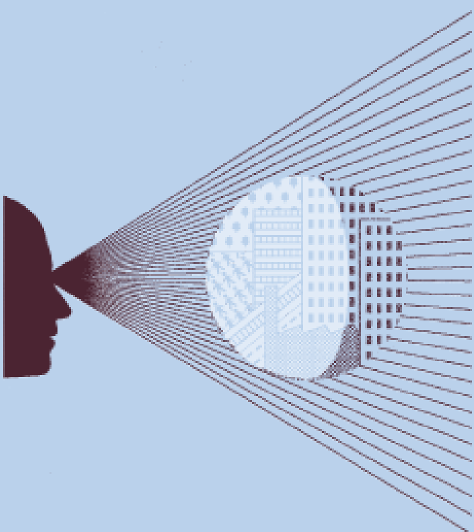
Oxera

Assessment of compliance costs and indirect costs as a result of the MMR lending reforms

Prepared for the Financial Services Authority

July 7th 2010



Oxera Consulting Ltd is registered in England No. 2589629 and in Belgium No. 0883.432.547. Registered offices at Park Central, 40/41 Park End Street, Oxford, OX1 1JD, UK, and Stephanie Square Centre, Avenue Louise 65, Box 11, 1050 Brussels, Belgium. Although every effort has been made to ensure the accuracy of the material and the integrity of the analysis presented herein, the Company accepts no liability for any actions taken on the basis of its contents.

Oxera Consulting Ltd is not licensed in the conduct of investment business as defined in the Financial Services and Markets Act 2000. Anyone considering a specific investment should consult their own broker or other investment adviser. The Company accepts no liability for any specific investment decision, which must be at the investor's own risk.

© Oxera, 2010. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.

Contents

1	**Introduction and summary of findings**	**1**
1.1	Objectives and remit	1
1.2	Methodology and information sources	1
1.3	Limitations and methodological issues	4
1.4	The Mortgage Market Review proposals	5
1.5	Summary of main findings	6
2	**Assessment of compliance costs and indirect costs**	**10**
2.1	Income verification (as part of affordability assessments)	10
2.2	Assessing affordability	14
2.3	Arrears charges	18
2.4	Indirect costs as a result of the FSA proposals	19

List of tables

Table 1.1	Survey sample of lenders	3
Table 1.2	Direct compliance costs, industry total (£m)	6
Table 1.3	Ongoing costs per application and per sale(£)	7
Table 2.1	Current proportions of mortgage applications that are/are not income-verified (in relation to current sales at the time of the survey, May 2010)	11
Table 2.2	What is the main documentation used by lenders to verify income? (in relation to current sales at the time of the survey, May 2010)	11
Table 2.3	Summary of the costs of income verification (scenario 4)	13
Table 2.4	Current approach to assessing affordability, by primary category (%)	15
Table 2.5	Total costs of the affordability requirement	17

List of figures

Figure 2.1	Would the provider make affordability assessment criteria available to intermediaries? (by primary category)	24
Figure 2.2	Would the provider make affordability assessment criteria available to sourcing systems? (by primary category)	24
Figure 2.3	Potential impact on turnover of the MMR proposals in isolation (by primary category)	27

1 Introduction and summary of findings

1.1 Objectives and remit

The Financial Services Authority (FSA) commissioned Oxera to assess the compliance costs and indirect costs of the Mortgage Market Review (MMR) proposals. In its 2009 Discussion Paper, 'Mortgage Market Review', the FSA stated the following:

> Our existing regulatory framework has proved to be ineffective in constraining particularly risky lending and unaffordable borrowing and clearly there is a need to address this. …
>
> We also recognise that consumers are not always able to protect their own interests and therefore propose to rely less on disclosure and to intervene where necessary to curb sales of high-risk products, or sales to particularly vulnerable borrowers, or both.[1]

The remit of this Oxera study was to assess both the direct compliance costs, and the indirect costs resulting from implementation of the new proposals, such as (negative) changes in firm strategy, any possible firm exit from the market, and the expected impact on competition and product provision.

This report provides an assessment of the proposals put forward in the July 2010 Consultation Paper on Responsible Lending*,* consisting, among others, of strengthened requirements for affordability assessments and income verification.[2] A subsequent report will be published alongside the proposed Q4 consultation setting out an assessment of the proposals in relation to the advice and sales process of mortgages. An assessment of the impact of the changes to the prudential regulations with respect to the retail mortgage market that are also being proposed by the FSA is beyond the scope of this study.

1.2 Methodology and information sources

The compliance and indirect costs have been assessed in accordance with standard practice and existing methodologies.[3] This means that 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. Firms' (compliance) departments undertake a number of activities, many of which they would carry out anyway, even without regulation. That is, some costs that may be considered as 'compliance' are likely to be incurred even in the absence of a regulatory requirement since they reflect the costs needed for good business practice. In assessing the regulatory burden, only *incremental* costs that are solely due to the existence of regulation should be considered, and this is the basis on which the costs have been reported here.

In this analysis Oxera first assessed the extent to which lenders already meet (some of) the proposed requirements and then looked at the additional costs of meeting the requirements. For example, one of the proposals is to require lenders to verify income for all mortgage applications. Lenders already do this for some or most applications, but typically not for those that are fast-tracked (income is typically verified for only a sample) or for self-certification

[1] FSA (2009), 'Mortgage Market Review', Discussion Paper 09/3, October, pp. 3–4.

[2] The report does not assess the proposals on interest-only loans as the FSA, as part of its July Consultation Paper, is not consulting on exact rule changes.

[3] 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 FSA, September.

mortgages. Oxera first 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 of competition; and the degree of market participation.

A number of other aspects relevant to an assessment of the costs are 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 refer 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 last five years was used as the base for the counterfactual;

– *The wider macroeconomic impact is not assessed*—the assessment here focuses 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 is recognised, a detailed examination is 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 will be a transition arrangement to the new system. This means that this study does 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, 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 are grossed up to produce an estimate of the total annual costs for the industry, using the average number of mortgages over the last 5 years.

1.2.1 Information sources

Oxera's identification and analysis of the potential compliance costs and indirect costs were informed by interviews with the industry and through a survey of lenders.[4]

– *Interviews*—in the course of the study, Oxera had 10 interviews with mortgage lenders of different sizes and type: 3 banks, 3 building societies and 4 non-deposit-taking lenders. Oxera also spoke to the trade associations representing lenders and intermediaries.

[4] To assess the proposals in relation to the advice and sales process of mortgages that will be covered in the proposed Q4 consultation, intermediaries were also surveyed.

– *Survey*—compliance costs were quantified using the survey results, and cross-checked in light of the interviews and Oxera's knowledge of the industry. Indirect costs were quantified where possible and appropriate, also from survey results. The interviews and Oxera's analysis suggested a number of mechanisms by which the reforms might have indirect costs—for example, through changes in firm strategy as a result of the compliance costs, or the exclusion of certain types of borrower. Survey questions enabled Oxera to quantify these costs in some cases, or to give an indication of whether the mechanisms were likely to be valid and significant in others. The questionnaire was designed on the basis of interview findings and in collaboration with the FSA. For many questions, data was requested for the year 2007, to cover a year of high mortgage activity, as well as for the year 2009 or current practice, as appropriate. After piloting, invitations to complete the questionnaire were sent to all regulated lenders,[5] of which 39 lenders in total responded, covering about half the mortgage market in terms of the value of mortgages outstanding.[6]

– *Existing studies and (FSA) data*—existing studies examining some of the issues addressed in the MMR and data from the FSA were used to inform Oxera's understanding of the mortgage sector.[7]

Table 1.1 Survey sample of lenders

Value of outstanding mortgage assets (as reported in the FSA Mortgage Lending and Administration Return)	Small and medium-sized lenders (<£9 billion)	Large lenders (>£9 billion)	Total
Sample	28	11	**39**
of which:			
banks	12	5	**17**
building societies	7	5	**12**
non-deposit-taking lenders	9	1	**10**
Population (overall total number of lenders)	305	26	**331**
Market coverage (by size of loan book)	14%	52%	**49%**

Note: For the purposes of the analysis in this report, a large lender was defined as a lender with a book value of mortgages in 2009 of more than £8.7 billion. This results in 11 lenders (ie, around one-third of the sample) in the category of large lenders and the remaining lenders in the category of small and medium-sized lenders. Small changes in the size bands (eg, defining a large lender as a firm with a value of mortgages of £10 billion or £12 billion in 2009) do not significantly affect the results or the findings of the analysis.
Source: Oxera analysis of survey data and FSA data.

Before analysing the survey results, the following two activities were undertaken.

– *Data cleaning*—before analysing the survey responses, the data was checked and cleaned to identify inaccurate responses and outliers, and, where appropriate, to remove these from the dataset or modify them.

– *Weighting analysis*—weights were used to map the sample responses to the population, and thereby to provide an indication of the response of the industry as a whole to the proposed MMR reforms. The primary weighting was applied to the two size categories

[5] To assess the proposals in relation to the advice and sales process of mortgages that will be covered in the proposed Q4 consultation, intermediaries were also surveyed, with the questionnaire being sent to all intermediaries and intermediary firms that had recorded at least ten mortgage sales in the previous year according to the FSA's Product Sales Database, and to a sample of 2,000 intermediaries and intermediary firms that had sold fewer than ten mortgages in the previous year.
[6] Responses covered half the mortgage market using, as the measure of size, the value of balances outstanding of regulated mortgage loans, based on data reported to the FSA under the FSA Mortgage Lending Administration Return (MLAR).
[7] The FSA Product Sales Database, the FSA MLAR, and the Council of Mortgage Lenders (2006), 'UK Mortgage Underwriting', a report prepared by Oxera, April.

as the response rate was significantly different: around half of all large lenders responded, while less than 10% of small and medium-sized lenders responded. The weightings were based on the size of the lenders' loan balances, measured by the total book value of regulated loans in 2009.[8] Where relevant, survey data was also weighted by the number of applications per survey participant (eg, to estimate the number of applications for which income is verified and for which affordability is assessed and the costs of these activities). The effect of this is that more weight is given to survey participants representing larger lenders.

1.3 Limitations and methodological issues

While all surveys are subject to some limitations, they provide a useful way of analysing the likely impact of a particular proposal on a firm. However, in the interests of clarity, some of the limitations of the survey approach adopted for this study are set out below.

– Firms were asked to provide their views on how they *would* respond to the MMR proposals. Their actual behaviour may differ from their survey response, for two main reasons. First, firms may not have a good understanding of the implications of the new rules and may therefore under- or overestimate the effects of the proposals on their business. For example, a firm may think that the proposals will not affect it very much (eg, it may claim that its sales volumes will not change significantly), but may in practice end up being more affected than it expected. Second, as with any survey, there is an incentive for the respondents to act strategically and provide answers that they think will affect the outcome of the study in a way favourable to them, rather than revealing their 'best guess'.

– Firms were asked to provide estimates of the costs they would incur in complying with the new requirements. For some firms it may still be too early to assess how they would respond to the proposals. Furthermore, cost estimates may be based on a specific way of complying with the new requirement and may ignore the possibility that market solutions may emerge that are cheaper than the solutions respondents expect to implement.

– For some questions, there are a small number of responses to the survey. Where the analysis is based on a small number of observations, the results are inherently less reliable and must therefore be treated with caution.

– The questionnaire was sent to firms regulated as mortgage lenders in 2009; thus, any lenders that exited the market after 2008 did not receive a questionnaire. Lenders that were still being regulated in 2009 but were no longer active in the market for mortgages did receive a questionnaire but declined to participate in the survey. The lenders that exited the market are likely to have had a portfolio with a higher-risk profile than the lenders that did not exit the market. This may have resulted in a response bias—for example, lenders that exited the market could have had a higher proportion of mortgages for which income was not verified or could have responded differently to some of the proposals than those lenders that did not exit the market.

Although it is not possible to overcome entirely some of these limitations, a number of activities were undertaken to ensure the robustness of the analysis. For example, a data-cleaning process identified outliers and subsequently assessed whether these could be explained by the characteristics of the survey participants, or, for example, by misinterpretation of the question asked. Cost estimates were also sense- and cross-checked by comparing them with data from other sources, such as previous studies, obtaining views

[8] The book value of regulated loans is likely to underestimate the size of lenders that sell on their mortgage book to other parties. However, examination of the data on securitisation suggests that this does not affect the classification of firms as large or small/medium-sized, and therefore does not affect the analysis.

from industry experts on the relevant components of the cost estimates (such as the time required and hourly costs of personnel), and checking the internal consistency of the responses. The survey participants did not provide answers to all questions, but the combined answers from all survey participants allowed an estimation of the costs of most of the proposals.

The analysis was also complicated by the fact that the counterfactual is inherently uncertain. For example, although it is possible to measure the number of mortgage applications for which income is currently not verified (and which would therefore be affected by the income verification requirements), the number of applications that would be affected in practice is uncertain. It is unlikely that the current sales volume (in particular in relation to self-certification mortgages) is representative of the likely behaviour (in the absence of the proposed regulations) over a full economic cycle. Where relevant, this is addressed by providing estimates of the impact on the basis of mortgages sales affected in both 2007 and 2009. However, even this approach needs to be treated with caution since the behaviour of both borrowers and lenders will be affected by recent experience and, as such, 2007 may not be fully representative of future periods of economic growth.

The analysis has resulted in estimates of direct compliance and indirect costs that are indicative and subject to a margin of error, but are nevertheless sufficiently robust to inform the FSA's cost–benefit analysis of the Mortgage Market Review proposals. In reporting numbers in this report they have generally been rounded to reflect the uncertainty. However, in a number of cases where it may be helpful to the reader to be able to see the underlying calculations in more detail, the unrounded numbers are reported. These numbers should not be taken as an indication of the accuracy of results, given the uncertainties involved, and should be interpreted accordingly.

1.4 The Mortgage Market Review proposals

The proposals relating to mortgage lenders are as follows. (Further details are given in the sections below and can also be found in the relevant FSA documents.[9])

1.4.1 Affordability assessments

- **Income verification**—the proposal is that lenders be required to obtain proof of income, in some form, for all mortgage applications. For example, this might be by checking payslips or some other means.
- **Assessment of expenditure and calculation of free disposable income**—the proposal is that, as well as income, lenders 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.
- **Credit-impaired borrowers**—the proposal is that, for credit-impaired borrowers, lenders be required to apply more stringent affordability tests than for non-impaired borrowers. As the proposals relating to credit-impaired borrowers have developed since most of the research for this project was undertaken, it was not possible to assess in full

[9] 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.

the cost of this aspect of the proposals, and therefore only a high-level assessment is presented here.

1.4.2 Arrears charges

In its 2009 Discussion Paper, the FSA proposed a more interventionist approach to monitoring and enforcement action against excessive charging practices in the mortgage market.

The FSA is proposing to amend rule 12.4 in the Mortgage and Home Finance: Conduct of Business sourcebook (MCOB) to address particular issues of poor practice and to clarify how arrears charges should be calculated and applied. This will include specifying which types of cost can be recovered and clarifying that arrears fees cannot be a percentage of the outstanding debt.

Although firms are already required, under MCOB 13.3, to deal fairly with borrowers in arrears, the FSA is proposing to tighten its rules in this area by limiting the number of times fees for missed payments are charged. Specifically, it is proposing to limit a firm from trying to take a payment more than twice per calendar month, unless it waives the administration charge for the additional attempts to take the payment.

The FSA is also proposing to widen MCOB 12.4 and MCOB 13.3 to apply to customers who are in payment difficulties but less than two months in arrears.

The subsequent Oxera report, to be published alongside the proposed Q4 consultation, will assess the proposals on distribution and disclosure.

1.5 Summary of main findings

1.5.1 Direct compliance costs

Table 1.2 summarises the estimated compliance costs by activity, broken down into ongoing and one-off costs for the industry. The variation in cost estimates is due to some variation in the estimates of the number of mortgages for which income is not verified or affordability is not assessed currently.

Table 1.2 Direct compliance costs, industry total (£m)

	Ongoing costs	One-off costs
Income verification	2.3–7.3	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	**5.8–20.3**	**3–15**

Source: Oxera analysis of survey data and FSA data, based on a sample of 29 lenders for ongoing costs of income verification, 13 lenders for ongoing costs of assessing expenditure and affordability and 21 lenders for one-off costs of assessing expenditure and affordability.

Table 1.3 presents the compliance cost per mortgage application and per successful mortgage sale for each *additional* mortgage that would now be subject to these processes.

Table 1.3 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.

There is significant uncertainty around these figures, two of the sources of which are as follows:

– *prediction*—it is difficult for lenders to predict accurately at this stage what each proposal will cost them because they have not yet undertaken detailed planning, and because the details of the proposals have not been finalised;

– *sampling error*—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. In certain cases, figures had to be calculated from a small number of responses and these results should be treated with particular care.

An assessment of the direct compliance costs as a result of the arrears charges proposals is provided in section 2.3.2 below.

1.5.2 Indirect costs

The indirect costs are described in detail in section 2.4 of this report. This section summarises some of the main indirect effects of the proposals.

Impact on quantity

The income verification and affordability proposals mean that some people will no longer be able to obtain a mortgage, or will only be able to obtain a lower amount than applied for. Two of the main effects are that there would no longer be a market for self-certification mortgages and that the market for interest-only mortgages would be significantly reduced. In relation to their own mortgage book, survey respondents predict that, on average, around 10% of existing mortgages would not pass the new income verification and affordability tests.[10] In particular, certain types of borrower would be affected, including those who are self-employed, are on low income and/or have a poor credit rating, This is the desired effect for those who would have gone into arrears and would not have been able to repay the mortgage had their application been approved. However, there may also be people who do not pass the lender's affordability test but would not have gone into arrears had they been given a mortgage. They may not pass the affordability test, for example, because of temporary low income followed by higher income after a few years, which the lender considered too uncertain to take into account, or because they could afford an interest-only

[10] This is consistent with the findings of the empirical analysis undertaken by the FSA in relation to the proportion of mortgages that would pass income verification and affordability tests.

mortgage but would not be able to afford the capital repayments (which, in line with the FSA proposal, would need to be taken into account).

Impact on efficiency of competition

The following possible effects were identified.

– The proposed rules on income verification and affordability assessment impose a new minimum standard in the market which to some extent will affect the quantity of mortgages actually sold. However, the proposals in themselves do not necessarily affect the nature of competition or the competitive process itself, within the group of potential borrowers who are still eligible.

– The affordability criteria are likely to vary across lenders. This could increase the search costs for consumers to find lenders whose affordability criteria they can meet—particularly for those consumers with non-standard characteristics (such as a lack of regular income or temporarily low income).

– The FSA income verification requirement makes income verification more important and could give deposit-taking lenders a competitive advantage over non-deposit-taking lenders, at least as far as their own (current-account) customers are concerned. This is because deposit-taking lenders can verify income by checking their customers' current account details electronically without having to ask for a hard copy (which is likely to take more time and result in additional effort on the part of their customers). However, in practice, for various reasons (explained in detail in section 2.4.2), there are likely to be limits to this advantage, and it is unlikely to have a significant impact on the competitive dynamics in the market.

Impact on innovation

– The income verification could slow down the fast-track process. Whether this would happen in practice to a significant extent would depend on how consumers respond and how quickly they are able to produce the relevant proof of income. For standard cases where a payslip or bank statement will suffice, it may not require much additional (elapsed) time. Furthermore, over time, when other more efficient methods become available, such as a link to HMRC data, the time it currently takes to verify income could be reduced.

– Some lenders explained that they could introduce models to predict income from other known factors. For example, databases might be developed to check the plausibility of income on the basis of combinations of job titles, industries, ages and addresses. Such innovations would arguably be prevented if lenders are required always to verify income directly rather than to check its plausibility.

Impact on market structure

The market structure may change as a result of changes in the relationship between lenders and intermediaries, and in the number of lenders in the market. The impact appears to be limited:

– it has been suggested that one of the responses to the MMR proposals could be a move towards greater consolidation in the sector. However, on the basis of the survey, there is limited evidence to date that lenders are intending to acquire intermediaries or other lenders;

– only two survey respondents indicated that they are 'likely' or 'very likely' to exit due to the MMR proposals. Both are private banks. Recognising that the business model of private banks is different, the FSA reflects on this in its Consultation Paper and considers giving firms the opportunity to apply for waivers;

– most lenders indicated that they will not be changing the product focus of their business in response to the MMR: 84% of survey respondents indicated that they will make no change in their focus on mortgages.

Nevertheless, the relationships between lenders and intermediaries are likely to change as a result of the proposed rules by the FSA. When lenders were asked whether they would expect to change the number of intermediaries through which they distribute their mortgages as a result of all the proposed changes in regulation, all except one indicated that they would expect to reduce the number. On average, survey participants reported an expected reduction of 29% (with a maximum reported reduction of 60%) of the intermediaries they work with. Although this would reduce to some extent the choice of consumers using an intermediary, each intermediary may still have access to a sufficient number of mortgage lenders—therefore, the reduction in the number of relationships between lenders and intermediaries may not affect the degree of competition between lenders.

2 Assessment of compliance costs and indirect costs

2.1 Income verification (as part of affordability assessments)

2.1.1 FSA proposal and current business practice

Lenders do not currently verify income for all applicants. For example, they do not verify income in the following cases:

– **fast-tracked application process**—some lenders fast-track certain types of borrowers—traditionally those with a relatively low loan-to-value (LTV) ratio and high-quality credit history. Income is typically verified for only a sample of these applications;

– **self-certification mortgage products**—self-certification mortgages allow applicants to certify their income themselves. The FSA defines self-certification as 'those mortgages marketed by the lender as not requiring the borrower to provide proof of income.'[11] This means that income is not verified by the lender or intermediary.

The FSA proposes that lenders must verify income for all mortgage applications. Its intention is to ensure that affordability assessments are based on fact. It proposes that lenders will be required to obtain proof that the income stated on the mortgage application form is correct.

The FSA's intention is to avoid being prescriptive in order to give lenders the flexibility to innovate and meet the needs of different market segments. It is therefore proposing not to be prescriptive about the following:[12]

– **the means used to verify income**—paper-based or electronic information techniques may be used;

– **the source of the evidence**—other than that it should be from a source independent to the applicant, such as from the applicant's employer, bank, accountant, HMRC, or business accounts. Where the lender holds the applicant's current account, the lender may use this information where appropriate;

– **the period of time that the evidence must cover; however,** in relation to variable sources of income, such as self-employed income, overtime payments or bonuses, the FSA will expect lenders to consider the variability of income over time. This may influence the period over which income is verified.

The survey suggests that income is currently verified for about 70% of the mortgage applications (see Table 2.1). This is higher than the FSA estimate, which is around 50% for mortgage sales in 2007.[13] The difference could be due to the changed market conditions having resulted in fewer self-certification mortgages and fewer mortgages being fast-tracked. Furthermore, there may be a survey response bias, in that lenders that verify income for a higher proportion of the mortgages were more likely to participate in the survey.

[11] FSA, 'Self-Certification Mortgage Lender Research – Results of Thematic Work', http://www.fsa.gov.uk/pubs/international/selfcertmortgages.pdf

[12] The information in the bullet points is more detailed than that specified in the questionnaire. Oxera does not expect that this would affect the responses.

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

Table 2.1 Current proportions of mortgage applications that are/are not income-verified (in relation to current sales at the time of the survey, May 2010)

	Weighted average response (%)
Income verified	72
Income not verified due to self-certification	<0.5
Income not verified due to application being fast-tracked	18.5
Income verified for a sample of fast-tracked applications	6
Income not verified (not due to self-certification or application being fast-tracked)	3.5

Source: Oxera analysis based on survey data, based on 36 responses.

Table 2.2 shows that survey respondents use a number of different sources to verify income, the most common being payslips (69%) as the primary source of verification.

Table 2.2 What is the main documentation used by lenders to verify income? (in relation to current sales at the time of the survey, May 2010)

	Weighted average response (%)
Payslips or P45	69
Existing information from bank (eg, copy of current-account statements)	9
Existing information from mortgagee (eg, tax returns)	2
Specific information generated by the employer in response to a specific request relating to the mortgage transaction	9
Specific information generated by the mortgagee's bank in response to a specific request relating to the mortgage transaction (eg, data from current account)	<1
Business accounts or accountant's certificate	9
Other	2

Source: Oxera analysis based on survey data, based on 31 responses.

2.1.2 Direct costs

In interviews, lenders indicated that since they already verify income for most applications, this requirement would not result in any significant one-off costs—systems for verifying income are already in place. This is confirmed by the survey evidence. Lenders indicated that they would use existing systems to verify income for those cases where they currently do not verify income. Although they would hire staff to verify income for these additional cases, no new investments into systems would be required.[14]

To estimate the compliance costs of the income verification proposal, several data sources have been used to produce a number of scenarios.

The ongoing costs for the industry will depend on the proportion of applications for which income is currently not verified, the ease with which income can be verified for these cases, and the method of income verification.

[14] Based on 10 respondents. One survey respondent indicated that they would have to invest in new systems to be able to verify income for those cases where they currently do not verify income. This response may be explained by the fact that this lender specialises in equity-release products where the level of income tends not to be an important factor in the mortgage application assessment. Equity release is a means of using the value of a property to receive either a lump sum of cash or regular monthly instalments. In the case of equity release, age (rather than income) is the primary factor in determining the percentage of the value of the property that can be released. 30% of the lenders that responded to the question about whether they would have to invest in new systems to be able to verify income indicated that they did not know this yet.

Lenders were asked to estimate the components of costs for assessing a single application—ie, employee time and employee remuneration—and this was used to estimate a cost of verifying income per application.[15] [16]

– A factor of 1.5[17] was applied to annual remuneration to give an estimate of the cost of the employee to the company. This factor was chosen to reflect costs such as pensions and national insurance, office accommodation, IT equipment and support, and similar costs. Average annual remuneration was around £22,000 across the sample, giving a cost to the company per employee year of £33,000, resulting in an hourly cost of around £18.[18]

– The average time required for income verification was estimated at 10 minutes. There was some variation ranging from around 5 minutes to 4 hours; large lenders estimated less time than small lenders.[19]

Multiplying the estimate of time (10 minutes on average) by hourly costs results in an average of around £3 per application.

Lenders were also asked to provide an estimate of the costs of verifying income for applications that require further investigation (for example, because data from the payslips or current account is not available or is available but is not consistent with the income stated on the mortgage application form). This was estimated at £12 per application on average based on an average time of around 40 minutes.[20] Again, there was some variation in the estimates, ranging from 5 minutes to 8 hours.[21]

The survey indicates that, on average there are 1.5 full mortgage applications for each sale—ie, where the money is actually lent.[22] Thus, the cost of income verification is approximately 50% higher per successful sale than per application.

The proportion of applications for which income is not currently verified varies across respondents. It is not possible to determine exactly the proportion of mortgages for which income would not be verified in the counterfactual (ie, in the absence of regulation over the economic cycle). 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%. Therefore, a range of cost estimates is provided based on the following four scenarios. To illustrate the

[15] Lenders were also asked whether, in addition to the time cost, they would incur any additional external or other costs. 98% of the survey respondents indicated that they would not incur any additional costs. The lenders that would incur some additional costs were very small in size (their costs would not have affected the weighted average costs across the market) and their estimates have therefore not been included in the analysis. (Based on a sample of 13 responses for 'additional external' costs and 14 responses for 'other costs.)

[16] Lenders were also asked to assess the costs of income verification by estimating the number of extra full-time-equivalent (FTE) staff they would need to employ to do this work, taking into account a mix of applications that do/do not require further investigations. Those who currently verify income for less than 100% of their applications and predicted that they would need to take on more staff (5 respondents) expressed quite divergent views on how many new staff would be required. One large lender with significant experience of verification was estimating a requirement for additional staff which would translate into around 10–15 minutes of staff time per application, while two others were predicting around 200–300 minutes per application. These estimates are not inconsistent with the estimates of the time currently required for income verification. Given the small number of responses, it was decided to estimate the costs of income verification on the basis of an estimate of the costs per current application (for which more responses were available).

[17] Chosen as the midpoint of a range of estimates, generated by comparing wage bills against other costs disclosed in the annual reports of lenders and other service firms, and using the stated salaries in the survey.

[18] Based on a sample of 23 responses.

[19] Based on a sample of 25 responses.

[20] This is the total cost of verifying income for non-standard cases—ie, the cost is not incremental to the cost of verifying income for standard cases. There was a very small but insignificant difference between the annual remuneration of staff for standard and non-standard income verification. In this analysis, the same annual remuneration was used for both cases.

[21] Based on a sample of 27 responses.

[22] Based on an average of the ratios for 2007 and 2009. This is consistent with the ratio used in 2003 for an assessment of the costs of the proposed regulation of mortgages. See FSA (2003), 'Mortgage regulation: Draft conduct of business rules and feedback on CP146, May.

calculations used to estimate the industry costs, Table 2.3 presents one of the scenarios in more detail.

Scenario 1 Assuming that total mortgage sales volumes would be equivalent to the long-term average over the period 2004–09[23] 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.

Scenario 3 Some applications are likely to require further investigation (for example, because a payslip is not available). 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. [24]

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

Table 2.3 Summary of the costs of income verification (scenario 4)

	Average time required (min)	Hourly cost (£)	Cost (£) per mortgage application	Cost (£) per mortgage sale	% of mortgage sales affected	Industry costs (£)
Standard income verification	10	18	3	£4.5	35	£2.7m
Complex income verification	41	18	12	£18	15	4.6m
Total					50	7.3m

Note: Total annual sales were estimated at 1,719,102, based on an average over the past five years.
Source: Oxera analysis and survey.

As explained, there is some variation across lenders in the estimates of income verification costs. This may suggest that, in particular for the smaller lenders, there may be opportunities to become more efficient and reduce their costs. More generally, for some lenders, the estimate of annual cost is more likely to be a reflection of the additional costs in the short term rather than the longer term, when more cost-efficient techniques for income verification may become available. Certain organisations may start collecting income data from various sources and offering an income-verification service to lenders, similar to the credit score service offered by credit reference agencies, for example.

The cost of income verification is likely to vary by the borrower's type of income. Income verification is harder for borrowers who are self-employed, take substantial income as dividends or similar (eg, directors of firms or partners of law or medical practices), or have a significant income from alimony payments.

Costs to consumers—the direct costs to consumers of the income verification requirement would consist of the value of their time multiplied by the time required to produce copies of the payslip and bank account statement, or, in cases where this is not available or sufficient, the costs of producing copies of business accounts and/or obtaining an accountant's certificate. These costs are likely to be limited.

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

[24] It is difficult to estimate the proportion of mortgage applications that would require further investigation to verify the applicant's income. These are likely to be applications from self-employed people. The Office of National Statistics shows that this is a significant proportion of the working population—around 14% in 2010.

2.2 Assessing affordability

2.2.1 The FSA proposal

The FSA stated that:

> 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.

The lender would 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,[25] 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 lenders can choose to use statistical data, derived from their own data or external sources, when assessing expenditure, or when assessing levels of income tax and national insurance, 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'. This would be calculated by deducting expenditure from income to give the applicant's free disposable income. The FSA proposes that this figure will be the maximum amount of money available for mortgage servicing—ie, the upper limit on affordable mortgage payments. From this, the lender would be able to calculate maximum borrowing capacity—ie, the maximum affordable loan.

The maximum borrowing capacity would be calculated using:

- a capital and interest basis (even if the mortgage is to be taken on an interest-only basis);
- 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.

[25] The prescription in the rest of this paragraph is more detailed than that assessed by Oxera through its questionnaire. This is unlikely to have affected the results, however, since few lenders were able to estimate the costs of this actual proposal. Prescribing three levels of expenditure could result in some lenders having to alter their systems.

For mortgages being taken on an interest-only (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 if 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.

2.2.2 Current practice

A study by Oxera for the Council of Mortgage Lenders in 2006 concluded that lenders' affordability assessment models were increasingly forming part of the toolkit used in the formal credit assessment process, either in conjunction with, or in place of, more traditional assessments and policy rules based on income multiples.[26] The number of lenders with an affordability model in place had increased from 9% in 2003 to 48% in 2005.

The survey undertaken for this current study shows that this trend has continued (see Table 2.4). Very few lenders make no attempt to assess affordability—only two lenders indicated that they did not carry out some kind of affordability check on 100% of their mortgages. In addition, the majority of lenders (~90% of those responding) assess affordability by looking at both income and expenditure, and on the basis of a model or methodology. This includes lenders with a formal affordability model in place (32%) where the assessment is typically automated, lenders with a methodology for assessing affordability where the assessment may be done manually (38%), and lenders (18%) that use an income multiple in combination with an affordability model or methodology. Only 12% of lenders, some of which are small building societies, assess affordability on the basis of an income multiplier—this way of assessing affordability is unlikely to meet the new FSA requirements.

Table 2.4 Current approach to assessing affordability, by primary category (%)

As % of respondents in this category	Income multiple	Methodology for assessing affordability	Formal affordability model	Income multiple + affordability assessment/model
Banks	13	33	33	20
Building societies	17	42	25	17
Non-deposit taking lenders	0	43	43	14
Total respondents	**12**	**38**	**32**	**18**

Note: Based on responses from 34 lenders. Lenders that indicated that they would apply income multiple said that they would apply an *advanced* income multiple which typically refers to applying the multiple to disposable income rather than gross income to calculate the maximum loan value.
Source: Oxera analysis based on survey data.

2.2.3 Direct costs

Lenders were asked whether they would incur one-off costs in implementing the new affordability requirements. Only 8 lenders answered this question, with 6 indicating that they would be likely or very likely to incur a one-off cost. Of these 6, 2 did not have an affordability model in place and therefore expected to incur significant additional costs, while the other 4 already had some kind of model or methodology in place but would still incur additional expenditure to make their model compliant with the proposed requirements. One already had a model or methodology in place and did not expect to incur additional costs and another also already had an affordability model in place but did not know whether it would incur additional one-off costs.

It is therefore difficult to determine precisely what proportion of lenders would incur one-off costs to meet the proposed affordability assessment requirements. It is likely to include those

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

lenders that currently do not have an affordability model or methodology in place (around 12%), and some of the lenders that do have a model or methodology in place but that may not meet the proposed requirements. As explained, the survey suggests that some of the lenders that already have an affordability model or methodology in place would incur some further one-off costs. This is around 66% of those with a model or methodology in place, but is based on a very small sample and therefore subject to a considerable margin of error. Most survey respondents did not answer the questions, which could suggest that they would not incur significant additional costs or found that it was too early to assess this. I

In interviews, most lenders indicated that they have a model or methodology in place and would not incur significant further one-off costs. Also, the 2006 Council of Mortgage Lenders report indicates that most lenders already take into account a range of different types of expenditure and allow for interest rate stress-testing. To take into account that some lenders that have a model or methodology in place would still incur additional costs, it is assumed that 50% of those with a model or methodology already in place would still incur further additional one-off costs (ie, 44% of lenders). It is assumed that they would incur the full costs of an affordability model—in practice, they may incur only some of these costs since they already have a model or methodology in place. Only 5 lenders were able to estimate the one-off costs of meeting the proposed affordability requirements. However, the costs of other lenders' existing affordability models provide an indication of the costs that lenders may incur. Larger lenders tend to have larger system costs due to the greater integration of mortgage application systems with other systems. For large lenders (as explained in section 1, defined for the purposes of the analysis presented here as those with an outstanding mortgage book of more than £9 billion), the average one-off costs were estimated at around £700,000 (with an upper boundary of £2.5m), while for smaller lenders the average was around £25,000 (with an upper boundary of £200,000). The weighted average reflecting the number of small and large lenders is around £80,000 per lender.

There are around 330 active lenders in the market. Assuming that 56% of lenders (12% plus 44%) would incur one-off costs averaging this amount, the costs for the industry would amount to around £15m.

However, there is considerable uncertainty around whether existing systems will actually have to be upgraded, especially for those systems that are already quite sophisticated. If only the 12% or so of lenders currently using relatively simple systems have to incur significant costs, the total one-off expenditure for the industry would be much lower, at around £3m.

The ongoing cost of the affordability proposal has been estimated in a similar way to that for income verification, starting with the cost per application. Lenders were unable to estimate the ongoing costs of implementing the affordability proposal, so the costs from lenders that already assess affordability were used instead.

In two respects, the situation for affordability contrasts with that for income verification. First, the assessment of affordability is not cyclical in the absence of regulation. Instead, there has been a trend towards using affordability assessment models. Thus, the best estimate of the proportion of mortgage applications for which affordability is not assessed, in the absence of regulation, is current practice, and there is no need to take account of previous years. Second, most firms with an affordability assessment model tend to apply it to all customers.

Across the industry, the proportion of institutions that do not use affordability methods or models is estimated to be around 12%.[27]

[27] Based on a sample of 34 responses. The 12% of survey participants that do not use affordability methods or models are responsible for around 6% of mortgage sales in the survey sample. Oxera considered that this estimate of 6% could be driven too much by the composition of the sample. To be conservative, an estimate of 12% is used for the costs of affordability.

Survey respondents indicated that it would take them around 40 minutes on average to assess affordability—there was a considerable variation in the estimates, ranging from a few lenders indicating that it would take 10 minutes or less, to a few lenders (in particular private banks) at the other extreme suggesting that it would take around 3–4 hours.[28] More than 90% of the survey respondents indicated that the required time would be one hour or less. Large lenders generally estimated that it would take less time than small lenders; therefore, across the market as a whole, the average time taken to assess affordability is in the region of 30 minutes.[29]

As for income verification, the cost of assessing affordability per mortgage has been estimated using 'time of an employee' and annual remuneration, again applying the factor of 1.5 to obtain an estimate of the cost to the business. Although the survey also asked for estimates of additional external costs, and other costs, these have been excluded as very few responses were given, and those given were very small per application. Using this methodology, the average cost per application across the market is estimated at around £11.50, and per successful mortgage sale, £17.[30]

Most mortgage applications already have some affordability assessment applied to them (see above). The 12% or so of mortgages that do not will require this assessment, so the costs associated with these mortgages would be incremental. However, for the remainder of mortgages, it would be inappropriate to apply the full cost, as most, if not all, the time required is already being expended in the existing processes. Taking account of the additional one-off costs that have been included (see above), it would seem to be appropriate to calculate the lower-bound estimate by assuming that no additional time is required to apply any new affordability assessment in order to meet the new requirements. For an upper bound, 10 minutes (33%) could be added to the existing assessment procedures. Table 2.5 breaks this calculation down into its components.

Table 2.5 Total costs of the affordability requirement

Average cost per mortgage sold	£17
Number of mortgages not currently assessed (12% of total)	206,292
Total ongoing costs per annum (lower bound)	**£3.5m**
Additional 10 minutes required for all mortgages—unit cost	£5.60[1]
Total number of mortgages sold	1,719,102
Additional costs per annum	£9.6m
Total ongoing costs per annum (higher bound)	**£13.1m**

Note: [1] As explained in the text above the table, this is based on an assumption of 33% extra time (ie, 33% of £17).
Source: Oxera analysis based on survey data.

As with income verification, some firms may find quicker and cheaper ways than their competitors to assess affordability, and these techniques may be copied by others.

Testing for future interest-rate increases

With regard to prescribing the stress test of 2% above the standard variable rate, this is unlikely to add significantly to the costs of an affordability model. Most lenders' existing

[28] Based on a sample of 27 responses. This would mean that, in order to assess affordability and verify income, lenders would on average require more than one hour (43 minutes plus 29 minutes). There may be some double-counting since, within the organisations of some lenders (in particular those with manual underwriting processes), income may be verified at the same time as affordability is assessed. However, as there is insufficient information on the extent to which there is such double-counting, no adjustments have been made.

[29] Based on a sample of 27 responses.

[30] This is based on an annual remuneration of £25,600 (with a factor of 1.5 applied to cover overhead costs) resulting in an hourly cost of £21.33. The average time required to assess affordability was estimated to be 32 minutes.

affordability models are likely to allow for some form of stress-testing,[31] while some may have to upgrade their model and incur some costs.

Lenders were not specifically asked to estimate the costs of increased stress-testing for credit-impaired customers. Such costs are likely to be limited and would depend on the ease with which these applicants could be identified and whether their affordability model or methodology already allows for interest rate stress-testing. The term 'credit-impaired' is defined by the FSA and already used by lenders when submitting data to the FSA. As explained above, most lenders' existing affordability models are likely to allow for interest rate stress-testing.

Interest-only mortgages
Very few lenders responded to the survey question about the cost of verifying the existence and adequacy of the repayment plan. It has therefore not been possible to estimate the compliance costs of this proposal. However, several lenders indicated that the costs could be significant, depending on the type of evidence required to verify and prove that a repayment plan does indeed exist, and the costs would probably vary by type of repayment plan. Assessing the adequacy, for example, of a repayment vehicle in the form of investments largely in shares would require a different set of knowledge and experience from assessing a pension plan. Furthermore, an investment-based plan may be more than adequate one year but not if there are significant stock-market falls. The overall effect might be to curtail volumes in this market.

Compliance costs to consumers
As a result of the affordability assessment, lenders may ask applicants more questions about their income and expenditure. The increase in time has not been quantified and is likely to be limited.

2.3 Arrears charges

2.3.1 The FSA proposal

In its 2009 Discussion Paper, the FSA proposed a more interventionist approach to monitoring and enforcement action against excessive charging practices in the mortgage market.

The FSA is proposing to amend MCOB rule 12.4 to address some instances of poor practice and to clarify how arrears charges should be calculated and applied. This will include specifying which types of cost can be recovered and clarifying that arrears fees cannot be a percentage of the outstanding debt.

Firms are already required under MCOB 13.3 to deal fairly with borrowers in arrears; however, the FSA is proposing to tighten its rules in this area by limiting the number of times fees for missed payments can be charged. Specifically, it is proposing to limit a firm from trying to take a payment more than twice per calendar month, unless it waives the administration charge for the additional attempts to take the payment.

The FSA is also proposing to widen MCOB 12.4 and MCOB 13.3 to apply to customers who are in payment difficulties but less than two months in arrears.

2.3.2 Direct compliance costs

There is already a requirement under MCOB 12.4 for lenders to make sure that their charges are a fair reflection of the additional administration costs faced by the lender. This means that the further guidance that the FSA intends to provide would not necessarily result in any incremental costs to the firms. However, the FSA has found evidence of lenders looking to

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

recoup costs through arrears charges for activities that are unrelated to the additional costs of arrears handling.[32] It is therefore likely that some lenders would have to undertake a fairly detailed cost analysis to make sure that arrears charges (and other fees for payment shortfalls) are cost-reflective.

In interviews, lenders indicated that it would be difficult to estimate the costs of assessing whether their arrears charges (and any other individual charges for payment shortfalls) are cost-reflective, and, if they turn out to be higher than the costs, the costs of making them cost-reflective. Some lenders indicated that it would not be straightforward to assess whether charges are currently cost-reflective; this would depend, for example, on how common costs are allocated. Other lenders, however, indicated that they already have systems in place to make sure that their charges are cost-reflective. One medium-sized lender indicated that it had introduced a costing model a few years earlier to enable it to set charges based on costs and to assess the cost-reflectiveness of mortgage charges on an annual basis. It noted that the costs of developing the model (which covered arrears charges and other charges such as payment shortfall fees) ran into the tens of thousand pounds (probably not more than around £60,000), while the costs of an annual review once the model had been developed amount to several thousand pounds. A smaller lender that also had a costing model also indicated that the costs incurred were relatively small. In general, lenders that have assessed the cost-reflectiveness of their charges have looked not only at arrears charges but also at payment shortfall fees (potentially suggesting that the broadening of scope to customers who are in payment difficulties but less than two months in arrears would not necessarily result in significant additional costs).

Some lenders have imposed limits on the number of missed payment fees that can be charged within a certain period of time (eg, a month). Nevertheless, lenders' current practice may not be in line with what the FSA intends to propose, and they may therefore have to make changes to their systems. Medium-sized lenders indicated that it would be difficult to estimate exactly how much this might cost, but that it would be a number of thousand or possibly in the low tens of thousand pounds.

2.4 Indirect costs as a result of the FSA proposals

2.4.1 Impact on quantity of mortgage sales (access to mortgages)

The affordability assessment proposals (to verify income and assess expenditure, etc) may have an impact on the quantity of mortgage sales, with two main effects being that there would no longer be a market for self-certification mortgages and that the market for interest-only mortgages would be significantly reduced. This section describes these and other effects in more detail.

Impact on access to mortgages as a result of the income verification requirement

In relation to the income verification requirement, lenders may choose to focus on customers whose income is easier to verify, while customers with unstable incomes and/or who are self-employed may be discouraged by the extra effort required to produce proof. The following observations can be made.

– To verify the income of self-employed mortgage applicants, lenders would have to examine business accounts and/or require an accountant's certificate. Most survey respondents already use business accounts or an accountant's certificate as one of the main sources of income verification for some of the applications (although currently for a relatively small proportion of their mortgage sales). This suggests that lenders already have the systems and procedures in place to verify income for non-standard applications, and that non-standard applicants would have sufficient choice.

[32] FSA (2010), 'Mortgage Market Review: Arrears and Approved Persons', January.

– Lenders were asked whether mortgage sales would have been lower if the income verification proposals had been in force. For sales in 2009, survey respondents reported that they would, on average, have expected a 6% reduction in mortgage sales had the income verification proposals been in place. They indicated that there would have been a greater reduction due to income verification in 2007—on average, a 10% reduction in mortgage sales.[33] (Self-certification mortgages, which are affected by the income verification proposal, were more prevalent at that time.) However, survey respondents representing smaller lenders are much more likely to be predicting a significant reduction in mortgages than survey respondents representing larger lenders. Within the survey respondents representing larger lenders, the average reduction predicted for 2007 was only 3% and no large lenders responding suggested that there would be any reduction for 2009. In general, survey respondents with a relatively high proportion of self-certification mortgages in 2007 also expect a higher reduction in mortgages as a result of the income verification requirement. However, most respondents (78% of respondents in relation to sales in 2009 and 67% in relation to sales in 2007) indicated that their sales would not have been affected by the income verification requirement. There was no clear pattern of non-deposit-taking lenders expecting a greater or smaller reduction in sales due to the income verification proposals in either 2007 or 2009.

Mortgage sales may be affected by income verification proposals via two primary drivers: customers may be excluded from the market due to their inability to prove income; or mortgage lenders may not offer a mortgage due to the expense of verifying income. The survey participants indicated that between 90% and 100% of the expected reduction in sales volumes would be due to the applicants being unable to prove income.[34] Applicants that are unable to prove income are likely to include self-employed people and those in the first years of business. In other words, the additional expense of verifying income is, in itself, not considered an important factor in gaining access to a mortgage.

Impact on access to mortgages as a result of the proposed affordability assessment

The requirement for assessing affordability may also mean that some people will no longer be able to obtain a mortgage, or will only be able to obtain a lower amount than applied for. This includes people who would have taken an interest-only mortgage but can no longer do so, for example, because their income is not sufficient to pass the affordability test that, in line with the FSA proposal, would be conducted as though the interest-only mortgage were a capital repayment mortgage. This is the desired effect for those people who would have gone in arrears and would not have been able to repay the mortgage had their application been approved. The FSA has quantified this benefit of the proposal. However, there may also be people who do not pass the lender's affordability test but would not have gone into arrears had they been given a mortgage. They may not pass the affordability test, for example, because of temporary low income followed by higher income after a few years, which the lender considered too uncertain to take into account, or because they could afford an interest-only mortgage but would not be able to afford the capital repayments (which, in line with the FSA proposal, would need to be taken into account).

Lenders were asked to estimate the overall impact of the verification and affordability proposals in terms of the proportion of their existing mortgage book that would be likely to 'fail' the proposed requirements. They were also asked for an estimate of the impact on the whole market. In relation to their own book, survey respondents were predicting, on average, that around 10% of existing mortgages would not pass the new tests. However, survey respondents representing larger lenders were predicting a smaller reduction, in the region of less than 5% on average. When predicting the impact on the market as a whole (compared with sales in 2007) by different types of borrower, respondents expected a more substantial

[33] Estimates for 2007 and 2009 based on 24 and 23 responses, respectively. This estimate of 10% is consistent with the findings of the empirical analysis undertaken by the FSA in relation to the proportion of mortgages that would pass income verification and affordability tests.

[34] Based on a sample of 22 responses for 2007 and 21 responses for 2009.

impact (ranging from 20% to 60%), except for standard 'good' borrowers for which lenders did not expect any reduction in supply. For those borrowers wanting to borrow more than 90% of the value of the property, a significant reduction in market volume is predicted (60%).[35] The relatively large market impact being predicted in parts of the market (compared with the impact on individual survey respondents) may be due to various factors, including that these changes are targeted at specific types of borrower, and groups that contain a high proportion of these types will experience a significant impact. In addition, the survey respondents are likely to be more conservative than the average lender in the market in 2007: some of the lenders that offered mortgages to high-risk consumers may not have participated in the survey and/or may no longer be active in the market.[36] Furthermore, it is very difficult to predict the impact on the market; hence, the responses are likely to be subject to a considerable margin of error and should be considered indicative only.

Although applicants with non-standard characteristics may not pass standard affordability tests used by some lenders, they may still be able to find a lender that is willing to examine their financial situation in more detail without using standard affordability tests. Survey respondents seem to confirm this. Although the market impact on the various categories of borrowers (eg, self-employed, low income, mortgages with a loan-to-value ratio of 90%, etc) is substantial, within each category there are still borrowers who are expected to be able to obtain a mortgage. In other words, rather than, for example, excluding all people who are self-employed, lenders would take the time to examine these cases in more detail. The FSA is considering some exceptions to the proposed approached in relation to interest-only mortgages—for certain types of applicant, lenders would not be required to assess affordability on a capital and interest basis. This is also likely to reduce the risk of wrongly excluding people from mortgages who can afford them.

Impact on existing mortgage holders

Some existing mortgage holders may not be able to pass the new affordability and income verification tests. As explained in section 1, the FSA has asked Oxera to conduct the assessment on the assumption that, where appropriate, there will be a transition arrangement to the new system. However, even if lenders are not required to apply the new regulation to existing mortgage holders, it is possible that they will do so in practice—they may not be willing to offer mortgages to borrowers who, under the new rules, cannot afford their mortgages. This may limit the choice of lenders for these people when they want to re-mortgage their existing mortgage and could affect the competitiveness of the mortgage deal they obtain (from their existing lender or from other lenders).

This issue would be exacerbated if lenders that specialise in high-risk borrowers exit the market as a result of the proposals, or if those lenders that have already exited the market (due to current market conditions) are less likely to re-enter the market as a result of the FSA proposals. The proposals in relation to affordability and income verification are unlikely to have a *direct* effect on lenders' decisions on whether to exit or enter the market (as explained below, only two lenders indicated that they would probably exit the market as a result of the FSA proposals), but there may be an indirect effect. The proposals are likely to reduce the demand for mortgages since some categories of customer will not be able to pass the new affordability and income verification tests and will therefore be excluded. This means that some of the lenders that have exited the market could decide not to re-enter because of lack of demand for mortgages (in particular from the categories of customer they used to specialise in). This could, in turn, limit the choice of lenders for high-risk mortgage holders to some extent.

[35] The expected reduction in sales for the different categories of people was estimated as follows: self-employed (38%), income not from employment (32%), poor credit rating (55%), low incomes (48%), 90% LTV or higher (60%), for combined business and residential property (36%), mortgage renewal (20%), first time buyers (24%), likely to get into arrears (52%) (based on 20 responses).

[36] Also, some strategic response (ie, survey respondents overestimating the impact) cannot be ruled out.

2.4.2 Impact on efficiency of competition

Impact on the nature of competition

Lenders can increase their revenues and/or profits by reducing the price of the mortgage, thereby increasing the demand for their mortgages, or by going 'deeper into the credit market' by offering mortgages to higher-risk consumers (or offering higher-value mortgages to such consumers). It is generally understood that in the years leading to the peak of the mortgage market, fierce competition, combined with ample availability of capital, led lenders to go deeper into the credit market offering mortgages to higher-risk borrowers. The question is whether the affordability assessment proposals would change the nature of competition in the market for mortgages and change the market outcome. A number of observations can be made.

The income verification and affordability proposals do not significantly change the price of mortgages,[37] but are likely to affect the quantity of mortgages in terms of the value of the mortgage that can be offered per applicant and the number of people to whom a mortgage can be offered. Under the proposed affordability assessment proposals, certain categories of customer are unlikely to be able to obtain a mortgage because of insufficient income or may only be able to obtain a lower-value mortgage.

The proposed rules do not necessarily change the incentive structure of lenders and intermediaries and the competitive dynamics. Intermediaries (and consumers) have an incentive to identify those lenders that are willing to offer their customers a mortgage or the highest mortgage amount (at a competitive price). If one of their customers has characteristics that make it difficult to pass standard income verification and affordability tests, the intermediary is likely to attempt to identify a lender whose lending criteria are easier to meet for its customer. Competition between lenders could therefore, in principle, lead to a lowering of lending criteria across the market in times when sufficient capital is available.

It is difficult to determine by how much the lending criteria could be lowered as a result of competitive forces. The FSA's enforcement action and assessments by the Financial Ombudsman Service of complaints about mortgages that were provided to people who could not afford them are likely to be important in signalling to lenders the position of the minimum standard for lending.

This means that the proposed rules on affordability in themselves do not necessarily affect the nature of competition or the competitive process itself, within the group of potential borrowers who are still eligible, or up to the value they can still borrow. It 'merely' imposes a new minimum standard in the market which to some extent will affect the quantity of mortgages actually sold.

Could the proposed requirements be avoided?

One way of conceptually testing whether the income verification requirement could be avoided (or 'gamed') by lenders is to assess whether the situation that occurred a number of years ago at the peak of the mortgages market (during which, for example, self-certification mortgages were offered to people with a high-risk profile and insufficient income to afford the mortgage) would be prevented.

It cannot be assumed that the income verification requirement would mean that the income figure used by the mortgage underwriter will always be correct. For example, verification of income is likely to involve some judgement by the underwriter if, for example, the income is not regular or the applicant is self-employed. Furthermore, although lenders would be required to verify income, the FSA does not prescribe the method of income verification. In

[37] It may affect the price to some extent as a result of the additional compliance costs that will be incurred. Furthermore, the proposals may result in more accurate risk-based pricing because of the additional (and potentially more reliable) information about the applicant that will be received. However, this effect could be limited if most of the information on risks is currently already captured through lenders' credit score assessments.

most cases lenders currently use payslips and bank statements to verify income. Recent research has shown that payslips are not immune to fraud—it is not too difficult for consumers to counterfeit a payslip by using software that is available on the Internet.[38]

This means that even if lenders were to comply with the proposed income verification requirement, some consumers may still be able to obtain a mortgage that they cannot afford, for example by counterfeiting a payslip and overstating their income. However, it is possible that new methods of income verification will be developed that are more reliable and fraud-proof.

Generally speaking, lenders have an incentive to offer mortgages to those who would fail any affordability test if, *as a group*, they would be profitable to serve, absent any significant regulatory penalty as a result of making these loans. If the customers can cheat in the test (for example, by using a fraudulent pay slip) then both customers and lenders may have a motivation and means to bypass the rules. Whether they will, depends on where the rules are set. If the rules create a significant number of customers who, as a group, are profitable to serve but are excluded, the incentives will be quite high. On the other hand, if the rules essentially only exclude groups who are unprofitable to serve, the motivation to bypass the rules is limited or non-existent. Without a close analysis of the detail of how the affordability assessments will be made that can then be mapped onto the profitability of the excluded groups, it is not possible to make this assessment. Such an analysis is outside the scope of this research and is difficult to conduct until the regulatory line has been drawn as to when a loan is affordable (and, therefore, within the rules) and when it fails an affordability test.

Increase in search costs

The FSA does not prescribe in detail how lenders should assess applicants' affordability. This means that lenders can put in place their own models and methodologies, and that the affordability criteria are likely to vary across lenders.

This could increase the search costs for consumers—in particular, those with non-standard characteristics (such as a lack of regular income or temporarily low income)—to find lenders with affordability criteria that they can meet.

Intermediaries can, in principle, play a role here. Over time they have built up an understanding of lenders' appetite for risk and use sourcing systems that contain information about lenders' policy rules and underwriting criteria.

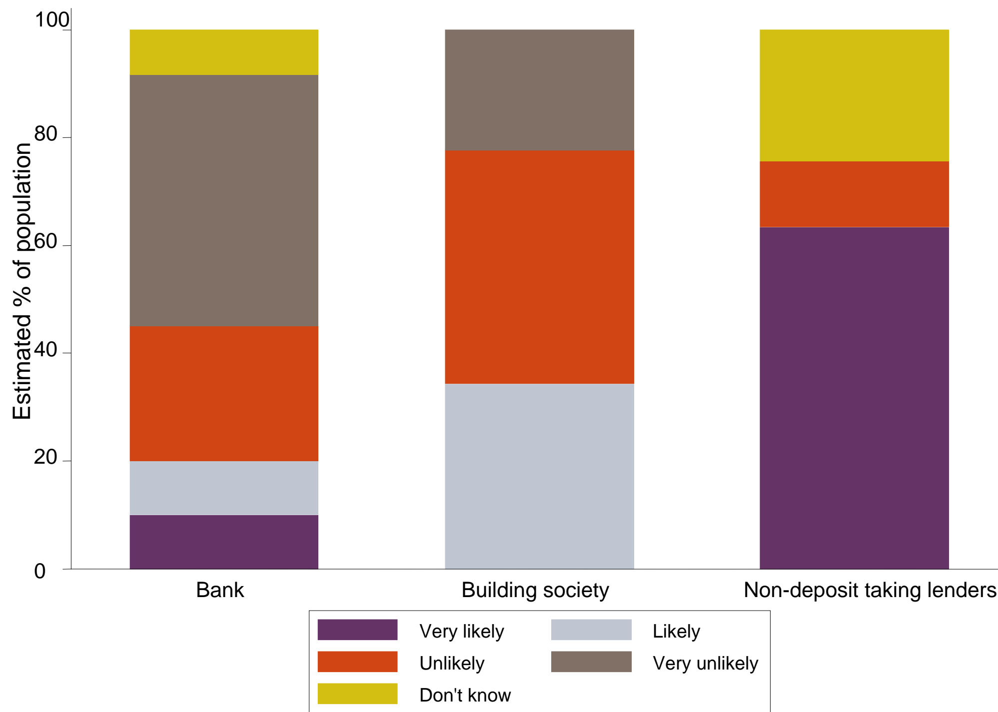
However, in the interviews, it was explained that some lenders are reluctant to disclose their affordability assessment criteria to intermediaries or providers of sourcing systems. The survey confirms this. 53% of lenders who have responded on whether they intend to do so have indicated that they are unlikely to disclose their affordability criteria to intermediaries.[39] Similarly 57% of lenders indicated that they were unlikely to disclose their criteria to sourcing systems.[40] A breakdown by type of lender is provided in Figures 2.1 and 2.2. This suggests that banks are less likely than building societies or non-deposit-taking lenders to make their assessment criteria available to either intermediaries or sourcing systems. Although this may temporarily result in a cost to consumers and intermediaries (in terms of spending more time to find the right lenders), the lenders' position may change. For example, competitive pressure may make lenders decide to share their criteria with intermediaries or sourcing systems. Furthermore, the survey also suggests that lenders are likely to reduce the number of intermediaries they work with (see the section on market structure). In other words, they may decide to share their affordability criteria with a more selected number of intermediaries.

[38] For example, the Council of Mortgage Lenders has noted that: 'Income verification based on paper documents can also be manipulated and is not immune to fraud'. See Council of Mortgage Lenders (2010), 'FSA must be clear about verifying income', CML news and views, Issue no.2 – 2, February.

[39] Based on a sample of 36 responses.

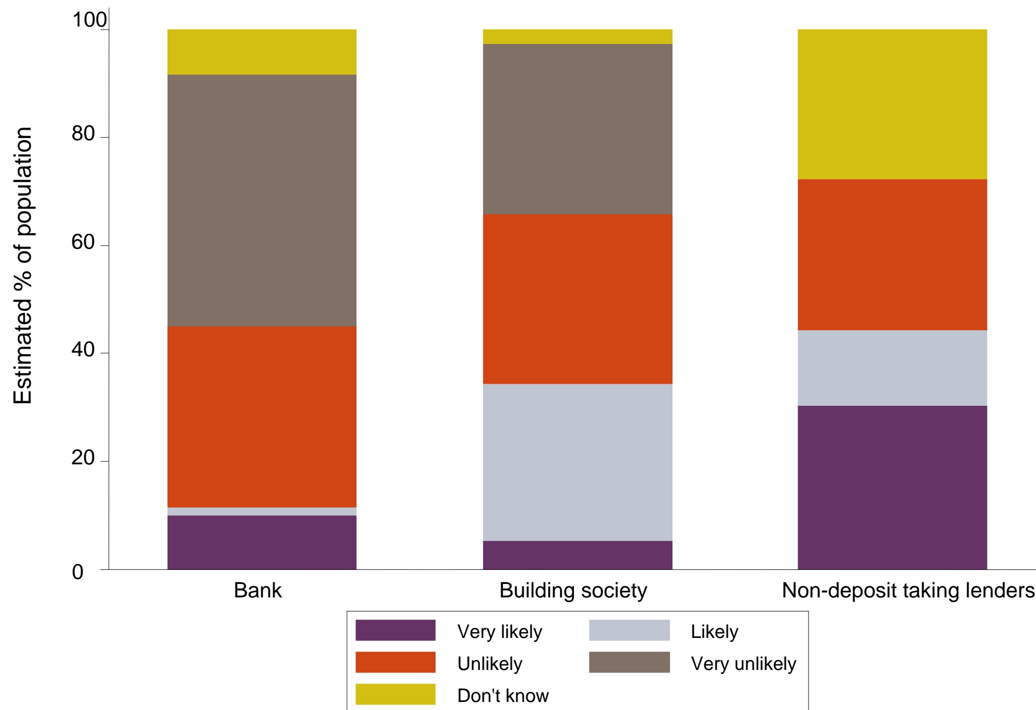
[40] Based on a sample of 35 responses for 2009.

Figure 2.1 Would the provider make affordability assessment criteria available to intermediaries? (by primary category)



Note: Based on a sample of 36 responses.
Source: Oxera analysis based on survey data.

Figure 2.2 Would the provider make affordability assessment criteria available to sourcing systems? (by primary category)



Note: Based on sample of 35 responses.
Source: Oxera analysis based on survey data.

Distortion of competition

Although both deposit- and non-deposit-taking lenders can rely on copies of current-account statements to verify income, deposit-taking lenders arguably have an advantage over non-deposit-taking lenders when their own customers apply for a mortgage since deposit-taking institutions can verify income by checking their customers' current account details electronically, without having to ask for a hard copy (which is likely to take more time and result in additional effort on the part of their customers). In other words, the FSA income verification requirement makes income verification more important and could give deposit-taking lenders a competitive advantage over non-deposit-taking lenders, at least as far as their own (current-account) customers are concerned.

However, in practice, there are likely to be limits to this advantage and it is unlikely to have a significant impact on the competitive dynamics in the market.

- Current-account information is already used as one of the main sources for verifying income. Although the survey suggests that deposit-taking institutions use such information more than other lenders, some of the other lenders use it as well. Anecdotal evidence suggests that at present some banks ask applicants to hand in a hard copy of their current-account statement even if they have a current account with them and statements could be checked electronically. Although, in principle, deposit-taking institutions could automate this—thereby speeding up the application process and/or making it easier for their customers—such a decision would not necessarily be driven by the introduction of an income verification requirement—it is something they could already do.

- As explained, the costs of verifying income on the basis of payslips and/or copies of bank statements are relatively limited. Although checking current-account data electronically is quicker and probably more cost-efficient, it is unlikely to give deposit-taking lenders such a cost advantage over non-deposit-taking lenders that it would affect competition.

- Deposit-taking lenders already have some competitive advantage over non-deposit-taking lenders. They can use their current-account customer base to cross-sell other products such as mortgages. The incremental benefit of being able to verify income electronically may be limited.

- Other methods may be introduced to verify income (such as access to HMRC[41]), which would be available to all (deposit- and non-deposit-taking) lenders, making the verification of income on the basis of bank statements less important.

Impact on innovation

Speed of the application process—it has been argued that income verification may slow down the fast-track process, and thereby undermine the advantage of lenders who have such processes in place. Lenders with such a process were asked whether income verification would affect the length of the fast-track process. The average expected delay is estimated at 3.4 days (all within the range of 3–4 days).[42] Survey respondents indicated that, on average, the fast-track application process currently takes 7 days—the minimum length being 5 days and the maximum 9.[43] This suggests that it would take, in total, around 10 days (7 plus 3.4) to verify income since the income verification process could start when the application process starts.

[41] No decision has been taken yet. It is for the HMRC to decide whether to make data on incomes available.

[42] Based on a sample of 4 responses; only 5 lenders out of 38 respondents indicated that they had a fast-track process in place currently.

[43] Based on a sample of 3 responses.

Lenders were also asked whether the income verification requirement would affect their fast-track processes. Of those survey respondents with such a process in place, 20% indicated that they would no longer offer a fast-track service, 20% would reduce its usage (eg, possibly using it only for applications where income can be verified relatively easily), and 40% indicated that it is too early to say what the impact would be (with 20% not responding).[44]

The 10 days required to verify income reflect not so much the increase in the amount of time the provider takes to do the verification (as explained above, estimated at an average of 10 minutes of additional employee time for an application that does not require further investigation, rising to 40 minutes for one that does), but more the time for lenders to receive a copy of the payslip and/or bank account statement (and to chase applicants if they fail to do so). The main challenge to reduce this elapsed time would be to get applicants to produce, sufficiently early in the process, the relevant documents. This may require a behavioural change—applicants would need to understand that, without supplying proof of income at the start of the process, it would not be possible to obtain a mortgage quickly. In other words, the 10-day estimate is based on the existing fast-track processes assuming current lenders' efficiency and consumer behaviour. If consumers need their mortgage quickly—for example, so as not to lose out on the purchase of a property—they would have an incentive to produce the required proof of income as quickly as possible.

In sum, whether the income verification would indeed significantly slow down the fast-track process would depend on how consumers respond and how quickly they are able to produce the relevant proof of income. For standard cases where a payslip or bank statement will suffice, it may not require much additional (elapsed) time. Furthermore, over time, when other more efficient methods become available, such as a link to HMRC data, the current estimates of income verification time could be reduced, although some one-off costs could be incurred in putting these systems in place.

Methods to verify income—direct verification of stated income is arguably only one model of income verification and may have certain disadvantages. For example, as explained above, recent experiences suggests that using payslips as the main source of proof of income is not immune to fraud. Another model is verifying income for only a random sample of the applications (as lenders do for fast-track mortgage applications where income may be verified for all applications by the intermediary but only for a sample by the lender). Some lenders explained that they could introduce models to predict income from other known factors. For example, databases might be developed to check the plausibility of income on the basis of combinations of job titles, industries, ages and addresses. Such innovations would arguably be prevented if lenders are required always to verify income directly, rather than to check its plausibility.

Impact on market structure

The market structure may change as a result of changes in the relationship between lenders and intermediaries, and changes in the number of lenders in the market.

Consolidation or partnerships in the industry—it has been suggested that one of the responses to the MMR proposals could be a move towards greater consolidation in the sector—for example, to take advantage of economies of scale and thereby minimise the potential increases in costs. However, there is, as yet, limited evidence that lenders are intending to acquire intermediaries or other lenders—no survey participant reported being likely to acquire other distributors as a result of the MMR proposals, while only 3% of survey participants reported that they are likely to acquire other product providers.[45] Some survey participants do, however, appear more open to setting up distribution arrangements or

[44] Based on a relatively small sample: 4 lenders responded on how the length of their fast-track process would be affected.

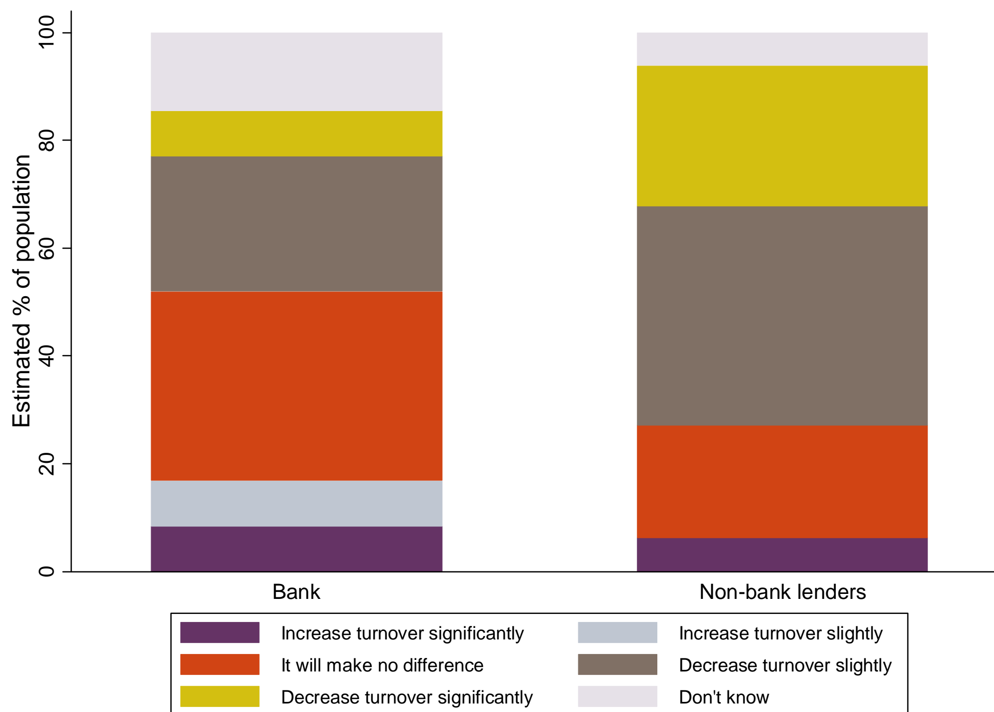
[45] Based on a sample of 34 responses.

partnerships with other financial firms in response to the proposals, with 14% reporting that they are 'likely' or 'very likely' to enter into such arrangements.[46]

Likelihood of exit due to MMR proposals—only two survey respondents indicated that they are 'likely' or 'very likely' to exit due to the MMR proposals. Both are private banks, one of which suggested that the MMR is too rigid and transactional, and does not appear to give adequate consideration to private banks that serve high-net-worth individuals and non-domiciled clients that do not want to be treated as though they are financially unsophisticated. Recognising that the business model of private banks is different, the FSA reflects on this in its Consultation Paper and considers giving firms the opportunity to apply for waivers.

Impact on turnover—about 49% of the survey respondents anticipate that the MMR proposals will reduce the turnover generated by their mortgages business, while 27% anticipate that there will be no change, 8% expect an increase in their turnover, and 16% do not yet know what the impact will be.[47] As shown in Figure 2.3, non-banks are marginally more pessimistic than banks that their turnover will decrease in response to the proposals.

Figure 2.3 Potential impact on turnover of the MMR proposals in isolation (by primary category)



Note: The impact here is considered 'in isolation'—ie, excluding other influences, such as prudential reforms. Based on a sample of 37 responses.
Source: Oxera analysis based on survey data.

Impact on product focus—most lenders indicated that they will not be changing the product focus of their business in response to the MMR: 84% of survey respondents indicated that they will make no change in their focus on mortgages.[48] Similarly, the majority of survey

[46] Based on a sample of 34 responses.
[47] Based on a sample of 37 responses.
[48] Based on a sample of 37 responses.

respondents (69%) indicated that they do not envisage any shift in their customer focus as a result of the MMR proposals.[49]

The relationships between lenders and intermediaries may change as a result of the proposed rules by the FSA:

Reduction in number of relationships—when lenders were asked whether they would expect to increase or reduce the number of intermediaries through which they distribute their mortgages as a result of all the proposed changes in regulation, all except one indicated that they would expect to reduce the number of intermediaries.[50] On average, survey participants reported an expected reduction of 29% (with a maximum reported reduction of 60%) of the intermediaries they work with.

Although this would to some extent reduce the choice of consumers using an intermediary, each intermediary may still have access to a sufficient number of mortgage lenders—therefore, the reduction in the number of relationships between lenders and intermediaries may not affect the degree of competition between lenders.

In the interviews, lenders indicated that the proposals on income verification, together with the requirement for affordability assessment, would be important drivers for the reduction in the number of intermediaries they work with. The FSA proposals mean that lenders (rather than intermediaries) will become ultimately responsible for verifying income and assessing affordability. It is in the interest of lenders to have better control over the quality of applications they receive and the way these applications are assessed and prepared by intermediaries.

Changes in the use of direct sales channel—in interviews it was mentioned that, by giving lenders the responsibility to verify income and assess affordability, lenders become more involved in the application process, which could in turn lead them to prefer direct sales over introduced sales. In particular, deposit-taking lenders that already have access to current-account data from their own customers (which could be used for income verification purposes) may see less of a need to use intermediaries. Furthermore, due to current market conditions, there already appears to be a trend towards the use of direct sales forces.

The survey indeed suggests that this trend may be strengthened as a result of the proposed regulations. When lenders were asked whether they would set up a direct sales force or expand their direct sales force, 14% indicated that they are planning to set up or expand their direct sales force.[51] Although direct sales may have certain advantages, this option also places more responsibility on the consumers themselves to make sure they shop around to obtain a good deal—when using the independent intermediary channel, the mortgage adviser shops around on behalf of its customer.

Increase in the role of intermediaries—in interviews it was also mentioned that the FSA proposals could, in principle, increase the role of intermediaries in the value chain. For example, lenders are likely to implement affordability assessments in different ways, and intermediaries would be able to assist their customers (in particular those less likely to pass a standard affordability test because of their specific personal circumstances) in identifying lenders that would be willing to lend to them, and assist them in preparing the relevant evidence required for the income verification. As explained above, although not all lenders are willing to share their affordability criteria with intermediaries, it is likely that, through experience, intermediaries will build a better understanding of lenders' criteria.

[49] Based on a sample of 38 responses.

[50] Based on a sample of 18 responses.

[51] Based on a sample of 35 responses.

Indirect costs of proposals on arrears charges

It is not possible to quantify the indirect costs of the proposals in relation to arrears charges (since this would require actual data on the extent to which charges are not cost-reflective, for example), but they can be assessed in qualitative terms.

If arrears charges are currently higher than the actual costs of arrears handling, the difference between the costs and the charge may be competed away, possibly in the form of lower interest rates and initial arrangement fees[52]—these are the prices that are most likely to be taken into account when consumers and intermediaries compare different mortgage offers and are therefore most subject to competitive pressure. Given that the mortgages market is generally considered to be highly competitive, the difference between arrears charges revenues and costs is likely to be competed away.

This means that if arrears charges are reduced and brought into line with costs, this may have implications for the other prices of a mortgage product—in particular, initial arrangement fees and mortgage interest rates may go up.

The net effect on individual consumers would depend on a range of factors, including the extent to which excess revenues are currently competed away and the extent to which some of this results in a transfer from one group of borrowers (eg, those who incur arrears charges) to another group (eg, those who do not incur arrears charges). A detailed analysis of these effects is beyond the scope of this report.

[52] This is typically refererred to as a 'waterbed effect'.

Park Central
40/41 Park End Street
Oxford OX1 1JD
United Kingdom

Tel: +44 (0) 1865 253 000
Fax: +44 (0) 1865 251 172

Stephanie Square Centre
Avenue Louise 65, Box 11
1050 Brussels
Belgium

Tel: +32 (0) 2 535 7878
Fax: +32 (0) 2 535 7770

Thavies Inn House
7th Floor
3/4 Holborn Circus
London EC1N 2HA
United Kingdom

Tel: +44 (0) 20 7822 2650
Fax: +44 (0) 20 7822 2651

www.oxera.com