The Risk Outlook for Mortgage Lenders

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Clive Briault

Managing Director, Retail Markets, Financial Services Authority

Good afternoon and thank you for the kind invitation to speak to you today.

When I spoke at a CML lunch in April I mentioned some of the areas where we had worked together to achieve good outcomes. Once again I would like to thank you and Michael Coogan for your continued cooperation, resulting in some good outcomes for the industry and its customers, including:

- support for our work on mortgage exit administration fees;
- the identification and reporting of mortgage brokers who may be involved in fraudulent loan applications – more on this later;
- working with us on establishing standard definitions for the various categories of "sub-prime" adverse credit lending; and
- suggesting ways to improve the data we collect from lenders on product sales.

These areas – and the other subjects I will cover this afternoon – are all examples of our preferred approach of working in partnership with the industry to deliver the fair treatment of consumers and to facilitate efficient and effective markets. As Michael will emphasise in his closing speech, the UK mortgage market is highly innovative and competitive, and it is important to recognise the benefits that such a market delivers for consumers.

Today I will cover:

- current market conditions;
- the handling of arrears and possessions;
- responsible lending; and
- the consequences of current and prospective market conditions for individual lenders.

Current market conditions

We have been living in a rather unusual period of economic and financial market stability, both at home and abroad. The UK's economic growth has continued unabated for 67 quarters, and both unemployment and inflation have remained low. These benign economic conditions in many large economies, particularly the US and the UK, encouraged a cycle where credit was cheap and abundant, consumers were willing to take on ever-increasing amounts of debt, and house prices were boosted by consumers' increasing demand for these assets and their increased ability to borrow to finance their purchase.

I said to you in April that I expected these benign conditions would continue over the next year. Since then, the decline in volumes of new mortgage lending and the latest forecasts for house prices indicate a more difficult environment for you, and it remains to be seen how much further the "events of the late summer", as the Treasury so nicely calls them, will affect the real economy. I also noted how important it was that mortgage lenders should undertake regular stress testing, in particular of their credit risks. That remains true, although with the benefit of hindsight I under-emphasised the importance of liquidity risks.

Late last year it started to become clear that robust housing market conditions were starting to turn sour across the Atlantic. The market's first adverse reaction to the realisation that the 2006 vintage of variable rate sub-prime loans were performing poorly came in the first quarter, but the market quickly recovered. As we all know, market jitters emerged once again over the summer and quickly developed into a more serious and sustained problem. Investors became markedly less willing to invest in or fund mortgage assets, irrespective of their quality, and this spread even to non-mortgage assets. Moreover, banks and building societies found it much more difficult to raise wholesale market funding, especially at anything other than very short maturities. And long-established relationships broke down, such as the linkage between three-month LIBOR and official policy rates, which is of particular importance to the rates charged to mortgage borrowers.

These developments exposed a number of vulnerabilities in retail banking. The risks of relying heavily on securitisation or wholesale funding have received the highest profile. But it is also important to observe that some types of retail funding have behaved differently than we have seen in the past, with internet and other rate sensitive accounts, especially those in excess of the compensation limit of £35,000, proving to be much more mobile than had previously been assumed.

I hesitate to look ahead again. But it would be prudent to assume that market conditions will remain very difficult for a sustained period. And against that backdrop the negative impact of any adverse macroeconomic and credit shocks could be considerably magnified, with consequences for both sides of the balance sheets of mortgage lenders. So there is a very real prospect that conditions will worsen further.

Current and prospective market conditions also raise some important risks for consumers: if their financial plans depended on cheap and abundant credit, the absence of those conditions is likely to cause significant consumer stress. And, as with lenders, the impact of this will be accentuated further if house prices fall, or even if they increase by less than borrowers had hoped. From our Product Sales Data, we know that at least 1.4 million short-term fixed rates will end in 2008. Many of these borrowers are on relatively high loan-to-value ratios or income multiples and will find it difficult (if not impossible) to refinance their mortgage on favourable terms, which will leave them facing a significantly higher interest rate on their borrowings, which may prove too much for many of them to afford. Moreover, sub-prime borrowers may not have access to the market at any price, at least until the normal market mechanism of risk-adjusted pricing returns.

Handling arrears and possessions

In this ever more challenging economic environment, arrears and possessions have increased significantly, albeit from a very low base and concentrated in specific sectors of the market. And attitudes towards mortgage arrears have already hardened.

We recognise that it becomes more difficult to fund a sympathetic approach in the current environment. Nevertheless, we expect lenders to meet the requirements on the treatment of customers in payment difficulties set out in our mortgages conduct of business sourcebook. Firms must have in place, and operate in accordance with, a written policy and procedures for dealing fairly with customers in arrears.

We have set out a number of factors which we consider are likely to be central to such policy and procedures, including using reasonable efforts to reach agreement with the customer; adopting a reasonable approach to the time over which any shortfall in payments can be made good; and only possessing a property where all other reasonable attempts to resolve the position have failed. The rules - which consolidated good practice standards in the industry when we introduced our mortgage regime - were drafted in a high level way to give firms the flexibility to respond to the individual circumstances of customers in payment difficulties.

The treatment of customers in arrears was one of the areas prioritised in the second stage of our review of the effectiveness of the mortgage regime, on which we will report at the end of February next year. The preliminary results of our research in this area suggest that a number of firms may be failing to meet our requirements. A fairly consistent picture is emerging of some lenders across the market, in both the prime and sub-prime sectors, appearing to be unwilling to consider cases on an individual basis, unwilling to agree a solution tailored to the borrower's individual circumstances, and apparently adopting a one-size fits all approach to arrears recovery. In response to this emerging picture, we will shortly be launching a piece of firm-facing thematic work on the arrears management practices of firms, to establish whether there is a problem of non-compliance with our rules and with the general principle of Treating Customers Fairly. Clearly, this needs to be done as a matter of some urgency, before any further increase in arrears rates, and we expect the initial phase to be completed by the end March next year.

The impact of poor arrears handling practices can be substantial for the borrowers affected. There will be cases where the borrower has no realistic prospect of getting back on track, so dealing with the inevitable sooner rather than later will be in everyone's best interests. However, in other cases inflexibility and resorting hastily to court action may lead to properties being taken into possession when a less drastic solution was a realistic prospect and one that would have led to a better outcome for both the borrower and the lender.

Responsible lending

So what else should you be doing for your customers?

You will all have seen the results of our latest series of thematic reviews, which looked at the processes used by mortgage intermediaries to ensure the quality of advice they give to their customers. We had looked at the ways firms assess affordability; at self certified mortgages; at training and competence; at how senior management exercise control over their businesses; and at what their advisers are doing. We encountered many issues, some very serious, in our assessment of the forty-eight firms who we knew to have been doing large amounts of self certification business.

The failures we found were all in relation to mortgage business which was being directed to lenders. What happened when those applications were reviewed by the lenders? I am talking here about your responsibility as lenders to take into account the ability of your customers to repay their mortgages. Are you following your own lending policies?

Last year, when we undertook our first review of the quality of mortgage advice processes, we included lenders in the sample population. The findings from that work concluded that while standards were generally higher in the larger firms, some lenders were not adhering to their policies. This year you will recall that we carried out an in-depth review of the sub-prime market. Once again we found some lenders who had lending policies in place but who were not following them.

Last month we began a new thematic review, focused on lenders, to assess responsible lending. We intend to report the results in March next year, and we shall see then whether the problems we have encountered in the intermediary sector are being repeated at the desks of your underwriters.

Of course I know that many of you do have the necessary systems and processes in place to assess and determine the applications you receive, and I am also very conscious of the value of the intelligence we receive from some of you in relation to brokers you believe to be engaging in fraudulent activity. This is a very important task, to identify and pursue firms whose actions can be enormously detrimental to consumers. I am very grateful to the 31 of you who have responded to the joint CML/FSA initiative launched in April 2006, and who have alerted us to more than two hundred cases of suspected or proven fraud. A third of those cases have resulted in referrals to our enforcement division. Some of the cases your information has led us to have been truly appalling. I would therefore ask for more of you to help support our efforts to deter fraud in the industry. I know that Michael Coogan has been working with the CML Board to broaden this initiative, in particular to include more of the specialist sub-prime lenders, and I am most grateful for this support.

You might ask why only a third of cases have resulted in a referral to enforcement. The explanation is that in some cases we respond through actions other than enforcement, which we use in the most serious cases, while in other cases we might be able to take tougher action if you were all prepared to let us use the evidence you give us. This is a point I would ask you to take away and consider in the context of your own firms. For example, one lender has told us that to reveal that they provide the regulator with this information would harm their reputation. Let me play that one back: one lender at least – and I do wonder if there might be others – is concerned that allowing it to be known that it does not do business with potentially fraudulent firms will be bad for its business. Of course I recognise that some firms do have concerns about their legal position, but other lenders have satisfied themselves that it is appropriate to give us that freedom, and our success in following up their intelligence is due in large part to being able to use the hard evidence on the customer files. So for those of you who are considering joining the initiative, or thinking about allowing us to make proper use of your evidence, I ask you to reflect on the importance of what we are collectively seeking to achieve, and help us tackle what we all know is a serious problem.

Taking this even further, I know that some of you are frustrated that some brokers who are dropped from your panels because you suspect or know them to be acting improperly are able to move on to take their business to other lenders. If one lender has evidence to suggest that a broker may be breaking the law, then can that information be made known across the lending community to prevent further abuse? Finding a way to share the names of suspect brokers would add enormously to the impact of our joint efforts, and I very much hope that a way can be found to realise the potential of such an arrangement.

For our part we will continue to work with firms to improve standards. This will include allocating more resource towards the small firms in the industry to accelerate the rate at which they engage with our requirements. We announced an enhanced supervision strategy for small firms two months ago. From January we will be beginning a programme of work which will bring us into direct contact with thousands of small firms, among them every small mortgage broker in the UK. No-one will be off the radar. That contact will enable us to identify, and where necessary target for action, those firms who are not engaged with our requirements and with the help and advice we are providing to the industry. For some firms that will result in their removal from the industry. This will benefit those firms who are trying to raise their standards, to improve the quality of their advice, and to treat their customers fairly. And it will raise the quality of the advice given on the mortgages that you provide.

Consequences of current and prospective market conditions for individual lenders

I want to return to the opening theme of this conference, when you decided who will survive in the years ahead. Far be it for a regulator to refer to "blood in the water", but I know what you mean. So what do I expect you to be doing to maintain control of your business in current circumstances, including the very real prospect that conditions will worsen further into next year, in terms of both liquidity and credit risks? We have been discussing this actively with firms, so I know that many of you are already keenly aware of the points I am about to raise, and are giving them your full attention.

First, firms should be assessing their funding and liquidity positions. You should be protecting yourselves from current vulnerabilities by actively putting in place adequate levels of liquidity, including the maturity of your liabilities and undrawn facilities. And you should be focusing on the quality of your liquidity: is it readily available or is some of it in the form of undrawn facilities which are subject to material adverse change clauses? I realise that holding higher levels of liquidity, with longer maturities, is much easier said than done at a time when wholesale funding is much more difficult to raise, the securitisation market has virtually dried up, and loan books sales are harder to achieve. But it would be prudent to pay a correspondingly higher price – and to forego some profits - to secure this protection, or otherwise to scale back balance sheet growth. And it would be better to take such actions in a planned, controlled way rather than having to react suddenly to an unexpected event.

Second, firms should undertake robust stress testing. There are specific requirements for liquidity stress testing for deposit takers set out in our rules, and we would expect robust stress testing to form part of the risk management framework of all lenders. Moreover, we would expect you to revise your stress testing parameters to reflect current and prospective market conditions, taking into account both firm-specific and market wide problems and covering both liquidity and credit risks. This is likely to result in much tougher stress tests being applied, for example to include what position you would be in if you had no – or only limited - access to wholesale funding for a sustained period, and to reflect the mobility of some types of retail deposit. And you should consider what liquidity and credit stresses would take you to the point of destruction, so that you can decide whether you are comfortable with what that implies about how you are currently positioning your business.

Third, the environment in which you operate has changed and there is almost certainly more change to come. It is very unlikely that we will return to the conditions that prevailed before August. Boards and senior management should therefore be reviewing and assessing their medium and longer term strategies and the options open to them. It is clear that some business models are no longer as economically viable as they used to be, either because some markets have simply disappeared or because their profitability has been adversely affected by shifts in pricing and in default rates.

Those of you whose business relies on these models will no doubt have reached a view on their future viability. Some of you may batten down the hatches and weather the storm, waiting for a return to calmer conditions. Others will have decided that more radical solutions are required. There will be both winners and losers emerging from this situation. It is not the role of a regulator to determine who these will be, although we do have a clear interest in the losers departing in an orderly fashion that protects both their own customers and market confidence and stability more generally.

Fourth, you need to consider contingency plans against the worst outcomes, and to review and revise these in the light of market conditions. These plans might include the very practical issue of how you would cope with an upsurge in retail deposit withdrawals, both from your branches and over the internet; how you could access emergency funding; and the circumstances in which you might need to curtail or wind down your business, or to seek a corporate solution through raising new capital or seeking a new owner. Again, any such plans need to be considered well before you are engulfed by a crisis since by then it will almost certainly be too late to develop practical responses.

Fifth, it is essential for lenders to have in place the management expertise to be able to deal with adverse conditions. Following a long period of benign conditions in the mortgage market, the senior management of many firms have no direct experience of more difficult conditions and therefore may not necessarily be best placed to deal effectively with a much more difficult and challenging environment and the issues that this brings. It is the responsibility of boards to ensure that they have in place a senior management team that can respond appropriately and in a timely manner to current challenges and to the possibility that there may be a further deterioration in the position over the next year or so.

Finally, I should say something here on the subject of firms buying mortgage books. I would like to stress that we have never said that a bank or building society should not be buying a mortgage book at the moment. What we have said is that in current market conditions it is essential that liquidity management is treated as a key priority and that lenders should be holding adequate liquidity. Therefore, boards and senior management should be asking themselves whether now is the right time to be exchanging liquid cash for illiquid mortgage assets. So we might expect a bank or building society wanting to buy a book to have built up sufficient liquidity ahead of the purchase. We would expect the usual due diligence on the book to have been carried out and for purchasers not to be unduly carried away by the prospect of being able to acquire assets at a discount. And, as in any conditions, it is essential for purchasers to assess and to understand fully what is being bought, including the book's risk profile and to know how this will affect the purchasing firm's overall risk profile. We would also expect there to be appropriate stress testing of the book, since without this it is difficult to understand how a board and senior management can be in a position to challenge any performance forecasts or to determine a price for purchasing the portfolio.

Conclusion

To conclude, I ask you to reflect today on two issues.

First, in the light of current and prospective market conditions that you give your full attention to the liquidity and credit risks you face, that you stress test your ability to survive these risks, and that you consider your contingency plans against these risks crystallising. We want there to be a competitive and thriving mortgage market in the UK which clearly meets the needs of consumers. This requires lenders who have clear strategies - appropriately stress tested - that take account of the changing world, with viable funding models, and with boards and senior management that understand and know how to operate in the best interests of their customers in a variety of market conditions.

Second, that despite these liquidity and credit risks you maintain your focus on treating your customers fairly, including in the areas I have highlighted on responsible lending and on your treatment of customers in arrears.