# Mortgage customers: proposed changes to responsible lending rules and guidance

BSA response to CP19/14

Restricted
26 June 2019

# Introduction

1. The Building Societies Association (BSA) represents all 43 UK building societies, as well as 5 credit unions. Building societies have total assets of £415 billion and, together with their subsidiaries, hold residential mortgages almost £330 billion, 23% of the total outstanding in the UK. They hold over £280 billion of retail deposits, accounting for 19% of all such deposits in the UK. Building societies account for 37% of all cash ISA balances. They employ approximately 43,000 full and part-time staff and operate through approximately 1,470 branches.

2. We welcome the opportunity to respond to this paper and thank the FCA for its collaborative approach throughout the Mortgage Market Study process, we hope this continues post the consultation period and throughout implementation phase.

# General Comments

3. Regulation introduced by the Mortgage Market Review (MMR) and the subsequent implementation of the Mortgage Credit Directive (MCD) has clearly impacted borrowers as identified by the FCA in the Mortgage Market Study. Some existing borrowers, routinely meeting their mortgage payments, find it difficult under the rules, to remortgage to a new lender.

4. We previously stated in our response to the FSA Mortgage Market Review Responsible Lending Consultation CP 10/16 2009:

   *"The FSA needs to be aware that the outcome for these mortgage prisoners will not be to exit homeownership, but instead they may need to maintain their mortgage on a more expensive rate. Particularly this is the case in a market of higher and/or rising interest rates. The borrower is therefore unable to control their finances in a desirable manner, which could lead to an affordability issue for these borrowers through no fault of their own"*

5. We are pleased that the FCA is attempting to address the regulatory barriers for mortgage prisoners. We will continue to work closely with the FCA to improve the mortgage market for all.

6. The Interim Report identified approximately 10,000 customers who were with active regulated firms but unable to switch mortgage products. Industry responded positively with a voluntary agreement which went further than the FCA's own filtering process in identification of these customers, offering the ability to switch products to an even greater number of customers.

7. This consultation paper looks at tackling the MCD and allowing consumers who have demonstrated a good payment record over 12 months the opportunity to remortgage to a better rate by using a "modified affordability" approach.

8. Whilst we welcome this positive step from the regulator, it is important to remember that these changes are only likely to help a fraction of "mortgage prisoners".

   Annex 3 of the consultation identifies 500,000 consumers with inactive lenders and unregulated entities who are:
   - On a reversion rate
   - Up to date with payments
   - Have a residential mortgage that is not a lifetime mortgage

   The FCA suggests that these customers should receive a letter directing them to a solution, possibly via intermediaries sourcing a suitable lender. The FCA cost benefit analysis suggests that only, 2000 – 14,000 consumers would be able to switch to a better deal as a result of these proposals.

9. It is often perceived that customers within closed mortgage books are paying a very high rate of interest in comparison to the lower rates available in the wider market. We must consider that not all customers would be eligible for the lowest rates available in the market. Lenders price for risk therefore mortgages at a higher loan to value (LTV) or customers with a poor credit history would not be eligible for the best headline rates widely quoted. It is possible that some commentators are over-estimating the savings customers would make by switching to an active lender.

10. **In order to fully understand the circumstances of these customers, we suggest that FCA requests more granular data from third party administrators. The provision of this data, profiling the mortgages held in these closed mortgage books, will help lenders determine whether they wish to adopt the modified affordability approach and also enable better targeting of communication with customers. Even with this additional information some societies may decide that adopting this modified approach is beyond their credit risk appetite. Adoption of these rules is, as the FCA has stated, a commercial decision for the mortgage lender.**

11. Building Societies have a responsibility to their members' this includes responsible lending which protects the organisation and its members. The Prudential Regulation Authority has warned lenders about moving up the risk curve. Sam Woods (CEO of the PRA) spoke at the BSA annual conference on 24 May 2019, he stated:

   "*As we mark today the 150th birthday of the BSA, an obvious place to start is the UK housing market. For deposit-takers including banks and building societies, this is the biggest single loan exposure, and it is also the biggest liability of UK households. And in insurance, firms are taking on more exposures to housing in response to the developing financial needs of consumers. So this will always be an important asset class for the PRA. But there are a number of areas to which we are paying particularly close attention currently. First, as all borrowers and lenders are well aware, we have seen something of a price war in the mortgage market over the last couple of years. This may be good news if you are, for instance, a young supervisor in the PRA looking to buy your first property. But it is less good news if you are a lender concentrated in mortgages, given the impact on net interest margins. The response of such lenders has been entirely unsurprising: a material move up the risk curve. You can see this absolutely clearly in several ways: a dramatic fall in spreads demanded over the risk-free-rate; a marked shift in the high-LTV share of new lending by building societies; and a significant increase in firms' appetite for higher LTV and higher LTI lending. Now, it may be that these shifts are well within firms' management capabilities, and they should be well captured by our capital framework. But we should be watching them like a hawk."*

Our members each have a clear lending strategy which fits within the risk appetite of the organisation, in order for them to continue to operate safely and for the benefit of members any decision to lend to customers should remain a commercial decision of the society.

12. Many of the identified “mortgage prisoners” fall outside of the risk appetite of our members such as:

    - Interest only mortgages without a repayment strategy
    - Very high loan to values/negative equity
    - Individuals who have maintained mortgage payments for 12 months but not maintained payments on other debt.

13. This is not a shift in position as these types of scenarios were often outside of risk appetite prior to the introduction of MMR and MCD which led to the tightening of affordability rules.

14. Some building societies are required to have Mortgage Indemnity Guarantee insurance (MIG) to lend above 80% LTV. The BSA has engaged with MIG providers as have some of our members. There could be some reluctance to insure against this type of approach which could have a number of consequences:-

- Some members use 80% as a maximum LTV.
- Insurers increase premiums which would mean members would need to price accordingly.
- Some Building Societies decide against using this approach which could limit customer options.

15. It is important that the regulator provides a clear rationale as to why using the “modified affordability approach” within defined parameters is responsible lending. Without this regulatory assurance some lenders may be deterred from adopting this approach because of the potential threat of challenge from Claims Management Companies (CMCs). The FCA and government have re-interpreted MCD to enable this intervention, it would be helpful if the FCA share the legal justification for this change of direction as firms may be cautious of legal challenge down the road.

16. Building Societies are also regulated by PRA rules and guidance, as such they would have to carefully assess the impact of this new lending on their portfolio. Clearly the FCA has engaged with key stakeholders however, to date the Financial Policy Committee and the PRA have been guarded on their views. We would welcome clarification in the Policy Statement that both the FPC and the PRA are content with lenders adopting the proposed changes.

17. The regulator must not underestimate the time/resource required to effect a change of this scale. Lenders may need to create new products, redesign sales/advice processes, amend policy, update systems and carry out a large training exercise. Realistically lenders cannot start planning a process change until rules are finalised, in view of this mortgage products and processes may not be in place immediately and may follow a few months, in some cases up to six months after the changes go live. Clearly any letter writing exercise to “mortgage prisoners” should only be initiated once sufficient products are available in the market.

## Protecting borrowers when mortgages are sold on

18. HM Treasury (HMT) launched a consultation in 2009 focusing on [mortgage regulation.] Chapter 4 of this consultation looked at the sale of mortgage books. In this consultation HMT discussed the lack of consumer protections in some instances when mortgage books are sold;

*"Firms will not be subject to FSA regulation simply because they buy a lender's mortgage book. They will be subject to regulation if they carry out an activity described in the legislation. Some of mortgage lenders' customer-facing activities fall within the definition of "administering a regulated mortgage contract", which is a regulated activity. Many of the firms currently active in this market outsource customer handling to third-party firms, meaning that they do not engage in this regulated activity. In order to administer a regulated mortgage contract this third party must be authorised, but the owner of the regulated mortgage contract will not be subject to FSA regulation.*

*Firms not engaging in a regulated activity are not bound by the requirements of FSA regulation including, importantly, the requirement to treat customers fairly. Non-regulated owners of regulated mortgage contracts may seek to maximise margins by raising interest rates and charges, potentially to levels that are unaffordable to borrowers. In some cases, the lack of regulation and the possibility of acting in this way to extract profit may be a contributing factor to firms' desire to purchase these mortgages.*

*Such activity clearly has the potential to cause severe harm to borrowers. These borrowers are not agents in the market where mortgages are sold on, and the costs imposed on them can be seen as a negative externality of this market. The onward sale of regulated mortgage contracts may also be seen as unfair, as it leads to a reduction in protections for some consumers, both in absolute terms and relative to other borrowers who have purchased similar financial services."*

19. Following this consultation in 2010 an impact assessment was conducted as part of proposed secondary legislation. Four options were considered by government:

- Option 1: to maintain the existing framework;
- Option 2: to create a new regulated activity of 'purchasing' a regulated mortgage contract;
- Option 3: to create a new regulated activity of 'managing' a regulated mortgage contract; and
- Option 4: to expand the definition of the regulated activity of 'administering' a regulated mortgage contract.

20. Government did not feel there was sufficient evidence of customer detriment at the time and took the decision not to take forward the legislation but would instead keep the position of contracts sold to unregulated firms under review and return to legislation if there was evidence consumer detriment is taking place. We understand from Economic Secretary to the Treasury, John Glen's letter to the Treasury Select Committee in January of this year that government do not propose pursuing any broader public policy response at this time.

21. Competition is fierce in the mortgage market, there has been several high profile withdrawals from the market in recent times. It is possible these mortgage books will

be purchased by a closed book or non-regulated entities which could create more "mortgage prisoners".

22. Any organisation can buy a mortgage book without regulatory permissions as long as it is administered by a regulated entity. A third party administrator has to follow the FCA's rules in a number of areas, in particular, when a customer is in arrears. However, the book owner retains responsibility for setting policies and pricing.

23. This potentially leads to customers becoming disadvantaged because the book owner is not subject to the full FCA regulatory remit such as the overall Principles for Business including a broad requirement to treat customers fairly (Principle 6) or the SYSC rules (systems and controls).

24. The book owner is not caught by MCOB 11.8 that requires that "mortgage lender[s]… should not (for example, by offering less favourable interest rates or other terms) take advantage of the customer's situation or treat the customer any less favourably than it would treat other customers with similar characteristics.)

25. **The FCA has just published its Perimeter report for 2018/19. Within this report it is clear that the FCA are unable to offer the same level of protection to borrowers with unregulated book owners as for consumers that have mortgages with regulated firms. The BSA strongly believes that the best solution would be to extend the regulatory perimeter and require a regulated legal title holder in every book sale. This happens in some cases already and would mean that the legal title holder would be caught by the FCA's regulation. The unregulated book owner could retain beneficial ownership. Government previously felt there was insufficient evidence of customer detriment, it is clear the FCA feel this is no longer the case and should join us in persuading government to revisit this urgently, including how it can ensure that all mortgage borrowers have the full protection of FCA rules.**

# Questions

**Q1: Do you agree that our proposals should only apply to firms dealing with consumers that meet the conditions of "eligible consumers"?**

Yes, however the definition of eligible customers is very broad and many of these consumers will fall outside lenders' risk appetites such as those with very high LTV or negative equity, those with poor payment history elsewhere or interest only customers without repayment strategies.

There may also be limited consumer value in remortgaging with low balances or short remaining mortgage terms. It is also likely that participating lenders will take a commercial decision on a minimum term and balance due to the expense of on-boarding new customers.

**Q2: Do you agree that "up-to-date with payments" should be decided by not being in payment shortfall, both at the time of application and over the previous 12 months?**

We agree in principle, however this is a fairly blunt credit risk metric, it is possible for applicants to remain up to date with their mortgage but have other credit issues elsewhere which may come to the surface in time.

This approach also falls down where a customer is within an initial product period with a low rate, essentially they have no evidence of affordability over a sustained period at the higher reversion rate. We therefore suspect lenders could take a 2 tier approach, with added due diligence on customers who have not demonstrated affordability at a higher reversion rate.

This could take the form of a stress rate or additional income/expenditure verification, these types of steps add a layer of complexity for consumers and intermediaries, and we therefore feel a better approach would be to limit the "modified affordability" to customers who have been on a reversion rate for 12 months or longer at this time.

The majority of customers who have yet to move onto a reversion rate are with active lenders, therefore it is highly likely they can switch products internally without any affordability requirements. The paper makes some vague statements about saving time in the remortgage process, but does not present any evidence of customer detriment. At this moment in time we do not feel the FCA has made a strong enough case for extending this intervention to all like-for-like remortgages where the customers' are unable to demonstrate up to date payments at a higher rate.

**We would suggest a staged approach, modified affordability should be offered to customers who have been on a reversion rate for 12 months or longer. Sufficient time should be permitted for the FCA to measure success of the intervention via Product Sales Data (PSD). Once this exercise has been completed the FCA could extend the approach if required.**

Lenders are required to request certain documents for KYC/AML purposes such as:

- Proof of Identification
- Proof of address
- Proof of deposit

Additional information such as payslips and bank statements are often collected as an anti-fraud measure, firms will continue to request documents for KYC/AML purposes. Participating firms may also wish to continue these anti-fraud measures for all customers.

That said, it is important that where lenders follow the spirit of the FCA proposals they are not penalised further down the road. We would welcome confirmation that where information has been gathered for reasons outside of affordability the FCA does not require this information to be used for creditworthiness assessments.

Our expectation is that lenders may not use up to date payments as their only credit risk metric and would expect other measures to be utilised such as credit searches and some form of income/expenditure verification. We are concerned around the wording of MCOB 11.9.4 as set out in Annex A, which states:

"*The firm may not elect that only some of those modifications apply in relation to the proposed regulated mortgage contract, but not others.*"

We interpret this as lenders should apply all the new proposed tests for affordability and this would not hinder a firms' ability to retain some additional underwriting measures. We would be grateful for clarity here as if the FCA were looking for lenders to completely disapply all existing rules as per the CP, take up could be very limited due to difficulty in assessing risk with such a basic credit risk metric as being up to date with payments for 12 months.

A big question also remains around how to evidence the customer is up to date with payments and what rate they are currently paying. There are a number of options:

- Customer to provide their most recent mortgage statement.

- Credit Search.
- Outgoing lender to provide the required information (possible industry agreed template)

All of these suggestions are imperfect, we would be happy to work with the FCA and members to come up with the best solution.

**Q3: Do you agree with our approach to defining a "more affordable" mortgage, both where product or arrangement fees have been added to the mortgage and where they have not?**

No, we cannot see the case for 2 separate approaches for scenarios where fees are added or paid upfront as this adds unnecessary complexity. The FCA's suggested approach for a consumer who pays the product fee upfront assesses total cost over the initial product period in comparison to existing payments over the same period. This test could also be applied effectively where a consumer adds a fee to the loan.

Lenders are familiar with this approach as they currently use the total cost over the initial product term to decide between recommending a fee bearing or non-fee product as it looks at total cost it is the fairest approach for consumers.

The simplicity of this rule potentially misses a trick in helping interest only customers without adequate repayment strategies. The lending landscape has changed drastically in recent years, many lenders have extended their maximum ages. It may be possible for some of these customers to convert their mortgage to capital repayment by extending the term, this could mean higher payments but would offer a much better customer outcome. We believe there should be some flexibility in the rules for interest only customers changing to repayment, it should be left to firms to determine how much detail is required in assessing affordability for these customers.

Whilst the examples provided in Annex 1 are helpful they are very simple scenarios. Some mortgages may have more than one sub-account and the customer could have different interest rates and terms on these accounts, there may also be scenarios where the majority of the mortgage balance may have moved to a reversion rate but there is a small balance on a sub-account which remains in a product period and has an Early Repayment Charge (ERC) attached. A calculation of total cost over a product term which is then compared to existing circumstances could be utilised to define more affordable in this scenario, i.e. the ERC could be added to the calculation to ensure cost effectiveness.

The FCA's current proposal requires the new mortgage rate to be lower than each of the existing mortgage sub accounts, whilst this is the simplest approach it may disadvantage some customers as explained above. A blended interest rate which takes account of the balances on each sub-account would be the preferred approach, however this could add a level of complexity to the process. We are happy to work with members and the FCA to determine the best approach.

**Q4: What are your views on a definition of "more affordable" mortgage that refers to both the interest rate during any incentivised deal period and the new lender's existing reversion rate at the time?**

**We strongly disagree that the new lender's reversion rate should be used as a benchmark to assess suitability. We agree that all lenders utilising this approach should have a clear internal switching policy which makes the point about reversion rates irrelevant. If a customer has engaged with this new process it would be**

**surprising for them to suddenly become disengaged and linger on a higher reversion rate when their initial product period ends.**

This approach would exclude our members who tend to have higher reversion rates due to the nature of funding models for building societies and would extend beyond the "small or specialist lenders" the FCA reference. This would limit customer choice as well as excluding lenders who would be best placed to help these customers due to their extensive experience in dealing with complex scenarios utilising strong manual underwriting.

This type of approach would doom this intervention to failure as it would essentially limit the option to larger lenders who generally have a much more conservative approach to lending and may feel these customers fall outside their risk appetite.

In recent times we have seen the increasing popularity of longer term fixed rate products, this indicates that customers can value longer term security over the lowest rate. If interest rates were to rise, customers may find that their ability to use the modified affordability approach could be limited across product ranges. This could lead to a bias towards the lowest rates rather than the most suitable product.

**Q5: Do you agree that we should allow lenders to extend the term of the mortgage when they undertake the modified assessment?**

Yes, we believe lenders should have the flexibility, if you consider a customer converting to capital repayment from interest only, a term extension may be beneficial as it could be in other situations of changes to circumstances. Lenders would only extend the term in suitable situations as described.

These proposals suggest disclosures relating to term extension and additional interest payments are provided no later than the mortgage offer document. We suggest this is too late in the process, it would be preferable for the customer to be given this information at the time of the mortgage advice or prior to submission of a mortgage application. It would be prudent that where a customer is looking at a term variation they complete their application through an advice service.

**Q6: Do you agree with our proposal to only allow lenders to use the modified affordability assessment if they have a policy allowing consumers to switch to a more affordable mortgage?**

Yes, this is an essential step in helping avoid the creation of more "mortgage prisoners" in the future.

**Q7: Do you agree that we should allow lenders that choose to use the modified affordability assessment to disapply our income and expenditure rules (MCOB 11.6.5R to 11.6.15G)?**

Yes, flexibility should be afforded to participating lenders who choose to utilise these changes. We expect some lenders will retain some additional credit risk measures such as a credit search and some form of income verification.

**Q8: Do you agree that we should require lenders to consider whether the consumer's income after retirement would be enough to enable them to meet their commitments under the contract?**

Yes, this is important to maintain responsible lending we would also suggest extending this where it is apparent the customer will have a change of circumstances i.e. children, change of job etc... In these situations customers should be diverted to lenders traditional affordability assessment to ensure the suitability of the advice.

**Q9: Do you agree that we should allow lenders that choose to use the modified affordability assessment to disapply our interest rate stress test rules (MCOB 11.6.18R to 11.6.19G)?**

We agree that customers who have demonstrated payment on a higher reversion rate for 12 months and then move onto lower payments have essentially provided the new lender with a credit risk "buffer". As mentioned earlier this does not work for customers who have not demonstrated repayment at a higher level than their new rate.

The low interest rate era we currently live in could change in the future, lenders may want to hedge against this risk by applying some form of stress test or proportionate affordability assessment.

**Q10: Do you agree that we should introduce guidance that, in considering future interest rate rises, lenders may wish to take into account the fact that the consumer is currently meeting payments at a higher rate than on the more affordable mortgage?**

Yes, clear guidance would help lenders who are considering this.

It would also be helpful if the FPC provide a clear statement outlining their approach to stress and the 4.5 LTI flow rates with respect to this consultation. Current guidance is obscure and buried within other documents, lenders would welcome this clear message when designing solutions.

**Q11: Do you agree that we should allow lenders that choose to use the modified assessment to disapply MCOB 11.6.40G to 11.6.48R and MCOB 11.6.50R to 11.6.52G as long as the consumer is not trying to increase the proportion of the loan on an interest-only basis?**

We disagree with this approach and are surprised the FCA has suggested it, none of our members have expressed a desire to take on customers without a suitable repayment vehicle and put simply you are moving the problem from one lender to another.

There are many new solutions in the market; later life lending, retirement interest only and equity release, which could help. Customers without a repayment strategy should be encouraged to seek independent advice, services such as the Money and Pension Service could be utilised as a central information provider.

Much good work has been done and continues to be done to engage with interest only customers with the intention of finding the best solution for them. We feel this would be a backward step and is the wrong message for the regulator to be sending to the market.

**Q12: Do you have views on whether the modified assessment should be available for home movers looking to switch to a new lender?**

As this would be a classed as a "new purchase" lenders would have to apply the required 3% stress rate to the reversion for any product that does not fix beyond 5 years, this would limit the number of customers who could be helped.

Generally people who move property do so because of a change of circumstances, from a credit risk perspective lenders would want to understand the changes meaning a "light touch" approach is unlikely.

Many mortgage products allow "porting" and on like-for-like situations transitional rules would apply so again we are unsure to how many customers would benefit.

In view of the above we fail to see the case for extending the modified assessment to home-movers at this time.

**Q13: Do you agree that we should require inactive lenders and administrators acting for unregulated entities to contact their customers and make them aware that our rules mean they may be able to switch to a new mortgage product with a new lender?**

Yes, however a simple letter approach is likely to get a poor response, further engagement with consumer organisations will be required to get the message out to those affected.

There should also be a sensible phased approach rather than sending 500,000 letters at once. It is also important that there are sufficient products available in the market when these letters are sent. The customer journey has yet to be finalised and we will continue to work with the FCA to ensure a smooth journey for any customers. Our preferred approach would be for the customers to be directed to intermediaries who would then place the customer with a suitable lender, however some of our members would also offer customers the opportunity to transact directly with them, these options are important for consumer choice.

Clearly the FCA's estimates predict there will be many customers who will not be helped by this intervention. We all have a duty to manage expectation and we would ask the FCA to engage with government and consumer bodies to ensure false hope is not being created.

**Q14: Do you agree that administrators and inactive lenders should only contact customers that have a residential mortgage, that is not a lifetime mortgage, and who are up-to-date with payments and on a reversion rate?**

Yes, however as many as 500,000 customers may receive a letter, as mentioned early managing expectations is key and we certainly do not want to give consumers false hope, in order to effectively target customers who may be helped we suggest the following filters be applied by the administrators;

- Must be up to date with payments with no shortfall in the last 12 months.
- If Interest only without a repayment vehicle.
- No LTV higher than 95%
- No mortgage term of less than 5 years.
- Minimum balance of £25,000 (lenders may set this balance higher for commercial viability)

**Q15: Do you agree we should require lenders to give this disclosure?**

Yes, however our members would benefit from additional guidance on the below disclosure;

"What steps the lender has taken to determine whether the new mortgage is more affordable than the existing mortgage, and how those steps differ from the lender's standard approach to assessing affordability."

There is a danger this could be interpreted as a "lesser" approach which could lead to unsuitable outcomes and challenge via the Financial Ombudsman Service (FOS) or CMCs. An example disclosure and further explanation would help provide clarity.

**Q16: Do you agree we should require lenders to report data on use of the modified affordability assessment?**

We appreciate that the FCA would need to track the numbers of customers benefitting from this approach. The FCA have recently consulted on changes to reporting requirements. We request conduct and reporting rules are issued at the same time with the same implementation period to do otherwise is to risk firms delaying implementation or withdrawing when final reporting rules are issued.

**Q17: Do you agree that we should amend SUP to state that, where lenders have sold a mortgage using the modified assessment, they are not required to report the affordability data required in PSD.**

Yes.

# Conclusion

26. We appreciate that the FCA has tried to keep the proposals as simple as possible and we agree over-complexity will not encourage these changes. As we have discussed there are a number of questions where there is no perfect answer so we feel it is time for the FCA to work directly with firms to overcome challenges and take this work forward via an implementation group which we are happy to support.

27. If you have any questions relating to this response please contact harinder.chohan@bsa.org.uk

By Harinder Chohan
Policy Manager
harinder.chohan@bsa.org.uk
02075205922

York House
23 Kingsway
London WC2B 6UJ

020 7520 5900
@BSABuildingSocs
www.bsa.org.uk

BSA EU Transparency Register No: 924933110421-64

www.bsa.org.uk

The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £400 billion, and account for 23% of the UK mortgage market and 19% of the UK savings market.