

Mortgage lending – Back to the future?

At the same time as the FSA are working through enforcement cases against Mortgage Brokers, with announcements on an almost daily basis, we hear a number of speeches and useful data on the current state of the market and what regulatory changes could prevent a repeat of these problems.

Looking from today's perspective there is a temptation for the past to take on a rosy glow with a mental picture of Mr Mannering as the role model with only customers best interests at heart.

The past was not as rosy as it seems. We did have tight controls over mortgage lending, we also had a social environment where Banks and building Societies were our masters not our servants. Readers aged over 40 years may recall some of the features of the "services" we were, sometimes, allowed to take advantage of:-

- Limited opening hours and no access to cash outside those times
- Fees for having a Bank Account
- A very paternalistic attitude to customers
- Two references from existing customers to even open an account

As a Bank employee I was only permitted to take out a mortgage if I had no intention of marrying as the favourable benefit of a fixed rate mortgage was only available to men. Unbelievable, if not illegal now!

In today's world we want and need the facilities that Banks and Building Societies make available to us. The speed and choice of transactional banking through a range of mediums and the feeling that the Bank is our servant with whom we choose to place our money and with whom we expect to contract for loans where we can evidence our ability to support the interest payments and eventually repay.

We also want the help that professional mortgage Brokers provide to us by helping us to make the right selection of rates, terms and conditions that are on offer.

So, what are the main causes of dishonest, reckless and sometimes criminal activities that are coming to light as the full impact of the decline in house prices and unemployment hits 2.2m.

- Fraudulent information on mortgage applications about the nature and extent of employment
- Fraudulent information to verify income
- Absence of information to verify income
- No evidence of affordability

There are other reasons for the actions; often the inability to continue to trade and failing to meet the Threshold Conditions which is bound to happen when the mortgage market shrinks and business is non-existent.

In the heady days of 2003/6 those individuals who simply purchased a property in which to live seemed to lack initiative and entrepreneurial spirit. We were bombarded with advertising such as the memorable mortgage for seven times income offer from Abbey and invitations to attend free seminars and learn how to become a millionaire through buy to let property purchase.

The absolute failure to follow the "affordability" rules in MCOB are borne out by one of the many interesting statistics provided by Adair Turner at the FSA Mortgage Conference on the 12 May 2009. Of the Higher Risk loans made in 2007:-

- 45% Non-income verified
- 35% Interest-only
- 30% Loan-to-income ratios of 3.5 or over
- 15% LTV thresholds of 90% or over
- 5% To individuals who were already credit impaired

Mr. Adair indicates in his speech that the FSA is minded to set limits and that the debate is really about whether those limits should focus on Loans to Value or Loans to Income. *“So should the FSA end up recommending limits to LTV or LTI – the headline issue on which the debate about the future of the mortgage market sometimes focuses?”* He goes on to point out the many other micro and macro issues that have played a part in the current situation and concludes that we have time to ponder the matter in order to make the right decisions.

At this point there is relevance in returning to the past. In the minds of lenders the value of the property was only relevant at two points in the lifetime of the mortgage. Firstly at the outset the loan would not be more than 75-80% of the current value of the property. As well as conforming to rules for Mortgage Lending then in force it allowed for reasonable fluctuation in the value of the property driven by the market or by the level of repair. The second point at which the property value became of any relevance to the lender was in the event of default by the borrower.

The ability of the borrower to repay the mortgage was the next, and overriding, consideration in making the decision to lend and for the potential borrower was something of a challenge. First of all there was no possibility of borrowing from a Bank or Society where you had no track record evidencing your ability to save on a regular basis. Know your customer was the basis on which the lender would even give consideration to your request. A full budget including such matters as the cost of living in all its aspects (down to the cost of birthday presents!) as well as the additional expenses incurred by buying a property or moving to larger one had to be itemised. Evidence of earnings was required in the form of original payslips and the information was checked directly with your employer. For the self employed audited accounts for the last 3 years were needed.

Of course, lenders realised that the economic environment with supply and demand for housing, levels of employment and fluctuating interest rates would put strains on the viability of the original decision to lend over the lifetime of the mortgage but by starting with prudent margins they expected that they as lenders and you as a borrower would be able to sustain the repayment schedule over the 25 years of the loan.

The principle of LTI has always been in place. This is what the Mortgage Code Compliance Board captured in its Mortgage Code (1998):-

All lending will be subject to our assessment of your ability to repay. This assessment may include:

- taking into account your income and commitments;
- how you have handled your financial affairs in the past;
- information obtained from credit reference agencies and, with your consent, others (for example, employers, other lenders and landlords);
- information supplied by you, including verification of your identity and the purpose of the borrowing;
- credit assessment techniques (for example, credit scoring); your age;
- any security provided, including the condition and value of the property.

Under FSA Regulation we have the standard of suitability enshrined in MCOB 4.7.4 that *“a regulated mortgage contract will be suitable if, having regard to the facts disclosed by the customer and other relevant facts about the customer of which the firm is or should reasonably be aware, the firm has reasonable grounds to conclude that: (a) the customer can afford to enter into the regulated mortgage contract”*

We have evidence from the past that rigorous supervision and enforcement actions do achieve conformance. Consider the sea change in behaviours in the financial advice arena when the PIA focussed on the evidence of suitable advice in the early '90's. While painful, and to some extent bureaucratic, that approach forced improved standards and better evidence of customers circumstances.

The missing link in the recent past has been the failure of lenders to manage their own risks allowing loans. Sometimes relying upon third parties to make the assessment of the borrowers ability to repay and setting lending parameters that could only remain viable in current market conditions.

The latest picture coming out from the data presented by Mr Adair shows some small reduction in LTV and LTI levels but LTI still sits at above 3 times income. Sadly this commonly used yardstick to assess the

level of loan as a multiple of income is still with us despite the rules clearly focussing on what a borrower can afford to repay.

We will never live in world where future house prices, interest rates or employment levels are predictable and we cannot go back to the days of Mr Mannering and the intimate knowledge of a customers complete financial dealings. What we can do is enforce the rules we have to ensure affordability and control the prudence of lenders.

To do that we will need people as well as computer based credit assessment to tease out the real situation of the customer. The process should help the customer to recognise the feasibility of their proposition by looking at the facts in an objective rather than judgemental way.

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Published by Complinet in November 2009