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Agenda

Advancing economics in business

Forecasting the future or crystal ball gazing? Assessing mortgage applications

The financial crisis has led regulators and policy-makers around the world to review the regulations surrounding mortgage lending. In the UK, it has also led to a more fundamental appraisal of the regulatory philosophy followed since the creation of the Financial Services Authority (FSA); namely, that intervention in financial markets should be principles- and risk-based. What are the limits of the FSA's 'responsible lending proposals' and its new approach to financial regulation?

During the recent financial crisis, evidence emerged that, for some borrowers in the USA, and to a lesser extent in the UK, the cost of loan repayments was such a high proportion of their current income that they were left vulnerable to adverse shocks, such as interest rate increases. This meant that they would no longer be able to afford repayments and were therefore more likely to default on the loan. As a result, regulators are now attempting to ensure that mortgages offered to borrowers today will be affordable in the future—ideally throughout the lifetime of the mortgage. This has led to a renewed focus on the concept of affordability.

Mortgage market reforms being proposed in the UK represent a change in the regulatory philosophy of the Financial Services Authority (FSA). Until recently, the key themes underpinning UK financial regulation were that it should be principles- and risk-based, and that an element of responsibility for decision-making should lie with the consumer.[1] A principles-based approach meant moving away from dictating how firms should operate, with detailed, prescriptive rules and supervisory actions, to placing considerable emphasis on encouraging firms to develop their own systems and procedures, supported by regulatory guidance, that would achieve the FSA's desired outcomes. Intervention was justified only where there was evidence of either market failure or the emergence of risks giving rise to undesired outcomes. Although these underlying themes remain, the proposals to reform mortgage lending do seem to represent a change in the FSA's approach to intervention: they are based more on rules than principles, with a move away from a risk-based approach and a shift in responsibilities from consumers to firms. Indeed, the FSA itself recognises a change in its approach when it states that it is:

> prepared to take a much more robust and interventionist approach to regulating firms and markets[2]

Some elements of the proposed rules on affordability assessment are clear examples of this new approach to financial regulation. This article examines how affordability is viewed in the UK and highlights some issues that may emerge through the FSA's efforts to ensure that any mortgage offered is affordable.

The FSA proposal

Under the FSA's 'responsible lending proposals',[3] lenders will be required to assess the affordability of all new mortgage applications by looking at the applicant's expenditure, calculating free disposable income, and testing for the ability to withstand future interest rate increases.

In practice, lenders have been undertaking affordability assessments for some time. An Oxera study in 2006 indicated that the number of lenders with an affordability model in place had increased from 9% in 2003 to 48% in 2005.[4] This trend appears to have continued; a more recent Oxera survey indicates that 88% of lenders have an affordability model or methodology in place.[5]

This article is based on Oxera (2010), 'An Assessment of the FSA's Proposed Rules for Mortgages', report prepared for the Council of Mortgage Lenders, November, available at www.oxera.com. The CML study complements Oxera's analysis undertaken as part of its impact assessment for the FSA, which was based on an earlier version of the FSA proposals as described in FSA Discussion Paper 09/03: Oxera (2010), 'Assessment of Compliance Costs and Indirect Costs as a Result of the MMR Lending Reforms', prepared for the Financial Services Authority, July 7th.

Lenders typically use data from public sources such as the Office of National Statistics to estimate mortgage applicants' expenditure, and allow for some discretionary spending. The sophistication of these models varies, however, with some lenders taking into account a range of factors (eg, number of children, age and other socio-demographic information), and some varying the amount of discretionary spending built into the model (eg, depending on the applicant's level of default risk). There is also evidence that most lenders' affordability models allow for some interest rate stress-testing (where the borrower's ability to repay the loan is assessed on the basis of higher interest rates than at present).[6]

What is new is that the rules proposed by the FSA require a more forward-looking assessment of a customer's ability to repay a mortgage. Lenders will be required to:

> take into account any *known or foreseeable future* changes to income or expenditure, including (but not limited to) the effects of retirement on the income of the customer, where the terms of the regulated mortgage contract or home purchase plan will extend into the customer's retirement [emphasis added][7]

In addition, the loan should be affordable 'at any time during the term of the regulated mortgage contract'. What precisely does this mean in practice? Is it actually possible to identify all potential changes in income and expenditure over the entire length of a mortgage?

A statistical approach?

Over the typical mortgage term, an individual borrower is likely to experience many (idiosyncratic) events and lifestyle changes (such as redundancy, marriage, divorce, retirement or the birth of a child), which may affect their income or expenditure, and in turn will have an impact on how 'affordable' the loan is at any one point in time. That said, the actual incidence of any event(s) as they apply to individuals will, in most cases, not reflect the average probability of these events for all borrowers. For example, over the following five years of the mortgage term, the borrower may have another child or may not—it cannot have the average of, say, 0.7 of a child.

In theory, the likelihood of known or foreseeable events could be assessed statistically. All new borrowers could be categorised according to certain characteristics (eg, age, marital status, health, location and nature of employment). Their likelihood of experiencing lifestyle-changing events (eg, divorce, redundancy or serious illness) would be determined according to the actual occurrence of these events among a pool of borrowers with the same characteristics at the time they had taken out loans.

Two problems immediately emerge, however. First, even if probabilities can be assigned to lifestyle-changing events for the individual borrower, this alone does not give an indication of the size of the loan that could be affordable. The probability of the event would need to be converted into a likely income or expenditure effect. This would then have to be applied to a borrower's own current income or expenditure, ideally making allowances for potential increases in earned income over the mortgage period. In such cases the loan could then be reduced by applying a scaling factor between the amount requested and that offered, depending on the likely impact of the event on the borrower's free disposable income. Determining the size of the scaling factor to be applied in each case would represent a major challenge to a lender.

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

The second problem is that this approach tells the lender very little about the behaviour of an individual borrower when faced with a lifestyle-changing event. This would require the historical data to show not only the proportion of borrowers who experienced the event, but also how they responded to it in terms of changes to their income and expenditure. It might be that those who go into arrears as a result of an event are not good at financial management. With better financial management, they might be able to cope more effectively by changing their discretionary expenditure. Borrowers who have problems with the affordability of a mortgage are often those who have not shown the ability to cope with debt repayments in the past. On the other hand, borrowers who have been able to cope with lifestyle changes in the past while still maintaining payments on existing credit commitments are more likely to be aware of the need to change behaviour to cope with the impact of future events on income or expenditure.

In this context it can be noted that a borrower's attitude and the way they respond to certain life events are already captured by the credit score used by lenders to assess the riskiness of mortgage applicants.

Financial exclusion?

One effect of the new rules is that responsibility for ensuring that the mortgage is affordable has very clearly been passed to the lender. However, this creates its own issues. In the event of default on a mortgage, it will be up to the lender to prove that all foreseeable events had been appropriately accounted for at the time of the original decision to grant the loan, even if their probability had been relatively low in the initial assessment. If it is not possible to prove that this was the case, a borrower might be able to claim they had been mis-sold the mortgage contract.

In such a situation, it is important how the FSA and/or the Financial Ombudsman interpret the requirements relating to events that, with a particular probability, may affect income and expenditure. If all loans have to be safeguarded at an individual level against such events, *all* loans would need to be scaled down by the full amount required to pass an affordability test. This amount should be sufficient to ensure that, when the event occurs for a particular borrower, the lender is not vulnerable to the charge that they did not take a particular 'foreseeable' (ie, probabilistically predictable) event into account. To protect themselves against such a charge, lenders are likely to err on the side of caution and scale back *all* loans (which might prevent a purchase being made), or reject an individual's mortgage application outright. Borrowers who would be able to meet their financial obligations would therefore be excluded from the market.

Consumer responsibility or lie detector?

A key part of the affordability check is ensuring that the gross income stated by the borrower is accurate, and the new proposals do place greater responsibility on the borrower for providing such information, along with evidence to back it up. At the same time, the lender is required to ensure that it has systems in place to verify that the evidence provided is not fraudulent. (For example, it is relatively easy nowadays to forge a payslip with the use of certain websites.) This raises the question of what evidence will be acceptable to a lender when it could be faced with possible sanctions from a regulator if, at some later date, the application is found to be fraudulent.

While the ultimate responsibility for the decision to grant a loan must necessarily lie with the lender, the potential borrower should arguably bear some responsibility for providing sufficient accurate information to enable the lender to assess affordability. If lenders cannot rely on the assumption that potential borrowers are providing accurate information about themselves and the information provided turns out to be fraudulent, for example, a lender could still be required to provide compensation to a borrower on the basis that the loan was unsuitable when assessed against the borrower's actual income, even though the mortgage would have been affordable on the basis of the claimed income. Under this interpretation of the proposed rules, there would be an additional risk to the lender.

No crystal ball gazing

There is no doubt that, prior to the financial crisis, some mortgage lenders were taking a less-than-rigorous approach to the assessment of affordability. Many of those firms have since exited the market, but the FSA's desire to ensure that lenders pay more attention to affordability when granting a loan has not abated. There is still a concern that the risk of mortgage default is not properly being accounted for.

At first sight, asking lenders to conduct a forward-looking assessment of affordability may seem to make sense: what would be the point of knowing that a mortgage is affordable on the basis of current income and expenditure if it might become unaffordable later on? However, requiring lenders to take into account future changes to income and expenditure is impractical. The reality is that, although the degree of risk can be managed and kept within limits, lending will always remains an inherently risky business. It is not possible to eliminate the risk by requiring lenders to be able to foresee all possible events.

Regulators in other countries have also recently amended their standards for mortgage lenders. In addition, the UK Office of Fair Trading (OFT) has published its own guidance on responsible lending in relation to unsecured loan contracts. In the USA and Australia there have been moves to tighten the requirements for affordability assessments. However, this is a very recent development and there is not yet any indication of how market participants will interpret or react to the changes. Furthermore, the authorities in these countries have yet to issue any guidance on how they expect the rules to be interpreted. As far as Oxera is aware, the OFT is the only regulatory authority that has so far provided clarification on how to take into account foreseeable events.

In an earlier draft of its guidance on responsible lending, the OFT referred to the need for lenders to take account of 'reasonably foreseeable' events when assessing affordability. In responding to the feedback on the earlier draft, the OFT provided clarification, noting that it would regard as reasonably foreseeable:

> a future event that may impact on the borrower's ability to make payments on a credit agreement in a sustainable manner which the borrower *knows* will occur and of which the creditor is, or should be, *aware*. [emphasis added][8]

The OFT also made it clear that it would not require lenders to engage in 'crystal ball gazing and/or speculation'. For example, the possibility of being made redundant, when it was not 'known' at the time of the affordability assessment, would, according to the OFT, *not* be a matter that creditors could be reasonably expected to take into account.

The OFT makes it clear that any future changes to income or expenditure that should be taken into account can be based only on what is known at the time of assessment. The onus is on the lender to ask appropriate questions to determine whether the borrower knows of any circumstances that might affect their future ability to repay the loan. In revising its guidance, the OFT has adopted a narrower, but arguably more realistic and practical, interpretation of 'reasonably foreseeable'.

The consultation period on the FSA proposals closed on November 16th. The FSA aims to publish a Policy Statement with its finalised rules in Q1 2011. The FSA has also just published a separate consultation paper on distribution and disclosure issues in the mortgages sector.[9] The consultation period for this set of proposals closes on February 25th 2011.

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[1] Financial Services Authority (2007), 'Principles-based Regulation—Focusing On The Outcomes That Matter', April.
[2] Financial Services Authority (2010), 'Mortgage Market Review: Responsible Lending', Consultation Paper 10/16, p. 6, July.
[3] Financial Services Authority (2010), 'Mortgage Market Review: Responsible Lending', Consultation Paper 10/16, July.
[4] Council of Mortgage Lenders (2006), 'UK Mortgage Underwriting', report prepared by Oxera, April.
[5] Oxera (2010), 'Assessment of Compliance Costs and Indirect Costs as a Result of the MMR Lending Reforms', prepared for the Financial Services Authority, July.
[6] The 2006 Oxera study for the Council of Mortgage Lenders indicated that 74% of lenders undertook some form of stress testing.
[7] Financial Services Authority (2010), 'Mortgage Market Review: Responsible Lending', CP 10/16, Affordable Borrowing and Home Financing Draft Instrument, Guidance 11.3.12, July.
[8] Office of Fair Trading (2010), 'Summary of Responses to the Consultation on Irresponsible Lending—OFT Guidance for Creditors', OFT1107resp, August, p. 42. In addition, the UK Office of Fair Trading (OFT) has published its own guidance on responsible lending in relation to unsecured loan contracts: Office of Fair Trading (2010), 'Irresponsible Lending—OFT Guidance for Creditors', updated version, August.
[9] Financial Services Authority (2010), 'Mortgage Market Review: Distribution & Disclosure', Consultation Paper 10/28, November.

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

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