Mortgage Market Review summary – Responsible lending

This factsheet sets out a summary of the key changes to the MCOB rulebook relating to responsible lending requirements. Under the MMR requirements the responsible lending rules only apply to lenders. However, intermediaries are expected to consider if their clients are likely to obtain the mortgage from the lender's criteria. As such these rules are also relevant to mortgage intermediaries.

The assessment of affordability

- Before entering into, or varying, a mortgage contract, a lender must assess whether the customer will be able to pay the sums due
- The lender must not enter into the mortgage unless it can demonstrate that the new or varied mortgage contract is affordable for the customer
- Payment of sums due means the making of the payments to repay the sums advanced and interest as they fall due.
- The above points do not apply for interest roll-up mortgages and transitional arrangements

Where the affordability assessment does not apply

The affordability assessment rules do not apply to:

- A variation of an existing mortgage contract; provided the conditions below are met.
  - The proposed new or varied mortgage contract would not involve the customer taking on additional borrowing, other than to finance any product fee or arrangement fee
  - There is no change to the terms of the mortgage contract which is likely to be material to affordability
- Not considering the following points as likely to be material to affordability may be relied upon as tending to show contravention of affordability assessment rules:
  - An extension of the term of the mortgage which it is reasonable to expect will extend into the customer's retirement
  - Changing from a repayment mortgage to an interest-only mortgage, or vice versa
  - The addition or removal of a customer.

(The list is not exhaustive).

Assessing affordability

When assessing whether a customer will be able to pay the sums due, a lender must:

- Not base its assessment of affordability on the equity in the property or take account of an expected increase in property prices

- Take full account of the income of the customer, net of income tax and national insurance; and, as a minimum:
  - The customer's committed expenditure
  - The basic essential expenditure
  - Basic quality of living costs of the customer's household
- Assess affordability on the basis of both repayment of capital and payment of interest over the term, except where lending under the interest-only mortgage rules
- Take account of the impact of likely future interest rate increases on affordability.

End of self-certification

A lender must not rely on a general declaration of affordability by the customer or their representative.

Income multiples

Income multiples can still be used but lenders must also be able to demonstrate that the mortgage is affordable, having taken full account of the customer's income and expenditure, the impact of future likely interest rate increases on affordability.

Income

In considering the customer's income:

- A lender must obtain evidence of the income declared by the customer.
  - Whether document-based or derived from an automated system it must be of a type and for a period to support the income being taken into account
  - It must be subject to appropriate anti-fraud controls
- A firm must not accept self-certification of income.

Types of income

- Income may be derived from sources other than employment (such as investments)
- The necessary evidence will vary according to such factors as:
  - Employment status (employed, self-employed, a contractor or retired)
  - The length of employment
  - Any elements of income that are not contractually guaranteed. For example income from overtime may be evidenced by payslips over a period of time or by checking the level of income regularly paid into a bank account
- For a self-employed customer, a firm may wish to consider using projections of future income, where these form part of a credible business plan
- A firm may use information it already holds about a customer's income, for example where the customer holds a current account with the mortgage lender.
- The source of evidence must be independent. The evidence can be independent of the customer even where it is supplied by the customer, for example, in the form of payslips, bank statements or tax returns
- A lender may use information provided by an intermediary or other third party but the lender will retain responsibility for compliance with the responsible lending rules.
- Mortgage lenders must adhere to their obligations under SYSC 8 in respect of outsourcing where they choose to use a third party to verify income information.

Expenditure

A lenders assessment must consider:

- Committed expenditure of a customer - credit and other contractual commitments, which will continue after the mortgage (or variation), is entered into. Examples are:
    - Loans and credit cards
    - Hire purchase agreements.
    - Child maintenance
    - The cost of a repayment strategy (for an interest-only mortgage)
- Basic essential expenditure of a customer:
    - Housekeeping (food and washing)
    - Gas, electricity and other heating
    - Water
    - Telephone
    - Council tax
    - Buildings insurance
    - Ground rent and service charge for leasehold properties
    - Essential travel (including to work or school).
- Basic quality of living costs - expenditure which is hard to reduce and gives a basic quality of life (beyond the absolute essential expenditure in):
    - Clothing
    - Household goods (such as furniture and appliances)
    - Personal goods (such as toiletries)
    - Basic recreation (TV, basic recreational activities, non-essential transport
    - Childcare.

Evidence of expenditure

- A lender may generally rely on any evidence of income or information on expenditure provided by the customer unless it has reason to doubt the evidence or information
- When taking account of the customer's committed expenditure, a lender must take reasonable steps to obtain details of the customer's actual outstanding commitments. For example by using:
    - A credit reference agency
    - A checking credit card or bank statements
- When considering basic essential expenditure and basic quality of living costs a lender may use details of the actual expenditure or statistical/modelled data as appropriate.

Future changes to income and expenditure

A lender must take account of any likely changes to income and expenditure when assessing whether the customer will be able to pay the sums due.

- Examples of future changes to income and expenditure are:
    - Reductions in income occurring from retirement or redundancy
    - Where another loan commitment that will become due during the term.

Lending into retirement

- A lender should take a prudent and proportionate approach to assessing the customer's income if the term extends beyond their retirement date
- The degree of scrutiny required will vary according to the period of time remaining to retirement when the assessment is made
    - The closer the customer is to retiring, the more robust the evidence of the level of income in retirement should be. For example, if retirement is many years away the existence of a pension may be sufficient. If retirement is close a more robust assessment of expected pension income may be required.

Debt consolidation and credit-impaired customers

Where the purpose of the mortgage is debt consolidation and the customer is credit-impaired:

- Where the debts which are to be repaid using the sums raised by the mortgage were not repaid, the transaction would not be affordable for the customer, the lender must take reasonable steps to ensure that, on completion of the transaction, those debts are actually repaid.
- If the lender has assumed that the customer's existing debts, which are to be repaid using the sums raised by the mortgage, will not in fact be repaid it must include them in the committed expenditure in the affordability assessment.

Considering the effect of future interest rate rises

- The mortgage lender must consider the likely future interest rates over a minimum period of five years, unless the interest rate for the mortgage is fixed for a period of five years or more
- A mortgage lender must be able to justify the basis it uses for determining likely future interest rates
  - An example of market expectations is the forward sterling rate published on the Bank of England website
  - A mortgage lender should not use its own forecast
- Even if the mortgage lender believes interests rates are to be less than 1%, during the first five years, it must still assume a minimum interest rate of 1% over the period.

Responsible lending policy

Lenders must set a responsible lending policy which sets out the factors they will take into account when assessing a consumer's ability to pay the sums due.

Monitoring

Lenders must put in place, and be able to demonstrate that they have, robust systems and controls to monitor the effectiveness of its affordability assessments.

Alternative provisions for loans with high-net worth mortgage customers

Where a mortgage is for a high-net worth mortgage customer, a lender may opt to apply alternative provisions for these high-net worth customers, in place of the standard affordability assessment requirements.

When assessing whether a high-net worth customer will be able to pay the sums due, a lender must:

- Not base its assessment of affordability on the equity in the property or take account of an expected increase in property prices
- Take full account of the income, net of income tax and national insurance, or net assets (or both) of the customer; and the customer's committed expenditure; and
- Take account, in general terms as a minimum, of the basic essential expenditure and basic quality of living costs of the customer's household
- Assess affordability on the basis of both repayment of capital and payment of interest over the term, except where lending under an interest-only mortgage where a creditable repayment strategy is understood
- Take account of the impact of likely future interest rate increases on affordability

- Must not rely on a general declaration of affordability by the customer or their representative.

Income - Alternative provisions for loans with high-net worth mortgage customers

In taking account of the high-net worth customer's income and/or net assets:
- A lender must obtain evidence of the income and/or net assets being declared
- The source of the evidence must be independent of the customer.

Expenditure - Alternative provisions for loans with high-net worth mortgage customers

- The consideration of committed expenditure, basic essential expenditure and basic quality-of-living costs are the same as that used for the standard assessment
- Lenders should be aware of any likely future changes to the income and expenditure during the term of the mortgage contract.

Interest-only mortgages - entering into interest-only mortgages

- A mortgage lender may only enter into an interest-only mortgage, or switch a repayment mortgage onto an interest-only basis for all or part of its term, if:
    - It has evidence that the customer will have in place a clearly understood and credible repayment strategy
    - The repayment strategy has the potential to repay the capital borrowed and any interest expected to be accrued under the interest-only mortgage
- An interest-only mortgage includes any mortgage that includes an interest-only period or where only part of the sum is advanced is on an interest-only basis
- A mortgage lender must not accept 'speculative' repayment strategies.

Repayment strategies

The following are examples of repayment strategies that may, subject to the circumstances of the customer, be acceptable:
- Regular deposits into a savings or investment product
- The periodic repayment of capital from irregular sources of income (such as bonuses or some sources of income from self- employment)
- The sale of assets such as another property or other land owned by the customer.

The following examples may be relied upon as tending to show contravention of that rule on clearly understood and credible repayment strategies:
- An expectation that the value of the property will increase over its term sufficiently to enable the customer to sell the property to repay the capital borrowed
- An intention to utilise an expected, but uncertain, inheritance to repay the capital
- The sale of the property where that is the customer's main residence and the mortgage lender does not consider whether the property will have the potential to:
    - Provide sufficient funds for the customer to repay the capital borrowed, and
    - Allow the customer to purchase a cheaper property to reside in or execute any other associated strategy
- Where the repayment strategy is the sale of the property a mortgage lender may wish to consider factors such as the equity in the property in relation to the level of property prices in the relevant area at the time of the consideration.

(The above list is not exhaustive).

Assessing affordability under an interest-only mortgage

Instead of assessing the affordability on a capital and repayment basis, for an interest-only mortgage, a lender may assess affordability on the basis of payment of interest only over the term and include the cost of the repayment strategy in the committed expenditure.

Review during the term of interest-only mortgages

- The review rules will apply to all interest-only mortgages which a mortgage lender enters into on or after 26 April 2014, except:
    - Lifetime mortgages
    - Bridging loans
    - Where the repayment of capital borrowed and interest accrued, is certain
- A mortgage lender must carry out a review once during the term of the mortgage
- The review is not required where, despite reasonable efforts to contact the customer, the mortgage lender has been unable to do so
- Following the review, if appropriate, the mortgage lender must take reasonable steps to discuss with the customer what may be done to address the situation.

Interest-only policy

A mortgage lender which enters into interest-only mortgages must include in it lending policy a policy on interest-only mortgages lending.

Assessing the customer's repayment strategy for bridging loans

For a bridging loan which is an interest-only mortgage:

- Where the customer's repayment strategy is the sale of his existing home, the mortgage lender may wish to consider asking for it to be supported by an independent valuation, as a condition of accepting that repayment strategy.
- Where the customer's repayment strategy is to replace the bridging loan with a mainstream mortgage contract, the mortgage lender should not accept that repayment strategy unless it is reasonably satisfied that a mainstream mortgage lender will be willing to enter into a mortgage contract with the customer..
- Entering into a bridging loan for credit repair, where the repayment strategy is remortgage on to a longer term regulated mortgage contract once the credit status is improved, may be relied upon as tending to show contravention of the repayment strategy rules. Except where the mortgage lender has evidence of a guaranteed offer for such a longer-term contract.

Extending the term of a bridging loan

- When considering extending the term of a bridging loan, a mortgage lender must comply with the affordability assessment rules as if the bridging loan were a new loan.
- Where the affordability assessment rules do not apply in relation to extending the term of a bridging loan (because the bridging loan is an interest roll-up mortgage), the mortgage lender must consider the impact of the extension on the customer's remaining equity in the property which is the subject of the bridging loan.
- A lender must not agree to extend the term of a bridging loan unless the customer has made a positive choice to do so.

This does not include secured overdrafts solely for business or high-net worth mortgage customer.

Customer best interests – extending the terms of a bridging loan

When extending the term of a bridging loan lenders must act honestly, fairly and professionally in accordance with the best interests of their customer.

Interest roll-up mortgages

The affordability assessment requirements do not apply in relation to an interest roll-up mortgage. A mortgage lender may not enter into an interest roll-up mortgage, or vary an existing mortgage so that it becomes an interest roll-up mortgage, unless it is:

- A lifetime mortgage
- A bridging loan
- A loan to a high-net worth mortgage customer
- A loan solely for business purposes.

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About AMI and this Factsheet

This factsheet has been designed to provide members with information on the Mortgage Market Review (MMR).

It is provided as a matter of record for reference purposes. It is not intended to be read as a replacement to understanding the MCOB rule book that takes effect from 26th April 2014.

Furthermore, it is important to remember that MMR amends existing MCOB rules. It is not a new set of rules in its own right. As such firms must also consider existing MCOB rules, which in some instances are unchanged.

The Association of Mortgage Intermediaries was created to be the trade association for professional mortgage intermediaries. It is our role to lobby the regulator to ensure light touch and proportionate regulation. As part of our remit we endeavour to bring insightful and plain English information to the market. This factsheet has been produced in this spirit.

Firms are advised to seek professional advice rather than rely on comments on this brief text. For more information on AMI, contact the address below.

Prepared on the basis of our understanding at April 2013.

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