

Mortgage sector

Considerations for Treating Customers Fairly (TCF)

1. TCF considerations for the mortgage sector
2. Product design and associated issues
3. Financial promotions and disclosure
4. Selling and advising
5. Remuneration strategy
6. Conclusions

TCF considerations for the mortgage sector (1)



1. This report is based on our supervisory work, information from individual firms, trade bodies and consumer bodies active in this sector (rather than firm specific visits, surveys or similar). It sets out some of the key issues which mortgage firms need to consider when ensuring they treat their customers fairly.
2. As we have always said, TCF is not 'one-size-fits-all' and it is for senior management to decide what TCF means for their particular firm. Generally, the examples of good and poor practice that we report here are to help firms and their management make that decision: we think the good practice is likely to help a firm treat its customers fairly and the poor practice is likely to get in the way of a firm doing so. However, some of the good or poor practice we report relates to compliance with or breaches of detailed rules which we think have a significant impact on fair outcomes for customers; where this is so, firms must comply with the detailed rules.
3. The FSA Baseline Survey of UK financial capability (1) revealed that customer awareness of financial products (including mortgages) is low, particularly amongst 18-40 year olds. This age group includes those most likely to be first-time buyers and therefore new entrants to the mortgage market.
4. Many firms in the mortgage sector have recognised TCF is a key issue and are working on implementing it in their organisations. Progress has been fastest among medium and larger firms in the sector. Some small firms say they are unsure what is required of them and how best to approach it.
5. Complying with the mortgage conduct of business (MCOB) requirements is a key step towards delivering TCF, and relatively few firms comply with all the MCOB requirements.

Footnote (1) Financial Capability in the UK: Establishing a Baseline, 2006 (available at www.fsa.gov.uk/pubs/other/fincap_baseline.pdf)

TCF considerations for the mortgage sector (2)



6. Strong competition in the mortgage market has brought many advantages to customers. But one aspect of that competition has been a tendency for increased product complexity. This can be beneficial (where products are appropriately targeted at particular niches) but it also raises important TCF issues which firms need to bear in mind. For example, the need to communicate clearly the nature of a product to customers, including significant features outside the headline price (e.g. portability restrictions and charges) so customers can make informed decisions.
7. Over 50% of mortgage sales are through intermediaries. As in other sectors, it is important that both product providers and distributors are clear about their respective responsibilities and reflect these in their operating procedures. Some firms (mainly intermediaries) have said there seems a lack of clarity about the TCF responsibilities of product providers and distributors which is apparently holding them back from deciding what TCF means for them. We will report on product provider/distributor issues separately.
8. Rapid expansion of mortgage lending is a significant contributor to the rising stock of consumer debt. It is important that firms meet their obligations to consider the ability of consumers to service and repay their mortgage, as failure to do so may further contribute to consumer debt.
9. In considering TCF, firms need to pay particular attention to more complex or risky products or the needs of potentially more vulnerable customers. Areas such as equity release products, the sub-prime sector, interest-only products and products where self-certification is an option are marked by some combination of product complexity, potential customer vulnerability and lock-ins. Because they are higher risk, firms need to be particularly careful to ensure they have considered issues such as the target market for their product, that the risks and features of the products are clearly explained and whether customers that want it are provided with appropriate advice.

TCF considerations for the mortgage sector (3)



1. This report explores in detail some particular issues for the mortgage sector at present. These are the areas where firms have the most progress to make and on which we expect firms to focus their efforts in the short term. However, in focusing on these areas, firms should not lose sight of the need to consider other TCF issues which apply equally to the mortgage sector as they do to all other regulated retail business. These include:
2. **Management information (MI)** - Developing adequate and competent systems and controls including MI can be part of the product design process. In addition to considering MI at the product design stage, firms should also review their MI (generally as part of their gap analysis) to identify any gaps in provision and in the way they use MI throughout the product/service lifecycle. When looking at the firm's mortgage business, it will also be helpful to look more widely throughout the firm's activities, particularly in relation to those products often sold at the same time as mortgages (e.g. PPI, critical illness insurance, home contents and buildings insurance). For example, collating MI on the subject of complaint and call centre queries, persistency rates and the results of any testing of consumer understanding may reveal a lack of customer understanding of a product. This could be a result of difficulties customers have in understanding a firm's product literature or with the sales process.

MI for a small mortgage broker is likely to look very different to that for a large mortgage lender offering a full suite of products. But each firm's gap analysis will identify the key issues relevant to it.

TCF considerations for the mortgage sector (4)



3. **After-sales service** – Lenders in the mortgage sector deal with significant volumes of business with currently over 2m new mortgages a year, and some larger lenders are each processing over 100,000 new mortgages a year. In the mortgage sector, whether or not advisers are involved in the initial sale, the after-sales service tends to be done by the lender concerned and, with these sales volumes, is reliant on automated systems and controls often developed during the product design stage. The need to consider TCF continues throughout the life of a mortgage and in some circumstances beyond (e.g. dealing with complaints). Firms should ensure that TCF is incorporated into all parts of the after-sales process. This includes post-sale information (e.g. annual mortgage statements and information on early repayment charges), contact with customers (e.g. if re-mortgaging, in arrears, or in response to queries), or processing changes to a mortgage (e.g. changing from an interest-only to a repayment mortgage or increasing borrowing).
4. **Complaints handling** - As for all other sectors, complaints handling in the mortgage sector should be fair, effective and prompt. Firms can use both the fact of, and the subject of, a complaint to feed back to the relevant parts of the product lifecycle. The complaints process should be capable of recognising and dealing with TCF issues. And an effective complaints mechanism that deals properly with customers who have not been treated fairly will, in practice, be likely to reduce the need for regulatory intervention.
5. **Training** – Some mortgage firms, particularly mortgage intermediaries, will be relatively new to FSA regulation, although most were subject to the industry's non-statutory code before FSA regulation. Others may have been exposed to the FSA, albeit indirectly, through regulated activities in other parts of their group. Whatever the level of awareness of FSA regulation, training is crucial so that relevant staff – not just customer facing staff – are aware of what TCF is, why it is important and how their particular firm is implementing it. For some firms, TCF will be incorporated into their existing customer care regime (and indeed the term 'TCF' may not be used), for others it will be a separate initiative. However training is organised, the effect should be the same.

1. New entrants to the UK mortgage market and new products are common. Consequently there is much product design activity. Considering how to treat customers fairly when a product is designed will produce TCF gains in all other stages of the product life cycle. It may also introduce associated benefits - some firms have experienced more and better communications across their business as a direct result of integrating TCF into their product design process and encouraging different areas to communicate more with each other.
2. An essential part of TCF in the mortgage sector is helping customers understand mortgage products and their features. The development of increasingly complex mortgage products (e.g. offset mortgages, part and part mortgages and restricted under- and over-payment) underlines the importance of firms ensuring customers are provided with clear, fair and not mis-leading information to enable them to make informed decisions.
3. Product design generally also involves the development of product literature, including but not limited to prescribed disclosure (KFI and IDD) and any other communications with intermediaries and customers (e.g. product marketing information). To develop this literature effectively, firms need a clear view of their target market and the marketing strategy they will use to sell the product.
4. Firms need to make sure that, in addition to the headline features of a mortgage product (e.g. the interest rate), other features (e.g. charges or lock-in periods) are clearly explained to customers in product literature to help them understand the implications for them. This may also help to reduce complaints (e.g. complaints about early repayment charges may be reduced if firms explain why they are needed when a customer leaves a special deal early).
5. In tandem with product design, particularly for complex new products, firms should consider whether they have the necessary infrastructure to competently administer products.
6. New entrants to the market have brought additional competition and a variety of business models i.e. telephone sales and internet sales. Whatever business model a firm adopts, it should take full account of TCF in all aspects of its business and address the implications of the business model for TCF.

Good examples of TCF we have seen include ...

1. One lender has developed a customer risk assessment process to review new mortgage products and check they are TCF compliant. This review includes the clarity of product literature and whether the product is unnecessarily complex for the target market. Other lenders have developed similar processes.
2. To ensure that intermediaries understand its products and the target market, in addition to the usual product literature and sales calls, a lender:
 - has regular product briefing seminars covering TCF;
 - sets out the potential TCF issues for each product on its website; and
 - discusses TCF on sales calls with intermediaries, including the most common complaints and mitigating action.

Examples of poor practice include ...

1. Some firms seem to give little attention to the needs of potential customers when designing products but instead allow design to be dictated by other factors such as the wants of intermediaries.
2. Some firms equate customer satisfaction with TCF. While customer satisfaction is important, the measures used to assess it do not always reflect whether a customer has been treated fairly (e.g. whether the features and risks associated with a product have been effectively communicated to customers). This could be addressed by customer testing to check this information has been explained.
3. Not all firms use valuable existing information sources (e.g. complaints) to inform the design of new products or development of explanatory literature for customers.

Good examples of TCF we have seen include ...

3. A lender that previously only sold single premium PPI with its sub-prime mortgages decided to offer its customers a choice of single and regular premium PPI as it recognised a regular premium option would suit some customers better.
4. One lender obtains customer feedback via a website link and feeds this back into the product design process.
5. Some lenders have developed administrative systems for use by intermediaries distributing their products.
6. One lender has adopted a pro-active approach to communications with customers - by giving them regular updates on the progress of their mortgage application.
7. One lender has developed training about new products. This training uses the results of market research about the areas customers find particularly difficult to understand.

Examples of poor practice include ...

4. Some firms design products with significant limiting features (e.g. portability restrictions for lifetime mortgages). They do this without considering the impact on the target market and how such restrictions can be effectively explained.
5. Administrative errors and delays at one lender have been caused by:
 - the administration for an innovative product with complex features not being in place and tested before the product was launched; and
 - underestimating the sales of a new product which meant the firm was not able to cope with the volume of business and didn't have appropriate contingency measures in place.
6. Administrative errors and delays at some lenders can mean customers not completing on time on a special deal and consequently losing the product fee paid.
7. Some firms have failed to put processes in place to confirm the effectiveness of their administrative systems, resulting in errors not being spotted for considerable periods. Consequently these errors can lead to incorrect monthly repayments and potential under-funding of mortgages and may go unnoticed.

1. The MCOB rules on financial promotions and service and product disclosure were developed by considering what would be fair to the customer. There are clear risks to delivering TCF to customers if the basic information they receive does not meet the relevant MCOB requirements. Firms should look at their disclosure and financial promotion information and focus on ensuring that it works for the customer.
2. Recent FSA project work (2) that looked at disclosure in the mortgage sector, has shown significant progress by a sample of firms in the mortgage sector in meeting the relevant MCOB requirements since our initial work on this issue in 2005, although problems still remain. The 2006 results show that:
 - large lenders have made good progress in taking steps to improve the quality of their initial disclosure documents (IDDs) and key facts illustrations (KFIs) and are on course to meet required standards by autumn 2006;
 - IDD's produced by small lenders were generally of an adequate standard;
 - KFIs from some intermediaries and small lenders showed a number of material errors relating to fees and charges which, when taken together, could cause consumer detriment as inaccurate information on fees and charges may mean that consumers are not able to effectively compare products; and
 - the proportion of intermediary IDD's sampled containing five or more errors improved from 80% (in 2005) to 55%, although this is still inadequate.
3. Where a lender uses a distribution channel other than its own sales force, the distributor needs information from the lender about the product being sold. Where MCOB provides, distributors are entitled to rely on information received from a lender.

Footnote (2) FSA's 2006 review of Mortgage Disclosure Documentation available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/064.shtml>

Good examples of TCF we have seen include ...

1. One lender includes in their product literature a payment schedule showing how repayments would change over time, the capital outstanding and the accumulating interest (where the product type allows).
2. Pending making changes to the KFI, a lender has prepared briefing notes for intermediaries to accompany the KFIs currently supplied, explaining particular aspects of the KFI which customers may need further information on. Internal staff have been similarly briefed.
3. A lender uses the KFI and IDD as a positive sales tool, using them as an integral part of the sales process, rather than regarding them as just something that must be supplied to customers.
4. Some lenders are positively encouraging compliance by using systems which prompt advisers about the relevant regulatory requirements. They are monitoring advisers and acting on any failings. This reduces the scope for errors.

Examples of poor practice include ...

1. Some firms have had problems with the quality of product literature produced by a number of sources, including lenders. These problems include incorrect or incomplete information being supplied and not supplying MCOB compliant IDD or KFIs.
2. Some firms are not complying with the MCOB requirements on financial promotions and disclosure, which means customers cannot compare products properly or make decisions based on full information. For example:
 - Financial promotions - some small firms, particularly in the sub-prime sector, are not using standard risk warnings and prescribed wordings.
 - Disclosure – some intermediary and small lender firms' KFIs still contain inaccurate or contradictory information on fees and charges, and unclear descriptions of what fees cover and their basis - despite guidance provided after FSA's 2005 Mortgage Disclosure work.

Good examples of TCF we have seen include ...

5. Most large lenders and some smaller lenders have made good progress in taking steps to improve the quality of their disclosure documentation over the past year. This means that customers receive clearer information, and should be better able to effectively compare products.

Examples of poor practice include ...

3. One firm's PPI proposal documentation did not present information in a balanced way. It aimed to persuade readers of the need to take out a PPI policy with their mortgage. It also steered customers towards a single premium rather than regular premium policy.

1. Increasingly in the mortgage market, advisers are using software systems to source products and provide 'in principle' decisions to customers. This can have undoubted benefits for advisers and customers alike, particularly in terms of the speed of response. However, firms must take care to ensure that these software systems are used as a tool to aid the suitability process and not to replace it.
2. Self-certification products (either pure self-cert or fast-track) comprise around a third of the mortgage market currently. Not verifying income means these products are potentially open to abuse and that customers may perhaps be tempted to borrow more than they can afford to service or repay. While our work on self-certification reported in 2005 did not reveal any widespread abuse, there are still some concerns about this issue across the industry. Lenders should continue to apply proportionate checks and controls to their responsible lending responsibilities (e.g. looking at consistency between jobs and earnings, or raising queries with intermediaries). Advisers, when looking at affordability, should continue to encourage customers to give accurate disclosure of their income.
3. Products such as PPI or critical illness insurance are sometimes sold alongside a mortgage. Firms should continue to make sure that there is no undue pressure on customers to take other products alongside a mortgage and that where products are bundled together, customers do understand that they have a choice.
4. One provider has recently changed their practice on PPI sold with a mortgage and no longer requires minimum business levels before dealing with an intermediary. Some industry commentators are attributing this change to the FSA's TCF agenda.

Good examples of TCF we have seen include ...

1. Some advisers talk customers through product features, rather than relying on them to read and digest the product literature.
2. To improve the quality of advice that customers receive, some firms have introduced a programme of action to address failures in the advice process. Individual advisers who are not achieving the required standard are subject to increased monitoring, further training and disciplinary action, if appropriate.
3. Staff at a lender's contact centre which generates leads are specifically trained not to provide advice on mortgages and products.
4. One firm is developing systems to provide intelligence and feedback on TCF issues arising during the advising and selling process.
5. For its equity release product, one firm recognises the higher risk presented by these products and produces product literature similar to a suitability letter, although there is no MCOB requirement to do so.

Examples of poor practice include ...

1. Responsible lending:
 - some lenders base their lending decisions on the LTV without considering whether a customer can afford to service or repay the amount borrowed; and
 - some lenders are asking customers to sign a declaration about the way a mortgage will be financed, relying on this to meet their responsible lending responsibilities.
2. Suitability:
 - not all firms consider a customer's ability to service and repay the mortgage debt throughout the mortgage term as required in MCOB (e.g. when lending into retirement or setting up interest-only mortgages where for about a fifth of cases there is no recorded repayment vehicle); and
 - not all firms consider affordability on a realistic basis (e.g. using net rather than gross income) but rather focus on producing figures that seem to justify the proposed product and level of borrowing.

Good examples of TCF we have seen include ...

6. One firm allows at least 2 face to face meetings for each sale of its equity release product and actively encourages discussion about the product with the customer's family.
7. When advising on equity release, some firms encourage customers to consider all other options, including contacting the local Council, CAB, Age Concern and the customer's bank to see if there is a possibility of a loan, or downsizing.
8. Most firms advising on regular premium PPI products with prime mortgages are doing so in accordance with the relevant FSA requirements. Advised sales considered a customer's financial situation and protection needs, and provide advice accordingly. ⁽³⁾

Footnote (3). FSA's PPI project work reported on in 2005 available at http://www.fsa.gov.uk/pubs/other/ppi_thematic_report.pdf

Examples of poor practice include ...

3. One firm does not explain that where products bundled with a mortgage result in a lower fee or mortgage interest rate, not taking the bundled product will increase the mortgage charges.
4. Some firms are credit checking customers who are only shopping around, thereby leaving a hard footprint on their credit file. Credit checks are usually done only at formal application stage.
5. Some firms consistently source products from the same (larger) lenders who offer a full suite of products on the basis that a product will be found for their customer, rather than checking the market as their status requires.
6. One firm's product literature implied that it sourced the market to find the best product, but it was actually tied to one provider.
7. An intermediary pursued the sale of an equity release product to a customer, despite the lender to whom the intermediary was tied being unable to offer the equity release product the customer wanted and which best suited their needs.
8. One firm would not provide advice on equity release products until customers completed an application form.

1. Attracting and retaining staff of the appropriate quality and motivating them to achieve business objectives such as sales, profit and growth are issues which may be covered in an advising firm's remuneration strategy. With the large volumes of mortgage business done in the UK mortgage market, and the involvement of intermediaries in over half the sales made, it is possible that remuneration structures for intermediaries may focus on the volume of business done to the exclusion of other performance measures. While no particular remuneration strategy is inherently unacceptable, all will impact on behaviour, unless any conflicts are actively managed.
2. Firms should design their remuneration strategy (including the way in which conflicts are managed) to reflect the TCF principle and ensure that staff are not providing advice motivated by the highest commission rates (e.g. selling a particular sub-prime product to a customer eligible for one with a better interest rate but that pays lower commission) or simply by selling as much business as possible. In practice this means that where there are such incentives, firms need to be more diligent than usual in ensuring that commission is not resulting in sales bias and that the MCOB requirements are adhered to.
3. It may be that advisers favour a product for reasons other than commission (e.g. processing time, administrative excellence or if self certification is an option), but senior management still need to be aware of and monitor any TCF issues that arise. Effective use of MI can help identify anomalies or bias towards products that pay higher commission or that stand out in any other way.
4. It is also important to look wider than those directly engaged in selling. The responsibility for applying TCF rests with senior management but too often their remuneration structures give them little incentive to push the TCF agenda, focusing for example on business volumes.

Good examples of TCF we have seen include ...

1. Some firms are developing remuneration strategies that take account of TCF measures, including complaints, customer retention rates and record keeping, as well as income measures.
2. Some firms are thinking about the soft skills used by advisers in interviewing, listening and explaining products.
3. Some firms include TCF in objectives for staff and assess progress in the normal appraisal process which directly impacts on salary.

Examples of poor practice include ...

1. A firm's remuneration structure includes TCF measures but uses tougher tools (e.g. written warnings) to make staff focus only on sales volumes.
2. A lender launching a new product incentivised intermediaries by offering a higher procurement fee than for existing products, on delivering a high volume of new applications within the two months after launch.
3. Deliberate commission differentiation by lenders so they can manage the mix of business sold. This can encourage intermediaries to sell the product which pays the higher fee unless any conflicts are actively managed.
4. One firm operated a remuneration strategy which incentivised advisers both financially and using non-financial rewards. The incentives awarded varied between lenders and resulted in a significant business bias towards those lenders for which the highest incentives were received.

1. It is clear that many large and medium-size firms are making progress in implementing TCF, and that for some it is more a case of augmenting customer focused initiatives already in place, rather than developing a whole new approach. Equally others across the spectrum, particularly smaller firms, are having some difficulty working out what TCF means for them and how to approach it. For some this is because they have not yet started to engage with the whole issue. Our self-assessment tool for small firms will help in prompting those firms about the areas to focus on when considering TCF. Firms do need to understand the importance of TCF and that we expect to see progress towards it in all areas of the mortgage market by all firms in the sector.
2. The key TCF areas on which firms involved in the mortgage market need to make progress are:
 - Product design – Considering how to treat customers fairly when designing new products will produce TCF gains in all other stages of a product life cycle. Firms and their customers benefit from firms considering associated issues as an integral part of the design process. These include the marketing strategy, developing product literature, effective administration systems and controls, and considering the training implications and information needs of all involved in distributing the product. While some firms consider and address some of these areas, few seem to cover all.
 - Disclosure – it is important that firms consider whether their product literature is capable of delivering customer understanding. This is against the background of the low customer understanding of financial products including mortgages revealed by FSA's recent Baseline survey of Financial Capability. Product literature is the information customers will rely on at the point of sale. It is important that customers can compare products and understand features and are aware of those relevant to their position. The MCOB rules are designed to deliver this to customers, and the compliance of firms with these requirements is a key step towards TCF.
 - Remuneration strategy for advisers – Firms should design their remuneration strategy to reflect the TCF principle and so that commission rates do not result in sales bias. We have come across some firms where the effect of the remuneration strategy could lead sales staff to focus on the volume of business done to the exclusion of any other performance measures, potentially creating a commission driven culture.