Unit 4
Mortgage applications

After studying this unit, you will be able to demonstrate an understanding of:

- the role of a mortgage adviser and the importance and principles of providing advice, including the key factors affecting the advice given;
- the implications for consumers of 'gazumping' and 'gazundering';
- the purpose of additional security, including the role of guarantors;
- the fees and charges involved in arranging a mortgage, identify where these apply, the services they cover, when they become due, which are refundable, and how the opportunity for refunds diminishes as the process nears completion;
- the principal factors affecting the value of property, including their implications for consumers seeking mortgages and when consumers should be referred for specialist advice;
- the different forms of valuation and survey, and which might be appropriate for different properties and/or the borrower's circumstances;
- the need to obtain local authority planning consent for house development/extensions.

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Section 1

The role of the mortgage adviser

Introduction

The mortgage market is often baffling for the average potential purchaser. Few people understand the complexities of the house-buying process, the mortgages available and the importance of choosing the most appropriate repayment method. This is where the mortgage adviser will play a pivotal part: he can inform and guide the customer towards the most suitable mortgage for his needs.

Advisers are expected to give *ethical advice*, which means asking appropriate questions to ascertain the customer's attitudes and needs, to identify the customer's full financial situation, verify information where possible and offer advice and recommendations that best suit the customer. The customer's best interests should always be at the forefront of any advice or recommendations given.

The adviser's exact role depends on the level of service to be offered. The customer can be offered an advised sale, where the adviser selects the most appropriate mortgage product to suit the customer's needs and makes a personal recommendation. Alternatively, the customer can be given information about specific products that meet his requirements. No recommendation is given and the decision rests with the customer. For the purposes of this section we will focus on the advised sale.

Section 1 covers the MCOB rules relating to giving mortgage advice; and the mortgage advice process, including the considerations the adviser must take into account.

Section 1 covers part 1 of the syllabus for Unit 4.

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1.1 Mortgage Conduct of Business rules

Before going into detail about the role of the adviser, it is important to understand how the Mortgage Conduct of Business (MCOB) rules 4, 5 and 11 impact on the role.

1.1.1 MCOB 4 – Advising and selling standards

The terms 'adviser' and 'firm' are interchangeable in relation to the advising and selling standards.

1.1.1.1 The scope of service

The adviser's exact role depends on the *scope of service* to be offered. The customer can be offered an *advised sale*, where the adviser asks questions about the customer's needs and circumstances, selects the most appropriate mortgage product to suit the customer's needs and then makes a personal recommendation. Alternatively, the customer can be given information about specific products that meet his requirements: no recommendation is given and the decision rests with the customer. This is often referred to as a *non-advised sale*.

There are three levels of service that the adviser can offer to customers; the service to be provided must be clearly indicated to the customer when first making contact. The three levels are:

- to select and recommend a product from the whole market, which means that a wide range of products and providers from across the entire market must be considered;
- to select and recommend a product from a limited number (a *panel*) of lenders;
- to select and recommend a product from a single lender. This would usually apply to building society advisers.

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1.1.1.2 Initial disclosure requirements

When first making contact with a potential client, other than by telephone, where the anticipation is that personalised information or advice will be given on a regulated mortgage contract, the firm must:

- establish with the customer whether it will provide advice or information;
- establish with the customer how much he will pay for the advice or information;
- provide the customer with an initial disclosure document (IDD).

1.1.1.3 The initial disclosure document (IDD)

The adviser must give a new customer an *initial disclosure document (IDD)* at the start of the meeting. The IDD must include:

- a statement about the FSA;
- whether the mortgages on offer are:
  - from the whole market,
  - from a panel of lenders,
  - from one provider only;
- which service is provided:
  - advice and recommendations;
  - information on products but no advice or recommendation;
- whether a fee will be payable or commission will be received;
- what cover is available to the customer under the Financial Services Compensation Scheme.

An IDD does not have to be given where:

- one has already been given to the customer and the information in it is still current and appropriate to that customer;
- the firm is certain that the proposed contract will not be a regulated mortgage.

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1.1.1.3.1 Telephone contact

Where the initial contact is by telephone, the adviser must provide the following information at the start of the call:

- the name of the firm and the purpose of the call;
- the scope of the service provided. Where the scope does not include the whole market, the customer must be told that a list of the providers whose mortgage contracts are offered can be provided;
- whether the company will provide advice on the regulated mortgage contracts it offers.

All of the above must be confirmed in writing. Where the call suggests that the customer is not ineligible for any of its regulated mortgage contracts, he must be sent an IDD within five working days.

1.1.1.4 Advised sales

With *advised sales*, the firm must take reasonable steps to ensure that any personal recommendations are suitable for the client. This requires the adviser to gather information about the customer that will help him to assess which mortgage, if any, is suitable for the customer's needs and circumstances.

Suitability will be demonstrated where the information disclosed by the customer shows that:

- the customer can afford the contract;
- the contract is appropriate to the customer's needs and circumstances;
- the contract is the most suitable from the range offered within the firm's scope.

No personal recommendation should be made if there is no contract from within the scope offered by the firm that is appropriate to the customer's needs and circumstances.

Where the mortgage is to consolidate debts, the following should be taken into account:

- the cost of increasing the period of the debt;
- whether it is appropriate to secure a previously unsecured loan;

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- if the customer has known payment difficulties, whether it would be better for him to negotiate an arrangement with his creditors.

When assessing affordability, considerations include:

- information about the customer's income and expenditure;
- any likely changes to income and expenditure;
- costs after the end of any discount period.

When assessing suitability, considerations include whether the customer:

- meets the lender's eligibility criteria – income, loan-to-value ratio, etc;
- should have a repayment or interest-only mortgage, or a combination of the two;
- has a preference for a particular mortgage term;
- has a preference or need for stability of monthly payments (fixed or capped);
- has a preference or need for reduced initial payments – discount etc;
- intends to make early repayments;
- has a preference or need for any other mortgage features – payment holidays, overpayments etc.

Remember if the adviser does not have access to a suitable mortgage product from within the range that he deals with, it is not acceptable to recommend the closest fit from those available. A good example is where the adviser is a sub-prime specialist – only offering mortgage products designed for those with poor credit records. If a customer with a good credit record were to ask for advice, the adviser must not recommend a sub-prime mortgage. The one exception will be if the adviser can demonstrate that the costs, terms and conditions of the contract will not disadvantage the customer when compared to suitable standard mortgages.

1.1.1.4.1 Records

The firm must keep records of all information provided by the customer and the reasons for the recommendation.

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1.1.1.5 Non-advised sales

In some situations, a customer may ask for information on a particular type of product or products, rather than seek advice and a recommendation from the adviser. In some cases, the adviser might present the customer with a shortlist of products that appear to meet his requirements, leaving the customer to decide which one, if any, best suits his needs. If the customer decides to apply for a contract on this basis, it will be a *non-advised sale*.

MCOB 4 sets out basic requirements for non-advised sales:

- all questions the adviser asks the customer about his needs and circumstances should be scripted in advance;
- information given to the customer should be clear, fair and not misleading.
- if it becomes clear during the conversation that the customer is considering an unsuitable product, he should be encouraged to seek advice;
- staff who use the scripted questions should be trained in their use and should understand the difference between making and not making a personal recommendation;
- the firm must make a record of all scripted questions on the date they are first used. The records must be kept for one year after the last date on which they were replaced by new questions.

1.1.2 MCOB 5 – Pre-application disclosure

Pre-application disclosure is the information that must be provided before the customer completes an application for a regulated mortgage contract. The principle is that the customer should make an informed decision to apply for a regulated mortgage contract. This means that he must be given sufficient information, specific to his case, to be able to make that decision.

The information includes:

- the features of the proposed mortgage;
- the price the customer will pay;
- any linked borrowing or products required as a condition of the contract.

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1.1.2.1 Illustration

A customer-specific *illustration* must be given to the customer at the point when any recommendation is made and before an application is made. It must also be given where the firm provides written information that is specific to the amount the customer wishes to borrow. If the recommendation is made over the telephone, the illustration must be sent to the customer within five business days.

The customer must be given an illustration if the adviser or firm:

- makes personal recommendation to the customer;
- provides information to the customer that is specific to the amount he wishes to borrow;
- provides the means for the customer to make an application.

The illustration must be clear, fair and not misleading, and an accurate reflection of the costs of the contract. The content is prescribed by the FSA; the firm is not permitted to add information other than that prescribed. The headings of the prescribed content are as follows:

- *date produced*;
- *about this illustration* – what it is and what it does;
- *the level of service provided* – advice and recommendation or information only;
- *what you have told us* – the amount of loan required; the price of the property; the desired term; interest-only or repayment basis;
- *description of this mortgage* – lender; interest rate option chosen; period of any special rate;
- *the overall cost of this mortgage* – the amount to be repaid in total; the amount repaid for each £1 borrowed; the APR;
- *what you will need to pay* – the amount of each regular payment at the rate quoted; the total number of payments; whether the payments are fixed or variable. With an interest-only mortgage, the illustration must stat that separate arrangements should be made to repay the capital at the end;
- *are you happy with the risks?*
- *what fees you must pay* – itemising all fees included in the APR calculation. A description of each fee – amount, when payable, recipient if not the

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lender, whether refundable; a statement to confirm if a fee is to be added to the loan; higher lending charge statement (if applicable);

- *insurance* – insurance that must be taken out through the lender/adviser; insurance required as a condition of the mortgage (but not necessarily through the lender/adviser); amounts;
- *what happens if you do not want this mortgage any more* – early repayment charges; moving house;
- *what happens if you want to make overpayments?*
- *additional features* – underpayments; payment holidays; borrow-back facility; incentives; linked savings accounts, etc;
- *using a mortgage intermediary* – deleted if arranged directly through the lender.

  The key part of this section is that the fee payable by the lender to the intermediary must be stated:

  - if the fee is £250 or less, the illustrator can state that the fee payable will be no more than £250;
  - If the fee is more than £250, the exact amount must be stated;
- *where can you get more information about mortgages?*

The adviser/firm must explain the importance of the customer reading and understanding the illustration before making an application.

The firm must keep an adequate record of each illustration it issues for a year from the date of the customer's application.

1.1.3 MCOB 11 – Responsible lending

MCOB 11 is aimed particularly at the lender but it does place responsibility on the adviser to gather the information required for the lender to support its decision.

Before entering into the mortgage contract, the lender must be able to show that account has been taken of the borrower's ability to repay the mortgage. A record must be made of the information used in reaching the decision and kept for at least one year from the start of the contract.

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The lender must establish and operate a written policy outlining the factors it will take into account in assessing the borrower's ability to repay the mortgage.

1.2 The advice process

The adviser should first interview the customer to find out as much relevant information as possible. In most cases the adviser will need to explain terminology, products and procedures so that the customer can give reasoned and informed answers.

Among other things, the interview will include establishing:

- the customer's intended purchase price or price range;
- the type of property to be purchased;
- the customer's feelings about the term of the mortgage;
- the customer's income and outgoings;
- the amount of deposit available and other cash available to meet expenses;
- the customer's current employment status and employment history;
- the customer's budget for mortgage repayment and whether this is vulnerable to rate increases: whether he needs the stability of a fixed or capped rate; whether he needs to start at the lowest possible cost via a discounted mortgage;
- the customer's attitude to fixed and variable rates, and to potential rate rises in the future;
- the potential/intention for the customer to make early repayments – partial or total;
- protection needs that will arise when the mortgage is arranged – life cover, mortgage payment protection and so on, assuming the adviser has the appropriate authorisation to advise on these products;
- the fees, charges and costs involved in the mortgage products, including early redemption charges.

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Figure 1.1 The advice process

1.2.1 Affordability

The adviser must ensure, as far as possible, that the customer will be able to afford any solution that is recommended. If a borrower takes on a mortgage that he cannot afford and on which he cannot keep up repayments, there is a danger that the property will be repossessed or, at best, he will have to sell. A number of key issues should be covered when assessing *affordability*.

- What is the customer's occupation? In some cases he might be on a career path that will lead to higher income, perhaps on passing exams or achieving benchmarks; this could help future affordability. On the other hand, have there been any redundancies or cutbacks at work recently?
- Is the customer's monthly disposable income sufficient to cover the monthly repayments? Current mortgage or rent payments can be offset against the potential mortgage payments. Are any income increases expected? This will involve a breakdown of monthly income and expenditure, as many people underestimate their actual spending. If the customer is prepared to make 'sacrifices' to afford the payments, how realistic are they?

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- How does the customer run his bank account? If it is usually in credit, it shows an ability to manage finances; if it is often overdrawn, it might suggest difficulty with financial management – a mortgage might increase the problem. The position might be checked by looking at the last three months' bank statements.
- What effect would increases in interest rates have on the customer's ability to maintain payments? This is particularly relevant where the customer is looking to borrow the maximum available, leaving them with little or no spare income. It is also an important issue where the customer is considering a fixed, capped or discount rate in the initial years, because the payments may increase significantly at the end of the initial term.
- If money is tight, how does the customer feel about a mortgage that starts lower but increases payments later on – a discount or low-fix, for example?
- Are there are any other likely expenses that will affect affordability in the future? What are the customer's feelings towards this?
- Does the customer have sufficient funds to pay the required deposit and cover expenses and charges?

Once the information has been gathered, steps should be taken to verify its accuracy; this is particularly the case with income. The adviser should establish a breakdown of income – basic salary, bonuses and overtime, including whether or not it is guaranteed. Irregular or non-guaranteed income might not be taken into account by a lender, or a proportion might be included. This information can be seen on payslips, while total income will be shown on the individual's P60.

Self-employed individuals often have more difficulty proving income. Lenders will require evidence of income, including the time the business has been running and profit and loss records for the last three years; where the business is new, the customer's previous career record will be relevant. There may be a temptation on the part of the self-employed customer to choose a self-certified mortgage, where he declares his income but no evidence is required. While this can be appropriate for those who have trouble providing evidence, it is tempting to overstate income in order to secure a bigger mortgage. This is both illegal and dangerous, and the adviser should warn the customer of the consequences of such action; the customer could end up with a mortgage he cannot afford, and falsifying income, even on a self-certification basis, is fraud punishable under law.

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1.2.2 Suitability

When advising a customer, the adviser should recommend the most suitable mortgage for the customer's circumstances. The following issues will need to be considered in assessing *suitability*:

- the customer's objectives and future plans;
- affordability, based on the customer's current financial position and current interest rates – both of which may change in the future;
- that the product is appropriate for the customer's needs and circumstances now, and that the customer is satisfied that it will continue to be suitable later, particularly with regard to early redemption and flexibility;
- whether the customer intends to make early partial repayments or repay the whole loan early – does the product allow this without penalty? If there are penalties, the customer must be satisfied that the penalties are outweighed by the benefits of the mortgage;
- the customer's eligibility for the mortgage – income multiples, loan-to-value ratio and so on;
- that product structure must be the most suitable for that customer from the range of products considered – interest-only, repayment, fixed or variable etc. Assessing suitability of the product structure will be carried out by asking appropriate questions about the customer's views on interest rates, the need for certainty of payment amounts in order to budget, the need for reduced payments in the early years and the ability to borrow more later etc. In some cases, the most suitable product might be subject to terms and conditions that discourage early repayment or switching to another lender; the customer must be aware of this;
- that the term of the mortgage meets the customer's needs and circumstances;
- that no recommendation must be made where there is not an entirely mortgage product from within the range considered.

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1.2.3 Risk

The customer's attitude to, and awareness of, risk is another important consideration. In mortgage terms, *risk* can be:

- the fact that the home is at risk if the borrower fails to keep up repayments on the mortgage;
- borrowing a high percentage of the property's value presents the risk of negative equity if prices go down;
- those who do not wish to take a risk that the mortgage will be repaid at, or by, the end of the term should be advised to select a repayment rather than interest-only;
- interest rate risk – rates can increase, making the repayments higher. Rises may place pressure on the customer's ability to keep up repayments. His attitude to risk may suggest that a fixed or capped rate would suit him;
- fixed rate risk – if the customer takes out a fixed-rate mortgage, there is a risk that variable rates may fall below the fixed rate. This will mean he is paying more than someone on the variable rate and he must be aware of this risk and satisfied that the benefit of the fixed rate outweighs the risk;
- there is the risk that variable rates have risen significantly by the end of a fixed rate or discount term. How would the customer cope in this situation?
- there is a risk that an investment vehicle running alongside an interest-only mortgage may not perform to expectations. Is the customer aware of this risk and the consequences of such underperformance? Does he have other resources that might be used in that eventuality?

1.2.4 Term of the mortgage

In general terms, any mortgage should be arranged over the shortest possible term. People generally dislike debt and would like to be mortgage-free at the earliest opportunity. In terms of the *term of the mortgage*, the key considerations will be:

- the age at which the customer would like to have repaid the mortgage;

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- whether the customer feels there is a possibility of paying off the loan early – if there is, mortgages with early repayment penalties should be avoided;
- whether the mortgage term takes the customer near or into retirement, there will be sufficient income to maintain the repayments;
- while settling the mortgage as early as possible is important, is the customer aware that shorter terms require higher monthly repayments, either on a repayment basis or to the investment vehicle running alongside an interest-only loan?

Once the adviser has gathered the relevant information, he will be well placed to provide the customer with well-founded, ethical advice and help him to cut through the potential minefield that is the mortgage market.

1.2.5 Principles of ethical advice

The mortgage adviser has a great deal of responsibility because his advice will result in the client taking on a long-term financial commitment. Getting it wrong can cause major problems and distress for the customer. It is even more important now that mortgages and mortgage advice are fully regulated by the FSA that an adviser takes all the necessary steps to ensure that he is fully aware of his client's circumstances, needs and objectives before giving advice and recommending a suitable product. It is also important to establish the client's attitude to risk because some mortgage products clearly involve a greater element of risk than others: for instance, the risk involved in how future interest rate movements will affect the monthly payments on a capped or discounted mortgage compared with the certainty provided by a fixed-rate product.

Having collected all the relevant facts about the client, the adviser must then be able to show clearly how the product that is being recommended meets the client's precise needs and objectives. This must be explained in language that can be easily understood by the client, without the unnecessary use of technical jargon. It is vital that the client fully understands why the product is being recommended and that any questions or any concerns he has are properly addressed.

Ethical advice is a simple concept. It means giving advice based on what is best for the customer in view of information known at the time, regardless of the needs of the adviser. For example, the adviser should not be influenced by

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commission or bonus payments that he might receive for selling certain products.

The FSA has encapsulated ethical advice in its Treating Customers Fairly (TCF) initiative, which focuses on one of the FSA's Principles for Business:

- *customers' interests* – a firm must pay due regard to the interests of its customers and treat them fairly.

The concept of Treating Customers Fairly is central to the FSA's principles and is a key element of one of its objectives – securing an appropriate level of protection for consumers. The reality is, however, that the FSA has limited ability to deliver fairness through regulation. The concept of fairness will differ from product to product, customer to customer and service to service. As a result, it will be very difficult to produce rules to cover all eventualities without stifling the ability of firms to operate efficiently. The FSA is concerned that even more regulation might stifle the market and lead to many companies focusing on compliance rather than providing quality to customers. This, in turn, would increase costs and reduce the range of products available.

As a result, the FSA has taken steps to address TCF by putting measures in place to:

- improve the information provided to customers;
- increase standards of risk management and transparency for customers;
- improve complaint handling.

In many cases, the measures seek to improve or clarify what is already in place, rather than to develop new rules. The FSA is also working with firms, and industry and consumer groups, to develop best practice guidelines. Future FSA supervision will consider how well firms meet the principles of Treating Customers Fairly.

1.2.6 Advising those in arrears

Advising those in arrears is dealt with in detail in Unit 6, and is a specialist area but advisers may sometimes become involved in the initial discussions with customers with problems.

People have differing attitudes to debt and debt repayment. Most take the responsibility seriously and will take any realistic action to make payments on time – but even these individuals will sometimes fall behind with their

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payments, through no fault of their own. Those who do fall into arrears should be encouraged to seek advice at the earliest opportunity because speedy action can reduce the potential arrears and put the customer on the road to recovery. Delaying action is likely to result in increased arrears and a more serious problem.

In this situation, a borrower has a number of options available, depending on the extent of the problem, including:

- capitalising the arrears;
- reaching an agreement with the lender to repay the arrears over an agreed period. This is only practical where the borrower can afford the increased payments;
- paying only interest for an agreed period – only available on a repayment mortgage. This still leaves the arrears outstanding but reduces the immediate pressure;
- working through income and expenditure with an expert to adjust the budget and agree a way forward;
- increasing the term on a repayment mortgage to reduce the payments;
- surrendering an investment policy – endowment/ISA – attached to the mortgage. The borrower should be warned he may not receive the full value of the policy on early surrender and he then has no method of repaying the mortgage at the end of the term;
- trading down to a cheaper property and using the cash raised to settle the arrears and possibly reduce the mortgage.

There are a number of sources of advice, including the Citizen's Advice Bureau, Money Advice Centres and the Consumer Credit Counselling Service.

There are also, of course, those who do not seem to take debt seriously. Some borrowers in arrears appear happy to hand back the keys and move on, others see bankruptcy as an option.

1.2.6.1 Handing back the keys

Those who feel that *handing back the keys* is an option should be warned that:

- they will still be responsible for paying the mortgage until the property has been sold by the lender. This will lead to even more arrears being added;

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- the arrears will be taken from the sale proceeds in addition to the original mortgage;
- the price attained for the house is unlikely to be the same as for a normal sale, despite the best efforts of the lender;
- their credit record will be seriously blemished.

1.2.6.2 Bankruptcy

There are some who feel *bankruptcy* will solve their problems. Indeed, for those in serious debt, it can be a viable solution if there is no other way of settling the debt.

For the majority of debtors, however, there are potential problems:

- any possessions can be sold to pay off the debts. In a forced sale situation, these are unlikely to realise their true value;
- financial freedom is severely restricted before discharge, including the availability of banking facilities and day-to-day matters;
- although bankrupts can now be discharged after 12 months and can theoretically borrow as soon as they are discharged, few lenders will be prepared to offer loans and are likely to charge high rates if they do lend;
- the stigma of bankruptcy will stay with the individual for many years.

Bankruptcy should be seen as an absolute last resort and customers should be advised to pursue all other avenues before contemplating such a serious step.

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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 1. Review the text if necessary.

Answers can be found on page [4] 22.

Answer true or false to the following statements.

1. It is not necessary to establish the customer's attitude to risk when advising on mortgages because there is no investment exposure.

2. When an adviser selects a number of suitable products for the customer to select from, it is referred to as an 'advised sale'.

3. George has been asked to talk to Mike regarding arranging finance to buy an apartment in Turkey. He will not have to give Mike an initial disclosure document.

4. The mortgage illustration must show the amount repaid per £1 borrowed.

5. The firm must keep a copy of the illustration for 12 months after the advice is given.

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Answers

1. ***False***: attitude to risk relating to mortgages is important.
2. ***False***: an advised sale is where the adviser selects and recommends a particular product.
3. ***True***: an IDD is only required for regulated mortgages.
4. ***True***: the mortgage illustration must show the overall cost of the mortgage.
5. ***False***. the illustration must be kept for 12 months after the application is made.

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