the perfect storm: the credit crunch hits home

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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.

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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 and the National Consumer Council 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 in the short and long-term.

Our full report is available at www.ncc.org.uk and www.inclusioncentre.org.uk.

Summary

The perfect storm

This financial storm is brewing from a mixture of factors:

- Record debt levels: personal debt stands at £1.4 trillion, with £1.2 trillion of that 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 increases of 20–50 per cent each month for many people.
- The credit crunch: lenders are tightening lending conditions, restricting the availability of affordable credit and increasing interest rates.
- Rising prices: bills for essentials, 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 2008[2] and 1.3 per cent in April, with some predicting falls of up to 15 per cent by 2010[3].

Who is vulnerable?

We estimate that up to four million consumers are vulnerable to changes in their financial circumstances[4]. These include:

- 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).

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 could be pushed aggressively as 'lifeboat' schemes for struggling consumers.
- Damaged credit ratings: effects will be long-term as they impact on consumers' ability to access affordable credit and other financial products.

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

Measures to help ride out the storm

Policy-makers and regulators face a huge challenge. They must strike a 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.

Policy recommendations for industry

As a proactive 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 and loans market. This guidance is designed:

- to flesh out the principles relating to the Financial Services Authority's (FSA) 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.

A Treating Customers Fairly checklist for industry

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 advice.

Target vulnerable customers

- Set up dedicated intervention teams to target and assist borrowers who are in financial difficulty, specifically those who are: vulnerable to arrears (for example, first-time buyers or those coming off fixed-rate deals – pre-delinquency stage); in early-stage arrears; or in serious arrears and repossession stage. Details can be found in the main report.

Tailor solutions to circumstances

- Develop a range of interest-rate relief options to bring mortgage and loan repayments to an affordable level, to help borrowers manage short-term difficulties and avoid repossessions. See the main report for the range of options.

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.

Policy recommendations 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 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 and 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.

Background

A perfect storm is brewing. A combination of events threatens vulnerable, over-indebted consumers.

Record debt levels

Personal debt levels in the UK have rocketed over the past decade; millions of people may be struggling to cope with debt. On some measures the proportion of disposable income spent servicing debt is now higher than during the last major housing-market crisis in the 1990s.

Much of this increase in personal debt can be attributed to the increase in property prices and consequent need for bigger mortgages. Average house prices rose by 11.4 per cent a year from 1997 to 2007[5], while average wages grew by 4.2 per cent a year[6]. As a result, millions of first-time buyers seem to be particularly exposed: the average loan-to-value for this group was 90 per cent, as compared to 71 per cent for consumers who are moving home. The average mortgage advance for a first-time buyer by the end of 2007 was running at 3.36 times their annual income – the highest on record.

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; this is the highest level since 1990[7].

Fixed rate and discounted rate deals ending

We estimate that around three million fixed-rate and discounted-rate deals will expire in 2008 and 2009. Many borrowers will see their monthly payments go up by anything from 20 to 50 per cent. For some consumers this increase will be simply unaffordable.

The credit crunch

Our research shows that lenders have significantly tightened their lending policies and practices[8]. This is confirmed by Bank of England Credit Conditions survey, which expects conditions to deteriorate even further[9]. Increasingly risk-averse, lenders are refusing more loan applications, reducing the availability of secured credit and in some cases putting up mortgage costs, even though base rates have fallen. The government has had talks with lenders to try to get base interest rate cuts passed on to consumers. It has also backed the Bank of England's £50 billion special scheme which is intended to help resolve the problems in the credit market.

Lender behavior

Many lenders have not passed on Bank of England interest base-rate cuts to borrowers. However, fixed-rate borrowers would not directly benefit from base-rate cuts anyway. Many lenders are seeking to reduce risk by rebalancing the way they fund mortgages, moving away from wholesale market funding back towards traditional mechanisms – including attracting money from savers by offering higher savings rates. Lenders are also trying to rebuild their own profit margins, which could lead to higher mortgage rates for more borrowers.

Rising prices

Against this background of rising mortgage costs and significant levels of unsecured personal debt, consumers have experienced huge price rises in essential bills. Food, gas and electricity, council tax and petrol are all going up. Utility bills are expected to rise by around 15 per cent in 2008, and the typical joint gas and electricity bill is expected to rise above £1,000 a year[10].

No safety net

While some borrowers have substantial personal resources to fall back on, research suggests nearly half the households in the UK (49 per cent) have less than £1,500 in savings, and 28 per cent have no savings at all[11]. Average gross monthly earnings in the UK are currently £2,145 a month[12]: therefore, nearly half the households in the UK don't even have savings of one month's salary to fall back on.

Falling house prices

House prices fell by 2.5 per cent in March 2008 and by 1.3 per cent in March[13], and further falls are expected. Most homeowners will have equity in their homes and should be unaffected. But borrowers with high loan to value mortgages will have even fewer refinancing options. Sympathetic treatment by lenders will be vital for these consumers if they fall into difficulties.

Evaluating the impact on consumers

On the edge

Millions of consumers already appear to be missing payments or falling behind with bills. Several other indicators – including debt advice inquiries, insolvencies, mortgage arrears and repossessions – suggest a growing problem. FSA research suggests that the proportion of consumers who would struggle with their financial commitments if mortgage payments rose by just ten per cent (or roughly a 0.5 per cent increase in interest rates) would double[14].

Expected impact

The types of consumer detriment we expect to see would include:

- increased repossessions, arrears, and debt problems;
- damaged credit reports, leading to long-term difficulties obtaining affordable credit, creating financial exclusion;
- lack of choice as more consumers are pushed into the non-prime, or non-standard, lending markets – where rates are higher and lenders can be less sympathetic;
- borrowers trapped in expensive and arguably unfair mortgages and loans;
- low levels of protection as consumers are exposed to poorly regulated debt consolidation and debt management companies, and currently unregulated products such as sale and rent-back schemes; and
- inappropriate sales of equity release and secured loans or second charge mortgages, which could be pushed aggressively by the industry as 'lifeboat' schemes for struggling consumers.

A substantial rise in arrears and repossessions

The Council of Mortgage Lenders forecast a 50 per cent increase in repossessions, to 45,000, in 2008 – the highest figure for 12 years. The good news is that the current unemployment level – 5.3 per cent – means repossessions are unlikely to rise to past the levels seen in 1991-1992, when unemployment was at nine per cent. However, by other measures debt affordability is more stretched than it was in the early 1990s. Therefore, consumers are arguably more vulnerable to changes in market conditions. Any downturn in the economy and subsequent increase in unemployment could lead to repossession levels like those of the early 1990s.

Expansion of the two-tier market

Growing numbers of consumers will be pushed out of the mainstream lending markets into the non-prime markets, or excluded from credit altogether[15].

- nearly one in five mortgages written in 2007 was non-standard – that is, sub-prime or self-certified[16].
- With an estimated 4.2 million sub-prime customers in the UK, the sector is forecast to grow twice as fast as the mainstream over the next five years[17].
- On some measures, one in three households could be considered as a non-standard risk by lenders.

High risk equals high cost

The typical standard variable rate on a non-prime mortgage by January 2008 was 9 per cent – or 3.5 per cent above base rates[18]. Like many mainstream lenders, non-prime lenders have also been increasing their arrangement fees. Borrowers can face arrangement fees of £1,000, and early redemption penalties of five or six per cent of the money redeemed, which acts as a disincentive to switching.

High cost equals high risk

The FSA suggests that the rate of arrears for non-prime mortgages is up to 20 times higher than for mainstream mortgages[19]. As non-prime lenders tend to be less willing to negotiate with borrowers in arrears[20], they are responsible for a substantially disproportionate share of repossessions.

High risk equals less choice

Research by Moneyfacts found that over the year to March 2008 the number of products in the non-prime sector has been reduced by over 70 per cent, and a number of providers have withdrawn from the market. This means less choice for the increasing number of vulnerable consumers entering this market. This could lead to ineffective competition.

Market failure

Research from the FSA and Citizens Advice points to serious detrimental practices along the entire non-prime mortgage chain – at point of sale, Treating Customers Fairly when in arrears, and during repossession. We found that consumers can face very high penalties and fees because of the mortgage contract terms.

Irresponsible lending

The FSA's review of 11 sub-prime lenders found that none had 'adequately covered all relevant responsible lending considerations in their policies' and 'many' failed to apply the policies they did have[21]. Failures in lenders' controls were also found to have led to the approval of unaffordable mortgages.

Detrimental sales practices

Many non-prime customers rely on the services of a mortgage broker. In uncertain times people may be even more likely to seek their services. Worryingly, the FSA's review identified major failings by mortgage intermediaries: a third of files reviewed had 'an inadequate assessment of consumers' ability to afford the mortgage'. In almost half of cases there was 'an inadequate assessment of the customers' suitability for the mortgages'. Large numbers of consumers had also been advised to remortgage (which involved new sets of fees for intermediaries) without any evidence provided 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. This means that consumers may never know the identities of the other two-thirds. This lack of transparency could fail to protect both consumers and responsible lenders. We welcome government proposals in the Regulatory Enforcement and Sanctions Bill to require regulators to disclose details of all civil sanctions. The FSA is working to improve transparency[22]; we look forward to seeing how that develops. New measures 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, they have 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[23]), we would expect it to call for the removal of these legal barriers to transparency.

Consumer protection

There is a patchwork of safeguards in place, which are meant to protect consumers from the consequences of over-indebtedness.

Treating Customers Fairly

Lenders are required to follow written policy and procedures for dealing fairly with customers in arrears. However, the FSA reports that, as lenders get tougher on credit risk, attitudes towards mortgage arrears have already hardened. Preliminary FSA research suggests that many lenders may be failing to meet requirements. Some lenders appear unwilling to consider cases on an individual basis or to agree a solution tailored to the borrower's circumstances, instead adopting a one-size-fits-all approach to arrears recovery. Our research supports the FSA's findings. Lenders may say they want to treat customers fairly, but it is a concern that so few seem to have made detailed plans for dealing with borrowers in distress.

Self-regulatory codes

The Banking Code has been improved, and now puts a requirement on lenders to spot borrowers in financial difficulty[24]. However, 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.

The Finance and Leasing Association Lending Code, which covers many sub-prime lenders, doesn't contain this proactive element. Subscribers are required to treat customers sympathetically, but what this means in practice is at the lender's discretion. This difference creates uneven protection for borrowers, and an uneven playing field for lenders.

State help

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 could face a shortfall of between £60 and £165 a month.

Market response

Insurance

Mortgage payment protection insurance (MPPI) has not filled the gap, covering only around 22 per cent of mortgages. 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 to leave the homes they expected to stay in after a short rental period.

Notes and references

1. *Family Resources Survey*, Table 5.9, 2005-06
2. Halifax House Price Index, March and April 2008
3. Morgan Stanley chief economist David Miles, April 2008
4. Details of the up to 4 million breakdown can be found in the main report
5. Nationwide House Price Index
6. Average earnings index for whole economy seasonally adjusted, National Statistics
7. Credit Action, www.creditaction.org.uk/debt-statistics.html
8. Details of the findings can be found in our full report
9. *Bank of England Credit Conditions Survey*, 2008
10. energywatch
11. *Family Resources Survey*, Table 5.9, 2005-06
12. Derived from Labour Force Survey (LFS) *Historical Quarterly Supplement* –Table 37: Average gross weekly/hourly earnings by industry sector (£s - not seasonally adjusted),
13. Halifax House Price Index, March and April 2008
14. *FSA Financial Risk Outlook*, 2007
15. We use 'non-prime' as a general term for the sub-prime, adverse credit, non-conforming loans market
16. Intermediary Mortgage Lenders Association (IMLA): figure represents sub-prime and other non-standard lenders
17. Datamonitor
18. Rates of 11 per cent are not uncommon
19. Clive Briault Speech at CML Annual Lunch, 20 April 2007
20. Citizens Advice Bureau, *Set up to fail*, December 2007
21. Financial Services Authority, *Review of the behaviour of intermediaries and lenders within the sub-prime mortgage market*, 4 July 2007
22. Financial Services Authority, , April 2008
23. Decision notices FS50090010 and FS50075781, Office of the Information Commissioner, 7 August 2007
24. 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

Further work

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 Financial Inclusion Centre 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 Financial Inclusion Centre 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 purpose and needs to be reformed to reflect the realities of consumers with expensive sub-prime mortgages. The Department for Work and Pensions should review the adequacy of the scheme.

Home ownership targets

The scale of detriment that up to four million consumers could be facing 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 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 access to affordable credit will be reduced for many consumers. Radical interventions are needed to ensure that excluded consumers have access to fair and affordable loans in the medium-to-long term. NCC chairs the Financial Inclusion Taskforce's affordable credit sub-group that has been tasked with scaling up third sector credit provision. Further interventions will be the subject of later work by the Financial Inclusion Centre.

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. NCC led the Financial Inclusion Taskforce's Third Sector Credit Working Group, which 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 Financial Inclusion Centre is developing the concept of social investment bonds to provide access to other sources of funding for third-sector organisations.