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Financial Services Authority

Good Practice Examples – Interest-only mortgages

Source: Responsible Lending Policies review and interviews with 3 major firms.

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MCOB 11 requires lenders to consider a customer's ability to repay before they enter into, or make a further advance on, a mortgage contract. This chapter sets some guidelines but it is mainly up to individual lenders to decide their own approach and what factors to use.

For interest-only mortgages, we expect a policy at least to include three things. These are: how the lender checks the customer has a strategy to repay the capital; how they assess each strategy they allow as plausible; and if the strategy requires payments to be made, how the lender takes them into account and assesses affordability.

We have looked at a representative sample of firms' Responsible Lending Policies and held discussions with several market leading lenders. We have identified some examples of good practice, where lenders developed their approach to some specific post-sale challenges of interest-only lending and have come up with processes to mitigate the relevant risks.

Action	Examples of good practice
Checking at the underwriting stage whether the borrowers' proposed strategy is plausible.	One firm, whose business is mainly introduced by intermediaries, states in its Responsible Lending Policy that the underwriter will consider whether the borrower's intention is plausible and where doubt exists (the firm) may request further information to support the borrower's proposal. Another firm's policy reflected its intention to assess all the information in the application form on its merits and seek further clarification when interest-only lending may not appear to be in the interests of customers. For example, a customer states that they will sell the property at the end of the mortgage term, trade down and redeem the mortgage. If it is known or suspected that the property being bought is at the lower end of the market, the underwriter may want to question the validity and likelihood of the customer being able to trade down and buy another property. One policy suggests that if an interest-only borrower states that he or she plans to switch to repayment later but is close to retirement, further enquiries may need to be made into the feasibility of such strategy. One firm uses outbound tele-underwriting to ask customers for more information about their repayment vehicles. A case worker contacts the applicant and asks them specific questions to make sure the selected method of building a fund is plausible and acceptable to the lender.
Building in extra safeguards, specifically for 'riskier' options, such as selling main property.	Two of the firms who are prepared to accept 'sale of main/mortgaged property' as a method of repaying the loan make clear their additional parameters. For example: • they only lend on lower than average loan to value ratios (LTV); and • they ask for a minimum equity 'buffer' expressed in cash terms, linked to the ability to trade down.
Designing and using clear proposal forms that capture applicants' repayment strategy and feed into a robust management information (MI) system.	Several firms said they are working towards issuing comprehensive proposal documents to record applicants' choice of repayment strategy and, where available, reasons for choosing it. The firms then transfer to an electronic system so they can analyse the risk and segment the population. One firm has designed a comprehensive list of acceptable repayment vehicles, including less traditional ones, such as use of bonus or inheritance, which the lender allows to use in a small proportion of cases. The matrix includes an option of 'no repayment vehicle in place'. This is to encourage honesty and transparency between the firm and its customers, and to help the lender understand the risks in their book. One lender is building an electronic system to capture information at the point of sale and to incorporate data already collected from customers. This is to enable them to carry out further analysis of their interest-only mortgages book. By being able to segment interest-only customers, e.g. by repayment strategies recorded, the lender believes it will be able to tailor communications more effectively and deliver better customer service.

Action	Examples of good practice
Effective disclosure of risks to consumers, supplementing reminders in annual statements	Several firms issue mortgage communications that contain carefully drafted "health warnings". They inform the borrowers of risks and encourage them to take action if they are unsure of their ability to repay the capital. One firm includes a special leaflet with the annual statement mailing, drawing customers' attention to various repayment vehicles and risks associated with each. One firm undertakes a periodic mailing of interest-only borrowers throughout the life of their mortgage to remind them to keep their repayment vehicle up to date, particularly targeted as customers near the end of term.
Pro-actively reviewing the maintenance of the repayment vehicle.	Most lenders write to customers before the end of the term to remind them of key dates, reiterate the amount outstanding and suggest getting in touch if a customer needs further information or advice. The timelines vary between firms; some lenders send a letter 5 years before the repayment is due and others leave contacting borrowers as late as two months before the redemption date. We would suggest that it is better practice to contact borrowers reasonably early, to allow them to consider their options if they are not on track to repay the capital at the redemption date. In addition to annual reminders sent to borrowers, one firm intends to ask customers to give details of their repayment vehicles and whether they are on track to repay the outstanding loan ten years from the end of the mortgage term. In the absence of a satisfactory response, the firm will consider making arrangements for switching to a repayment mortgage. One firm places emphasis on keeping in touch with customers and offering periodic reviews of their product. They set up a dedicated review team which phones borrowers at certain 'trigger points' and asks specific questions about the sum assured and maturity dates of policies. If the firm identifies a shortfall, it offers to administer the loan on a part interest-only/ part repayment basis.

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