

Regulatory developments in the mortgage sector

These are busy times in the area of mortgage regulation. The Financial Services Authority (FSA) has recently published, as part of its Mortgage Market Review, Policy Statement 10/9 on Arrears and Approved Persons (PS10/09) and Consultation Paper 10/16 on Responsible Lending (CP10/16). In addition, on 22 July 2010, the European Commission produced a working paper on responsible lending and borrowing within the mortgage sector.

PS10/9

PS10/9 sets out feedback received by the FSA in response to its proposals in Consultation Paper 10/02 relating to current arrears rules and extending the approved persons regime to home finance business. It also contains near final rules and guidance. The FSA is looking to implement the changes from 31 March 2011, but there will be transitional arrangements put in place for new rules concerning call recording and the new approved persons requirements.

As a result of the feedback, the near final rules and guidance include:

- Clarification of the FSA's requirements that prohibit lenders from levying arrears charges where customers have a performing arrangement to repay the arrears in place. The FSA has produced guidance in Chapter 12.4 of the MCOB as to what constitutes an arrangement to pay.
- The conversion of guidance relating to forbearance tools in Chapter 3.3 of MCOB into rules. In addition, the FSA expects firms to adopt the same approach to forbearance for borrowers with mortgages that have been securitised, as for borrowers whose mortgages remain on the firm's books.
- A requirement for calls that discuss the sums outstanding and the ways in which borrowers can resolve their payment difficulties be recorded. The recording must be kept for three years from the date it is made.
- Clarification of MCOB Rule 12.4.1B so that payments must first be allocated to missed payments and not charges. In addition, the FSA would only expect capitalisation of arrears charges to occur in limited circumstances.
- Extension of the approved persons regime by introducing a new customer function, CF31. CF31 will apply to all individuals who:

- advise on 'Home Finance Transactions' (regulatory mortgage contracts, home purchase plans, home reversion plans and sale and rent back agreements)
- arrange Home Finance Transactions on behalf of a mortgage intermediary
- enter into Home Finance Transactions on behalf of a mortgage provider

The CF31 controlled function will not cover functions which take place after the application by the customer for a Home Finance Transaction and it will only apply to transactions where new monies are to be advanced.

- Extension of the compliance oversight function (CF10) to Home Finance activities.
- Subjecting applications seeking approval for CF31 and/or CF10 to the FSA's existing policy on conducting criminal records checks.
- The modification of the FSA's existing forms used to seek approval to conduct a control function.

The clarification of the timetable for the approval process for the FSA to accept applications for individuals to conduct the new controlled functions. The aim for the FSA to accept applications for a three-month period starting on 31 March 2011 and transitional provisions will allow such individuals to continue to undertake their roles until the FSA has determined the applications.

CP10/16

In CP10/16, the FSA sets out changes it believes are needed to deliver a more responsible approach to lending and describes the FSA's proposal for a more interventionist approach to challenging unfair charging practices in the market. The proposals include:

Affordability assessments

The FSA considers that firms' failure to perform proper affordability checks underlies many of the problems in the mortgage market today. The FSA is therefore proposing that lenders should assess a consumer's ability to repay for all mortgage applications, through an assessment of their income and expenditure, and to lend only where a mortgage is assessed as being affordable.

Although the FSA has evidence that fast-track mortgages have a lower rate of arrears and repossessions than income-verified mortgages, the proposal effectively bans self-certification and fast-track mortgages where income is not verified. The FSA is not

proposing to be prescriptive on the types of income a lender can take into account when assessing affordability, but does propose to make lenders consider the variability of income and to discount one-off sums or temporary income received during a short-term period of increased activity.

Also, in order to calculate what the FSA calls 'free disposable income' (i.e. the maximum amount the borrower can afford to pay towards mortgage repayments), lenders will have to deduct various categories of expenditure from gross income. These categories include other credit commitments, 'committed expenditure' (e.g. tax, National Insurance, utilities bills, pension contributions, maintenance payments and school fees); 'personal expenditure' (e.g. food and drink, clothing, transport and recreation); and 'contingency expenditure' (where the lender may make a prudent allowance for undeclared or under-estimated expenditure). The FSA recognises the difficulties in obtaining comprehensive expenditure data from customers and so is proposing to allow lenders to use statistical data (from their own data or external sources) when assessing expenditure.

In addition, the FSA is concerned that many interest-only mortgages have been taken out on affordability grounds in order to maximise borrowing capacity. The FSA is therefore proposing that affordability assessments be based on a capital and interest basis and on a maximum term of 25 years, even where the actual term is longer. This does not mean that interest-only mortgages will be banned, but in the FSA's view, interest-only mortgages should only be offered where there is a valid repayment method in place and where this does not rely solely on house price inflation.

Also, to provide extra protection for impaired credit borrowers, the FSA is proposing that lenders apply a 'buffer' to the calculation of those borrowers' free disposable income. The FSA has suggested 20% from an impaired credit borrower's disposable income to start the debate.

Product Regulation

In Discussion Paper 09/3, the FSA suggested there could be a case for prohibiting certain types of mortgage lending to borrowers with multiple high-risk characteristics. However, in light of the proposals to apply a buffer in relation to borrowers with impaired credit histories, the FSA is no longer proposing to ban any particular high-risk combinations. Similarly, the FSA is not at this stage looking to ban loans with high loan to value or high loan to income ratios, as this may deny borrowers a mortgage without assessing their ability to pay.

Arrears charges

As a result of analysis it has undertaken, the FSA states that most lenders have not adequately considered the underlying costs when setting their arrears charges, even though lenders are required to do so under current FSA rules. Allocation of costs and overheads was an area where the FSA considered there to be particularly poor practice. Overheads should only be recovered from borrowers in arrears if they have a substantial connection with the administration of borrowers in arrears and are not too remote. As part of its proposals, the FSA will continue to publish its findings on the Mortgage Market Review, including market figures on arrears charges, and will use its findings to inform its more intrusive supervisory approach and will challenge firms where arrears charges appear to the FSA to be extreme.

The FSA is also proposing to extend its arrears charging rules to all charges related to 'payment shortfalls', a term the FSA proposes to define.

In addition, in light of the FSA's thematic work on arrears handling which suggests that some lenders may be excessively re-presenting unpaid direct debits and charging a fee each time, the FSA will be requiring firms not to charge a fee for missed payments (e.g. unpaid direct debits) more than twice a month.

Responsible borrowing and better informed purchasing

The FSA acknowledges that consumers have an important role to play in the mortgage process – irresponsible lending goes hand in hand with poorly informed and/or irresponsible borrowing. The FSA states that the affordability assessment proposals should encourage consumers to engage more in the mortgage process.

The FSA also points out that the Consumer Finance Education Body has undertaken several financial capability initiatives focusing on mortgage borrowers, including adding additional information concerning repossessions on its MoneyMadedclear web site and undertaking the Stay on Top of Your Mortgage consumer awareness campaign.

Non-deposit taking lenders

In Discussion Paper 09/3, the FSA questioned whether it needed to do anything further concerning the prudential regulation of non-bank mortgage lenders. As a result, the FSA is proposing to introduce a prudential regime for such non-banks that incorporates some elements contained in the FSA's Prudential Sourcebook for Banks, Building Societies and Investment firms that currently apply to banks and building societies. The FSA's current thinking is that an appropriate prudential regime for non-banks could consist of:

- more risk based capital requirements, including:
- a securitisation requirement
- a standardised credit risk requirement
- an operational risk requirement
- an other assets requirement
- restrictions under quality of eligible capital
- a tailored liquidity requirement

EC Working Paper on Responsible Mortgage Lending and Borrowing

Whilst the regulation of retail mortgages has been around for a number of years in the UK, the European Commission points out in its recent Working Paper that within the EU as a whole, there are regulatory gaps in the European legal framework for credit intermediaries and non-bank lenders in the retail mortgage sector. The Working Paper therefore sets out a number of issues which could be covered when addressing irresponsible mortgage lending and borrowing at EU level in order to minimise consumer detriment, improve customer mobility and facilitate cross border activity.

The Working Paper envisages that only certain aspects of mortgage credit agreements would be covered by EU legislation, namely the pre-contractual stage and the authorisation and regulation of certain mortgage market participants. The manner in which such mortgage products should be designed, the terms and conditions of early repayment of mortgage credit, and most aspects of the post-contractual relationship between consumers and creditors, would

be outside of the envisaged proposals. Neither would the scope include certain 'equity release' credit products.

Authorisation

The proposals call for new regulation of the way in which mortgage distributors conduct their business and call for all mortgage participants to be subject to appropriate regulation and supervision.

In this respect, principles for prudential and supervisory requirements for mortgage intermediaries and non-deposit taking lenders would be established at in EU level and would give rise to passporting rights for those subject to such requirements.

Conduct of business

The conduct of business proposals contain similar provisions to those set out in the Consumer Credit Directive 2008 and include:

General operating conditions for credit provision – mortgage providers and intermediaries would be expected to act honestly, fairly and professionally in the best interest of clients, and staff should possess appropriate knowledge and competence in relation to mortgage agreements.

The content of advertising and marketing – any advertising and marketing communications concerning mortgage credit should be complete, fair, clear and not misleading. Such advertising should also specify that the product advertised is credit and should include the borrowing rate, the annual percentage rate charged, together with the cost of any compulsory ancillary service.

Standardised pre-contractual information and an obligation to provide adequate explanations – consumers should be provided, in good time, with certain general information about the credit offered. Once the consumer has given the necessary information about his/her circumstances, he/she should receive additional personal information. The European Commission has suggested a layout for the personalised information contained in a European Standardised Information Sheet and which is included in the annex to the Working Paper. The consumer should also be given adequate explanations by the mortgage provider or intermediary, according to the consumer's knowledge and experience with credit, and therefore be put in a position to assess whether the proposed products are adapted to his or her needs and financial situation.

An obligation to assess creditworthiness of the consumer and the suitability of credit products – before the granting of mortgage, the mortgage provider should assess the consumer's ability to repay it, taking into account the consumer's personal circumstances, such as income, expenditure and any other elements that might influence his or her ability to repay the loan. Also, before the conclusion of the mortgage agreement, the mortgage provider or intermediary should thoroughly assess the suitability of mortgage contracts taking into account the consumer's personal and financial circumstances on the basis of sufficient information, where appropriate, obtained from the consumer.

Advised standards needs to be adhered to when advice is provided.

Comment

Even though there is a lot of upheaval in the UK's regulatory framework, with the FSA's functions being separated into a new Prudential Regulatory Authority and Consumer Protection and Markets Authority, the FSA has made it clear, as has the Government, that the structural changes will not deflect the FSA from delivering its reform of the mortgage market.

In a number of ways the EU Commission's proposals in its Working Paper reflect the existing FSA regulatory structure in the UK with strong elements of the requirements set out in the Consumer Credit Directive. Do not be surprised if the OFT regulation of consumer credit is moved to the Consumer Protection and Markets Authority, with existing consumer credit legislation being simplified.

However, if the FSA goes ahead with its proposals as outlined in CP10/16, then UK regulation will be tighter than that proposed at EU level. The changes required to ensure all arrears calls are recorded could prove to be an expensive process for FSA-authorized firms. The FSA also expects law firms engaged in the arrears process to record calls, meaning firms will have to bear this in mind when choosing their partners. The extension of the approved persons regime could also prove to be a logistical headache for firms and those not familiar with the relevant FSA forms would do well to take stock of the information required by the FSA as early as possible.

The imposition of stricter affordability tests and mandatory income verification will also undoubtedly increase costs for lenders, reduce the number of eligible borrowers and the amount they would be able to borrow. However, as Moody's points out in its recent *Weekly Credit Outlook*, the measures are likely to boost the credit quality of UK mortgage lenders' portfolios in the long term as new loans will have to undergo stricter underwriting checks compared with existing mortgages in their portfolios. There should also be an improvement in the credit quality of residential mortgage-backed securities.

Get in Touch

For more information please contact:

Paul Estlin - Associate - 03700 86 56 67 - paul.estlin@shoosmiths.co.uk