cml
Council of Mortgage Lenders

Mortgage insurance: market structure, underwriting cycle and policy implications

Response by the Council of Mortgage Lenders
to the Basel Committee on Banking Supervision Joint Forum

Introduction

1. The CML is the representative trade body for the UK first charge mortgage lending industry that includes banks, building societies and specialist lenders. Our 110 members currently hold around 95% of the assets of the UK mortgage market. In addition to lending for home-ownership, the CML's members also lend to support the social housing and private rental markets.

2. We are grateful for the opportunity to respond to the consultation document issued by the Basel Committee for Banking Supervision on "Mortgage insurance: market structure, underwriting cycle and policy implications", published in February 2013. In preparing this response to the consultation document, we have included comments from some of our members.

3. Since the publication of the consultative document, there have been significant changes to the market structure in the UK; namely, the Help-to-Buy: mortgage guarantee scheme (the scheme) announced in the UK budget in March. Details have yet to be published, but the outline of the scheme would currently suggest the introduction of a government backed mortgage guarantee that would protect lenders from some of the losses incurred on particular high LTV loans and which would thus encourage more of these loans to be made. This can be seen as a form of mortgage insurance but not one that has precise parallels in other jurisdictions.

4. In particular, the proposed structure does not require private sector underwriters outside the mortgage lenders to be involved in underwriting each loan covered by the guarantee. It will be for the underwriting departments of lenders to evaluate applications. However, their conduct will be covered by existing regulation. The FCA's Mortgage Market Review (MMR) will ensure that lenders maintain their high underwriting standards and can thus be seen to be in line with the Forum's recommendations.

5. We welcome this consultative document since it provides a framework for participants in the new scheme against which to measure their proposals and it will help deliver a robust structure.

6. The CML broadly supports the principles outlined in the document, recognising that some of the design features of the proposed UK scheme will make some of the recommendations inapplicable: e.g. the potential for capital arbitrage between lenders and the insurance/guarantee provider or for the insurance/guarantee provider to build long-term capital buffers. **If, in future iterations of government-backed guarantee schemes separate underwriting by a private sector insurer formed part of the scheme, we would consider the proposed recommendations to form a sensible supervisory approach.**

Overview of Help-to-Buy: mortgage guarantee

7. Help-to-Buy: mortgage guarantee will potentially make available up to £12bn of government guarantees, sufficient to support £130bn of high loan-to-value mortgages and be available for a period of three years starting on 1 January 2014. The guarantee will last for 7 years on each mortgage. The scheme is designed to support lending between 80-95% LTV i.e. to help households with between 5-20% deposits.

8. While some details of the scheme are not known, currently buy-to-let mortgages will not be eligible. A qualifying mortgage has to be taken out by an individual rather than a corporation and the property value must be less than £600,000. Other restrictions on eligibility include repayment mortgages only and that the lender must ensure the borrower meets certain requirements in respect of the ability of the borrower to repay for example proposed loan-to-income and credit score tests.

9. Lenders will be able to access the scheme by way of a commercial fee. This will be set at a level designed to compensate the government for the expected losses under the scheme, the cost of capital to provide the contingent liability that the guarantee creates and the administration costs of the scheme.

10. The scheme will be designed to ensure that lenders will not be able to restructure the more risky part of their existing loan book and that borrowers remain the beneficiaries of the scheme. Thus, it is proposed that some types of re-mortgage transactions will not be eligible. Significantly, a borrower re-mortgaging with a new lending institution will be able to benefit from the scheme.

11. It is anticipated that the scheme will allow lenders to achieve capital relief based on the credit risk mitigation provided by the guarantee. However, as the final details are not known, at this stage it is not clear whether capital relief will be available under both the standard and IRB approaches.

Comments of the Help-to-Buy: mortgage guarantee scheme in relation to the recommendations outlined in the consultative document

12. Some of the specific features of the scheme make some of the recommendations contained within the document inapplicable, e.g. the need to build long-term capital buffers or the opportunity for capital arbitrage between the lenders and the providers of mortgage insurance and/or a guarantee.

13. While we also agree with the recommendation that the provider of the guarantee and the originator of the loan maintain strong underwriting standards, we would caution that this should not mean that mortgage applications undergo two sets of underwriting.

14. The use of LTI models or credit score tests may not ensure credit quality of the loans for the provider of the guarantee. Lenders use different lending models to assess credit risk and no one LTI multiple or credit score test reflects the different models that lenders use. There is no industry standard for either LTI or credit score tests and, therefore, the use of such controls by the provider of the guarantee may result in lenders either reducing their underwriting criteria or not extend loans since they would fall outside the criteria determined by the guarantor.

15. The experience of the UK in the 1980s when obtaining insurance from private insurance companies is, we believe, instructive. Too intrusive and onerous secondary underwriting requirements by insurance companies meant that borrowers faced extra delays in obtaining mortgages, which undermined confidence in the market. In addition, when lenders and insurance company underwriting criteria differed, it caused confusion for borrowers as to why mortgages had been turned down.

16. Furthermore, the reluctance of some insurance companies to meet claims and the long audit process required by insurance companies before meeting out claims, undermined the effectiveness of the system. Both were factors in the withdrawal of mortgage insurance in the UK.

17. We do not believe that the imposition of this scheme needs to result in further legislation or additional regulatory supervision, in the UK. Nor do we believe that the introduction of the scheme will allow for a weakening of underwriting standards. Responsible lending requirements are being tightened up by the new MMR rules being introduced by the FCA in April 2014. We do not believe additional requirements are needed over and above that.

18. Likewise, the powers the FCA already have powers sufficient to deal with a threat to underwriting standards caused by behavioural incentives.

Conclusions

19. The development of the UK scheme is at an early stage. We agree with outline of many of the recommendations of the consultative document and hope they will be incorporated in the scheme.

20. At the same time, given the experience the UK had with mortgage insurance in the 1980s, we would highlight some of the issues involved in the creation of the scheme. In particular, we would

caution against the imposition of industry wide lending criteria in the form of LTI requirements or a credit-score test.

21. We would also conclude that the existing regulatory regime has sufficient powers to ensure that any pressure to reduce underwriting standards given the creation of a guarantee scheme can be prevented.

22. If you have any comments or queries regarding this submission please contact Jon Saunders, jon.saunders@cml.org.uk on +44 207 438 8934.