Financial Services Authority

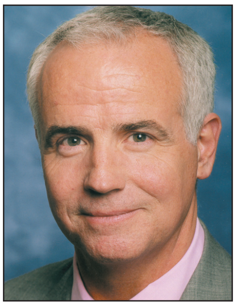
Mortgage effectiveness review

Stage 2 Report

March 2008

Contents

Foreword



Dan Waters

Post-implementation 'effectiveness' reviews are part of our approach to Better Regulation. They are designed to measure whether major policy interventions in the market make a real difference in practice. The findings from our review of the effectiveness of the mortgage regime are in the main encouraging. Stage 1 (2006) suggested that the prime mortgage market works well for most customers most of the time: customers are able to shop around and use the information they get to make informed choices that reflect their preferences. Stage 2 (2007) has found similar results for the lifetime mortgage market, although there are less encouraging signs for the sub-prime market. Perhaps not surprisingly, most sub-prime consumers are pleased if they are able to obtain a mortgage. Their financial circumstances are such that, although they do gather information on different products, they are not in a position to shop around in practice, being limited to those firms identified by brokers as willing to accept their business. They also tend to focus on affordability in the short term and so they may not be making properly informed choices.

The research for this stage 2 report was undertaken in September last year, when economic conditions were more benign than they are today. A sustained period of low inflation, low unemployment, consistent growth and low interest rates had helped the mortgage industry to flourish. Credit was cheap and abundant, consumers were willing to take on ever-increasing amounts of debt, and house prices were boosted by consumers' increasing demand for these assets and their increased ability to borrow to finance their purchase.

Since then, conditions in the mortgage market – and in particular the sub-prime market – have become more difficult, as described in our *Financial Risk Outlook* 2008, and it seems likely that these conditions will persist.

In addition to our Mortgage Effectiveness Review, which has focused on the experiences of consumers, we have also been undertaking since 2005 a programme of firm-facing thematic work on the mortgage market, to assess how the market is operating and to look in particular at issues which may have been causing consumer detriment. The findings from our earlier thematic work – covering affordability assessments, self-certification mortgages, training and competence standards and the effectiveness of senior management controls – were generally disappointing, resulting in enforcement action against some firms, a number of firms changing their permissions and a number of others required to undertake past business reviews.

Our most recent thematic work, on which we will report in June this year, has covered:

- the **arrears management practices of firms**, assessing whether lenders are treating customers fairly when they go into arrears. This will be informed by the consumer research undertaken during the second stage of the effectiveness review;
- the **responsible lending practices** of firms, following on from the intermediary focused work we undertook on affordability and self-certification last year; and
- the **quality of mortgage advice processes**, assessing the processes underpinning the giving of advice by mortgage intermediaries.

All of this work relates to our overarching priority to bring about changes in firms' behaviour so that our **Treating Customers Fairly** initiative is embedded by all retail firms. We are expecting all firms to be able to demonstrate **by the end of December 2008**, through use of their own management information, that they are consistently treating their customers fairly. Firms will need to pay particular attention to this in the current challenging business environment.

In our *Business Plan* for 2008/09 we committed to undertaking a broad **review of the mortgage conduct of business regime**, including the scope for moving towards a greater reliance on principles and other high-level rules. That wider review will take forward the outcomes from stages 1 and 2 of the Mortgage Effectiveness Review, and it will reflect issues identified through our thematic work that might benefit from changes in policy. However, we do not intend to rush into changing our rules. The priority for us this year is to see measurable improvements in firms meeting existing regulatory requirements and in their treatment of customers. This will require considerable wider focus and energy from senior management and firms. We will also use our review to inform future negotiations on the proposals in the EU White Paper on mortgages, which suggests that if EU legislation emerges it may cover issues in our mortgages conduct of business regime such as disclosure, early repayment charges, responsible lending and the APR. So while our own review will help to inform future negotiations on the proposals, it will be important to have a clearer picture of possible developments at a European level before committing to any rule change.

We believe this to be a balanced and proportionate approach to help the industry meet the regulatory and financial challenges in the year ahead. We look forward to working with the industry and relevant trade bodies and consumer groups in taking this agenda forward.

Executive summary

Overview

The first stage of the Mortgage Effectiveness Review began in December 2005 in line with the commitment we made in 2004 to review the effectiveness of the mortgage regime.[1] The purpose of the review is to investigate the effectiveness of the mortgage regime, focusing on how far the Mortgages and Home Finance: Conduct of Business (MCOB) requirements for firms are delivering our five intended outcomes for consumers (see consumer outcomes overleaf).

Stage 1 of the review was completed in September 2006 and we then published the report setting out our findings and conclusions.[2] The focus of stage 1 was pre-sale disclosure and advice and selling standards in the prime market, with respect to the consumer outcomes that we felt could be tested at that time.

Scope of stage 2

We announced the beginning of stage 2 in April 2007. This stage focuses on more specialised sectors of the market where we believe that there is a greater risk of consumer detriment.

It is important to note that we are not assessing compliance levels in the mortgage market in this review: We are investigating the effectiveness of the mortgage regime in achieving the five intended consumer outcomes. However, the effectiveness of the rules in achieving the intended outcomes relies on compliance with the rules. Although we also intended as part of this review to cover the treatment of consumers in arrears, we have been unable to test the effectiveness of our requirements on arrears. This is because the evidence indicated that some lenders across both the prime and sub-prime markets might have been failing to abide by the MCOB requirements on arrears. We are undertaking focused thematic work on the arrears management practices of firms to establish whether there is in fact a problem of non-compliance. We expect to report on this work in June 2008. The review's findings on arrears will be published at the same time.

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1. Clive Briault: 'The lending landscape post October 31: the Financial Services Authority's view.' (7 December 2004) www.fsa.gov.uk/Pages/Library/Communication/Speeches/2004/SP217.shtml
2. FSA: Mortgage Effectiveness Review stage 1 Report (September 2006) www.fsa.gov.uk/pubs/other/mortgage_review.pdf

Methodology

We developed our methodology with the aim of using different pieces of research to ensure that our results were robust and valid. We commissioned qualitative consumer research from Illuminas on consumers' experiences in the relevant sectors (CR3). We analysed quantitative consumer research from the Consumer Purchasing Outcomes Survey (CPOS) on the mortgage purchasing process (CR4). It is important to note that the base sizes of some of the sub-groups within the lifetime and sub-prime samples are quite low. The sub-group analysis should therefore be viewed as indicative only. All references to the qualitative and quantitative research in this report refer to the Illuminas research and CPOS data respectively.

We carried out an analysis of sub-prime mortgages to find out whether MCOB had increased the degree to which consumers are being sold suitable mortgages using arrears rates as a measure of suitability. We have also referred to product sales data to provide evidence on sales patterns. Although we also conducted an analysis of interest rate sensitivities on lifetime mortgages to strengthen our results, it did not provide us with any meaningful evidence so we have been unable to use this work (see methodology in Annex 1).

Key findings

Outcome 1 – Consumers shop around for mortgages

We found that consumers in both the sub-prime and lifetime mortgage markets are generally shopping around, but while lifetime mortgage consumers are doing this for themselves, sub-prime consumers have to rely on the broker to do the shopping around for them to find lenders willing to accept their business. While the Key Facts Illustration (KFI) was seen as an important document and used to check any points of detail and clarify uncertainties, it was not viewed primarily as a means for product comparison or shopping around.

Outcome 2 – Consumers understand whether they are being given advice or information by firms

Our research found that neither sub-prime consumers nor lifetime mortgage consumers recognised a difference between the types of service they could get. Moreover, they did not consider the distinction to be an important one, because they believed that the final purchasing decision was theirs. Both sub-prime and lifetime mortgage consumers assumed that all brokers, whatever the service, would recommend appropriate options, or at least not suggest inappropriate ones. The Initial Disclosure Document (IDD) is not prompting consumers to think about the level of service they could get.

Outcome 3 – Consumers better understand the risks and features of the mortgages they take out, including the affordability risks

We found that lifetime mortgage consumers have (or believe they have) a good understanding of the risks and features of the mortgages they take out from their own research into the products. Sub-prime consumers tend to focus on the cost of the mortgage and are happy to rely on the information on risks and features provided by their broker. For both, the KFI did not prompt a consideration of product risks and features before purchase but was used post-purchase to confirm the consumer's understanding and as a check on what the broker or lender had said.

Outcome 4 – Consumers take out suitable and good value mortgages

As part of this review we hoped to assess whether consumers take out suitable and good value mortgages. We carried out a piece of work to find out whether MCOB has increased the degree to which consumers are being sold suitable mortgages using arrears rates in the sub-prime mortgage market as a measure of suitability. Our analysis could not identify an appreciable impact of MCOB on suitability levels (see annex 1).

We indicated in the stage 1 report that we would draw on thematic work looking at the Quality of Advice (Outcomes)[3] to provide evidence against this outcome, but this work is still being piloted.

The qualitative research suggests that consumers still focus on costs; for sub-prime consumers the overriding consideration is to find the cheapest deal or APR; for lifetime consumers, it is finding products with lower interest rates.

Outcome 5 – Consumers are treated fairly over the life of the mortgage, including when they go into arrears

As noted earlier, the suggestion of non-compliance with our arrears rules means that we have been unable to assess and test the effectiveness of our arrears rules. We are undertaking focused thematic work on the arrears management practices of firms, which we expect to report on in June 2008. The review's finding on arrears will be published at the same time.

Next steps

The policy implications from both the first and second stages of the review will feed into the wider review of MCOB recently announced in our *Business Plan*.[4] That review will focus initially on identifying the underlying drivers of problems identified through our thematic work[5] (for example, poor suitability assessments) and explore the scope for moving towards high-level rules and the potential for simplification.

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3. Also referred to as 'Suitability of Recommendations' in FSA Business Plan 2008/09.
4. FSA: *Business Plan* 2008/09: www.fsa.gov.uk/pubs/plan/pb2008_09.pdf
5. Press Release: 'FSA finds poor practice by intermediaries and lenders within the sub-prime market' (4 July 07) www.fsa.gov.uk/pages/Library/Communication/PR/2007/081.shtml

Introduction

Background to the review

Post-implementation 'effectiveness' reviews are part of our approach to Better Regulation. We want to ensure that major policy interventions in the market are making a real difference in practice.

The first stage of the Mortgage Effectiveness Review began in December 2005 and focused on the prime market, looking at disclosure and advice and selling practices. We completed the review and published the report setting out our findings and conclusions in September 2006.[6] The second stage of the review started in April 2007. It has looked at disclosure and advice and selling practices in the sub-prime[7] and lifetime mortgage markets, and the treatment of consumers in arrears (see previous note on scope on page 4).

The intended consumer outcomes of mortgage regulation

The overall objective of the review has been to evaluate the effectiveness of our MCOB rules against five intended consumer outcomes. Those consumer outcomes are:

1. Consumers shop around for mortgages.
2. Consumers understand whether they are being given advice or information by firms.
3. Consumers better understand the risks and features of the mortgages they take out, including the affordability risks.
4. Consumers take out suitable and good value mortgages.
5. Consumers are treated fairly over the life of the mortgage, including when they go into arrears.

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6. FSA: Mortgage Effectiveness Review Stage 1 Report (September 2006) www.fsa.gov.uk/pubs/other/mortgage_review.pdf
7. For the purposes of this report, we define 'sub-prime' as being the impaired credit captured within the reporting of Product Sales Data (PSD) i.e. lending to a borrower who does not have a standard credit history; e.g. they have a recent history of arrears on a loan of some type within the last two years with a cumulative amount overdue of three or more monthly payments; an Individual Voluntary Agreement; County Court judgments or they filed for bankruptcy within the last three years.

Stage 1 focused on the first four outcomes in relation to the prime market, and disclosure and advice and selling practices. We found that the rules relating to disclosure were working reasonably effectively across the prime market, and that the market itself was operating efficiently. Consequently, we did not identify any areas where we felt rule changes would be appropriate at that stage.

Scope of Stage 2

Stage 2 focuses on the first four outcomes in relation to areas of the market where consumers may be exposed to greater risk, namely the sub-prime[8] and lifetime mortgage sectors. We also proposed to cover the treatment of prime and sub-prime consumers in arrears. Unfortunately, the evidence from the qualitative research indicated that some lenders across both the prime and sub-prime markets might have been failing to abide by the MCOB requirements on arrears. So we have been unable to assess and test the effectiveness of our arrears rules.

We discussed our plans for stage 2 with stakeholders from the industry and consumer groups, who provided us with valuable feedback on our proposals and the best way forward.

Performance indicators

For the purposes of the Mortgage Effectiveness Review, outcomes are long term, ultimate measures of success or strategic effectiveness. Performance indicators are measurable approximations of the outcomes we want to achieve.

We retained most of the indicators from stage 1 of the review to inform our findings in stage 2. This was to ensure a consistent approach and enable us to compare and contrast our findings (where appropriate) on the sub-prime and lifetime mortgage markets with the stage 1 findings on the prime market (see analysis, conclusions and next steps). We excluded those indicators which measured compliance with the disclosure requirements in MCOB (we have not measured compliance as part of the second stage). We also excluded those indicators which were not relevant for stage 2 because many consumers in the sub-prime and lifetime markets purchase through an intermediary (rather than having multiple interviews with different providers). Although we introduced new indicators for outcome 5, we have not used them to measure the intended outcome (the fair treatment of consumers in arrears) because of the possibility of non-compliance with our rules.

The relevant indicators are listed under each outcome in the chapter on the stage 2 findings.

8. PSD definition, see note 3.

Stage 2 findings

Outcome 1: Consumers shop around for mortgages

Background

The mortgage regime is designed to enable consumers to look at several sources of information and encourage comparisons of that information before making a decision on which lender to borrow from and what type of product to purchase. The pre-sale disclosure requirements are central to this process: firms must provide information to consumers in a format prescribed by us to enable them to make comparisons and shop around.

Initial disclosure (in the form of the Initial Disclosure Document[9] ('IDD')) is the information that a consumer will get from the lender or intermediary at the initial point of contact. Its purpose is to help and encourage consumers to consider whether they are making the right choice in using a particular firm and to make it clear to the consumer the service being offered to them, for example, whether they are receiving advice or not.

Pre-application disclosure (in the form of the Key Facts Illustration[10] ('KFI')) is the information that a consumer will get from the lender or intermediary before they apply for a mortgage. Its purpose is to help consumers understand the features and risks associated with a particular mortgage and to enable and prompt consumers to make comparisons across different lenders' products.

Findings for the sub-prime mortgage market

Indicator: Consumers gather information from more than one source

If consumers are gathering information from more than one source, it would suggest that they are actively engaged in shopping around.

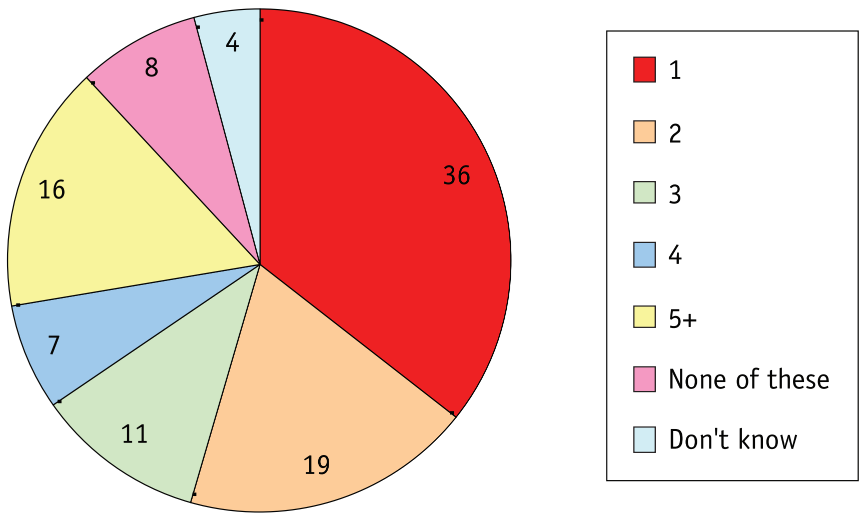
There is no clear evidence from the qualitative research that sub-prime consumers are gathering any background information on rates and products before going to a broker. Most of the main sub-prime or 'non-standard' specialist lenders operate solely through brokers, a fact recognised by sub-prime consumers. Many consumers

9. See example disclosure templates on our website: www.fsa.gov.uk/Pages/Doing/small_firms/mortgage/disclosure/broker_mortgage/index.shtml
10. As above.

(particularly remortgagers and house movers as opposed to first time buyers) acknowledged that High Street lenders were not a realistic option. They expected to be turned down or had actually been turned down by traditional lenders given their atypical situation and credit history. Brokers were largely viewed as being the only method by which these consumers could track down a specialist lender (most probably unknown to them) who would be willing to accept their business and offer them a mortgage at a competitive price. Some consumers also claimed they had limited time and/ or inclination to shop around for themselves.

By contrast, the quantitative research indicates that some consumers do conduct independent searches. Figure 1 illustrates the percentages of consumers that personally collected information from companies regarding the products they provided. 36% of sub-prime consumers collected information from one company, and 53% collected information from two or more companies.[11] Although they may be looking at what products may be available on the market, sub-prime consumers are in fact constrained by what they can get. They have to use the services of a broker to find a lender willing to accept their business. The reality is that for sub-prime consumers, shopping around is limited to the range of products presented by the broker.

Figure 1: Number of companies sub-prime consumers personally collected information from regarding the products they provided (CR4)

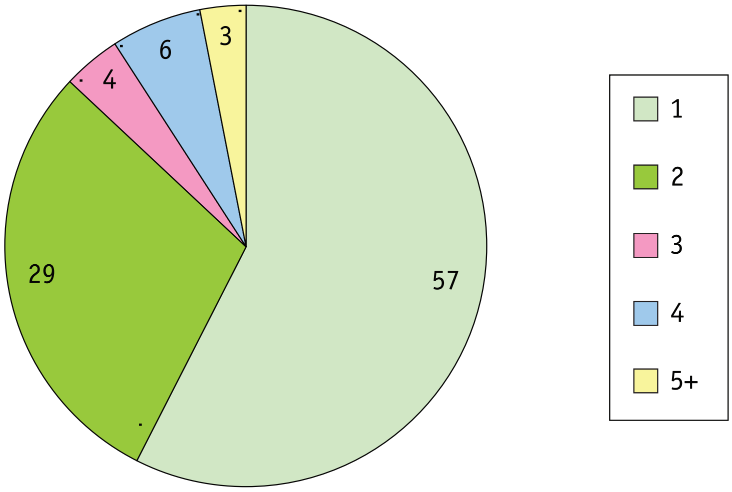


Sample size: All sub-prime consumers (84)

Are consumers shopping around by approaching a number of brokers? The qualitative research suggests that the majority of consumers used the service of one broker only. This is supported by evidence from the quantitative research which indicated that most respondents (57%) who had spoken to a professional adviser spoke to one adviser[12] (figure 2) with whom they usually had an existing relationship.[13] The remaining 42% spoke to two or more advisers.

11. Information not expressly defined and includes checking best buy comparative tables on the internet and in newspapers.
12. Advisers = IFA, mortgage broker, manager/ adviser at bank/ building society and company representatives.
13. 29% were aware of the professional adviser because of an existing relationship, and 24% via recommendation by family/ a friend.

Figure 2: Number of professional advisers that sub-prime consumers spoke to (CR4)



Sample size: 67 sub-prime consumers had spoken to a professional adviser.

Indicator: Consumers use KFIs to compare different mortgage products

Our research would suggest that while consumers may be looking at/ shopping around for different mortgage products, it is the broker who has to shop around for those suitable products that consumers can realistically expect to get. If the broker recommends more than one suitable product, we would expect them to obtain a KFI for each one; but are consumers using those KFIs to compare the different mortgage products that are available to them? Although there is evidence that some brokers were using KFIs to compare different mortgage products for consumers during the interview, the qualitative research tells us that consumers did not recognise or see the KFI as an obvious means to draw comparisons or prompt shopping around.

We have no evidence from the quantitative research on how sub-prime consumers used the KFI due to the small sample sizes.

Indicator: Consumers read KFIs

The qualitative research indicates that sub-prime consumers rely heavily on their brokers because of their ability to simplify and personalise information. Consumers felt that brokers better understood their circumstances and needs so were able to disseminate information to them in a tailored fashion and translate generic information into specific detail. Most consumers had therefore decided on their mortgage before reading through the KFI. They felt that the information the broker gave them had largely been adequate, so there was no strong need to subsequently read the literature in-depth. Most consumers had trusted, or at least accepted the information the broker provided, and had been willing to 'sign-up' to the deal as long as it sounded acceptable or appropriate to their needs and circumstances.

The qualitative research suggested that the KFI had limited direct influence on purchasing behaviour because consumers did not read or review it until after they spoke to their broker and made their purchase decision. They rarely revisited this decision. The KFI was seen as a tangible manifestation of what had been discussed and agreed with the broker and was, therefore, used as a record-keeping document.

Findings for the lifetime mortgage market

Indicator: Consumers gather information from more than one source

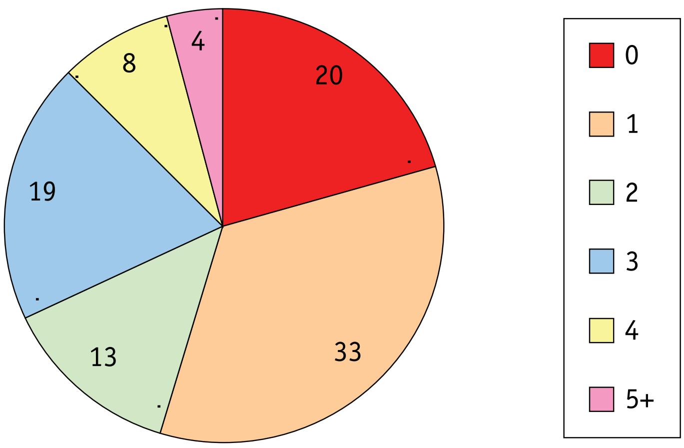
As noted previously, if consumers are gathering information from more than one source, it may suggest that they are actively engaged in shopping around. The findings from the qualitative research suggest that consumers in the lifetime mortgage market generally gather lots of information about equity release and lifetime mortgages before going to a broker or lender. The qualitative research also suggests that the decision to purchase a lifetime mortgage is often a highly involved and lengthy process. Consumers weigh up the benefits and disadvantages of products against those of any potential alternative, and consult family members before making a decision.

Respondents stated that equity release products were widely advertised and had received press and television coverage. Articles in the press were frequently cited as a key source of information about equity release products. Particular newspaper money advice sections were often mentioned. These articles were deemed useful for providing an overview of lifetime mortgages and highlighting potential product pitfalls although some respondents had used the press for guidance on which lifetime mortgage providers or financial advisers to contact.

Lifetime consumers take time over their decision. The quantitative research indicates that 37% of consumers began looking for information two to three months before purchase. 22% began looking for information 12 months or more before making a purchase. The qualitative research suggests that the length of time taken by respondents was dependent on the level of necessity for funds.

Figure 3 illustrates the number of lifetime consumers who had personally collected information from companies. 20% did not collect any information from companies. 33% collected information from one company and 44% collected information from two or more companies.

Figure 3: Number of companies lifetime consumers personally collected information from regarding the products they provided (CR4)



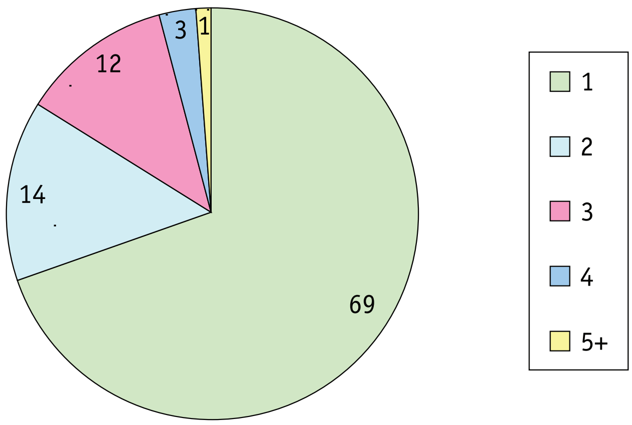
Sample size: All lifetime consumers (79)

The qualitative evidence suggests that the consumers who had more financial knowledge and confidence approached providers directly to obtain specific products which they considered to be suitable and appropriate for their circumstances. They believed they had conducted sufficient research to fully understand the products and felt confident that they knew exactly what they wanted. There were differing levels of shopping around in this group. Some respondents gathered information from a range of providers and considered a number of alternative products. Others were content to approach just one or two providers whom they considered to be reputable. The research findings state that in general, consumers who had approached providers contacted a limited number of companies which resulted in the final choice being made from a narrow pool of options.

The qualitative research highlighted that consumers consulted brokers to help them determine which product was right for them, once they had decided that a lifetime mortgage was an appropriate and suitable product for their needs. The research also showed that the lifetime consumers who used brokers did so because they were unaware of the range of lifetime lenders and desired guidance and advice in order to help them make an informed decision. As with the sub-prime sector, this is understandable because most lenders distribute their products through brokers and do not deal with consumers directly.

We asked the respondents (quantitative research) who had spoken to a professional adviser how many advisers they had spoken to. The majority (69%) had spoken to one adviser (figure 4) and 30% had spoken to two or more advisers.

Figure 4: Number of professional advisers lifetime consumers spoke to (CR4)



Sample size: 73 lifetime consumers had spoken to a professional adviser

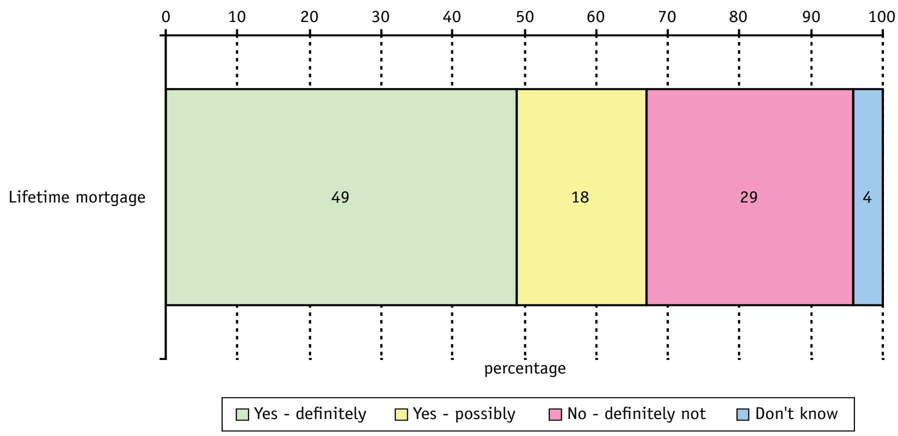
Consumers buying through a broker wanted them to do much of the work in terms of shopping around for the right product reflecting their preferences. Shopping around was therefore limited to the products presented to them by their broker.

Indicator: Consumers use KFIs to compare different mortgage products

Respondents to the qualitative research failed to register that a key purpose of the KFI[14] was to help consumers compare products and encourage shopping around. It was generally viewed as a 'back up' and a tool or device to confirm consumers' expectations about the product they were purchasing. The KFI did not have an effect on their purchasing decision. Consumers had already made their decision by the time they received the documentation.

We asked respondents to our quantitative research whether they obtained or looked at a KFI at any stage since they had started to look for information. Figure 5 shows that almost half of the lifetime respondents, 49% definitely did look at or obtain a KFI. In total, two thirds of the lifetime respondents had definitely/possibly obtained or looked at a KFI.

Figure 5 – Did you obtain or look at a KFI? (CR4)

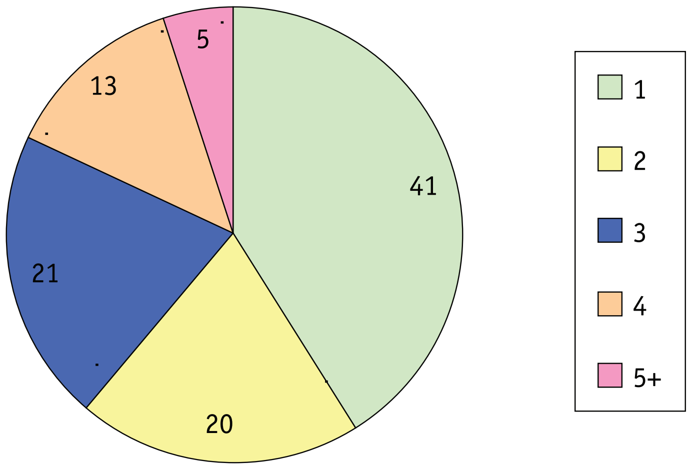


Sample size: All lifetime consumers (79)

14. See KFI example template used for lifetime respondents on our website (Horse Lifestyles): www.fsa.gov.uk/pages/About/What/thematic/disclosure/provider_equity/index.shtml

Figure 6 illustrates how many KFIs were obtained by those respondents who had definitely looked at or obtained a KFI (49% of the total sample). 41% of this group looked at or obtained 1 KFI and 59% looked at or obtained 2 or more KFIs. This means that less than a third of the overall lifetime sample had obtained or looked at more than one KFI.

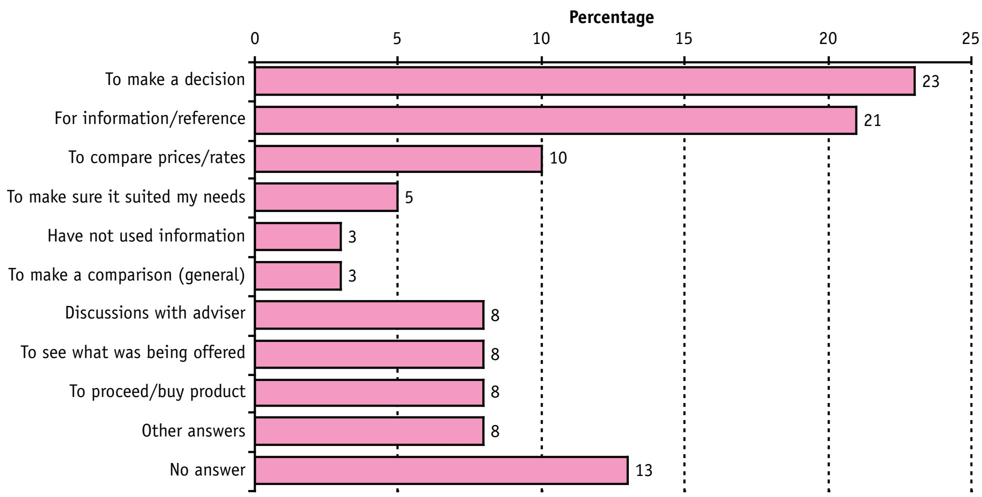
Figure 6 – Number of KFIs looked at or obtained by lifetime consumers (CR4)



Sample size: 39 lifetime consumers had definitely obtained or looked at a KFI (N.B. small sample size).

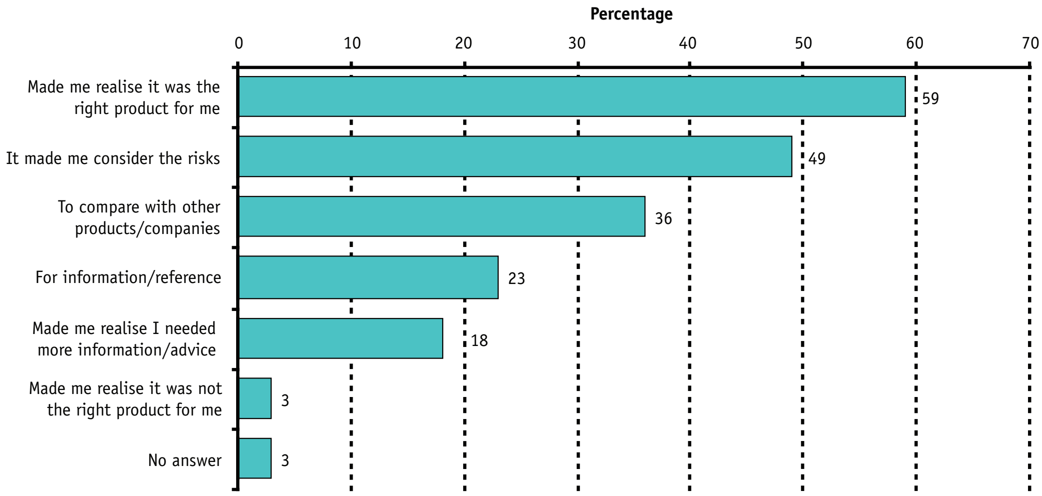
These findings are indicative only due to the small sample size. The 39 respondents that had definitely looked at or obtained a KFI were asked about the ways in which the KFI information was used. When asked specifically about whether they had used it to compare prices/rates and make a general comparison, 13% of this group unprompted said they had (figure 7). This rose to 36% when the question was prompted (figure 8). This would suggest that the KFI is not being used mainly as a comparative tool.

Figure 7: Ways in which KFI information was used – lifetime unprompted response (CR4)



Sample size: 39 lifetime consumers had read at least some of the KFI or whose adviser had explained it (N.B small sample).

Figure 8: Ways in which KFI information was used – prompted response (CR4)



Sample size: 39 lifetime consumers had read at least some of the KFI or whose adviser had explained it (N.B. small sample).

Indicator: Consumers read KFIs

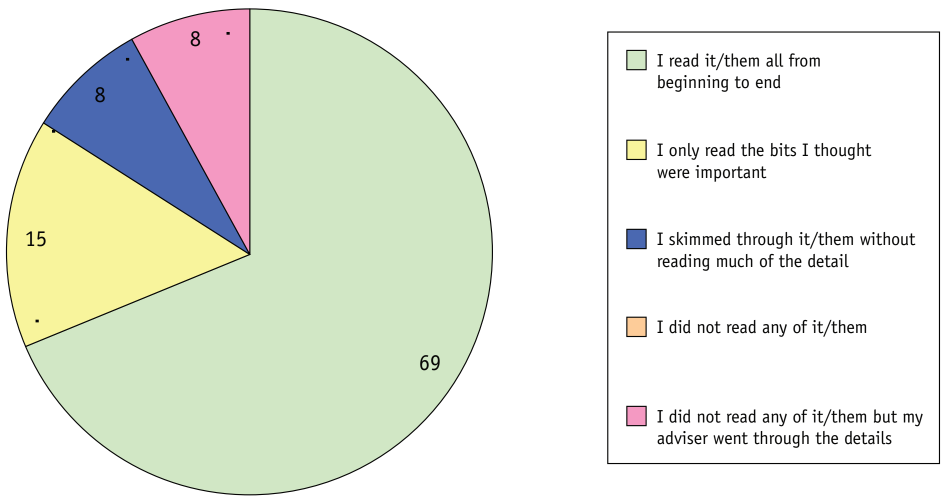
Despite the fact that the qualitative research found that consumers had already made their decision by the time they had received the KFI, most had read it in great detail before filing it away for future reference. The literature was also seen as a source of security; no matter how useful the verbal advice and information had been, consumers did find the written documentation comforting to read in their own time. Some stated that they had gone on to clarify certain specific points with their lender or intermediary.

There is some indicative evidence from the quantitative research regarding the ways in which the KFI information was used based on 49% of the total sample. Unprompted, 23% of those who had read at least some of the KFI said that they had used it to make a decision (figure 7). When the question was prompted, 59% of this group (figure 8) stated that the KFI had made them realise it was the right product for them, and 49% used it to consider the risks. Both the prompted and unprompted responses show that a similar percentage of consumers indicated that they used it for information/ reference. 18% of consumers when prompted also stated that the KFI had made them realise that they needed more information/advice (figure 8).

The qualitative research showed that the small number of lifetime consumers who did not study the documentation as thoroughly as most had a more immediate need for the funds. This was primarily because they felt that reading the documentation would have no bearing on their purchasing decision.

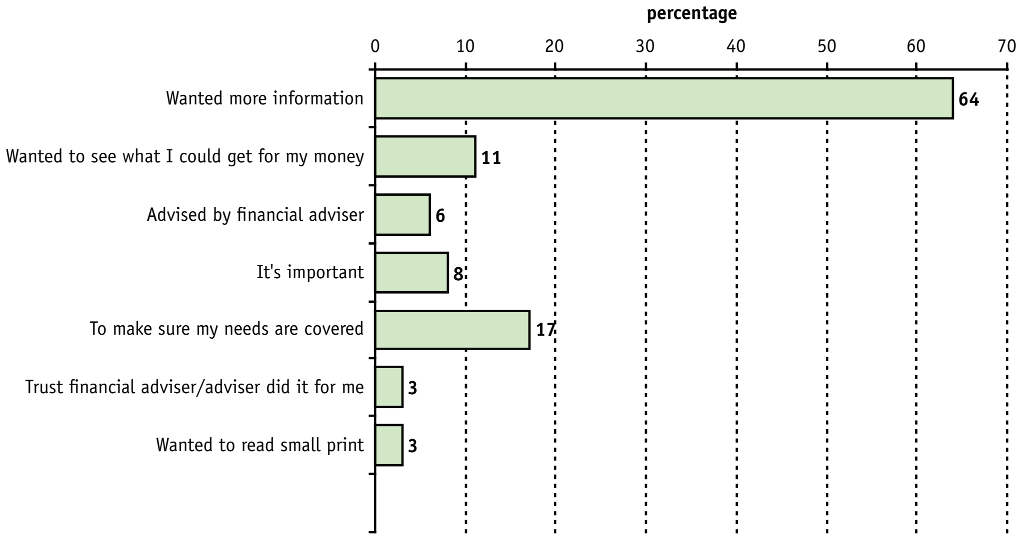
Respondents to the quantitative research who said they had definitely looked at or obtained a KFI were asked about the extent to which they had personally read the KFI (figure 9). 69% of this group stated that they had read it from beginning to end. Figure 10 illustrates that this was primarily to gather more information.

Figure 9: Extent the KFI was personally read by lifetime consumers (CR4)



Sample size: 39 lifetime consumers who had definitely looked at or obtained a KFI (N.B. small sample).

Figure 10: Why KFI was read in such detail by lifetime consumers (CR4)



Sample size: 36 lifetime consumers had read some of the KFI (N.B small sample).

Summary of findings for outcome 1

The quantitative research indicates that both sub-prime and lifetime consumers are shopping around to varying degrees. The findings suggest that lifetime consumers are gathering product information and shopping around for themselves. Sub-prime consumers are also gathering product information but, in reality, they are restricted to the products their brokers can get for them. The qualitative research confirms that sub-prime consumers consult brokers to help them find a lender who is prepared to accept their business. Lifetime consumers consult brokers to help them decide which product is right for them.

The KFI is not generally used by consumers during the process of shopping around; they fail to recognise that a key purpose of the KFI is to make it easier for them to compare products. It appears that the KFI may be provided too late in the sales process to influence the purchasing decisions of sub-prime or lifetime consumers. Consumers received it after their period of shopping around and their discussions with their brokers whose recommendation they trusted. Therefore they did not feel it necessary to shop around any further.

The necessary involvement of intermediaries for sub-prime consumers and the importance of face-to-face contact suggest that oral disclosure may be more important than written information. Although the KFI is considered important and useful, sub-prime consumers see more value in it as a purchase record which they used to check the verbal information provided by their broker (for example, that the cost and payments were as expected). Lifetime consumers viewed the KFI as a tool to confirm their understanding and expectations of the product, no matter how useful they had found the verbal advice and/ or information provided by the broker/lender.

Stage 2 findings

Outcome 2: Consumers understand whether they are being given advice or information by firms

Background

The mortgage regime is designed to ensure that consumers understand the type of service they are receiving, and to make them aware there is a choice in the market. One of the key reasons for providing consumers with initial disclosure is so that from the outset, they are aware (particularly before any fees are charged) of the level of service they will receive. This is important because the consumer's access to redress is limited if they do not receive advice. The intention is that consumers will be prompted to think about whether a particular firm is right for them. The tool for delivering this at the start of the sales process is the IDD.[15] This sets out the scope and level of service that the customer is getting and (as the disclosure has to refer to both service types) also what they are not getting.

Research note

We were unable to rely on the quantitative research for this outcome because the research did not fully test consumers' understanding of the type of service received. The respondents in the sample answered the questions according to the service type that they thought they had received, and the qualitative evidence suggests that consumers failed to understand whether they were being given advice or information. Our findings are therefore based on the qualitative research.

Findings for the sub-prime mortgage market

Indicator: Consumers understand whether they have received advice or information only

The qualitative research suggests that the IDD did not have an impact on consumers' understanding of the service they received. Many sub-prime consumers did not see the type of service as important. Instead, the foremost consideration in consumers' minds was obtaining a mortgage and pinpointing the cheapest appropriate option. Consequently they considered the role of the broker to be the procurement of

15. See IDD example template on our website: www.fsa.gov.uk/Pages/Doing/small_firms/mortgage/disclosure/broker_mortgage/index.shtml

affordable mortgage options. They placed a great deal of trust in their brokers; having assumed that all brokers whatever the service, would suggest appropriate mortgage options, or at the least not suggest inappropriate ones. They would then choose a product from the pool of suggested options and make their final decision.

Most of the sub-prime consumers in the sample felt that they had received 'advice' from their broker in the broadest sense. Very few sub-prime consumers had made, deliberated over or recognised the advised/ non-advised distinction, or even considered it to be important when told. The final decision was ultimately considered to be theirs to make whether a precise recommendation had been made or not.

Indicator: Consumers understand and can use the IDD

Evidence from the qualitative research showed that most sub-prime respondents felt that the IDD should be available although they did not consider it to have been particularly useful. The information in the IDD was not seen as memorable as that contained within the KFI and its content was described as 'legalistic bumph, unimportant or 'so what' information.'[16] To consumers, the IDD did not appear to be personalised or tell them anything substantive or new. However, there is some evidence that a minority of consumers were prompted to approach or consider alternative brokers if they viewed the fees as excessive or above what they had expected.

Findings for the lifetime mortgage market

Indicator: Consumers understand whether they have received advice or information only

The qualitative research found there was general uncertainty amongst respondents about whether they had received advice or information only. They did not think about the purchasing process in these terms. In fact most thought they had received both. What they considered to be important in terms of the service provided was whether the product was purchased directly from a provider or via an intermediary.

Those consumers who bought their lifetime mortgages directly from providers had already made a decision about purchasing the product. These consumers were not looking to be 'advised' or 'recommended' a product and, although they were prepared to take note of any information provided, they ultimately felt it was their responsibility to make the final product decision.

By contrast, those consumers who had used an intermediary were looking for guidance on their purchase decision. Most consumers with advised sales thought that the adviser had provided them with information and advice - but not a recommendation. In fact, some respondents felt that the term 'recommendation' had negative connotations, suggesting they had been pressured or given the 'hard sell.' These consumers were adamant that this had not occurred. They ultimately believed it was their responsibility to make the final decision about which product to purchase despite having received some degree of information or advice from brokers.

16. CR3, Illuminas: Mortgage Effectiveness Review Research report (P26).

Respondents often described the advised purchasing process as a 'joint' consultation, with the decision being ultimately their responsibility but from an informed standpoint. It was seen as a case of 'me and the broker' considering the options, but the final decision was naturally the responsibility of the consumer. Even where intermediary guidance was in the form of 'advice' consumers felt that the final purchase decision had to be their responsibility.

Indicator: Consumers understand and can use the IDD

Our qualitative research showed that lifetime consumers did understand the IDD to be a document that described the service that would be provided by their lender or intermediary. Overall, however, the IDD was seen as largely irrelevant and only some respondents had kept their IDD for future reference. In contrast to the verbal information received from the intermediary or lender, the IDD was perceived as a generic impersonal document and another standard piece of paperwork.

Summary of findings for outcome 2

Neither sub-prime nor lifetime consumers recognised the distinction between advice and information only – or the importance of the distinction. They did not consider the purchasing process in these terms. Lifetime consumers saw the distinction as being between buying directly from the lender or buying through a broker. There is some evidence that some (sub-prime) consumers were motivated by the stated fee level to consider other options. However, the IDD was not otherwise used to further their understanding of the types of service available; consumers did not recognise that it could be used to compare services between firms. Moreover they felt that it was for them to make the final purchasing decision, regardless of the type of service received.

Stage 2 findings

Outcome 3: Consumers better understand the risks and features of the mortgages they take out, including affordability risks

Background

An important objective of the mortgage regime is to help consumers understand the risks and features of mortgage products. The key method for delivering this disclosure is the KFI, which is intended to provide a clear description of a product's features, plus personalised information on the customer's borrowing, including the costs and how these might change (for example, it illustrates the effect a 1% rise in interest rates would have on their payments).

This information is intended to be received and considered by the customer before they make a decision to apply for a particular mortgage product. The KFI was also designed to improve consumers' ability to understand and compare products on offer so that they can make informed decisions. It is important that consumers fully understand the short-term and long-term costs of a particular mortgage so that they can determine its affordability.

Findings for the sub-prime mortgage market

Indicator: Consumers understand and can identify information on the key risks and features of mortgage products using the KFI

As we have seen, the qualitative research findings under outcome 1 show that most consumers had decided to purchase their mortgage before they read the product disclosure. They gained their understanding of the product from their broker. The KFI was viewed as a purchase record and check on the verbal information provided by the intermediary. It was used to check any uncertainties, clarify any doubts and provide reassurance. In this way, the KFI was used to confirm consumers' understanding of the risks and features of their product. When they received it, most consumers checked the overall mortgage cost and payments were in line with their expectations. Consumers also thought that the fact they received written information ensured that the broker would not mislead them about the product, and would be honest about the charges and risks.

Consumers' response to the risks and features information within the KFI

Most sub-prime respondents (qualitative research) did recall receiving a document outlining the key features of the product but did not recall the term 'key facts' and had to be shown the document for confirmation. Most said that they were more likely to refer to the KFI than any other documentation provided because it was simple, succinct and an easy read. The sections on the mortgage cost and monthly payments were viewed as priority information. Most sub-prime consumers said they had checked that the figures and the details regarding the mortgage product (mortgage type, amount borrowed, APR) were correct when they got the KFI.

However, the risk information was not of immediate interest to sub-prime consumers, despite their financial circumstances. Many consumers needed and wanted a mortgage regardless of the risks involved. They also tended to assume that their income would be sufficient. Although consumers stated that they were aware of the risks associated with a fall in income, it was not important to them at that stage. Most did not appear to consider the future or any longer-term issues.

Findings for the lifetime mortgage market

Indicator: Consumers understand and can identify information on the key risks and features of mortgage products using the KFI

The qualitative research evidence suggests that lifetime consumers understood (or believed that they understood) the key features and risks of mortgage products from their own research, discussions with lenders/ brokers and background reading. Consumers had taken the time to seriously consider the advantages and disadvantages of the product before purchase. Subsequently, all consumers were aware of the future implications of taking out a product (namely a reduction in the value of their estate and the amount left for inheritance).

The consumers with a higher degree of financial capability who had directly approached lenders believed that they had conducted sufficient research and done enough shopping around to understand the product. The consumers with advised sales required their brokers to provide them with explanations and guidance to aid their understanding of the different product types and offers available.

The majority of the lifetime respondents recalled receiving the KFI and acknowledged that it contained crucial and personal information regarding their products. As mentioned previously, 64% of respondents to the quantitative research who had obtained or looked at a KFI and read at least some of it, read the KFI in detail because they wanted more information about the product. The KFI was used to clarify uncertainties, confirm their understanding and acted as a source of security which helped to instil confidence that they had made an informed decision. It also represented a confirmation of the verbal information provided by the intermediary or lender. The quantitative research showed that 62% of consumers who had obtained or looked at a KFI said it helped them to a great extent with their final decision about which product to buy. As we have seen earlier, when prompted with answers, 59% of the consumers who had read some of the KFI indicated that it had made them realise that it was the right product for them. Consideration of risks was not something consumers mentioned unless prompted, when 49% of this group indicated that it had made them consider the risks.

Consumers' response to the risks and features information within the KFI

The personal details section (amount borrowed, mortgage description) was of interest to consumers who checked that the details were correct and in accordance with their expectations. Consumers also felt it reassuring to have the risk details in writing, in addition to the verbal explanations provided by the lender/broker. Some consumers were alerted to the social security/tax implications. Many respondents found the illustration of the mortgage cost over time in the 'what you will owe and when' section particularly useful. Although many considered the illustration to be frightening in some respects, they felt it was important. In the same way, the illustration of how the value of the home could change was also considered to be useful, particularly by those with beneficiaries.

Summary of findings for outcome 3

Sub-prime consumers got their understanding of the risks and features of their mortgage products from their discussions with brokers, whereas lifetime consumers got their knowledge from their own research. Both sub-prime and lifetime consumers used the KFI as a check on the information provided by brokers/lenders and to confirm their understanding and clarify any uncertainties. Both sub-prime and lifetime consumers tended to focus on the sections detailing the mortgage cost and monthly payments, although lifetime consumers did have more awareness of the risks attached to their mortgage product. Sub-prime consumers, by contrast, tended to focus on affordability in the short term and wanted the mortgage regardless of the risks involved.

Stage 2 findings

Outcome 4: Consumers take out suitable and good value mortgages

Background

The expectation is that this outcome will be achieved by providing consumers with the necessary tools to shop around (Outcome 1) including disclosure to enable them to make informed product comparisons (Outcome 3). Consumers should also be able to seek advice if required and have clarity about whether or not they are receiving advice (Outcome 2). So achieving this key outcome is in many ways seen as a natural consequence of the delivery of the previous three outcomes. Before regulation, research suggested that consumers focused very heavily on what the initial payments would be, often to the exclusion of all other considerations. The regime was intended to lead consumers to make a more considered and long-term assessment of the suitability and value of the product. Consumers should consider what they can afford both now and in the future, taking into account any likely changes to their circumstances.

We hoped to assess whether sub-prime and lifetime consumers took out suitable and good value mortgages. We planned to use the findings from our Quality of Advice (Outcomes) project to assess the suitability of mortgage recommendations made by advisers and provide evidence for this outcome. However, that work is still being piloted. So our findings for this outcome are based on the qualitative research which provides evidence on how consumers decided on their final mortgage product and the considerations they took into account during the purchasing process.

In addition, we carried out a piece of work to find out whether MCOB has increased the degree to which consumers are being sold suitable mortgages using arrears rates in the sub-prime mortgage market as a measure of suitability. The study compared arrears levels before and after the introduction of MCOB. Our analysis could not identify an appreciable impact of MCOB on suitability levels (see annex 1).

Findings for the sub-prime mortgage market

Indicator: Consumers shop around for mortgages

As the findings for outcome 1 have shown, sub-prime consumers generally rely on their brokers to do the shopping around for them. The qualitative research also indicates that sub-prime consumers focus on short-term affordability in making their product purchase decisions. They do not appear to consider or make an assessment of suitability in the long term. They first require their broker to find lenders who are willing to accept their business at their required LTV ratio and an affordable rate. Then the determining factor is price, the cheapest deal or APR, and acceptable fees. Trust in the broker was highly influential. The broker's advice and service was considered vital to obtaining a range of suitable products. Although sub-prime consumers acknowledged that they were not going to get the 'best deals' available on the market, they did want a 'good deal.' Affordability was their key priority.

Short-term deals (of around two to three years) were prevalent amongst sub-prime mortgage holders, particularly remortgagers and house movers. There is also evidence that remortgagers roughly knew the date their deal would end and would contact brokers before the end of the deal. Rates were predominantly fixed because consumers wanted to know what their monthly payments would be. Sub-prime consumers also preferred to avoid tie-in clauses because doing so helped to remove the uncertainty of being left on a variable rate. A mortgage no longer represented a 25-year repayment deal but a succession of two- to five-year deals for many sub-prime mortgage consumers.

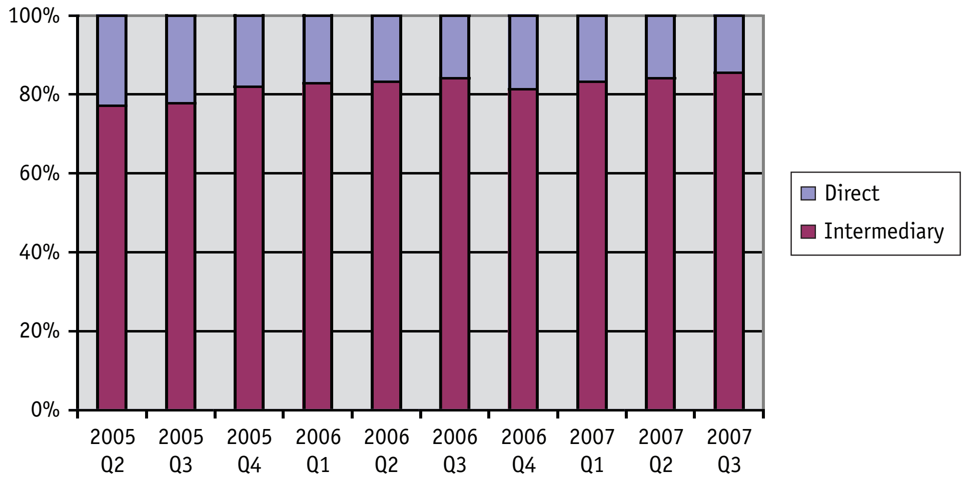
Indicator: Consumers seek advice in appropriate circumstances

The evidence has shown that consumers do not understand or appreciate whether they had received advice. Nevertheless brokers were seen to provide the necessary support to the purchasing process, due to their expertise, knowledge and experience. Consumers wanted guided decision-making, their adviser to investigate the offers, simplify and personalise information, compare prices and guide them through the key features of the product.

Product Sales Data (PSD) submitted by mortgage lenders for the third quarter of 2007 shows that intermediary sales represented 86% of the total of sub-prime mortgage sales[17] (figure 11).

17. See note 3 on P2 for PSD definition of sub-prime mortgage sales.

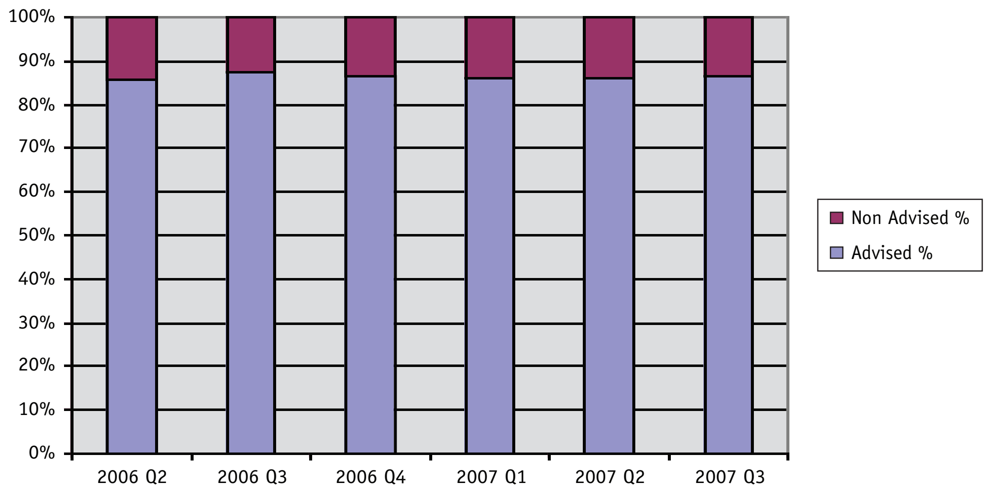
Figure 11: Sub-prime mortgages by selling channel (PSD)



There was an overall increase in the share of intermediary sales for the period illustrated in figure 11. The average share of intermediary sales for this period was 82%.

Of those intermediary sales in the third quarter of 2007, 87% were advised (figure 12). The average percentage of advised intermediary sales for the period illustrated in figure 12 is also 87%. We do not have complete PSD about the number of sales that were advised in 2005 because data on advised sales was not a mandatory requirement until the second quarter of 2006.

Figure 12: Percentage of sub-prime intermediary sales that were advised and non-advised (PSD)



Findings for the lifetime mortgage market

Indicator: Consumers shop around for mortgages

The findings for outcome 1 showed that respondents gathered information from a variety of available sources, with most relying on their broker to shop around while others shopped around for themselves.

The qualitative research showed that lifetime consumers also focused on price; the level of interest was commonly cited as the most influential determining factor. The loan also had to meet a consumer's particular requirements (for example, a fixed rate deal or lump sum with additional amounts to draw on). In addition, most respondents wanted to purchase a lifetime mortgage from a brand name that was well known and considered trustworthy. Fees and administrative costs were generally a low priority because most consumers believed that the costs would be similar across providers. The level of trust consumers had in their adviser and the perceived quality of the advice and support received were influential in the final product choice.

The qualitative research suggested that, whilst the product disclosure did not have a direct impact on consumers' decisions, its role was still considered as important, namely, to confirm their expectations and understanding of the product. The KFI provided reassurance and acted as a tangible manifestation of what they had purchased. It generally helped to instil confidence that they had made an informed decision.

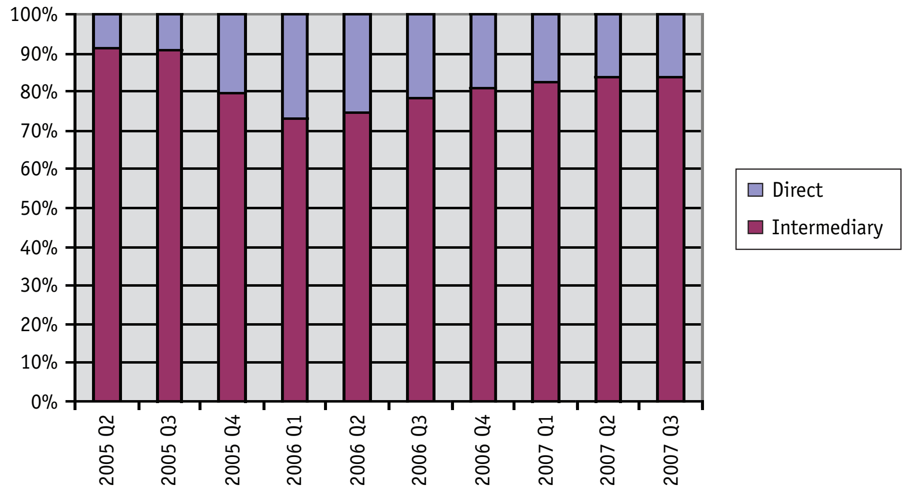
The lifetime consumers who purchased their products directly from the provider had done their own background work and believed they had shopped around sufficiently to identify suitable product types. They often looked for this specific type of product at the cheapest interest rate and found providers accordingly. There were differing levels of shopping around in this group of consumers; some considered alternative products as they were aware of different types of lifetime mortgages, whilst others approached just one or two providers. Evidence from the quantitative research indicates that 62% of lifetime consumers stated that they found comparing information about products from different companies fairly or very easy.

Indicator: Consumers seek advice in appropriate circumstances

Evidence from the qualitative research indicates that the lifetime consumers who sought advice from a broker had decided to purchase some sort of equity release product but were initially unaware of the variety of providers, the range of product types and needed advice and guidance. These consumers were less confident about financial matters but had used brokers for other financial products. The quantitative research also shows that most respondents received advice from an IFA or mortgage/insurance broker.[18] This is supported by evidence from PSD which shows that the average share of intermediary sales in the market was 81% between the second quarter of 2005 and the third quarter of 2007. In the third quarter of 2007, intermediary sales were 84% of total lifetime mortgage sales. The fluctuation in the share of sales during this period can be explained by the entry of a new market participant selling direct (figure 13).

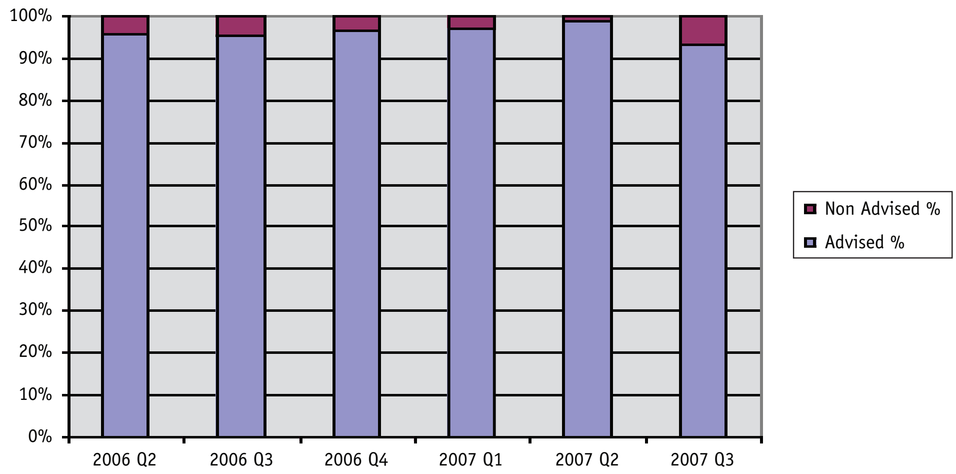
18. Member organisations of Safe Home Income Plans (SHIP) account for over 90% of the equity release market. SHIP members agree that sales 'may be made only after an advised and personal recommendation.'

Figure 13: Lifetime mortgages by selling channel (PSD)



Of those intermediary sales in the third quarter of 2007, 93% were advised (figure 14). The average share of advised intermediary sales for the period illustrated in figure 14 is 96%.

Figure 14: Percentage of lifetime intermediary sales that were advised and non-advised (PSD)



The qualitative research showed that many lifetime consumers were satisfied with the contact received both at the information/advice stage and subsequently, and felt sufficiently confident to make an independent final decision. Many valued the caution they were encouraged to exercise from their first contact point. All lifetime mortgage consumers were happy, confident and comfortable with their final product choice whether they had received advice or not. This evidence is supported by the quantitative research, 96% of the respondents who had spoken to a professional adviser did not reject their adviser's recommendation and most purchased the recommended product. 79% of respondents said they were confident that their product was suitable for their needs.

Summary of the findings for outcome 4

The qualitative research shows that consumers are still focusing on price in the short term. There does not appear to be any evidence that sub-prime consumers are making a considered and long term assessment of the suitability and value of the product. Both sub-prime and lifetime consumers placed a considerable amount of trust in their brokers, assuming that they would recommend appropriate options. PSD shows us that intermediary sales for impaired credit mortgages have increased from 78% in the third quarter of 2005 to 84% in the third quarter of 2006 and 86% in the third quarter of 2007. Lifetime intermediary sales fell from 91% to 78% and then increased to 84% in the same period.

Stage 2 findings

Outcome 5: Consumers are treated fairly over the life of the mortgage, including when they go into arrears.

Background

Our rules on arrears and possessions aim to ensure that consumers in arrears are treated fairly and not exploited by firms, for example, by being repossessed when the situation could be resolved by less drastic means. The rules – which consolidated good practice standards in industry at the time of introduction of the mortgage regime – were drafted in a high-level way to give firms the flexibility to respond to the individual circumstances of their customers in payment difficulties.

Unfortunately, the evidence from the qualitative research suggested that some lenders across both the prime and sub-prime markets may have been failing to abide by the MCOB requirements on arrears. So we have been unable to assess and test the effectiveness of our arrears rules. We are undertaking focused thematic work on firms' arrears-management practices to establish whether there is, in fact, a problem of non-compliance. We expect to report on this work in June 2008, the qualitative resaerch findings on arrears will be published at the same time.

Analysis, conclusions and next steps

Introduction

In this section, we have set out the key conclusions from stage 2 of the Mortgage Effectiveness Review, identified the key messages from stage 1, compared them with the ones from stage 2, and set out our next steps.

Key conclusions from Stage 2

- The KFI is considered to be important and useful as a record of the purchase decision. However, it is largely not used for shopping around and product comparison and does not prompt consumers in these markets to think about the risks and features of a particular product.
- Sub-prime and lifetime consumers do not recognise the distinction between receiving advice and information-only, nor do they consider it to be significant given that the final decision to purchase a product is considered to be one for them. The IDD is not prompting them to think about the level of service they should get.
- Sub-prime consumers rely to a considerable extent on their broker to get them a mortgage and assume that their broker will sell them a suitable and good value product. Most lifetime consumers also rely on their broker and are prepared to accept their adviser's recommendation. Both sets of consumers focus on price with sub-prime consumers focusing on payments/affordability above all else. There were high levels of customer satisfaction with brokers in both sectors.

Comparison of key messages from stages 1 and 2 of the Mortgage Effectiveness Review

Are consumers shopping around for mortgages? Do consumers better understand the risks and features of the mortgages they take out?

- The findings from Stage 1 indicated that the proportion of prime consumers seeking advice had increased in the last few years and alongside this, shopping around was fairly commonplace. However, prime consumers did not identify that the KFI was intended to assist comparisons between mortgages. Prime consumers could understand and use KFIs and were able to identify and discuss risks in a research situation (qualitative research). They saw the KFI as a useful prompt to ask questions to clarify their understanding.

- The stage 2 findings generally support the findings from stage 1. Both sub-prime and lifetime consumers did gather information and shop around but sub-prime consumers were constrained in their choice and needed their brokers to find lenders willing to accept their business. Although the KFI was viewed positively and considered to be important and useful by all consumers, most did not identify that the KFI was intended to help them compare mortgages, and it was not used for shopping around. Sub-prime and lifetime consumers also used it to check any points of detail, clarify any uncertainties and confirm their understanding of the product. It is clear from stage 2 that sub-prime consumers see value in the disclosure as a clear and easy-to-read record of their purchase, and lifetime consumers as a tool to confirm their expectations regarding the product. In general, sub-prime and lifetime consumers received the KFI after their discussions with brokers/ lenders and period of shopping around. Lifetime consumers generally had more risk awareness than sub-prime consumers but got their knowledge from other sources and not the KFI. Sub-prime consumers tended to accept the information provided by their broker as sufficient, and did not feel it necessary to read the product information.

Do consumers understand whether they are being given advice or information by firms?

- The stage 1 findings showed that a third of prime consumers were unable to recall whether they had received advice or information. They did not recognise that not all firms would give advice, or what it would mean to receive information only (a consumer's ability to seek redress is limited if they do not receive advice). The prime consumers could identify and discuss the key messages of the IDD in a research situation, but they did not usually identify that a key purpose of the IDD was to compare the services offered by different firms. Consumers also tended to focus on the scope of service in discussions (that is, the distinction between whole of market and a limited range) rather than the type of service.
- The stage 2 findings showed that neither lifetime nor sub-prime consumers made a distinction between advice and information, nor did they consider the service type to be important. The key distinction for lifetime consumers was whether they purchased directly from the provider or through a broker. Consumers did not consider the distinction to be significant because they felt it was for them to make the final purchasing decision. The IDD is not prompting them to think about the type of service, and whether it is appropriate for them. Consumers did not recognise that the IDD could be used to compare the services offered by different firms. Sub-prime and lifetime consumers assumed that all brokers, whatever the service, would recommend appropriate options.

Are consumers taking out suitable and good value mortgages?

- In stage 1, we reported that our analysis of market data suggested that prime consumers have continued to make efficient purchasing decisions since regulation began, although there was no evidence of an increase in efficiency. In stage 1 we were not able to establish that prime consumers were buying more suitable mortgages for their needs and circumstances. However, the quantitative evidence did show that 41% of consumers based their final decision on price.
- In stage 2, our analysis indicates that both sets of consumers focus on initial payments/ affordability above all else, and rely to a considerable extent on their broker, assuming that they would sell them a suitable and good value product. This is broadly consistent with the findings from stage 1, where price was the key factor in a purchasing decision and customer satisfaction levels with brokers were high. Consumers did not appear to make any long-term assessments of the suitability and value of the product, preferring to focus on the short-term costs.

Conclusions

The findings from stages 1 and 2 suggest that our market intervention, in relation to disclosure, in particular, may not be working as intended. This suggests that we may need to look further at our approach to disclosure in general but in intermediated sales in particular. Moreover, it seems clear that we need to do something more to ensure consumers understand the implications for them of choosing between an advised and non-advised service.

The evidence also suggests that sub-prime consumers are not able to effectively shop around for themselves having to rely on brokers to find them suitable deals and lenders willing to accept their business. This reliance on brokers is hardly surprising given the distribution channels in this market. However, it may be that something more needs to be done to protect sub-prime consumers who tend not to look out for themselves in the way that other consumers (prime/lifetime) appear to do.

Next steps

The policy implications from both stages of the Mortgage Effectiveness Review will help to inform the wider review of the MCOB regime, which was announced in our Business Plan 2008/09.[19]

19. FSA: Business Plan 2008/09: www.fsa.gov.uk/pubs/plan/pb2008_09.pdf

Annex 1

Methodology

We commissioned and undertook various pieces of research to ensure the validity and robustness of our results. In some areas we were able to triangulate our research (that is, target questions from several angles) through different pieces of research to corroborate our findings. In other areas, this was not possible either because of the nature/ methodology of the research and/ or the findings were not directly measurable against the indicators to the consumer outcomes. Additionally, some of the analysis that we carried out did not provide us with meaningful results to inform the Mortgage Effectiveness Review. This section describes all the areas of research that we undertook and used for the stage 2 report.

- We commissioned qualitative consumer research to find out more about consumers' experiences in the relevant sectors (CR3).[20]
- We analysed quantitative consumer research from the Consumer Purchasing Outcomes Survey (CPOS) project on the mortgage purchasing process (CR4).[21]

To provide some market context for the work we were undertaking, we:

- carried out an in-house study and analysed arrears rates in the sub-prime market before and after the introduction of MCOB to investigate suitability;
- analysed Product Sales Data (PSD) to provide evidence of sales patterns within the sub-prime and lifetime mortgage markets; and
- analysed interest rate sensitivities on lifetime mortgages, but this did not provide us with meaningful evidence to inform the Effectiveness Review.

Qualitative consumer research (CR3)

We commissioned a research agency, Illuminas to carry out this research. The research consisted of a total of 100 face-to-face depth interviews with consumers who had recently purchased either a sub-prime or lifetime mortgage, or who were currently, or had recently been, in arrears on their mortgage. As noted in the stage 2

20. Available on our website at: www.fsa.gov.uk.
21. When published, report will be available on our website at: www.fsa.gov.uk.

report, we were unable to test the effectiveness of our requirements on arrears because of the suggestion of non-compliance. We are undertaking thematic work on firms' arrears-management practices to establish whether there is, in fact, a problem of non-compliance. It is expected that this work will report in June 2008, the qualitative findings on arrears will be published at the same time.

The research sought to understand all aspects of the consumer experience. This included the consumers' engagement with information and advice when taking out either a sub-prime or lifetime mortgage, or when falling into arrears, and its effect on their behaviour.

The sample sizes for each component were 30 sub-prime consumers (15 heavy adverse, 15 light adverse), 30 lifetime consumers (20 advised, 10 non-advised) and 40 in arrears (20 with mainstream lenders and 20 with sub-prime lenders). The samples for lifetime and sub-prime included a spread of age, gender, financial sophistication and amount of mortgage. The sample for arrears included a spread of consumers who had been in arrears for differing lengths of time.

Interviews were conducted in the South, Midlands and North of the UK. They lasted approximately one hour and took place between 14 September and 5 October 2007. Respondents from the lifetime and sub-prime samples were asked to bring all the information they had received on the product and its purchase and highlight any areas that they considered important or useful. During the interviews respondents were asked about their approach to:

- buying the product;
- the purchasing process;
- their understanding of the type of product they had purchased;
- the approach of the adviser or contact with the lender; and
- their use of the product disclosure/written documentation including its impact on decisions.

During the interview these respondents were presented with examples of the Initial Disclosure Document (IDD) and the Key Facts Illustration (KFI) and asked to discuss their role and importance in the overall purchasing process. Their attitude towards the documents received and its effect on their purchase decision and behaviour had already been established on an unprompted basis. The example copies were introduced to help stimulate recall and prompt response. At this point, respondents' reactions to each document were observed. They were asked to discuss in some detail the importance of each document, the extent to which they had used this type of information when they had originally received it, and its overall influence on their final purchasing decision. The stimulus material was useful in gauging consumer understanding of the documentation and provided a focal point for assessing and developing the effectiveness of the current regulatory mortgage regime.

It is important to acknowledge that qualitative research of this nature cannot produce statistically significant results. These findings indicate market behaviour, the approach to the sale of mortgage products in the lifetime and sub-prime markets and the treatment of customers in arrears.

Quantitative consumer research (CR4)

Our Consumer Purchasing Outcomes Survey (CPOS) is a large scale quantitative research study. It was designed to provide information about the progress of the Financial Services Authority (FSA) towards achievement of Strategic Performance Indicator number 1: Consumers receive and use clear, simple and relevant information from the industry and the FSA. The Strategic Performance Indicators have been developed to measure our effectiveness in meeting our statutory objectives on consumer protection and the promotion of public understanding of the financial services sector.

The study covers a range of retail financial products including mortgages, with the aim of finding out whether consumers receive and use clear, simple and relevant information from the industry and FSA, and which financial products, if any, consumers end up purchasing. Respondents are interviewed at key stages during the purchasing process to gather information on their decision-making processes.

CPOS has three target groups of consumers, Groups A, B and C. Group A were gathering product information at the time of the survey, and deciding whether to proceed with a purchase. Group B had purchased a financial product within the last 12 months and Group C between one to five years ago. The CPOS Group A methodology consisted of an initial interview followed by a second interview (up to six months later) to check whether respondents had purchased a product. The mortgage element of this survey consisted of 738 consumers in Group A who were planning to purchase a mortgage in the following six months. There were 84 respondents in credit groups 2 to 4 in Group A. We devised four levels of credit rating. Level 1 refers to a clean credit history.

Those consumers with a credit rating at level 2:

- had not been declared bankrupt;
- AND (had last missed a payment on their mortgage/secured loan more than 12 months ago), and (did not have a current CCJ taken out against them for money owed, or within the last three years);
- OR (the last CCJ taken out against them was more than three years ago) and (they had not missed a payment on their mortgage/secured loan within the past month or 12 months).

Consumers with a credit rating at level 3 had:

- not been declared bankrupt;
- AND (had last missed a payment on their mortgage/secured loan more than 1 month ago, within the past 12 months) and (did not have a current CCJ against them);

- OR (they had had a CCJ against them within the last three years) and (had not missed a payment on their mortgage/ secured loan within the past month).

Consumers with a credit rating at level 4:

- had been declared bankrupt;
- OR had last missed a payment on their mortgage/secured loan within the past month;
- OR they had a current CCJ against them.

There were 79 lifetime mortgage respondents in Group B.

The initial interviews for the prime and sub-prime consumers were conducted between March and May 2007. Our analysis is based on the interim data from these first stage interviews. Those in Group B (one interview only) which included the lifetime consumers were interviewed retrospectively in April and May 2007.

For Group A respondents the second interview was conducted by telephone which meant it would have been difficult to fully discuss disclosure issues. So this second interview only focused on the final outcome achieved. Due to the sample size of the lifetime and sub-prime consumers, the base sizes of some of the sub-groups within these samples are quite small. Subsequently, the lifetime and sub-prime mortgage analysis has been used to support the findings of the qualitative research, where possible, but it should be viewed as indicative only.

The final CPOS report had not been completed at the time of publication of this report. The Personal Finance Research Centre at Bristol University have analysed the findings from the survey and these will be finalised and published in Q2 2008. The report will be available on our website.

FSA empirical research on the effect of MCOB on suitability of sales in the sub-prime mortgage market

Introduction and summary of conclusions

Within the second stage of the Mortgage Effectiveness Review, we undertook an empirical study testing the longer-term consumer outcome 4 ‘Do consumers take out suitable and good value mortgages?’ using arrears[22] rates in the sub-prime[23] mortgage market as a measure of suitability.

The analysis is based on the assumption that arrears rates in the sub-prime mortgage market observed at a certain point after origination can be used as a proxy for the suitability of mortgage sales. Sub-prime mortgages are almost exclusively available

22. Arrears defined as shortfall equal to two monthly payments.

23. We applied the PSD definition of impaired credit – lending to a borrower who does not have a standard credit history; e.g. a recent history of arrears on a loan of some type within the last two years with a cumulative amount overdue of three or more monthly payments; an Individual Voluntary Agreement; County Court judgments or filed for bankruptcy within the last three years.

through intermediaries on which customers rely to identify the best option for them. In addition, sub-prime consumers can be classified as particularly vulnerable. Thus, we believe that it is reasonable to use arrears rates in this market as a proxy for the suitability of the mortgage sale and as an indicator for mis-selling.

The MCOB rulebook contains three key suitability criteria. A mortgage contract should be affordable for the customer, appropriate to the borrower's needs and circumstances and the most suitable of those that the firm has available. The rules require firms to take reasonable steps to ensure that these criteria are met and the mortgage is suitable. We believe the arrears rate is a good indicator of performance relative to the first criterion of suitability: it is closely linked to the affordability of mortgages. The arrears rate also tells us something about the second criterion: the average appropriateness of loans to borrowers' needs and circumstances. However, the arrears rate would not inform us about the third criterion of suitability.

We have adopted the reasoning that arrears rates observed 12 months after the point of sale are a good proxy for suitability of the mortgage sale as long as other factors which could lead to arrears are taken into account. In particular, there is a need to control for changes in the macroeconomic environment and changes in the details of the loans made. The effect of MCOB regulation on the first and second strand of suitability as discussed above can then be assessed by comparing arrears rates before and after MCOB.

However, we could not detect a systematic effect of MCOB on arrears rates. There was no visible step change in arrears rates around the time of MCOB and our model suggested an effect of MCOB that is not significantly different from zero. Also, the sign on the MCOB variable has not been stable to changes in the controls used, that is, the effect of MCOB in the model on arrears was not consistently negative when different controls were added to the equation.

We are fairly confident that if MCOB has had any effect on arrears rates, this effect was small. Our confidence interval for this effect is sensitive to what controls we use. However, the model controlling for macroeconomic variables, details of loans made and type of borrower suggests that the range (95% confidence interval) of a possible MCOB effect on arrears rates is from a 4.6% decrease to a 1.4% increase in arrears probability.

Data

The sample size used for the econometric analysis consisted of more than 300,000 individual mortgages originated between 1998 and 2007, about two thirds originated before and one third after MCOB. These mortgage data provided by the main firms in the market were matched up with information from the Product Sales Data (PSD) we hold. We subsequently appended macroeconomic variables to the dataset: Data to calculate indices for changes in unemployment, base rate and house prices were retrieved from the Office for National Statistics (ONS), the Bank of England and two major mortgage lenders (Halifax and Nationwide), respectively.

While there is no generally accepted definition of sub-prime in the literature, we have applied the definition of impaired credit as it is used for FSA's Product Sales Data (PSD) reporting for this study and asked firms to clarify where their definition is not the same. In PSD, impaired credit (sub-prime) is defined as lending to a borrower who does not have a standard credit history; for example, a recent history of arrears on a loan of some type within the last two years with a cumulative amount overdue of three or more monthly payments; an Individual Voluntary Agreement (IVA); County Court Judgements or filed for bankruptcy within the last three years. Cross-checking data provided by firms with information from PSD suggests that this definition is fairly consistent across the data set.

Methodology

We used a (standard) logit model processing arrears of the individual mortgage (which are defined as shortfall equal to two monthly payments) as the dependent variable. So, we considered whether mortgages sold at time t (date mortgage account opened) were in arrears at time t+j. Thus, in each regression, t varies across observations, but j does not, so as to compare, for example, arrears rates 12 months after mortgage inception for mortgages started at different dates in time.

In order to detect and isolate the influence of MCOB on arrears rates, we carried out a series of regressions with varying observation date of the arrears j after the mortgage was sold at date t and different levels of control for other factors. As previously pointed out, if MCOB were to reduce arrears relative to a state without MCOB, we would expect that the respective dummy variable in the regression is both negative and significant.

Formally, the logit model used can be summarised as:

$$ar_{t,t+j} = \alpha + \beta_1\, MCOB + \beta_2\, \Delta unemp_{t,t+j} + \beta_3\, \Delta baserate_{t+inc.,t+j} + \beta_4\, \Delta rHPI^k_{t,t+j}$$

$$+ \beta 5\, LTV_t + \beta 6\, LER_t\, \beta_7\, initialrate + \beta_8\, D_{selfc} + \beta_9\, D_{int\ only}$$

$$+ \beta_{10}\, D_{ftb} + \beta_{11}\, D_{young} + \beta_{12}\, D_{single} + \beta_{13}\, D_{rtb} + \beta_{14}\, D_{rmg}$$

$$+ \textstyle\sum_i \beta_{14+i}\, D^i_{firm}\ (+\beta_{15}\, timetrend) + \varepsilon_{t,t+j}$$

Besides the constant and the MCOB dummy, the standard model configuration contained variables covering changes in the macroeconomic environment, details of loans made, type of borrower as well as firm dummies capturing lender-specific effects. In order to control for the effect of time in general and test the stability of the MCOB dummy against, we also run regression including a time trend variable.

Main regression results

We could not detect a systematic effect of MCOB on arrears rates. Running the regressions for arrears observed 12 months after the point of sale, we found the envisaged combination of a negative sign and significance only in one setting, if we include neither time trend nor control variables for the type of borrower. Not controlling for the type of borrower is reasonable since there could potentially be an overlap between type of borrower variables and MCOB dummy since the type of borrower is something to be discussed thoroughly in the sales process. However, this result did not hold after putting the time trend into the regression. This means that the finding of a significant negative impact of MCOB is not robust and that the negative effect could be due to other time-dependent influences.

Besides the analysis for arrears rates observed 12 months after origination of the mortgage, we also carried out regressions for arrears observed 24 months after point of sale. The result of this analysis suggested, as expected, that the effect of MCOB on the probability of a borrower to get into arrears is weaker than in the 12 months period. We did not detect in any of these regressions a significant impact of MCOB. This finding also corroborates our reasoning that arrears observed after 12 months are a better indicator for the suitability of the mortgage sale.

Product Sales Data (PSD)

Since the 1 April 2005, product providers have been required to provide the FSA with transaction level data on all sales of regulated mortgage contracts, retail investment products and certain pure protection products to retail and private customers. This covers direct sales by firms' own sales forces and sales made via intermediaries. Reporting firms are required to submit PSD reports quarterly. Since 1 April 2006, all PSD reporting firms have been required to state whether customers received advice at the point of sale. The data allows us to identify the types of products individual firms are selling and the channels products are being sold through.[24]

We have used this data to provide evidence on sales patterns within the sub-prime and lifetime sectors of the mortgage market. More information on Product Sales Data (including the latest Trend Reports) is available on our website. [25]

24. FSA: Mortgage Product Sales Data Trends Report (June 2007) www.fsa.gov.uk/pages/Doing/Regulated/Returns/psd/pdf/mortgagetrends_jun07.pdf

25. www.fsa.gov.uk/Pages/Doing/Regulated/Returns/psd/index.shtml

Interest rate sensitivities on lifetime mortgages

We conducted an analysis of interest rates charged on lifetime mortgages considering variables such as the borrower's age, the valuation of the house, or amount advanced. Many current market providers do not supply us with interest rate information, as it is an optional PSD field. Of those that do supply it, while there are rate variations over time (largely in line with interest rate changes) there is little or no evidence that it is being used to differentiate customers in terms of the borrower or loan characteristics reported to PSD. It is unclear whether this is genuinely representative of the providers' interest charges, or just a reflection on the way they report their returns, given that the information is voluntary. So this analysis has not been referenced.

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