

Treasury Committee
Inquiry into Mortgage Arrears and Access to Mortgage Finance
Memorandum from the Financial Services Authority (FSA)

1. This memorandum is submitted to the Committee as part of its inquiry into Mortgage Arrears and Access to Mortgage Finance in advance of the FSA's evidence session on 7 July. It covers:
 - the current situation in the mortgage market, especially in relation to mortgage arrears;
 - our role in relation to the regulation of mortgages;
 - what we have been doing on mortgage arrears and repossessions;
 - access to mortgage finance; and
 - the way forward.

A. MORTGAGE MARKET - CURRENT SITUATION

2. Home ownership and mortgage credit play a vital role in individual lives, in the financial system and in the macro economy. Net housing equity (the value of people's houses after mortgage debt) even after the 20% to 25% fall in prices we have now seen, amounts to about £2.4 trillion – easily the largest segment of household sector net worth.¹ Residential mortgage debt of £1.2 trillion in turn accounts for over half of all credit extended by banks and building societies in the UK. Residential mortgage bad debts can therefore have an important influence on the health of the banks and building societies, as well as a serious impact on the households concerned. Trends in property prices and thus in household wealth have a vital influence on consumer confidence and spending. Trends in the availability of mortgage credit also have a significant impact on house prices. Both over the next few years – as the UK pulls through this recession – and over the long term, the role of the housing market is central.
3. In the UK, as in the US, developments in the mortgage and housing markets in the years running up to the financial crisis created significant risks (the slides referred to below are included in the Annex to this memo):
 - the UK, like the US, saw very rapid growth of household debt as percentage of GDP, with that growth (slide 1) dominated by mortgage credit, up from about 55% of GDP in 1998 to over 80% by 2007;
 - income leverage increased (slide 2) and an increasing supply of mortgages was available at very high initial loan to value (LTV) ratios, as some borrowers and lenders² assumed that debt burdens were likely to fall with continuous property price appreciation. And mortgage credit was extended – not to the same extent as in the US, but still significantly – to categories of borrowers that had not previously had access to it and which were exposed to high credit risk. At the peak of the market, higher-risk loans e.g. sub-prime,

¹ ONS, 'Capital stocks tables for publication', Table 5.10, Bank of England and FSA calculations

² Lenders within the context of this memorandum refers to mortgage lenders and third party administrators.

buy-to-let, self-certified and high LTV, had come to account for a significant share of the total market; and

- mortgage arrears and repossessions are now rising (slide 3), and are likely to reach similar levels to those of the early 1990s.
4. On 22 June, we published the latest edition of our Mortgage Lending & Administration Return (MLAR) covering the period from 2007 Q4 to the end of 2009 Q1. The key results in terms of arrears and repossessions as at Q1 2009 are as follows:
- Helped by lower interest rates, numbers of new arrears cases in Q1 2009 were 12% fewer at 60,000 compared to the 68,000 recorded in Q4 2008, and are now back to volumes seen in Q3 2008. Even so, this is still 10% more than the typical quarterly volumes of 54,000 seen in the 18 months to mid 2008.
 - But with borrowers increasingly struggling to clear their arrears, the total number of loan accounts in arrears has been steadily increasing since early 2007. At the end of Q1 2009 there were 399,000 loan accounts in arrears, an increase of 22,000 or 6% since Q4 2008, and representing a rise of 33% on a year earlier.
 - Numbers of new repossessions have grown significantly since Q3 2007, but the sharply rising trend noted up to Q3 last year appears to have moderated in the last two quarters. After 13,469 cases in Q3 2008, numbers fell to 13,115 in Q4 2008, with a 13% rise in Q1 2009 to 14,825 cases. New repossessions in Q1 2009 were nonetheless 62% higher than a year earlier.

Mortgage arrears and repossessions – comparison to the 1990s

5. Although repossessions are now at a similar level to the 1990s cycle (see slide 4) the economic conditions look very different. Between 1988 and 1990, mortgage interest rates rose from about 9% to 14% and stayed there until autumn 1992. That rise produced a very large increase in the percentage of income devoted to mortgage interest which, alongside rising unemployment, played a crucial role in driving the dramatic rise in arrears and repossessions between 1988 and 1992.
6. In addition, data³ shows that from 1995 to 2005/06 the main reasons for mortgage arrears were loss of income from sickness, unemployment or household changes such as marital breakdown. This is supported by recent Bank of England analysis suggesting that the key determinants of mortgage arrears are unemployment and available housing equity.
7. In this recession, interest rates have fallen dramatically and many consumers with tracker mortgages are benefiting from very low rates of interest. This suggests that other factors are contributing to current arrears and repossession levels. In 2007, mortgage equity withdrawal was significantly greater than in the 1990s, and its fall since the general tightening of credit conditions and the fall in house prices in late 2007 has been much greater. Up until 2007 consumers were still able to remortgage to release equity to continue to supplement discretionary income and

³ Report from Survey of English Housing

finance their debts which is likely to have lowered the number of repossessions in late 2008/early 2009.

8. The sharp drop in house prices, tightening of credit conditions and the demise of the specialist lending market is likely to increase the number of repossessions in the rest of 2009 and into 2010, as highly indebted borrowers heavily reliant on equity withdrawal are no longer able to refinance outstanding debts. As slide 5 shows, non-bank and building society lenders whose business models have typically targeted indebted consumers have seen their share of repossessions increase since the beginning of 2007 relative to their overall market share.
9. Many of these consumers also relied heavily on unregulated sources of credit (also now severely restricted) to increase their spending power. Our analysis of repossession orders has shown that even where the original lending decision looked to be affordable, affordability was severely compromised by the overall level of debt secured against their home, including second charges and other forms of unregulated credit. This is one of the reasons we are considering, as part of the Mortgage Market Review work (see paragraphs 41 - 42), whether we should recommend to the Treasury that our scope should be extended to include second charge lending so that we have overall sight of affordability and responsible lending.
10. Another factor not present in the last recession was buy-to-let mortgages. While real rental returns net of mortgage payments have been negative for most of the period since 2004, many landlords continued to hold onto their properties if the capital appreciation was expected to more than offset the net loss from the rental income. As property prices started to fall, many landlords found that the losses being made on the rentals through falling real rental returns and plummeting house prices meant that the investment was no longer viable. In addition a significant proportion of defaults are occurring on new houses, and prices in this sector have shown little growth since 2005, increasing the probability of default.
11. The upward trend in arrears and repossession remains of great concern particularly as we believe we have yet to see the traditional determinants of default such as unemployment feed through into the figures. It is, however, important to look at the levels of arrears and repossessions in comparison to all mortgages outstanding. According to recent figures published in our Mortgage Lending and Administration Return the proportion of the residential loan book that is in arrears, and hence not fully performing, rose to 3.64% at end Q1 2009, up 0.27% in the quarter and up 1.23% on a year earlier.

B. FSA ROLE

12. The FSA took on responsibility for regulating mortgage lending, administration, advice and arranging in October 2004. This was limited to first charge mortgages on residential properties and lifetime mortgages. In April 2007, our scope was extended to cover home reversion plans and home purchase plans.

Our rules

13. We have set out the standards we expect firms to meet in dealing with their mortgage customers. Our mortgage regime is designed to deliver the following outcomes:
 - Consumers are able to shop around for mortgages;
 - Consumers understand whether they are being given advice or information by firms;
 - Consumers take out suitable and good value mortgages;
 - Consumers better understand the risks and features of the mortgages they take out, including the affordability risks; and
 - Consumers are treated fairly over the life of the mortgage, including in arrears or repossessions.
14. Our rules include 11 Principles of Business which are applicable to all firms, including mortgage lenders and intermediaries. The Principles set the high level standard that firms must meet, including Principle 6 which states that:
 - *A firm must pay due regard to the interests of its customers and treat them fairly.*
15. In pursuit of our consumer protection and public awareness objectives, our Mortgage Conduct of Business Handbook provides rules and guidance on financial promotion, advising and selling standards, disclosure (at pre-application, offer, and post sale stage); equity release products; responsible lending; charges; annual percentage rate; and arrears and repossessions. These rules apply to mortgage lenders and intermediaries.
16. Our rules on mortgage arrears require lenders to have a written policy and procedures in place designed to ensure that they treat customers in financial difficulties fairly. These include requirements to use reasonable efforts to reach agreement with the customer, adopt a reasonable approach to the time over which any shortfall in payments can be made good and take repossession action only where all other reasonable attempts to resolve the position have failed. They also require that charges imposed on a customer in arrears do not exceed a reasonable estimate of the additional cost incurred (see the section below on *Mortgage arrears and repossessions handling review* for examples of the action we have taken on this issue).

Sale and rent back (SRB) schemes

17. SRB schemes involve individuals selling their home, usually at a discount, and obtaining an agreement to remain in the property for a set period - typically through an assured shorthold tenancy⁴ of six to 12 months. In October 2008, the OFT published a SRB market study⁴ which recommended statutory regulation of SRB schemes. In June this year, the Treasury announced that it would be extending our regulation of mortgages to include SRB schemes.

⁴ http://www.of.gov.uk/shared_of/reports/consumer_protection/oft1018.pdf

18. We are taking a two-stage approach to implementing the Treasury's decision. An interim regime came into force on 1 July. Under this regime, firms will need to meet our threshold conditions including the requirement to have adequate resources and to be run by fit and proper people. They will also have to comply with the Principles for Businesses and meet a number of systems and controls and conduct of business rules. This will be followed by a more comprehensive regime, which will start on 30 June 2010 and on which we will consult in autumn 2009.

Second charge lending

19. We do not regulate second charge lending which is the responsibility of the Office of Fair Trading (OFT) under the Consumer Credit Act.

Buy-to-let (BTL) mortgages

20. We do not regulate BTL mortgages. When the Government introduced mortgage regulation through the FSA in 2004, it drew a distinction between owner-occupiers who face losing their home if things go wrong, and BTL landlords, whose properties are investments and who do not face the same risks. Consumer protection regulation, therefore, did not extend to BTL mortgages. However, lenders that advance BTL mortgages are subject to prudential regulation as they are required to hold capital against the mortgages they have advanced.

Social housing

21. Nor do we regulate social housing. Social landlords are regulated by the Audit Commission and the Housing Corporation, the government agency that funds new affordable housing and regulates housing associations in England.

C. FSA WORK ON MORTGAGE ARREARS AND REPOSSESSIONS

22. Since we took on responsibility for mortgage regulation we have carried out a programme of work designed to monitor the effectiveness of our regulation of mortgage lending, address key issues in the mortgage sector and ensure that consumers are treated fairly and can make informed decisions.

Mortgage arrears and repossessions handling review

23. In late 2007, we became increasingly concerned by evidence, both from our own mortgage effectiveness review and from external reports by charities such as the Citizens Advice Bureau and Shelter, that some mortgage lenders were failing to treat their customers fairly when they fell into arrears. We reviewed the arrears-management policy and practices of a sample of mortgage lenders. We have begun enforcement action against five lenders for failure to adhere to our rules in this area. Several more lenders are being assessed for further investigation, with a view to taking enforcement action.
24. The first phase of the review was launched in December 2007 and considered a broad cross-section of mortgage lenders, including high-street firms, smaller

building societies and specialist lenders.⁵ In our findings, published in August 2008, we noted that mainstream lenders were largely complying with our requirements. However, there were particular concerns with specialist lenders, including that they:

- operated a 'one size fits all' approach, focused too strongly on recovering arrears according to a strict mandate, without reference to the borrower's circumstances;
- were too ready to take court action; and
- had lower standards of systems and controls in place to control mortgage arrears handling, including training and competency arrangements.

25. The review also found issues with lenders in general, including that some:

- could have done more to consider customers' individual circumstances and offer more options to resolve the arrears position;
- imposed charges in circumstances that could result in the unfair treatment of customers; and
- did not exercise sufficient oversight of third parties contracted to carry out mortgage arrears and repossessions handling activities on behalf of lenders.

26. To help lenders assess and improve their arrears-handling practices, we provided feedback to the individual lenders and required them to take action to address the shortcomings. We also published good and poor practice examples on our website, illustrating where lenders were operating at/above or below our minimum requirements respectively.⁶

27. We continued to maintain our focus on arrears handling and in November 2008, Jon Pain (our Managing Director, Retail Markets), wrote to the chief executives of all mortgage lenders and administrators to remind them of their responsibilities under our Mortgage Conduct of Business rules. We required senior management to review their current arrears policies and management practices and procedures. We specifically asked them to review a sample of cases to assess whether our requirements are being met and to revert to us with their findings.⁷

28. In line with our commitment to continue to scrutinise lenders' treatment of customers in arrears, we have followed up the responses to the letter in a number of ways. This includes:

- requiring a number of lenders to make further changes to their policies and procedures – we have set review dates to follow this up with them; and
- continuing to focus on arrears handling and collections as part of our ongoing supervision of lenders.

29. Phase two of our review began in early 2009 and focused more specifically on areas identified as problematic in phase one, in particular specialist lenders to the impaired credit market who are no longer lending, and third party administrators (TPAs) contracted to handle mortgage arrears and repossessions work on behalf of

⁵ In the context of our arrears work, the term specialist lender refers to non deposit taking lenders with business models that target indebted consumers/those who cannot provide income verification

⁶ http://www.fsa.gov.uk/pages/About/What/thematic/mortgage_arrears/examples/index.shtml

⁷ <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/142.shtml>

lenders. It also looked at arrears charges and the treatment of borrowers whose mortgages have been securitised.

30. We published our results from phase two on 22 June this year.⁸ We found that poor practice had been prevalent among some specialist lenders and TPAs including:
- an approach focused too strongly on recovering arrears without reference to the borrower's individual circumstances;
 - being too ready to take court action;
 - imposing arrears-related charges unfairly;
 - specialist lenders not exercising sufficient oversight of contracted TPAs; and
 - terms in securitisation covenants which could lead to inequitable treatment of borrowers in arrears.
31. All the lenders we investigated had made recent changes to policies and procedures and there were signs of greater awareness of the need to treat customers fairly. This included providing a greater range of options to distressed borrowers. However, we did not see evidence that this had yet translated into better outcomes for customers in arrears.
32. We are requiring all firms from our sample to take action to remedy particular failures identified. In addition, we are formally investigating a further four lenders, with a view to taking enforcement action. We have also published a more detailed briefing for mortgage lenders, which includes practical examples designed to help lenders improve their mortgage arrears and handling practices.⁹ We have also updated the fees and charges section of the good and poor practice examples we published following the first stage of the review in August 2008.
33. We will feed the findings from the project into the wider Mortgage Market Review (see below) which we are carrying out and we will use them to identify areas where in the longer term we may need to change our rules. This may include changes to our rules on fees and charges, on the relationship between lenders and third party administrators and on the interaction between securitisation and arrears handling.

Consumers

34. To help consumers in arrears to decide what steps to take we have published a wide range of mortgage material on our [Moneymadeclear](http://www.moneymadeclear.fsa.gov.uk) website. This includes, the '*What to do when you can't pay your mortgage*' guide, which offers practical help for people who are struggling with mortgage repayments and states the options available to them.¹⁰ We require lenders to send this guide to consumers who fall into arrears.

⁸ <http://www.fsa.gov.uk/Pages/Library/Communication/PR/2009/080.shtml>

⁹ http://www.fsa.gov.uk/pages/About/What/thematic/mortgage_arrears/examples/index.shtml

¹⁰ http://www.moneymadeclear.fsa.gov.uk/pdfs/mortgage_cantpay.pdf

Civil Justice Council pre-action protocol

35. On 19 November 2008, the Ministry of Justice introduced a pre-action protocol which sets out the steps that mortgage lenders are expected to take before bringing a repossession claim to the courts.¹¹ This is currently applicable to England and Wales only. Lenders are now required to demonstrate to the courts that they have investigated all alternatives before resorting to repossessions. We welcome the pre-action protocol which complements our requirements for the fair treatment of customers in payment difficulties in our Mortgage Conduct of Business sourcebook

D. ACCESS TO MORTGAGE FINANCE

36. Our analysis shows that despite a tripling in lending between 1998 and 2008 from £400bn to £1,200bn of mortgage balances outstanding (slide 6), home ownership during that period has remained stagnant (slide 7). This is because most mortgage lending occurred for the purpose of equity withdrawal or buy-to-let mortgages (slide 8).

37. The reduction in gross mortgage lending in the last 12 months is almost entirely due to a reduction in remortgaging activity (as borrowers opt to stay on lenders' standard variable rates or cannot remortgage more cheaply due to a decline in their equity). Lending for house purchases has increased throughout 2009 and net mortgage lending has remained positive throughout the past 18 months.¹² We have taken steps to reduce the unintended procyclicality effects of the Capital Requirements Directive. We have applied a flexible approach to help reduce the risk that capital requirements under the Basel II framework do not increase sharply during the economic downturn thereby restricting lending, while also ensuring sufficient capital is held. However, even if banks have sufficient capital to hold against new lending there is still a need to fund this and, in the absence of a significant increase in the savings ratio or a thawing of the wholesale funding markets, this remains difficult.

38. It should be noted that, while we will form a view of the sustainability of a firm's business model and the appropriateness of its systems and controls to support this (and we will act where we have concerns in these areas), it is not our role to dictate business volumes to firms. That remains a commercial decision.

Asset Backed Securities Guarantee Scheme

39. Before the financial crisis broke in August 2007, the securitisation markets played a key and fundamental role in the capital markets. At its peak, the securitisation markets funded approximately one third of all UK Mortgages. The closure of the securitisation markets has had a significant impact on the availability of funding for the UK housing and mortgage market. Given the significance of the securitisation market, the Treasury and the FSA worked closely with market participants to design the Asset Backed Securities (ABS) Guarantee Scheme which was launched in the April Budget. This scheme provides either a credit or a

¹¹ http://www.justice.gov.uk/civil/procrules_fin/pdf/protocols/prot_mha.pdf

¹² <http://www.bankofengland.co.uk/publications/other/monetary/TrendsJune09.pdf>

liquidity guarantee on Residential Mortgage Backed Security (RMBS) backed by eligible mortgages originated after January 2008. The scheme is intended to provide confidence to the RMBS market to encourage investor appetite and thus improve banks and building societies access to capital markets funding and to help support lending to credit worthy borrowers in order to promote robust and sustainable markets over the long term. The ABS Guarantee Scheme was met with a positive reaction from issuers and investors on its launch.

Liquidity

40. We are currently conducting a comprehensive review and restructuring of our liquidity regime. We have published three Consultation Papers on strengthening liquidity standards (December 2008, April 2009 and June 2009). Our proposed policy will increase the cost of lending to certain consumers, which will align this type of lending activity with the increased liquidity risks associated with it. Our new policy will also require firms to quantify the liquidity costs, benefits and risks in relation to all significant business activities and to incorporate them in their product pricing and performance measurement. This will ensure that the risk-taking incentives of individual business lines - including mortgage lending - are properly aligned with the liquidity risk to which a firm is exposed as a result of such activities. In addition we anticipate that our new liquidity policy will result in a check on unsustainable expansion of bank lending during favourable economic times.
41. As noted in the *Turner Review*, we believe that our liquidity policy will imply less aggregate maturity transformation than would otherwise occur, and this must in theory carry some economic cost. The crucial trade-off – as with the costs of higher bank capital – is between a small net cost to the economy during ‘normal times’ and the benefits of the reduced probability of extreme adverse events. Assessing and comparing these potential costs and benefits is extremely difficult. However, given the scale of the economic fallout from the financial crisis, a reasonable judgement is that a significant tightening of regulatory constraints on liquidity (and thus on aggregate system-wide maturity transformation) is justified in order to reduce risks to future financial stability.

E. LOOKING FORWARD

42. In our *Business Plan* for 2008/09 we committed to reviewing our mortgage conduct of business regime. Our work on assessing whether the regime has delivered the right outcomes for consumers suggested that changes to our rules in this area alone would not be sufficient. We, therefore, expanded the scope of the work to encompass a comprehensive review of the wider mortgage market, with a view to achieving two outcomes: a market that is sustainable for all participants (consumers, intermediaries, lenders and investors); and a flexible market that works for customers. The review cuts across the economic cycle and identifies issues that arose during the boom before the financial crisis broke, with the aim of implementing a suitable regulatory framework before the next upswing of the cycle. We will develop a view on the future shape of this market and on how our approach to regulation should evolve. Our review covers the complete value-chain in the market (e.g. lenders, intermediaries, consumers and investors) and all

aspects of regulation, including prudential, conduct of business, and financial crime. We are also considering whether any read-across to the mortgage market is appropriate from the proposals in our Retail Distribution Review.

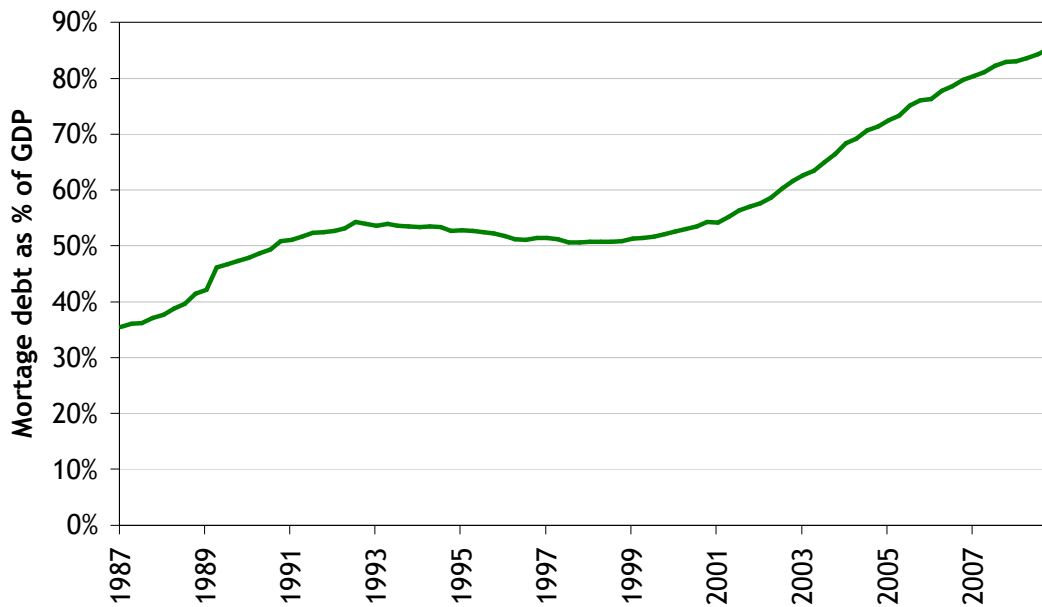
43. In the *Turner Review*, we raised the issue of whether we should consider limits on maximum loan-to-value (LTV) or loan-to-income (LTI) ratios. We will address this, along with the issues identified in the Mortgage Market Review, in a Discussion Paper (DP) to be published in autumn 2009. The DP will also assess:
 - whether we should recommend to the Treasury that our scope should be extended to buy-to-let and/or second charge lending;
 - whether we should change our rules to require income verification for all mortgages or should encourage lenders to lend responsibly through our capital requirements;
 - the extension of the approved persons regime which would mean that all mortgage advisers and arrangers would be individually vetted and registered; and
 - the role of responsible borrowing and whether further consumer education is required.
44. The European Commission is working on measures to promote responsible lending and borrowing and is planning to present policy measures in the autumn, as well as creating a regulatory framework on credit intermediation. We will contribute fully to these discussions.
45. Ensuring that consumers in mortgage arrears are treated fairly will remain a high priority for the FSA, and firms can expect continued focus and scrutiny in this area, including more use of outcomes testing, as part of our normal supervision process.

2 July 2009

Annex

Slide 1

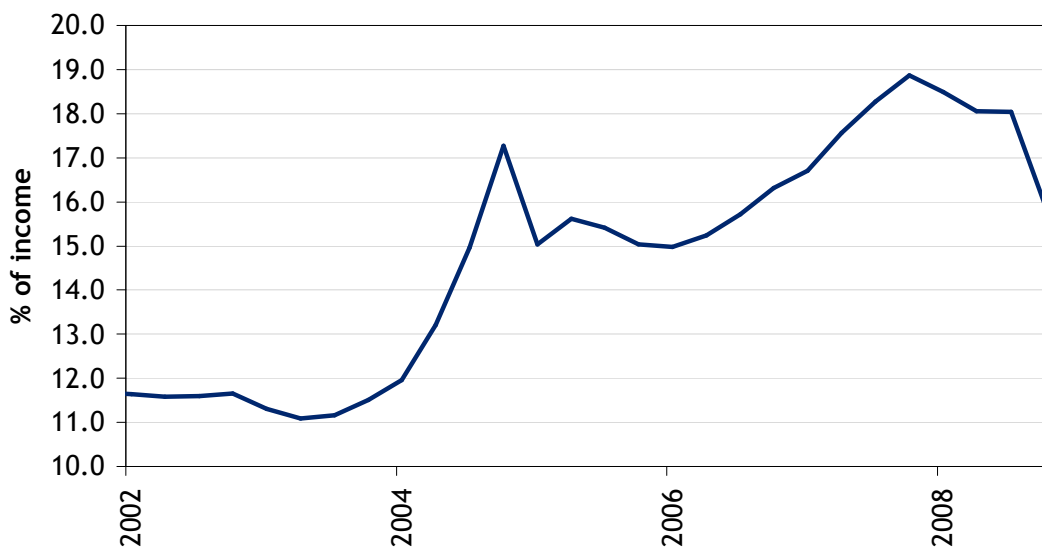
Mortgage debt outstanding (UK)



Source: Bank of England

Slide 2

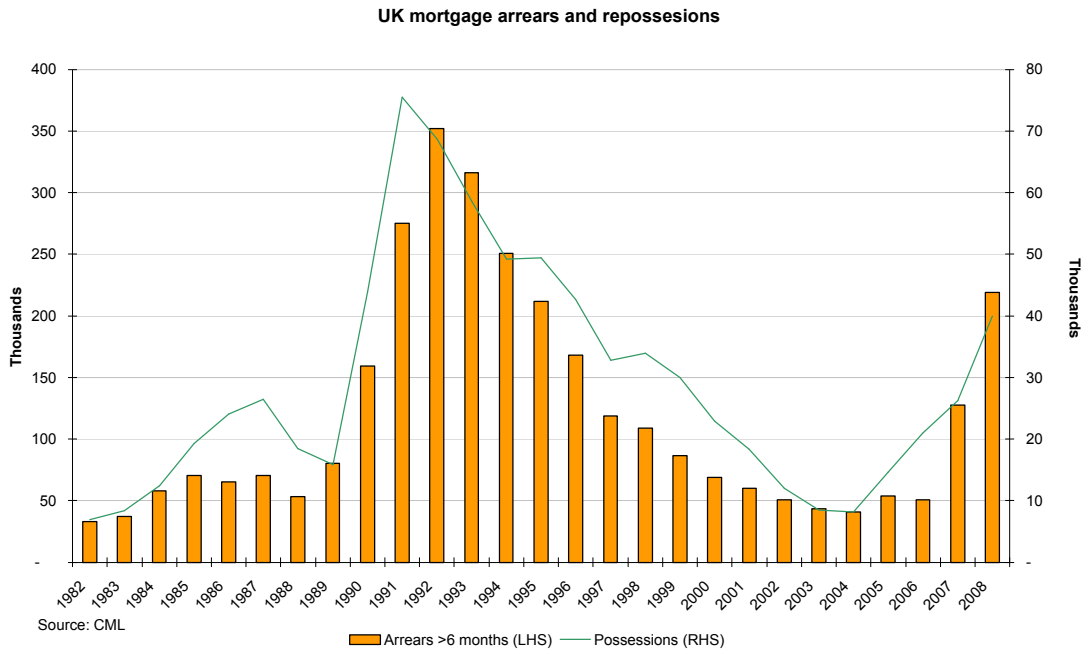
Median mortgage interest payments as a percentage of income



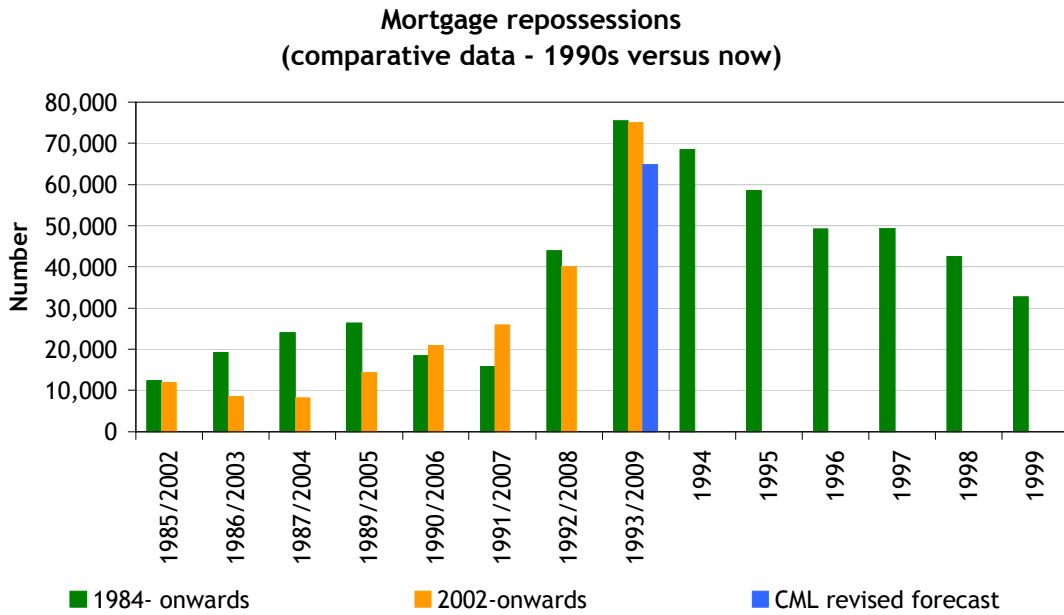
The long term average of mortgage interest as a percentage of income is 15.8% for the period since 1974

Source: CML Regulated Mortgage Survey

Slide 3

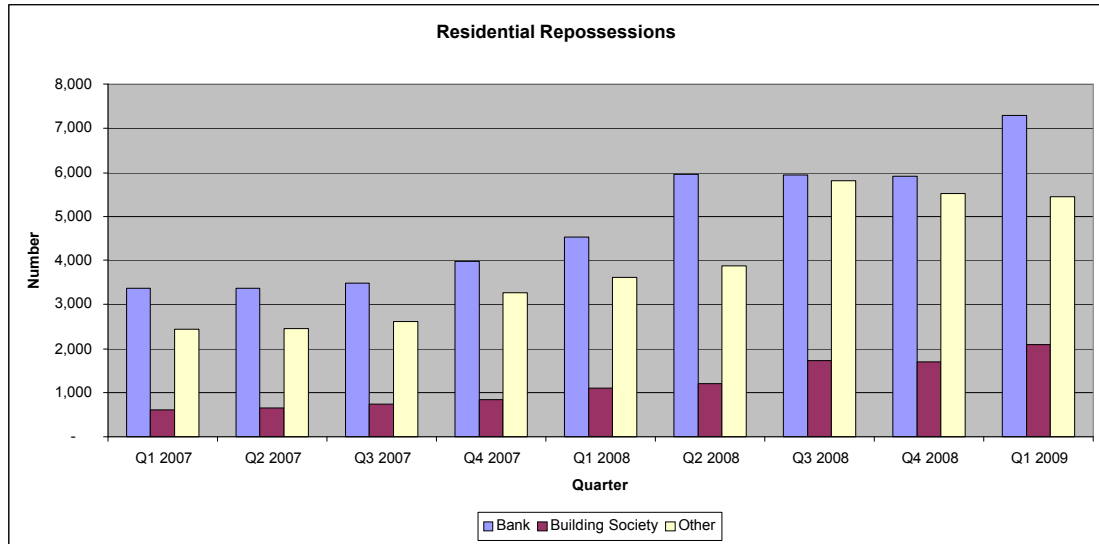


Slide 4

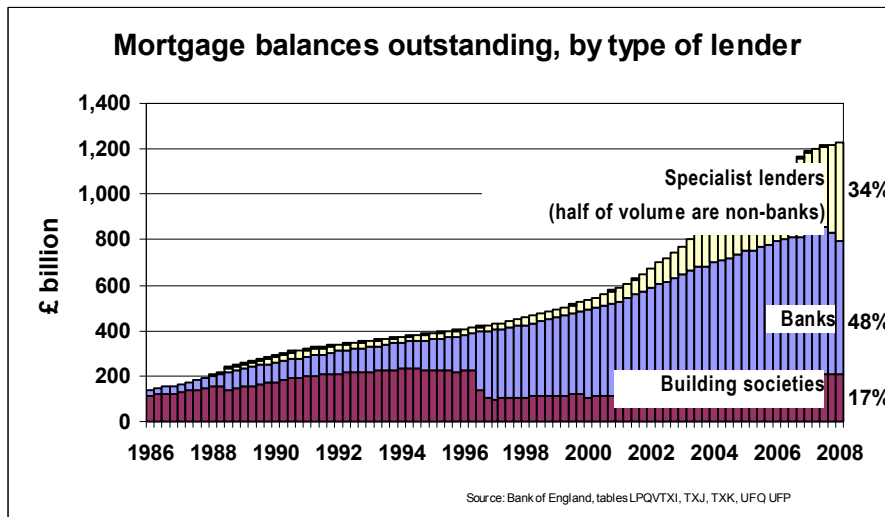


Source: CML

Slide 5

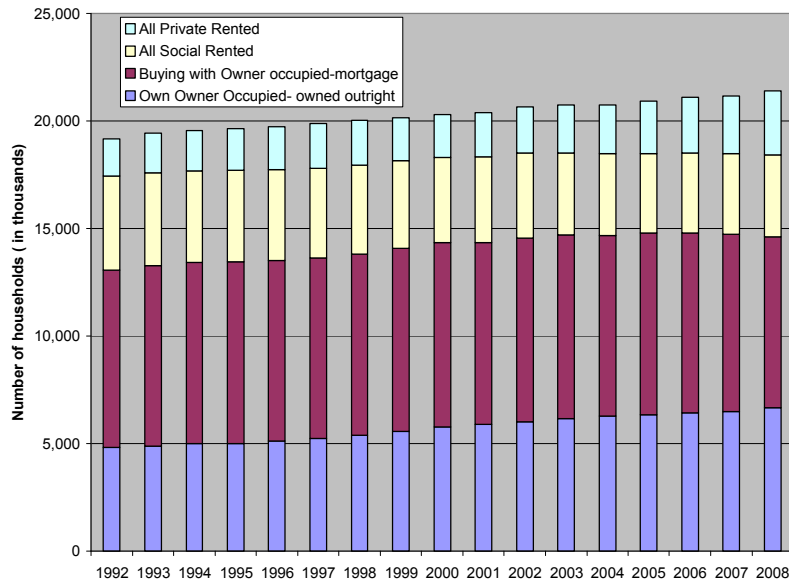


Slide 6



Slide 7

Home Ownership Characteristics of UK households



Slide 8

Mortgage lending by purpose 2001-2007

