



Association of Mortgage Intermediaries response to FSA's consultation paper 10/16 MMR Responsible Lending – interest-only

This response is submitted on behalf of the Association of Mortgage Intermediaries (AMI). AMI is the trade association representing over 75% of UK mortgage intermediaries.

Intermediaries active in this market act on behalf of the consumer in selecting an appropriate lender and product to meet the individual consumer's mortgage requirements. Our members also provide access to associated protection products.

Our members are authorised by the Financial Services Authority (FSA) to carry out mortgage and insurance mediation activities. Firms range from sole traders through to national firms and networks with thousands of advisers.

This submission should be considered in conjunction with AMI's previous submission to Financial Services Authority's for Mortgage Market Review (MMR) Discussion Paper (DP09/3).

AMI's submission is only in relation to the interest-only issues in the CP. We have not submitted a response to the non-bank lending issues and we have not been involved in any pre-consultation activities on this subject. AMI will respond to FSA on the remaining issues in the CP by 16 November 2010.

We welcome that FSA continues to consult openly with the industry on its thinking on interest-only mortgages. However, the fragmented approach taken, by breaking the various Consultation Papers and Policy Statements into subject issues, adopted by FSA has made it difficult for us to fully respond to these issues.

Executive summary

- Interest-only is still an important product with great relevance to a significant minority of consumers in the current and future mortgage market.
- Appropriate advice is the key to ensuring that those consumers considering an interest-only mortgage make the right choice and have a suitable repayment method in place.
- Many lenders have already adapted their position on interest-only mortgage lending due to changing market conditions and perceptions of risk, by alternating their criteria and restricting certain customer groups across the mortgage industry.
- We are concerned that the implementation of the FSA's proposals for interest-only mortgages would result in lenders withdrawing the majority of their interest-only products from the mortgage market. What would remain would be a limited number of very niche products which would limit lending and the recovery of the housing market and would be insufficient to support consumers' needs.
- Requiring that lenders check the existence and validity of the repayment method being employed by the consumer to support their interest-only mortgage, on an annual basis, would result in substantial increases in the cost of compliance. These costs will



eventually be passed on to the consumer resulting in higher costs for interest-only mortgages.

- Expecting lenders to make a judgement on the adequacy of the repayment method will substantially increase the regulatory risk profile of lenders. This could lead to further measures been taken over the types of repayment methods they will accept. This could lead to some lenders viewing the risk as greater than the benefit, so withdrawing this option.
- We are concerned about those consumers who are currently on interest-only mortgages, with a current valid repayment method in place, becoming mortgage prisoner due to the requirements around their chosen method of repayment changing. If the FSA is to implement its proposals, as made in this CP, it will need to ensure that appropriate transitional arrangements are in place for those consumers who will fall outside of the criteria for holding a valid repayment methods.
- Selling the property at a later date should not be banned and FSA has not provided sufficient evidence to justify further product regulation. Consumers should have some level of responsibility for ensuring they can repay their interest-only mortgage at the end of the term in the same way in which they have responsibility for ensuring that they can repay the mortgage on a capital and repayment basis.

Interest-only mortgages – consumer benefits

Interest-only mortgages allow consumers the flexibility to choose how they repay the capital element of their mortgage. In some cases a consumer will decide that contributions into an investment backed repayment vehicle will provide a better outcome, over the longer term, than simply paying an additional sum towards a capital and repayment mortgage. However, this is not the only way in which consumers can benefit from the flexibility that an interest-only mortgage offers. Interest-only can also be used by some vulnerable groups, such as first-time buyers and those in payment difficulty, and is of particular relevance when used on a short-term basis as a means of easing affordability.

It must also be remembered that many mortgage products (both capital and interest and interest-only) now allow over payment facilities which can be used to reduce the capital balance without consumers being constrained to the rigid capital and interest schedule of repayments from the outset. This can be particularly useful for those consumers who do not benefit from a set monthly income, such as those who are self-employed.

Lender responsibility

There are obvious risks to the consumer if they are unable to repay the capital element of the mortgage at the end of the term, however, these risks are alike to those faced by lenders. The consumer will be able to sell the property at the end of the term to repay the mortgage, regardless of the repayment methods selected at the outset. However, the lender will want to guard against bearing the loss if the funds are not sufficient to repay the capital. Therefore, lenders already apply risk controls to limit any potential loss.

The percentage of interest-only mortgage sales compared to capital and repayment sales has fallen from 24% in 2007 to 21% in 2008 and 14% in 2009.¹



Therefore, consumers and lenders have clearly taken action to reduce their exposure to interest-only products.

In addition, CML data shows that *“over the last year or so, almost 75% of all loans for house purchase have repayment mortgages. This year, 8% of loans for house purchase have been on an interest-only basis, but with a specified repayment vehicle in place”*.²

It can be seen that lenders have already taken responsible action in tightening the products being offered. Furthermore, as consumers take account of the current economic conditions their attitudes to risk, and the expectations that drove some to previously select an interest only mortgage, have changed.

Whilst there is likely to be some merit in lenders checking the validity of repayment methods, the frequency of doing this must be balanced against the outcome of such checks at a given point in time, and the cost of doing so.

Lenders should not be required to become responsible for the anticipated performance of investment backed repayment vehicles. The lender is not in a position to make such assumptions about performance or about any subsequent adjustments to the premium that might be required. If the consumer approaches the lender pro-actively about such issues then they should be encouraged to seek appropriate financial advice on issues surrounding the performance of any investment backed repayment vehicles.

Product regulation

We do not believe that FSA has provided sufficient justification for it to apply caps on LTV, LTI or equity levels. Such decisions should be left for individual lenders to take based on their own risk-based commercial judgments. Furthermore, regional variations on property prices and income over time would be difficult to account at a product regulation level. Any outright ban on using the sales of a property would exclude too many consumers for whom this repayment method is valid. Furthermore, it may cause detriment to those vulnerable consumers for whom the sale of their property is the only option available to them.

Lenders should have systems in place to measure the risks associated with each application and decide whether they are prepared to lend to the particular consumer. Such a decision should not be constrained by rules from a strict centralised position. Guidance around what types of consumers these products may not be suitable for could be provided, such as those consumers undertaking a right to buy purchase and/or those receiving social benefits.

It would be helpful for FSA to provide greater clarity around the terms: repayment method, repayment plan and repayment vehicle. Such phrases are used in what appears to be an interchangeable manner throughout the consultation. Furthermore, individual firms, be they lenders or intermediaries, may have their own interpretations and definitions of these terms.

Social impacts of restricting interest-only mortgages

The social impacts of restricting access to interest-only mortgages have not been considered sufficiently. The alternative to buying a property is renting, be it privately or through social housing. Therefore, even if a consumer, after owning a property through the duration of the interest only mortgage returns to renting after selling the property at the end of the mortgage



term, their situation would not be any different from if they had not decide to purchase the property on an interest-only basis in the first place. What they would have potentially benefited from is some level of capital appreciation and an erosion of their debt, in real terms, due to the probable long-term effects of inflation. That is not to say that they have relied on such factors to leave them with a given sum of equity at the end of the term.

Furthermore, those consumers would have benefited for a greater degree of security of tenure than renting under a short-term tenancy agreement. However, it is essential that consumers are made aware of the risks that there is no guarantee that the sale price of the property will be sufficient to repay their mortgage at the end of the term.

For many the basic cost of renting may be higher than purchasing a property on an interest-only basis. In July 2010 Zoopla's Rent v Buy Index found that buying on an interest-only basis was cheaper than renting in 74% of Britain¹. By placing further restrictions on interest-only, not just through the affordability assessment criteria, consumers may be forced into incurring a higher cost through renting than they would have otherwise faced if they were able to purchase a property on an interest-only basis. This issue will be considered further in our response to the affordability assessment.

Consultation questions

Q16: How prescriptive should we be in defining a valid repayment method?

The validity of the repayment method will vary for consumer to consumer, therefore, the FSA should not be prescriptive about what constitutes a valid repayment method. Creating a list of FSA approved methods will limit consumer choice and remove some consumers who have a perfectly valid repayment method for their own individual circumstances from the market place. Furthermore, any such list would be inflexible for taking account of developing market condition or alterations to legal and taxations requirements.

Advice surrounding the consumers need for certainty of repayment is a more important consideration.

Investment vehicles

Some investment products may be considered too volatile or too high risk for some consumers to use. For others they may be appropriate if the consumer has the ability, and desire, to increase their premiums and/or have a contingency plan in place if the investment return is not achieved at the end of the term.

If any investment product is to be used to repay the capital element of the interest-only mortgage then the consumer should seek appropriate financial advice from someone qualified to provide such advice, to ensure that the product recommended best fits their individual needs and circumstances.

Those consumers who have a high-net worth or are financially capable may hold a portfolio of investment products as part of their investment strategy. They may not have a set product or policy in mind to repay their mortgage but rather rely on an overall return from their investments. Such investment portfolios are likely to have a mix of both high risk and low risk



products. However, some of these high risk products may not be acceptable methods of repayment by FSA but may be a core part of the overall investment portfolio that the consumer holds. These may also have a higher degree of volatility that makes any short-term assessment of performance a sub-optimal decision.

It is highly likely that such consumers would have already received investment advice from an Independent Financial Adviser and are receiving regular reviews regarding the performance of their portfolio over time. However, the lender themselves would find it externally difficult to take a view on whether these consumers investment portfolios will be valid and adequate as a method of repaying an interest-only mortgage.

Using a portfolio of investments is a perfectly legitimate strategy that could potentially be prohibited because of the investment products contained within it and the lack of a clearly assigned investment product that the lender can easily validate to fulfil FSA's requirements.

Selling the property at the end of the mortgage term

Whilst we accept that selling the property at the end of the interest-only mortgage term may not be a valid repayment method for all consumers, for many it will be. In particular there will be many circumstances when the consumer will not directly be downsizing their residential property, such as where it is an investment property, a second home, or under an equity release scheme. Controls will already have been put in place by the lender in these circumstances, such as setting an appropriate maximum LTV.

Defining a valid repayment method

We believe that lenders should be required to have policies in place as to the methods of repayment they will accept and the controls they have in place to reflect the risks of particular repayment methods to both the lender and consumer. FSA should certainly have a supervisory oversight of the lenders policies to ensure they are adequately robust. Allowing lenders to set their own policies on the repayment methods they will accept, and the criteria around them, will allow lenders to take into consideration a range of consumer groups, whilst still being able to adapt to change and innovation within the mortgage market.

The proposals, however, could lead to lenders adopting more generic criteria. Consumers who had previously had a valid repayment method could become mortgage prisoners as their repayment method is no longer acceptable. Of particular concern would be the view lenders would take on consumers using the sale of a business to repay their interest-only mortgage, for example upon their retirement.

Consumer responsibility

The FSA's proposals around the lenders oversight of repayment methods at the point of sale and during the life of the mortgage are likely to have an impact on the type of repayment method that lenders will accept. However, we believe that it is essential that the borrower maintains responsibility for the repayment of the capital and therefore the management of the repayment method. Lenders can take a view on whether the consumer's repayment method is both valid and adequate to manage their own risks and controls. However, the consumer will need to take some responsibility in ensuring that a valid and adequate repayment method remains in place.



The majority of consumer may find it difficult to judge all the factors which should be consider before establishing if an interest-only mortgage is the right product for their needs and circumstances. Consumers considering an Interest-only mortgage will need expert advice to establish whether an interest-only is right for them and what repayment methods it appropriate, valid and adequate. This is best achieved through financial advice being offered to them.

If FSA is concerned about consumers not selecting interest-only for the correct reasons and not fully considering the risks, FSA could require that interest-only is sold solely on an advised basis. This will give those consumers the enhanced level of service their circumstance could require. It will also give greater accountability to the validity of the method of repayment selected by ensuring that an approved person has considered their suitability when provideding regulated advice.

Q17: Should lenders be required to check that there is a valid repayment method in place at the start of the mortgage, and then periodically through the term of the mortgage? How do you think this should work? How often should lenders check on the repayment method?

We certainly believe that lenders should be accountable for ensuring that a valid repayment method is in place at the outset of the mortgage. Most will currently request such information already. The question of whether the mortgage lender should continue to enquire whether the repayment method is still valid and how often this should be approached would depend, in part, on the stated method of repayment.

The wider MMR appears to be setting a distinction between responsibilities for assessing affordability, appropriateness and separately advice. The suggestions surrounding interest-only and repayment vehicles appear to run counter to the clarity that we think FSA is trying to deliver.

If the consumer is using an investment product to repay their mortgage then they will receive performance updates from the product provider. Is it FSA's intention that lenders effectively have sight of these? Or are they simple asking whether the repayment vehicle is in place?

When considering the adequacy of a method of repaying a mortgage, consideration will need to be given to general market conditions and those specific to the product. The terms and conditions of any product, taxations issues, both in terms of income and capital and the past performance of such products should also be considered. For an investment already in place or a portfolio of investments the current performance would need to be considered as would the volatility of the performance of the investment.

It will be impossible for anyone, lender or adviser, to ensure that an investment linked repayment vehicle will be adequate to repay a mortgage. Only if the consumer is prepared to take some responsibility for the risk they have accepted, the performance of the product and then take action can they be assured of the product reaching its required target. Consumer must be able to make amendments, such as increasing the premium paid on their chosen repayment vehicle.



Consumers' circumstances are likely to change over the term of the mortgage. They could reduce or stop their premiums being paid but the product may still be used to repay the interest-only mortgage in full or in conjunction with another method.

If the repayment method is no longer valid and/or adequate

If they cease contributing towards a repayment vehicle then is FSA expecting the lender to revert the mortgage to a repayment basis, as the consumer would effectively be in possession of an interest-only mortgage with no valid method of repayment? One of the first signs of financial difficulties could be that contributions to a repayment method ceases. If this is identified by the lender, and the consumer is reverted to a repayment mortgage, they could be subsequently moved to an interest-only mortgage for forbearance reasons.

If the consumer is moved to a repayment mortgages, as they no longer have a valid repayment method, then this forces consumers to pay down the cheapest credit first. i.e. where a customer has higher rate credit card, or personal loan debts, it would be wise to pay interest-only on the mortgage and pay those debts with higher interest rates down first and then to move to repayment on the mortgage. In a sense, the unintended consequence of FSA's proposals would be to force consumers to take actions that are not actually always in their best interests

Mortgage prisoners

The regulatory approach for new interest only sales is likely to have an impact on existing interest-only customers. We are concerned about those consumers who currently have an interest-only mortgage with a repayment method that will become prohibited under FSA's proposals, or generally no longer accepted by lenders. Those consumers who have long maintained a method of repayment may no longer be able to use it against an interest-only mortgage in the future.

Therefore, we would hope to see that FSA will propose some form of transitional arrangements to mitigating the impacts of some of these proposals on these groups of consumers.

Q18: Do you think there should be further controls on repayment methods? For example, how should the 'sale of property' be controlled to prevent it from being used where it is not a realistic option? If a minimum LTV, amount of equity or income level was set, where and how should this be done?

Product regulation

As we have stated above, we believe that the sale of the property can be a perfectly valid method of repayment for many consumers and for certain types of products. We do not believe that product regulation is justified or that it would achieve the FSA desired outcomes. Lenders already place controls around the maximum LTV and the maximum sum they will lend.

Using the sale of property at the end of term is now, and can be in the future, a genuine and logical option for some consumers. The purchase of the property on an interest-only basis may have been used to facilitate specific needs, such as acquiring appropriate housing in a



particular area for work or children's schooling needs. Those consumers will have more options than simply trying to purchase a downsized property out of the remaining equity. Many consumers may consider renting as a viable option as their circumstances change over time.

Advised route only for interest-only mortgages

Suitable advice is the key to ensuring that the method by which the consumer takes out a mortgage is appropriate for their circumstances. We believe that the majority of consumers will still opt for a capital repayment mortgage. For those who consider an interest-only mortgage, allowing interest-only mortgages to only be sold on an advised basis would provide consumers with the enhanced level of service and protection they require. It would also ensure that an approved person is accountable for assessing the suitability of the interest-only mortgage for the consumers' needs and circumstances.

Q19: Do you agree that these customer types benefit from interest-only mortgages? Are there any other customer types that might benefit from interest-only?

Overall we agree with the customer types included in the FSA's list. However, individual circumstances will also dictate who interest-only mortgages are suitable for. Whilst it is possible to construct some broad categories in which to place consumers, this should not be at the expense of excluding individuals who do not fit within the prescribed categories. Therefore, any list of consumer categories that interest-only mortgages could be suitable for should not be exclusive.

To the list that FSA has included within the CP we would certainly add those smaller business customers who are borrowing against commercial premises and foreign nationals residing in the UK for only short period of time.

For lenders and consumers the ability to move a consumer who is experiencing financial difficulties to an Interest-only mortgage is essential forbearance policy. Therefore, it is of the utmost importance that the use of interest-only for forbearance is not included as part of these proposals.

Q20: Do you agree that some form of interest-only product without need for a repayment vehicle may be appropriate on a temporary basis for first-time buyers? If so, how should this be achieved? Would there be any specific impact on older consumers?

First time buyers

The decision as to whether an interest-only mortgage is appropriate or not for a consumer is multifaceted. It is clear that many first time buyers would benefit from having an initial interest-only period on their mortgage.

A 'low start' mortgage is still effectively a repayment mortgage with an interest-only element, therefore, it should not need a separate repayment method attached to the interest-only element. After all the method of repayment is that the mortgage will be converted to a capital repayment basis, after the initial period, which will repay the capital before the end of the term.



A further consideration could be to allow first time buyers affordability to be assessed over a longer term than the 25 years used in the maximum borrowing capacity calculation. However, this issue will be considered further in our submission on the affordability assessment elements of the CP.

Short-term finance and bridging loans

The CP ignores the issue of short-term finance, such as bridging loans qualifying as regulated mortgage contracts. Bridging finance is short-term finance which generally does not exceed a term greater than one year. The product is never designed to repay a mortgage over a long-term but rather as a means of covering a temporary short-fall in finance. Bridging loans are generally used by consumers to purchase a new home before the sale of their current property has completed or for purchasing a property via an auction. The consumer will generally convert the loan to a standard mortgage when it is suitable for them.

It would not be appropriate to require that a repayment method is in place for this type of finance. The design of these products means that the repayment method will be to convert to a standard mortgage after a short period of time. The standard mortgage application would then be undertaken in line with FSA rules.

In addition, given the nature of this type of product it would not be appropriate to calculate the affordability on a capital and interest basis, over a 25 year term. This issue will be explored further in our submission on affordability assessments.

Q21: Do you agree that there are some limited customers where assessing affordability on an interest-only basis may be appropriate? If so, when? And should any additional controls be applied to prevent the being gamed on affordability grounds?

There are circumstances where lenders should not be required to assess a mortgage application on a capital and interest basis. This could be where it is clear that the property can be sold to repay the mortgage, without affecting the consumers' residential property, such as where the property is an investment or a second home.

Likewise those consumers who will only reside in the country for a limited period of time should be able to have their mortgage application calculated on an interest-only basis. Although the mortgage will be used to pay for their primary residence, the sale of the property at the end of the term will not require them to fund the purchase of a further property in the UK.

Furthermore, those high-net worth consumers who are using existing assets, and not relying on future income, to repay their mortgage should also be allowed to have their income assessed on an interest-only basis.

Whilst FSA has proposed these exemptions would need to be agreed between individual firms and their supervisors, through the use of waivers or modifications, FSA needs to consider what the consequences for consumers would be if the waivers and/or modifications are withdrawn at a later date.



Q22: Do you think that any changes to our interest-only requirements will impact any groups with protected characteristics (e.g. race, religion)?

No.

References

¹ <http://blog.zoopla.co.uk/2010/07/21/zoopla-rent-v-buy-index-buying-cheaper-than-renting-in-74-of-britain/>

² CML/BankSearch Regulated Mortgage Survey

³ <http://www.cml.org.uk/cml/publications/newsandviews/73/265>

AMI
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