the perfect storm: background paper

Mick McAteer

The **Financial Inclusion Centre**

Promoting fair, affordable financial services

NCC National Consumer Council

Making all consumers matter

The NCC makes a practical difference to the lives of consumers in the UK, using its insight into consumer needs to advocate change.

We work with public service providers, businesses and regulators, and our relationship with the Department for Business, Enterprise and Regulatory Reform – our main funder – gives us a strong connection within government.

We conduct rigorous research and policy analysis to investigate key consumer issues, and use this to influence organisations and people that make change happen.

Check www.ncc.org.uk for our latest news.

The Financial Inclusion Centre is a not-for-profit think-tank.

Acknowledgements

The Financial Inclusion Centre and the National Consumer Council would like to acknowledge the following: representatives of the Council of Mortgage Lenders (CML), British Bankers Association, Intermediary Mortgage Lenders Association (IMLA), and Financial Services Authority who provided comments on the report, plus other organisations and firms who helped with the research.

Special thanks to MoneyFacts for access to data on mortgages and loans, and MoneySavingExpert.com for access to its forums which provided insight into the impact of market developments on consumers.

Published by the National Consumer Council
May 2008

PD 22/08

Contents

Executive summary

The perfect storm: the impact of the credit crunch on over-indebted consumers

There is compelling evidence that a perfect storm has been gathering, threatening the financial well-being of the most vulnerable consumers. Our analysis suggests that up to four million consumers may be adversely affected by changing financial conditions over the next few years.

The Financial Inclusion Centre (FIC) and the National Consumer Council (NCC) have examined what the unique mix of circumstances is really going to mean for UK consumers – who is most likely to lose out, and what can be done now to limit the impact, both short- and long-term.

The perfect storm

The financial storm is brewing up out of a mixture of factors. These include:

- **record debt levels**: with personal debt at £1.4 trillion, £1.2 trillion of that is secured on property.
- **an end to special mortgage rates**: an estimated three million fixed-rate and discounted mortgage deals will end in 2008 and 2009, leading to payment shocks of 20-50 per cent for many people.
- **the credit crunch**: lenders are tightening lending conditions, restricting availability of affordable credit and increasing interest rates.
- **rising prices**: essential bills, including food and utilities, are rising fast.
- **limited saving:** half of UK households have little or no savings to help them weather a financial storm[1].
- **falling house prices**: house prices fell by 2.5 per cent in March, 1.3 per cent in April 2008[2], and 2.5% in May[3], with some predicting falls of up to 15 per cent by 2010[4].

Who is vulnerable?

We estimate that up to four million mortgage customers are vulnerable to changes in financial market conditions and their personal financial circumstances. This includes:

- over-indebted and higher-risk consumers who face 're-rating' by lenders;
- borrowers coming off fixed or discounted-rate mortgages;
- first-time buyers;
- borrowers with interest-only mortgages; and
- borrowers in the non-prime or non-standard market (including the so-called sub-prime market).

---

[1] Table 5.9 Households by amount of savings and composition, Family Resources Survey 2005-2006, Department for Work and Pensions , http://www.dwp.gov.uk/asd/frs/2005_06/chapter5.pdf

[2] Halifax House Price Index, March and April 2008.

[3] Nationwide House Price Index, 29 May 2008

[4] Morgan Stanley chief economist David Miles, April 2008.

Probable impacts

- **Greater debt problems:** we predict a substantial increase in secured and unsecured debt, arrears and repossessions.
- **Non-prime expansion:** more consumers could be pushed into the non-prime or non-standard lending markets, where prices are higher.
- **Trapped consumers:** many people will be at risk of being trapped in expensive and potentially unfair mortgages and loans.
- **Bad choices:** more consumers will be exposed to poorly regulated private-sector debt consolidation and advice companies, and market innovations, such as sale and rent-back schemes, which are currently unregulated.
- **Inappropriate solutions:** equity release schemes and secured loans or second-charge mortgages are likely to be pushed aggressively as 'lifeboat' schemes for struggling consumers.
- **Damaged credit ratings**: these will impact on consumers' ability to access affordable credit and other financial products.

A positive response now from lenders and regulators and government can avert disaster for many of these consumers.

Policy recommendations

Measures to help ride out the storm

Policymakers and regulators face a huge challenge. They must strike the balance between improving regulation, to restore confidence in the UK's financial system, and protecting consumers without choking off access to affordable retail loans. Measures already taken by government and industry have been welcome, but more must be done. We have set out a number of practical policy recommendations, focused on one of the regulator's main principles for business: Treating Customers Fairly.

For industry

As a pro-active attempt to limit the impact of the 'perfect storm', we have developed guidance for industry on what Treating Customers Fairly should mean in practice in the mortgage market. This guidance is designed:

- to flesh out the principles relating to Financial Services Authority (FSA)'s Treating Customers Fairly, the voluntary Banking Code (which covers non-mortgage debt), and the Finance and Leasing Association Lending Code;
- to help the FSA and Office of Fair Trading (OFT) assess compliance with principles-based regulation, and to inform the FSA review of arrears management practices;
- to help industry to demonstrate Treating Customers Fairly compliance and support corporate social responsibility claims;
- to establish a more level playing field by promoting best practice in Treating Customers Fairly; and
- to limit the increase in arrears and repossessions by creating a package of 'intensive care' measures to help consumers.

Treating Customers Fairly: a checklist

Raise awareness

- Alert consumers to the potential impact of interest rate changes at point of sale and post-sale, using relevant examples and timing – for example, when fixed-rate deals are running out.

- Alert customers when enforcement action has been taken by regulators, highlighting the redress options open to them.

- Provide information on free independent advice agencies that can help with debt repayment plans and independent advice.

Target vulnerable customers

Set up dedicated intervention teams to target and assist borrowers who are in or who may face financial difficulty, specifically those who are:

- **vulnerable to arrears (pre-delinquency stage)**: for example, first-time buyers or those coming off fixed-rate deals. At this stage, raising consumer awareness and providing information on expected changes to repayments is important as it can help people to prepare and manage their budgets.

- **in early stage arrears**: at this stage, providing a range of options to borrowers who have missed one or two payments may prevent the problem escalating.

- **in serious arrears**: at this stage, discussing available options with consumers and directing them to specialist help or advice from independent sources for assistance may help to avoid repossession;

- **at repossession stage**: lenders should be considering repossession only as a last resort which should mean having followed the stages in this checklist.

Tailor solutions to circumstances

Develop a range of interest-rate relief options to bring mortgage repayments to an affordable level, to help borrowers manage short-term difficulties and avoid repossessions. Options could include:

- **payment holidays**;

- **temporary interest rate reductions** – with no direct or indirect penalties – to ensure that the consumer has sufficient remaining resources to cover their actual living costs leaving the consumer with a fair disposable income.

- **deferring unpaid interest to the end of the loan,** ensuring that the financial consequences of doing so are fully explained;

- **rescheduling or extending the loan period** to reduce monthly payments, ensuring that the financial consequences of doing so are fully explained; and

- **developing longer-term plans** for borrowers who face permanent reductions in income.

Reward action on debt management

- Suspend penalty fees for customers who participate in arrears management programmes.
- Consistently record positive credit data for borrowers who participate in arrears management programmes.

Suspend enforcement

Third-party collection agencies and court action should be used *only* as a last resort, after the first four steps in the checklist.

For the regulator

A clear and consistent approach

We support principles-based regulation. However, implementation of Treating Customers Fairly appears to have been slow to respond to market innovation, market complexity and the displacement of risk within the financial system. The FSA needs to be clear about how these principles apply in practice, and must be prepared to enforce them effectively.

- **The FSA should increase its emphasis on principles-based regulation ensuring that it sends clear and consistent messages to all lenders on striking the right balance between Treating Customers Fairly and managing credit risk.**

Sales and promotions review

Previous weak regulation governing the sales and promotion of mortgages and loans meant that irresponsible lending and some unscrupulous practices were not effectively controlled. Many consumers did not understand the risks involved. There are also concerns that commission payments may distort behaviour in the mortgage market.

- The FSA should use its effectiveness review of Mortgage Conduct of Business Rules and its work on the Retail Distribution Review to ensure that consumers have the same protection and clarity around sales and advice for mortgages as for other investments.

Transparent enforcement

To create a level playing field for responsible lenders, the FSA should:

- take tough and transparent enforcement action against lenders who have breached Treating Customers Fairly rules;

- require lenders who have breached the rules to contact borrowers to alert them to the potential for redress; and

- call for the removal of any barriers to transparency that it may have identified in the Financial Services and Markets Act.

Unfair contracts

Our analysis suggests that some of the contract terms in the non-prime market are potentially unfair, and possibly even contrary to the requirements of unfair contracts and commercial practices regulations.

- The FSA should convene a working group with the Office of Fair Trading to investigate whether contract terms in non-prime mortgages and loans are unfair and to establish a plan of action for dealing with any breaches.

Introduction

Both overseas and in the UK, chaos in the financial systems has filtered down and is impacting on borrowers. In the past year the terms 'credit crunch' and 'sub-prime' have moved out of the financial pages and onto the front pages of the UK's media and our television screens. Record debt levels, low saving and the rising cost of essential goods and services have created the conditions for a 'perfect storm' which is affecting the financial well-being of consumers[5]. How this will play out for mortgage customers over the next few years will depend very much on the response from lenders and the regulator. This situation requires consideration of a number of connected issues, including:

- **the impact of the credit crunch and market changes on vulnerable consumers.** Up to four million people in the mortgage market are vulnerable – including first-time buyers, the estimated three million coming off fixed rate mortgage deals in 2008 and 2009, the over-indebted, borrowers with interest-only mortgages, and borrowers in the non-prime or non-standard market[6];

- **clear and consistent regulation of the financial system and firms.** The importance of clear and consistent messages is arguably greater since the Financial Services Authority's (FSA) move to principles-based regulation. Regulation needs to strike a difficult balance between protecting consumers, by enforcing the Treating Customers Fairly principle, and maintaining consumer confidence in the financial system. But at the same time it must give industry the right steer on managing credit risk, to maintain stability and avoid an overkill in restricting credit;

- **the impact on the UK housing market.** The UK's dependency on property means that the both economy as a whole and individual consumers are vulnerable to shocks in the housing market.

This report from the National Consumer Council (NCC) and The Financial Inclusion Centre (FIC) is particularly concerned with the impact of the perfect storm on vulnerable consumers in the mortgage market; this will have far-reaching economic, social and political consequences. We will look at what lenders, regulators and others can do to limit the impact of the impending crisis.

Vulnerable consumers: who and how many?

The groups of consumers we were concerned about included:

- borrowers coming off fixed- or discounted-rate mortgages;
- first-time buyers;
- borrowers with interest-only mortgages; and
- consumers in the so-called non-prime (including sub-prime) or non-standard market.

[5] Appendix II summarises the impact of different factors on consumers.
[6] See appendix I for estimates of numbers of consumers affected

Mortgage market variation

The UK's 11.8 million mortgages are made by a variety of lenders. The lenders differ on pricing, the scale and focus of their businesses and how they treat their customers. It is to be hoped that the mortgage industry generally adopts the standards of the best, and drives out the worst, in both the mainstream and non-prime markets. However, incidents where customers have not been treated fairly by their lender, and recent changes in lenders' approaches, give cause for concern.

Methodology

To assess the impact of market changes on consumers we used a combination of primary and secondary, quantitative and qualitative methods, including:

- modelling the impact of interest rate changes on borrowers;
- assessing whether lenders' policies and practices were affected by the credit crunch. This was done by undertaking a survey and interviews with major lenders in the market, analysing Bank of England research, and analysing databases to track changes in product offerings and terms and conditions;
- interviewing trade bodies and the FSA to understand their response to the unfolding crisis;
- undertaking comparative analysis of interest rates and charges in the prime (standard) and non-prime markets;
- secondary research to estimate the growth of the non-standard market; and
- policy analysis of the regulatory framework.

The appendices contain further detail background data and information.

Background to the crisis

The evidence we have gathered, and that of other commentators, paints a bleak picture for UK borrowers. The credit crunch is already biting and this must be considered in the context of the total level of personal debt in the UK.

Debt:

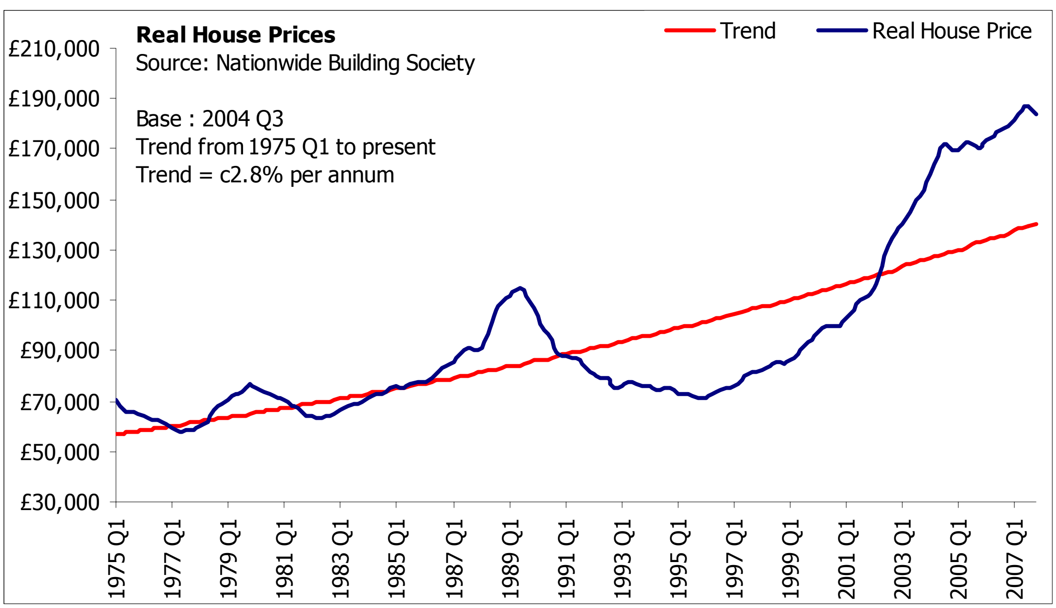
- Total UK personal debt stands at nearly £1.4 trillion – an increase of nearly ten per cent on 2006.

- Total lending secured on homes stands at £1.2 trillion – an increase of nearly ten per cent on 2006.

The level of secured debt as a percentage of disposable income reached 126 per cent in the third quarter of 2006, while unsecured debt as a percentage of disposable income amounted to 26 per cent. This is a considerable increase on the levels of 76 per cent and 15 per cent respectively in the late 1980s[7].

Much of the massive increase in total personal debt can be attributed to the housing market. House prices in the UK have grown by around 11 per cent a year over the past ten years (see Chart 1). The average household debt including mortgages in May 2008 was £57,420[8].

Chart 1: Real house prices



[7] P.92, Financial Risk Outlook, Financial Services Authority 2007
[8] Debt Statistics, Credit Action, May 2008

Average household debt in the UK excluding mortgages is £9,216[9]. However, this figure increases to £21,433[10] if the average is based on the number of households who actually have some debt.

Debt advice

In 2006/7, Citizens Advice Bureaux in England and Wales received record numbers of debt enquiries – a total of 1.7 million, an increase of 20 per cent over the year and double the figure of ten years ago. Debt is now the number one issue the bureaux advise people on; accounting for one in three of all enquiries.

Credit and mortgages

Research by housing charity Shelter found that a million consumers had resorted to using their credit card to pay the mortgage or rent in the past year.

Mortgaging the future

The huge increase in property prices explains much of the growth in personal debt. From 1997-2007 the average house price rose by 11.4 per cent a year[11], while wages grew by 4.2[12] per cent. By definition, this has pushed up house price-to-income ratios.

Mortgage/income ratios

While property prices and mortgage-to-income ratios are at record levels, this appears to be offset by the fact that interest rates are currently much lower than in 1990. In the third quarter of 1990, interest payments represented 27 per cent of net income. At December 2007 the level stood at almost 21 per cent[13].

The last time the interest payments-to-net income ratio was at current levels, UK base rates were around ten per cent. Base rates for the first quarter of 2008 have been between five and 5.5 per cent, which suggests that each upward tick in interest rates is now having a much greater negative leverage effect. This is because house prices have significantly outstripped growth in incomes, thereby inflating the size of loans advanced.

In December 2007, the average mortgage advance for first time buyers was running at 3.36 times income[14] – one of the highest level on record – which means that capital repayments now take up a higher proportion of income.

Postponing payments

Significant numbers of borrowers are attempting to make home-buying affordable by 'putting off' repayments.

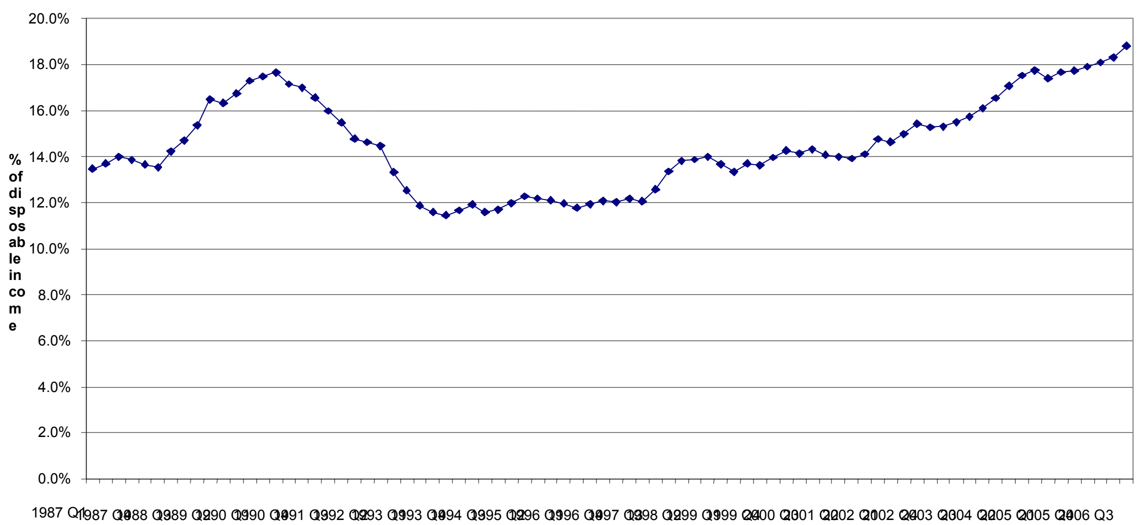
9 Debt statistics, Credit Action, May 2008, http://www.creditaction.org.uk/assets/PDF/stats/2008/may.pdf
10 Debt statistics, Credit Action, May 2008 http://www.creditaction.org.uk/assets/PDF/stats/2008/may.pdf
11 Derived from Nationwide House Price Index.
12 Derived from Office for National Statistics Average Earnings for the whole economy, seasonally adjusted, Q4 1997-Q42007
13 Table ML2, First time buyers: lending and affordability, Council of Mortgage Lenders, 2008
14 Table ML2, First time buyers: lending and affordability, Council of Mortgage Lenders, 2008

- Repayment mortgages have fallen from 90 per cent of mortgages for first-time buyers in 2003 to a low of 65 per cent in 2007.
- Interest-only mortgages (where the means of repayment has not been specified) went up from 5 per cent in 2002 to 22 per cent in 2007.

This makes a mortgage affordable in the short term. For example, a borrower with a typical £150,000 mortgage would pay just under £729 per month on an interest-only mortgage, whereas they would pay £950 with a repayment mortgage[15]. But while interest-only mortgages can seem cheaper in the short term they can be more expensive over the long haul, as repayment of capital is put off. This undermines the usefulness of the 'interest payments-to-net income' ratio as a measure of affordability or indebtedness.

It is important to look at the level of debt in the economy at the aggregate level. PriceWaterhouseCoopers estimates that total debt servicing costs (including principal, as well as interest, payments) accounted for nearly 20 per cent of household disposable income in 2007; the previous peak was 18 per cent in the third quarter of 1990 (see Chart 2).

Chart 2: Total debt servicing costs



Source: PwC estimates based on ONS and Bank of England data

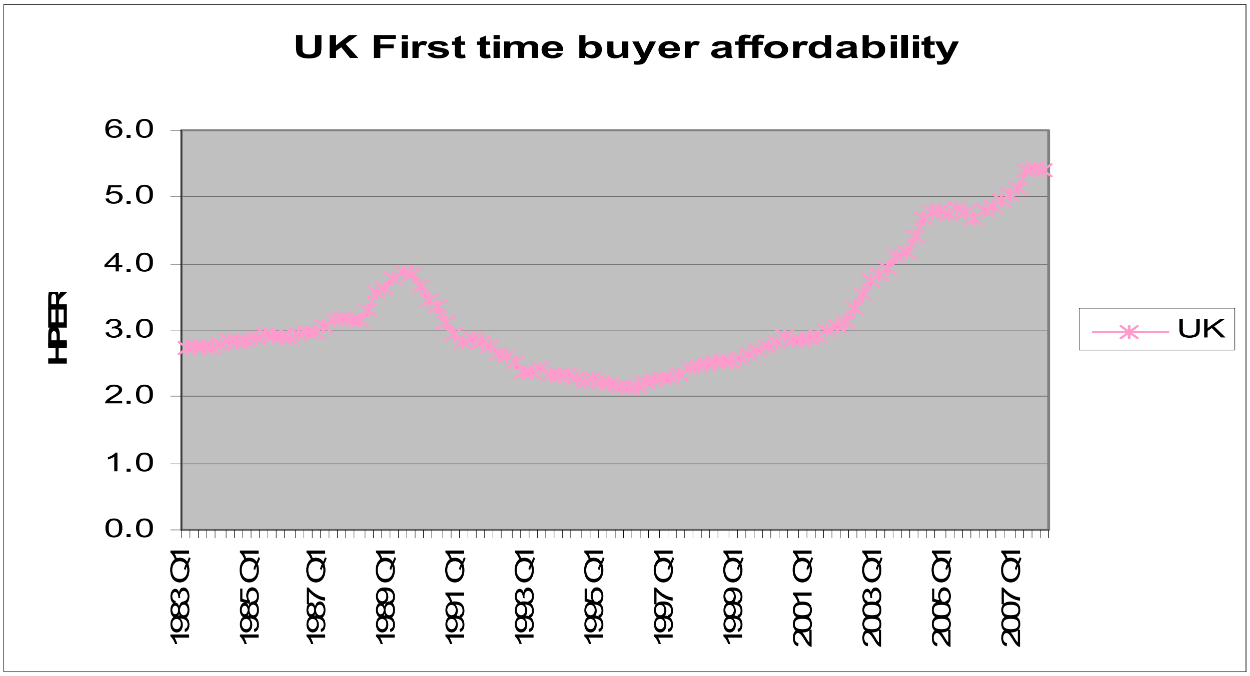
Interest rate shocks

First-time buyers are vulnerable to changes in interest rates. As Chart 3 shows, house prices stood at 5.4 times annual earnings in the fourth quarter of 2007 – the highest figure on record. On the eve of the property crash in the early 1990s the gap was over 20 per cent less, with house prices averaging four times income. While interest rates are much lower now than in the early 1990s, the gearing effect is greater and total debt is higher now, by some measures, than it was then.

---

[15] Based on May 2008 interest rates.

Chart 3: House price-to-earnings ratios (HPER)



Source: Nationwide

Higher loan-to-value ratios

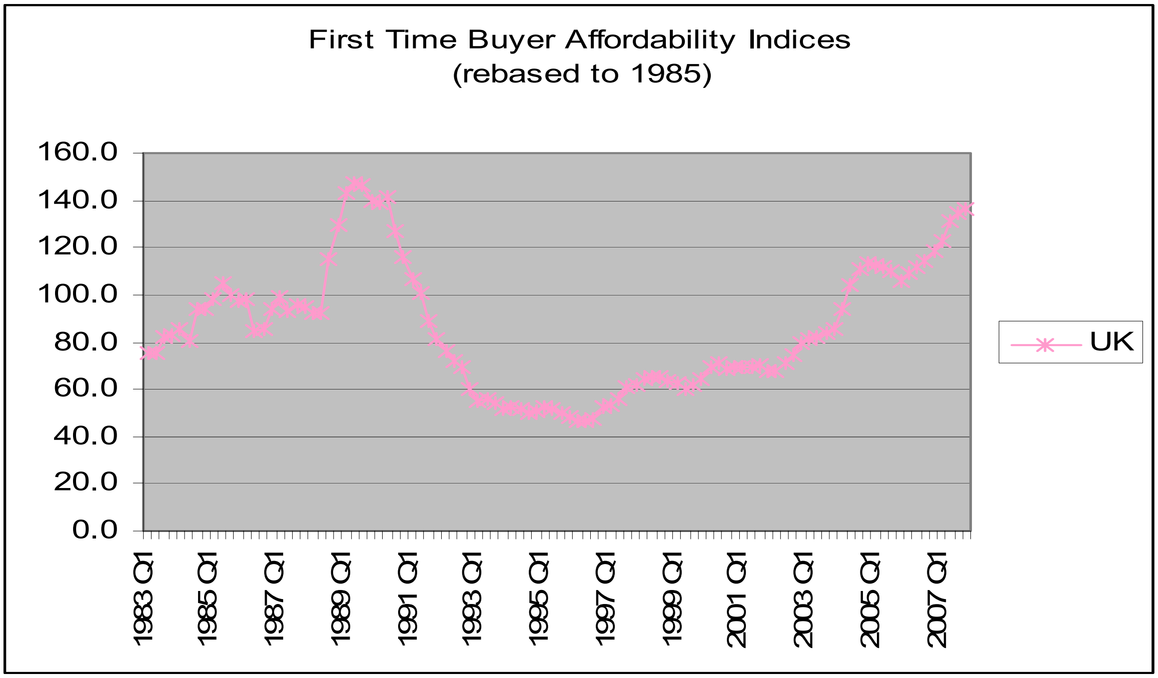
Higher loan-to-value ratios and rising property prices leave first-time buyers exposed to greater interest rate risk.

- In 2006 the average loan-to-value for a first-time buyer was 90 per cent[16], compared to an average 72 per cent for consumers moving home[17].
- In May 2008 the average mortgage for a first-time buyer was 3.36 times income.
- The 'typical' two-income couple buying their first home at the beginning of 2007 would have had to commit 34 per cent of their take-home pay to service their mortgage – the highest level since 1990[18].

Looking at affordability overall for first time buyers, there is real cause for concern. Affordability is already stretched to levels last seen around 1990 – and these indices do not yet reflect the impact of the end of fixed-rate and discount rate deals.

[16] Table ML2, First time buyers: lending and affordability, Council of Mortgage Lenders, 2008
[17] Table ML2, First time buyers: lending and affordability, Council of Mortgage Lenders, 2008
[18] Debt statistics, Credit Action, June 2007.

Chart 4: First-time buyer affordability index



Source: Nationwide

Bank of England research suggests that mortgage/income gearing levels are rising. This should be no surprise, given the increase in property prices. The percentage of those with mortgages spending more than a fifth of their income on servicing mortgage debt has risen from 19 per cent to 34 per cent between 1995 and 2006[19]. The higher the level of mortgage gearing, the more likely people are to have problems with mortgage repayments. This is also borne out by econometric analysis[20].

On the edge

These levels of household debt appear to leave huge numbers of consumers vulnerable to changes in the market. We can't say for sure whether we will see a return to the conditions of early 1990s, with increases in repossessions and so on. Indications are that our high employment levels should minimise the impact. However, changes here could be devastating.

[19] Derived from: Chart 5 Distribution of mortgage income gearing, The State of British Household Finances: results from the 2006 NMG Research Survey

[20] For example see May and Tudola, 2005

The perfect storm

The elements likely to affect the mortgage market are the end of fixed-rate and discounted rate deals, and the way lenders behave in response to the credit crunch.

The end of fixed-rate and discounted rates

An estimated three million borrowers will come off fixed-rate or discounted-rate mortgages by the end of 2009. This rises to over four million if figures from the second half of 2007 are included[21].

We estimate that these fixed and discounted loans were taken out at an average interest rate of 4.84 per cent in 2006. The average fixed rate in December 2007 was 6.3 per cent – a substantial difference. However, because of the credit crunch, many borrowers may not be able to roll over to new fixed rates and could find that their loans will revert to lenders' Standard Variable Rates (SVRs) and not new base-rate trackers. The SVR of the major UK lenders was 7.5 per cent as at December 2007[22].

We estimate a rise in payments of between 20 and 50 per cent for borrowers coming off fixed-rate and discounted-rate mortgages[23].

Increases will depend on individual circumstances and borrowers' ability to renegotiate a new deal. But increases in utility, food and other essential household outgoings mean that a sudden hike in mortgage payments may become unsustainable for many consumers. The attitude of lenders towards borrowers who get into difficulty will be critical.

Treating Customers Fairly requirements emphasise the importance of communication with consumers *after* the point of sale. However, our research indicates that few lenders seem to be writing to borrowers far enough in advance about the potential impact of the increase in monthly payments so that they can plan ahead.

Lender behaviour in response to the 'credit crunch'

To assess how lenders were behaving in response to the credit crunch we surveyed lenders, and analysed information in the public domain, including Bank of England surveys on credit market conditions.

---

[21] See appendix III for estimates of numbers of borrowers coming off fixed and discounted deals.
[22] Source: average of Bank of England interest rate data. Rates for April 2008 were 7.2 per cent
[23] See appendix III for full matrix of increases.

FIC research findings

Our research suggests that most lenders have changed their lending policies and practices since August 2007. The main changes include:

- tightening lending criteria, for example by reducing LTVs or mortgage income multiples;
- changing the way they assess borrowers' ability to repay; and
- withdrawing or restricting availability of products.

Few lenders seem to have a policy of writing to borrowers coming off fixed-rate deals to alert them to the potential impact of their fixed- or discounted-rate deal ending. However, lenders point out that they are likely to be in touch with borrowers whose deals are ending, for competition purposes – that is, to retain them as customers. Lenders also say that the new revisions to the Banking Code will require them to be pro-active in identifying borrowers who may be in financial difficulty.

Some lenders allow non-prime customers to migrate from non-prime mortgages to prime mortgages after certain periods. However, because of commercial sensitivity we were unable to obtain precise details on policies. However, in the current risk-averse climate lenders may be less likely to allow sub-prime borrowers to migrate to prime mortgages.

Lenders are expecting an increase in the number of customers getting into financial difficulties over the coming year. However, few were able to show us detailed, published policies or action plans for treating individual borrowers fairly. Lenders say they are revising their policies, both in light of changing market conditions and as a result of guidance from the FSA. This may be one reason why we could not locate published policies on their websites. In addition, it was difficult to find many mainstream lenders' tariff of fees charged to borrowers in arrears. Overall, there is significant scope to improve transparency around how borrowers in financial difficulty are treated.

Similarly, although lenders have collections teams, few lenders operated dedicated teams, websites, or telephone help lines for borrowers facing or already in financial difficulties.

Lenders say they offer customers in arrears several options, including allowing customers to refinance or extend the term of the loan, to take payment holidays, or to make underpayments. However, detailed policies were not available as lenders said these options would be offered on a case-by-case basis.

Bank of England research

The Bank of England market survey[24] reinforces the view that lenders are significantly tightening lending conditions.

Contrary to expectations in the previous survey, lenders reported that between mid-September and mid-December 2007 the level of secured credit available to households showed a marked reduction. They expected this trend to continue.

It was felt that lenders were reducing their risk appetite, targeting a slightly lower market share. The Bank of England thinks that this change may be due to a reduction in the lenders' ability to transfer risk off their balance sheet, together with reported tighter conditions for raising new capital.

However, concerns about the macroeconomic outlook, including the housing market, were also important considerations.

Confirming other evidence that lending conditions are tightening, the Bank of England reports that lenders achieved this reduction in the availability of secured credit in part through a tightening of credit-scoring criteria, and by reducing maximum loan-to-value ratios.

Spreads on secured lending to households were reported to have increased significantly between September and December 2007; this is critical in terms of the impact of interest rate changes on consumers. Further increases were expected over the next three months. For consumers who are becoming overstretched, a reduction in headline base rates will provide some needed respite.

Table 1: Changes in lending spreads

		June	September	December
How have overall secured lending spreads changed?	Past three months Last three months	38.5 -18.7	-17.6 4.3	-56.2 -17.9
of which: spreads on prime lending(a)	Past three months Last three months	42.1 -18.7	-17.0 5.0	-53.2 -9.8
of which: spreads on other lending	Past three months Last three months	-1.1 -3.4	4.4 -4.5	-53.8 -12.0

Source: Bank of England, Credit conditions survey 2007, Q4

Default rates on secured lending to households were reported to be broadly unchanged in the last quarter of 2007, though the actual losses on loans in default had risen by more than expected. Lenders expect default rates on secured lending, and losses on default, to increase even further.

[24] Credit Conditions Survey 2007 Q4, Bank of England.

Demand for prime lending for house purchase was weaker than expected. A significant proportion of lenders reported that demand for buy-to-let lending, and other secured lending (for example, loans to borrowers with poor credit histories) was stronger than expected. A number of these lenders who reported increased demand for buy-to-let and other secured lending commented that the strong demand for their products was related to other lenders cutting back on credit availability. This supports the view that, as lenders tighten their lending criteria and more consumers become non-standard risks, the non-prime market is set to grow.

Pressure on household bills

In addition to potentially significant increases in mortgage costs, the cost of many other core goods and services is rising. The All Items Retail Prices index rose by 4.3 per cent in the year to November 2007. The result for consumers has been:

- housing costs up by 9.9 per cent;
- food costs up by 5.3 per cent; and
- transport costs up by 4.8 per cent.

Fuel bills are rising again after a period of reductions: price rises averaging 15 per cent are expected in 2008. The consumer watchdog, energywatch, estimates that some bills will rise by £95 a year for gas and £64 for electricity, pushing average annual bills back through the £1,000 barrier to £1,056[25].

With the cost of major items of non-discretionary spending set to continue rising, many consumers will not have the spare capacity to deal with a substantial increase in mortgage costs as well.

The long-term burden of mortgage debt may be higher than people realise, given the likelihood that the real value of the mortgages will not be eroded by inflation nearly as fast as it was in the 1970s and 1980s. As initial low-interest deals run out and principal eventually has to be repaid, the real costs of servicing mortgage debts are likely to rise over the lifetime of loans.

[25] Energywatch press release 4 January 2008: www.energywatch.org.uk/media/news/show_release.asp?article_id=1077

Can consumers cope?

Safety nets

Safety nets will be increasingly important as more consumers get into financial difficulty.

There are a number of mechanisms in place that are meant to safeguard consumers, or at least cushion them from the blow. The key safeguards are:

- consumers' own financial resources – their savings, and access to alternative sources of finance such as equity release;
- the attitudes and policies of lenders towards consumers in financial difficulties;
- regulatory and other consumer protection measures; and
- welfare safety nets.

Vulnerable people

FSA research indicates that with little in the way of savings to replace lost income, and a reliance on borrowing to make ends meet, over a quarter of consumers in households where at least one person is in paid employment are vulnerable to an income shock. The most vulnerable groups are those on a low income and those who are currently struggling and over-indebted[26].

However, even consumers who are financially sound or managing reasonably well could face difficulties if they were to experience even a temporary fall in income.

Restricted headroom

Many consumers will have built up savings which will allow them to cushion the impact of interest rate rises or a change in personal circumstances. However, the low level of personal savings in the UK, and the profile of non-mainstream consumers, suggest that this is simply not an option for most vulnerable consumers. In addition, changes in disposable income suggest that the option for consumers to rein back on discretionary spending is quite limited as the table below shows.

Table 2: Household income and spending trends average annual growth

	1995-2006	2004-2006
Household disposable income (after tax)	4.9	4.7
Non-discretionary spending (of which)	4.5	6.3
- electricity/ gas	3.6	15.0
- water	4.7	8.9
- rental payments	5.4	5.6
Debt servicing costs	9.0	10.7
Discretionary disposable income	4.2	3.1

Figures in percentages. Source: PwC

[26] p85, Financial Risk Outlook 2007, Financial Services Authority , http://www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2007.pdf

Debt servicing costs

Despite base rates being comparatively low in nominal terms, debt service costs appear to take up a greater proportion of household disposable income than they did in the late 1980s and early 1990s.

- Household disposable incomes rose by 4.9 per cent a year from 1995-2006.

- Debt servicing costs rose by nine per cent a year over the same period.

Closer analysis of recent trends suggests that the increase in debt servicing costs has accelerated over the past three years.

- Debt servicing costs increased by 10.7 per cent 2003- 2006.

- Disposable income rose by 4.7 per cent over the same period.

Non-discretionary spending rising

As well as debt servicing costs outstripping disposable incomes, it is important to look at how the components of spending have changed. Consumers spending can be divided into discretionary and non-discretionary (for example, on electricity and gas) spending. Spending on non-discretionary items has gone up since 2005 and is forecast to rise further.

Limited savings

Consumers who struggle to cope with increases in their mortgage payments may be able to draw down on savings they have built up. However, not everyone is able to withstand a deterioration of their financial circumstances.

- 28 per cent have no savings at all[27].
- 20 per cent of people with a mortgage said they had no savings [28].
- 49 per cent UK households don't have savings of even one month's income to fall back on[29].

Table 3 – savings levels

Weekly income	No savings	<£1,500
£300-400	34 per cent	22 per cent
£400-500	29 per cent	24 per cent
£500-600	25 per cent	24 per cent
£600-700	18 per cent	24 per cent

Source: Family Resources Survey, Section 5: Assets and Savings, Table 5.12: Households by amount of savings and total weekly household income

[27] Table 5.9 Households by amount of savings and composition, Family Resources Survey 2005-2006, Department for Work and Pensions , http://www.dwp.gov.uk/asd/frs/2005_06/chapter5.pdf

[28] Access to Financial Services by those on the Margins of Banking Final Report November 2006 Prepared for the Financial Inclusion Taskforce by BMRB Social Research. See appendix for full table.

[29] 49% households in the UK have less than £1,500 in savings, Family Resources Survey, Table 5.9. Average gross monthly earnings in the UK are £2,145 a month. Derived from Labour Force Survey (LFS) Historical Quarterly Supplement –Table 37: Average gross weekly/hourly earnings by industry sector *(£s - not seasonally adjusted)*

Perceived burden of debt

Consumers on lower incomes perceive the debt they face to be a greater burden than consumers on higher incomes. The impact of even relatively small increases in interest rates will have a huge leverage effect on them.

Table 4 – perceived burden of debt[30]

	Under £10k	£10-20k	£20-30k	Over £30k
A burden: (of which)	33 per cent	31 per cent	28 per cent	24 per cent
- something of a burden	17 per cent	17 per cent	22 per cent	20 per cent
- a heavy burden	16 per cent	14 per cent	6 per cent	4 per cent

Interest rate changes

Work done by the FSA on how interest rate changes might affect consumers showed that 20 per cent fewer consumers would be able to pay their mortgage and other financial commitments without difficulty if mortgage payments rose by ten per cent (see Table 5 below). This equates roughly to a 0.5 per cent increase in base rates.

End of fixed and special-rate deals

People coming off fixed rate and discount deals over the next few years are likely to face very sharp and significant payment increases whether they revert to lenders' SVRs or move onto new fixed rate deals. Many could be facing an increase in monthly payments of between 20 and 50 per cent. This would put large numbers of households under strain; Credit Suisse has argued that one million mortgage borrowers may see their repayments rise by a third[31].

Table 5 suggests that a 20 per cent increase in payments would not have a much greater effect than a rise of ten per cent, in terms of the numbers who would struggle to pay their mortgage. Possible explanations for this are either that a ten per cent or 20 per cent increase in mortgage payments would have the same effect, or respondents find it hard to conceive what the impact of a 20 per cent rise in payments would be.

30 Data taken from table 8c, p97, Access to Financial Services by those on the Margins of Banking Final Report November 2006 Prepared for: Financial Inclusion Taskforce Prepared by: BMRB Social Research

31 Croft, J, 'Time bomb for 1m mortgages', *Financial Times*, 2 June 2007

Table 5 coping with increase in mortgage payments[32]

	Current situation	10 per cent rise	20 per cent rise
Pay mortgage and other commitments without difficulty	**82 per cent**	**61 per cent**	**60 per cent**
Pay mortgage, struggle with other financial commitments	**14 per cent**	**27 per cent**	**25 per cent**
Struggle to pay mortgage/ financial commitments	**3 per cent**	**10 per cent**	**10 per cent**
Struggle to pay mortgage, fall behind with other financial commitments	**<1 per cent**	**@2 per cent**	**4 per cent**
Fall behind with mortgage payments/ other financial commitments	**<1 per cent**	**@1 per cent**	**1 per cent**

Falling further into the red

Financial comparison website Moneyexpert.com claims that as many as 6.9 million bills went unpaid since June last year[33]. It found that:

- council tax bills are most likely to be overlooked;
- 2.3 million people – around one in twenty adults – claim to have paid their council tax late or not at all in the first half of 2007;
- 1.39 million people said they struggled to pay either a gas or electricity bill on time in the second half of 2007; and
- five million credit card-holders failed to make payments on time in 2007[34], affecting their credit ratings.

Economic and employment factors

The other key factor in predicting the number of consumers who will fall into arrears or face repossession is the state of the economy – in particular, employment levels. There are significant differences between the economic conditions in the late 80s or early 90s and now. The unemployment rate in 2008 is 5.3 per cent, compared to around nine per cent when repossessions were at their highest in 1991-2. However, on some measures debt affordability is even more stretched than it was in the early 1990s, and consumers are more vulnerable to changes in market conditions.

---

[32] Data derived from Chart D, P85, Financial Risk Outlook 2007, Financial Services Authority

[33] See: www.moneyexpert.com/ContentArticle/None/UNPAID-BILLS-PILE-PRESSURE-ON-HOUSEHOLD-BUDGETS/

[34] Moneysupermarket.com survey carried out between 19th-21st December 2007 http://www.moneyexpert.com/ContentArticle/None/Unpaid-bills-pile-pressure-on-household-budgets/Article.aspx?articleID=342&productTypeID=0

Evaluating the impact on consumers

Significant numbers of consumers are already struggling with personal debt. They are likely to be seriously affected by changes in the market.

Not all consumers coming off fixed rate deals, or already in the sub-prime market, will face increased mortgage payments. However, many will. Their bills could increase by between 20 and 50 per cent[35]. The extent of the increase will depend on individual circumstances and consumers' individual ability to renegotiate a good deal. Of particular concern are consumers who get into difficulties and fall into arrears or face repossession.

An incomplete picture

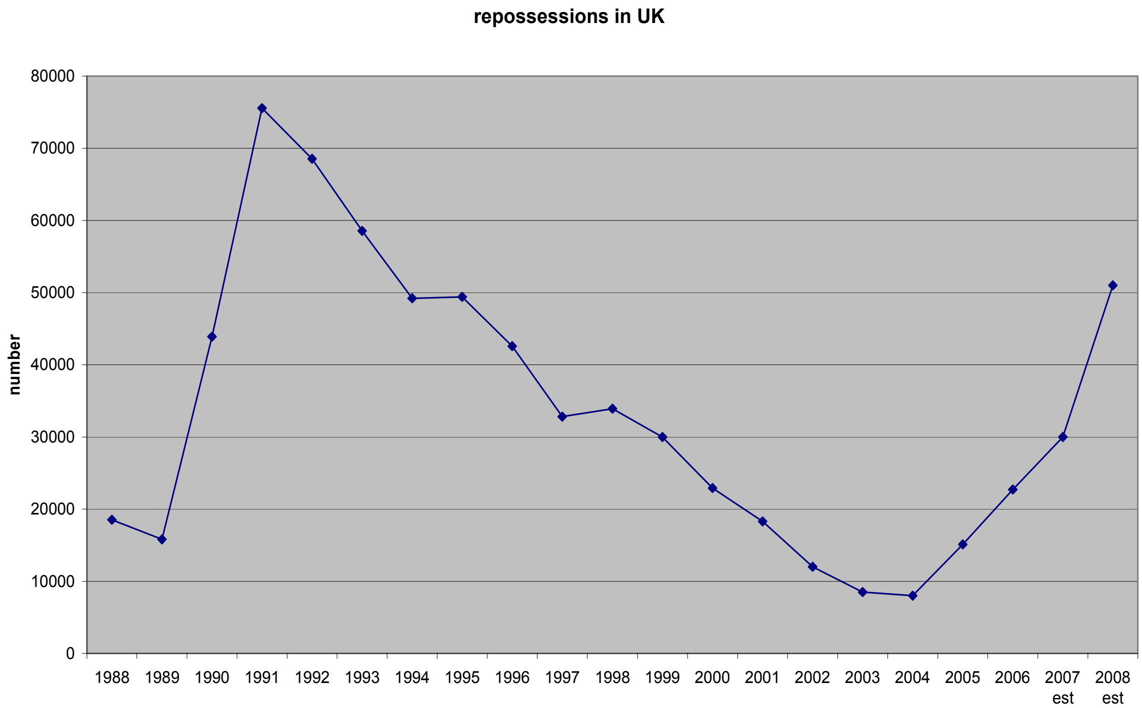
Trying to build an accurate picture of the problem is critical to developing effective policy solutions. In the absence of consistent, accurate long-term data it has not been possible to create an accurate econometric model to estimate the correlation between market changes and the number of people in arrears or repossessions. But the Financial Inclusion Centre has developed an 'implied' model, which has allowed us to try to assess this impact.

The Council of Mortgage Lenders (CML) estimates that repossessions in 2008 will rise to 45,000 – up from 27,000 in 2007.

However, this may be an underestimate. FIC is of the view that the figure could be closer to 50,000 unless there is some form of concerted intervention. Our estimates are set out in the chart below.

[35] See appendix IV for break down of various interest rate combinations on borrowers.

Chart 5: FIC estimates of repossessions[36]



One of the main reasons for this higher figure is the growing role of the sub-prime sector. The CML's figures for arrears and possessions are estimates and relate only to first-charge lenders who are members of the CML. They do not include arrears and repossessions relating to other secured lending or firms that are not CML members. The housing charity Shelter forecasts up to 53,000 repossessions (including those resulting from secured loans).

Arrears in the sub-prime sector are running significantly higher than in the mainstream market. Sub-prime lenders also tend to be quicker to repossess if borrowers get into difficulty[37].

Limiting the impact

The number of people who get into serious difficulties will depend on the pattern of interest rates over the coming period and how the wholesale markets respond. If there are significant Bank of England interest rates cuts or wholesale market rates reductions – and, critically, if lenders pass on these cuts to consumers – the numbers affected will clearly be lower.

But there are a number of factors that mitigate against this positive scenario; in particular, record levels of personal debt.

[36] Please note that the CMLs historical data has been revised recently and it has warned that care should be taken when making direct comparisons with previous years. Therefore, these figures should be seen as guides to the trends. However, the critical point here is trying to establish the general trend.
[37] Set up to fail, Citizens Advice, December 2007.

Base rate cuts limitations

Base interest rates in May 2008 stood at five per cent, however rises in inflation make significant further reductions unlikely in 2008. The effect of base rate cuts on consumers depends on how lenders respond. The picture so far hasn't been wholly positive, despite talks with government to get movement on this issue. It may be that rather than passing any rate cuts on to borrowers, lenders could use base rate reductions to rebuild their margins.

Competition has squeezed margins on retail mortgages – down from 1.1 per cent in 1999 to 0.38 per cent in 2007[38]. In the current economic circumstances lenders will be under pressure to rebuild these margins, which will limit their ability to pass on base rate or wholesale funding rate cuts.

However, even when base rate reductions are passed on they are likely to be of more benefit to consumers in the mainstream market – those who are considered a good risk. Consumers who are considered a non-standard risk – a group that is growing – are unlikely to see the same benefits as mainstream consumers.

A two tier market

Bad news for some consumers may turn out to be good news for others. Despite the turmoil in the mortgage markets, some more fortunate consumers may benefit. Consumers who are still considered a good risk may be able to access good deals, and savers may benefit because of the competition to attract their deposits.

The growing non-standard market

Many more consumers will be pushed out of the mainstream mortgage market into the non-standard markets[39]. It is difficult to estimate accurately the number of non-prime consumers, as definitions change between lenders and over time. However, the available research suggests that the number of consumers who are considered non-prime or non-standard has grown hugely – and will continue to grow.

- Nearly one in three borrowers could be considered non-standard in some way[40].
- Nearly one in five mortgages written in 2007 was non-standard – either sub-prime or self-certified[41].
- The non-standard market is worth an estimated £125 billion[42].

---

[38] As defined by spreads of effective rates on stocks of lending over appropriate funding costs. See chart 16, Speech by Paul Tucker, Executive director, Markets (and a member of the Monetary Policy Committee), Monetary Policy and the Markets Conference, London, 13 December 2007

[39] We use this as a general term for sub-prime, adverse credit, non-conforming loans market

[40] Non-standard includes: existing 'sub-prime' borrowers; consumers who have recently or will miss payments/ household bills and need to remortgage; plus others who are self-employed or who do not have regular incomes. Mintel Oxygen Reports - Non-Standard Lending - Nov 2007, http://www.mintel.co.uk/press_releases/309266.htm

[41] The Intermediary Mortgage Lenders Association (IMLA) which represents sub-prime and other non-standard lenders

[42] Non-Standard Lending, Mintel Oxygen Reports, Nov 2007

Growing sub-prime market

The sub-prime sector is a significant part of the non-standard market, and it is also growing fast.

- There are now an estimated 4.2 million sub-prime customers in the UK[43].
- The sub-prime mortgage market grew by 28 per cent during 2006 and is worth £25 billion[44].
- The sub-prime sector is forecast to grow at twice the rate of the mainstream over the next five years and will be worth £32 billion by 2011[45].

A growing divide

A fundamental shift in the credit market may be underway, with greater emphasis on the stratification of borrowers or households into standard and non-standard risks. This follows a major rise in home ownership, as millions of consumers became home owners for the first time, facilitated by policy initiatives such as the government's Right to Buy scheme and liberalisation of the market.

Long-term trends

On some measures, one in three households could be considered as non-standard risks. Changes in socio-demographics and the labour market (with more people self-employed), and increasingly sophisticated risk-based, differential pricing strategies by lenders, mean that this trend is not likely to reverse. This has major implications for consumers, lenders, regulators and policymakers (in terms of financial exclusion). The two major concerns here are the cost to consumers of non-prime mortgages and the behaviour of lenders in the market.

A high price to pay

Consumers who are considered a poor risk by the market pay a higher price. Our research has found that many non-prime lenders increased their interest rates by around 0.5 per cent between September and December 2007. The typical SVR on a non-prime mortgage at the end of 2007 was nine per cent – 3.5 per cent above the base rate.

Additional charges

Many lenders, both non-prime and mainstream, have also increased their arrangement fees. Borrowers may now face arrangement fees of £1,000 and early redemption penalties of five to six per cent of the money redeemed. In addition, some lenders charge late payment or arrears fees of £40 a month, adding nearly £500 a year to arrears rather than easing the burden[46].

---

[43] UK Sub-prime Mortgages 2007 (Segment Report), Datamonitor, July 2007
[44] UK Sub-prime Mortgages 2007 (Segment Report), Datamonitor, July 2007
[45] UK Sub-prime Mortgages 2007 (Segment Report), Datamonitor, July 2007
[46] FIC research found that in some cases, lenders charge £50 per month arrears fees until the arrears are cleared, plus additional interest on arrears, £20-30 for each direct debit/ cheque missed, plus £100 for sending a debt counsellor to visit the borrower

Reduced choice

In addition to all this, there are fewer non-prime products on the market. The data collection organisation Moneyfacts, found a 70 per cent reduction in the number of products available[47], and several providers have withdrawn from this market completely. The reduced supply of both products and providers raises concerns about competition in the market. Just as more vulnerable consumers are pushed over into the non-prime market, competition may be becoming less effective.

Consumer detriment

Many lenders in the non-mainstream market operate fairly and to high standards. And this market serves a consumer demand for non-mainstream credit. However, the behaviour of some lenders in the non-prime market has been criticised. FSA and Citizens Advice research point to serious detrimental practices in the non-prime market, along the entire mortgage supply chain – at the point of sale, treating consumers fairly when in arrears and during repossessions.

Failure to remedy these problems could lead to large numbers of consumers being exposed to serious detriment because parts of the market do not operate to the same high standards as the rest of the industry.

Mis-selling and fraud

In July 2007, the FSA published a review of the behaviour of 11 lenders – more than half the non-prime market. It found that none of them 'adequately covered all relevant responsible lending considerations in their policies' and 'many' failed to apply even the weak policies they did have in practice.

The FSA also found that failures in lenders' controls had led to the approval of unaffordable mortgages to some clients. The regulator also identified failings by mortgage intermediaries after surveying 34 firms, and has launched enforcement proceedings against five.

The FSA said that in a third of the files it reviewed there was 'an inadequate assessment of consumers' ability to afford the mortgage' and in almost half there was 'an inadequate assessment of the customers' suitability for the mortgages'. It also found that large numbers of consumers had been advised to remortgage (which involved new sets of fees for intermediaries) without any evidence that this would be in their best interests.

Opaque enforcement

The FSA's enforcement work in the mortgage market has lacked transparency. In a joint initiative by the FSA and the Council of Mortgage Lenders, only a third of 200 cases of suspected or proven fraud in the non-prime market were referred to the FSA's enforcement division. Consumers may never get to know the identities of the other two-thirds. This lack of transparency, which may have protected some offending lenders, could constitute a failure to protect both consumers and responsible lenders.

Therefore, we welcome government proposals in the Regulatory Enforcement and Sanctions Bill to require regulators to disclose details of all civil sanctions. The FSA is also doing work to improve regulatory transparency and we look forward to seeing how that develops[48].

---

[47] March 2007 to March 2008
[48] Financial Services Authority, *Regulatory Transparency: Discussion Paper*, April 2008

New measures in this area must provide meaningful incentives for firms to treat their customers fairly. While some of the FSA's proposals are welcome, such as publishing complaint records, in other areas, such as mystery shopping exercises and financial promotions, the FSA has not been bold enough. The FSA claims that the Financial Services and Markets Act prevents it from disclosing this information, but, if this is true (and the Information Commissioner has in some respects reached a different conclusion[49]), we would expect it to call for the removal of these legal barriers to transparency.

Growth in debt management companies

The other major consequence of the increasing number of consumers in serious debt problems has been the growth of private sector debt consolidation and debt management companies. Concerns have been raised about the quality of advice consumers receive from these providers and the weak regulation surrounding authorisation of debt counsellors.

[49] Decision notices FS50090010 and FS50075781, Office of the Information Commissioner, 7 August 2007

Measures in place to protect consumers

The ‘perfect storm’ of events in the mortgage and credit markets could have a number of major detrimental impacts on vulnerable consumers, including:

- increasing numbers of consumers getting into financial difficulty, with rising numbers of arrears and repossessions;
- vulnerability to unfair and aggressive practices by lenders;
- significant numbers of vulnerable consumers being pushed out of the mainstream markets into non-prime sector, or denied access to fair and affordable credit altogether; and
- more people being exposed to poorly regulated debt consolidation and debt management companies.

The scale of the crisis in the UK mortgage market and its consequences for consumers now largely depend on how policymakers, regulators and industry respond.

Action so far

Policymakers and regulators face a huge challenge. Measures already taken by government and industry are welcome, including:

- government calls for industry to pass on base interest rate cuts to borrowers;
- government calls for industry best practice on the treatment of borrowers;
- industry consultation with consumer groups and other stakeholders on this best practice;
- government support to boost advice provision for consumers;
- government to consider reform to the Income Support to Mortgage Interest Scheme; and
- provisions in the 2008 Banking Code to be pro-active in contacting consumers who may be in difficulty.

Acute need for best practice

Our research into lenders’ policies and practices reinforced the FSA research, which indicated a wide variation in how lenders respond, or intend to respond, to borrowers in financial difficulty. Consumers need certainty, and industry needs a level playing field in how people in difficulty are treated. Therefore it is essential to monitor the best practice developed to set out how this is achieved – and those failing to meet best practice should be named. This report outlines a checklist for industry, to ensure that they are Treating Customers Fairly; this will be fed into the CML’s work for government on industry solutions.

Existing consumer protection measures

There are a number of measures in place which are supposed to protect consumers, including both statutory and voluntary regulatory initiatives as well as other safety nets. However, they currently offer limited protection.

Lenders flexibility

Lenders may allow a degree of flexibility when it comes to mortgage repayments. This is welcome, but if lenders' flexibility depends on their risk assessment of the borrower it may be of limited benefit for vulnerable consumers. The most vulnerable are often the most risky, and could potentially end up either with least flexibility from lenders, or paying out for flexible products that carry an added interest-rate loading to protect the lender against risk.

Lenders arrears policy and practice

All lenders (both mainstream and non-prime) must have in place, and follow, written policy and procedures for dealing fairly with customers in arrears. The factors the FSA considers to be central to lenders' policy and procedures include:

- using reasonable efforts to reach an agreement with the customer;
- adopting a reasonable approach to the time over which any shortfall in payments can be made good; and
- repossessing a property only where all other reasonable attempts to resolve the position have failed.

These rules consolidated good practice standards in the industry. The treatment of customers in arrears was one of the areas given priority in the second stage of the FSA's review of the effectiveness of the mortgage regime, and the rules were drafted to give firms the flexibility to respond to customers' individual circumstances. However, the findings indicated that a number of lenders were failing to meet the FSA requirements.

Failing individuals

There are concerns that some lenders, in both the prime and non-prime sectors, appear to be unwilling to consider cases on an individual basis or to agree a solution tailored to the borrower's individual circumstances; these lenders could be considered to be adopting a one-size fits all approach to arrears recovery. Our own research suggests that, while lenders claim to treat customers fairly, few seem to have detailed plans in place to deal with borrowers in distress. Lack of transparency in how lenders treat borrowers in difficulty is a concern.

High risks

The FSA suggests that non-prime mortgage arrears are running at up to 20 times the rate of arrears on mainstream mortgages[50]. Worryingly, research has found[51] that non-prime lenders tend to be less willing than mainstream lenders to negotiate with borrowers in arrears. They are responsible for a share of possession actions substantially above their market share.

Self-regulatory codes

Although the Banking Code now puts a requirement on lenders to spot borrowers in financial difficulty[52], more work needs to be done to agree on detailed standards of behaviour – for example, the conditions under which lenders must provide temporary relief on debt repayments. Both the implementation and the effectiveness of these provisions will need to be monitored over time. However, few of sub-prime lenders are members of the Banking Code[53].

The Finance and Leasing Association Lending Code, which covers many sub-prime lenders, doesn't contain this pro-active element. Subscribers are required to treat customers sympathetically, but what this means in practice is at the lender's discretion. This creates uneven protection for borrowers, and an uneven playing field for lenders. However, the next review of the Lending Code will present an opportunity for this difference between the self-regulatory regimes to be addressed.

Industry best practice on how to treat customers in difficulty, which is being developed by the CML, should address these gaps in self regulation.

Regulatory compliance

More needs to be done to ensure that lenders treat individual customers fairly if they get into financial difficulties, and to ensure that they develop programmes to deal with increasing numbers of consumers affected by changes in the mortgage market. With FSA research indicating some failures to comply with regulations, enforcement of the existing regulatory framework is just as important as work on best practice.

Income support mortgage interest

Income support mortgage interest (ISMI) provides limited protection. Since October 1995, borrowers with new mortgages have had to wait nine months to become eligible for ISMI. But millions may lack the financial resources to last nine months. Also, the benefit wouldn't provide enough protection for sub-prime customers: the way ISMI is calculated means that consumers with a £100,000 mortgage on a high rate could face a shortfall of between £60 and £165 a month. Government consideration of reforms to the scheme must move swiftly in order to help the most vulnerable and prevent people from losing their homes.

---

[50] Clive Briault Speech at CML Annual Lunch, 20th April 2007
[51] Set up to fail, Citizens' Advice, Evidence Report, December 2007
[52] The Banking Code does not explicitly cover mortgages. But it is clear that the effectiveness of the Code is important, given the number of consumers who have mortgages and unsecured debt
[53] For a full list of operations and subsidiaries subscribing to the code see http://www.bankingcode.org.uk/subscriberlist.htm

Market response

Mortgage Payment Protection Insurance

Mortgage payment protection insurance (MPPI) has not filled the gap, covering only an average of 22 per cent of new mortgages since 2005. There are also major concerns about the value of this insurance and potential large-scale mis-selling of the product. Large numbers of consumers may have been paying out for insurance they can never claim on. The Competition Commission is undertaking an inquiry into the PPI market.

Equity release schemes and secured loans

While house prices remain high, properly structured and fairly sold, equity-release schemes can provide relief to some consumers. However, falling house prices and lower equity levels mean that this is not a universal solution. We expect to see secured or second-charge loans being heavily pushed as a means of coping with short-term debt pressures. These product promotions will need to be monitored closely to prevent mis-selling.

Sale and rent-back schemes

These schemes are not regulated, so there is little protection for consumers. The potential for confusion with regulated equity-release products leaves consumers doubly exposed. Consumers who sell their homes through this kind of scheme are at significant risk of getting a raw deal, selling at a discount and often getting only an Assured Short-hold Tenancy. There have been numerous examples of vulnerable, often elderly, people being forced after a short rental period to leave the homes they expected to stay in.

Conclusions

There is no single cause of the crisis we currently face. The 'perfect storm' seems to be the result of a potent combination of factors, including:

- **disintermediation of risk:** attempts to transfer risk in the financial system have led to risk being displaced to other parts of the financial system, leading to greater complexity. Much of the growth in mortgage lending has come from non-traditional sources of funding.

- **lender reaction to competition:** a fiercely competitive market often changes market behaviour. The relaxation of lending criteria, such as price-to-income ratios, might be explained partly by lenders competing for distribution as well as weak regulation.

- **dependency on property:** as well as a highly competitive market, the UK dependency on property has created a toxic mixture in the mortgage markets.

- **regulatory focus:** the move to principles-based regulation appears slow; implementation of Treating Customers Fairly has been slow to respond to market innovation, complexity and the displacement of risk within the financial system.

- **disclosure requirements:** the existing disclosure requirements have not been effective in helping consumers to understand the risks involved in long-term borrowing, or to recognise the potential impact changing market conditions might have on their financial circumstances. The failure of some firms to alert borrowers to changes in contract terms, such as the end of fixed-rate deals, means that consumers are facing interest rate shocks.

- **distribution strategies:** the distribution strategies used to sell mortgages, particularly in the sub-prime sector, have raised concerns. The use of commission to attract the custom of brokers or intermediaries, and other remuneration practices which link sales-staff rewards to volume of mortgage sales, means the quality of advice given to consumers may have been put second.

Crisis management

Just as there is no single cause for the current situation, there is equally no single solution. The scale of the potential consumer detriment arising from interest rate changes and the credit crunch means that dedicated, well-funded interventions are needed to pre-empt a full-blown crisis, and to protect consumers in difficulties. While industry, the FSA and government are doing much valuable work, there is still more to do. We have developed industry and regulatory solutions which could limit the impact of the 'perfect storm' on vulnerable consumers in the mortgage market. These are designed to:

- raise awareness of assistance options among consumers at risk;

- prevent increased numbers of arrears and repossessions;

- create a package of 'intensive care' services to ensure that consumers who cannot avoid getting into difficulty are treated sympathetically and fairly;

- flesh out some of the ill-defined regulatory principles that relate to treating customers fairly, and guidance in the self regulatory codes (the Banking Code and the Lending Code);

- ensure that Corporate Social Responsibility initiatives in the industry are underpinned by meaningful action; and

- contribute to industry best practice being developed by the CML, and ensure that this is followed by lenders across the industry.

Policy recommendations

Measures to help ride out the storm

Policymakers and regulators face a huge challenge. They must strike the balance between improving regulation, to restore confidence in the UK's financial system, and protecting consumers without choking off access to affordable retail loans. Measures already taken by government and industry have been welcome, but more must be done. Below are a number of practical policy recommendations, focused on one of the regulator's main principles for business: Treating Customers Fairly.

For industry

A Treating Customers Fairly checklist

As a pro-active attempt to limit the impact of the 'perfect storm' we have developed guidance for industry on what Treating Customers Fairly in the mortgage market should mean in practice. This guidance is designed:

- to flesh out the principles relating to FSA's Treating Customers Fairly, the voluntary Banking Code (which covers non-mortgage debt) and the Finance and Leasing Association Lending Code;

- to help FSA and the Office of Fair Trading to assess compliance with principles-based regulation, and to inform the FSA review of arrears management practices;

- to help industry to demonstrate Treating Customers Fairly compliance and support corporate social responsibility claims;

- to establish a more level playing field by promoting best practice in Treating Customers Fairly;

- to limit the increase in arrears and repossessions by creating a package of 'intensive care' measures to help consumers.

Treating Customers Fairly checklist

Raise awareness

- Alert consumers to the potential impact of interest rate changes at point of sale and post-sale – for example, when fixed rate deals are running out – using relevant examples.

- Alert customers when regulators have taken enforcement action, highlighting the redress options open to them.

- Provide information on free independent advice agencies that can help with debt repayment plans and independent advice.

Target vulnerable customers

Set up dedicated intervention teams to target and assist borrowers who are, or may be, in financial difficulty, specifically those who are:

- **vulnerable to arrears (pre-delinquency stage**): for example, first-time buyers or people coming off fixed-rate deals. At this stage, raising consumer awareness and providing information on expected changes to repayments is important as it can help people to prepare and manage their budgets.

- **in early-stage arrears**: at this stage, providing a range of options to borrowers who have missed one or two payments may prevent the problem escalating.

- **in serious arrears**: at this stage, discussing available options with consumers and directing them to specialist help or advice from independent sources may help to avoid repossession;

- **at repossession stage:** lenders should be considering repossession *only* as a last resort, which should mean they have followed the stages in this checklist.

Tailor solutions to circumstances

Develop a range of interest-rate relief options to bring mortgage repayments to an affordable level, to help borrowers manage short-term difficulties and to avoid repossessions. Options could include:

- **payment holidays**;

- **temporary interest rate reductions** – with no direct or indirect penalties – to ensure that the consumer has sufficient remaining resources to cover their actual living costs leaving a fair disposable income;
- **deferring unpaid interest to the end of the loan**, making sure that the financial consequences of doing so are fully explained;

- **rescheduling or extending the loan period** to reduce monthly payments, ensuring that the financial consequences of doing so are fully explained; and

- **developing longer-term plans** for borrowers who face permanent reductions in income.

Reward action on debt management

- Suspend penalty fees for customers who participate in arrears management programmes.
- Consistently record positive credit data for borrowers who participate in arrears management programmes.

Suspend enforcement

- Third-party collection agencies and court action should be used *only* as a last resort, after following the first four steps in the checklist.

For the regulator

A clear and consistent approach

We support principles-based regulation. However, implementation of the Treating Customers Fairly appears to have been slow to respond to market innovation, market complexity and the displacement of risk within the financial system. The FSA needs to be clear about how these principles apply in practice, and must be prepared to enforce them effectively.

- The FSA should increase its emphasis on principles-based regulation ensuring that it sends clear and consistent messages to all lenders on striking the right balance between Treating Customers Fairly and managing credit risk.

Sales and promotions review

Previous weak regulation governing the sales and promotion of mortgages and loans meant that irresponsible lending and some unscrupulous practices were not effectively controlled. Many consumers did not understand the risks involved. There are also concerns that commission payments may distort behaviour in the mortgage market.

- The FSA should use its effectiveness review of Mortgage Conduct of Business Rules and its work on the Retail Distribution Review to ensure that consumers have the same protection and clarity around sales and advice for mortgages as for other investments.

Transparent enforcement

To create a level playing field for responsible lenders, the FSA should:

- take tough and transparent enforcement action against lenders who have breached Treating Customers Fairly rule;

- require lenders who have breached the rules to contact borrowers to alert them to the potential for redress; and

- call for the removal of any barriers to transparency that it may have identified in the Financial Services and Markets Act.

Unfair contracts

Our analysis suggests that some of the contract terms in the non-prime market are potentially unfair, and possibly even contrary to the requirements of unfair contracts and commercial practices regulations.

- The FSA should convene a working group with the Office of Fair Trading to investigate whether contract terms in non-prime mortgages and loans are unfair and to establish a plan of action for dealing with any breaches.

Further work

This is a complex area, and this report does not seek to cover all of the issues associated with this crisis. However, it is apparent that there are a number of big issues that need to be addressed to limit consumer detriment arising from the perfect storm. Some of these issues are set out below.

Sale and rent-back

The market is currently unregulated. Anecdotal evidence suggests widespread consumer detriment and an urgent need for action. The timetable for the OFT's investigation must take account of this urgency.

Equity-release schemes

The FIC intends to develop, with consumer representatives and the industry, benchmark home equity schemes for consumers who are not commercially viable for mainstream financial services firms.

Insurance schemes

The FIC also plans to work with industry and consumer representatives to promote access to affordable protection insurance for consumers.

Safety mechanisms

ISMI, the state safety mechanism, is not fit for the purpose. It needs to be reformed to reflect the realities of consumers with expensive sub-prime mortgages. We welcome the government's intention to consider reform of the scheme, and emphasise the urgency of undertaking this work.

Home ownership targets

The scale of detriment that could be facing up to four million consumers is bringing the government's home ownership targets into question. Consideration should be given to mechanisms to help people to maintain their owner-occupier status, including more accessible and innovative shared ownership schemes.

Fair and affordable loans

The immediate priority is to protect consumers and limit the scale of detriment. However, the credit crunch will have longer-term implications, as many consumers will find their access to affordable credit reduced. Radical interventions are needed to ensure that excluded consumers have access to fair and affordable loans in the medium-to-long term. The NCC chairs the Financial Inclusion Taskforce's affordable credit sub-group, which has been tasked with scaling up third sector credit provision. The FIC will be doing work on further interventions.

New institutional funding mechanisms

The UK is witnessing a growing divide, between consumers who are commercially viable for the market and those who are unprofitable or represent too high a risk. The third sector could play an expanded role in providing fair and affordable loans, if it had access to sustainable institutional funding. The Financial Inclusion Taskforce's working group on third-sector credit, led by the NCC, secured a commitment from the high street banks to help develop third-sector credit providers in 26 'red alert' areas where demand for affordable credit far outstrips supply. The FIC is developing the concept of social investment bonds to provide access to other sources of funding for third-sector organisations.

Appendices

Appendix I
Estimates of numbers of consumers affected by changes in financial market conditions

Appendix II
Summary of impact of changes in market conditions

Appendix III
Estimates of number of fixed rate and discounted rate deals ending in various periods

Appendix IV
Impact of interest rate changes on different groups of borrowers

Appendix V
FIC questionnaire on lender behaviour

Appendix VI
Percentage of respondents by financial savings products owned

Appendix VII
Bank of England Credit Conditions Survey 2007 Q4

Appendix I

Estimates of numbers of consumers affected by changes in financial market conditions

Many households will be largely protected from the worst of the perfect storm, including people with: no mortgage; a small mortgage; real equity in their homes; substantial savings and assets to fall back on; and secure, predictable incomes. However, others will be in a far more vulnerable position including borrowers who are over-indebted[54].

Our estimate of how many people this will affect focuses on the period July 2007 to December 2009 because the effect of fixed and discount rate deals unwinding began to be felt in the second half of 2007. We do not expect the effects to have worn off before December 2009 unless there are significant government interventions and easing of market conditions. Our comparisons are with July 2005 to December 2007.

The table below outlines our estimates of the numbers of consumers in different categories who we expect to be affected by the various factors affecting the market.

Estimates of numbers of consumers affected

Category of consumer	Estimates of numbers potentially affected
Fixed/ discounted rate borrowers	Over three million fixed or discounted rates are ending in 2008 and 2009[55]. Adding in those deals that ended in the second half of 2007, the numbers affected rises to over four million[56]. Not all of these will see major increases in payments, but many will see, or have seen, payment increases of between 20 and 50 per cent.
Over-indebted borrowers	In 2006, around one third of mortgage borrowers were spending 20 per cent or more of their pre-tax income on servicing mortgage debt. With nearly twelve million mortgages outstanding, this implies that four million mortgage holders are spending 20 per cent or more on mortgage debt. Increased mortgage costs for many since 2006 suggests that these consumers will now be spending an even greater proportion of incomes on mortgage debt.

[54] A summary of factors affecting consumers is in Appendix II
[55] See Appendix III
[56] See Appendix III

First-time buyers (FTBs)	Nearly one million (967,700) first-time buyers took out a mortgage between July 2005 and December 2007[57]. This group is vulnerable because they have an average loan-to-value of around 90 per cent compared to 71 per cent loan-to-value for consumers moving home[58]. In December 2006 the 'typical' two income first time buyer couple would have had to commit 34 per cent of take home pay to service mortgage debt – the highest since 1990[59].
Non-standard borrowers	Recent estimates suggest that around one in three borrowers could be considered 'non-standard' in some way[60]. This includes: existing 'sub-prime' borrowers; consumers with an adverse credit history; plus others who are self-employed or who do not have regular incomes. This implies that of the twelve million mortgages, around four million could be considered non-standard in some way. Non-standard borrowers can expect to pay a price in terms of higher loan rates, higher arrangement fees, and penalty fees if they get into arrears or miss payments.
Restricted access to mortgage funding	Financial market conditions mean that the level of net mortgage lending is being reduced. The Council of Mortgage Lenders estimates that net lending in 2008 will be around £55 billion – almost half the £108 billion in 2007. Mortgage approvals are expected to be 35 per cent lower[61]. Over 750,000 first time buyers and 1.4 million home movers took out a mortgage over the past two years[62]. If these forecasts are right for 2008 and 2009, this suggests 735,000 fewer mortgage approvals restricting the ability of consumers to get on the housing ladder in the first place or move home.

[57] See CML statistics, Table ML2 First time buyers lending and affordability 2008
[58] CML statistics, Table ML2, First time buyers: lending and affordability, 2008
[59] Debt statistics, Credit Action, June 2007
[60] Mintel Oxygen Reports - Non-Standard Lending - Nov 2007
[61] See CML Housing and mortgage market forecasts: 2008
[62] See CML Housing and mortgage market forecasts: 2008

Appendix II: Summary of impact of changes in market conditions

Market development	Impact	Outcome
High level of over-indebtedness: record levels of personal debt = £1.4 trillion	Record debt makes households more vulnerable to changes in financial market conditions and personal financial circumstances.	Total debt service costs estimated to account for 20 per cent of household disposable income in 2007. Consumers spending above this are vulnerable because of increases in mortgage payments and household bills. This is exacerbated further by a lack of savings to provide cushion against adverse change in financial circumstances. In 2006, 34 per cent of mortgage borrowers were spending more than one fifth of pre-tax income on servicing mortgage debt[63]. First time buyers spending 34 per cent of take-home pay on servicing mortgage also vulnerable.
Fixed and discounted rate deals expiring	Millions of fixed rate and discounted rate deals have already ended and more will end over the period July 2007 to 2009.	The majority of borrowers are likely to face an increase in monthly interest payments. Many will face increases of between 20-50% a month. First time buyers already spending record amounts servicing mortgage debt.

[63] Derived from: The State of British Household Finances: results from the 2006 NMG Research Survey, Chart 5 Distribution of mortgage income gearing

Increases in utility and other household bills (eg. food and petrol)	Substantial increases in utility bills and food and petrol prices.	Potentially affects all consumers but already over-indebted consumers (with secured and unsecured loans), and those facing increases in mortgage payments are especially vulnerable.
Tightening of lending criteria by mainstream lenders/ growth in 'non-standard' category of borrowers	Both mainstream and non-standard lenders have been tightening lending criteria. The number of consumers considered 'non-standard' by lenders expected to grow as a result of policy changes and increase in numbers missing payments or getting into arrears.	This includes borrowers who fall into arrears/ miss payments, or are otherwise considered a higher risk by lenders eg. because they are self-employed, have irregular incomes etc. On some measures, one in three households in the mortgage and lending market could be considered non-standard risks by lenders[64]. Applying this to the 12 million mortgages (approximate) in the UK means that up to 4 million could be considered non-standard.
Reduction in availability of credit	Financial market conditions mean that the level of net mortgage lending is being reduced. The Council of Mortgage Lenders estimates that net lending in 2008 will be around £55 billion – almost half the £108 billion in 2007. Mortgage approvals are expected to be thirty-five per cent lower[65].	First time buyers and borrowers looking to move home and/ or remortgage will be affected. Over three-quarters of a million first time buyers and 1.4 million home movers took out a mortgage over the past two years[66]. If these forecasts are borne out over 2008 and 2009, this suggests 735,000 fewer mortgage approvals restricting the ability of consumers to get on the housing ladder in the first place or move home.

[64] Mintel Oxygen Reports - Non-Standard Lending - Nov 2007
[65] See CML Housing and mortgage market forecasts: 2008
[66] See CML statistics, Table ML2: First Time Buyers: lending and affordability

Appendix III: Estimates of number of fixed-rate and discounted rate deals ending in various periods

Period	Fixed Rate	Discounted	Totals
taken out in:			
2004 H2	551,900		551,900
2005 H2	818,100	121,700	939,800
2005	1,322,500		1,322,500
2006	1,466,600	295,400	1,762,000
2007	1,514,300	138,000	1,652,300
ending in:			
2007 H2	751,550	121,700	873,250
2008	1,430,575	295,400	1,725,975
2009	1,502,375	138,000	1,640,375
totals for periods:			
H2 2007/2008	2,182,125	417,100	2,599,225
2008/2009	2,932,950	433,400	3,366,350
H2 2007/2008/H1 2009	2,933,313	486,100	3,419,413
H2 2007/2008/2009	3,684,500	555,100	4,239,600

H1 January-June
H2 July-December

Assumptions

For fixed rate estimates, we have assumed that for relevant periods, three-quarters of fixed rate deals taken out are 2 year fixed rate and one quarter 3 year fixed rate. For discount rate deals we have assumed 2 year discounted period.

Underlying data taken from CML statistics table – ML5: Fixed and variable rate lending – house purchases and remortgages.

Appendix IV: Impact of interest rate changes on different groups of borrowers

The table sets out the impact of changing interest rates on consumers coming off fixed or discount rate deals and moving onto different rates.

The tables read across from the left. Examples:

Table 1 shows that a borrower coming off a two year 95 per cent loan-to-value fixed rate deal moving onto a two year 75 per cent loan-to-value fixed rate deal in the period July 2007 – June 2008 would have seen an average 21 per cent increase in payments.

Similarly, a borrower coming off a two-year 95 per cent loan-to-value fixed rate deal during 2008 and moving onto a new two-year 95 per cent loan-to-value fixed rate deal would on average face an increase in payments of 32 per cent.

The underlying data is based on the averages of the Bank of England data for banks and building societies mortgage interest rates. Please note that the estimates for the remainder of 2008 and 2009 are based on current rates. Clearly, if market rates reduce over the period then borrowers could be in a better position.

FR= fixed rate; LTV= loan-to-value; SVR= standard variable rate; Discount= discounted rate

Table A

2007/8	2 yr FR 75%LTV	2 yr FR 95% LTV	2 yr discount 75% LTV	2 yr discount 95% LTV	SVR
2 yr FR 75% LTV	28%				54%
2 yr FR 95% LTV	21%	32%			51%
3 yr FR 75% LTV	20%				49%
5 yr FR 75% LTV					39%
5 yr FR 95% LTV					34%
2 yr 75 % LTV discount			25%		53%
2 yr 95 % LTV discount			18%	25%	47%

Table B

2008	2 yr FR 75% LTV	2 yr FR 95% LTV	2 yr discount 75% LTV	2 yr discount 95% LTV	SVR
2 yr FR 75% LTV	23%				46%
2 yr FR 95% LTV	15%	32%			38%
3 yr FR 75% LTV	21%				44%
5 yr FR 75% LTV					47%
5 yr FR 95% LTV					43%
2 yr discount 75 % LTV			31%		53%
2 yr discount 95 % LTV			26%	30%	47%

Table C

2008/9	2 yr FR 75% LTV	2 yr FR 95% LTV	2 yr discount 75% LTV	2 yr discount 95% LTV	SVR
2 yr FR 75 % LTV	14%				35%
2 yr FR 95% LTV	7%	22%			28%
3 yr FR 75% LTV	23%				47%
5 yr FR 75% LTV					38%
5 yr FR 95% LTV					34%
2 yr discount 75 % LTV			20%		41%
2 yr discount 95 % LTV			15%	19%	35%

Table D

2009	2 yr FR 75% LTV	2 yr FR 95% LTV	2 yr discount 75% LTV	2 yr discount 95% LTV	SVR
2 yr FR 75 % LTV	4%				24%
2 yr FR 95% LTV	-2%	12%			17%
3 yr FR 75% LTV	18%				40%
5 yr FR 75% LTV					29%
5 yr FR 95% LTV					26%
2 yr discount 75 % LTV			11%		29%
2 yr discount 95 % LTV			5%	8%	23%

Appendix V: FIC questionnaire on lender behaviour

FIC asked lenders the following questions, using a combination of email and telephone interviews.

Have you made any changes to your lending policies and practices in the past six months, or plan to do so next year? For example:

- have you tightened lending criteria, eg. by reducing LTVs or mortgage income multiples?
- have you changed the way you assess borrowers ability to repay, eg. by checking more closely stated incomes?
- have you changed your credit scoring models, eg. by tightening up qualifying criteria for your prime mortgages?
- has the number of mortgage applications rejected risen?
- Have you withdrawn or restricted availability to any products within the past six months?

What steps do you take to assess whether a customer can afford the mortgage in the long term?

Have you revised your policies and controls for checking affordability recently, say, within the past year? Have you any current plans to revise policies and controls?

Do you write to customers coming to the end of fixed rate deals to alert them to potential changes in monthly payments? Do you have plans for doing so?

What is your policy on non/sub-prime customers migrating from non/sub-prime mortgages to prime mortgages? For example, can customers repair their credit history so that they qualify for your prime rates after a certain period? How long before they can qualify for your prime rates?

Do you have a specific published policy for treating customers who are in financial difficulty or in arrears? What is your policy on repossession – eg. are proceedings triggered after a certain level of arrears is built up? Have you revised your policy recently as a result of changing market conditions or as a result of guidance from the FSA?

Are you expecting an increase in the number of customers getting into financial difficulties over the coming year? If so, what action are you taking to deal with this?

What options do you offer, or recommend to, customers in arrears? For example:

- can customers extend the term of the loan?
- can customers take payment holidays? If so, how many?
- can customers make underpayments? If so, how much and how long for?
- can customers refinance the loan eg. enhance the current loan to value ratio?
- do you offer equity release?

If customers use any of these options does it affect their credit score?

Appendix VI: Percentage of respondents by financial savings products owned

Source: Access to Financial Services by those on the Margins of Banking, BMRB Social Research for the Financial Inclusion Taskforce, November 2006

	Base		**Bank/ building society deposit account**	**ISA (incl. TESSA and TOISA)**	**National savings account**	**No savings**
All	2007	%	52	37	8	33
Fully banked households	1536	%	53	39	9	31
Marginally banked households	471	%	33	9	2	62
England	1057	%	53	38	9	33
Scotland	480	%	48	32	7	38
Wales	470	%	46	26	10	42
Men	868	%	55	40	8	31
Women	1139	%	49	33	9	36
16-24	189	%	21	23	4	58
25-44	748	%	51	32	8	34
45-64	911	%	58	43	9	28
65+	159	%	60	43	9	30
Household income <£10K	719	%	34	21	5	55
£10K<£20K	408	%	41	31	6	42
£20K<£30K	229	%	51	40	8	29
£30K+	319	%	77	69	14	10
Tenure: Own outright	397	%	67	54	13	18
Own with mortgage	566	%	61	48	10	20
Private renter	217	%	38	14	6	52
Social renter	753	%	32	10	2	62

Appendix VII: Bank of England Credit Conditions Survey 2007 Q4

		Jun 07	Sep 07	Dec 07
How has the availability of secured credit provided to households changed?	Past 3 months	-2.9	0.1	-31.2
	Next 3 months	13.4	5.8	-25.3
Factors contributing to changes in credit availability:(a)				
changing economic outlook	Past 3 months	-7.2	-9.6	0.5
	Next 3 months	2.1	-3.3	-19.9
market share objectives	Past 3 months	20.0	21.3	-7.6
	Next 3 months	29.6	19.7	-25.5
changing appetite for risk	Past 3 months	1.8	-1.5	-35.2
	Next 3 months	13.4	14.3	-28.0
changing cost/availability of funds	Past 3 months	-9.3	10.0	-12.5
	Next 3 months	13.3	-15.1	-17.3
How have credit scoring criteria for granting loan applications by households changed?	Past 3 months	-2.4	-5.7	-32.3
	Next 3 months	19.5	3.1	-41.0
How has the proportion of household loan applications being approved changed?	Past 3 months	-5.3	-2.7	-21.5
	Next 3 months	9.5	5.6	-3.8

Numbers in percentages