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FSA'S MORTGAGE MARKET REVIEW: CP 10/16 – RESPONSIBLE LENDING

RESPONSE FROM THE BUILDING SOCIETIES ASSOCIATION ON INTEREST ONLY MORTGAGES AND NON-DEPOSIT TAKING LENDERS

INTRODUCTION

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 49 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 21% of all such deposits in the UK. Mutual deposit takers account for about 36% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.
2. We welcome the opportunity to contribute to the FSA's consultation on responsible lending as set out in CP 10/16. This response focuses on the issues and questions raised in the CP relating to interest only mortgages and possible changes to prudential regulations for non-deposit taking lenders. The BSA shall respond to the remaining issues raised in the CP by 16 November as requested.
3. We welcome that the FSA is not, at this stage, consulting on detailed rule changes to either interest only mortgages or prudential changes for non-banks. It is correct that a full, open and consultative debate on these issues takes place prior to any further consultation on proposed rule changes. This includes ensuring that all proposals are supported by a robust evidence base and a thorough assessment of all impacts, costs and benefits (financial as well as social) on all affected participants.
4. Overall, the mortgage market remains restrained despite some recent recovery. It is critical that the FSA's Mortgage Market Review (MMR) does not cripple the recovery, either as a result of a disproportionate response to the perceived failures it aims to address, or by being over zealous or overly hasty in its implementation.
5. We look forward to continuing to work with the FSA, and other industry bodies, on these issues ahead of any further consultation later this year. We are committed to providing resource to assist the FSA in arriving at an effective and proportionate regime that will deliver a flexible mortgage market for consumers.

EXECUTIVE SUMMARY

6. As has been stated in previous responses the BSA remains concerned with the overall direction, impact and timing of the FSA's MMR.
7. We remain unconvinced that the recent financial crisis was a direct result of irresponsible lending in the UK. Though there were some instances of poor practice displayed by some lenders during the housing boom of the last decade, on the whole, much of the market acted responsibly.
8. Conversely, gaps and weaknesses in the supervision of firms contributed to poor practices and we welcome the steps already taken by the FSA to enhance its supervisory regime. We do not believe rule changes in themselves are the remedy. We believe that the FSA should carry out a full impact assessment on its new enhanced supervisory arrangements and prudential regime, before deciding what, if any, future remedial action is required.
9. The summer consultation on responsible lending is wide in scope and represents a significant shift in lender and borrower responsibilities. We do not agree with the overall

trend that sees evermore responsibility for the mortgage loan being placed on the lender. We believe the FSA, through the MMR, should be exploring how responsibility is balanced between the parties, and in particular how to raise consumer financial capability and encourage responsible borrowing.

10. The FSA seeks feedback on the issues of interest only mortgages and non-deposit taking lenders.

Interest only mortgages

11. We agree that historically interest only mortgages were popular among many borrowers. Though this trend has been in reverse for several years, there are some risks with interest only mortgages that the FSA is right to examine. Principal is the absence of a suitable repayment method which leaves the borrower exposed at the end of their mortgage term and unable to repay the capital remaining on their loan. However, this risk can be mitigated.
12. Furthermore, it is not common practice for a lender to repossess a property if there is a shortfall or no valid repayment vehicle at the end of the term. Rather, lenders will endeavour to transfer the borrower onto a capital and interest mortgage before the end of the term or will often extend the term if this is not possible. Very rarely would an interest only mortgage customer that has maintained their contractual mortgage payments be forced to sell their property if that was not their original intention.
13. We agree that lenders have a role to play in ensuring borrowers understand the significance of an interest only mortgage and the importance of a repayment plan. We also think it is right that lenders check at the outset that the borrower has arrangements to repay the loan at the end of the term. Furthermore, under existing MCOB rules, lenders are required to, on an annual basis, remind customers of the need to check their repayment plan remains adequate.
14. However, we do not believe it is appropriate for a lender to take responsibility for carrying out regular checks on the adequacy of repayment plans. Lenders may not possess the necessary expertise to be able to carry out such a role particularly when complex investments are being relied upon. It should remain the responsibility of the borrower, with support from their advisers, to ensure that any investment is performing sufficiently well to repay the capital. If not then reminders from the lender should prompt them to take action or contact the lender if they have concerns.
15. Interest only mortgages serve a useful purpose and provide valuable choice to many worthy customer groups. We believe interest only mortgages must be allowed to continue to serve these customers. Key among these are some first time buyers, high net worth customers and those purchasing second homes.
16. We remain concerned that tight, and in our view disproportionate, regulation of this product area will see many lenders withdraw from this market altogether. This will have a significant and detrimental effect on many existing and future homeowners.
17. Lenders have taken many steps in recent years to tighten their lending controls particularly in the area of interest only mortgages. Therefore, many of the FSA's concerns have already been identified and are being resolved by the industry. We do not support the FSA's cost benefit argument that regulatory intervention is required or would improve outcomes for consumers.
18. Yet, the risk of over regulating this area will be to increase costs for consumers and likely to restrict choice particularly for existing customers who may find it much more difficult to remortgage on better terms. The FSA is urged to think very carefully about the impact on existing customers, and the need for appropriate transitional arrangements to ensure that rule changes do not create 'mortgage prisoners', with the knock on effect to social mobility.
19. We also urge the FSA to think about the practical impact of potential regulation, and the opportunity for any rules to be gamed. For example, by requiring borrowers to switch from interest only payments to capital and interest repayments, there is a risk that some

borrowers may struggle to meet the higher monthly payment they face, due to a change in their circumstances. As a result it would be a valid forbearance measure to revert back to an interest only arrangement. This highlights the many inconsistencies and anomalies with regulating this product area. Rather than force borrowers to transfer to capital and interest at a fixed point we believe it is better for customers to understand the risks and features of this type of mortgage and make an informed decision.

Non-deposit taking lenders

20. We welcome the FSA's intention to consider how non-deposit taking lenders may be regulated. The BSA strongly supports the promotion of a diverse and competitive market for the provision of financial services as outlined in the Government's Coalition Agreement.[1] This includes diversity in terms of different business models as well as the products firms offer.

21. A diverse financial services sector is more likely to provide economic stability whilst also encouraging competition, innovation, quality and choice for consumers.

22. However, we are concerned that the market has become less competitive in recent years, due largely to disproportionate regulation, impacting small and mutual lenders; and state intervention during the recession which has contributed to a more contracted market dominated by fewer, larger providers.

23. Whilst it was unfair that some specialist lenders that took advantage of rapid credit expansion and relaxed lending standards pre-2007 were able to exit the market having made considerable profit, we recognise the need and role of specialist lenders who serve many niche markets well.

24. Any regulation of non-deposit taking lenders will need to achieve a productive balance between promoting equality and fair competition in the market, whilst also not serving as a detrimental barrier to entry for new lenders.

[1] http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf

INTEREST ONLY MORTGAGES

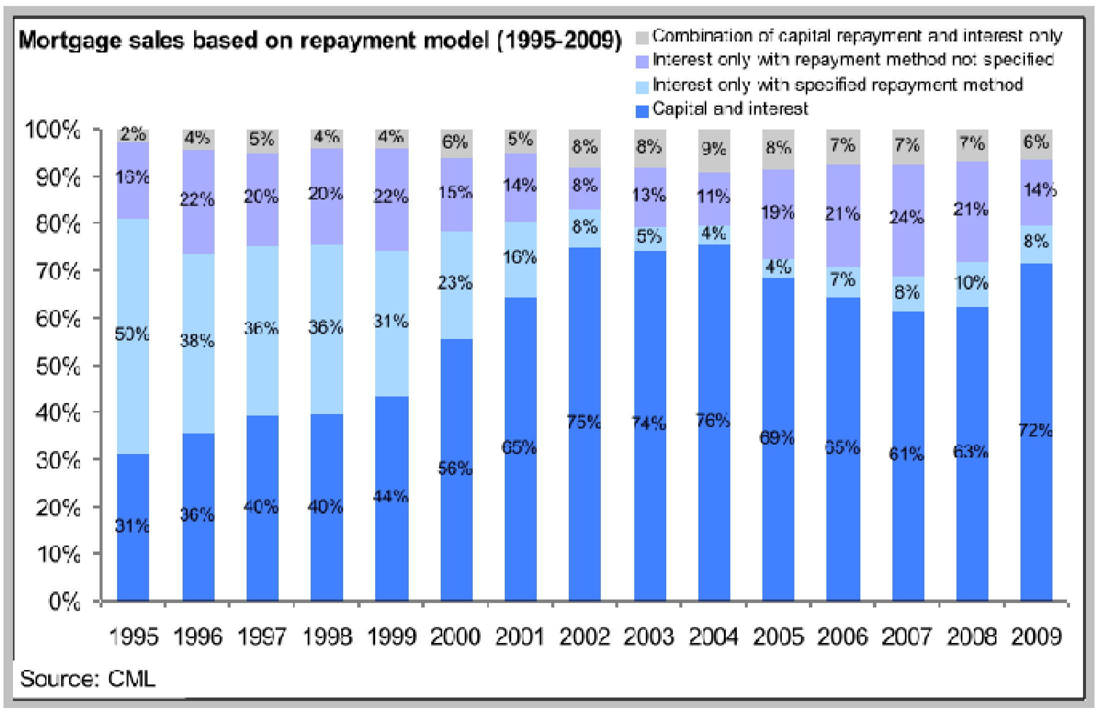
25. This section of the response deals with questions 16 – 22 of the consultation.

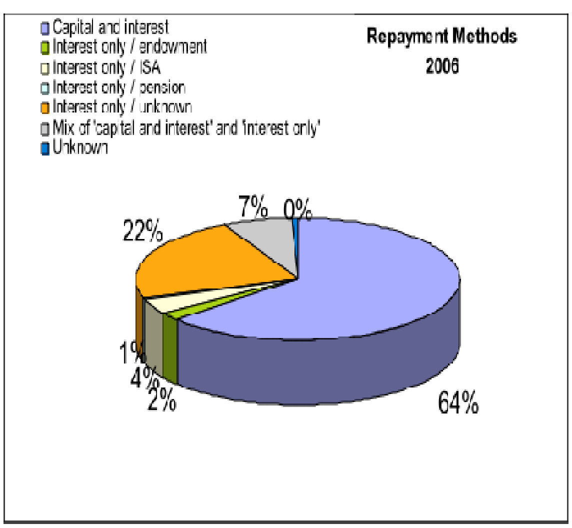
Purpose of interest only mortgages

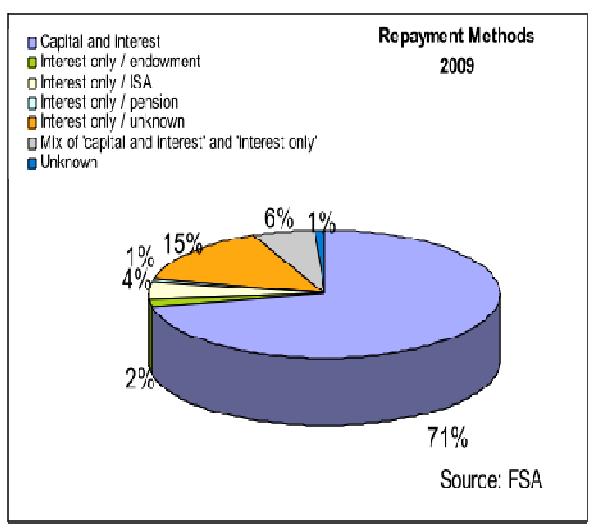
26. Interest only mortgages have been present in the UK mortgage market for some time, being particularly popular during the 1980s and early 1990s. Rapid house price inflation further increased their popularity, however, it is the case that over the last decade capital and interest mortgages have routinely accounted for the majority of mortgages sold.

27. Generally, interest only mortgages can be safe and worthy products that provide valuable flexibility to consumers which better enables them to obtain a suitable mortgage for their circumstances.

28. The majority of mortgages sold by lenders are capital and repayment mortgages. This is not simply, as suggested in the CP, a result of the recent downturn in the market. Over the past decade capital and repayment mortgages have been more popular than interest only mortgages, including during the peak of the housing boom in 2006/07. This is illustrated in the charts below.







29. Interest only mortgages work on the basis that the borrower's monthly repayments comprise only of the interest due on the total loan and that the loan gets repaid in full at the end of the mortgage term. To ensure that the borrower is able to repay the full amount of the loan at the end of the term, they ought to have an appropriate repayment strategy in place. This may take the form of a variety of repayment vehicles or investments depending on individual circumstances.

30. Interest only mortgages can provide for a more cost effective way to purchase a property. Monthly repayments are lower, and with an appropriate repayment strategy, the borrower will be able to repay the full debt, including more quickly and/or more cheaply.

31. Another advantage is that it can benefit those who have limited resources in the early stages of their mortgage but expect to have greater resources in the future, for example, young professionals who will earn considerably more later in their career paths.

32. It is also important to recognise that some borrowers have only a proportion of their loan on interest only basis, with the remainder on capital and interest repayment structure. Therefore, the 'acceptability' of repayments strategies for borrowers with only a small part of their loan on interest only will be quite different to those where the total loan is interest only. This adds an additional layer of complexity to any prescriptive rules that are being considered.

33. Peoples' living patterns and attitudes to housing tenure have changed considerably in the last decade. For example, people are much more mobile in terms of where they work and live. Life events, such as starting families, are also much more staggered than before. Therefore, for many different reasons, including affordability, many look to purchase property at different stages of their life and for different purposes. It is important that the mortgage market continues to provide flexibility and choice to consumers to reflect their lifestyle needs. It is our belief that overly prescriptive rules will deny this flexibility to many borrowers in the future.

Risks posed by interest only mortgages

34. We recognise why the FSA is looking to identify the risks associated with interest only mortgages. These risks potentially extend to lenders and borrowers alike. However, we disagree with the rationale that detailed regulation of this product area is required, and are unconvinced of the need for product level regulation more generally.

35. For mortgage customers the risks of interest only mortgages can be significant if the product features are not fully understood, although there are a number of steps that can mitigate the risk, and make it a very worthy option. The biggest risk is that the borrower is unable to repay the loan at the end of the mortgage term. Having no repayment strategy clearly leaves the borrower exposed at the end of the term, and potentially relying on house price rises to repay the mortgage. Though this may be enough, it may leave the customer without enough funds to purchase another property if that is their intention.

36. For lenders the risk is that at the end of the term the borrower is unable to repay the loan, even after the sale of the property.

37. A repayment strategy mitigates the risk of loss and having to sell if that was not the original intention. However, in practice it is very unlikely that a customer will be forced to sell their property. In the majority of cases, the lender will work with the borrower to reassess and extend the mortgage term allowing the borrower to make the necessary arrangements that will enable them to repay the capital.

38. It should also be noted that having a repayment strategy in place does not in itself guarantee that the borrower will be in a position to repay the loan.

39. Though some repayment strategies are more plausible than others, lenders should not be required to advise customers on the expected performance of these – either explicitly or implicitly. There is a risk that should a lender be required to periodically check that a

borrower's repayment plan is being maintained, the borrower may place reliance on this, believing the lender has approved the strategy thereby guaranteeing it will be adequate. As a result, the borrower may fail to take responsibility for reviewing their arrangements on a regular basis.

40. We believe this is an unacceptable extension to the responsibilities of the lender. Instead, the lender has a clear role and duty to explain risks to the customer and point them to where they can obtain further advice. The customer should be seeking expert advice and choosing a suitable repayment strategy based on their individual circumstances and needs.

41. The FSA is right to look at the role of interest only mortgages in light of its own proposals on affordability set out in Chapter 2 of the consultation.

42. However it must do so to ensure customers can access the right range of products that best meet their needs and budgets. It would be wrong to make changes to the way interest only mortgages work or are sold simply because the perception, rather than the evidence base, is that they may be (or have been previously) used to overstretch affordability. Rather, such loans can genuinely represent a cost efficient option for many borrower types.

43. The possibility of regulation in this area has seen some lenders already decide to retreat or withdraw completely from this form of lending. Though lenders' decisions to do so were based on a number of considerations, over burdensome regulation will in effect eradicate interest only mortgages from the market altogether. However, we do not believe this is desirable, or the FSA's intention.

<u>Repayment strategy</u>

44. We welcome the FSA's intention that interest only mortgages are made available to those that would benefit from such an arrangement and that, as a general rule, customers should support such a mortgage with a repayment strategy. However, there are a number of practical issues to be considered further before any possible rule changes can be consulted on.

45. It is positive that the FSA does not intend to apply any rule changes in this area to existing interest only mortgages. Retrospective rule changes are unlikely to help any existing customers. However, the FSA will need to consider fully, in consultation with industry, how existing customers may be affected and what the implications for them will be when they come to remortgage. Suitable transitional arrangements will need to be fully thought through and implemented carefully.

Q16: How prescriptive should we be in defining a valid repayment method?

46. We do not believe that the FSA should be prescriptive in defining a valid repayment method. Lenders should be free to determine what repayment methods they accept based on their lending policies and own risk appetite.

47. There are numerous difficulties with a FSA prescribed approach. Though the FSA attempts to define what it means by a "valid repayment strategy", lenders and borrowers will need further clarification for this to achieve desired objectives.

48. A key issue with the FSA's working definition, which is based on the strategy being 'realistic', is that it fails to take individual circumstances into account. What is very valid and realistic for one customer may be very high risk and unrealistic for another.

49. Though we accept that future disposal of the property should not be the default strategy, it should not be prohibited either as for many this represents a valid plan based on their future intentions. A prescriptive list or criteria may, therefore, have the effect of marginalising customers and excluding many from the market.

50. Many lenders already do not accept the future sale of the property as a repayment strategy. However, ruling this out altogether as an 'invalid' strategy would be draconian.

The future disposal of a property and downsizing may be appropriate and suitable for some customers. To deny them this, for fear that others may abuse this option, is counter to the FSA's aim of creating a mortgage market that works better for consumers and restricts their choice.

51. Lenders routinely investigate whether a repayment strategy is in place and how the customer intends to repay the loan at the outset of the mortgage. Though each lender may have their own lending policy based on their risk appetite, the BSA believes it is correct that the lender should not be seen to be advising on the merit of specific strategies.

52. The FSA is right to recognise that a repayment vehicle may not 'guarantee' repayment of the capital at the end of the term. Therefore, it is crucial that customers take responsibility for their own financial well-being and, with the support of their lender and others in the financial services professions, consider what options best meet their circumstances.

53. In conclusion, we would not like to see any prescriptive definitions for a valid repayment vehicle, as these are likely to be too blunt and therefore unhelpful.

Q17: Should lenders be required to check that there is a valid repayment method in place at the start of the mortgage, and then periodically through the term of the mortgage? How do you think this should work? How often should lenders check on the repayment method?

54. We agree that all lenders should check what the borrower's intentions are at the outset of the mortgage and, as far as reasonably possible, check what repayment method(s) are in place at the application stage. This will help inform the lender's overall risk assessment of the loan.

55. All lenders should be required to explain to the borrower the importance of having a plausible repayment vehicle in place at the outset of the loan. This means advising them of the risks and sign-posting them to where they may get further specialist advice.

56. Though it may be possible for some lenders to generally outline the different types of repayment vehicles available on the market, it would be difficult for them to identify whether a repayment vehicle is suitable, particularly if a complex or non-standard solution was preferred by the customer.

57. Additional verification of the repayment method by the lender is likely to incur significant cost and require specialist input. This is likely to serve as a barrier for many lenders and result in them withdrawing from the market or restricting the availability of the product to any customer with a non-standard (though not necessarily poorer) repayment method.

58. A further development may be that lenders charge a higher rate or impose an administration fee for the additional checks and underwriting that would be necessary for a loan to be approved.

59. Under existing MCOB rules (MCOB 7.5.3 R) lenders are already required to remind customers on an interest only mortgage, on an annual basis, that their payments do not repay the capital element of the loan; that they need to make separate arrangements for this; and that they should monitor and check the performance of their repayment method to ensure it is adequate for the purpose of repaying the loan.

60. We disagree that a lender should be responsible for monitoring the existence and adequacy of the repayment method through regular inspections throughout the life of the mortgage. In accordance with existing practice, lenders will remind borrowers on an interest only product of the need to ensure that a repayment strategy is in place.

61. The role of the lender should be to highlight the importance of a repayment plan at the outset of the loan and to remind the customer of the importance of maintaining the plan as the mortgage continues. It should not be the lender's responsibility to actively advise on repayment methods. Instead, customers should be advised to seek expert and specialist advice on this.

62. However, more fundamentally regular ‘checking’ of repayment vehicles may be construed by customers as investment advice by the lender, or an implicit guarantee that the repayment vehicle will deliver the necessary return at maturity. We strongly resist any movement in this direction.

63. It could also create a moral hazard where consumers become less active in the management of their own financial arrangements. This is counter to what we believe the FSA aims to achieve and does not promote the well informed and actively engaging consumer the FSA is hoping to breed.

<u>Repayment methods</u>

Q18: Do you think there should be further controls on repayment methods? For example, how should “sale of property” be controlled to prevent it being used where it is not a realistic option? If a minimum LTV amount of equity or income level was set where and how should this be done?

64. As described above, we do not believe it helpful to prohibit the sale of the property as a repayment strategy in all cases.

65. The FSA rightly identifies that many lenders have taken action to limit or stop lending on an interest only basis. However, the reasons for this vary and the limits introduced by such lenders also vary, for example, imposing LTV caps or a limit on the size of the loan. We believe that there may be good and plausible circumstances when the sale of the property should be permitted.

66. We welcome the FSA’s intention to consider when this may be acceptable. Though the exceptions identified in the CP (para 2.100) are a start, there are practical problems with setting such limits. For example, setting maximum limits on LTV or minimum equity requirements will be difficult and arbitrary. As would setting limits on the customer type allowed to sell the property as a repayment strategy, though most lenders would agree that disposal of the property is not appropriate for all borrowers. Lenders must retain discretion as to how they set any parameters on their products in line with their overall lending policy.

67. Lenders should be free to determine the plausibility of the repayment strategy on a case by case basis. This will help ensure that individual circumstances are catered for and reduce the impact of unintended consequences.

<u>Customer types</u>

Q19: Do you agree that these customer types benefit from interest-only mortgages? Are there any other customer types that might benefit from interest-only?

68. The BSA agrees that there are a number of customer types that benefit from interest only arrangements and borrowers from within these groups should not be prevented from accessing interest only mortgages.

69. The following groups are particularly suitable:

- **Borrowers with second homes/investment properties** – interest only products are suitable for such borrowers, who would otherwise be priced out of the market. Risk of failure to repay the loan is mitigated by the possibility of selling the property and not risking the primary residence. In fact, this is often the medium/long term intention in any case.
- **First time buyers (FTBs)** – affordability is one of the biggest single barriers for most FTBs. Though FTBs will be subject to an affordability assessment on a capital repayment basis like other borrowers, they may particularly benefit from an interest only period – to help with set up costs or whilst their earning potential is yet to peak.
- **Young buyers** – though the average age of the FTB is increasing many young people may benefit from an interest only arrangement during the initial stage of their mortgage. Similar to the arrangements for a low-start mortgage, young borrowers

would benefit from an interest only product whilst they build their earning capacity and have time to switch to a repayment mortgage later in their life.

- **Older customers** – lifetime mortgages can be an effective way for some customers to repay their mortgage whilst enjoying tenure of the property during their lifetime. Older customers with a high equity share in the property who wish to downsize at a latter time may also represent suitable customers for an interest only arrangement.
- **High net worth customers** – some borrowers have the financial capacity to repay the mortgage loan through other assets or investments, without having to rely on the sale of the residential home. The purchase of property has also been used by such individuals for tax efficiency and planning purposes and this should not necessarily be prevented.
- **Financially capable customers** – consumers who are financially astute and can demonstrate that they can manage their finances responsibly should not be penalised.

70. We believe the FSA should carry out a detailed impact assessment for these groups before further consultation.

71. A concern is the general proficiency of FTBs and younger borrowers. We believe that both FTBs and young buyers can be vulnerable segments of the market. Many lack the experience of managing a large monthly financial commitment, and for many it can take some time to adjust. We do not promote the view that interest only is a suitable option for all FTBs and young borrowers. As is the case already, an assessment ought to be made based on their individual circumstances.

72. We welcome the FSA's intention to retain interest only as a forbearance method in accordance with the requirements set out in MCOB 13. However, the FSA will need to think carefully how it reconciles any conflicts that may ensue between MCOB 13 requirements and possible changes to interest only mortgages generally.

Q20: Do you agree that some form of interest-only product without the need for repayment vehicle may be appropriate on a temporary basis for first time buyers? If so, how should this be achieved? Would there be any specific impact on older consumers?

73. We agree that a form of interest only product without the need for a repayment vehicle may be appropriate on a temporary basis for some borrowers, such as first time buyers.

74. As stated in our response to Q19 above, FTBs can already benefit from low-start style mortgages where payments at the start of the term are lower than in subsequent years because they start with a short interest only period before switching to a capital repayment model. These mortgages can be particularly attractive during periods of high interest rates.

75. However, not all FTBs may need such a product feature. Lenders should be free to determine, in accordance with the customer's circumstances, whether such an arrangement is suitable. The lender is likely to consider a range of factors including:

- The customer's current earnings and future earning potential.
- The customer's age and whether the loan will continue into retirement.
- Other factors pertinent to the customer's ability to maintain the mortgage, for example, plans to trade up in the near future.

76. One area of concern with enabling FTBs to enjoy the benefits of an interest only arrangement for a limited period is how conversion to capital repayment is managed.

77. It is important that there is clarity as to when the loan is converted and who is responsible for this. This may be built in as part of a FTB product's terms and conditions, however, where the interest only option is flexible, it must be clear who is responsible for instigating the change to capital and interest. We are concerned that borrowers may use the interest only period for as long as they can, not realising that having to pay the capital off

over a shorter remaining term will increase their eventual payments. Without clear responsibilities, there is great potential for consumer confusion.

Older borrowers

78. There is a potential risk that older customers may be disadvantaged, particularly if the mortgage term continues into their planned retirement. However, lenders will consider the ability of the customer to continue payments throughout the term, and customers who can demonstrate that they will realistically be able to maintain payments for the entire term should not be adversely affected.

Q21: Do you agree that there are some limited circumstances where assessing affordability on an interest-only basis may be appropriate? If so, when? And should any additional controls be applied to prevent this being gamed on affordability grounds?

79. As previously discussed in this response, interest only as a forbearance tool must be maintained.
80. In addition to this, we believe that there may be other circumstances where it is appropriate to assess affordability on an interest only basis. These include:
    - FTBs – particularly for a limited period of their term
    - Second home owners and other investors
    - Those looking for bridging finance
81. To ensure lending decisions are risk based and yet fair to consumers, it is important that lenders consider all circumstances of the customer.

Interest only and lifetime mortgages

82. We welcome the FSA's intention not to require that a repayment vehicle is in place where interest only payments are made under a lifetime mortgage.

Equality and diversity

Q22: Do you think that any changes to our interest only requirements will impact any groups with protected characteristics (e.g. race, religion)?

83. We are not aware of any direct implications for any groups with protected characteristics, however, we welcome the FSA's intention to conduct further analysis here. The impact of limiting or withdrawing interest only mortgages will be variable for many different borrowers and it is crucial that the full range of implications are understood before changes are introduced.

NON DEPOSIT TAKING LENDERS

84. This section of the response deals with the issues and questions raised in Chapter 6 of the consultation.

85. We agree that responsible lending and borrowing is central to a sustainable and well functioning mortgage market. However, we remain unconvinced that the current economic difficulties are borne out of irresponsible mortgage lending in the UK.

86. That said, we do believe that change is inevitable, indeed necessary, in the regulation of non-deposit taking lenders (“non-banks”).

87. It is iniquitous that those organisations that took advantage of rapid credit expansion and relaxed lending standards pre-2007 were able to effectively shut up shop as soon as the situation changed, leaving many of their borrowers subsequently stranded.

88. As acknowledged in the CP, some non-deposit taking lenders even had an objective to take abnormal profits and then leave the market. Such irresponsible actions should never be able to be repeated again.

Application

89. We welcome the FSA exploring the need for prudential requirements for non-deposit takers. We are also pleased that the FSA is taking a consultative approach to this area and not rushing proposals.

90. We have assumed that the themes discussed in chapter 6 do not refer to the subsidiaries of banks and building societies (para 6.5 appears to confirm this) and therefore their capital and liquidity requirements remain unchanged. An explicit confirmation would, however, be welcome.

91. It is unhelpful, and confusing, that the terms “specialist lenders” and “non-banks” are used interchangeably throughout the chapter. For example, para 6.7, refers to “specialist lenders” (whilst it may have perhaps been more helpful to have the figures broken down or just shown non-banks). Yet further on in the discussion about arrears in para 6.13, non-banks are banded together with subsidiaries of banks and building societies (though separated in exhibit 6.2).

92. As an aside, we challenge the usefulness of the degree of lending risk measure as shown in exhibit 6.2. The risks attached to, for example, high LTV and credit impaired borrowers are separate and distinct. Combining them serves only to blur underlying trends.

Assumptions

93. We question some of the assumptions in paragraph 6.12. Retail funding is not always cheaper than wholesale; neither do the higher funding costs of non-prime mortgages “inevitably” lead to higher arrears. However, we agree with the comment that securitisations (which remove the exposure to the credit risk of the underlying mortgages) encourage some lenders to compete by weakening standards.

A competitive and diverse mortgage market

94. The BSA strongly promotes diversity in the provision of financial services. This includes diversity in terms of different business models as well as the products firms offer.

95. A diverse financial services sector is more likely to provide economic stability whilst also encouraging competition, innovation, quality and choice for consumers.

96. However, we are concerned that the market has become less competitive in recent years, due largely to disproportionate regulation, impacting small and mutual lenders; and state intervention during the recession which has contributed to a more contracted market dominated by fewer providers.

97. Whilst it is important that a wide variety of lenders are able to operate and compete in the market, they need to do so on a more level playing field. A system where non deposit taking lenders opportunistically crowd into the market with low entry costs to make easy pickings during a period of credit expansion, and then prove not sustainable and disappear in the downturn, is not only damaging to the individual consumers, but markedly increases pro-cyclicality, which we now understand is a negative for financial stability.

Q33: Do you have any comments on this suggested regime?

98. We agree there is a case for imposing enhanced capital requirements directly on non-deposit taking lenders, but any rules must be proportionate.

99. We also agree that this may constrain the level of lending by non-deposit takers although we do not believe that this will have a significant impact on reducing the probability of a financial crisis as suggested.

100. It may be more useful if the forthcoming requirement on non-deposit takers (and also on banks and building societies) to retain a net economic interest of at least 5% on any securitisation position. We believe this is a reasonable extension.

101. While we support the principle of enhanced requirements for non-banks, we feel that the requirements proposed will be too onerous and may deter them from entering the lending market. If they do, they may end up as *de facto* credit institutions. One example is liquidity. This is less important for non-banks – they have no retail depositors for a start. This alone renders the simplified liquidity regime unworkable. We suggest omitting that requirement completely. Similarly, the imposition of the standardised approach to credit risk for on-balance sheet mortgage assets appears to be a disproportionate response and may curtail any high LTV lending (not all of which is hazardous).

102. Operational risk is real, however, for non-banks and we agree that they should be required to hold capital against such losses. We think the basic indicator approach as set out in BIPRU 6 might be a useful starting point.

103. On eligible regulatory capital we agree there is a good case for differentiating between banks and non-banks, and that non-banks should therefore have some equity backing but at a lower level than banks. The proposal of applying the MIPRU restriction for intermediaries that hold client assets seems a reasonable basis. We agree that non-banks should no longer be able to meet their capital requirements by subordinated loans alone.

Q.34: Do you have any comment on the macro-prudential considerations set out above?

104. We agree with the argument for extending macro-prudential regulation to non-banks if the provision of credit by those firms comprised a significant proportion of the credit supply. We agree that this might limit the potential for risk exposures to shift from the banks to non-banks should regulators seek to build up capital buffers. We would, of course, be interested in determining "significant proportion" and the exact macro-prudential tools that would be used. This is important to prevent any changes having an unintended consequence on the building society and bank sector.

COST BENEFIT ANALYSIS

Q36: Do you have comments on the high-level cost-benefit analysis on our current position on interest only mortgages and non-banks?

Interest only mortgage proposals

105. As noted in the consultation, compliance costs can only be identified and quantified if and when detailed proposals are consulted on. However, any requirement for lenders to take responsibility for checking the validity and adequacy of repayment methods will incur cost to the lender. Clearly, if lenders are to be required to monitor and regularly validate repayment methods this will incur further cost throughout the mortgage term.

106. These costs are not just process costs but represent the necessity for full and proper examination of investments and/or assets, and the likelihood for specialist advice as to their adequacy for the purpose of repaying the mortgage.

107. As we have already stated in our response, there are some inherent risk with interest only mortgages. However, we remain unconvinced that there is an empirical case for additional regulation of interest only mortgages. We do not support the FSA's assertion that those taking out interest only mortgages do so purely to overstretch affordability or that they are potentially at any greater risk of falling into repayment difficulties.

108. Further analysis is needed as to what the effects of tighter controls on interest only mortgages might be for the market as a whole, as well as several specific customer groups. We strongly believe that many FTBs in particular will be adversely affected whilst providing them significant benefit or protection from harm.

109. We also encourage the FSA to further consider the impact on competition of any proposals on interest only mortgages. Lenders who also provide investment products may benefit from an unfair advantage.

Non-deposit taking lenders proposals

110. Similarly, it is difficult to assess at this stage what any compliance and other costs may be in relation to greater regulation of non-deposit taking lenders.

111. As stated in our response, we see it as a necessary outcome of the MMR that there is a fairer playing field between all lenders regardless of their business model. Smaller lenders in particular face particular disadvantage as a result of much of the regulation that exists and is proposed.

112. However, we are also concerned that over regulation of non-deposit taking lenders may act as a barrier to entry for new lenders. This would significantly impact many niche customer groups who will as a result find it much more difficult to get a mortgage, and in many instances be excluded from homeownership altogether.

CONTACT

113. This response has been prepared by the BSA in consultation with its members. The BSA looks forward to working with the FSA throughout its consultation process.

114. Comments and queries should be addressed to Paul Broadhead, Head of Mortgages, on 0207 520 5917 or paul.broadhead@bsa.org.uk.

30 September 2010

BSA