



The changing face of non-standard mortgage lending

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Executive summary

While mortgage borrowers have experienced considerable changes since the start of the financial crisis as a result of adjustments in lender behaviour and regulation, it is non-standard borrowers (the self-employed, those borrowing into retirement or with adverse credit and those with complex financial affairs), who have faced the greatest impacts.

This paper considers the impact on four type of non-standard borrower as follows:

- **Self-employed.** On the face of it, the Mortgage Market Review (MMR) has not greatly changed the position of self-employed borrowers. But the additional complexity in the income/expenditure assessment makes it harder for large lenders with automated underwriting systems to assess these borrowers. This could increase the role played by niche lenders in this segment. At the same time, the removal of self-certified loans has reduced options for the newly self-employed, who cannot provide several years of accounts.
- **Adverse credit.** The MMR has not greatly altered lenders' approach to assessing borrowers who have had previous incidents of adverse credit, as it remains for the lender to make a judgement about the borrower's creditworthiness. One exception is heavy adverse credit, where prior to the financial crisis a market developed with lending based on the equity in the property independent of the borrower's ability to pay. The affordability requirements of the MMR should prevent a return of this type of lending.
- **Borrowing into retirement.** The MMR has had a greater impact on the lender's decision regarding borrowers whose loan is likely to remain outstanding beyond normal retirement age. As the MMR requires that lenders ensure that the loan is affordable, many lenders believe that lending into retirement now carries additional conduct risk as some borrowers may find their retirement income disappoints.
- **Complex lending.** The MMR requires lenders to carry out a comparison of the borrower's income and expenditure to evaluate affordability. This potentially disadvantages borrowers with substantial assets as these assets carry no weight in the affordability calculation. The same issue applies across the market. For example, someone who has saved for a child's school fees cannot apply these savings to this item of expenditure under the affordability calculation, artificially limiting the amount they can borrow.

Preface

This paper has been prepared by the secretariat of the Intermediary Mortgage Lenders Association (IMLA) to further the debate over the impact of changing mortgage regulation on non-standard borrowers in the UK.

IMLA is a long established specialist mortgage lender trade body focused upon the efficient and effective functioning of the intermediated mortgage market, where lenders sell their mortgage products via intermediaries/mortgage brokers. IMLA currently has 22 full members drawn from banks, building societies and specialist lenders and 11 associate members (see www.imla.org.uk for details).

This is the fourth in a continuing series of research reports issued by IMLA in 2014. The reports do not represent the specific views of individual members or associates but are provided as a collective contribution to the key issues of the day. IMLA draws on this material as part of its on-going debate and dialogue with government and regulators.

Contents

- 1 – Introduction
- 2 – Regulatory changes in response to the financial crisis
- 3 – Changes in lending criteria for non-standard borrowers
- 4 – Has the pendulum swung too far towards conservatism in the UK regulated mortgage market?
- 5 – Conclusion

Section 1 – Introduction

While the aggregate mortgage lending figures since 2007 show the impact of the financial crisis and subsequent economic recession, they shed little light on how mortgage borrowing has changed for the ordinary customer. They shed even less light on the changes faced by those borrowers who do not conform to the characteristics that define a 'normal' or standard borrower.

This paper focuses on the dramatic changes that 'non-standard' borrowers have faced since 2007, seeking to explain how enhanced regulation and the evolution of lender behaviour have influenced these changes.

First we need to define what we mean by a non-standard borrower. We have identified four categories of borrower that we believe cover most non-standard mortgage customers: the self-employed; those seeking to borrow into retirement; those who have had previous incidents of adverse credit; and those with complex financial affairs.

Section 2 – Regulatory changes in response to the financial crisis

We have talked before about the triple lock of new financial regulation. This comprises the changes to the prudential regulatory regime known as Basel 3; the MMR; and the introduction of a new system of 'macro-prudential' regulation with the establishment of the Financial Policy Committee (FPC) at the Bank of England.

Basel 3 capital adequacy regime

The Basel 3 regime sought to make banks and building societies safer by increasing the minimum level of capital they must hold against their loan books on a risk weighted basis, imposing a minimum leverage ratio (capital as a proportion of assets on an unweighted basis) and establishing liquidity requirements.

Macro-prudential regulation

The FPC first acted to cool the mortgage market in its June 2014 meeting when it decided to introduce two new requirements:

- That lenders must apply a 3% increase in bank rate when assessing the affordability of new regulated mortgage loans – the stress test.
- That lenders must limit lending at a ratio of 4.5 times income or above to no more than 15% of their new mortgages each quarter.

The Mortgage Market Review (MMR)

The MMR came into effect in April 2014 after a long consultation process that started with the publication of the Financial Services Authority's (FSA) discussion paper DP09/3 in October 2009. The main elements of the final rules are:

1. Lenders are responsible for assessing whether the customer can afford the loan, and they have to verify the customer's income.
2. Lenders are still allowed to grant interest-only loans, but only where there is a credible strategy for repaying the capital.

Transitional arrangements have been put in place to support existing borrowers. For example, existing borrowers will only require an affordability check where they are increasing the amount of the loan, or where a change has a material impact on affordability. However, this paper focuses on cases where the transitional rules would not apply.

Section 3 – Changes in lending criteria for non-standard borrowers

How have these regulatory changes and lenders' reaction to them impacted on lending to non-standard borrowers?

Borrowing into retirement

It is not uncommon for borrowers to find themselves needing to borrow into retirement. Any borrower over the age of 40 who is seeking a loan with a standard term of 25 years will be borrowing beyond a normal retirement age of 65, so the number of affected customers is substantial.

In the draft MMR proposals outlined in CP11/31 published in December 2011, the FSA provided more details on lending into retirement. The FSA proposed “that a lender should consider the effect of retirement on the income of the consumer if a mortgage will extend into retirement” and “that lenders should assess the plausibility of the stated retirement age.”

With most private sector employees now holding defined contribution (DC) pensions, where the customer is not in a position to know what their pension income will be with any certainty, lenders will find it hard to determine how affordable a loan extending into retirement might be. In response, many lenders decided to limit the term of loans which extended significantly into retirement. However the FSA's successor body, the Financial Conduct Authority (FCA), has argued that the rules provide the flexibility needed to meet the needs of this borrower group.

Nonetheless, lenders' concerns have not been fully addressed. The combination of scope for interpretation in the rules and an onus on the lender to assess affordability, with the aim of “protecting the borrower from themselves”, has left lenders with a concern that some lending could give rise to conduct risk.

For example, could a customer who borrows into retirement and then finds their pension insufficient to pay their mortgage seek to question the contract on the grounds that the lender breached the MMR? And how will future regulatory staff view cases of this kind where the customer has lost out?

As a result of these concerns most lenders have maintained their cautious approach. It is hoped that the FCA thematic review of the MMR, which is set to examine responsible lending in the first half of 2015, will provide more clarity and help lenders to better meet the needs of borrowers who are seeking flexibility from their lender.

The self-employed

The self-employed are a large and growing part of the workforce. Office for National Statistics (ONS) data shows that there are currently 4.6 million self-employed workers in the UK, 15% of the total of those in work, which is the highest percentage on record. Between Q1 2008 and Q2 2014, 732,000 (67%) of the 1.1 million increase in employment was in self-employment. The total number of employees rose by only 339,000 over the same period.

Assessing whether a loan is affordable is inherently more difficult when the customer does not have a regular salary. This has always been the case but for the larger lenders that rely on automated loan underwriting, the enhanced requirements that the MMR imposes on the lender to assess income has made lending to the self-employed more cumbersome. Previously these lenders could 'fast track' self-employed borrowers with high credit scores, removing the need to manually check the borrower's accounts or other financial statements.

As a result, the role of smaller lenders could increase in lending to the self-employed. These lenders are used to using manual underwriting processes and can take the time to understand how to obtain a fair measure of borrower income from reading sets of accounts, for example, adding back the salary of a spouse to get to a more accurate family income.

The termination of self-certified lending

Also, for some self-employed borrowers a self-certified loan was a convenient and speedier alternative to having to provide several years' financial paperwork. The MMR's requirement that the borrower's income is verified in all cases has shut off the self-certified option. However, after the financial crisis lenders had ceased offering self-certified loans so this regulatory change hardwires in a practice that the market had already adopted.

Prior to the financial crisis, self-certified mortgages represented an estimated 6-7% of all mortgage lending. As well as appealing to those seeking convenience, these loans were helpful to non-standard borrowers who had difficulty proving their income (e.g. newly self-employed borrowers who lacked a track record of annual accounts), but there was evidence of widespread abuse by customers seeking to borrow more than they could based on a normal affordability calculation. So there were sound public policy reasons for terminating self-certification even though it reduces borrowing options for the newly self-employed.

Adverse credit

Adverse credit covers a wide spectrum of borrowers from people with previous serious loan defaults to those that missed a monthly phone payment. Lenders have become more sensitive to adverse credit since the financial crisis but this is more a

commercial response to the heightened perception of risk since a crisis triggered by US sub-prime mortgage losses than a response to regulation.

The exception lies in the heavy adverse credit category. Whereas in the past some lenders might have offered a loan to a borrower with up to three county court judgements against them, today this so called 'heavy sub prime', where the lender focuses on the equity in the property rather than the borrower's income, has been excluded by the MMR.

Complex credit cases

Some wealthy individuals do not have the reliable income that forms the basis of the MMR's affordability calculation. For example, an individual with substantial assets such as a large equity investment that pays a modest or irregular dividend may not need to rely on their income to fund their lifestyle. The MMR is poorly suited to assessing the potential creditworthiness of these borrowers because it requires lenders to assess affordability with regard to the borrower's income and expenditure without regard to their assets or net worth.

In fact the MMR's emphasis on assessing affordability by comparing income and expenditure creates a broader problem because borrowers who have saved for specific expenses such as school fees cannot use these savings to offset these items of expenditure. So any ordinary salaried borrower could find their borrowing capacity reduced by the exclusive focus on expected income and expenditure. Previously lenders could take savings and other assets into account in assessing affordability but the more prescriptive approach set out by the MMR prevents this.

Section 4 – Has the pendulum swung too far towards conservatism in the UK regulated mortgage market?

The sign of a healthy but not over-exuberant lending market is one where risk is accurately priced. One feature of the market since the financial crisis has been that some categories of borrower have been entirely excluded. For example, those seeking loans above 95% LTV and many credit impaired borrowers have been effectively locked out of the market. This was the result of the violent swing in market conditions from 2008 but has been reinforced by the Basel 3 requirements.

To consider whether regulatory changes have contributed to an overly restricted market you need to view the market from both a lender and a borrower perspective:

Consumer protection perspective

Clearly the MMR is not just designed to protect lenders from potentially risky lending but also to protect consumers from taking on too much risk (referred to in DP09/3 as “protecting consumers from themselves”). While the industry has supported the removal of products such as self-certified loans, which allowed some consumers to act irresponsibly, there are many responsible borrowers who have always successfully managed their finances and do at times require a flexible approach to their mortgage in order to meet their personal objectives.

Lending into retirement is a classic example. With house prices elevated relative to incomes, many borrowers are not managing to purchase an appropriate family home until well into their forties or even their fifties. Indeed, an increasing number of people are not buying their first home until their forties.

A 50 year old borrower seeking a £200,000 loan would pay £1,055 a month in capital and interest on a 25 year term at an interest rate of 4%. If they were required to take out a mortgage with a 15 year term, their monthly payment would be £1,479, 40% more. While it is reasonable to consider the affordability of the loan once the borrower has retired, consideration also needs to be given to the practical financial implications for the borrower.

If, faced with the requirement to meet an accelerated repayment schedule, a family decides to remain in rented accommodation, they could suffer significant longer term financial detriment. Assuming they started with a rent of £1,055 a month and that rents subsequently rise by 2.5% a year, after 15 years this family would be paying £1,528 a month in rent with no housing equity to fall back on. Using this example, it is clear that an inflexible approach to lending into retirement will not serve the customer well.

Prudential perspective

The MMR is concerned with the borrower covenant component of credit risk (the borrower's ability to pay). But the security of the property is an equally important risk element, so an accurate assessment of credit risk needs to recognise the trade-off between loan-to-value and the strength of the borrower covenant. The MMR and recent macro-prudential requirements make no allowance for such risk trade-offs.

For example, interest only mortgages are not permitted without a 'credible' repayment strategy, regardless of how low the LTV is, and a credible strategy is not deemed to include the sale of the home. Ironically, for lenders this can result in a rise in the overall risk profile of the loan book, if low LTV business has to be turned away because it does not meet MMR or other regulatory criteria.

Disadvantage to owner-occupation

One concern from the above is that buy-to-let borrowers have been left with fewer constraints, for example being able to borrow on an interest only basis, giving them an advantage over owner-occupiers in the market place. The public policy benefits of homeownership do not seem to have figured in the regulator's thinking. This has led to the risk of future consumer detriment as individuals who are discouraged from buying their own home, for example because of the cost of a capital repayment mortgage, may be disadvantaged financially in the longer term by remaining in the rental market relative to entering owner-occupation.

Section 5 – Conclusion

Fewer and fewer borrowers fall into the traditional category of a salaried person, with no credit blemishes paying off their loan before a set retirement date. The UK mortgage lending industry has generally been able to meet the needs of the growing army of non-standard borrowers and the MMR has, for the most part, not prevented lenders from continuing to service these borrowers.

However, there are elements of the new rules that have inhibited lenders from taking a pragmatic approach. The conduct risk associated with MMR rules that could be interpreted differently by the regulator in the future is a real concern. The solution must be more clarity from the FCA about the boundaries of permissible practice and it must be hoped that next year's thematic review will provide this greater clarity.

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About IMLA

IMLA is the specialist trade body representing the interests of mortgage lenders who market their products through brokers, rather than solely direct or through a branch network. Its directors and members are drawn from the senior ranks of mainstream banks, building societies, 'challenger' banks and specialist lenders.

IMLA provides a unique opportunity for senior industry professionals to meet on a regular basis to discuss key current initiatives and contribute actively through IMLA and other industry forums.

IMLA was formed in 1988 as the Association of Mortgage Lenders and was instrumental in the creation of the Council of Mortgage Lenders (CML). It changed its name to IMLA in 1995. Subsequently IMLA helped bring the Association of Mortgage Intermediaries (AMI) into being and was instrumental in bringing the mortgage advisers qualification CeMAP to fruition. For more information, please visit www.imla.org.uk

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