



**PricedOut.org.uk**  
The campaign for affordable house prices

**PricedOut submission to the FSA Consultation Paper 10/16:**

### **Mortgage Market Review: Responsible Lending**

*“If there is one common theme to the vast range of crises we consider ... it is that excessive debt accumulation ... poses greater systematic risks than it seems during a boom... Private sector borrowing binges can inflate housing and stock prices far beyond their long-run sustainable levels, and make banks seem more stable and profitable than they really are. Such large-scale debt build-ups pose risks because they make an economy vulnerable to crises of confidence... Debt fuelled booms all too often provide false affirmation of a government’s policies, a financial institution’s ability to make outsized profits, or a country’s standard of living. Most of these booms end badly. Of course debt instruments are crucial to all economies, ancient and modern, but balancing the risk and opportunities of debt is always a challenge, a challenge policy makers, investors and ordinary citizens must never forget.”*

‘This Time is Different’, Carmen Reinhart and Kenneth Rogoff, Princeton University Press 2009.

PricedOut is a group representing the interests of First Time Buyers (FTBs). This includes those who are currently either unable to afford housing in the UK or face very high levels of mortgage debt if they can. PricedOut aims to raise awareness of the damage being caused by unaffordable house prices through its website, its campaign activities and active canvassing of policy makers and the media.<sup>1</sup> PricedOut was founded in February 2006 and is staffed entirely by volunteers. We have more than three thousand registered members.

Whilst there are a number of organisations, charities and campaigns dealing with the important issues of social housing and homelessness there is no group representing First Time Buyers who are being negatively affected by high house prices.

We welcome the opportunity to comment on this consultation. We view First Time Buyers as a critical consumer in the mortgage market – and one whose view is often either not heard or is misrepresented by other housing market interests.

In this submission we make some general observations about First Time Buyers, mortgage debt and the role of financial regulation in section one before answering the specific questions raised in CP10/16 in section two.

## **Section One**

### **Introduction**

We strongly welcome the FSA’s move to “take a much more robust and interventionist approach to regulating firms and markets” [para 1.5].

The overwhelming priority of a financial regulator should be to ensure financial and economic stability. This should be coupled with the rigorous protection of the consumer. The previous light touch regulatory

---

See [www.pricedout.org.uk](http://www.pricedout.org.uk)

approach achieved neither aim, whilst giving excessive attention to the demands of the industry it was meant to be regulating.

This focus on financial and economic stability and consumer protection is particularly important for mortgage lending.

The UK housing market has a long history of cyclical behaviour. This has too often been driven by a damaging credit cycle of loose lending followed by sharp contraction.

The UK is not alone in this. There are many examples of real estate bubbles created by excess credit and lax mortgage lending – from the Florida real estate bubble of 1926, the Japanese bubble of the 1980s or the most recent European and US experience.

Housing is particularly vulnerable to these credit booms and busts – given its tendency for momentum effects and lack of effective arbitrage systems (see for example Andrew Farlow<sup>2</sup>). As CP10/16 itself notes, NIESR have found that an acceleration in real house price growth can be the most important factor contributing to the emergence of a financial crisis [para 6.8]<sup>3</sup>. These bubbles bring with them few economic benefits and create many large long term costs.

These costs include the negative economic impact of higher housing costs. High house prices reduce labour mobility, add an additional cost to UK businesses in higher wages and drain disposable income out of the wider economy. The misallocation of resources impacts on the total level of investment capital available for businesses and wider consumption levels. As Martin Wolf observes, economically, “it is mad to applaud ever-rising prices”.<sup>4</sup>

Housing credit booms and busts also pose systematic risks to the long term health of households and the wider financial system. They increase personal debt levels, concentrate individual wealth portfolios disproportionately in one asset class and increase vulnerability to external credit shocks. And, given the scale of potential mortgage debt at national level, a particularly acute problem with the high levels of owner occupation of the UK, they endanger the banking system and the national economy.

Effectively regulating mortgage lending is therefore of upmost long term national concern. Until now regulation has put the interests of mortgage lenders above the interests of either consumers or the economy.

The proposed rebalancing of approach is long overdue and welcome. However we have concerns that much of the detail of the Mortgage Market Review and this Consultation Paper are markedly too weak to achieve this outcome.

### **First Time Buyers, Vulnerability and Mortgage Debt**

First Time Buyers are a particularly vulnerable group of consumers of mortgage finance. They usually enter the housing market at a point when most financially overstretched: with high mortgage debt and no equity cushion to protect themselves against house price falls or income shocks.

First Time Buyers vulnerability and debt burdens have increased significantly over the past thirty years. In 1984, the average FTB used income multiples of 1.99 to obtain a mortgage, by 2004 this figure was 3.03. In

---

<sup>2</sup> ‘The UK Housing Market: Bubbles and Buyers’, Andrew Farlow, Department of Economics at Oriel College, University of Oxford, Credit Suisse First Boston, January 2004 <http://www.economics.ox.ac.uk/members/andrew.farlow/Part2UKHousing.pdf>

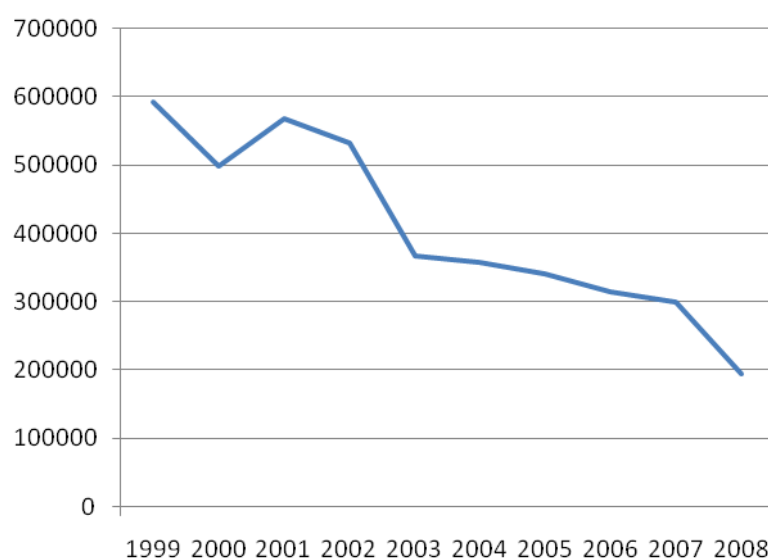
<sup>3</sup> National Institute of Economic and Social Research

<sup>4</sup> Martin Wolf, Financial Times, July 10 2008 <http://www.ft.com/cms/s/0/69ebb588-4ead-11dd-ba7c-000077b07658.html>

the mid 1990s only 1 percent of FTB mortgages were based on income multiples of 4.0 or above, by 2005 this applied to 20 percent of them.<sup>5</sup>

At the same time the number of First Time Buyers has been declining, with this decline being most sharply pronounced over the past decade (see Graph 1). First Time Buyers are now at all time lows, with high house prices causing an estimated 1.2 million 'new' households to be displaced away from Owner Occupation<sup>6</sup> and around 1.4m fewer First-Time Buyer mortgages since 1999.<sup>7</sup>

**Graph 1: Number of New First Time Buyer Mortgages, 1999 - 2008**



Source: Halifax

During the past decade, UK housing and financial regulatory policy has managed to produce much more expensive houses, far fewer First Time Buyers and much higher debt levels for those First Time Buyers who have taken out mortgage finance.

This is clearly not a resounding success story and one that should worry anyone concerned with First Time Buyers financial well being.

The changes in the First Time Buyer experience can be assigned to several factors. These include long term changes to macro economic conditions – in particular the fall in rates of inflation and interest rates, a liberalised mortgage market and changes to the composition of the UK housing market. It has also been underpinned by a failure of mortgage market regulators to take a robust approach to restraining both levels of mortgage risk and total levels of secured mortgage debt.

### **Macro Economic Changes**

First Time Buyers since the mid 1990s have faced a radically changed structure in the shape and duration of their mortgage debt burdens.

Prior to this period, First Time Buyers faced steep initial entry barriers caused by higher interest rates, but this was coupled with the initial debt being quickly eroded by high levels of inflation.

---

<sup>5</sup> 'Affordability – more than just a housing problem', NHPAU, May 2009

<sup>6</sup> 'Affordability – more than just a housing problem', NHPAU, May 2009

<sup>7</sup> <http://www.telegraph.co.uk/finance/newsbysector/constructionandproperty/2821472/First-time-buyers-set-to-rescue-house-prices.html>

The more recent First Time Buyer experience has been one of lower initial barriers caused by lower interest rates, but combined with a debt that lasts over a much longer period of time due to lower levels of inflation.

However, over time the initial benefit of lower interest rates as an entry barrier has been eroded as benign macro economic conditions and more aggressive mortgage lending has led to higher levels of debt being forwarded to borrowers, often under the guise of 'affordability' criteria rather than traditional loan to income valuations.

In short, higher capital repayments filled the gap that higher interest payments used to occupy. This has meant that entry barriers are now as, if not more, significant as during previous high interest rate periods.

As the CML notes "the sea-change decrease in UK interest rates since the early 1990s has had a profound effect on the size of mortgage that can be serviced from any given level of income"<sup>8</sup>

As a result, First Time Buyers now face the worst of both worlds – both high initial entry costs and a much longer period in which their debt burden remains high.

### **Mortgage Market Changes**

This change in macro economic conditions have occurred alongside a change in the structure of the mortgage market.

There has been a significant liberalisation of housing mortgage finance since the 1970s, with a striking break from the 'protected circle of housing finance'.

Demutualisation of building societies and the removal and weakening of previous lending constraints has combined with innovation in mortgage finance origination and sales – most notable the securitisation of lending in the past decade – including widespread use of global capital markets. Both trends have significantly increased the total flow of liquidity into the UK housing market.

This has occurred alongside a substantial rise in the number and type of mortgage lenders, including the emergence of specialist non bank lenders, and changes to the within-company incentives for mortgage sales. As the Consultation Paper notes, these trends have led to a major increase in competitive pressures on market participants.

### **Changes to the Composition of the UK Housing Market**

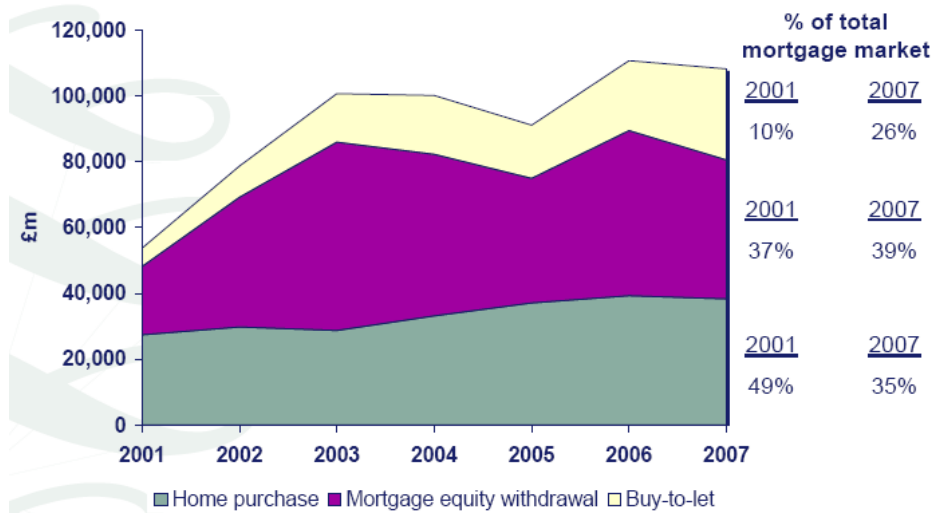
Accompanying higher levels of mortgage lending and increased competitive pressures amongst lenders has been the rise of the Buy-to-Let investor.

The growth of mortgage finance for BTL has been impressively large. The number of outstanding BTL mortgages increased ten-fold from mid-2000 to reach over one million by 2007, with a total value of over £122 billion. It has been the outstanding area of growth in total mortgage financing for UK house purchases (see graph 2 below).

### ***Graph 2: UK Mortgage Lending by Purpose 2001 - 2007***

---

<sup>8</sup> Source 'Affordability and First Time Buyers', CML Housing Finance Issue 01 2010)



Source: FSA, Bank of England, CML, taken from 'The Mortgage Market: Issues for Debate', Adair Turner Chairman FSA Mortgage Conference 12 May 2009

BTL mortgages rose from just 3.5% to 28.9% of total house purchase mortgages in the UK between 1999 and 2006. Whilst BTL mortgages as a percentage of total housing transactions grew from 3% in 1999 to approaching 20% of transactions in 2006.

Official BTL financing is almost certainly an understatement of the total level of BTL finance in the UK residential market – given the widespread use of mainstream mortgage finance to fund investment and the large numbers of cash purchases involved. Michael Ball of Reading University estimates that only 54% of BTL landlords use mortgage finance for purchasing their properties.<sup>9</sup>

First Time Buyers have therefore found themselves in a market where they are under much greater pressure from competition from Buy-to-Let participants – who have also been financed by higher risk, often securitised, forms of interest-only mortgage finance.<sup>10</sup>

### The Failure of Regulation to Protect First Time Buyers

At the centre of this story of failure for First Time Buyers stands a failure in robust regulation to protect their financial interests.

As the original FSA Mortgage Market Review discussion paper set out; regulation failed to restrain growing risk taking amongst mortgage lenders; regulation has failed to control the rise of the volatile and speculative Buy-to-Let sector – indeed Buy-to-Let mortgages still remain outside the FSA's regulatory remit three years after the start of the credit crunch; and regulation has failed to constrain the structural change in the levels of debt being taken on by new entrants to the housing market.

### The Problems with an 'Affordability' Approach

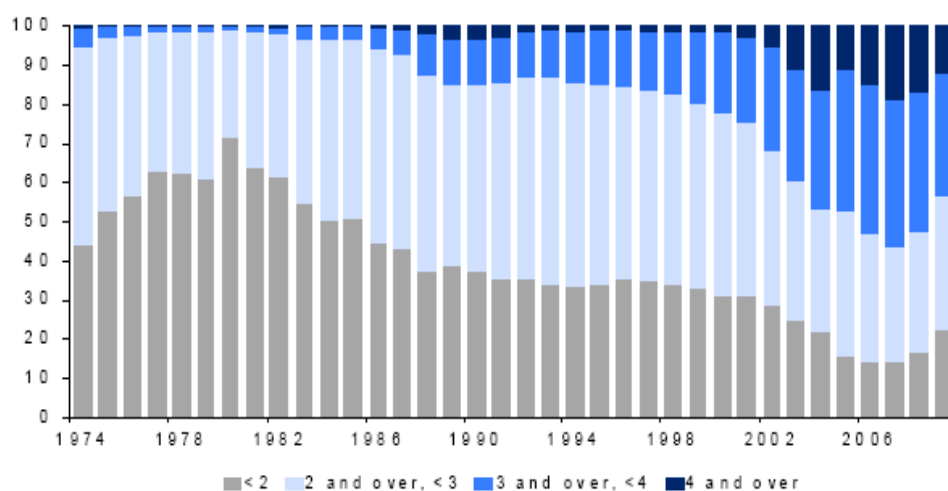
As we note above, First Time Buyers are now taking on much higher levels of debt than they were twenty years ago.

<sup>9</sup> See Ball, M. (2006) Buy-to-Let: The Revolution Ten Years On – Assessment and Prospects, Association of Residential Letting Agents (ARLA), available at: [http://digitalnation.fileburst.com/arla/arla\\_btl\\_report\\_2006.pdf](http://digitalnation.fileburst.com/arla/arla_btl_report_2006.pdf)

<sup>10</sup> Buy-to-Let also benefits from a further competitive advantage against First Time Buyers through tax breaks that enable the writing off of interest payments against business costs.

This has been driven by the effective abandonment of previously long standing industry standards to assessing Loan to Income lending criteria.

**Chart 1: Income Multiples, Loans for House Purchase**



Source: CML/Banksearch Regulated Mortgage Survey, Survey of Mortgage Lenders

In the wake of the greater levels of financing available through changes in financial markets and driven by the greater profits available through lending much higher levels of debt, mortgage lenders have moved more and more towards ‘affordability’ calculations in their lending criteria. The FSA too easily acquiesced in this process.

As chart 1 from the CML shows, in the years from 1974 until 1988 at least 40% of house purchase loans were for an income multiple of less than two (in 1980 this made up 70% of all mortgage lending). During this period multiples of more than three were very rare and multiples of more than four unheard of. But in the last ten years the situation has almost reversed. From 2003, income multiples of more than three take up over 40% of all house purchase loans and in the boom years, income multiples for more than four outnumber those of less than two.

In the short term this undoubtedly increased the profitability of the banking sector. But in the long term it has not benefited the well being of the UK economy or consumers.

The current ‘affordability’ approach has greatly increased house buyers overall debt burden and has lengthened the time period in which house buyers are vulnerable to economic shocks, be it income shocks or payment shocks.

As the CML observes, “affordability measures based on initial mortgage interest payments only therefore risk giving an overly positive picture of the true position [of consumer mortgage debt levels]”.<sup>12</sup>

It has also created a sharp generational divide in the experience of the mortgage market. Older home buyers benefited from a constrained mortgage market and low levels of debt and have now inherited a system that transfers large windfalls of housing wealth to them through higher house prices. Younger generations of First Time Buyers have inherited a liberalised mortgage market that extracts far higher levels of mortgage debt and gives them – because of the higher house prices that these higher levels of mortgage debt create – much more expensive housing.

<sup>12</sup> Source ‘Affordability and First Time Buyers’, CML Housing Finance Issue 01 2010

<sup>13</sup> Source ‘Affordability and First Time Buyers’, CML Housing Finance Issue 01 2010

This liberalised system also creates much greater risks to the UK economy, as the credit crunch demonstrated.

### **Headline Recommendations for the FSA**

1. We welcome the tentative steps the FSA is proposing to take constrain risk taking amount mortgage lenders, including better scrutiny and prudential regulation on non banks and better regulation of mortgage intermediaries.
2. We remain deeply concerned that the government has still not expanded the remit of the FSA to include Buy-to-Let mortgages or include Buy-to-Let mortgages within the proposed set of changes put forward in the Mortgage Market Review.

For First Time Buyers this is deeply worrying; potentially giving Buy-to-Let investors much weaker regulatory oversight and leading to further displacement of the chance of owner occupation by property investors. It also seems highly unjustified – Buy-to-Let investment has been much more volatile, has had a strong speculative component, has been more reliant upon securitised lending and specialised lenders and has suffered from substantially worse delinquency rates.<sup>13</sup>

We urge the FSA to press H M Treasury to bring Buy-to-Let under the FSA's regulatory remit and ensure that regulation does not favour Buy-to-Let investors over First Time Buyers – particularly on the proposed new obligations around the use of interest-only mortgages.

3. We are disappointed that the FSA it not using the Mortgage Market Review to take a broader and more far reaching approach to reform of the mortgage market – particularly in its approach to debt levels and the use of 'affordability' in assessing levels of mortgage lending.
4. We are deeply disappointed that the FSA has not taken the opportunity of the Mortgage Market Review to revisit the 'affordability' approach to mortgage lending and bring in simple maximum Loan to Income ratios.

The point of a regulator is to act in the wider interests of the UK economy and society. The failure to challenge the 'affordability' approach of mortgage lenders is a de facto facilitation of the greater transfer of the lifetime wealth from consumers to lenders. It is unclear in what other industry this approach to consumer welfare would be considered acceptable.

## **Section Two**

### **Responses to Questions in CPI0/16**

#### *General Observation on the FSA's approach and Pro-Cyclicality*

PricedOut are concerned that the 'affordability' approach taken by the FSA and the frequent emphasis on lender discretion rather than firm obligations contains an inherent pro cyclicality.

Given the strength of competitive pressures in the mortgage market, individual and organisational lender incentives, and the increased levels of international capital flows (coupled with the rise in non bank and specialist lenders) there will be huge incentives for lenders to take an optimistic view of affordability criteria and use all leeway – whether in the spirit or not – of broader 'affordability' rules to push the FSA's parameters.

---

<sup>13</sup> For further details of these higher risk features of Buy-to-Let investment see PricedOut's recent submission to the Treasury consultation on the Private Rented Sector: [http://pricedout.org.uk/Download/Treasury\\_Consultation\\_on\\_the\\_Private\\_Rented\\_Sector.pdf](http://pricedout.org.uk/Download/Treasury_Consultation_on_the_Private_Rented_Sector.pdf)

This is well borne out by the experience of the past decade – whether it is through the growing abuse of interest-only mortgages, of self certification or of income and affordability calculations.

It is also something the FSA itself recognises in this consultation paper, for example: “As credit becomes more freely available these parameters will be relaxed by some lenders” [para 2.32] and “this situation has been largely driven by competitive pressure among lenders to win new business, with ... criteria being relaxed across the industry” [para 2.89]

We would urge the FSA to strengthen those areas where there is current undue emphasis on lender discretion. If the mortgage industry is arguing that the FSA’s proposals are difficult to implement, we would urge the FSA to revisit the option of firm caps on Loan to Income ratios as an alternative.

#### *Q1. Income Verification*

We support the FSA’s proposals that lenders must verify income for all mortgage applicants.

However the proposals give too much discretion to lenders and there is too much emphasis on giving “lenders the flexibility to innovate” [paragraph 2.23] on the means of evidencing income, the source of evidence and the period of time involved. We find it puzzling that as the financial regulator in an area in which the FSA has found well documented and widespread forms of abuse that the FSA is “not proposing to be prescriptive about income verification” [paragraph 2.25].

We hope that the FSA will roll out the pilot scheme to ensure that all lenders are required to verify income statements with HMRC [para 2.27].

We strongly support the introduction of income verification for fast track mortgages [2.34], but question why fast track mortgages themselves are not being more tightly controlled given the evidence cited from Moody’s of higher arrears rates [para 2.29]

We strongly support the proposed approach to verifying income for the self employed [para 2.35], however we suggest that the four suggested methods of verifying income are prescribed as obligatory by the FSA. We again believe there is too much leeway given to lenders over verification in this proposal.

#### *Q2. Assessing Income*

We find it hard to understand why the FSA is not being prescriptive about the type of income to be used by a lender when assessing affordability [para 2.36]. There are a limited number of income sources and these are usually backed up by official company, income or tax data. Those few exceptions to these could be narrowly dealt with through separate focused guidance.

It would be helpful for public discussions if the FSA could outline what state benefits it views as acceptable as forming the basis for mortgage borrowing [para 2.36].

We welcome the lender considers the variability of income over time [para 2.37]. However we do not agree that bonuses should be an acceptable form of income for lenders to consider [para 2.37]. Bonuses, by definition, are one off payments that tend to occur during periods of higher economic performance – they therefore have a strong pro cyclical character which we should be looking to restrict when setting out the framework for more robust housing market regulation.

#### *Q5. Calculating Expenditure*

We welcome the efforts made by the FSA in putting pressure on lenders to make much more robust assessments of customer expenditure and are required to take it into account when assessing affordability [para 2.41].

The traditional route by which mortgage lenders used to do this is by requiring customers to save towards a deposit over a period of time – and this still has much to recommend it, not least its simplicity.

The new proposals of expenditure seem, from a broader perspective, a way in which the FSA is excessively accommodating to the affordability approach favoured by the mortgage industry.

We are concerned that the FSA is proposing lenders use statistical data derived from their own data [para 2.42]. This is likely to be a particular problem with smaller and niche lenders, and we hope the FSA will introduce regular checks and robust penalties for any abuses that would arise out of this system.

One omission from this section is that there is no explicit consideration of the issue of expenditure on student debt. This is already a widespread debt commitment for many First Time Buyers and this is likely to increase significantly as Tuition Fees increase. Student debt terms often differ from more traditional loans and a separate consideration may be needed once government reform proposals are settled.

#### *Q6. Affordability Calculated on a Capital and Interest Basis*

We strongly support the proposal that would require lenders to assess affordability in every case using a capital and interest basis, and maximum term of 25 years and a check on continued affordability in the light of possible interest rate increases [para 2.47]. These are the type of robust assessments that are needed to ensure that lending decisions protect the majority of borrowers and avoid excessive lending and price pressures in the housing market.

We strongly agree with the FSA's analysis that many interest-only mortgages have been taken out for affordability reasons and that there has been widespread abuse of their original purpose in the past few years [para 2.49].

We strongly agree that customers who cannot afford a repayment mortgage should not be given a mortgage on other terms [para 2.50].

However we are concerned that the wording put forward by the FSA ('consideration of payment of the capital element of the loan') [para 2.50] is too weak and indicates that the proposals that the FSA is planning to bring forward will not be robust enough.

We do not believe that there are any reasons why there should be 'limited exceptions' where it 'may be appropriate to assess affordability on an interest-only basis' [para 2.51] and are disappointed that the FSA will be consulting on this in due course. The past decade has demonstrated amply that the mortgage industry has been fully prepared to drive a coach and horses through 'limited exceptions' and a robust approach would not seek to give them further opportunities to do so.

#### *Q7. Maximum Mortgage Terms of 25 Years*

We strongly support the proposal that affordability is calculated on a maximum term of 25 years [para 2.54]. But we do not understand given the clear evidence of extended terms being used to 'stretch affordability' in the end years of the recent boom [para 2.53] why the FSA is not seeking to impose compulsory limits on the length of a mortgage. This would be an opportunity for the FSA to stand up for the interests of younger and more vulnerable consumers and provide proper parameters in which to control the mortgage market.

We are puzzled as to why the FSA is assuming and finds acceptable the fact that "younger consumers and first time buyers are likely to borrow more, and have a longer working life to repay" [para 2.53]. Is it not the job of a robust regulator to introduce measures that prevent these intergenerational and inter consumer inequalities from happening?

#### *Q8. Future Interest Rate Calculations*

Whilst we strongly support the introduction of regulation to ensure that lenders take account future interest rates rises, we have some concerns at the FSA's proposals in this section.

Although use of swap rates is in some ways a sensible approach to a factor that changes over time, two issues are worth bearing in mind and suggest caution is needed:

Firstly, whether the FSA is proposing to use short term (6 month to a year) or longer term swap rates to calculate the band of possible future interest rates is important. We would caution against the use of shorter term swap rates as a reference point – given the volatility involved and the current low levels of base rates.

Secondly, there is clearly opportunity for the market to get expectations wrong – sometimes seriously wrong. Swap rates remain anchored to current base rates in a way that does not necessarily reflect the change that is likely to occur over longer time periods. The current UK twenty year swap rate is below 4%<sup>14</sup>, yet in the wider historical context rates of 4% are strikingly low and unlikely to remain at this level for twenty years. Relying solely on future swap rates in the current very low interest rate period would not reflect the historical record nor equip the UK well for unexpected events (which by their nature are not reflected in a consensus based market figure like swap rates) such as inflationary spikes or large currency movements.

Setting the margin for lenders to consider future interest rates too low, which the use of swap rates may do, also creates a political problem. The FSA says that it is considering publishing a 'guideline margin' of rates and 'review at regular intervals' [para 2.58]. Yet implementing rises of the margin after low interest rate margins have become imbedded in market behaviour is likely to prove much more politically difficult than the FSA expects.

As the financial crisis amply demonstrates, a large enough constituency of debtors and exposed lenders becomes a critical consideration in government macroeconomic policy making and a significant political lobby. The Mortgage Market Review process is also demonstrating how powerful this lobby can be at putting pressure on a regulator to avoid implementing sensible and rational policy changes. Far better to put in place robust and wider margins now, than try and raise margins once this lobby has become entrenched.

#### *Q10. Lending Into Retirement*

We support the FSA's proposals for a more robust assessment of lending which extends into retirement. Indeed we find the industries current practice surprisingly lax and suggestive of a significant problem with lack of proper scrutiny and the growing use of longer term mortgages.

Retirement age has broad social and political support in the UK as a period in which older people should be free from the obligations of work and there is a large statute of law guaranteeing this. The FSA should perhaps be asking deeper questions as to why mortgage lending is increasingly encroaching into retirement, and whether its approach at mortgage regulation is strong enough in securing and supporting this widely recognised social good from market pressures.

The paper cites that figure that 19% of all new mortgages advanced in 2007 extended into retirement. Interestingly, an impact assessment released by the Department of Work and Pensions of the Support for Mortgage Interest scheme for people in mortgage repayment difficulties found that 52% of those in receipt of the benefit were also receiving the state pension.<sup>15</sup> This disjuncture between the percentage of new mortgages and the level suffering from financial distress is worrying and suggests the problem may be larger than the industry is currently admitting.

#### *Q11. Waivers to Affordability Requirements*

---

<sup>14</sup> As of 15 November 2010

<sup>15</sup> <http://www.dwp.gov.uk/docs/support-for-mortgage-interest.pdf>

As in our response to question 6, we do not think there are specific exceptions that should be exempt from affordability requirements.

#### *Q14. Transitional Measures*

There is a question here of timing for the FSA [para 2.82]. Any tightening of lending criteria will, almost certainly, impact upon previous borrowing from a time when credit and mortgage lending was exceptionally loose. But this is not a valid excuse for postponement, for it to be so would imbed lending practices that were extremely undesirable. The danger of postponement is that you simply extend the period in which future non-conforming lending is made.

The FSA would be wise to move quickly to implement any agreed changes, particularly whilst mortgage lending is still subdued and mortgage lenders are still being risk averse.

#### *Q16, Q17, Q18 Interest Only Mortgages and Repayment Methods*

Again, we strongly agree with the FSA's analysis that many interest-only mortgages have been taken out for affordability reasons and that there has been widespread abuse of their original purpose in the past few years [para 2.49 & 2.87]. We urge the FSA to put in place a regulatory structure that returns interest-only to a position in which it was originally designed – for very niche elements that occupy a very small part of the total mortgage market.

We strongly support the proposal that interest-only should only be used where there is a genuine repayment vehicle in place [para 2.91]

We are disappointed that the FSA's future discussions on this issue will be limited to "the industry" [para 2.92] and hope the FSA will include consumer groups.

We strongly welcome the proposal for lenders to be required to make regular inspections on the existence and adequacy of the repayment mechanism, and agree with the proposed timelines of a yearly check and a five yearly assessment [para 2.96].

We strongly welcome the proposal that a 'valid repayment plan' should not include house price inflation or expectations of downsizing [para 2.95] and should restrict other types of repayment method [para 2.98].

We do not think it is wise or necessary to encourage exceptions to the exclusion of 'sale of property' as a valid repayment method, for example large family homes [para 2.99]. Large family homes already have enough price pressure on them within the market, and the use of interest-only as an acceptable method for some customers to overextend themselves would not help other consumers using repayment vehicles.

We would much prefer the option of banning the sale of property as a repayment method outright [see para 2.101]. Mortgage finance options that are dependent upon realising value from the house which is being financed seem to us a risky and unhealthy addition to the housing market. The FSA should again remember that wider concerns of economic stability should always come before exceptions put forward by the mortgage industry – and this exception is not important enough to warrant a changed approach here.

#### *Q19, Q20 Interest Only Mortgages and Customer Types*

The approach outlined here again shows a risk that the FSA is in danger of prioritising flexibility for quite narrow and small market niches of 'customer type' over the financial well being of the majority of consumers who would be negatively affected by the resulting additional liquidity and risk injected into the market.

We can see very little merit in allowing exception for any of the examples given in paragraph 2.102 and do not agree that the small individual benefit that customer examples may gain from being able to utilise interest-only mortgages should justify exceptions here.

The proposed exception to allow customers to have more financially leveraged use of second homes via interest-only mortgages is a good example of where the FSA is losing sight of the wider social and economic good against the minutia of individual financial advantage.

#### *Q20 Interest Only Mortgages and First Time Buyers*

As a body representing First Time Buyers we find the proposed exception for interest-only mortgages for First Time Buyers to help with “home set up costs” [para 2.102] puzzling.

Firstly, First Time Buyers have many other financing options available for home set up costs – from personal loans to accumulated savings. It is unclear why an exception for a form of mortgage that has seen widespread abuse is justifiable in these circumstances. We see no ‘legitimate need’ [para 2.104] here.

Secondly, the proposal of interest only payments for an initial period such as five years [para 2.104] has many potential problems attached to it. The US experience suggests significant issues attached to introductory offer periods on mortgages, and there is a substantial body of evidence that suggests that the pressure to get on the ladder is leading to overstretching of First Time Buyer finances. It would also reinforce a tendency for excessive optimism about future earning capability.

Thirdly, the proposal ignores the market effects this exclusion could have on other First Time Buyers. First Time Buyers are at record low numbers and usually compete in particular small segments of the housing market – notably lower priced flats and housing. Having the widespread use of temporary interest-only mortgages for some First Time Buyers would merely increase the price pressure on these properties and put other First Time Buyers on repayment mortgages at a disadvantage. This would clearly be unfair and would reward those who were prepared to take out more financially risky products. From a consumer perspective it is difficult to justify this.

#### *Q21. Interest Only Exceptions*

We are not in favour of exceptions when assessing affordability criteria for the use of interest-only mortgages.

#### *Q33 Non Banks and a Risk Based Prudential Regime*

We agree with the FSA’s analysis of the damaging role played by specialist lenders in the recent housing boom, their pro-cyclical nature and the role that competition played in weakening lending standards [para 6.11 and 6.12].

We welcome the proposals for greater business scrutiny of these non banks by the FSA [para 6.17] and would hope the FSA takes forward the suggestion for a more risk based prudential framework [para 6.18] and are in favour of the FSA imposing enhanced capital requirements directly on non banks [para 6.19].

#### *Q34 Macro Prudential Considerations*

We would favour these proposed macro prudential regulations also being applied to non banks [para 6.47]