Financial Services User Group's (FSUG)

response

to the Financial Stability Board (FSB) Principles for Sound Residential Mortgage Underwriting Practices

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FSUG response to the Financial Stability Board (FSB) Principles for Sound Residential Mortgage Underwriting Practices

Introduction

The FSUG is pleased to submit a response to the FSB consultation on principles for sound residential mortgage underwriting practices.

The financial crisis has demonstrated that flawed mortgage underwriting practices and irresponsible lending have the potential to cause significant consumer harm.

The FSB's draft principles for sound residential mortgage underwriting practices attempt to address many of the issues that have contributed to the financial crisis. However, FSUG would like to encourage the FSB to go further and ensure that the proposed underwriting principles do not only protect financial markets but also individual consumers.

Earlier this year, the FSB proposed principles to protect consumers in unsecured credit. In our response we argued that consumer protection should be redefined so that the emphasis is on:

- protecting users from unfair market practices
- changing the behaviours of market actors along the supply chain and
- cleaning up financial markets to get rid of toxic products.

We have therefore proposed a new principle covering consumer protection features in our response to this consultation. The new principle proposes three specific tools to protect consumers:

- proactive regulation
- product intervention
- fair treatment of existing customers

It is important that all three tools work hand-in-hand. Proactive regulation and product intervention can take a number of forms including identifying unsuitable marketing and sales practices, defining expected outcomes for consumers, regulating terms and conditions, and product intervention at the 'manufacturing' stage. In certain cases, product banning may be required. Fair treatment of existing customers is particularly relevant for the mortgage sector as the only way consumers can exit the mortgage market is to sell their home.

In its report on consumer finance protection with a particular focus on credit, the FSB states that "more work is needed to protect consumers entering the market to buy credit products", and we believe that this most certainly applies to mortgages as consumers who want to exit the mortgage market usually have to sell their home in order to do so. We would therefore urge the FSB to add the consumer protection principle to the other mortgage underwriting principles proposed in this consultation.

Principle 1: Effective verification of income and other financial information

Income verification is an essential part of the mortgage underwriting process. It is therefore important that verification is based on authoritative sources such as tax returns, bank statements and independent accountants.

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In the UK, between 2005 and 2010, 45 % of all mortgage applications were processed without income verification[1]. Originally, self-certification mortgages were marketed at borrowers who found it difficult to provide proof of income like the self-employed. However, in the run-up to the financial crisis the availability of these mortgages had been extended far beyond the original target groups. FSA statistics show that self-certified mortgages have a noticeable higher default rate than income-verified mortgages[2]. Lenders do not check income for this type of mortgage and this fact constitutes part of the marketing of the product. These products usually attract a higher APR to offset the greater risk incurred by the lender.

Whilst lenders should have ultimate responsibility for verifying a borrower's income there also needs to be an important role for the intermediaries/broker's in this issue.

The role played by information on the current client's credit relations can be a useful tool with regard to the assessment of existing financial commitments and the borrower's ability to make regular repayments.

Although it is important that lenders verify and document applicants' employment status, history, and other information submitted for mortgage qualification, the use of credit scoring and credit registries 'to measure a borrower's historical propensity to repay' is currently often being used in an non-transparent manner which can lead to unjustified rejections of creditworthy applicants simply because of the way they have been classified by the system.

Credit scoring, is a classification and profiling technique based on mathematical algorithms that determine the probable repayments of debts by consumers, assigning a score to an individual based on the information processed from a number of data sources and categorising credit applicants according to risk classes.

Credit scoring is used as a tool to mitigate the likelihood of a borrower not repaying a mortgage is limited[3]. However, research shows that in the vast majority of cases non-repayment of mortgages is due to people being willing to repay but being unable to do as a result of a life-changing event such as loss of job, illness, death of family members, separation or divorce, etc[4]. These are situations that cannot be predicted by credit scoring – on the contrary information of past defaults or late payments caused by such circumstances are likely to affect the credit capacity of affected consumers in future.

We therefore object to the indiscriminate use of credit-scoring and believe that a 'duty-of-care' should be introduced to Principle 1.1. The wording 'propensity to repay' should also be deleted from Principle 1 as it focuses the principle on the behaviour of a very small number of consumers who choose not to repay a credit commitment rather than focusing on the vast majority of instances where the consumer is willing to repay although in some cases may not be able to do so.

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1 FSA, CP 10/16, exhibit 2.4.

2 FSA, DP 10/16, exhibit 2.6.

3 Credit registers, credit histories and credit scoring are not used in all EU countries. The rate of default of payments is not lower in countries where such tools are used/allowed (see France where the default rate of payments for mortgage credits is low). Furthermore, these tools generate a lot of problems in terms of personal data protection and inaccurate data that are very detrimental to consumers.

4 Centre for Social Justice; *Breakthrough Britain: Ending the costs of social breakdown*, Vol. 5 Serious Personal Debt, p. 15.

Consumers also need to be given better information about the use of credit scoring. Importantly, consumers should have a right to a manual review where the rejection is based on credit scoring rather than negative credit data of the individual consumer.

Income verification should also not be allowed to develop into an insurmountable hurdle for consumers due to automated decision making processes. Lenders should adjust verification requirements for consumers who may not be able to provide standard documentation e.g. the self-employed or contract workers. Periods for income verification should also be set at a reasonable level. It should not be necessary for consumers to provide evidence of income and expenditure going back several years as proposed in Principle 1.2.

Principle 1.2 should also be amended to include a requirement on creditors to specify the information they want from the consumer to avoid disputes over claims of provision of incomplete information at a later stage.

We also believe that the use of data from credit reference agencies necessitates the introduction of a new sub-principle providing consumers with rights to amend the information and access to redress in the case of incorrect information.

Principle 1.4: Jurisdictions should ensure that consumers have the right to access the information obtained by the lender from databases and the right to ask for the correction of incorrect information contained in a database file free of charge. Furthermore, they should also ensure that where inaccurate information is found on a database file the consumer has a right to redress and to financial compensation from the originator of the inaccurate information.

Principle 2: Reasonable debt service coverage

It is important that lenders and intermediaries assess both income and expenditure to determine whether the mortgage is affordable. Which?, the UK consumer association, conducted a mystery shopping of mortgage advisers in the run-up to the financial crisis found that only 30 % conducted a proper check of both income and expenditure to determine overall mortgage affordability. Assessments of the capacity to repay should also distinguish between different types of income e.g. fixed monthly income like pensions and contractual wages and other sources of income that are not guaranteed like bonus payments and some government provided benefits where condition of allocation can change over time.

We agree that lenders should take into account the highest payment currently scheduled to apply during the term, rather than base the assessment on any initial discounted or ‘teaser’ rate. It is also important that the affordability standard is built to take into account interest rate increases to reflect a possible rise in mortgage rates. It is important that this also applies to the ‘go-to rate’ which will be applied at the end of the fixed-rate mortgage contract. In the UK, this rate is usually the lender’s Standard Variable Rate, where in the majority of cases lenders do not have to vary these in line with a benchmark rate. Indeed, recent Which? research found that a number of lenders had increased these ‘Standard Variable Rates’ despite the Bank of England holding the base rate at its historic low of 0.5 %[5].

[5] http://www.which.co.uk/news/2011/06/variable-mortgage-rate-customers-squeezed-by-lenders-says-which-256695/

It is important that borrowers are provided with the information listed in Principle 2.4 by both lenders and mortgage intermediaries/brokers. To aid comparability, regulators should set a standardised format for the communication of this information which should be tested with consumers.

We believe that mortgage intermediaries also have an important role to fulfil to highlight the impact of increases in interest rates to consumers. They will only be able to do this effectively if they have assessed affordability and based on that assessment can show the effect of interest rate increases to the consumer.

It is also essential that consumers understand the overall cost of their mortgage including fees.

Recent focus-group research undertaken in the UK for the European Commission has focussed on consumers' perceptions of the mortgage market.[6] It found that:

- Fees did not feature as a significant criteria for selecting or narrowing mortgages, instead the period of the deal/tie-in, interest rate (and type), monthly repayments, deposit necessary and amount of credit available featured more highly.
- Consumers considered that price comparison was simple, focusing on either monthly repayment, interest rate or set-up fee ("if you are just going on price, it is just the highest or lowest price per month so it is quite easy").
- There was a concern about the simplicity or clarity of pre-contract information, with examples cited of people being caught out by fees.
- Mintel research[7] found that high fees would deter about 10–20 % of respondents from those mortgage deals. This view was more popular with existing mortgage borrowers than first-time buyers, who were also much more likely to consider a higher fee in order to pay a lower interest rate.

As a minimum measure we believe that firms should be required to present the total cost over the lifetime of the mortgage and the lifetime of the deal to highlight the impact on upfront-fees on the overall cost of the mortgage.

Lending decisions should also not be based solely on automated assumptions. Lenders should be required to take evidence about a consumer's personal circumstances into account e.g. where it shows that a consumer has a lower spending profile than is typical for similar households.

Principle 3: Appropriate loan-to-value ratio

We agree that national jurisdictions should consider imposing LTV limits in appropriate circumstances. They should also have the power to change these in a counter-cyclical manner to smooth out volatility in house prices. In the UK, lenders acted pro-cyclically with regard to maximum LTV ratios, offering high LTVs throughout the housing boom and then heavily restricting or withdrawing these high LTV mortgages after house prices had fallen.

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[6] This qualitative research was conducted by Which? on behalf of the European Commission. The research took place on 29 June 2009 with 11 representative consumers were taken through a structured focus group.

[7] Figure 62, p. 134, Mortgages, Finance Intelligence, March 2010.

This highlights a further issue not covered in the principles, which is that changes in the availability of mortgage lending and under-writing criteria can result in borrowers being stuck with their existing mortgage lender. Jurisdiction should also have to ensure that lenders are not able to apply new LTV restrictions retrospectively to existing borrowers and cancel their mortgages. In these circumstances it is important that lenders are not able to exploit these borrowers by unfairly increasing the interest rate that they are paying.

Principle 4: Effective collateral management

Collateral assessments need to be a true reflection of the value and state of the property. In the past, surveyors or valuation experts often provided the exact value of the collateral needed for loan approval rather than the actual value of the property[8].

At the same time, some of the methods used by assessors were unprofessional – they used indicative prices from some websites, not real prices. Sales comparison approach must be based on real transaction prices, not just offers posted on websites[9].

Assessments also often only try to establish whether the value of the property is high enough to protect the lender's exposure without taking into account whether it contains enough value to protect the share of the property already owned outright by the borrower at the time the mortgage is taken out.

Such evaluation practices can contribute to inflated house prices. Assessors should therefore be independent from the respective mortgage acquisition, loan processing and loan decision process.

Principle 5: Prudent use of mortgage insurance

We agree that it is important that mortgage insurance does not substitute for sound underwriting practices. Mortgage insurance premiums are paid by the consumer, even though they ultimately benefit the lender. In many cases, despite paying for mortgage insurance, consumers will still have to pay the additional costs of any shortfall to the lender. These shortcomings need to be clearly explained to the consumer.

In addition, there is a substantial risk of a conflict of interest if lenders are using a linked mortgage insurer or have chosen a mortgage insurer on the basis of the level of commission returned to the lender.

The fact that the mortgage insurance represents a secondary purchase (bought only due to taking out the primary purchase of the mortgage) means that there is a substantial risk of cross-subsidy and the weakening of effective competition. Lenders should not be permitted to inflate the cost of the mortgage insurance to make the terms of the mortgage appear cheaper. An extra principle should be added:

Principle 5.5: Jurisdictions should ensure that the way mortgage insurance is priced does not lead to a conflict of interest with the customer or is used to disguise the true cost of the mortgage. The costs of the mortgage insurance should be communicated to the consumer as part of the disclosures required by Principle 2.4.

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[8] In the UK, there have been some recent court cases in which the overvaluation of properties by surveyors was part of the complaint e.g. Scullion v. Bank of Scotland.

[9] See footnote 8.

Principle 6: Implementation framework

Treatment of customers in mortgage arrears

Regulators also need to have the power to enhance consumer protection and effective competition by being able to limit ancillary/default charges. In some circumstances, consumers subject to ancillary/default are likely to have little ability to limit them. This could include occasions such as where consumers are in mortgage arrears. Controls on mortgage arrears charges can also be justified as promoting responsible lending by ensuring that lenders do not gain significant additional benefits from consumer arrears and default activity. We suggest that the following text is inserted as Principle 6.6.

Principle 6.6: Jurisdictions should ensure that consumers in mortgage arrears are treated fairly. This should include offering appropriate forbearance options to customers. Supervisors should limit mortgage arrears and default charges to a reasonable reflection of the costs incurred by the lenders.

Principle 7: Effective supervisory tools and powers

Controlling inappropriate incentive and compensation structures has been recognised as a tool which regulators should deploy to improve practices in the market. The FSB thematic review of mortgage underwriting practices recommended that “compensation policies provide for credit risk managers’ compensation to be independent of sales volumes” and that “incentive compensation for sales teams should likewise include meaningful consequences for adverse loan quality”.

Whilst a significant amount of time has been spent by regulators reforming remuneration structures at a senior level to ensure that they do not encourage excessive risk taking, the same focus has not been applied to the impact of remuneration structures on consumer protection.

The FSB’s principles for sound compensation practices do not explicitly mention that arrangements should take into account the risks to the firm from poor standards of consumer protection or that the emergence of these risks should be part of clawback arrangements. One option would be to amend the principles to make it clear that poor standards of consumer protection which result in losses for the firm are one aspect which should trigger clawback or malus arrangements for senior executives.

Further examination could also be conducted of the incentive and compensation structures for frontline advisers and staff. Any inappropriate structures could be controlled by the financial conduct regulator. In the UK, the FSA is currently conducting a thematic review of reward structures for frontline bank staff to determine whether incentive structures guard against poor standards of consumer protection. In the US, the Dodd-Frank act imposed a ‘steering incentives ban’ which prohibited “yield spread premiums and other forms of compensation that vary based on the terms of the loan (other than the amount of principle)”.

Remuneration systems linked to commission or sales targets can create a conflict of interest between the consumer and the firm. They encourage intermediaries to recommend courses of action which result in the sale of a product, rather than that which is most suitable for the customer. Financial services firms should reform their remuneration structures at all levels (from senior management to frontline staff) to encourage responsible business conduct and the fair treatment of consumers. Regulators should examine remuneration and commission systems for both frontline

staff and senior management and should have the power to prohibit remuneration structures which encourage mis-selling.

- The FSB remuneration code should include specific reference that risks from poor consumer protection should be taken into account in variable remuneration schemes. Poor standards of consumer protection should result in clawback of variable remuneration.
- Further examination could also be conducted of the incentive and compensation structures for frontline advisers and staff. Any inappropriate structures could be controlled by the regulator.

We recommend that an additional bullet should be added to Principle 7.1: “Monitoring compensation and incentive structures within lenders and mortgage intermediaries which could lead to a conflict of interest between the firm and the customer. Where appropriate, supervisors should take action to align these structures with responsible mortgage underwriting practices.”

New Principle 8: Consumer protection features

Proactive regulation

FSUG believes that consumer protection regulators should move from a purely reactive approach to one which seeks to tackle the root causes of consumer detriment. They should be willing to intervene proactively to tackle poor products or incentive structures. In addition, consumer organisations should be given special powers in the form of the UK ‘super-complaints’ to highlight areas which require regulatory action.

Principle 8.1: Jurisdictions should ensure that regulators have the power to proactively intervene to tackle practices in the mortgage underwriting process that can lead to consumer detriment. Furthermore, they should also provide consumer organisations with adequate legal tools to highlight such areas of consumer detriment.

Product intervention

It is increasingly recognised that there are limits to using disclosure as an effective regulatory tool and that to increase consumer protection, regulators need to have the willingness and powers to proactively intervene at an earlier stage in the product lifecycle. In the FSUG response to the consultation on the OECD draft high-level principles on financial consumer protection we stated that:

“FSUG is of the opinion that efficient and protective product regulation must be envisaged as principle of financial consumer protection. In fact, product regulation is a regulatory tool that can directly address and control the characteristics of the product being sold. Among its advantages it should be considered that, on the one hand, designing a rule that bans certain products or product features, may sometimes be easier than trying to prescribe precisely the behaviour of providers or advisers. On the other hand, monitoring and enforcement of compliance with product regulation may be easier than with prudential regulation. A precautionary stance, however, could include for instance anticipating and addressing risk and problems throughout a product’s life cycle, namely product design, marketing and advertising, and not solely in response to the onset of consumer detriment effects, which usually take place in sales and advice, after sales information and complaint handling.”

In our view, mortgages are certainly a product where such product intervention can be called for. Past work from the FSB has discussed product intervention. The FSB's report on mortgage underwriting standards noted the problems associated with 'teaser rate' loans in the US. It suggested that one of the principles for sound mortgage underwriting should be 'minimum acceptable standards'. This noted that "the layering of risks should be avoided, in particular practices that combine aggressive underwriting practices with aggressive mortgage products, for example low-doc loans coupled with teaser rate or interest-only products, or loans with high LTV ratios that include negative amortisation"[10].

Principle 8.2: Jurisdictions should ensure that regulators have the power to ban mortgage underwriting practices that result in products and product features that are harmful to consumers.

Treatment of existing customers

FSUG believes that particular attention needs to be paid to ensuring that existing customers are treated fairly when lenders or regulators make changes to mortgage underwriting standards. Regulators should take action to ensure that where products contain variation clauses allowing lenders to change interest rates and charges, these are fair and clearly explained to consumers.

Where changes to the underwriting criteria lead to a situation where existing customers no longer meet the underwriting criteria, regulators should ensure that lenders are required to continue to offer mortgages to these customers. As mentioned under Principle 3, it is also important that lenders are not able to exploit these borrowers by unfairly increasing the interest rate that they are paying.

Lenders should not be allowed to use a change in mortgage underwriting criteria that has been introduced by either themselves or a regulatory body as a reason to start repossession procedures against any of their customers. There should also be a legal requirement that reductions to the rate tracked should be passed on automatically by the provider to the customer.

Principle 8.3: Jurisdictions should put measures in place to protect existing borrowers when changes to mortgage underwriting criteria are introduced by regulators or lenders.

[10] FSB peer review on mortgage origination and underwriting practices, http://www.financialstabilityboard.org/publications/r_110318a.pdf.