Oxera

An assessment of the FSA's proposed rules for mortgages

A report prepared for the Council of Mortgage Lenders

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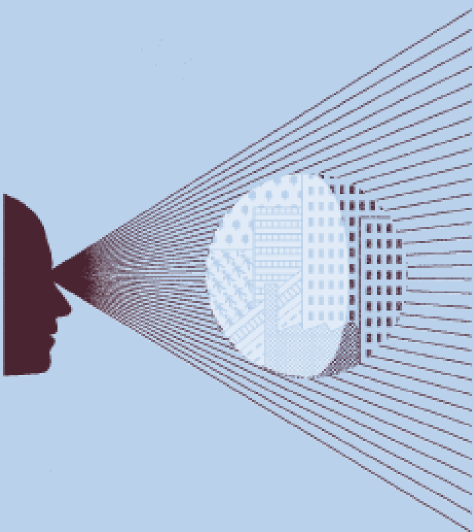

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1 Introduction and summary of main findings

1.1 Objectives and remit

The Council of Mortgage Lenders (CML) asked Oxera to review the draft FSA rules on income verification and affordability assessment in relation to mortgages. This report presents Oxera's analysis and findings.

In its July 2010 Consultation Paper CP10/16, the FSA set out its proposals for reform of the mortgage market. This was the culmination of a process which began in 2006 with the publication of the first stage of the Mortgage Effectiveness Review and continued through the second stage in 2008 to the final publication in October 2009 of the Mortgage Market Review Discussion Paper DP09/3. The remit of the early studies was broadened over time to take account of specific issues raised by the financial crisis.

Oxera has recently produced an assessment for the FSA of the likely compliance costs and indirect costs of the Mortgage Market Review (MMR) proposals.[1] This impact assessment was based on the description of the proposals in DP09/03 and additional explanation provided by the FSA.

The July Consultation Paper updated the mortgage market analysis in these earlier studies and translated the proposals into draft amendments to the Mortgages and Home Finance: Conduct of Business Sourcebook (MCOB). The proposed amendments contain some new elements not described in DP09/03 and therefore not assessed in Oxera's impact assessment for the FSA. The CML has asked that these new elements in relation to income verification and affordability assessment be assessed.[2] Thus, the analysis presented here complements Oxera's analysis as part of its impact assessment for the FSA.

1.2 The FSA proposals

The proposals relating to income verification and affordability assessments as described in DP09/3 (and assessed by Oxera in its report for the FSA) are as follows. Further details can be found in the relevant FSA documents.[3]

- **Income verification**—the proposal is that lenders will be required to obtain proof of income, in some form, for all mortgage applications.
- **Affordability assessment**—the proposal is that, as well as income, lenders will be required to assess borrowers' expenditure; for example, taking account of any other debts they might have, and of the expenditure necessary given their household composition. This is to be used in the affordability assessment to calculate disposable income available for mortgage repayments, and, under the proposal, this must be compared with the actual level of mortgage repayments.
- **Taking account of future interest rate increases**—this proposal would require lenders to include interest rate stress-testing in their affordability assessments.

[1] Oxera (2010), 'Assessment of compliance costs and indirect costs as a result of the MMR lending reforms', prepared for the Financial Services Authority, July 7th.

[2] These new elements are set out in CP10/16, Appendix 1, Part 1, paras 11.3.2–11.3.5 and 11.3.12.

[3] Specifically, FSA (2009), 'Mortgage Market Review', Discussion Paper 09/3, October, and FSA (2009), 'Mortgage Market Review: Feedback on DP09/3', Feedback Statement, 10/1.

– **Credit-impaired borrowers**—the proposal is that, for credit-impaired borrowers, lenders will be required to apply more stringent affordability tests than for non-credit-impaired borrowers.

In CP10/16 the FSA has translated these proposals into detailed rules that include some additional elements (which were not assessed in the Oxera report). For example, in relation to income verification, a firm will need to have adequate systems and controls in place to assess the authenticity of the evidence provided to it, and to guard against fraud. In relation to assessing affordability, the key new element is that lenders will be required to take account of known or foreseeable changes in the customer's income and expenditure. This implies that lenders will be required to undertake a more forward-looking assessment of the consumer's ability to pay than they do now. These new elements are explained and assessed in sections 2 (income verification) and 3 (affordability assessment).

1.3 Approach and information sources

The aim of the review of the proposal on income verification is to understand the activities that lenders would need to undertake (beyond those already assessed in Oxera's report for the FSA) to comply with these new elements, and to assess the costs of these activities in terms of order of magnitude. The aim of the review of the proposal on affordability assessment is to consider how lenders would comply with the rules as now specified and their potential impact on consumers.

Oxera's understanding of how the proposed rules could be implemented in practice was informed by two sources, as follows.

– *Interviews* were conducted with 12 lenders of different size and type: six banks, four building societies and two non-deposit-taking lenders. Oxera also spoke to two credit reference agencies. These interviews gave Oxera a broad perspective on how the rules could be implemented in practice by different types of lender. This report presents Oxera's assessment (partly informed by these interviews) rather than the views of individual lenders.

– *In relation to the affordability assessment*, the proposed rules were compared with those in other countries and regions, as well as those applying to unsecured credit products in the UK. This was particularly valuable since a number of other countries have also recently amended their lending standards, and therefore proves useful in determining whether the FSA rules are in line with those introduced elsewhere. While not exhaustive, the comparison includes the USA, Australia, the European Commission and recently published new guidance from the Office of Fair Trading (OFT) for lenders of unsecured credit in the UK.

1.4 The Oxera report for the FSA

Since the analysis presented in this report complements the earlier analysis undertaken by Oxera as part of its impact assessment for the FSA, it is useful to provide some information about the scope of the earlier Oxera.[4]

The Oxera report assessed the impact of the responsible lending proposals, which included strengthened requirements for affordability assessments and income verification. A subsequent Oxera report will be published alongside the proposed Q4 consultation, setting out an assessment of the proposals in relation to the advice and sales process for mortgages. An assessment of the impact of the FSA's proposed changes to the prudential

[4] The text in this section has been taken from the Oxera report.

regulations with respect to the retail mortgage market was beyond the scope of the Oxera report for the FSA.

The Oxera report assessed the compliance and indirect costs in accordance with standard practice and existing methodologies.[5] Thus, the costs of the proposed MMR regulations have been assessed on the basis of increases in costs over and above the impact of other regulations, and over and above normal good business practice. Compliance costs were quantified using the survey results, and cross-checked in light of the interviews and Oxera's knowledge of the industry.[6] Indirect costs were quantified where possible and appropriate, also from survey results.

In this analysis, having first assessed the extent to which lenders already meet (some of) the proposed requirements, Oxera looked at the additional costs of meeting the requirements. For example, lenders already verify income for some or most applications, but typically not for those that are fast-tracked (income is typically verified for a sample only) or for self-certification mortgages. Oxera identified the percentage of mortgages for which income is not verified and then examined the costs per application of verifying income; the product of these two results in the total incremental costs per lender. Potential indirect costs include changes, for example, to the availability of, access to, and pricing of mortgage products; the degree of competition and/or potential distortions to competition; and the degree of market participation.

The Oxera report listed other aspects relevant to an assessment of the costs, as follows.

– *Scope*—the proposed regulations would be applied to first-charge mortgages—ie, excluding buy-to-let and second-charge mortgages. Estimations of compliance and indirect costs therefore referred to first-charge mortgages only;

– *Counterfactual*—the costs of the changes in regulation were assessed in terms of their impact over the economic cycle. The mortgage market is currently relatively subdued, and a number of relatively risky lending practices that were fairly common in the recent past have become much less widespread, for example. Thus, by comparison to current lending practice, the regulations might affect relatively few mortgages, but during a period of high mortgage lending, far more mortgages could be affected (both absolutely and proportionally). Where relevant, an average of mortgages sales for the past five years was used as the base for the counterfactual;

– *The wider macroeconomic impact is not assessed*—the assessment focused on the impact on the mortgage market. Changes in the use of mortgages may have effects on the wider economy—for example, through changes in the extent to which people buy houses and potential subsequent effects on property prices and the rest of the economy. The extent to which these possible effects materialise would depend on a range of (macro-economic) factors. Although the impact of the reforms on the wider economy was recognised, a detailed examination was beyond the scope of this study.

– *Transition*—the FSA asked Oxera to conduct the assessment on the basis of the assumption that, where appropriate, there would be a transition arrangement to the new system. Therefore, this study did not assess the costs of customers with existing mortgages who might be prevented from re-mortgaging due to the new requirements for lenders and intermediaries. This might, for example, include customers whose mortgages are assessed as unaffordable under the new rules, but who, nevertheless,

[5] See, for example, Alfons, I. and Andrews, P. (1999), 'Cost–Benefit Analysis in Financial Regulation—How to do it and how it adds value', Occasional Paper 3, FSA; and Oxera (2006), 'A Framework for Assessing the Benefits of Financial Regulation', prepared for the Financial Services Authority, September.

[6] All regulated lenders were invited to complete the questionnaire, with 39 lenders in total responding, covering 49% of the mortgage market in terms of the value of mortgages outstanding. For the questions in relation to affordability assessment, responses from 34 lenders were received.

are up to date with their payments. These issues would be addressed by introducing a transition regime for existing mortgages or existing mortgage holders.

The estimates of the costs per mortgage application and mortgage sale were grossed up to produce an estimate of the total annual costs for the industry, using the average number of mortgages over the past five years.

1.5 Summary of new findings

1.5.1 Impact of detailed rules on income verification

In relation to income verification, the key new elements in the detailed rules proposed by the FSA are that lenders will be required to put systems in place to ensure that the evidence used to verify income is reliable and that the type of evidence that can be used will depend on the circumstances of the customer. This means that some applications may require further investigation to check that the income stated is indeed accurate and the evidence provided is indeed reliable.

The new elements in the rules are unlikely to affect the indirect costs (eg, the impact on innovation, market structure and competition), as assessed in the Oxera report for the FSA. However, there could be a specific additional effect, in the sense that the draft rules suggest that lenders may not be able to rely on an assumption that potential borrowers are providing accurate information about themselves. So, if the information provided turns out to be, for example, fraudulent, a lender could still be required to provide compensation to a borrower on the basis that the loan was unsuitable when assessed against the borrower's actual income even though the mortgage would have been affordable on the basis of the claimed income. Under this interpretation of the draft rules, there would be an additional risk to the lender.

The analysis in this report focuses on estimating the compliance costs and shows that they are likely to be higher than the estimates presented in the Oxera report.

The Oxera study for the FSA identified the additional compliance costs that are likely to arise from the MMR proposals under a number of scenarios.[7] The first two scenarios resulting in the lowest compliance costs assumed that verifying income for all applications would be relatively straightforward (for example, based on a payslip or bank statement) and that no applications would require further investigation for the lender to be able to verify income. However, the draft rules suggest that lenders would be expected to undertake further investigation, at least for a sub-set of all applications, to establish that the income stated is indeed accurate. This means that the first two scenarios are no longer realistic.

The third and fourth scenarios (resulting in the highest compliance costs) assumed that applications requiring further investigation would be likely to be from self-employed people. However, as a result of the draft rules, some applications from employed people might also require further investigation, depending on the characteristics of the applicant and application, and in particular if there were reason to believe that the income stated was inaccurate and/or the evidence provided unreliable.

The costs of income verification are therefore likely to be higher than estimated in the Oxera report for the FSA. The new estimates indicate that the annual industry costs would lie between £7.1m and £10.3m (ie, higher than the estimates of £2.3m–£7.2m in the Oxera report for the FSA). Based on this further research, it would seem that it is this range of estimated costs that the FSA should use in its cost–benefit analysis of the final proposals.

[7] Oxera (2010), 'Assessment of compliance costs and indirect costs as a result of the MMR lending reforms', prepared for the Financial Services Authority, section 2.1, July.

1.5.2 Impact of detailed rules on affordability assessment

In relation to affordability assessment, the key new element in the detailed rules proposed by the FSA is that lenders will be required to take into account known or foreseeable changes in the customer's income and expenditure. This implies that lenders will be required to undertake a more forward-looking assessment of a consumer's ability to pay than they do at present.

It is not clear (at least to Oxera) whether the rules are indeed intended to request lenders to undertake a rigorous assessment of the foreseeable changes in income and expenditure, or whether there is a problem with the way the rules have been drafted. The fact that the rules go beyond existing FSA guidance and use different language to that in the existing guidance (which refers only to taking into account actual or *reasonably anticipated* income) would suggest that the FSA is indeed proposing a significant change in its policy.

On the basis that the FSA is proposing a change and taking the new rules at face value, Oxera's analysis indicates that, as currently drafted, the rules requiring lenders to take into account foreseeable changes in income and expenditure are unworkable and could result in the unintended consequence of excluding a significant number of mortgage applicants, among them those who would, in the event, be able to afford the mortgage over its actual term. Lenders are likely to err on the side of caution and scale back *all* loans (which might prevent the desired property purchase being made). Therefore, the draft rules proposed by the FSA in relation to affordability assessment are unlikely to deliver the FSA's policy intentions.

The likelihood of known or foreseeable events could in theory be assessed in one of two ways: by undertaking a statistical approach or using an individual-level approach. Under the former, all new borrowers would be categorised according to certain characteristics (eg, age, marital status, health, location, nature of employment). The likelihood of their experiencing lifestyle-changing events (that could affect their income and/or expenditure—eg, starting a family or adding to it, redundancy, divorce, or serious illness) would then be determined according to the actual occurrence of these events among a pool of borrowers with the same characteristics at the time of taking out their loans. Under the latter approach, the borrower's individual characteristics would be examined to assess affordability. This would require a detailed and, potentially, more intrusive questionnaire on the customer's current and expected lifestyle. Oxera's analysis (presented in section 3.3) suggests that, although, in theory, both approaches are a way of taking into account known or foreseeable changes in income and expenditure when assessing affordability, neither is practical for lenders to implement.

A number of other countries have recently amended their standards for mortgage lenders. In addition, the OFT has published its own guidance on responsible lending in relation to unsecured credit. As far as Oxera is aware, the OFT is the only regulatory authority to provide more clarity on how to take into account foreseeable events. Its guidance makes it clear that any future changes to income or expenditure that should be taken into account can be based only on what is known at the time of assessment, and that lenders are not required to engage in 'crystal ball gazing and/or speculation'.[8] The OFT has adopted a narrower, but arguably more realistic and practical, interpretation of 'reasonably foreseeable' than can be found in the draft rules proposed by the FSA.

1.5.3 Direct compliance costs

Table 1.1 summarises the compliance costs: the costs for income verification are based on the new analysis presented in this report, while the costs of the affordability assessment rules are based on the estimates in the earlier Oxera report for the FSA—since the detailed rules appear to be unworkable, it is difficult to quantify the compliance costs of the detailed rules in relation to affordability assessment.

[8] Office of Fair Trading (2010),'Irresponsible Lending – OFT Guidance for Creditors', updated version, August, p. 43.

Table 1.1 Direct compliance costs, industry total (£m)

	Ongoing costs	One-off costs
Income verification	7.1–10.3	0
Assessing expenditure and affordability (including calculating free disposable income and testing for future interest rate increases)	3.5–13	3–15
Total compliance cost	**10.6–23.3**	**3–15**

Note: As explained in the Oxera report for the FSA, there is significant uncertainty around these figures. It was difficult for lenders to predict accurately at this stage what each proposal will cost them because they have not yet undertaken detailed planning. Furthermore, respondents cover about 50% of the mortgage market, with a variety of lenders by size and type. However, there is substantial variation between the responses of different lenders. The actual position of large firms could make a significant difference to the estimates.
Source: Oxera (2010), 'Assessment of compliance costs and indirect costs as a result of the MMR lending reforms', prepared for the Financial Services Authority, July 7th, and further Oxera analysis.

Table 1.2 presents the compliance cost per mortgage application and per successful mortgage sale for each *additional* mortgage application that would now be subject to these processes.

Table 1.2 Ongoing costs per application and per sale (£)

	Cost per application	Cost per sale
Income verification		
Standard verification	3	4.5
Verification that requires further investigation	12	18
Assessing expenditure and affordability (including calculating free disposable income and testing for future interest rate increases)	12	17

Note: Standard verification was defined in the questionnaire as an income verification that does not require further investigation (eg, data from a current account may be available and is consistent with the income in the mortgage application form and does not require further investigation). A verification that requires further investigations refers to cases where, for example data, from a current account may not be available or is available but is not consistent with the income stated on the mortgage application form.
Source: Oxera analysis of survey data and FSA data, based on a sample of 21 lenders for cost per application in standard verification, 14 lenders for cost per sale in standard verification, 22 lenders for cost per application that requires further investigation, 24 lenders for cost per application to assess expenditure and affordability, and 13 lenders for cost per sale to assess expenditure and affordability.

2 Impact assessment of detailed rules in relation to income verification

2.1 The FSA proposal and new elements in the proposed rules

There is currently no specific requirement to verify the income of the customer, or to take account of disposable income (which in turn will take account of both planned and discretionary expenditure) in the decision-making process.

In its Mortgage Market Review Discussion Paper DP09/3 in 2009, the FSA proposed that mortgage lenders must obtain proof of income for all mortgage applications. It indicated that it would be for lenders themselves to assess what method(s) to use for income verification—ie, the method would not be prescribed by the FSA. In CP10/16 the FSA has translated this proposal into detailed rules that include a number of additional elements. The new proposed rules state that:

> For the purposes of assessing the affordability of a regulated mortgage contract ... a firm must verify the customer's current income (and, if future income is relied on for affordability purposes, known future income) from evidence independent of the customer. The evidence used by a firm must be sufficient to allow the firm properly to assess affordability for that customer.[9]

The FSA provides additional guidance on the application of this new rule as follows:

> Whether the available evidence is sufficient for the purposes of verifying a customer's income will depend on the individual circumstance of the customer, and will vary according to such factors as the nature of the customer's employment and length of service in a profession.[10]

In addition, the FSA states that:

> In order to comply with Principle 3, a firm will need to have adequate systems and controls in place to assess the authenticity of the evidence provided to it, and to guard against fraud.[11]

These proposed rules require the lender to verify the level of income that the customer purports to earn, with evidence such as payslips, bank statements, or information directly from a current account, and to put systems in place that ensure that the evidence used is reliable. At the same time, the new guidance does allow firms to use an element of discretion in the type of evidence required, depending on the customer's circumstances. In some ways this appears to conform with the FSA's intention, often stated prior to the financial crisis, of allowing firms to pursue a risk-based approach to the interpretation of regulation. However, the rules do appear to imply that verification of some sort will be required for all applications—including those previously categorised by lenders as 'fast-track'.

[9] Financial Services Authority (2010), 'Mortgage Market Review: Responsible Lending', Consultation Paper 10/16, Affordable Borrowing and Home Financing Draft Instrument, Guidance 11.3.2, July.
[10] Ibid, Guidance 11.3.3.
[11] Ibid., Guidance 11.3.5.

2.2 Assessment of compliance costs

2.2.1 What activities are required to comply with the FSA draft rules?

In order to comply with the FSA rules, as stated, lenders would have to undertake a number of activities, which can be categorised as follows.

First, the income stated by the mortgage applicant would need to be checked against another source. This might include performing a manual check against payslips, a P60 or bank statements. Mortgage lenders that are banks and where the applicant is already that bank's customer may be able to verify income by using data taken from the customer's current account. If the applicant is self-employed, the lender would have to use annual accounts or, in the case of sole traders without registered-company status, bank statements. Applicants that have considerable variation in their income from month to month (those for whom commission represents a significant proportion of income, for instance) may also require a more detailed assessment and/or more supporting independent documentation.

Second, lenders need to have systems and controls in place to assess the authenticity of the evidence of income provided, and to guard against fraud. In other words, if a lender relies on payslips or bank statements as the main piece of evidence to verify income, it will need to be able to identify those applications where the evidence may have been forged. In practice, this could be done in a number of ways.

– If the applications are assessed manually, the underwriter may have the experience to ascertain the authenticity of the evidence. Checks could be made by the underwriter by comparing the stated income with aspects of the applicant's lifestyle, such as their history of credit commitments, location and type of job.

– The lender may identify cases with certain characteristics of the applicant or application—ie, the loan-to-value (LTV) ratio—which would suggest that it would be prudent to check whether the evidence is reliable. Other systems, such as services offered by credit reference agencies that allow lenders to check whether the income stated is higher than on previous applications, could also be used.

– In particular, some of the larger lenders may be able to develop an automated system to identify applications where the income stated by the applicant does not look realistic. An example is a predictive income model that is currently being used by at least one large lender. Such a model takes information provided by the borrower (nature of employment, length of time with the employer, age, location, etc) and provides a prediction of the approximate income level that the applicant should be earning. This can then be compared with the stated income level and any significant anomalies can be investigated further. Within the industry there are currently different views on the usefulness of such models, with some lenders still claiming that manual verification of the authenticity of documents remains the most effective way of preventing fraudulent applications.

For those cases where there have been inconsistencies between stated income and assessed income, or where there are other doubts over the authenticity of the evidence provided, lenders would have to conduct further investigation. This is the third activity. Here, a comprehensive investigation of the applicant's income declaration would be made, usually involving following up an employer reference. The amount of information that can be obtained from an employer is limited, but it should be possible to confirm that the applicant is actually employed in the position they claim to hold and that they have worked for the firm for the number of years claimed. Again, difficulties may emerge with groups such as the self-employed, where references may not be available. Audited reports and accounts could be used, but these may be out of date and/or limited in the information they provide. Also, not all self-employed people will have registered-company status.

2.2.2 Current practice

The interviews conducted by Oxera with lenders show that, at present, a wide variety of methods are used for income verification. A number of the smaller or specialised lenders will require documentary evidence of income in all cases and may well validate this with an employer's reference as well. Others will require documentation but will undertake further authenticity checks only when inconsistencies emerge or the applicant is a non-standard borrower (eg, self-employed).

The methods used fit, broadly, into a number of categories.

- To establish that the stated income is correct, some lenders—in particular, the smaller building societies or non-deposit-taking institutions—will undertake full manual verification, an initial authenticity check for all applicants, and, if necessary, further checking (eg, taking up employer references).
- Some lenders will verify evidence of income for those applications that do not go through the fast-track process and will also have limited systems in place for an initial check of authenticity. If the evidence reveals an anomaly between stated income and proof of income, the application will, typically, be declined.
- Some deposit-taking institution lenders use information from their customers' current accounts to verify income, while they have a manual process for non-current-account customers (which includes some initial checks of authenticity). In the case of at least one large lender, a predictive income model is used to assess whether the stated income is in line with that predicted according to the characteristics of the applicant. (Further verification and, possibly, additional checks are then carried out on a sub-set of the cases where anomalies between stated and predicted income are apparent).

For a proportion of applications that meet certain criteria (traditionally those with a relatively low LTV ratio and high-quality credit history), some lenders have, in the past, adopted a fast-track process. In such cases, the lenders typically undertook income verification for only a sample of applicants. Fast-track was introduced to improve the efficiency and reduce the costs of the application process.

It is worth noting that, although the FSA now requires income verification for all applications, the draft rules do seem to accept a risk-based approach by stating that the type of evidence would depend on the circumstances: 'Whether the available evidence is sufficient for the purpose of verifying a customer's income, and will vary accordingly to such factors as the nature of the customer's employment and length of service in a profession'. A fast-track process (which is applied only to low-risk cases and where lenders verify income for only a sample of customers) would conceptually be consistent with a risk-based approach. However, the FSA has also made it clear that income needs to be verified in some way for all applications.

2.3 Estimation of compliance costs

The Oxera study for the FSA identified the additional compliance costs that are likely to arise from the MMR proposals under a number of scenarios.[12] For the current analysis, interviews with lenders have attempted to determine the appropriateness and validity of these assumptions in order to ascertain whether the scenarios remain indicative of the likely outcome of the new proposed rules.

On the basis of the survey among lenders, the costs of verifying income were estimated in the earlier Oxera report at £3 per application for cases that do not require any further

[12] Oxera (2010), 'Assessment of compliance costs and indirect costs as a result of the MMR lending reforms', prepared for the Financial Services Authority, section 2.1, July.

investigation and £12 for cases that do require further investigation. The survey indicated that, on average, there are 1.5 full mortgage applications for each sale—ie, where the money is actually lent. Thus, the cost of income verification is approximately 50% higher per successful sale than per application. This means that the cost of verifying income would be around £4.5 per application and where further investigation is required around £18.

The discussions with lenders have not provided sufficient additional evidence to warrant changing these cost estimates. Furthermore, lenders did not indicate that they would incur significant one-off costs as a result of the rules on income verification. Although the rules require lenders to have adequate systems and controls in place to assess the authenticity of the evidence of income provided to them, and to guard against fraud, some lenders assess most or all applicants manually and may therefore not need to establish additional systems, while other lenders already have some systems in place to guard against fraud. One lender has a predictive income model in place; if other lenders were to take a similar approach, they would incur some one-off costs.

The industry-wide costs can be estimated by applying the aforementioned estimates of cost per mortgage sale to the proportion of applications for which income is not currently verified and the proportion that would require further investigation. Determining these proportions is the next step in the analysis.

The earlier Oxera/FSA survey suggested that income is currently verified for about 70% of mortgage applications. This is higher than the FSA estimates, which was around 50% for mortgage sales in 2007.[13] The difference could be due to changed market conditions having resulted in fewer self-certification and fast-track mortgages. Furthermore, there may have been a response bias, in that lenders that verify income for a higher proportion of the mortgages were more likely to participate in the survey.

As explained in the Oxera report, it is not possible to determine exactly the proportion of mortgages for which income would not be verified in the absence of regulation over the economic cycle (ie, the counterfactual). Since the mortgage sector was at its peak in 2007, it is likely to be below 50%, but at the same time unlikely to be close to the current proportion of 30%.

In the earlier report, Oxera developed four scenarios to allow for different assumptions about the percentage of mortgage applications that would require income verification and that would require further investigation. The first scenario assumed that income is not verified for 30% of applications, while the second scenario assumed 50%. The third scenario assumed that income is not verified for 30% of applications and that 30% of this 30% would require further investigation, while the fourth scenario assumed that income is not verified for 50% of applications and that 30% of this 50% would require further investigation.

The annual industry costs were estimated as follows.

Scenario 1 Assuming that total mortgage sales volumes would be equivalent to the long-term average over the period 2004–09[14] and that income is not verified for 30% of the mortgage sales, the annual costs would amount to £2.3m.

Scenario 2 Assuming that total mortgage sales volumes would be equivalent to the long-term average over the period 2004–09 and that income is not verified for 50% of the mortgage sales, the annual costs would amount to £3.9m.

[13] According to the FSA's Product Sales Database.

[14] Total annual sales were estimated at 1,719,102 based on an average over the past five years.

Scenario 3 Assuming that income is not verified for 30% of the applications, including 9% (ie, 30% of this 30%) that require further investigation, the annual cost would amount to £4.4m.

Scenario 4 Assuming that income is not verified for 50% of the applications, including 15% (ie, 30% of this 50%) that require further investigation, the annual cost would amount to £7.3m.

As noted above, since the draft rules require lenders to undertake further investigation to verify income, at least for a sub-set of applicants, scenarios 1 and 2 are no longer realistic.

It is difficult to estimate what percentage of applications would require further investigation. The Oxera study commented that further investigation is likely to be required for applications from self-employed people. The Office of National Statistics (ONS) shows that this is a significant proportion of the working population—around 14% in 2010. This assumption is reflected in scenario 4, where 15% of the applications would require further investigation.

As a result of the new draft rules, some applications from employed people might also require further investigation, depending on the characteristics of the applicant and application, and especially if there are reasons to believe that the income stated was not accurate and/or the evidence provided not reliable. Furthermore, under the draft rules, some of the applications for which income is currently already verified may now also require further investigation because the draft rules require lenders to ensure that the evidence used to verify income is reliable. Some lenders indicated that currently around 15% of applications (which are not self-certification) are subject to further investigation.

The costs of income verification may therefore be higher than estimated in scenarios 3 and 4 in the Oxera report. If it is assumed that an additional 15% of applications for which income is currently not verified (and which are not self-certification) would be subject to further investigation, and a further 10% of applications for which income is currently verified would also be subject to further investigation, the costs would be around £7.1m in scenario 3 and around £10.3m in scenario 4 (ie, higher than the estimates in the Oxera report for the FSA).[15] Based on this additional research, this higher range of cost estimates would seem to be what the FSA should now use in its cost–benefit analysis of the proposals.

As explained above, some lenders may decide to reject applications that would require further investigation. These applicants may then go to another lender that is willing to verify income and investigate further. Arguably, the lenders that decide to reject applications which require further investigation would incur some costs in processing the application and reaching the decision to reject the application. Furthermore, there could be costs in terms of consumer inconvenience, since it may take more time for a consumer to find a lender willing to assess their application. These costs have not been quantified.

Some of the larger lenders indicated that their (automated) systems and procedures would not make it attractive for them to deal with more complex cases, and they would therefore be more inclined to reject any applicants requiring further investigation. In other words, the rates of declining applications and the extent of consumer inconvenience could indeed increase.

[15] In the original scenario 4, it was assumed that income was not currently verified for 50% of the applications and that 30% of this 50% would require further investigation. If it is assumed that an additional 15% (of the 50% of applications for which income is not currently verified) plus an additional 10% of those applications for which income is currently verified would require further investigation then a total of 27.5% (45% of 50% and 10% of 50%) of all applications would require further investigation and 27.5% (55% of 50%) would require standard investigation. Using the mortgages sales and costs of income verification as reported in the Oxera report, this results in an industry cost of £10.3m. For the 10% of applications that would require further investigation but for which income is currently already verified, only the incremental costs of further investigation have been included in the estimate of compliance costs (estimated as the costs of further investigation per application minus the costs of standard verification per application). The calculation of the costs in scenario 3 follows the same logic.

3 Review of the proposed rules on affordability assessment

What do the new rules imply in terms of the additional activities that firms may have to undertake in order to comply with them? This section considers this question and potential interpretations of the rules, as well as the approaches to affordability adopted by other regulatory agencies.

3.1 The FSA proposal[16]

The FSA stated:

> In our view, a key problem has been the lack of proper affordability assessments and we indicated in the [Discussion Paper] that there is scope to strengthen our requirements. We propose to make lenders ultimately responsible for verifying affordability. We also proposed that in each case, lenders assess consumers' borrowing capacity based on free disposable income.

Under this proposal, lenders will be required to assess affordability for all new mortgage applications by looking at expenditure, calculating free disposable income and testing for future interest rate increases. When assessing affordability, the FSA may propose that the lender be required to:

- use both verified income and an assessment of expenditure to calculate the borrower's free disposable income and borrowing capacity. Lenders will be permitted to obtain this information via intermediaries, but the assessment itself will be the responsibility of the lender. Current-account providers may be able to draw on the information they already hold about the customer to inform this assessment. The proposal does not necessarily require a 'line-by-line' assessment of expenditure; instead, lenders may use their own affordability assessment models or sources of average expenditure, such as ONS. However, there should be a method in place to assess any applicants with an unusual level of expenditure;

- take into account any foreseeable changes to the applicant's income and expenditure (including retirement where the loan extends into retirement), and verify income in retirement (if the loan extends into retirement) as part of the application process.

The FSA is proposing that lenders be required to take expenditure into account when assessing affordability,[17] including the servicing of debts and general expenditure, according to the three categories of expenditure outlined in its discussion paper: committed expenditure (eg, tax, national insurance, utility bills and the servicing of debts); personal expenditure (eg, food, clothing, recreation); and contingency expenditure (where the lender may make a prudent allowance for undeclared or underestimated expenditure). The FSA is proposing that, when assessing expenditure or income tax and national insurance, lenders can choose to use statistical data derived from their own data or external sources (such as the tables published by HMRC).

The FSA has proposed prohibiting the lender from lending more than the consumer's maximum borrowing capacity, which is calculated by deducting their expenditure from their income, using:

[16] The text in this section has been taken from the Oxera report for the FSA, and was based on the FSA DP 09/03 and further details provided by the FSA.

[17] The prescription in the rest of this paragraph is more detailed than that assessed by Oxera in its report for the FSA. Prescribing three levels of expenditure could result in some lenders having to alter their systems.

– a capital and interest basis (even if the mortgage is interest-only);
– a maximum term of 25 years (even if the mortgage extends over a longer term); and
– a stress test against increases in interest rates, in which repayments are tested against interest rates of 2% over standard variable rates.

For mortgages taken on an interest (or part-interest)-only basis, the FSA is considering whether it should require lenders to check, before lending, that adequate repayment plans exist, and to check regularly afterwards that the plans are being adhered to. In a later version of this proposal, the FSA decided to impose a limit of five years on interest-only mortgages where no adequate repayment plan is in place. Finally, lenders would be required to implement stricter affordability tests for sub-prime borrowers. The alterations have not yet been specified, but might include a larger increase in interest rates for stress-testing.

3.2 New elements in the proposed rules

CP10/16 translates these proposals into draft amendments to the MCOB. The first set of amendments being proposed by the FSA relates to the assessment of affordability.

Under the current version of the MCOB:

> A firm must be able to show that before deciding to enter into, or making a further advance on, a regulated mortgage contract, or home purchase plan, account was taken of the customer's ability to repay.[18]

Furthermore:

> A mortgage lender must put in place, and operate in accordance with, a written policy setting out the factors it will take into account in assessing a customer's ability to repay.[19]

In DP09/3 the FSA did not prescribe a particular method for conducting affordability assessments, but did refer to the need to ensure that affordability was assessed according to free disposable income once personal and contingency expenditure have been deducted from gross income. The FSA defined affordability as follows:

> A mortgage is affordable if its level and terms allow the consumer to meet current and future payment obligations in full, without recourse to further debt relief or rescheduling, avoiding accumulation of arrears, while allowing an acceptable level of consumption.[20]

In CP10/16 the FSA has translated the assessment of *current and future payment obligations* into detailed rules which appear to go beyond a standard affordability assessment by emphasising the importance of taking into account foreseeable future events in relation to income and expenditure. Going beyond the requirements in the existing version of the MCOB, the new rules note that:

> 1. A regulated mortgage contract or home purchase plan is not affordable for a customer ... if it is foreseeable that, at any time during the term of the regulated mortgage contract or home purchase plan, the payments to be made to it by the customer for a particular month (or other agreed payment interval) will be equal to or more than the customer’s free disposable income over the same interval.
>
> 2. In assessing a customer’s free disposable income over the term of a regulated mortgage contract or home purchase plan, a firm must:

[18] MCOB Rule 11.3.1, last updated April 6th 2007.
[19] MCOB Rule 11.3.4, last updated April 6th 2007.
[20] FSA (2009), ‘Mortgage Market Review’, DP09/3, October, p. 52.

a) take into account any information it has about the variability of the customer's income over time;

b) take into account any *known or foreseeable future* changes to income or expenditure, including (but not limited to) the effects of retirement on the income of the customer, where the terms of the regulated mortgage contract or home purchase plan will extend into the customer's retirement; [emphasis added]

c) where a customer indicates an intention to work beyond the age at which that customer may reasonably be expected to retire during the term of the regulated contract or home purchase plan, consider both whether it is reasonably plausible that the customer has that intention and whether, in the particular circumstances of the customer, the intention is reasonably capable of being realised.[21]

The key element here is that lenders will be required to take account of known or foreseeable changes in the customer's income and expenditure. This implies that lenders will be required to undertake a more forward-looking assessment of the consumer's ability to pay than they do now.

The proposed rules also go beyond existing guidance on assessing affordability, which require the lender to take account only of the customers':

> actual or *reasonably anticipated* income, or both, in reaching a decision on whether to enter into a regulated mortgage contract with that customer or make a further advance.[22] [emphasis added]

This guidance makes no reference to anticipated expenditure changes. However, in CP10/16 the FSA is now requiring lenders to take account of potential changes in expenditure. The justification for this is that the FSA's principal objective when setting the affordability rules is to ensure that loans are made only to borrowers who can meet both current and future payment obligations in full without incurring additional debt or having to reschedule existing commitments. The FSA argues that although many consumers do make changes to their expenditure patterns in order to finance a mortgage, these tend to be relatively short-lived.[23]

The following sections identify some of the ways in which lenders currently assess affordability, considering the extent to which existing practices may have to be adapted or new techniques implemented to meet the requirements of the new rules as currently drafted. The extent to which lenders can implement the rules in practice and the potential impact on consumers are then assessed.

3.3 Current practice

In the past ten years, affordability assessment models have increasingly become part of the toolkit for formal credit assessments—either in conjunction with, or in place of, more traditional assessments and lenders' policy rules based on income multiples.

An Oxera study for CML in 2006 indicated that the number of lenders with an affordability model in place had increased from 9% in 2003 to 48% in 2005.[24] Oxera's survey undertaken for the FSA (for its impact assessment) showed that this trend had continued, with very few lenders making no attempt at all to assess affordability—only two indicated that they did not carry out an affordability check on any of their mortgage applicants. In addition, the majority of lenders (88% of survey respondents) assess affordability by looking at both income and

[21] FSA (2010), 'Mortgage Market Review: Responsible Lending', CP 10/16, Affordable Borrowing and Home Financing Draft Instrument, Guidance 11.3.12, July.

[22] FSA, Mortgages and Home Finance Conduct of Business Sourcebook, Guidance 11.3.5, last updated 06/04/2007.

[23] FSA (2010), 'Mortgage Market Review: Responsible Lending', CP 10/16, para 2.40, p. 22.

[24] Council of Mortgage Lenders (2006), 'UK Mortgage Underwriting', report prepared by Oxera, April.

expenditure, using a model or methodology. Only 12% of lenders surveyed, some of which were small building societies, assess affordability using an income multiplier, a method that is unlikely to meet the proposed requirement of assessing affordability. (They would incur additional costs, which were estimated in Oxera's report for the FSA).

Lenders typically use data from public sources such as the ONS to estimate expenditure for mortgage applicants, and allow for some discretionary spending. The sophistication of these models varies, however, with some lenders taking into account a range of factors (eg, number of children, age and other socio-demographic information), and some varying the amount of discretionary spending built into the model (eg, depending on the applicant's level of risk). Oxera's analysis for the FSA also indicated that most lenders' affordability models are likely to allow for some interest rate stress-testing (where the borrower's ability to repay the loan is assessed on the basis of higher interest rates than those pertaining at present), leaving a few lenders needing to pay to upgrade their models. Such firms will have to introduce new systems in order to comply with the new rules.[25]

3.4 Assessment of the way the rules could be implemented

As indicated, the new rules appear to require a more forward-looking assessment of a customer's ability to repay a mortgage. Although anecdotal evidence from the interviews with lenders indicated that the precise interpretation of these rules may still be open to question, they clearly go beyond existing guidance in relation to affordability, and put considerable emphasis on taking account of future eventualities.

It is not clear to Oxera whether the rules are indeed intended to request lenders to undertake a rigorous assessment of the foreseeable changes in income and expenditure, or whether there is a problem with the way the rules have been drafted. The fact that the rules go beyond existing FSA guidance and use different language to that in the existing guidance (which refers only to taking into account actual or *reasonably anticipated* income) would suggest that the FSA is indeed proposing a significant change in its policy.

Critically, the rules require lenders to take account of 'known or foreseeable changes in income or expenditure', while the loan should be affordable 'at any time during the term of the regulated mortgage contract'. But what precisely does this mean in practice? Indeed, is it possible to identify all potential changes in income and expenditure over the entire length of a mortgage? An individual borrower is likely to experience many (idiosyncratic) events and lifestyle changes over the typical mortgage term, which may affect their income or expenditure and in turn have an impact on how 'affordable' the loan is at any one point in time. That said, the actual incidence of any event(s) as they apply to individuals will, in most cases, not reflect the average probability of these events for all borrowers. For example, over the next five years of the mortgage term, the borrower may have another child or may not—it cannot have the average of, say, 0.7 of a child.

As currently drafted, no distinction appears to be made between events that increase income or reduce expenditure (so enhancing ability to repay) and those that reduce income or increase expenditure (adversely affecting ability to pay). Given the FSA's stated desired outcomes, the draft rules may be intended to focus on events that make loan repayments less affordable. However, a number of lenders commented that, in order to satisfy the requirement to treat customers fairly, it would also be necessary to take account of potential increases in income or reductions in expenditure. For instance, when children leave home

[25] Oxera's research in 2006 indicated that 76% of the affordability models already allowed for this type of stress-testing. See Council of Mortgage Lenders (2006), 'UK Mortgage Underwriting', a report prepared by Oxera, April.

and become employed, it could have the effect of reducing household expenditure and improving the affordability of the mortgage.[26]

Some of these predictable, likely events can be controlled by the borrower. Even where they cannot, it might still be possible to adjust behaviour to mitigate the impact of the event. Others, however, may be more or less randomly distributed among borrowers.

A few specific examples of events that could have a significant impact on income or expenditure were highlighted during the interviews with lenders. One interpretation of 'known and foreseeable' could be lifestyle changes whose likely incidence can be inferred from historical evidence. In other words, their probability can be determined for an individual or sample of individuals according to past frequency of the event occurring for a population with characteristics similar to the individual or sample being considered.

One such example would be divorce. It is possible to infer the probability of divorce over the term of a mortgage for a young couple applying for a loan, based on the historical divorce rate for couples of a similar age. Likewise, it is possible to establish the probability of the same young couple having one, two or more children over the term of the mortgage, again based on historical data on the characteristics of similar couples. Other potential changes for which probabilities could be inferred are serious illness and redundancy.

One event that is arguably certain (or almost certain) to occur is retirement. This is the (only) specific example referred to in CP10/16. However, even though the borrower is likely to retire at some stage, the actual timing is becoming far less certain. The effects of the falling real value of state pensions and the risks associated with the shift to defined-contribution schemes mean that some individuals may have to work beyond what used to be considered the statutory retirement age. In addition, greater longevity and improvements to healthcare mean that many people are now physically capable of working for longer than was previously the case.[27]

The above examples represent a mixture of events that are within or outside an individual's control (eg, childbirth and redundancy, respectively). Others, such as divorce, are more difficult to categorise. Certain types of illness are outside an individual's control, while others, such as heart disease, can be affected by changes to lifestyle.

The events described above may also affect both income and expenditure. The decision to have children is likely to increase expenditure for a couple, but may also affect their total income if either one decides to go part-time or stop working to look after the children. Long-term critical illness is also likely to affect both income and expenditure, while the effects of divorce are more uncertain for both individuals concerned.

Although these are the events that are most commonly thought of as representing significant lifestyle changes affecting income and/or expenditure, many more could be described as foreseeable, in that their likelihood could be estimated. However, the relative likelihood of the

[26] Much of the discussion with lenders centred on events that were likely to result in a reduction in income. However, the rules imply that any event which results in expenditure exceeding income for a particular month (and hence affecting the borrower's ability to service the mortgage) needs to be taken into account. The definition of expenditure given in the rules refers to items such as income tax, insurance and school/university fees. (See FSA, 'Mortgage Market Review: Responsible Lending', CP 10/16, Affordable Borrowing and Home Financing Draft Instrument, Guidance 11.3.7, July 2010.) Many of these items will arise at specific points in the year. During the months that such items are realised, overall expenditure may indeed exceed income. For example, an applicant who is self-employed will be required to fund tax payments at a specific point in time. During a month when such payments are being made, it could be argued that the applicant would not be able to meet the mortgage payments if income and expenditure for that month alone were being assessed. However, this ignores the possibility that individuals save for such events during the course of the year, meaning that the expenditure does not come out of the income for the month in question and the mortgage payment can be met.

[27] In addition, lenders will be required to make a judgement on the value of a mortgage applicant's pension through retirement. The valuation of pensions can be problematic, particularly the further the applicant is from retirement age. Public sector pensions are likely to be affected by government policy decisions, and, again, lenders will be required to take a view on such decisions in the future. Given that the rules are defining the standard mortgage term at 25 years, this will require considerable speculation.

events occurring and the extent to which they could affect income and expenditure should also be considered. Some may have a low probability of occurrence, such as certain types of illness, but may have a significant effect on a borrower's lifestyle and/or income. Others may have a higher probability of occurrence but a lower likely impact on either expenditure or income. This trade-off between likelihood and impact may need to be taken into account when assessing affordability. Likewise, there may be events that affect large numbers of borrowers which, with hindsight, might have been foreseen with a reasonable probability, but which, at the time, may have been deemed less likely to occur.

In theory, the likelihood of known or foreseeable events could be assessed in one of two ways: by undertaking a statistical approach or using an individual-level approach. The analysis of these approaches, presented in the next section, suggests that they are not practical for lenders to implement and could result in the exclusion of a significant number of mortgage applicants, including those who would, in the event, be able to afford the mortgage over its actual term.

3.4.1 Statistical approach

Under this approach, all new borrowers would be categorised according to certain characteristics (age, marital status, health, location, nature of employment). Their likelihood of experiencing lifestyle-changing events (eg, divorce, redundancy or serious illness) would be determined according to the actual occurrence of these events among a pool of borrowers with the same characteristics at the time they had taken out loans.

Two problems immediately emerge, however. First, even if probabilities can be assigned to lifestyle-changing events for the individual borrower, this alone does not give an indication of the size of the loan that could be affordable. The probability of the event would need to be converted into a likely income or expenditure effect. This would then have to be applied to a borrower's own current income or expenditure, ideally making allowances for potential increases in earned income over the mortgage period.

In such cases the loan could then be reduced by applying a scaling factor between the amount requested and that offered, depending on the likely impact of the event on the borrower's free disposable income. Without regulatory guidance on how such scaling factors should be applied, a situation could emerge whereby lenders set them too high (taking into account the risk that they might face sanctions if the regulator decided that arrears were running too high). This, in turn, could result in significant indirect social costs if large numbers of mortgage applicants were either excluded from the market or unable to obtain the size of loan they required. Interviews with lenders have, indeed, suggested that there is a significant likelihood of this occurring if lenders do not receive additional guidance on the scaling factor to be used.

If the scaling factor is based on the overall ('average') impact of the event on the benchmark group, it might be too high or too low to reflect that event's impact on a particular individual. As a result, if the loan amount is reduced to reflect some kind of average impact then, as the events in question play out, two distinct groups of borrowers emerge. One where the event has occurred, in which case the scaling factor will be too small and the borrower will still not be able to afford the loan; the other where the event has not occurred, in which case the borrower could have afforded a larger loan. In this case the scaling factor does not achieve its objective in the cases where the event happens, but it has constrained the choices available to those for whom the event does not take place, with no benefit to them.

The second problem is that this approach tells the lender very little about the behaviour of the individual borrower when faced with a lifestyle-changing event. This would require the historical data to show not only the proportion of borrowers who experienced the event, but also how they responded to it in terms of changes to their income and expenditure. It is this propensity to pay the mortgage that would be central to an assessment of affordability based on changes to projected income and expenditure.

The lender would need to be able to correlate the event with the likelihood of the borrower going into arrears on the mortgage, and then establish the causality (and the direction of causality) between the two events. Even though illness and mortgage arrears may be correlated, this does not necessarily imply that the illness itself caused the default. Other factors could have had an impact on ability to pay—indeed, the illness could have been 'caused' by the arrears, rather than the other way around. This potential reversal of the direction of causality was noted in a report to the government on the drivers of over-indebtedness.[28]

As mentioned, the FSA rules may also require lenders to take account of positive changes to income or expenditure in the future if they are to treat customers fairly. Therefore, any statistical model would also have to use inferred probabilities for these positive events and offset their impact against the probabilities of negative events occurring.

Even if statistical modelling identifies the probability of a lifestyle-changing event and the lender is able to use this to infer the likely impact on the borrower's income or expenditure, it still does not take account of any behavioural change by the individual borrower in the actual event. It might be that those who go into arrears as a result of an event are not good at financial management. With better financial management, they might be able to cope more effectively by changing their discretionary expenditure. Interviews with lenders confirmed that borrowers who have problems with affordability of a mortgage are often those who have not shown the ability to cope with debt repayments in the past. On the other hand, lenders commented that borrowers who had been able to cope with lifestyle changes in the past, while still maintaining payments on existing credit commitments, were more likely to be aware of the need to change behaviour to cope with the impact, on income or expenditure, of future events.

This suggests that one indicator of a borrower's ability to repay debts after an income shock could be their previous record in managing their finances. The credit scoring models used by lenders give an indication of the ability of borrowers to cope with debt commitments in the past. If they have a history of effective debt management, without entering arrears, this could be taken as an indicator of their overall financial management capability. Thus, a borrower's attitude and the way they respond to certain life events are already captured by the credit score used by lenders to assess the riskiness of mortgage applicants.

While using a statistical model may be one approach to meeting the requirement to take account of foreseeable events, if a borrower defaulted on repayments, and lost their property, there is a risk that they could lodge a complaint with the Financial Ombudsman that a rigorous affordability check had not been undertaken and that the lender had missold the mortgage contract. The lender would then need to prove that all foreseeable events had been accounted for appropriately even if their probability had been relatively low in the initial assessment. In such a situation, the way in which the FSA and/or the Financial Ombudsman interpret the requirements in relation to events that, with a certain probability, may affect income and expenditure is crucial. If all loans have to be safeguarded at an individual level against such events, *all* loans would have to be scaled down by the full amount needed to pass an affordability test. This amount should be sufficient in order to be sure that when the event occurs for a particular borrower, the lender is not vulnerable to the charge that they did not take a particular 'foreseeable' (ie, probabilistically predictable) event into account. To protect themselves against such a charge, lenders are likely to err on the side of caution and scale back *all* loans (which might prevent the desired purchase being made) or reject an individual's mortgage application outright. Thus, borrowers that would be able to meet their financial obligations would be excluded from the market.

[28] University of Nottingham (2008), 'Drivers of Over-Indebtedness', report produced for the Department of Business, Enterprise and Regulatory Reform, October.

In sum, the statistical approach is in theory a way of taking into account known or foreseeable changes in income and expenditure when assessing affordability, but it is likely to be impractical for lenders and could result in the exclusion of consumers from mortgages.

3.4.2 Individual-level approach

As an alternative to the use of probabilities based on historical population data, the particular characteristics of the individual borrower could be examined to assess affordability. This would require a detailed and, potentially, more intrusive questionnaire on the customer's current and expected lifestyle. At least three problems emerge from this.

– There is an obvious asymmetric information problem, with the borrower knowing more about their own personal circumstances than the lender. There would need to be an appropriate set of incentives to ensure that the borrower provides accurate information.

– Lenders would have to ensure that the questions did not contravene anti-discrimination legislation. Some lenders indicated that they would have to put systems in place to ensure consistent treatment of all lending applications, as not to do so would leave them open to potential accusations of discrimination and not treating all customers fairly.

– It is not clear how such information would be used to assess affordability. The lenders would have to infer, from the answers given, the probability of a lifestyle-changing event occurring and its impact on the applicant's income and expenditure, given that they might change their discretionary expenditure in response. Using anecdotal evidence to measure the impact in this way would be very difficult. This implies a potential return to a more traditional, non-automated application process that relies on face-to-face interviews between the borrower and an experienced underwriter who is able to gather the 'softer' evidence necessary for an affordability assessment.

Automation was originally brought into the application process to reduce the time it took to obtain a mortgage offer. It also resulted in an approach to lending that is less subjective which, in turn, gives rise to greater consistency in decision-making. Any move away from this might stall the decision-making process. The result could be increased costs for the lender due to the additional training of employees or the need to employ more loan officers. Such costs are likely to be passed on to the borrower in the form of higher charges.

3.4.3 Lending into retirement

The only specific example of a known or foreseeable event cited by the FSA is retirement. This is becoming a contentious issue for several reasons, including planned increases in the state pension age, employees' desires to continue working, and likely restrictions on employers' ability to make retirement compulsory.

Lenders currently take different approaches to lending into retirement. Some will not lend for a term beyond the age at which the borrower will receive state pension. Others are content to lend into retirement, but require evidence of how mortgage repayments will be financed. Where a borrower plans to cover these payments by continuing to work beyond normal retirement age, the FSA is requiring lenders to ascertain whether this is 'plausible' and 'capable of being realised'. Neither of these assessments can be determined absolutely. The probabilities of the aforementioned events occurring will vary by individual.

This may create problems for lenders. Even if it is not plausible for a borrower to continue working in their current job after normal retirement age (eg, for certain occupations such as fire fighters, airline pilots, police officers and certain manual labour jobs), this does not mean that they could not find alternative employment. Although they may get paid less than before, they may still be able to make the mortgage payments. How a lender could determine the plausibility of this occurring 15 years or more in the future is unclear.

Likewise, any attempt to ascertain whether the borrower's intention is 'capable of being realised' requires a highly subjective assessment of their likely future fitness, in addition to

factors such as the nature of the employment market in the long term. Typically, underwriters do not have the skills to undertake such an assessment.

3.5 Affordability assessments in other countries and for unsecured credit

A number of other countries have recently amended their standards for mortgage lenders, and it is useful to look at these. In addition, the OFT has published its own guidance on responsible lending. Although mainly concerned with unsecured loan contracts, this may also be worth considering in this context.

In the USA and Australia there have been moves to tighten up the requirements for affordability assessments. However, these are a very recent development and there is not yet any indication of how market participants will interpret or react to the changes. Furthermore, the authorities in these countries have yet to issue any guidance on how they expect the rules to be interpreted. As far as Oxera is aware, the OFT is the only regulatory authority that has provided a clarification on how to take into account foreseeable events.

3.5.1 European Commission

The Commission's recent working paper on responsible mortgage lending and borrowing sets out the principle that:

> Before granting a mortgage credit, the creditor should assess the consumer's ability to repay it (creditworthiness assessment), taking into account the consumer's personal circumstances such as his income, regular outgoings and any other elements that may influence his ability to repay the loan such as tax relief or other subsidies.[29]

This requirement does not refer specifically to the need to take account of *future* events. However, when referring to the suitability of the mortgage product, the Commission does conclude that:

> The information taken into account should be information current at the time of the suitability assessment and reasonable assumptions as to the consumer's future situation during the term of the proposed credit agreement.

In addition, the Commission recognises the need for consumers to take responsibility for disclosing information relating to their personal circumstances that the lender needs in order to undertake the affordability assessment. Likewise, if a borrower provides incomplete or incorrect information, the Commission refers to the need to impose sanctions on the borrower if they are then found to be incapable of meeting repayments on a debt contract.

No further guidance is available to ascertain what this requirement might imply in practice, although reference is made to 'reasonable assumptions' with regard to the borrower's future situation. This could imply that lenders need to consider some foreseeable events and their impact on both income and expenditure.

3.5.2 The USA

Recent legislative developments in the USA have produced a range of proposals for large parts of the financial system, including mortgage lending and affordability assessments. The Dodd–Frank Wall Street Reform and Consumer Protection Act, passed in July 2010, contained a section on affordability,[30] although the precise implications may not be entirely clear. The Act states that loans should be prohibited unless:

[29] European Commission (2010), 'Responsible Mortgage Lending and Borrowing', Working Paper, July 22nd.

[30] US Congress (2010), 'Dodd-Frank Wall Street Reform and Consumer Protection Act', Title XIV, Mortgage Reform and Anti-Predatory Lending Act, Subtitle B, Minimum Standards for Mortgages, Section 1411, July.

> [the] Creditor makes a reasonable and good faith determination, based on verified and documented information that, at the time the loan was consummated, the consumer has a *reasonable ability to repay the loan*...[emphasis added]

It then provides additional guidance on what is meant by 'reasonable ability to repay':

> A determination under this subsection of a consumer's ability to repay a residential mortgage loan shall include consideration of the consumer's credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status, and other financial resources other than the consumer's equity in the dwelling or real property that secures repayment of the loan.

Although referring to expected income, this is qualified in this section as income that the consumer is 'reasonably assured of receiving'. No reference is made to future foreseeable changes to expenditure.

3.5.3 Australia

Guidance on responsible lending published by the Australian Investments and Securities Commission (ASIC) in June 2010 requires lenders to make 'reasonable enquiries about a consumer's financial situation'.[31] These enquiries could be in relation to current income, current fixed and variable expenses, credit history, personal circumstances (eg, age and number of dependants), assets, geographical factors, and:

> any significant changes to the consumer's financial circumstances that are reasonably foreseeable (such as a change in repayments for an existing home loan due to the ending of a 'honeymoon' interest rate period, or changes to the consumer's employment arrangements such as seasonal employment or impending retirement)

There is therefore some similarity to the FSA requirements, although 'reasonably foreseeable' implies a more limited range of events than suggested by the strictest interpretation of the FSA rules. The ASIC expects lenders to create a buffer to offset these 'reasonably 'foreseeable circumstances.

Lenders in Australia will also need to introduce systems to identify where repayment of a loan is likely to lead to 'substantial hardship' for the borrower. The ASIC has stated that it does not intend to define 'substantial 'hardship at present, but will rely on precedent as court decisions and judgments are made. However, when considering whether a credit contract will result in 'substantial hardship', the AISC notes that the lender will need to take account of factors such as:

> (a) the money the consumer is likely to have remaining after their living expenses have been deducted from their after-tax income;
>
> (b) how consistent and reliable the consumer's income is (and the size of the loan relative to their income level);
>
> (c) whether the consumer's expenses are likely to be significantly higher than average (e.g. because they live in a remote area);
>
> (d) the consumer's other debt repayment obligations and similar commitments (e.g. child support);
>
> (e) how much of a buffer there is between the consumer's disposable income and the repayments (e.g. how vulnerable they are to an increase in interest rates, or the impact once any 'honeymoon' rate ends); and
>
> (f) whether the consumer is likely to have to sell their assets, such as a car, to repay the loan.

[31] ASIC (2010), 'Credit Licensing: Responsible Lending Conduct', Regulatory Guide 209, June.

However, the ASIC has also provided lenders with the opportunity to be flexible in their assessment of affordability by stating that they may wish to:

> take into account any other conversations that you have had with the consumer about how the loan will affect their living standards. For example, a consumer may be willing to make reasonable changes to their lifestyle to enable them to afford the loan without substantial hardship (such as cutting back on non-essential expenses).

3.5.4 Office of Fair Trading

The OFT has recently updated its guidance for lenders on what constitutes irresponsible lending practices.[32] This guidance relates mainly to unsecured lending, where contracts are likely to be of shorter duration than mortgage lending. In an earlier draft, the OFT referred to the need for lenders to take account of 'reasonably foreseeable' events when assessing affordability. In responding to the feedback on the earlier draft, the OFT provided clarification, noting that it would regard reasonably foreseeable as:

> a future event that may impact on the borrower's ability to make payments on a credit agreement in a sustainable manner which the borrower *knows* will occur and of which the creditor is, or should be, *aware*. [emphasis added]

As an example, the OFT cites the following kinds of event as those that should or should not be taken into account:

> a known end date of current employment due to circumstances such as retirement or the end of a fixed term employment contract - either of which may lead to a fall in the borrower's disposable income. The possibility of being made redundant, when it was not known at the time that the assessment of affordability was undertaken that this would happen, would *not* be a matter that the OFT considers creditors could be reasonably expected to take into account. [emphasis added]

It also provides additional clarification on events that it does not regard as foreseeable. It has stated that it will not require lenders to engage in 'crystal ball gazing and/or speculation':

> We have removed from the Guidance the reference to creditors taking account of 'wider economic changes' when considering reasonably foreseeable changes in future circumstances ... we accept that this may, to some extent, fall into the category of 'crystal ball gazing and/or speculation'.

The OFT makes it clear that any future changes to income or expenditure that should be taken into account can be based only on what is known at the time of assessment. The onus is on the lender to ask appropriate questions to determine whether the borrower knows of any circumstances that may affect their ability to repay the loan. However, a clear indication is given that, if the borrower fails to supply this information, after appropriate enquiries, the lender will not be liable if problems with repayment arise later:

> We do not consider that the creditor could be held culpable under circumstances in which it made a reasonable request for information from the borrower, in order to inform its assessment of affordability, and the information provided by the borrower was substantively incorrect/untrue and the creditor (acting reasonably) was not aware of this.

In revising its guidance the OFT has adopted a narrower, but arguably more realistic and practical, interpretation of 'reasonably foreseeable'. This guidance is in relation to short-term unsecured credit, often with a term of between one and five years. The OFT has concluded that, even over relatively short time periods such as this, crystal ball gazing is inappropriate. Over longer time periods, the problems of crystal ball gazing become more acute since, in general, the further into the future predictions are made, the more likely they will be wrong in any individual case.

[32] Office of Fair Trading (2010),'Irresponsible Lending – OFT Guidance for Creditors', updated version, August.

3.6 Conclusion: impact on consumers and alternatives to proposed rules

In both DP09/03 and CP10/16, the FSA has stated that, in reforming the requirements for mortgage lending, its principal objective is to ensure a sustainable and flexible market. It has also affirmed its intention to pursue a more 'robust and interventionist approach' in regulating both firms and markets. This implies that it will take action, at an early stage, to affect a market's structures and products to achieve its desired outcomes.

It is important to understand how the proposed rules could affect consumers. Any attempts to intervene more in the mortgage lending market—by defining the conditions for offering loans and the processes that lenders must follow to limit the number of borrowers who default—can result in lenders making two types of error. There may be mortgage applicants who:

– do not meet the affordability criteria but would nevertheless have been able to repay the loan (ie, the affordability test was too stringent);
– do meet the affordability criteria but in the end turn out to be unable to repay the loan.

The first type refers to the risk that restrictions on lending may exclude some potential borrowers from the market who would otherwise be capable of repaying the loan had they been offered one. This could take the form of being refused a loan outright or being offered a lower amount than requested, with the result that the desired property could not be bought.

Any set of regulatory rules needs to be sufficiently robust to minimise the second type of error, while being sufficiently flexible to minimise the incidence of the first type. In the latter case, getting it wrong could lead to financial, and potentially social, exclusion, for a proportion of the population who might otherwise be capable of managing additional debt effectively.

The analysis presented here indicates that it would not be possible for lenders to take into account foreseeable changes in income and expenditure. Any attempt to do so would result in a significant risk of the first type of error. Thus, in the absence of robust guidance on how the FSA and Financial Ombudsman will interpret the incidence of the first type of error—which will manifest itself as a specific complaint and which will expose lenders to costs and potentially reputational damage—lenders are likely to exclude potentially responsible borrowers from the market. Therefore, the draft rules proposed by the FSA in relation to affordability assessment are unlikely to deliver the FSA's policy intentions.

Given the potential problems seen above with the FSA rules as currently drafted, it would be useful to consider amendments to the proposed rules. For example, the proposed rules could be redrafted by including *only* the specified events that can be classified as foreseeable (eg, retirement), and where there is certainly (or at least a very high probability) of these events occurring in the case of that *specific* borrower. Another option, in line with the OFT's approach, would be to require lenders to take account of foreseeable events only when the borrower has referred to them specifically in response to a general question concerning the likelihood of an event occurring. This would put the onus for information disclosure on the borrower.

Furthermore, it may be useful to explore market-based solutions. Rather than restricting access to credit for many consumers, it may be more appropriate to provide solutions that enable consumers to manage their risks. Some of the issues the FSA appears to be seeking to address fall into the category of events that could be covered by insurance. As such, the impact of the event could be mitigated by taking out an insurance policy rather than reducing the amount that can be borrowed in case an event occurs that risks the borrower falling into arrears. This arrangement is currently usually in place to cover the borrower's untimely death, but could also be applied to some of the other events, such as unemployment and illness, which lenders may be required to take into account. Such an approach would directly address the second type of error. In relation to the first type, the reduction in borrowing

capacity for those who could repay is lowered by the insurance premium, not the impact of the event should it occur. In particular low-frequency/high-impact events (such as critical illness) would now be dealt with by a small reduction in borrowing capacity through the additional expenditure on insurance.

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