Section 5

The economic and regulatory context of mortgage advice

Section 5 covers the economic and regulatory background to mortgages, including: the market and what effects it; the supply of mortgage finance and the providers; and the regulatory context for marketing mortgages.

Section 5 covers part 2 of the syllabus for Unit 3.

5.1 The economic context

The UK has a mature property market, with home ownership seen as both desirable and essential; in many cases, it is seen as an investment. In many other countries, including most of Europe, home ownership is much less common and it is considered normal for families to rent accommodation. The reasons for this difference are unclear: it may be attributable to the facts that property is regarded by many in the UK as a good investment (despite the property slump after the 1980s boom) or that there are fewer hurdles and costs associated with UK property transactions than in some other markets. Social pressure is probably largely the culprit: buying a house is seen by many in the UK as a natural step in the life cycle – like getting a job, marrying or having children.

5.1.1 Demand for mortgages

The *mortgage market* in the UK is characterised by intense competition. In part, this arises from a period of deregulation in, and after, the 1980s that saw new lenders enter the market. It is also due to the increasing demand and

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sophistication on the part of borrowers, who are now accustomed to shopping around for the best deal and to comparing features and price. There is consequently a huge array of products on offer from many different types of financial institution.

The differentiating factors that influence a consumer's choice include such things as their view of the lender (brand), the lender's criteria (accessibility), the interest rate, loan features (flexibility, fixed or variable rates etc), the repayment options associated with the loan, cashbacks and other special deals, and, increasingly, the distribution channel by which consumer and lender are brought together.

The range of financial institutions engaged in UK mortgage lending is much wider now than it was a couple of decades ago: traditionally, building societies carried on the vast majority of residential mortgage lending. High-street banks, whose deposit base was generally short term, did not engage much in the market on the basis that it is bad practice to 'lend long' against assets that can be withdrawn at short notice. Over the last 25 years, however, there has been a blurring of the distinction between different types of financial institution and borrowers now have a much wider choice of provider.

The UK appetite for mortgage loans is substantial: according to the Council of Mortgage Lenders (CML), mortgages and remortgages of the order of £271 billion were arranged in 2003. Of this total, around 52% relates to remortgages and further advances. These are big figures, influenced, without a doubt by the British appetite for home ownership.

There are some worrying trends, however, for those hoping to profit from property. The number of first-time buyers has reduced from 55% of all new loans in 1994 to 29% in 2003. Concern has been expressed over the reduced numbers of first-time buyers because they are felt to drive the market. In reality, without the first-timer, no one further up the chain will be able to sell. With the average first-time property now in excess of four times the average first-time buyer's income, first-time buyers are more reluctant to commit to the market.

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5.1.2 What affects the mortgage market?

The mortgage market is affected by a number of issues, including the following.

- ***Interest rates*** – interest rates directly affect the cost of repaying a mortgage. When rates are high, as they were in the late 1980s and early 1990s, homeowners struggle to meet repayments, first-time buyers cannot afford to enter the market and house prices are likely to reduce. During the 1980s/1990s slump, even price reductions failed to stimulate the market because buyers were waiting for prices to go down even further. When interest rates are low, people find mortgage repayments affordable and will be prepared to commit to higher mortgages. This willingness to borrow lifts prices generally, resulting in a property boom, as in the late 1990s and early 2000s.

  Mortgage interest rates are linked to the Bank of England base rate, and it has been used as a crude method of trying to calm the housing market, but the government (through the Bank's Monetary Policy Committee) fights a constant problem: raising interest rates might dampen the mortgage market but it can cause problems for those already heavily committed. Leaving rates where they are is likely to lead to a continued boom.

  A number of factors will influence interest rates in the economy:

  – *the level of government borrowing* – when the government needs to raise money for public spending it can raise taxes or borrow. Borrowing is less likely to cause political problems. Upward pressure is placed on interest rates when the government increases borrowing significantly.

  – *higher levels of individual borrowing* – rates tend to move up when there is high demand for borrowing. Too much borrowing at an individual level is a worry for governments, as money floods into the economy and prices creep up. If interest rates increase dramatically, many people will be severely over-stretched financially.

  – *fiscal policy* – the government will use interest rates as a way of controlling the economy.

  – *foreign interest rates* – the value of Sterling against foreign currencies is affected by interest rates. When UK interest rates are higher than those abroad, the pound is popular and the exchange rate increases. This can have a negative effect on industry, because UK goods become expensive abroad and sales may be affected.

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The responsibility for setting UK interest rates was passed from the government to the Monetary Policy Committee (MPC) of the Bank of England in 1997. The MPC has been given a target for inflation and must adjust interest rates as necessary to meet the target. This means that the government no longer has direct control over UK interest rates.

The MPC sets the short-term rate at which the Bank of England deals in money markets. This rate is known as the *repo rate*, and will usually influence the interest rates set by banks and other institutions.

- ***Inflation*** – there are two elements to inflation in the property market:
  - *general inflation* is the decrease in the spending power of money over a period. For example, if general inflation runs at 2.5% over a one-year period, £100 at the start of the period will buy goods worth approximately 97.5p at the end of the period. To put it another way, in order to buy the same goods at the end of the period, the buyer will need £102.50. When general inflation is low, interest rates tend to be low as well;
  - *house-price inflation* relates to the increases in the price of houses over a period and, in general, house price inflation runs well ahead of general inflation.

  The Bank of England can control general inflation to some extent. It can be reduced by increasing interest rates, which will reduce the amount of disposable income available to spend; reduced spending will lead to lower general prices after a while. A prolonged period of interest rate increases to control inflation will lead to stagnation, or even a reduction, in house prices because people will be reluctant to make commitments.

  Inflation can be increased by lowering interest rates. This will increase the amount of disposable income and boost spending. It is accepted that a small (2% to 2.5%) amount of inflation is good for the economy and the government has set the Bank of England a target for inflation of 2% as measured by the Consumer Prices Index. When interest rates are lowered in an attempt to promote inflation, property prices will tend to rise as mortgage repayment becomes more affordable.

- ***The state of the economy*** – when economic prospects are good, employment is high and stable and interest rates are relatively low, and more people have the confidence to enter into a substantial transaction such as a mortgage. When the conditions are not so good, they may have to – or choose to – hold off any decisions.

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In periods of *recession*, unemployment rises and people worry about their jobs; they are certainly not looking to increase their mortgages. If we take the late 1980s/early 1990s property slump, a combination of factors influenced the market:

- relatively high inflation;
- high interest rates (as high as 15%) set partly to combat inflation and partly to maintain parity with the European Monetary Union;
- recession/poor performance in the economy;
- the change to the tax relief (MIRAS) available on mortgages from £30,000 per individual to £30,000 per property. This led to a large boom in first-time buyers taking advantage of the last opportunity for double tax relief and a resultant surge in prices. While this change was made before the slump, it resulted in prices surging, leaving the market artificially high and with further to fall.

As a result of these factors, the property market went through several years of falling prices, negative equity and turmoil.

♦ ***Supply and demand*** – property is no exception to the laws of supply and demand, whether categorised by geographical area or type of property. Quite obviously, if there are more buyers looking for one-bedroom flats in an area than there are flats, the price will be driven up. In some areas, there are too many executive detached properties – the lack of demand will drive down prices. Property prices in London and the south have been consistently higher than the rest of the UK; much of this is due to the dense population and lack of appropriate housing.

At present, we live in a low-inflation and low-interest rate environment and mortgage rates are at historically very low levels. On the face of it this is good for house sales and mortgage demand but the full picture, at the time of writing, is not entirely clear and many factors can affect consumers' appetite for entering into large loans. In particular these may include uncertainties about job security and the impact of the past two years' equity market turbulence on savings and pensions plans etc.

When there is a feeling that property prices have risen far and fast, people may also become cautious: many suffered badly in the falling property markets of the late 1980s and early 1990s, having overcommitted themselves in the belief that property prices could only go one way. These people sometimes found that their property became worth less than their outstanding loan (they were

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in a position of *negative equity*). Fears of another such 'bubble and burst' may well influence demand, especially if fuelled by the widely read financial press.

So, while low interest rates are certainly a factor in stimulating demand for mortgages, other issues can influence an individual's decision to take on a substantial commitment.

Another factor that influences the amount of mortgage borrowing is the increasing use of mortgage-secured borrowing for purposes other than property purchases, or even for property improvement. A mortgage can provide funding at better rates, spread over a longer term than many other forms of finance. Those consumers who are more sophisticated in the way they manage their finances appear to be seeking out the most cost-effective way to borrow, planning ahead and spreading their borrowing over time to minimise its immediate impact on their disposable income. Indeed, the early part of the calendar year is regarded as a traditional time for activity in the second-mortgage market, as families who have overstretched themselves for the seasonal festivities look to consolidate their credit card and other borrowings.

In an environment of rising house prices, consumers also use borrowings raised by way of a second mortgage on their existing property to release the increasing equity tied up in the value of the house – value that makes them feel richer but which, unless they borrow against it to translate it into cash, cannot be used for a better lifestyle. At the time of writing, there is considerable concern at the level of personal borrowing in the UK, driven in part by cheap borrowing and rising levels of equity for those fortunate to have bought property some years ago.

5.1.3 Supply of mortgage finance

Until 1980, the range of institutions offering mortgage finance was limited. Most banks did not offer mortgages and those that did were restricted by government policy on how much could be advanced. Building societies were the main suppliers but, as mutual institutions, gave preference to their members. Because the societies were themselves subject to tight restrictions that precluded them from much lending other than residential mortgages, the market was pretty much polarised: the building societies looked after the residential mortgage sector and other institutions looked after everything else.

The mid-1980s saw a period of deregulation and increasing competition, with a blurring of the traditional divisions between the activities of different types

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of institutions meaning that a range of different categories of lender entered the mortgage market.

5.1.3.1 Banks

As the largest category of financial institution in the UK, the availability of mortgages from banks completes their set of financial products. Until comparatively recently, one could obtain almost any financial product at all from a bank except a mortgage.

Now mortgage business is sought actively by banks and on a large scale, for the following reasons.

5.1.3.1.1 Return

Banks can now achieve a reasonable return on their investment in the mortgage business. The demise of what had, until the early 1980s, been in effect a building society mortgage-lending cartel, pushed up the interest rates on mortgages to market levels and made mortgage business more attractive commercially.

5.1.3.1.2 Low risk

The default rate on mortgages is extremely low and mortgage lending is, essentially, low risk. People in the UK will give up almost anything before they give up their home. This holds true even during recession.

5.1.3.1.3 Cross-selling

A mortgage customer is a potential customer for 25 years or more. At the outset and during the term, the bank can cross-sell a wide range of financial products – insurance, life assurance, pensions, money transmission services etc.

5.1.3.1.4 One-stop shop

The 1980s heralded the dawn of what might be described as the *one-stop financial services shop*, where the customer can fulfil most of his financial needs in one go.

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Banks are in a strong position to obtain mortgage business. Nearly every building society customer is also a bank customer, and so will compare products and buy the most attractive. In addition, the banks' role in the provision of current accounts etc, means that they have a ready-made database on prospective customers, with a profile of potential risk.

As large institutions, banks also enjoy considerable *economies of scale*: they benefit by virtue of their size, being able to buy money cheaper and take advantage of efficiencies created by effective use of information technology.

5.1.3.2 Building societies

Building societies began as self-help institutions in the early Industrial Revolution. The earliest recorded society was founded in Birmingham in 1776. They quickly prospered in the industrial Midlands and North of England. They began as mutual institutions (owned by their members) and remain so to this day.

Until 1986, building societies were legally restricted to lending on property in the form of heritable security in Scotland and freehold and leasehold estate elsewhere in the UK. With the passing of the Building Societies Act 1986, societies were allowed to diversify into new areas, including unsecured lending and banking services.

They must still devote a minimum of 75% of their total lending activities to residential mortgages, although they can convert to plc status if they wish to enjoy the same freedom as banks. Several have already done so.

Despite their new powers, most building societies are content to remain as specialists in residential lending. Some have ventured into corporate lending secured upon land, but this more risky activity has resulted in the demise of at least two societies. Several others withdrew from the commercial market in the early 1990s.

5.1.3.3 Insurance companies

Insurance companies can be general insurers, life assurers or composites offering both types of business.

Traditionally, life companies have occupied a small corner of the mortgage market. Their greatest gain is from the sale of related products such as endowment policies and pension plans linked to the mortgage.

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Some companies have offered *top-up finance* for many years. This enables a borrower to obtain an 80% advance, for example, from a primary lender such as a bank or building society, with an additional advance 'topped up' by the life company.

As the competition for mortgage business has intensified, insurers have lost some ground in the provision of loans, but have undoubtedly gained by selling their services alongside mortgages offered by others.

5.1.3.4 Specialised mortgage houses

Specialised mortgage houses developed during the growth years of the late 1970s and early 1980s. They are invariably limited companies and are either independent providers or subsidiaries of larger financial institutions.

Mortgage houses are funded mostly from the wholesale market and lend on a centralised basis; they have few, if any, branches.

The earliest institutions recruited their talent from banks and building societies. These specialised lenders gave a completely new dimension to the market, although they have been found to struggle when wholesale interest rates turn against them.

5.1.3.5 Mortgage packagers

Mortgage packagers are, in effect, middlemen who operate between the ultimate lender and the intermediary or customer. Their role is to undertake much of the administrative work, tailoring mortgage packages to specific situations – for example, loans for the sub-prime or credit-impaired market. Their emergence represents an increasing move towards institutions specialising in what they do best: a particular lender may be good at managing its treasury operations and making funds available, but it may not have – nor wish to acquire – skills and capacity in distributing loans, nor in the administration of loan application processing. It makes sense for the lender to work with another organisation that might have these skills but which does not itself have the funds to lend. Typically a mortgage packager will make its money by charging between 1% and 2% but it may pass some of this on as commission to the intermediaries who use its services.

Mortgage packagers generally operate in a particular area of specialisation: for example, they may aim to service the *sub-prime market* (those with CCJs or historic loans arrears histories), those who work in areas where it is hard for

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them to prove their income (eg those working in the arts, the self-employed or the newly-employed) or those with unusual employment. The packager will have direct access to lenders and underwriters and will use knowledge of its particular market to present them with cases within their lending parameters.

Critics have suggested that some packagers add needless cost to the process without truly adding value (they require payment for their services in addition to that of the intermediary referring a potential borrower to them) and further that the products they recommend may often carry high interest rates and penalties. They do, however, undoubtedly assist those borrowers with non-standard requirements to raise finance, as well as those lenders with the appetite to advance funds but without the resources to assess and process large numbers of non-standard applications.

5.1.3.6 Sub-prime and other specialist lenders

As well as more generalist providers, the mortgage market is home to a number of specialist businesses that have made a niche in lending to, or arranging loans for, people who might not fit neatly into standard lending criteria.

Among others, these include organisations that have expertise in lending to those with impaired credit track records (for example, they may have county court judgments (CCJs) against them) or to those who are self-employed and have such short track records that they cannot supply a number of years' past accounts. Such people might fail the lending criteria of a generalist lender because they do not fit into the lender's model of the 'norm'. This does not necessarily mean that they do not represent good business propositions – it just means that they require different and more specialised assessments.

Of course, such borrowers may often also represent a higher degree of risk. Part of the skill of the specialist lender or packager lies in setting the right level of interest rate to compensate the lender for this additional risk. This is often called *setting the rate for risk.*

Where the prospective borrower is in fact a worse risk than more standard cases – as opposed to being, for example, simply out of the normal run of things – he may be described as *sub-prime* (ie of less than perfect credit quality). Lenders who specialise in this market are themselves sometimes referred to as *sub-prime lenders.*

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5.1.3.7 Other providers

Finance houses provide finance to those wishing to raise loans on security of their dwelling houses. Such loans will often be at fixed rates of interest for a limited term and may be for such things as home improvement loans.

It is, of course, possible to create a private mortgage without a financial institution at all. To do so, the seller and buyer of a piece of land come to an agreement and draw up their deal on terms mutually agreed, usually through a solicitor.

5.2 The regulatory context

The FSA has responsibility for regulating mortgages. The rules that intermediaries must follow are covered in the Mortgage Conduct of Business Rules, which are similar in many ways to the rules that have applied to financial advisers and others since the FSMA 2000. If you have operated as a financial adviser you may notice the similarities.

5.2.1 Marketing of mortgages

The FSA Mortgage Conduct of Business rules refer to the marketing of mortgages as *Financial Promotions*. To quote from the FSA *Conduct of Business Sourcebook:*

'Financial promotions include but are not limited to, advertisements. They are invitations or inducements to engage in an investment activity (which includes mortgages). They can be solicited or unsolicited and can take various forms, such as mailshots and newspaper or TV advertisements.'

> Financial promotions are not allowed unless they are undertaken by an authorised individual, or the content has been approved by an authorised individual.

The rules split financial promotions into 'real-time' and 'non-real-time':

- A *real-time promotion* is one where the contact is through a telephone or face-to-face conversation;
- A *non-real-time promotion* is any other type of promotion – faxes, letters, adverts, etc.

Some types of promotion are exempt from the rules. In the main, these are promotions that only contain one or more of the following:

- the firm's name;
- a logo;
- a contact point;
- a brief factual statement about the firm's main business.

In essence these will be the type of promotion that advertises the firm without offering any inducement to take up a particular mortgage or service.

The key points regarding promotions are that:

- all qualifying credit promotions must be clear, fair and not misleading;
- non-real-time credit promotions:
  - must contain the company name and address, or a telephone number or email address where the full address is not available;
  - must state clearly and prominently if the product being promoted is conditional on other products being purchased – house insurance and so on;
  - must always contain the statement: 'your home may be repossessed if you do not keep up repayments on your mortgage';
  - must state the APR if it contains price information and make sure the APR is clearly distinguishable from any other rates shown;
  - must only use competitor comparisons where the comparison meets the same need or purpose (*like for like*) and must not denigrate or discredit the competitor, or take unfair advantage of the reputation of the competitor;
- the firm must keep records of all non-real-time credit promotions for at least 12 months from the time it was last communicated.

Real-time credit promotions are either solicited or non-solicited: *a solicited promotion* is one where the conversation was initiated by the customer; an *unsolicited promotion* is one where the contact/conversation is initiated by the firm or adviser. Cold calling, as such, is not allowed, so unsolicited promotions can only be made to existing customers who expect to receive unsolicited promotions.

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The rules for real-time promotions, including those made by call centres, are:

- they cannot be made at an unsocial hour (9pm to 9am and Sundays) unless previously agreed;
- contact cannot be made on an unlisted telephone number unless the customer has previously agreed;
- the caller must identify himself and his firm;
- the caller must check that the customer agrees to continue with the conversation if the time and method of communication has not been agreed earlier;
- the caller must terminate the conversation if the customer does not wish to proceed;
- the content of the conversation must be clear, fair and not misleading, and not make any untrue statements.

5.3 Mortgage functions

So the mortgage market has changed radically in a relatively short space of time: until recently, it would have been essential to go along to a branch of a financial institution and be interviewed prior to getting a mortgage; the preliminaries at least can now be handled by telephone from the comfort of one's own home, usually at no cost. The telesales operative can give a decision in principle almost immediately, send off the completed mortgage application form to the enquirer for confirmation and signature, and then set the wheels rapidly in motion to process the application.

The credit assessment process is no longer labour intensive: credit scoring can deal with initial enquiries, and information systems can generate quotations as well as offer documentation, legal forms and standard correspondence with professionals such as surveyors and solicitors.

As the market has become more complex, many bodies have begun to benefit from specialisation. Many institutions are now prepared to split the mortgage function into separate activities. This has led to a distinction between centralised and decentralised lenders.

- *Centralised lenders* are generally organisations that raise the funds they lend from the money markets. (This is in contrast to banks and building societies, which generally finance their lending from deposits taken in via

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their branch networks). Such organisations are characterised by a credit assessment and application process that is very much centrally retained and distribution that is reliant on intermediaries or packagers.

Applications may be submitted to a head office electronically, using a standard format questionnaire, and processed there using established criteria. The branches, if there are any, are used simply for customer relationship and marketing purposes and play little part in the decision-making process.

Centralised lenders often specialise in a particular niche in the market – for example, the self-employed or credit-impaired. Advantages of centralised lending include a greater degree of control over the risk criteria used and the ability to achieve economies of scale – costly loans assessment officers need not be employed in regional offices.

- *Decentralised lenders* are those whose credit assessment function is, in part at least, delegated out to branches. Advantages here are that the individuals in the branches may have enhanced knowledge of the local economic environment and the individual applicants, which may add value to the risk assessment.

Both approaches have their merits and disadvantages: centralised lenders can often achieve economies of scale that are unattainable by their decentralised counterparts but the price they pay for this is an element of removal from firsthand knowledge of the marketplace (and therefore also from a number of cross-selling opportunities); decentralised lenders often have good firsthand knowledge of their local marketplaces via their branches and should, in theory, have a better credit experience than their centralised counterparts. They may also benefit from a marketing advantage by way of the 'goodwill' generated from their local high street presence. Decentralised lenders pay the price by way of considerably higher costs in funding and staffing their branches and may find that the better credit experience they have gained through local knowledge is partly offset by the lack of a standardised approach. Lenders will make a business decision, assessing which approach is most appropriate to the particular market sector in which they are active.

During the early 1990s, several centralised lenders found it increasingly difficult to obtain new mortgage business. This was caused by the costs of wholesale funds increasing to a higher level than that of retail funds. In the absence of branch offices, the centralised lenders could not attract retail funds and could not lend competitively. Some institutions responded by moving into new areas

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of specialism, such as the secondary mortgage market and the separation of origin and administration.

5.3.1 Secondary mortgage market activities

Some institutions are active in the secondary mortgage market, buying and selling packages of mortgages. Closely allied to this is securitisation, which involves issuing securities backed by mortgage assets.

The secondary market is comparatively new to the UK but its growth has been an inevitable consequence of a mature and more complex market place.

5.3.2 Separation of origin and administration

If an institution cannot obtain sufficient mortgage business organically, it can act as a distributor for other institutions. Some centralised lenders have well-established links with independent financial advisers (IFAs), enabling them to use this channel to offer mortgage products originated by others. This was pioneered by some regional building societies in the 1980s, who found that they had the ability to deal with more mortgage business than they could fund directly. Some made arrangements with large overseas banks who were eager to get involved in what was perceived to be a lucrative, established and growing mortgage market.

This model was followed by several centralised lenders, often taking a portfolio of several institutions' mortgage products to IFA connections, and earning a commission on sales of these products.

This *separation of origin and administration* is perhaps inevitable because different institutions are able to build on their own specialisms. The main threat is that mortgage margins have been falling for some time, leaving less potential remuneration for the intermediate organisation.

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Test your knowledge and understanding with these questions

Take a break before using these questions to assess your learning across Section 5. Review the text if necessary.

Answers can be found on page [3] 120.

Answer true or false to each of the statements below.

1. All building societies are mutual organisations.
2. Lending to people who have county court judgments against them is referred to as the 'sub-prime market'.
3. 'Securitisation' is the buying and selling of mortgage portfolios.
4. Inflation can be reduced by reducing interest rates.
5. Firms must keep records of non-real-time promotions for at least three years.

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Answers

1. ***True***: but some building societies have converted to banks and become plcs.
2. ***True***: sub-prime lending is lending to those with poor credit histories.
3. ***False***: securitisation is the issuing of securities backed by mortgage assets.
4. ***False***: inflation usually increases when interest rates are reduced.
5. ***False***: copies of non-real-time promotions must be kept for at least 12 months.

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