

Agenda

Advancing economics in business

Safe as houses? The implications of the Mortgage Market Review

After three years and four consultation papers, the UK Financial Services Authority is nearing the end of its Mortgage Market Review, with a final policy statement and rules expected in summer 2012. Paul Smee, Director General at the Council of Mortgage Lenders (CML), reflects on the CML's analysis of the proposals, concluding that the new regime is likely to tighten access to mortgage finance overall, increasing consumer protection but potentially at the expense of access to finance for some creditworthy borrowers

The final response deadline has just passed for the Financial Services Authority's (FSA) fourth consultation paper on its Mortgage Market Review (MMR).¹ Weighing in at over 700 pages, CP 11/31 is the latest iteration of a package of proposals and ideas that first saw the light of day back in 2009. The CML has played a diligent role in responding to each of the FSA's consultations, and, thanks to the thorough work of many members and staff colleagues, I am confident that we have helped the FSA to avoid some of the bear traps into which regulatory reform might otherwise have led.

This is a good time to reflect on what we expect from regulation. Can it ever deliver the benefits that it seeks? To what extent is it inevitably backward- rather than forward-looking? And how can regulators strike the right balance between being intrusive enough to prevent poor practice, and not being so draconian that both firms and consumers are unable to comply with the regulatory burden?

The FSA's stated intention is to deliver a market that works better for consumers and that is sustainable for all participants. We have reviewed the latest proposals in the light of this intention. At the heart of the debate is the need to reflect on the importance of the mortgage market in the broader market and political context, as home ownership remains the aspiration of most people in the UK and is a cornerstone of the government's housing policy.

When CP 11/31 was published, we observed that the proposals appeared to be more practical than in their original form. Our aim switched to looking at the practicalities of the rules; whether there were any unintended consequences; and what sort of mortgage

market was likely to exist once they had been implemented. We have spent the last three months engaging with our members, the FSA and broader stakeholders to test the rules and determine what the impact will be on the market. We have been especially mindful of the effect of the proposals on innovation in the market and on competition. We are concerned that the regulatory regime should be capable of both evolving in a way that adapts to new circumstances, and implementing new ways of doing business. It would be wholly unfortunate if a failure to future-proof the rules led to a need for the entire regime to be revisited soon after.

In our detailed response, we identify four main areas on which changes and clarification are needed:

- a one-size-fits-all approach to advice;
- supervisory uncertainty;
- help for existing 'trapped' borrowers; and
- interaction with the European Mortgages Directive.²

On the first point (advice), the proposed rules seem to be based on the presumption that advice is face-to-face, whereas in fact it is increasingly being provided over telephone and Internet channels. The CML is also concerned that the definition of advice may be too wide, and needs amendment: the requirement to give advice whenever there is 'spoken or interactive dialogue' would drag into an advice process many borrowers who do not want or need it. The CML suggests that the FSA needs to:

- ensure a consistent approach with the perimeter guidance (which allows dialogue to occur with borrowers without it necessarily being deemed to

be advice), and amend the proposed rules (which do not);

- ensure that the advice proposals capture only those customer contact activities that will be undertaken by approved persons;
- require that, where new money is being lent, borrowers are encouraged to receive advice but can opt for execution-only if they want to; but
- require that customers in the four higher-risk borrowing groups (equity release, sale and rent back, right to buy, and debt consolidation) should not be able to opt out of advice.

If the FSA persists with its current approach, we fear that, by imposing a process that is developed for face-to-face sales onto remote channels, the regulator will hinder those channels that allow for a relatively easy point of access for new entrants into the mortgage market. We are concerned that the FSA's proposals would make it even more challenging for new players, in particular those operating mainly with an Internet platform, to enter the market, and that the—unintended—net effect would be to restrict competition. This seems unlikely to serve the consumer interest.

Foreseeable changes and supervisory uncertainty

One of the most controversial proposals in the FSA's original consultation paper (CP 10/16) was for lenders to factor the impacts of foreseeable changes in the applicant's income and expenditure into the affordability of the mortgage.³ In essence, this would require the lender to determine the likelihood and impact of these events. We asked Oxera to look at the practicalities of this approach and the potential impacts on consumer access.⁴

In the research, Oxera concluded that, to implement this proposal, lenders could use either an individual approach, where they would be required to ask detailed and more intrusive questions of the borrower, or a statistical model that would calculate the likelihood of life events happening based on the borrower's circumstances.

As both options require supposition from the lender (either statistically based or on an individual basis), the proposal would inevitably result in borrowers who could afford the mortgage being denied the loan, particularly if lenders take an over-cautious approach.

Looking at the UK Office of Fair Trading's Irresponsible Lending Guidance,⁵ and case studies from the EU, USA and Australia, Oxera's report concluded that the negative impacts of the proposals could be mitigated if the FSA required lenders to take account of foreseeable events alluded to by borrowers in response

to an application requirement for the borrower to disclose any factors that might affect their ability to repay, thereby placing the onus for information disclosure on the borrower.

The FSA accepted this analysis and amended its requirement on foreseeable changes to be based on the disclosure of the borrower. This change reflects a general shift in the paper to deliver a more pragmatic set of rules that should allow lenders a degree of flexibility on how to achieve compliance with the new rules. But this will depend on what supervisory approach is adopted.

All the positive intentions of the FSA to create a regime that allows borrowers access to the funds that they can safely and securely service will be undermined if it appears that supervisors are taking a harsher and more restrictive view that will, in effect, determine lending practices.

In our response we highlight one potential conflict that could have negative consequences. Again, we are concerned about the impact that an explicit requirement to take into account foreseeable changes will have on those with variable or uncertain income. In particular, we believe that the conduct of business regulation will potentially be in conflict with credit risk decision-making processes.

Credit risk decisions are a lender's assessment of the borrower's propensity to repay and are based on both the individual characteristics of the applicant and the socio-economic group to which they belong. Such decisions typically rely on techniques such as credit scoring and assessment of income multiples. A lender will use these to estimate whether a borrower is likely to be able to service a loan (ie, whether the credit risk is acceptable). In the past, these techniques have proved good indicators of borrower behaviour, but credit risk analysis can never proceed on the basis that there is *no* risk, simply that the risk is statistically unlikely to materialise and that a loan therefore makes sense in the particular applicant's circumstances. The lender will know that a relatively small number of borrowers in this cohort will end up in default, but will have no way of identifying in advance who those borrowers will be.

On the other hand, conduct of business rules in the FSA's MMR require the assessment of affordability on an individual basis, including a view of any 'foreseeable changes to income'. The way in which compliance with this provision is assessed will be important in determining the effect of the MMR proposals on the mortgage market. Take, for example, a prospective borrower on a fixed-term employment contract and with an impeccable credit history: can a lender offer such

a borrower a loan when it is clear that 'there will be a foreseeable change to income' by the time the fixed-term contract comes to an end?

The change to income is foreseeable, but its exact nature is unknown and this could place a credit risk regime and the conduct of business regime at odds. A lender could decide that the borrower's history made the granting of a loan a sensible commercial judgement (backed by evidence). But, if the borrower does not have their contract renewed or cannot find alternative employment and thus falls into arrears, can the lender be judged to be in breach of the FSA's rules? The same considerations will apply to the self-employed, and where the mortgage term extends into a borrower's retirement.

It is this uncertainty that is likely to result in lenders taking a risk-averse approach to borrowers with uncertain or variable income. This could have a significant structural effect on the market and make many perfectly creditworthy borrowers less likely to secure funds, with all the personal and economic dislocation that this might entail.

It is important that the FSA makes its policy intentions clear and ensures that monitoring, supervision and enforcement are in line with those policy intentions. Any discrepancy between these will cause real damage in the market and, in the current climate, will cause borrowers to be denied access to mortgage finance by an over-cautious response from lenders.

Conversely, if lenders can have greater certainty regarding the FSA's approach to supervision of the responsible lending proposals, lending to those groups where income is less predictable would be facilitated.

Help for existing 'trapped' borrowers

The FSA rightly identifies that, as a consequence of regulatory change, certain existing borrowers will not be able to transact, for example because they would not pass the proposed affordability test. As this is not the borrowers' fault, the FSA has drafted some rules intended to enable lenders to help the borrowers.

The rules as drafted in CP 11/31 are complex and cumbersome and are unlikely to be used by many lenders. The industry has developed a proposal for alternative arrangements, based on the exceptions processes used by many lenders. These lenders have processes in place that allow them to consider the merits of applications from borrowers who do not meet the conditions of their lending policy and to determine if they are prepared to lend. This approach could usefully be reflected in the regulatory regime and would make it easier for existing borrowers to find support.

We recognise that these borrowers have limited choices and may be vulnerable, and agree that fairness should be at the heart of this process. Our proposals have been drafted with this in mind.

Implementation and the European Mortgages Directive

Overall, the nature and scale of the changes proposed in the MMR cannot be underestimated. The FSA has stated that it intends to allow firms at least 12 months to implement the changes once the final policy has been published. Given the size of the task facing lenders—not only in implementing the MMR, but also in broader regulatory changes—we recommend that the FSA gives firms at least 18 months to plan, build and implement the bulk of the system changes.

Implementation of the MMR must also be dependent on the outcome of the European Mortgages Directive.⁶ This Directive is currently progressing through the legislative process and, while the final detail remains uncertain, it will cover many of the same issues as the MMR (such as disclosure, advice and responsible lending). As far as is possible, the FSA must ensure that the MMR and Directive do not contradict one another, even in small particulars, so that UK firms are not required to implement changes twice over a very short period of time.

Will the FSA's proposals work?

Coming back to the fundamental question asked at the start of this article, will the FSA's proposals have their desired effect of creating a market that works better for consumers and is sustainable for all participants? In our view, there are some crucial changes required in order to be able to say 'yes'.

For example, experienced homeowners with a track record of responsible mortgage borrowing, who prefer to make their own decisions and apply for a mortgage on an 'execution-only' basis, are clearly one group who may feel that the intrusion of regulation goes too far under these rules. Imagine a new lender planning to establish a lending presence using telephone or Internet distribution to relatively low-risk customers. Such a lender would be unlikely to see the face-to-face advice requirement as optimal for their business model. Indeed, it might even be sufficiently debilitating to discourage the lender from entering the market.

However, the FSA has shown itself to be a responsive regulator, capable of assessing evidence, listening, and flexing its proposed rules to try to ensure that its policy objectives are met. If it continues to do so, and if its successors in the form of the Financial Conduct Authority and the Prudential Regulation Authority maintain the same flexibility, we think that there is a

good chance that the regulatory framework can help to safeguard a sustainable mortgage market for the future. But these are big 'ifs' and, even if they are fulfilled, there are always risks of loopholes, exploitations and emerging practices on which regulators find themselves playing catch-up (while

potentially over-engineering solutions to yesterday's problems). Perhaps we need to be just as mindful about what regulation *cannot* deliver, as about what it can.

Paul Smee

¹ Financial Services Authority (2011), 'Mortgage Market Review: Proposed Package of Reforms', Consultation Paper CP 11/31, December; and Financial Services Authority (2011), 'Mortgage Market Review Data Pack', Supplement to CP11/31, December.

² European Commission (2011), 'Proposal for a Directive of the European Parliament and of the Council on Credit Agreements relating to Residential Property', COM(2011) 142 final, March.

³ Financial Services Authority (2010), 'Mortgage Market Review: Responsible Lending', Consultation Paper 10/16, July.

⁴ Oxera (2010), 'An Assessment of the FSA's Proposed Rules for Mortgages', report prepared for the Council of Mortgage Lenders, November.

⁵ Office of Fair Trading (2010), 'Irresponsible Lending – OFT Guidance for Creditors', March, updated February 2011.

⁶ European Commission (2011), op. cit.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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