the market, as noted in the DP, and we agree that potential issues identified by the FSA have occurred in a small number of instances. However, if the FSA has evidence of product bias due to the level of commission payments, we would urge the FSA to take appropriate enforcement action.
130. A move to trail fees may have a positive impact for all parties, by changing the transaction to become more focussed on the long term relationship between the lender, broker and customer. However, a formal requirement to move away from procuration fees to trail fees would take a significant amount of time to implement. We would therefore support flexibility to allow the lender to decide the type of commissions paid and allow the lender to vary this where appropriate.

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 by the DP?

131. Advice in the intermediary sector is currently focussed narrowly on product selection. We believe that a focus on suitability and longer term financial planning, will act to ensure borrowers receive a more complete and appropriate level of advice. In the current market there is little to prevent an intermediary encouraging or supporting irresponsible borrowing.

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

132. We agree with the comments in the DP that there is no reason to read across the PSB in its entirety to the mortgage market. However, we would suggest that aspects of the Board are utilised as an alternative to the approved persons regime, as we have outlined in our response to question 17.

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

133. We support the proposals to simplify the scope of service labelling. The use of 'independent' to refer to whole of market, is clear and should help to improve consumer understanding. The use of 'restricted advice' is less clear and may be interpreted as the type of advice being given, rather than referring to the limited panel of lenders which the intermediary has access to. We would therefore recommend removing 'advice' and refer to the two types as 'independent' and 'restricted'.

D: Disclosure and changing consumer behaviour

- We strongly oppose any shift towards any greater reliance on sole oral disclosure. This will be difficult and expensive for lenders to deliver, whilst placing lenders at a high risk of ill-founded or malicious claims.
- We disagree with the replacement of the IDD with disclosure of key information in a free format. Such a reform is unlikely to deliver any consumer benefit whilst imposing great cost to the lender.

- **The KFI should be retained. Despite its limitations, the KFI provides much valued information to borrowers. The BSA would like to see MCOB 5 revised to help simplify and streamline the KFI so that it better captures key information. The FSA highlights the possibility of EU level reform on mortgage disclosure – we share their anxiety in this area.**
- **We do not believe that greater regulation is in itself an effective or cost efficient way to influence consumer behaviour.**
- **It concerns us that there is an underlying assumption in the DP that lenders are liable for and should carry the cost of loans that go wrong. We support the FSA financial capability agenda and would like to see it strengthened with a greater emphasis on ensuring consumers understand (and act on) their responsibilities as borrowers.**

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?**

(i) The Initial Disclosure Document

134. We understand the rationale behind the FSA proposal to remove requirements for the Initial Disclosure Document (IDD), and agree that the document has failed to help consumers in their decision making and their navigation of the market. However, replacing the IDD with a letter to the customer may similarly fail to achieve consumer benefits and will come at considerable cost to lenders.

135. The BSA supports the intention behind clear and timely disclosure of information on the service and product the consumer is considering. Though intended to promote competition from providers by helping consumers make comparisons, the IDD has typically been disregarded by consumers. A key problem is the prescriptive nature of IDD which results in consumers feeling overloaded with information, much of which they don't want nor understand.

136. We agree that the timing of disclosure can be important, and that flexibility is required in the presentation and form of that information. Current arrangements for the IDD are very prescriptive and onerous for lenders, and as explained above, inefficient.

137. Nevertheless, the IDD is now an established part of the process. Though we agree the emphasis ought to be on ensuring that the customer receives relevant information pertinent to them making an informed decision and flexibility for the lender, we are concerned that the proposed arrangements will not resolve the issues and will come at great cost to building societies. Initial set up costs (including system changes, templates, personnel and training costs) will be high, although costs will vary depending on the size of the lender and the systems they already have in place.

138. We note that the FSA is keen to follow arrangements already in place in the investment and insurance markets. We are concerned that the insurance and mortgage markets operate differently and a common model may not be effective. The rationale for reforming disclosure arrangements in the insurance sector was based on a need to simplify often complex and differing insurance policies. The effectiveness and success of this approach in the insurance market is also unclear with much criticism that firms have felt under pressure to add more and more 'key information' that the disclosure document has become too long and confusing for the customer.

139. We would urge the FSA to retain the IDD whilst exploring how the document may be less prescriptive and produced so as to achieve its intended aims. The FSA should also fully evaluate the effectiveness of disclosure arrangements in the investment and insurance markets before considering extending them to the mortgage market.

(ii) Key Facts illustration (KFI)

140. The BSA agrees that fundamental changes to the KFI are not required, and that it ought to remain.
141. The KFI provides important and relevant product information to the customer, such as on fees and charges. Though not typically relied upon during the sales process, this information is often retained by the customer as a useful summary of the mortgage. It can also be useful for lenders as a historical record of the sale and as evidence that the sale has complied with regulation.
142. However, a key issue with the KFI and a barrier to its success (as intended), is that it is too long and clunky – for both lenders completing it and for consumers in terms of helping them to understand what product they may be purchasing.
143. When dealing with pre-application disclosure MCOB 5 should be simplified. It ought to provide lenders with flexibility in how important information relating to the individual sale is presented to the customer. However, any reform in this area will need to be carefully considered and will require full consultation with the industry given the high cost implications for lenders.

(iii) Elements of disclosure to be carried out on an oral basis

144. We oppose proposals to introduce greater reliance on oral disclosure.
145. Firstly, from a consumer perspective it is difficult to see how this improves their experience or quality of disclosure. There is a real and significant risk of consumer detriment as a result of a shift to sole oral disclosure. There will be greater pressure on consumers to understand the product and the risk to them at the time of sale. Consumers will lose the ability to take stock of the product and what it means for them in their own time. They also lose the benefit of having a permanent record of the sale that can be a useful point of reference. Furthermore, consumers also risk further vulnerability as a consequence of lenders (and brokers) reading 'scripts' which fail to engage consumers as intended, resulting in a poor understanding of the product.
146. Such an arrangement would be difficult to manage and could place the lender at risk of unscrupulous claims of mis-selling. It would also potentially leave the lender being unable to provide the necessary evidence to rebut such claims. As a consequence, lenders will feel compelled to follow up with their customer either in writing or recorded telephone discussion – both having the effect of adding duplication and delay to the process, and cost to the lender.
147. It is also likely that complaints to FOS will increase, though difficult to estimate the number of claims that may be made. In the absence of clear evidence to rebut claims at their outset, lenders will face a £500 case fee and typically a further £100 in admin costs for each. This will of course be significantly more for those cases that are not resolved quickly.
148. It also appears premature to introduce such a proposal before any assessment of its impact and effectiveness in other markets has been concluded.

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

149. We do not agree with the premise that because some consumers have behaved recklessly that is in itself a strong enough reason for the FSA to impose greater regulatory intrusion. Furthermore, it is a dangerous and flawed strategy to make the

lender fully responsible and accountable for the loan should it go wrong, absolving the customer from their duties.

150. As recognised by the FSA, consumers' behaviour is driven by an immediate want or need. As has been demonstrated, albeit in a minority of cases overall, access to greater information about the product and process, as well as raising customer proficiency and understanding can not prevent some customers from acting against their medium and long term interests.

151. However, it is important to appreciate that this is true only for a minority of customers, and as the FSA admits, the mortgage market has "served most well". Therefore, a more intrusive regulatory approach is likely to be disproportionate and unjustified.

152. Rather than greater regulation of lenders because this is the easiest option, it would be more effective and beneficial long term if there was a greater balance in responsibilities between the lender and the borrower. Indeed the customer should be encouraged to take greater responsibility for their decisions based upon the information provided.

153. Whilst recognising the FSA has no power to impose responsibilities on consumers, the regulator is nonetheless required by law to consider the general principle that consumers should take responsibility for their actions.⁹ Consumers already have several legal duties and responsibilities covering the pre-contract phase as well as the duration of the contract.¹⁰

Legal duties of a customer include acting lawfully and in good faith. This means:

- Not to make misrepresentations or withhold material information
- To abide by the terms of the contract
- To take responsibility for their own decision¹¹

Other non-legal responsibilities include:

- To take responsibility for management of their finances
- To gather relevant information about products to be able to make an informed choice

154. We would urge the FSA to focus its efforts on ensuring that responsibilities are balanced proportionately and equitably between lender, borrower and regulator.

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?

155. We agree that the FSA and other relevant government departments should have a role in preventing the extension of credit to individuals who may not be able to afford the debt. However, we do not agree that this is best achieved with generic models.

156. In the case of mortgage credit, we agree that responsibility for assessing a customer's affordability rests with the mortgage lender. Lenders are generally well capable of making sound decisions on the ability of a customer to service a loan at the point of application, based on information provided by the customer (As outlined in our response to question 8). We recognise that other forms of credit have been easily available in recent times, often to those who are most vulnerable and unlikely to service their loans fully. It is here where the bigger problem lies and where the FSA or other regulators ought to focus their attention.

⁹ http://www.fsa.gov.uk/pubs/discussion/dp08_05.pdf

¹⁰ This is expanded further in the BSA's response to DP 08/05 is at: http://www.bsa.org.uk/policy/response/consumer_responsibility.htm

¹¹ Section 5(2)(d) FSMA

157. As noted above, the FSA has a limited role in determining consumer responsibilities. However, consumers would benefit from greater clarity on and explanation of their obligations and responsibilities. The BSA welcomed the FSA DP on consumer responsibility¹², and will continue to work with the FSA on promoting consumer awareness.
158. Consumers are entitled to as clear as possible a picture of what can reasonably be expected on their part in relation to financial services. Indeed, consumers may risk damage to their own rights of redress if they do not carry out their obligations.
159. We believe the FSA, working with lenders and consumer groups, should ensure consumers are made aware of their obligations and encouraged to be more responsive to these. We would also like to see more information and guidance made available on consumer responsibilities as part of the information already available on TCF.

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

160. The BSA supports the FSA's intention to promote financial capability. Well informed, competent and confident consumers can only help ensure a well performing and sustainable mortgage market.
161. The FSA's financial capability programme has an important role in helping consumers understand their options, as well as the implications for the decisions they make.
162. We believe that helping consumers to understand the nature and extent of their responsibilities, as well as those actions they can take to protect their own best interests, is both helpful and consistent with objectives to:
- secure the appropriate degree of consumer protection; and
 - to promote public understanding of the financial system.
163. The BSA supports the FSA work through '*moneymadeclear*'. It is crucial that the most vulnerable and financially excluded groups, who may not be able to seek assistance from elsewhere, are able to proactively access guidance and support. We also support the FSA's intention to provide better support mechanisms for those who may become vulnerable to arrears and repossession through changes in personal circumstances. Relevant and timely advice at key trigger points can be a useful tool for many potentially at risk customers.
164. Similarly, the BSA supports the FSA's intention to further explore how to help consumers better understand the court process and access advice. We believe education around the court and legal process will help demystify the system for the benefit of both borrower and lender. A more confident customer is likely to act on notices and engage with their lender, which in itself will reduce the threat of legal proceedings and repossession.

E: Arrears and repossessions

- **Poor practices of some lenders identified in the thematic reviews are not indicative of the industry as a whole and failings should be dealt with directly.**
- **In the main, the vast majority of customers are treated fairly and offered a range of solutions to help them manage their arrears under the existing MCOB rules.**
- **A change to MCOB 13 concerning the use of forbearance tools from 'should be considered' to 'must be considered' may restrict lenders in providing flexible forbearance, based on the individual circumstances of the customer.**

¹² http://www.bsa.org.uk/policy/response/consumer_responsibility.htm

- We strongly oppose the inclusion of specific references to Mortgage Rescue and Homeowner Mortgage Support (HMS). Not only are both schemes temporary measures due to end in 2011, but HMS is a voluntary scheme and must remain as such.
- The FSA intention to prohibit monthly arrears charges, where the borrower is maintaining agreed payments is sensible. We are also supportive in principle of prohibiting firms charging Early Repayment Charges (ERCs) on the arrears fees, where there is evidence that the customer would experience significant detriment.
- The wider review of arrears charges is to be welcomed. However, we would argue strongly against the FSA acting as a price regulator and intervening on prices.

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

General Comments

165. We do not agree that the poor practices of some lenders are indicative of the industry as a whole. Most lenders, including building societies and other mutual lenders follow the intended policy aims of the FSA, by adopting approaches that are fair and meet the needs of both the customer and the lender. BSA members ensure that repossession is a last resort, and this can be seen in the MLAR data.

Mortgage Arrears and Forbearance

166. We do not agree that MCOB 13 should be amended to change the range of forbearance tools used from 'could be considered' to 'must be considered'. This change could have the consequence of removing the ability for lenders to apply flexible forbearance, based on the individual circumstances of the customer.

167. This will be very dependent upon how the rule is worded. For example, there is no point in requiring all firms to consider a change to the term for an interest only loan, as this will have no impact at all on the monthly payments. We also urge the FSA to work closely with Ministry of Justice to ensure there is a consistent approach between MCOB 13 and the pre-action protocol.

168. We believe that most customers are already treated fairly and are offered a range of solutions to help them manage their arrears under the existing MCOB rules. The concerns identified in the thematic work relate to a small proportion of firms, whose practices do not reflect the rest of the industry. We therefore do not think it is appropriate to amend the rules for all due to the failings of a few.

Government Schemes

169. We would strongly oppose the inclusion in MCOB rules of the Government's Mortgage Rescue (MRS) and Homeowner Mortgage Support (HMS) schemes, but would be comfortable with the inclusion of Support for Mortgage Interest (SMI).

170. MRS and HMS are not only temporary schemes, due to end in 2011, they are also voluntary schemes, which in the case of HMS in particular means that only one building society is formally participating.

171. Furthermore MRS is not a lender scheme. The lender has no say in the eligibility criteria and assessment process, as both are handled by the local authority. Therefore it would not be possible for the lender to consider MRS as a forbearance option, rather it could advise the borrower only that the scheme exists and suggest they seek independent advice.

172. With regards to HMS, during the development of the scheme, the BSA clearly outlined concerns that inclusion of HMS in MCOB and/or the pre-action protocol, would result in a voluntary scheme becoming mandatory via the back door. HMS has not proven to be an effective tool, with very few lenders using the scheme and instead resorting to internal forbearance measures.
173. The figures published by Communities and Local Government (CLG)¹³ on 9 December 2009 show that only 15 borrowers have been placed on the scheme since it launched in April 2009. Lenders have instead offered comparable arrangements, assisting over 6,000 borrowers, without the need for a formal government guarantee. We therefore see no need to include HMS within MCOB 13.
174. The issue of MRS and HMS being temporary measures is also important and should be considered carefully. Any amendments to MCOB 13 require a formal consultation period as well as sufficient notice for implementation to allow firms to comply with the amended rules. As such, changes are likely to be implemented towards the end of 2010 at the earliest. This potentially means that further changes would be required in under 6 months to remove reference to MRS and HMS once they reach their current end date of January and April 2011 respectively. We therefore see no benefit in including these schemes within MCOB 13.

Arrears Charging Practices

175. The BSA supports the approach of prohibiting monthly arrears charges, where the borrower is maintaining agreed payments. We also support the principle of prohibiting firms charging ERCs on the arrears fees, where there is evidence that the customer would experience significant detriment.
176. We do have concerns with the cost implications for lenders to make the necessary system changes to comply with the proposals. We will provide detailed analysis in our response to the consultation. However, the FSA should be aware that many firms will incur significant costs when implementing these changes. For building societies these costs will have to be borne by their members. We would therefore urge the FSA to ensure that their proposals achieve the right outcomes by conducting a full cost benefit analysis.
177. Whilst we welcome the wider review of arrears charges, we would argue strongly against the FSA acting as price regulator and intervening on prices. The FSA should review firms on the principle that the amount recovered in arrears fees and charges does not exceed the lender's costs of running the department. We believe that a careful and considered approach is needed with regards to fees and the FSA should recognise that many lenders do adopt a flexible approach to fees and will look to waive charges where appropriate. It is the FSA rules that require firms to publish a complete set of charges, which do not always show that some fees are charged in exceptional circumstances only.
178. Furthermore, we see no evidence that the practices identified during the thematic review are indicative of the wider industry. The recent regulatory action demonstrates that some lenders have fallen foul of regulation and this action should continue where the FSA identifies poor practice.

Third Party Administrators

179. The BSA shares the concern that in some instances, the standardised approach operated by Third Party Administrator's (TPA's) does not necessarily result in the fair treatment of customers. A more robust approach to supervision of these firms may have a positive impact for customers.

¹³ CLG press release 9 December 2009 <http://www.communities.gov.uk/news/corporate/1408110>

180. We do not agree that TPA's influencing a lender's policy and practice is always inappropriate. TPA's administer accounts for a number of different lenders. They therefore have the ability to share policy and practice of other firms in order to improve standards and share good practice.

F: Unfair charging practices and price regulation

- **The costs associated with mortgage products result from a combination of factors, such as the cost of funds and risk profile.**
- **We do not believe that most consumers are paying excessive charges.**
- **If borrowers were prevented from adding intermediary and product charges to the loan that would restrict consumer choice.**

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

181. In the main we do not believe that consumers are paying excessive charges. The costs associated with mortgage products result from a combination of factors, such as the interest rate, the cost of funds and the risk profile associated with the product.

182. As noted in the DP arrangement fees vary depending upon the nature of the product and it is common for a low interest rate to be offset by a higher arrangement fee. This practice promotes a competitive market, providing customers with the option of a low initial interest rate with a higher fee or vice versa.

183. The level of arrangement fees has indeed risen over the last few years, this is partly due to the effect of the competitive market up until late 2007 as lenders competed aggressively with pricing. In 2009, increased funding costs have raised the cost of borrowing to consumers, this is reflected in the current product pricing structures.

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

184. Intermediary fees and product charges should continue to be allowed to be rolled up into the loan. The market has functioned in this way for many years and we have not been presented with evidence which suggests this has resulted in consumer detriment.

185. Requiring customers to pay these fees up front adds further strain to finances, especially to those purchasing a property for the first time. Customers already have to fund a deposit, stamp duty and legal costs; adding to this list and causing further financial strain may drive some consumers to more expensive forms of borrowing, such as credit cards.

186. A further consequence is that customers may be driven away from the intermediary sector and therefore not seeking independent or longer term financial advice, which could be detrimental to non prime customers.

G: Data requirements from lenders

- **In principle we support a change to track arrears and repossession cases back to the original transaction.**
- **The FSA need to give consideration to how ported loans would be reported as the original transaction details may not be relevant**

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?

187. In principle we support a change to track arrears and repossession cases back to the original transaction.
188. The level of detail will determine the feasibility of the lender being able to provide the data and the costs involved. Whilst all societies are in theory able to provide the data, for some the costs will be significant, such as those who collate the data manually and those with various IT platforms within a single institution, such as lenders which have merged.
189. We would also question whether the data would always be useful. For example, if a mortgage is ported to a new property with a change to the loan, such as increased borrowing, the original transaction details would be less relevant. It is not clear from the DP how the FSA would require such loans to be reported and further analysis should be undertaken to understand the impacts.

H: Definitional issues

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

190. We do not believe that the FSA needs to standardise existing product terminology.
191. Any standardisation of product definitions and terms that are used by lenders would achieve little in practice.
192. Taking sub prime as an example, there is a wide range of factors, containing a myriad of attributes including arrears, CCJs, defaults, IVA and bankruptcy history. Different lenders will have very different attitudes to risk that cannot be addressed in such a narrow definition.
193. Whilst it is possible to categorise these products into broad clusters, it is still subject to different interpretation by lenders.
194. We would support standard definitions with regards to the forbearance tools used by lenders, especially in the following areas:
- Arrears capitalisation - A standard definition of capitalisation is needed as there are differences in the way individual lenders currently define capitalisation. In general most lenders will define capitalisation as rolling up arrears and charges into the total balance. The monthly payment is re-calculated based on the new figure and the arrears position is effectively re-set to zero. However, we are not convinced that all lenders follow the same definition. Furthermore, we do think there is scope for the FSA to provide guidance on how and when lenders can use capitalisation.
 - Voluntary possession - A standard definition of voluntary possession would be helpful. The BSA will be working with CLG, the CML and other trade bodies to agree definitions via the Home Finance Forum working group and we would encourage the FSA to adopt these definitions to ensure consistency.
 - Concessions and arrangements - It would be helpful for the FSA to clarify the definitions of arrangements and concessions. As we understand the term, an arrangement is where the borrower agrees to pay more than the contractual monthly payment in order to reduce the arrears. A concession is where the borrower is paying the contractual payment, or less than the contractual payment for a short period of

time, therefore the arrears balance is not being repaid. A standard definition would ensure consistency of terminology, making it clearer for consumers and lenders.

I: Fees and charges

- **We strongly suggest that it would be more proportionate for the FSA to collect details of fees and charges via existing measures, such as the product specification from the lender's website and the tariff of charges.**
- **This would be a far less costly exercise and would ensure that the majority of lenders which are compliant are not hit with unnecessary costs**

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

195. The costs in supplying the data would vary significantly depending on the level of detail required. For example, the proposal to collect Early Repayment Charge (ERC) data, could cover a number of variations such as:

- The ERC levied by product
- The ERC charged as a percentage of the balance and/or monetary value
- When the ERC is charged and trends in when this occurs in the mortgage life cycle
- The ERC versus the product costs to justify the charge.

196. The costs involved would include staff, systems and the impact on the interest rate margin to both savers and borrowers.

197. We strongly suggest that it would be more proportionate for the FSA to collect details of fees and charges via existing sources, such as the product specification from the lender's website and the tariff of charges. This would also put the fees into context, especially in relation to products. Where the FSA identifies potential concerns, further information should then be requested from the lender. This would be far less costly and would ensure that lenders which are compliant are not hit with unnecessary costs.

198. We would also strongly oppose the proposal for the lender to provide details of the intermediary fee from the KFI. There is likely to be system development required to ensure this data can be easily extracted. It is unlikely that many lenders would have this information readily obtainable, as it concerns only the customer and the intermediary.

199. Furthermore the proposal suggests that the lender would be effectively counter checking the intermediary KFI disclosure, which must be avoided. If the FSA wishes to collect this data, it must be via the intermediary.

J: Financial crime and mortgage fraud

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

200. In the financial crime arena vigorous enforcement activity is vital in persuading to criminals that the risks in committing crime are higher than the potential rewards. This is currently not the case for financial crime – police resources are under pressure, financial crime is not a priority area and lenders often find it difficult to get cases investigated and prosecuted.

201. We recognise that economic pressures are likely to lead to an even greater squeeze on police and other financial crime detection resources. We ask the FSA to influence Government to ensure that fraud enforcement resource is a priority area. Any significant

reduction would act as a signal, particularly to organised crime, that financial crime is a lower risk activity. As an example, we note with concern HMRC's decision to suspend its Income Verification scheme without explanation and against the wishes of both lenders and the fraud prevention authorities

202. We welcome the continuing success of the FSA Information from Lenders (IFL) scheme and the tough action that the FSA has taken to prosecute brokers involved in fraud. We believe this should be a model for similar schemes launched for other professions with members involved in fraud so that lenders could provide information to RICS (surveyors) or the Law Society (solicitors) on fraudulent activity by their members on the same terms of IFL, which would lead to actions against them by their regulator. We hope that the FSA will actively support efforts to set these schemes up.

203. The FSA should also encourage full disclosure of employee disciplinary issues when replying to reference requests to help firms recruiting from another financial services firm to reduce the risk of staff fraud or insider participation in organised fraud or ID theft. Currently, HR functions are often too reluctant to state more than length of employment.

K: Equity release and right to buy

Q33: Do you agree that the cumulative effect of the policy levels as outlined within our DP will have a positive effect on:

- (i) the equity release market; and/or**
- (ii) the right to buy market?**

(i) Equity release

204. We share the FSA view that no immediate reform is needed to the regulation of the equity release sector. The sector has seen an improvement in standards in recent years, and there is currently little evidence of consumer detriment, although this could be a consequence of both the small size of the equity release market and the considerable time that it can often take for problems to emerge.

205. We further support the FSA intention to keep the equity release sector under close supervision. However, equity release is still a relatively new product, and it is critical that the FSA ensures that equity release products can be developed that reflect changing market circumstances and customer needs.

(ii) The right to buy market

206. We agree that no further specific action is needed in respect of the right to buy market. This is a minute share of the overall market and diminishing.

207. Some of the proposals presented in the DP may help protect some who may be exposed in this market. However, given the market size and scale, the overall impact of the proposals is likely to be negligible.

L: Scope Extensions

Secured loans and second charge lending

208. Extending the FSA remit to include second charge lending is a welcome move.

209. We agree that second charge loans can have direct implications for first charge lenders. The split in regulatory arrangements can be confusing for lenders, and is also not necessarily understood by consumers. Therefore, simplification of where regulation lies for first and second charge lending should help lenders and consumers alike.

210. As well as a common regulator, the regulation for first and second charge lending should also be common – under MCOB. We note the Government’s separate consultation seeking views on the merit of transferring regulation [of second charge lending] to the FSA – though the detail of how this will be implemented is not set out. Clearly workable transitional arrangements will be required to bring about greater consistency in the regulatory regimes that are applied for both types of lending and we look forward to working with the FSA on agreeing how this may be best achieved.

Buy to Let

211. We do not agree that the scope of the FSA should be extended to cover buy to let mortgages.

212. The experience and knowledge of consumers entering into the buy to let market varies considerably and as such, we do not believe that regulation for all is necessary or appropriate.

213. We note the Government’s consultation on Mortgage Regulation and we will be responding on this basis.

M: EU dependencies

214. It is vital that lenders see a joined up approach to the regulation of mortgage business in the UK. Whilst this review looks purely at UK mortgage lenders, the European Commission are shortly due to consider the action that they will take across Europe. In its consultation *Responsible Lending and Borrowing in the EU*¹⁴ carried out in the summer of 2009 the Commission demonstrated that it is keen to harmonise mortgage regulation across the EU. In the BSA response to that consultation, we urged the Commission to await the findings of the FSA review of the mortgage market prior to finalising their decision about action to take across Europe. Whilst we acknowledge that the FSA has been very active in its engagement with the Commission, it is vital to UK mortgage lenders that this continues and that organisations are not subject to two sets of changes that will result in substantial wasted costs for mortgage lenders and confusion for mortgage borrowers.

215. The opportunity for conflict here is vast. For example, the FSA has stayed away from product regulation, while the EU considers banning certain products; there is a desire to harmonise disclosure arrangements across Europe that could mean a rework of the KFI; and fundamental changes to foreclosure arrangements envisaged in Europe could also have far reaching consequences for the UK mortgage market.

Contact

216. This response has been prepared by the BSA in consultation with its members. The BSA looks forward to continuing to work with the FSA and is keen to make a full and detailed contribution to the FSA working groups and its consultation process. Comments and queries in the first instance should be addressed to Paul Broadhead, Head of Mortgage Policy (paul.broadhead@bsa.org.uk).

28 January 2010

¹⁴ http://www.bsa.org.uk/policy/response/EU_consultation_responsible_lending.htm