Our ref: ICAEW Rep 46/12

Lynda Blackwell
Conduct Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

cp11_31@fsa.gov.uk

Dear Lynda

CP11/31 *Mortgage Market Review: Proposed package of reforms*

ICAEW is pleased to respond to your request for comments on CP11/31 *Mortgage Market Review: Proposed package of reforms.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

John Gaskell
Manager, Financial Planning & Advice,
Financial Services Faculty

T +44 (0)20 7920 8693
E john.gaskell@icaew.com

ICAEW REP 46/12

ICAEW REPRESENTATION

CP11/31 Mortgage Market Review: Proposed package of reforms

Memorandum of comment submitted in March 2012 by ICAEW, in response to Financial Services Authority consultation paper 11/31 Mortgage Market Review: Proposed package of reforms published in December 2011.

Contents	**Paragraph**

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on consultation paper CP11/31 *Mortgage Market Review: Proposed package of reforms*, published by the Financial Services Authority (FSA) in December 2011, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services and provides a monthly newsletter FS Focus.

GENERAL COMMENTS

5. ICAEW supports the broad thrust of the consultation. We believe the proposals are generally consistent with achieving the public policy goal of creating a regulatory framework that will serve to help create a more sustainable mortgage market that works better for consumers throughout the economic cycle, whilst helping to address the significant tail of poor mortgage lending.

6. The consultation recognises that the mortgage market is not homogeneous and for the majority of consumers the market has worked well, that consumers should have freedom of choice, and not every consumer needs advice. The regulatory review therefore needs to focus on finding more effective ways to address the tail of poor mortgage lending without restricting the supply of responsible lending, limiting choice or raising costs to end consumers. A fine balance will therefore will be required to ensure additional regulatory intervention is effective in addressing the tail of poor lending, but without impeding the mortgage market in serving the disparate needs of consumers during a particularly difficult period.

7. The conceptual framework of responsible lenders interacting with better informed, responsible borrowers within an efficient mortgage market provides a sound conceptual starting point. Given the diverse needs of consumers in this sector, and the complexities this brings to the marketplace, we welcome the principles based orientation of the proposals. An overly prescriptive approach to the regulation of this market would not be in the long term interests of consumers and would not serve to improve the sustainability of an efficient mortgage market during the economic cycle.

8. In respect of the mainstream mortgage market, we believe the thrust of these regulatory proposals should help resolve many of the elements of poor practice which tended to fuel the tail of poor mortgage lending. However, to serve the needs of specific segments of the mortgage market we believe that in certain respects a less prescriptive regulatory approach than outlined in the consultation paper is required to allow the mortgage market to provide access to affordable mortgage finance during a particularly difficult period. For example, interest-only mortgages play an important role in context of meeting the needs of a particular segment of consumers and the implementation of the regulatory proposals in their current format would be likely to impede the efficient operation of this part of the mortgage market. Execution-only mortgage sales also fulfil a useful purpose. Although the financial capability of the population as a whole is relatively poor, many mainstream customers are able to make informed decisions. A significant number of consumers therefore derive valuable benefits from having access to a low-cost execution-only distribution channel.

9. Appropriate professional standards provide an efficient mechanism for protecting consumers' best interests in the longer term. We believe more emphasis should be given to raising professional standards in the mortgage market, which should be pitched at the same level as the standards required of retail investment advisers under the Retail Distribution Review (RDR).

10. Overall, while we support the thrust of the proposals, it will be important to ensure that the final rules stress the underlying principles being advanced, and lean against any incentive for lenders to adopt an overly rigid approach to interpreting those rules, which could unduly restrict the supply of mortgage finance at a challenging time. It should also be borne in mind that a market as large as that for mortgages is unlikely to be susceptible to a 'one size fits all' approach. More specialised mortgage business (for example, interest-only and for buy-to-let or other business purposes) should not be inappropriately impeded.

SPECIFIC COMMENTS

Affordability assessments (Q2, Q3, Q4, Q23)

11. We support the general approach adopted in this consultation in connection with the affordability assessment and strongly support the premise that responsibility for affordability should rest with the lender.

12. ICAEW support the general principle that in the mainstream mortgage market affordability should be based on the ability to fund the cost of both interest and capital repayment over the term of the mortgage, although there are valid exceptions to this approach. Affordability criteria that are based on net income less basic committed expenditure with an allowance for quality of living, without relying on house price inflation as a repayment vehicle, seems a sensible starting point. We favour the principles based approach towards affordability as this means that lenders will have the latitude to assess each case on its individual merits. However, care will be required to avoid lenders adopting an overly prescriptive interpretation of the proposals outlined this consultation, which would not be in the best long term interests of consumers.

13. We note that the consultation recognises that affordability assessments primarily should be based on the circumstances of the applicant at the time of the mortgage application, as opposed to trying to factor in subjective projections as regards what may, or may not, happen to personal circumstances at some point in the future. The policy proposals are underpinned by detailed research into the performance of the domestic mortgage market over a considerable period of time. This research tends to supports the argument that it would be inappropriate to apply an overly prescriptive regulatory approach to formulating responsible lending, which should be based on commercial risk-based criteria within a framework of responsible lending criteria.

14. Sustainable, responsible mortgage lending needs to take into account the impact on mortgage payments of market expectations for future increases in interest rates. Subject to the caveat of the proposed minimum assumption of a 1% increase in rates over a five year period, the basis for interest rate stress testing as outlined in the consultation paper seems to represent a generally sensible starting point.

Income proposals including income verification (paras 3.126 - 3.136)

15. We note that the proposal appears to have addressed the concerns we expressed in our response to CP 10/16. We support the proposal that it is fundamentally the lenders' responsibility to assess affordability, and to obtain reliable evidence to confirm that the income stated on the mortgage application form is based on fact regardless of whether verification has been outsourced to an intermediary or not.

16. ICAEW and other professionally qualified accountants, whose opinion can be relied on, have a major role to play in income verification in that they are able to confirm a client's income as returned to HMRC. We agree that self-certification by the applicant or a third party declaration of affordability in the future should not be acceptable as evidence and that the overall affordability assessment of a loan should rest with the lender. We also welcome confirmation in para 3.131 that the lender may not accept a third party declaration of affordability (such as from an accountant)' and that therefore the accountant's role is restricted to providing purely factual details of income for the lender to use in its appraisal of whether the applicant can afford the mortgage or not.

17. All that said, we agree with the view of FSA in 3.117 that the ultimate responsibility for declaring income rests with the consumer applying for the loan.

18. In respect of assessing future income, we have advised our ICAEW members that no work would be sufficient to reach an opinion or to report on whether their client will have sufficient income in the future to service a proposed borrowing in our existing guidance. (Audit 2/01 *Requests for references on clients' financial status and their ability to service loans*)

Interest-only mortgages (Q21, Q22, Q25, Q27, Q89)

19. Although caution is required in respect of interest-only mortgage lending, we do not believe an overly restrictive approach in this area is in the best interest of all consumer segments. Interest-only mortgages, in appropriate circumstances, serve a very useful purpose. For example, when loan-to-value is at a relatively modest level, particularly in connection with mortgages involving older borrowers, it may not necessarily be inappropriate for the original mortgage debt to be repaid from the proceeds of downsizing, or on death.

20. In the area of business finance, interest-only mortgages also have an important role to play. Given the considerable store of value held in residential property, interest-only mortgages represent a vitally important source of accessible, affordable capital for small business owners and entrepreneurs. Repaying mortgage debt from the sale of a business or proceeds generated from operating a small business should be regarded as a potentially viable repayment strategy. Additionally, subject to sensible loan-to-value criteria, interest-only mortgages are necessary to support the buy-to-let market where affordability assessments and repayment basis are very different to the mainstream mortgage market. Considerable care will be required in the application of the Mortgage Market Review to avoid precipitating a sharp contraction in the availability of viable mortgage finance to this important sector of the housing market. Regulatory policy therefore needs to be framed to encourage lenders to serve the particular needs of all segments of the mortgage market on a responsible basis. An overly restrictive regulatory approach in respect of interest-only mortgages and/ or a narrow interpretation of responsible lending criteria by lenders in connection with this type of mortgage lending would have a detrimental effect on consumers and the broader economy.

Professional standards (Q30, Q31, Q32, Q33 Q35, Q54)

21. We support the proposal that ultimate responsibility for assessing affordability should rest with lenders but that regulated mortgage intermediaries should have a general obligation to ensure that borrowers meet the lender's criteria in respect of a particular mortgage. These obligations should equally extend to the sales staff of the lender.

22. As regards raising professional standards in mortgage advice more generally, similar standards should be expected from this sector of the financial services industry as will be required of retail investment advisers under the Retail Distribution Review (RDR), to include adherence to a code of ethics. We are led to believe that existing mortgage qualifications have not been substantially reviewed since on or around 2004, which seems a long time ago.

23. We note your comments in connection to the ambiguity or confusion that may exist in consumers' minds as regards whether they have or have not received an element of advice, and that internet distribution probably adds an additional layer of complexity. In general terms, the concept of interactive and non-interactive distribution may help to resolve some of these issues, but we believe that more work is required in this area before any firmer conclusions can be drawn.

24. We note your concerns over the potential risks posed by the relatively high proportion of execution-only mortgage sales and recognise the difficulty posed by striking the right balance between consumer responsibility and regulatory protection. On balance, however, we do not believe it would be in the best long term interest of consumers to impose regulations that serve to prevent consumers accessing non-advised mainstream mortgage products, provided that lenders are able satisfy themselves that individual borrowers meet responsible lending criteria. As broadly outlined in the consultation, however, certain areas of the mortgage market require different treatment from the mainstream mortgage market, (equity release, home income plans, and mortgages which consolidate debts), where greater regulatory interventions and consumer protection is required.

Arrears management (Q46)

25. We believe the key proposals as generally outlined in the consultation seem sensible in relation to affording greater consistency of charges and forbearance rules, and treatment of customers that have concessionary interest rates.

Basel III and non-deposit taking lenders (Q47, Q48, Q49, Q50, Q51)

26. The consultation paper argues that although the strengthening of prudential standards stemming from the Basel III agreement may reduce the tail of poor mortgage lending practices to some degree, it will not in itself have a sufficient impact on the identified conduct-of-business shortcomings. ICAEW agrees with that assessment.

27. We concur with the FSA's view that the primary objectives of Basel III concern prudential soundness and financial stability. The economic principles of instrument-assignment would suggest that, in general, at least one additional instrument would be needed to tackle a largely separate issue, namely business conduct standards. More specifically, as the paper notes, it is perfectly possible to conceive of mortgage lending practices which are reasonably sound from a prudential perspective (and so may not attract undue capital charges under Basel III) but which nonetheless are likely to lead to poor consumer outcomes. Excessive reliance on the collateral provided by the house mortgaged, as opposed to capacity to service the loan, is the prime example of this.

28. It follows from this analysis that a robust conduct of business regime for mortgage lending is required. Such a regime may in fact support prudential objectives, to the extent that it reduces risks to lenders' reputation and the likelihood of compensation payments for poor business conduct being required.

29. We agree that there is a case for strengthening the prudential regime applied to non-deposit taking lenders. While at their present scale of operation such lenders are unlikely to be of systemic significance, it remains the case that their rapid entry and exit can induce an undesirable volatility in mortgage credit supply and associated detriment to consumers.

30. We are not convinced that the proposals would make much difference to macro-prudential conditions. In order to affect such conditions, regulatory requirements would probably need to be adjusted so as to ‘lean against the cycle’. As the paper notes, that is something that the Financial Policy Committee may introduce in time, but it is outside the scope of the present consultation.

31. Turning to the micro-prudential proposals, there are a number of features which ICAEW supports. Use of the standardised credit risk requirement (rather than the sophisticated, models-based IRB) is a proportionate response, bearing in mind the impact not only on the costs of regulated firms but also of the regulator itself (which are passed on to firms, and indirectly the consumer). We also agree that the different approaches to funding and liquidity management employed by non-bank lenders points to use of well-defined qualitative requirements and not specific quantitative limits.

32. The decision effectively to ‘grandfather’ current capital requirements for existing mortgage lending may be appropriate in view of the difficulty for financial firms in raising new capital at present, as well as the desirability of not unduly impeding competition from non-bank lenders. However, that said, it is of course the case that in the early years of the new regime such grandfathering will substantially reduce the level of capital supporting the extant stock of non-bank mortgage lending.

33. There are three aspects of the proposals where we would advise the FSA to reflect further, which concern the definition of capital; the treatment of ‘other assets’; and the approach to securitisation.

34. We are not convinced that a requirement that at least 20% of eligible capital be share capital and reserves less intangible assets is sufficiently stringent. It is less demanding than the Basel III approach to banks. We acknowledge the arguments that non-bank lenders do not have retail depositors, and that they are unlikely to have the systemic implications of banks. However, this proposal would allow continued heavy reliance on ‘gone’ concern’ forms of capital (subordinated debt), which would seem to run counter to the stated objective of reducing the likelihood of rapid exits of non-bank lenders from the mortgage market in times of stress.

35. The 1% capital requirement for ‘other assets’ is clearly a lower risk weight than delivered by much of the Basel III framework. While it is a feature of the current MIPRU regime, we are concerned that it might significantly underestimate the risks of particular assets which can be held, and could lead to forms of regulatory arbitrage.

36. Turning to the securitisation proposals, both here and more generally we agree with the principle of cross-referring to the BIPRU prudential rules, rather than reproducing them. However, the BIPRU 9 securitisation rules are complex, and in our view the FSA should publish some form of guidance to highlight how MIPRU firms would generally be expected to implement BIPRU 9. This would minimise the risk of these complex rules being a barrier to entry for non-bank lenders that could restrict competition.

Lending beyond state retirement age (Q105)

37. We note that the proposals make reference to changing working patterns and recognise many people want to or may need to work beyond state pension age. From a public policy perspective, more attention is required to ensure lenders fully recognise the implications of demographics and changing working patterns. The mainstream mortgage needs to be positioned to better serve the needs of older customers. Regulation should be structured to help drive positive change in this area so that lenders adopt more flexible mainstream lending policies for older borrowers and/ or in circumstances where one spouse or partner is significantly older than the other. This should be incorporated into good practice guidelines for formulating responsible lending policies.

E john.gaskell@icaew.com

Copyright © ICAEW 2012
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is appropriately attributed, replicated accurately and is not used in a misleading context;
- the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

icaew.com