TOPIC 12

Suitability

LEARNING OBJECTIVES

In Topic 9 we looked at the factfind and the information that the adviser requires. The factfind helps the adviser to understand not only the client's financial position but also their needs and attitudes – for example, their attitude towards risk. Drawing on this information, the adviser can formulate a suitable recommendation.

By the end of this topic you should have an understanding of:

- the key issues that an adviser must consider in determining the suitability of a recommendation, including:
  - the mortgage term;
  - the approach to repayment;
  - the importance of the customer's attitude to risk;
- the factors to consider in relation to interest-only mortgages.

THINK ...

We have looked briefly at suitability requirements in earlier topics. Think about the following questions to focus your thoughts.

- What should the adviser do if there is no product in the range they offer that precisely meets the customer's needs?
- Should an adviser always provide the customer with the product they ask for?
- What information needs to be gathered at the factfind stage?

12.1 What does an adviser need to consider in assessing suitability?

With advised sales, a firm must take steps to ensure that any personal recommendations are suitable for the client. The adviser gathers information about the customer that will help them to assess which mortgage, if any, is suitable for the customer's needs and circumstances. For each issue summarised in Table 12.1, the FCA requires firms to assess appropriateness for the customer.

TABLE 12.1 ASSESSING SUITABILITY OF A RECOMMENDATION

Does the customer ...	Considerations
Meet the lender's eligibility criteria?	Income, loan-to-value ratio, etc
Require a repayment or interest-only mortgage, or a combination of the two?	
Have a preference for a particular mortgage term?	
Have a preference or need for stability of monthly payments (fixed or capped)?	What are the customer's views on changes in interest rates – do they need certainty of payment amounts in order to budget? In some cases, the most suitable product in terms of stable payments might be subject to terms and conditions that discourage early repayment or switching to another lender – the customer needs to be aware of these
Have a preference or need for minimised initial payments?	Is a discount or low-start mortgage appropriate?
Intend to make early repayments?	Does the product allow early repayments without penalty? If there are penalties, the customer must be satisfied that they are outweighed by the benefits of the mortgage
Have a preference or need for any other mortgage features?	Are features such as payment holidays, overpayments, etc, an important consideration?
Have a credit record that suggests the mortgage is appropriate?	
Need to pay any fees or charges up front, rather than have them added to the mortgage?	

CHECK YOUR UNDERSTANDING 1

In Topic 10, you covered three points that the adviser should consider if the purpose of the mortgage is to consolidate debts. Can you recall what they are?

If there is no contract suitable for the customer's needs and circumstances within the range available to the firm, it should not make a recommendation. It is not acceptable to recommend the closest fit from those available. A good example is where the adviser is a sub-prime specialist, only offering mortgage products designed for those with poor credit records. If a customer with a good credit record asks for advice, the adviser must not recommend a sub-prime mortgage. The one exception is if the adviser can demonstrate that the costs, terms and conditions of the contract will not disadvantage the customer when compared with suitable standard mortgages.

12.2 What must be considered in relation to the mortgage term?

The mortgage term is an important part of the suitability assessment. In general terms, any mortgage should be arranged over the shortest feasible term that suits the borrower's needs. People generally dislike debt and would like to be mortgage-free at the earliest opportunity. Key considerations are as follows:

- The effect the payments will have on the borrower's monthly budget. For example, a short term may not leave the borrower much room in their monthly budget. They might prefer a slightly longer term that creates a bigger cushion between income and outgoings.
- The age at which the customer would like to have repaid the mortgage.
- Whether the customer feels there is a possibility of paying off the loan early – if there is, mortgages with early repayment penalties should be avoided.
- If the mortgage term takes the customer near or into retirement, will there be sufficient income to maintain the repayments?
- While settling the mortgage as early as possible is important, is the customer aware that shorter terms require higher monthly payments, either on a repayment basis or to the investment vehicle running alongside an interest-only loan? In many cases, a customer may want a shorter term, but a longer term will allow higher borrowing. For example, monthly repayments on a £100,000 repayment mortgage at 3.8 per cent would be £522 over 25 years and £602 over 20 years. To put it another way, using the same interest rate, someone with a monthly budget of £602 could increase their maximum borrowing to £115,000 by opting for a 25-year term. The number

of first-time buyers opting for terms in excess of 25 years has increased, mainly due to affordability issues.

CHECK YOUR UNDERSTANDING 2

Think back to Topic 10. If the term of the mortgage will extend beyond the customer's expected retirement date (or state pension age if that date is unknown), what should the adviser consider?

12.3 Why is considering risk important?

We don't usually associate mortgages with risk in the same way as investments. However, mortgage risk is a factor that must be taken seriously. In mortgage terms, risk encompasses a number of issues.

- **Risk to the home** – the home is at risk if the borrower fails to keep up repayments on the mortgage.
- **Negative equity** – borrowing a high percentage of the property's value presents the risk of negative equity if prices go down.
- **Repayment risk** – those who do not wish to run the risk of the mortgage not being repaid at, or by, the end of the term should be advised to select a repayment mortgage rather than interest-only.
- **Interest-rate risk** – rates can increase, making the repayments higher. Any increase in the size of the repayments may place pressure on the customer's ability to keep up repayments. Depending on their attitude to risk, a fixed or capped rate may suit them.
- **Fixed-rate risk** – if the customer takes out a fixed-rate mortgage, there is a risk that variable rates may fall below the fixed rate. This will mean the customer is paying more than someone on the variable rate; they must be aware of this risk and satisfied that the benefit of the fixed rate outweighs the risk.
- **Rate rises at the end of a fixed or discount term** – there is the risk that variable rates may have risen significantly by the end of a fixed rate or discount term. How would the customer cope in this situation?
- **Underperformance of investment vehicle** – there is a risk that an investment vehicle running alongside an interest-only mortgage may not perform to expectations. Is the customer aware of this risk and the consequences of such underperformance? Do they have other resources that might be used to repay the mortgage in that situation?

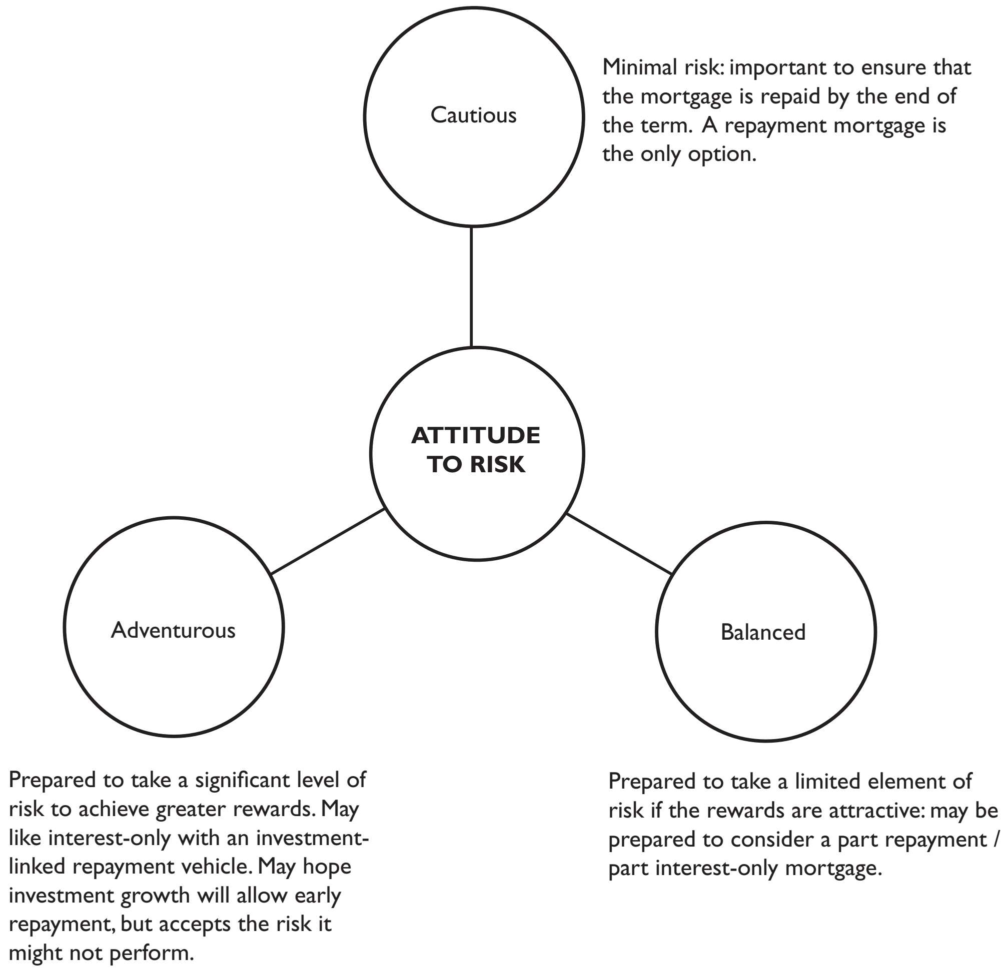
The two main issues to consider in this context are the customer's attitude to:

- the risk of not being able to repay the mortgage; and

- the risk posed by interest-rate changes.

Figure 12.1 illustrates an approach to categorising customers in terms of their attitude to repayment risk, but note that different lenders will categorise customers in different ways or may use more categories.

FIGURE 12.1 CUSTOMER RISK CATEGORIES FOR MORTGAGE REPAYMENT



In terms of interest rates, is the customer concerned about the impact an interest-rate rise would have on their payments? Do they wish to have certainty of payments for a specified period? Do they feel they have spare capacity to afford interest-rate increases? If they want to keep costs low initially (eg via a discount mortgage), how do they feel about the risk that their payments could go up significantly after a specified period?

The FCA has sought to limit the risk posed by interest-rate rises by establishing the interest-rate 'stress test', which lenders must use when assessing affordability, and in adherence with MCOB rules.

CHECK YOUR UNDERSTANDING 3

We looked at the interest rate stress test in Topic 10. Can you remember:

a) the minimum period over which lenders must consider the impact on affordability of potential interest-rate increases?

b) what the calculations of potential interest-rate increases are based on?

12.3.1 How is the customer's attitude to risk assessed?

There are many ways to assess a customer's attitude to risk, and each organisation will have its own procedures. Historically, advisers tended to conclude the process by asking the client to indicate their attitude to risk as a number on a scale. However, this is very subjective and reliant on the quality of the questions, the adviser's explanations and the client's understanding of the process and the questions.

Prompted by increasing concern from the FCA, most advisers now use a more formal approach involving a questionnaire. However, it is important that the adviser does not rely solely on the outcome of a questionnaire; they should ensure the client understands the questions and their implications, and then use the answers in conjunction with their own knowledge and experience in assessing risk, always ensuring that there are meaningful conversations with the client.

Some lenders use psychometric profiling, whereby the adviser uses software tools to assess the client's psychological attitude to risk in general. Psychometrics assesses the client's knowledge, experience, attitudes and personality rather than considering the risk they are prepared to take. The tests are validated statistically by using a large sample of the population. The questions will consider a number of aspects of the client's approach, including:

- their own feelings on their attitude to, and tolerance of, risk;
- past financial decisions they have made;
- how they would feel and react in a number of 'what if' financial scenarios containing positive and negative outcomes;
- how they would feel about a number of hypothetical events and outcomes in relation to their finances.

12.4 How do the suitability requirements affect interest-only mortgages?

IN BRIEF

WHY DID INTEREST-ONLY MORTGAGES BECOME A PROBLEM?

Many borrowers, particularly in the late 1980s through to the early 2000s, took out interest-only mortgages to cut monthly expenditure but did not arrange adequate repayment vehicles. Sometimes the problem was compounded because borrowers could use the interest-only approach to obtain a larger mortgage than they could afford with a repayment mortgage, but with little prospect of repaying it at the end of the term.

Many borrowers did not realise that this was a high-risk approach to mortgage repayment until they received warning letters explaining that their repayment vehicle was unlikely to produce enough to repay the mortgage; or until those who had no repayment vehicle found they had inadequate resources to repay the loan at the end of the term.

In response to the problems experienced by borrowers with interest-only mortgages, MCOB 4.7a and MCOB 11.6 require lenders to make sure the customer demonstrates that they have arranged a clearly understood and 'credible' repayment strategy, which the lender has assessed at the time as having the potential to repay the capital at the end of the term. The lender is not required to provide advice on that strategy, and MCOB is not prescriptive about what is meant by a 'credible' strategy (although MCOB 11.6 does provide some examples of strategies likely to be acceptable or unacceptable – see Table 12.2).

MCOB 11 requires the lender to assess affordability on a capital-and-interest basis unless there is a clearly understood and credible alternative source of capital repayment. In other words, an interest-only mortgage without a viable repayment vehicle is assessed in the same way as a repayment mortgage, and will not enable the borrower to obtain a larger mortgage. If there is a repayment vehicle to support the mortgage, its cost must be included in the affordability assessment as committed expenditure.

For interest-only mortgages other than lifetime mortgages, retirement interest-only mortgages and bridging loans, the lender must carry out a review at least once during the mortgage term (MCOB 11.6.49). The review checks that the customer's repayment strategy is still in place, and that it still has the potential to repay the mortgage at the end of the term. The review must be carried out at a stage in the mortgage term where there is still time for the customer to take remedial action if the strategy is shown to be failing. If the review identifies a problem, the lender must take reasonable steps to discuss potential remedial action with the customer.

The FCA introduced a new regulatory category of interest-only mortgage with effect from 23 March 2018. The retirement interest-only mortgage is available to those over a certain age (not specified by the FCA) who wish (or need) to extend their mortgage into retirement, but are not seeking a lifetime mortgage. Interest payments are made in the same way as a standard interest-only mortgage, but the mortgage would only be repaid on the borrower's (or surviving borrower's) death, move into residential care or sale of the property. Normal affordability checks are required, including income in retirement, but the lender can assess the mortgage affordability on an interest-only basis without a repayment vehicle or strategy because, unlike a standard interest-only mortgage, sale of the property would be an acceptable repayment strategy.

TABLE 12.2 ACCEPTABLE AND UNACCEPTABLE REPAYMENT STRATEGIES

Potentially acceptable strategies	Strategies likely to contravene the rules
Regular deposits into a savings or investment product	Expectation that the value of the mortgaged property will increase sufficiently over the mortgage term to enable the customer to sell the property and repay the mortgage
Periodic repayment of capital from irregular sources of income (such as bonuses or some sources of self-employment income)	Intention to use an expected, but uncertain, inheritance to repay the mortgage
Sale of assets such as another property or other land owned by the customer	Sale of the mortgaged property, where it is the customer's main residence (unless the lender has considered whether it will have the potential to provide enough for the customer to repay the mortgage and allow them to buy another property to live in or execute another strategy)
The sale of the property for a shared equity or retirement interest-only mortgage	

RECORD-KEEPING: INTEREST-ONLY MORTGAGES

The lender must keep records of each interest-only mortgage for the term of the mortgage contract. The record should include:

- the reasons for the decision to offer an interest-only mortgage;
- evidence of the customer's repayment strategy and, where applicable, its cost;
- details of the firm's attempts to contact the customer for reviews;
- the outcome of each review.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the general considerations for an adviser when assessing suitability?
- list the key issues to consider in relation to the mortgage term?
- explain what the adviser should do if the borrower is nearing retirement age?
- outline the types of risk that relate to mortgage products?
- describe how a customer's attitude to risk could be assessed?
- give examples of potentially suitable repayment strategies for an interest-only mortgage?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 12. Review the text if necessary.

Answers can be found at the end of this book.

1) If there is no contract suitable for the customer's needs and circumstances within the range available to the firm, it should not make a recommendation. True or false?

2) John is 55 and is seeking a 20-year repayment mortgage. The lender's affordability assessment must only take into account his financial position at the time of the application. True or false?

3) Duncan is keen to accrue as little interest as possible on his mortgage and is pressing the adviser to arrange as short a term as possible. Which of the following are factors the adviser should highlight to Duncan? Select all that apply.

    a) For a capital-and-interest mortgage, a short mortgage term means monthly repayments will be higher.

    b) For a capital-and-interest mortgage, the mortgage term does not impact the monthly payments.

    c) For an interest-only mortgage, a short term may limit the options of repayment vehicle.

    d) For an interest-only mortgage, a longer term will increase the monthly repayments.

4) It is not necessary to establish the customer's attitude to risk when advising on mortgages because there is no investment exposure. True or false?

5) Which of the following would be most likely to be considered a credible repayment strategy for an interest-only mortgage?

    a) Planning to use a promised inheritance from a relative.

    b) Relying on the increase in value of the property to provide equity that can be released to pay off the loan.

    c) Using the proceeds from the sale of another property owned by the borrower.

6) For an interest-only mortgage, how often must the lender carry out a review of the borrower's repayment strategy?

a) At least once during the term.

b) Whenever the borrower requests it.

c) At least once every five years.

d) Halfway through the term.