Evolution, not revolution
What next for UK mortgage regulation?
Evolution, not revolution: what next for UK mortgage regulation?

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And yet more regulation is on the horizon in the shape of the Mortgage Credit Directive (MCD), due to be implemented in March 2016. This, combined with ongoing media and political scrutiny and uncertainty regarding a base rate increase, makes it clear that we remain in a period of continuing disruption to the market which will continue for the foreseeable future.

The UK residential mortgage market has been subject to regulation for over a decade, with the Mortgage Conduct of Business (MCOB) rules being introduced in October 2004. The rules are far reaching, defining who is subject to regulation and setting out the regulator’s expectations in key areas such as the provision of advice, the information to be provided to borrowers and dealing fairly with customers in arrears.

Despite this regulation, the mortgage industry was subject to heavy criticism for its perceived position at the heart of the financial crisis.

MMR was a major part of a wider framework of change, designed to make sure that markets worked more effectively in the future and to manage some of the more high-risk areas within secured lending. From 26 April 2014, key changes were made to the provision of advice, how affordability is assessed and the treatment of different methods of repayment. This is alongside continued disruption to the mortgage market at a macro level from issues such as digital innovation, future rate rises and economic instability across Europe. Separately, the impending expansion of the FCA’s scope to cover regulation of a number of buy-to-let mortgages will require lenders to reconsider their business models, back books and affordability assessments. These new requirements will impact buy-to-let loans taken out by individuals where the loan is classified as not being ‘commercial’.

Where have we come from?

The Mortgage Credit Directive

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**Where are we now?**

Despite a broadly positive industry reaction to the final rules set out under the MMR, the immediate aftermath of implementation resulted in significant media attention on lending practices. In particular, there was an increased focus on what was perceived to be an onerous and overly intrusive approach to assessing affordability.

Through working with clients, EY has gained insight into practices that may result in poor customer outcomes which have received both press and regulatory attention. Some of these practices are given below:

- **Transitional guidance for the treatment of “mortgage prisoners”** is being applied inflexibly (or not at all). There have been reports of customers not being allowed to port existing preferential mortgage rates to new properties, or failing affordability assessments which lenders are making a requirement for a transfer from a standard variable rate (SVR) to a product with a lower rate.

- **Based on increasing customer complaints, media perception is that a number of major lenders are keen to purge borrowers on very low rates, older borrowers and those no longer deemed creditworthy by unfairly applying new affordability rules to refuse porting and lending requests. This may create an environment of unmet market demand for certain groups of under-served consumers.**

The Financial Conduct Authority (FCA)’s thematic review of advice and distribution revealed that despite the significant changes made to the requirements for providing advice, the quality was mixed. In terms of customer experience and outcomes, they noted in particular that:

- Consumers often struggle to understand the difference between advice (offered by the firm or broker), and other aspects of the mortgage application process, for example the lending decision. This may result in a poor understanding of the role of mortgage advice and the recommendation made. Many struggle to compare fees, charges and interest rates across a range of products, as well as the total cost when fees are not paid up front but rolled into the lending provided.

- Within some firms, processes are designed to prevent regulatory risk, yet may have the unintended consequence of frustrating customers and discouraging them from shopping around. Contrasting approaches to dealing with initial enquiries result in some customers struggling to access information and others being required to make an appointment with a qualified advisor for basic information.

A number of lenders are now starting to explore efficiencies in their mortgage processes and enhancements to customer experience, responding both to the changes in regulation and ongoing digital disruption in financial services. In particular, EY has seen a growing trend in firms developing systems and processes for:

- End-to-end online mortgage processing
- Online execution-only sales processes
- Digitised advice, with omni-channel capability

**Recent market activity**

The Summer 2015 UK budget announced a restriction in tax relief on mortgage interest payments for wealthier landlords. This will impact upon a number of UK private landlords with mortgages, as well as lenders, who may be faced with additional complexity in judging affordability. However, despite this announcement, a range of indicators suggest that the buy-to-let market is continuing to expand. Widening the focus from buy-to-let, data recently released by the Council of Mortgage Lenders (CML) suggests that gross mortgage lending in the UK is seeing both a monthly and quarterly rise, with the CML describing the mortgage lending market as “enjoying its best spell since 2008”.

“Many changes have been made to deliver a sustainable market and to deliver better consumer outcomes but, as always, there is still more to be done, particularly in the application of the transitional provisions for existing customers. I would strongly encourage lenders to review their policy stance to ensure that they are making common sense judgements that deliver sensible consumer outcomes.”

**Linda Woodall, Director of Mortgages and Consumer Lending**

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The European Commission has signalled its intent to end irresponsible lending and borrowing practices across EU member states. Through the MCD, it intends to take measures designed to strengthen consumer protection in the mortgage market. This will provide a set of robust rules on the end-to-end mortgage process, including advertising, pre-contractual information, advice, creditworthiness and early repayment. The intention is to ensure that consumers are adequately informed about possible risks and that mortgage lenders conduct their business in a responsible manner.

The Directive aims to create an integrated Europe-wide mortgage credit market resulting in an efficient, competitive single market for mortgages and a level playing field for all mortgage intermediaries across member states, making cross-border activity easier.

These provisions must be implemented into domestic legislation by all member states by 21 March 2016. This is likely to be challenging given the variance in current secured lending regulatory regimes across the EU.

In the UK, the FCA has already published its final rules for the implementation of the MCD. These affect lenders, intermediaries, consumers, some landlords and many firms involved in the second charge market.

While the aim of the MCD is to harmonise standards across the EU member states and promote cross-border lending, it is our view that this is unlikely to happen until member states demonstrate true parity in the implementation of the requirements. In fact, the immediate response could be a contraction in some niche parts of the market, for example, the use of foreign currency income for mortgage lending.

Firms entering or already active in the market will need to plan and respond to this latest regulatory change, particularly as these new regulations are being introduced at a time of intense and continuous regulatory focus in the UK.

The FCA previously announced its intention to conduct a review into responsible lending in 2015 and launch a study into whether the market is working well for consumers from early 2016. The European Banking Authority (EBA) has also published consultations on creditworthiness, arrears and foreclosure which could affect regulation within the EU.

In addition, the ongoing economic instability in the Eurozone, alongside potential UK interest rate rises and uncertainty regarding the UK remaining within the EU, creates an extended period of unsettlement.

“The risks around controls and behaviours go to the heart of our work as a conduct regulator ... we consider that there is a role for both frontline and senior staff to prove that lessons have been learned from the experiences of the past.”

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3 FCA Business Plan 2015/16, page 17
All lenders will need to consider how the new requirements will impact their business models, including areas such as cross-border lending, foreign currency, secured lending and lending in other member states.

EY considers that some of the most important sections of the new rules that secured lenders will need to prepare for include:

► **Transitional arrangements:** UK lenders are used to having a transitional period for regulatory changes that will have a significant impact on requirements or processes. This is not the case for the MCD and mortgage firms may find that this is one of the most difficult challenges to overcome. The buying and selling of property will not conveniently stop on the day before the MCD starts to apply. The operational and IT changes required in order to fulfil these requirements are likely to pose a challenge for many existing lenders.

Firms will need to consider how the impact of the required changes and ensure that they have adequate plans to allow timely implementation.

► **Early repayment charges:** The application of early repayment charges will need to be considered, in particular how these are calculated, taking into account the rules which require the charge to be “cost reflective” and “not excessive.” For customers who are not looking to increase their borrowing but no longer meet the new responsible lending requirements (for example, product porting, downsizing and rate switching), firms will need to consider how this is applied.

**Firms need to be able to justify and evidence these charges for all cases.**

► **European Standardised Information Sheet:** This is a new Europe-wide document that mortgage firms will need to issue to be compliant with regulation. The existing documents that firms are familiar with in the UK will need to be reviewed and redesigned. This may mean that a wider process review is required.

**Firms need to consider how they refine their affordability assessments to effectively serve different customer segments and to suit the increasing use of different channels by the modern borrower.**

► **Affordability:** The requirements for assessing affordability under the MCD will have implications for both interest rate stress testing and the MMR transitional arrangements. This is a time when the industry is already preparing for the consequences of a potential base rate increase. In addition, a wider regulatory focus on affordability was also referenced in the FCA Business Plan 2015/16, which outlined some of the regulator’s broader concerns on topics such as retirement income, vulnerable customers and consumer credit debt. These will also be relevant to mortgage lenders.

**Firms need to consider how they refine their affordability assessments to effectively serve different customer segments and to suit the increasing use of different channels by the modern borrower.**

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4 Implementation of the EU MCD, response by the Council of Mortgage Lenders to the HM Treasury consultation paper, page 1
Firms will need to consider which staff will be impacted, the robustness of their existing training and competency scheme and how best to ensure that all staff have an appropriate level of knowledge within the required timescales.

**Binding offers:** It is standard practice in the UK to make a mortgage offer on a conditional basis subject to status. Under the MCD, lenders must issue an offer which is binding on the firm. In addition, mandatory cooling-off periods for consumers are being introduced.

Firms will need to consider at what point the binding offer will apply and in what circumstances this could become void.

**Second charge lending:** UK providers of second charge lending have relatively recently been migrated from the Office of Fair Trading’s regime to the FCA’s Consumer Credit sourcebook (CONC). The MCD requirements mean that this lending will fall under the FCA’s MCOB regulation from March 2016.

Firms will need to consider how to define each segment and how successful self-declaration will be monitored and tested. A robust plan is also needed to prevent “gaming” of the rules for customers trying to avoid the more stringent checks of a regulated mortgage.

**Buy-to-let lending:** Of primary concern to the UK market will be correctly categorising borrowers into those who fall within the regulated lending requirements, as opposed to commercial buy-to-let customers, and adapting their interactions with this segment of their business accordingly. The new rules will also capture lending that was previously unregulated, such as consent-to-let.

**Foreign currency:** Obligations will be introduced regarding information provision and the impact of currency fluctuation.

Firms will need to consider the requirements of these rules and whether they can meet them on an ongoing basis.

**Calculation of annual percentage rate of charge (APRC):** The MCD will require firms to calculate the cost of borrowing differently. A further method will need to be applied where there is a variable rate of interest.

**The key questions for the mortgage industry are:**

- Where should lenders prioritise their activity while dealing with multiple regulatory driven disruptions to their business models?
- How can lenders stay competitive and innovative as well as compliant?
- What is next and where will lenders see the largest impact?
How EY can help

► EY has extensive experience in designing, leading and delivering major consultancy programmes prompted by new developments in regulation.

► EY can advise on the impact of changes in the tax landscape on your customers and firms.

► EY can provide “road maps” to guide firms along proposed regulatory timelines.

► EY can provide guidance on the interpretation of new regulation and the impact on your business.

About EY’s mortgage capability

► EY is a leader in the conduct risk space and was named Best Consultancy Firm for Conduct Risk at the Compliance Register Platinum Awards® in 2014.

► EY worked with firms to prepare for the MMR, including readiness assessments, MCOB attestations and advising the line of defence functions. We have used our skill, knowledge and regulatory insight to ensure that firms have fully delivered on the requirements set out by the FCA.

► EY has vast experience helping firms deliver key strategic requirements. Our core team tracked MMR developments from inception, regularly engaging with our clients and the FCA on proposed changes, and providing input on the development of the MCD.

► Our work with all the major lenders provides us with insight into good industry practice and allows us to provide analysis and comment on the effectiveness of firms’ processes.

► EY is able to advise firms not only in the delivery of regulatory requirements but also in the practical development of processes and solutions.

► EY has a proven track record of delivering high profile engagements across the mortgage lifecycle. EY is currently supporting a major UK institution with a dynamic multi-channel conduct risk assessment. This includes a specific focus on business modelling activities designed to validate and enhance existing payments calculations on the firm’s systems.

For more information on how EY can help, please contact:

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About EY
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