FSA Mortgage Market Review: The Final Score

Policy Statement 12/16 and its implications

Summary

In October 2012, the Financial Services Authority (FSA) published its final rules to reform mortgage market regulation. This follows earlier consultations and feedback statements through 2009-2011. Key features of the new rules confirmed last month include:

- **Advised versus execution-only:** an advised sale will be defined as any sale that stems from any sort of consumer-seller interaction, in which case the seller will have to assess suitability. Execution-only will only be possible in limited situations, such as if there is no interaction, if the customer is high net worth, or in some situations if the customer does not wish to take the advice. The non-advised regime has been effectively scrapped.
- **Professional standards**: all those selling mortgages, supervising call centre staff that do this, or designing scripted questions for non-advised sales, will need to hold a mortgage qualification at QCF Level 3 Certificate. Those who sell or oversee the sale of mortgages will also be brought into the Approved Persons regime, however implementation has been delayed until after the formation of the new Financial Conduct Authority.
- **Vulnerable customers**: the rules will be stricter for vulnerable applicants to protect them from unknowingly making unsustainable commitments. These will have to receive advice, and (in sale & rent-back situations) will have to take it.
- **Affordability assessment**: overall approach: mortgages could only be sold to customers who can afford them. Self-certification mortgages will be banned and income will have to be verified in every mortgage application. In assessing affordability, lenders will have to stress-test interest rate changes and consider major outgoings such as heating and council tax.
- **Interest-only mortgages:** would still be allowed but lenders will have to be stricter about assessing repayment vehicles. Relying on rising property values will be severely restricted.
- There will be a transition process and existing borrowers will be unaffected, and there will be flexibility to provide new mortgages to existing customers even if they fail the new affordability requirements.

Next Steps

- **Rules enter force:** final rules which will enter force on **26 April 2014**, subject to transitional arrangements. The rules will apply to new mortgages sold from this date, as well as existing mortgages varied from this date.
- **Qualifications requirements:** those mortgage sellers not at QCF Level 3 will have until **26 October 2016** to attain this qualification level. New joiners joining at any time after the rules come into force will also have until that date.
- **Approved persons regime**: the FSA announced that bringing mortgage sellers into this regime will not occur until after the Financial Conduct Authority is formed (in April 2013). The FCA will then introduce these changes “as soon as practically possible”.

Background to the FSA Mortgage Market Review

On 24 October 2012, the FSA published Policy Statement 12/16 setting out final rules reforming the residential mortgage market. This stems from the Mortgage Market Review (MMR), a series of consultations and feedback statements conducted by the regulator through 2009-2011 with the aim to create "a sustainable mortgage market that works better for all participants".[1]

Overall business impact of all the reforms

The reforms cover virtually all aspects mortgage transactions including distribution, responsible lending and affordability, interest-only, prudential reforms and niche markets:

Distribution and disclosure:

- **All mortgage sales involving a consumer-seller interaction would be advised.** Otherwise they are execution-only. The latest paper relaxes slightly the requirement for advice for post-contractual variations.
- **Execution-only barred for certain types of "vulnerable" borrowers.** This includes equity release, sale & rent back, and debt consolidation (but not first-time buyers).
- **Affordability assessment:** the seller (whether it is the lender or the broker) must check that the borrower meets the lender's eligibility criteria.
- **IDD scrapped/KFI used less:** the Initial Disclosure Document will be replaced by a requirement for firms to disclose key messages to the customer. The trigger points for the presentation of the Key Facts Illustration will be changed to reduce customer information overload.

Responsible lending/affordability:

- **Effective ban on self-certification:** lenders must verify income and be able to demonstrate affordability in terms of borrower's income and expenditure.
- **Self employed borrowers:** the regulator believes that income could be verified through evidence of taxable income, which businesses are required by law to provide to HMRC.
- **Mandatory interest rate stress tests:** the lender must also take account of the impact on mortgage payments of market expectations of future interest rate increases.
- Lenders will be allowed to waive some of these affordability requirements for existing borrowers for a transitional period.

Interest-only mortgages:

- Lenders must assess affordability on capital & interest basis. They must obtain evidence of a repayment strategy before signing off interest-only mortgages, and reasonably check that this strategy would work.
- Where the repayment strategy requires the borrower to make regular payments from income, lenders must assess affordability taking the cost of the repayment strategy into account.

Niche markets:

- **Sale & rent-back:** customers regarded as vulnerable (they are facing financial difficulties including repossession) so they cannot opt out of receiving advice, and also cannot opt for execution-only if the advice was not to buy a product.

[1] This policy statement and final rules, plus a comprehensive package of supporting data as well as links to previous MMR papers, have all been published here: http://www.fsa.gov.uk/library/policy/policy/2012/12-16.shtml

- **Equity release:** proposal to create a single equity release market comprised of lifetime mortgages and home reversions as substitutable products. Therefore under disclosure requirements, intermediaries offering just one of these would be classed as "restricted". Equity release customers would not be able to opt-out of receiving advice; but unlike Sale & Rent-Back, they would not be obliged to take it.
- **Home purchase plans:** part of the appropriateness assessment for this type of product should be whether a conventional mortgage should also be considered.
- **Bridging finance:** the lender is not required to assess affordability for these products, but must assess whether the consumer has an appropriate repayment strategy, in line with the interest-only policy. Bridging finance would have maximum 12-month term to prevent gaming.

Prudential reforms:

- Considers the reforms and key policy changes that will implemented under Basel III and concludes that they would not in themselves be an effective mechanism for deterring high-risk lending, hence the need for MMR.
- Non-deposit taking lenders: these institutions have a greater exposure to the higher-risk (non-conforming or sub-prime) market and therefore policies aimed at restricting this will have a greater effect.

Distribution Requirements

The final rules confirm some significant changes to the distribution and disclosure rules, reflecting an evolution in the FSA's thinking even since earlier consultations. There were also some minor changes since the last consultation in November 2011. The reforms centre on the treatment of advice versus execution-only.

Advised, Non-Advised or Execution-Only

- **Advice equals any customer-seller dialogue:** advice is any situation where there is an interactive two-way dialogue between the customer and the seller. This includes face-to-face, telephone or any other two-way interface including email, SMS, internet "live chat", etc. Includes any personalised question & answer.
- **"Non-advised" scrapped:** the regulator believes that it would be far more intuitive for customers to create a simpler "advised" versus "execution-only" choice. Non-interactive purchases such as pure on-line or postal sales would be transacted as "execution-only".
- **Professional and High Net Worth (HNW) can opt out of advice:** professional customers are those who have worked in the financial services sector for at least one year in a professional capacity which requires knowledge of the transactions or services envisaged. HNW is defined as those with a minimum annual net income of £300,000, or minimum net assets of £3m.
- **Post-contractual variations may need advice if more is borrowed:** in most situations can be done on an execution only basis such as changing rates, changing the monthly payments, switching lenders, porting the

Box 1: Post-Contractual Variations: When Advice is Needed

FSA PS12/16, table 2, pp.14-15

Contract variations	Advice or execution-only
Rate switches **This includes product switches and retention deals. Retention deals are usually lender driven, once the borrower comes to the end of their current product. Product switches are usually borrower driven when they will request a new product from their lender. Both have the same effect and are classed as rate switches under the final rules.**	
No increase in the current balance outstanding and the firm presents **all** the products for which the borrower is eligible via a non-interactive channel (e.g. in writing). The borrower selects their product via a non-interactive channel.	Execution-only
No increase in the current balance outstanding and the firm presents **all** the products for which the borrower is eligible via a non-interactive channel, but accepts the borrower's choice of product via an interactive channel.	Execution-only
No increase in the current balance outstanding, but the firm steers the borrower to a particular product or products (interactive or non-interactive).	Advice
The borrower wants to borrow more and is offered a new product.	Advice
Variations to existing contracts, or new replacement contracts intended to have the same effect, via an interactive channel.* *Variations carried out on a non-interactive basis, can be offered on an execution-only basis, including where there is additional borrowing.	
Further advances	
This involves an increase in the current amount outstanding.	Advice
Addition or removal of a party to the contract	
Involving **no** increase in the current amount outstanding.	Execution-only
Involving an increase in the current amount outstanding.	Advice
Change in monthly payment – (including extending term or changing the payment method)	
Involving **no** increase in the current amount outstanding.	Execution-only
Involving an increase in the current amount outstanding.	Advice
Porting – This involves taking the existing mortgage to a new property	
Involving **no** increase in the current amount outstanding.	Execution-only
Involving an increase in the current amount outstanding.	Advice
Consent to let – Allowing the borrower to let their property, which was previously owner-occupied	
Involving **no** increase in the current amount outstanding.	Execution-only
Involving an increase in the current amount outstanding.	Advice

mortgage between properties, and adding/removing a contract party. However increasing the advance or changing the product will require advice (see Box 1).

- **Advice required for certain types of products or consumers:** including equity release, right-to-buy, sale & rent-back, and customers consolidating debt. The view is that these customers are considered vulnerable.
- **Customers retain option to reject advice**: and opt for an execution-only purchase, this would apply to all customers except in sale & rent-back situations.

Professionalism

The rules have not changed much since the consultations in 2010. All staff selling mortgages would be required to hold a "relevant professional qualification" at QCF Level 3 Certificate, and will be brought into the FSA Approved Persons regime.

- Existing people not at QCF Level 3 will have until **26 October 2016** (30 months after the reforms enter force). New joiners joining at any time after the rules come into force will also have until that date.
- The mortgage QCF Level 3 syllabus will be reviewed, and an announcement on when this will begin is expected shortly, then it would be reviewed every 3 years.
- Application of the Approved Persons rules to mortgage sellers has been delayed until after the new Financial Conduct Authority is formed (around April 2013). The FSA has said the implementation will occur "as soon as practically possible" after that date.

CII View

The CII welcomes the publication of the FSA's final position on their proposals for the immediate future of mortgage regulation.

- Importantly there is now clarity for both lenders and broker advisers and the new requirements requiring advice to be given in all cases where new money is advanced and the requirement that lenders undertake a thorough assessment of affordability should ensure that borrowers are less likely to have difficulties meeting their commitments.
- We are also pleased that the FSA has retained its proposal to require advice in most interactive sales, with some sensible exceptions.
- The requirement for all staff selling mortgages to be professionally qualified will lead to greater consumer confidence in the buying process. This is important because those involved in the selling process or making decisions about the sale should be appropriately trained.
- The only thing missing from this is the need for practitioners to behave ethically and to keep their knowledge up-to-date with ongoing continuing professional development. These two elements must be considered.
- However we are concerned that the industry now has only 18 months to create a meaningful professional advisory market for niche products such as sale-and rent-back and right-to-buy. If the public must receive advice in these potentially complex situations, they must be able to turn to an adviser market that is professionally trained and equipped.

European Activities: The Mortgage Credit Directive

The European Commission (EC) has been undertaking its own review of the residential mortgage market across Europe. The total value of residential mortgage debt across the EU has remained at around €6trn (£4.8trn) since peaking in 2007, while gross mortgage lending across the EU remained high in 2011 at just under €750bn (£600bn).[2]

[2] FSA figures, see Mortgage Credit Directive: Key Considerations, FSA website (accessed Nov 2012).

The scale and complexity of the UK mortgage market means that any EU intervention could impact disproportionately on the UK, compared to other EU member states. For example, the UK and Germany have between them 45% of the €27trn (£21trn) of total outstanding residential loans in the EU. The UK market represents over one-fifth of the total value of EU residential mortgage debt.

In March 2011, published a legislative proposal for a Directive on Credit Agreements Related to Residential Property (commonly known as the "Mortgage Credit Directive").[3] Following debate in the European Parliament and Council of Ministers, both those groups have produced sets of amendments (in June and May 2012 respectively). The two bodies along with the EC are now in the process of a three-way discussion known as trilogue to reach a consensus.[4]

The trilogue will aim to arrive at a Directive which needs to be adopted by the two bodies. The current indicative date for the European Parliament's plenary session on the proposed Directive is 14-17 January 2013.

Convergence/Compatibility	Divergence
• **General approach:** the proposed Directive generally adopts a higher-level approach than the MMR and is not intended to be a substitute for national policy makers developing the appropriate detailed framework. • **National market compatibility:** Member State markets remain very different in their character. • **Responsible lending:** the aims align closely with the MMR objectives. • **Affordability assessment:** there is considerable consistency in the preferred approach, both the FSA and EC seem to be after a robust assessment of the affordability of any new lending.	• **Scope:** the EC focus on secured residential lending, whereas the FSA prefer to go wider with all mass-market consumer borrowing towards residential property, including buy-to-let, bridging finance, credit union lending. • **Disclosure:** the EC and FSA seem to be in a different place regarding pre-contractual disclosure. Having learned the lessons from the existing regime since 2005 that relied to heavily on written disclosure, the FSA have re-aligned its approach; whereas the EC is opting for a much more detailed KFI-type European Standardised Information Sheet.

The Council and Parliament amendments include removing most of the delegated acts, narrowing the scope of the proposal to focus more mainstream forms of lending, taking a more high-level approach to the assessment of creditworthiness, and specifically recognising the role of appointed representatives. These amendments have met stiff and coordinated opposition from the industry and other stakeholders, and the UK mortgage-related trade associations put together a joint statement in July 2012.[5]

Market Reactions

The mortgage industry seems to support the FSA for listening to their concerns and creating a more balanced set of proposals. Obviously there will be mixed opinions on the details, especially the advised/execution-only distinctions.

Council of Mortgage Lenders (Paul Smee):

- Welcomes the certainty that the FSA's publication of the final rules under the Mortgage Market Review today brings to the market.

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[3] European Commission, Proposal for a Directive of the European Parliament and of the Council on Credit Agreements Relating to Residential Property, COM(2011)142, 31 Mar 2011.

[4] See European Work on Mortgages, FSA website (accessed Nov 2012). See also European Parliament, Credit Agreements on Residential Property Trilogue Text Comparative Table, document version 25 June 2012.

[5] British Bankers Association, Council of Mortgage Lenders, Building Societies Association, Finance & Leasing Association, Confederation of British Industry, and Intermediary Mortgage Lenders Association, Briefing for Trilogue on the Directive on Credit Agreements Relating to Residential Property, 2 July 2012.

- Rules represent a widely anticipated focus on affordability for the borrower, and verification on the part of the lender, to ensure that lending is responsible. Supports this process, and hopes that the rules will be underpinned by sensitive supervision to help the industry meet them in practice
- In practical terms, the regulatory changes have already been widely anticipated and so are unlikely to create any significant additional or unexpected impacts.
- Looks forward to working towards implementation and hopes the regulator will focus just as much on helping lenders and brokers to meet regulatory expectations as on enforcement action if rules are broken.

Association of Mortgage Intermediaries (Robert Sinclair):

- Is concerned about the relaxed requirements on contract variations, believing they still allow lenders to potentially influence a customer's decision by presenting the range of products available and allowing the customer to choose.
- Allowing a consumer to just tick a box without fully understanding the consequences is a weakness in the proposals.

Building Societies Association (Paul Broadhead):

- It is common sense that a mortgage should be repayable from income, rather than rely on increasing property prices and this is the approach that building societies and other mutual lenders already take.
- Welcomes confirmation now that they accept that interest-only can be the right product for some people. The key will be that the borrower has a sensible repayment strategy in place.

Implementation Table

Activity	Date
Q1 2013	FSA publishes findings of analysis of existing interest-only borrowers to assess how many customers are unable to repay the capital and understand lenders' action to address this issue
14-17 Jan 2013	Indicative date in European Parliament plenary session to debate and adopt the Mortgage Credit Directive trilogue text
Q1 2013	Mortgage Credit Directive scheduled to be adopted by the European Parliament and Council of Ministers
April 2013	Financial Conduct Authority and Prudential Regulatory Authority due to come into being
after May 2013?	FSA Approved Persons regimes to apply to those selling mortgages
26 April 2014	FSA Mortgage Market Review final rules to come into force. With the exception of MCOB rule 11.8.1E which came into effect shortly after the PS12/16 was published on 26 Oct 2012)
Q1 2015	Mortgage Credit Directive enters force in member states including the UK
26 Oct 2016	Deadline for those selling or overseeing the sale of mortgages (and those designing scripted questions) to have attained the mortgage qualification at QCF Level 3.
Before 26 Apr 2019	FSA to carry out a formal review of the impact of the MMR rules within five years of their implementation.

To see the full FSA Policy Statement and final rules, see: www.fsa.gov.uk/library/policy/policy/2012/12-16.shtml

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