



April 2004

BRIEFING

# The Miles Report on the UK mortgage market

Taking a longer-term view

## Executive summary

This briefing looks at the recommendations of the Miles Report on the UK mortgage market, which was commissioned by the Treasury in 2003 as part of a series of studies on matters affecting long-term fiscal policy with the aim of maintaining stability in the British economy. The government and the Financial Services Authority will now consider Professor Miles' proposals to increase the take-up of longer-term fixed rate mortgages.

Professor David Miles' report *The UK Mortgage Market: Taking a Longer-Term View* (the Report) was commissioned by the Treasury in 2003 as part of a series of studies on matters affecting long-term fiscal policy with the aim of maintaining stability in the British economy. The government and the Financial Services Authority (FSA) will now consider Professor Miles' proposals to increase the take-up of longer-term fixed rate mortgages.

Professor Miles states that the aim of the Report is to make the UK mortgage market work better. Economic analysis suggests that the take-up of longer-term fixed rate mortgages (in the form of mortgages with fixed terms longer than current typical fixed interest terms of up to five years) in the UK is much lower than one might expect based on a model of optimal mortgage choices. It is believed that a significant proportion of UK households would choose a longer-term fixed rate mortgage if they were better informed and if such mortgages were available.

Professor Miles believes that implementation of his recommendations will:

- improve the information and advice that borrowers receive and create a fairer and more transparent pricing structure; and
- remove some potential obstacles to the emergence of new types of contracts to hedge interest rate risk and improve the ways fixed rate mortgages can be funded and the ways risks they generate can be hedged.

## Improving borrowers' understanding

The Report states that there is strong evidence to suggest that many borrowers focus excessively on the initial monthly cost of a mortgage and do not have a good understanding of the interest rate risk associated with different mortgage products. It recommends that the FSA require mortgage advisers to cover personalised 'what if' scenarios when giving advice to assess consumer attitudes to risk and identify personal preferences.

It is essential that mortgage advisers understand the risk characteristics of the different products they are recommending and how their costs to borrowers might evolve in order to give good advice. To this end, the Report recommends that the Financial Services Skills Council require appropriate examinations for mortgage advisers.

The Report suggests that many borrowers do not pay sufficient attention to the likely level of future interest rates when choosing between different mortgage products. It therefore recommends that the FSA require that a clear indication of variability in rates in the past and the impact of such variability on monthly mortgage repayments be shown in the pre-sale disclosure form (in addition to the current warning). It further recommends that the FSA revise its mortgage information leaflet to include personalised 'what if' scenarios and that the FSA consult with the Council of Mortgage Lenders, the Association of Mortgage Intermediaries and other stakeholders to identify the most effective distribution method.

## Fairer pricing in the UK

The Report finds that certain mortgage lenders distinguish between customers on the basis of whether they are first time buyers, existing customers or re-mortgaging from another lender. Where different mortgage rates are offered to these different groups they do not reflect differences in risk for the lender. This means that the only way some borrowers can get a better deal is to switch to another lender, which carries an additional cost. The Report recommends that the FSA require all lenders to make their full range of mortgage products available to all borrowers and suggests that a timescale of two years for implementing this change would prevent significant market disruption.

Survey evidence shows that borrowers perceive the process of switching a mortgage as costly and that this can act as a barrier to re-mortgaging. The Report recommends that the FSA create a short user-friendly guide for borrowers on the process of re-mortgaging. It suggests that this be made available through the FSA's consumer helpline and website.

The Report also suggests that borrowers should be made aware of sources of comparative information to enable them to make informed decisions. It recommends that the FSA require firms to include in all mandatory disclosure documentation the link to the mortgage comparative tables on the FSA website ([www.fsa.gov.uk/tables](http://www.fsa.gov.uk/tables)), together with a short description of the purpose of these tables.

The Report further suggests that borrowers be made aware of all mortgage products offered by their lender. It recommends that the FSA require lenders to include a leaflet with their annual statements setting out the current mortgage rates on all their products.

## Alternative protection from nominal payment uncertainty

Fixed rate mortgages provide certainty regarding the profile of mortgage repayments over time and protect against the risk of rising insurance rates. The Report discusses alternative methods by which borrowers can protect themselves against interest rate fluctuations while retaining a degree of flexibility. These methods include

capped mortgages, stepped fixed rates and part variable/part fixed rate mortgages. The Report states that if interest rate caps could be sold separately from the mortgages themselves this would protect against interest rate movements while offering greater flexibility.

The Report finds that there is uncertainty surrounding the tax and regulatory treatment of stand-alone insurance protecting against interest rate movements. It suggests that this uncertainty may hinder the development of such products. The Report recommends that the government treat interest payment protection as insurance for tax purposes (provided that the sum assured is no greater than the part of a mortgage with a variable interest rate). The Report also recommends that the FSA treat such a product as insurance (rather than a derivative) for regulation of sale purposes.

## Enabling cost effective long-term lending

The Report states that there are supply side factors affecting how mortgage lending is funded that may hinder the emergence of a market in longer-term fixed rate mortgages.

Certain obstacles to funding relate to the necessity of avoiding a mismatch in interest rates. This may be achieved by issuing covered bonds. The Report finds that the lack of specific covered bond legislation in the UK could hinder the development of a UK covered bond market, as it may prevent recognition of covered bonds under the Co-ordination Directive on Undertakings for Collective Investments in Transferable Securities (UCITS). If preferential treatment for UCITS is unavailable European investment funds will be less likely to invest in UK issued covered bonds. The Report states that the Directive requirement of recognition in law may possibly be satisfied by amending the FSA's rules rather than passing primary legislation. However, the FSA has provided a preliminary assessment that current insolvency law may be sufficient. The Report recommends that the FSA provide a definite view on whether current UK insolvency law is sufficient to allow recognition of covered bonds under the UCITS Directive.

The 10 per cent preferential risk weighting for covered bonds is not currently available in the UK. The Report says it may be possible to ensure that a bond issued by a

UK lender has the necessary general characteristics without the need for new legislation. If a requirement for specific covered bond legislation were included in the new Capital Adequacy Directive (CAD3), legislation would be needed in the UK to allow UK lenders to obtain more favourable capital weightings for these bonds than is currently possible. The Report recommends that the government aim to ensure that CAD3 does not require specific UK covered bond legislation.

Other obstacles to funding relate to the management of pre-payment risk. One option for lenders is the use of mark-to-market redemption charges. The Report suggests that such charges are not well understood, are popularly considered to be intrinsically unfair and may be unenforceable in the UK. Symmetric mark-to-market charges (where a payment can also be made *to* a borrower on redemption) could be particularly attractive to certain borrowers. The Report recommends that the FSA allow illustration of the potential gain from early repayment of a mortgage with symmetric mark-to-market charges in the pre-sale disclosure form, and require disclosure of the maximum charge. It also recommends that the government make compensation from symmetric mark-to-market charges tax exempt.

Another method of hedging pre-payment risk is through the purchase of interest rate derivatives, including call options. There may not be enough natural writers of long-term call options in the private sector to create a sufficiently liquid and efficient market to allow such options to be bought at a cost that is low enough to make this strategy commercially feasible. Writing call options could help reduce volatility for regular issuers of long-term fixed rate bonds (such as the government) when there is uncertainty about future interest rates. The Report recommends that the government give further consideration to the potential costs and benefits of its own issue of interest rate derivatives.

The Report identifies various regulatory issues affecting the ability of lenders to carry out cost effective long-term lending. CAD3 is intended to transpose the new Basel Accord into EU legislation. The CAD3 proposals could affect the capital treatment of fixed rate compared with variable rate mortgages. The FSA's initial proposals for implementation of CAD3 in the UK suggest that where firms can provide sufficient evidence that there is a

different default risk profile for particular mortgage products different capital treatments will be accepted. Most UK mortgage lenders have little historic data reflecting the differing credit risks. The Report recommends that the FSA allow a broad range of evidence (in addition to UK historic data) when assessing the default risk of different mortgage contracts.

For further information please contact

Mark Kalderon

T + 44 20 7832 7106

F + 44 20 7832 7244

E [mark.kalderon@freshfields.com](mailto:mark.kalderon@freshfields.com)