

Lending to higher risk borrowers

Sub-prime credit and sustainable home ownership

Moira Munro, Janet Ford, Chris Leishman and Noah Kofi Karley

This report contains the first analysis of the financial sector which lends to people who are considered high-risk borrowers.

Also known as the sub-prime finance sector, this business is specifically targeted at higher risk borrowers, including people who have an impaired credit rating because of CCJs or bankruptcy, or who cannot prove their income. The evident growth in advertising by such lenders, and regulators' fears that it may attract more vulnerable borrowers, make it important to know how the sector operates.

The research explores finance industry, regulator and consumer advice agency perspectives on sub-prime lending, focusing particularly on sub-prime secured lending. It explains the factors that have created buoyant growth and increased diversity in the sector over the last decade, and describes how the regulatory framework has evolved in response to the rapidly changing consumer credit market. It explores the potential benefits to consumers, – greater choice for those who would previously have been excluded from owner-occupation, and a safety net for those who get into financial difficulty. At the same time, however, it analyses the ways in which consumers who turn to sub-prime lending can face increased financial vulnerability and risk, which can ultimately result in house repossession and homelessness.

Sub-prime lending is now a well-established part of the UK financial scene, and has evolved rapidly to exploit an increasing range and complexity of market niches. The sector will become of particular significance to the sustainability of owner-occupation should the currently benign economic conditions change. This report is therefore essential reading for all those interested in consumer borrowing and debt, and housing and mortgage markets.



**JOSEPH ROWNTREE
FOUNDATION**



**Available
in alternative
formats**

This publication can be provided in alternative formats, such as large print, Braille, audiotape and on disk. Please contact: Communications Department, Joseph Rowntree Foundation, The Homestead, 40 Water End, York YO30 6WP. Tel: 01904 615905. Email: info@jrf.org.uk

Lending to higher risk borrowers

Sub-prime credit and sustainable home ownership

**Moira Munro, Janet Ford, Chris Leishman
and Noah Kofi Karley**



**JOSEPH ROWNTREE
FOUNDATION**

The **Joseph Rowntree Foundation** has supported this project as part of its programme of research and innovative development projects, which it hopes will be of value to policy makers, practitioners and service users. The facts presented and views expressed in this report are, however, those of the authors and not necessarily those of the Foundation.

Joseph Rowntree Foundation
The Homestead
40 Water End
York YO30 6WP
Website: www.jrf.org.uk

About the authors

Moira Munro is a Professor at the School of the Built Environment, Heriot Watt University.

Janet Ford is a Professor in the Centre for Housing Policy, and Pro Vice Chancellor of the University of York.

Dr Chris Leishman is a Senior Lecturer at the School of the Built Environment, Heriot Watt University.

Dr Noah Kofi Karley is a Lecturer at the School of the Built Environment, Heriot Watt University.

© Heriot Watt University 2005

First published 2005 by the Joseph Rowntree Foundation

All rights reserved. Reproduction of this report by photocopying or electronic means for non-commercial purposes is permitted. Otherwise, no part of this report may be reproduced, adapted, stored in a retrieval system or transmitted by any means, electronic, mechanical, photocopying, or otherwise without the prior written permission of the Joseph Rowntree Foundation.

ISBN 1 85935 334 7 (paperback)
ISBN 1 85935 335 5 (pdf: available at www.jrf.org.uk)

A CIP catalogue record for this report is available from the British Library.

Cover design by Adkins Design

Prepared and printed by:
York Publishing Services Ltd
64 Hallfield Road
Layorthorpe
York YO31 7ZQ
Tel: 01904 430033; Fax: 01904 430868; Website: www.yps-publishing.co.uk

Further copies of this report, or any other JRF publication, can be obtained either from the JRF website (www.jrf.org.uk/bookshop/) or from our distributor, York Publishing Services Ltd, at the above address.

Contents

Glossary	vii
List of abbreviations	ix
1 Introduction	1
Defining the sub-prime sector	1
Research approach	3
2 Changing context: borrowers and debt	6
Mortgaging and remortgaging	7
Indebted Britain	9
Summary	12
3 The evolution of the sub-prime lending sector	13
The development of sub-prime lenders	13
Drivers of growth in the sub-prime sector	15
Industry evolution	18
Summary	22
4 The contemporary sub-prime sector	23
Segmentation and differentiation	23
Regulation of the sub-prime industry	26
Evidence on the structure of sub-prime products	30
Defining degrees of adversity and risk	32
Redemption penalties	37
Other charges	38
LTV ratios	39
Sub-prime niche markets	39
The size of the sub-prime market	43
5 Sub-prime borrowers' perspectives	48
Responsible lending	48
Consumers' knowledge of sub-prime terms and conditions	49
Arrears and possessions	50
Payment protection insurance	52
Regulation	53
Other issues	53
Sub-prime credit as extortionate credit?	53
Selling sub-prime loans	54
The industry perspective: serving sub-prime customers	56
6 Conclusions	59
Market differentiation	60
Sub-prime lending and sustainable home ownership	61
Policy issues	62
Research issues	63

Notes	66
Bibliography	68
Appendix: Sub-prime search strategy	71

Glossary

The report contains some terms that may be unfamiliar to those outwith the mortgage industry. The following brief explanations are intended to help such readers.

- *Equity lending*: where a lender makes a loan with little concern for ability of the borrower to repay, instead anticipating an ultimate return from the loan to follow from house repossession.
- *Loan book*: the term for the loans that a lender has outstanding on its balance sheet.
- *Rent to mortgage*: this is a government scheme whereby the rent that a tenant would normally pay is converted into a mortgage and used to buy a portion of equity in a property.
- *Second charge loan*: this is a loan secured against the equity in a borrower's property, so called because it is in addition to the first mortgage.
- *Securitisation*: traditional UK mortgage lenders, like building societies, raised money from savers against which they could make loans to borrowers. Newer entrants to the business, who have no branch network, cannot (and do not attempt to) attract savings to finance their lending; instead they can seek to sell a parcel of their loans (their assets) to institutional investors, thereby raising finance to fund further lending. Selling a loan portfolio in this way is known as *securitisation* and it is becoming more widely used by a range of mortgage lenders. The risks of default and early repayment are passed from the original lender to the institutional investor, and the calculation of the extent of such risks is an important factor determining the price of the loan portfolio.
- *Unbundling*: this refers to the way in which different parts of the mortgage business are now being separated and handled by specialist firms. Traditionally, mortgage lenders would *originate* loans (that is, attract people to take out their loans through advertising, their branches, etc.); *underwrite* loans (gather information about credit ratings, incomes, etc. to ascertain the risk of – and therefore suitable products to offer – a potential customer); *finance* loans (from savings deposited with them); and *service* loans (deal with the customer through the life of the loan, including any periods of default or missed payment). Now lenders may rely more on *brokers* or *financial advisers* to originate loans on their behalf; *packagers* will both help brokers find the best deal and take brokers' customers to lenders, completing the credit referencing and income checks required; *securitisation* allows institutional investors to finance loans.

- *Volume override*: this is a payment from a lender to a broker, based on the volume or profitability of business brought to them, or for exceeding a target. They are to be disallowed under the FSA regulation of first charge mortgages, as, although hard to prove to exist, there is scope for consumer detriment, where brokers' advice (either about the lender, or the size of loan) is biased by the incentive of receiving payment.

List of abbreviations

BBR	Bank of England Base Rate
BHPS	British Household Panel Survey
CABx	Citizens' Advice Bureaux
CAIS	Credit Account Information Sharing
CCA	Consumer Credit Act
CCJ	County Court Judgement
CMC	City Mortgage Corporation
CML	Council of Mortgage Lenders
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
FTB	First-time buyer
IFA	Independent financial adviser
IVA	Individual Voluntary Arrangement
LIBOR	London Interbank Offered Rate
LTV	Loan to value
MFS	MORI Financial Omnibus Survey
MIG	Mortgage Indemnity Guarantee
MPPI	Mortgage Payment Protection Insurance
OFT	Office of Fair Trading
RMBS	Residential Mortgage-backed Securities
RTB	Right to Buy

1 Introduction

There has been a great deal of concern expressed about the rising levels of overall consumer debt. Government evidence showed that, in August 2004, household borrowing in Britain rose above £1 trillion for the first time. As interest rates remain at a relatively low level, higher debt repayments may well be affordable for many households. However, there is increasing concern that consumers in the UK are taking on unmanageable amounts of debt, which may well become of greater concern if the current upward trend in interest rates is maintained or if the currently benign macroeconomic climate takes a turn for the worse. Yet, at the same time, even a casual observer of the financial scene in the UK will have been struck by the increased marketing of products – including mortgages and remortgages, car loans and debt consolidation loans – specifically to people who have an impaired credit record or who are finding their existing debt difficult to manage. It might be predicted that such borrowers would be particularly vulnerable to unmanageable debt. As relatively recent arrivals on the financial scene, however, little has been written about this so-called ‘sub-prime’ lending sector outside the confines of the specialist financial press.

The research that is reported here is the first attempt to bring together and present more broadly evidence about the development of and activities within the sub-prime lending sector in the UK. As well as presenting a general picture of the sector, the research is also more specifically motivated by the impact of such activities on the sustainability of home ownership – as many of the loans are targeted specifically at the owner-occupied sector and secured against property, in the event of any default or arrears, the ultimate penalty is house repossession.

Defining the sub-prime sector

There is now a highly competitive lending market in Britain, with a wide choice of providers offering first mortgages, secured and unsecured loans. Indeed, the Miles (2004) review has characterised the UK mortgage market as the most ‘complete’ in the world. However, ‘high street’ prime lenders typically use a fairly rigid credit-scoring system to select only those ‘prime’ customers with low risks of default, based both on past evidence of a good repayment record and personal characteristics (such as being in stable employment, income level and being on the electoral register). This system excludes many who wish to borrow and who may have the ability to repay loans, but fail to attain the required credit score. Estimates show that over 25 per cent of applications for credit in general and 30 per cent of mortgage requests in particular are refused on the basis that borrowers do not meet the standard criteria (CML, 2002).

A range of lenders have entered this market gap, targeting their products to 'sub-prime' (sometimes also dubbed 'non-conforming' or 'non-status') borrowers.¹ In the US, the sub-prime lending market is longer established (and, indeed, many of the early entrants into the UK market were US companies), and this terminology is well known and understood by borrowers, but, in the UK, where borrowers would not necessarily recognise the term 'sub-prime', the products are sold as being for those with County Court Judgements (CCJs) against them, or who have been bankrupt; for those who have had arrears in the past; and for those who have been refused credit elsewhere or who have an impaired credit record. Another gap exists in relation to people who are not able to prove their income. Prime lenders would normally require, for example, three years of audited accounts from self-employed people, to prove that they have the income to support a loan. People whose income is substantially derived from bonuses or commission, for instance, may also have difficulty in proving their 'normal' income to the satisfaction of prime lenders. Sub-prime lenders (and some prime lenders), however, also offer 'self-certified' loans, where borrowers' statements of their income are not interrogated further (such borrowers are frequently referred to as 'non-status').

Kempson and Whyley (1999a) note that the 'non-status credit market' contains a broad range of lenders, from those operating much like mainstream banks, charging a slightly higher risk premium to 'the less reputable end ... dealing in secured loans with punitive terms and conditions' (p. 2). They also note that there has been little attention paid to 'non-status' lending to date, as access to credit and problems in relation to unmanageable debt have more usually been researched in relation to the most financially disadvantaged and excluded households, reflecting policy concern with the exorbitant cost of much of the credit that is available to the poorest households (such as doorstep collected loans).

While recognising that sub-prime lending fills a valuable gap for many, the research is motivated by the concern that such lending may increase the vulnerability of some owners. Many of these products are heavily promoted and may encourage people to take on more debt than they can really afford. For example, the willingness to lend without proof of income may encourage borrowers to overstate their capacity to repay. In addition, while it is clearly fair to charge a higher interest rate to reflect the higher risks of default among such borrowers, there is also a concern that unfavourable terms and conditions may exploit vulnerable consumers. While all unmanageable debt creates real problems for consumers, the key issue here is that default on such loans can lead to house possession and potential homelessness. Our research review will, therefore, focus on that part of the credit market that provides:

- first mortgages for sub-prime borrowers (credit impaired, CCJs, etc.)
- remortgages for sub-prime borrowers
- other secured (second charge) loans for sub-prime borrowers, including debt consolidation loans.

Research approach

In order to 'scope' the activities in this market, four exploratory approaches were adopted as detailed below. Ultimately, not all proved to be equally fruitful, but this was to be expected given the novelty of the research arena. In general, the approaches were pursued in parallel, allowing the different approaches to provide mutual corroboration of much material. The report presents the main findings thematically, pulling together the evidence from all the elements of the research.

Systematic literature search

There is no established academic literature on sub-prime lending and, indeed, remarkably little about consumer choices in financial services, or the activities of such suppliers – with the exception of the ongoing concern with the cost and availability of credit to the poorest households (see Kempson and Collard, 2005). Therefore, it was decided to undertake a computer-based, systematic literature search working with a skilled information scientist. A wide range of literature sources was drawn on in this review: academic articles, research reports, company reports, reports from regulatory and campaigning organisations, the trade press and financial press.

In order to locate as much literature of this kind as possible, a number of key databases were searched using a set of search terms. A number of limitations were also placed on the search process. With a few exceptions, only literature published since 1990 has been examined and the principal focus has been the UK. The output of the search was assessed and those sources that appeared to be relevant were then obtained and read in detail. The Appendix indicates the full search strategy. The Bibliography identifies all the major sources considered. In addition, the team pursued the more 'traditional' approach to reviewing literature – identifying and reviewing relevant government and academic research publications and following up citations.

The literature has been used in two ways. First, it provides a basis from which to characterise the development and contemporary operation of the sub-prime market. Second, the literature indicates a number of current issues associated with the operation, regulation and outcomes of the market. A number of key themes that structure the remainder of the report were identified. Key and major references from the systematic search are provided but not all sources that illuminated the themes are referenced. This is particularly the case with newspaper articles.

Expert interviews

The researchers contacted a range of experts with different perspectives on the industry including:

- senior managers in sub-prime lending organisations
- experienced mortgage brokers
- representatives of the regulatory agencies
- money advice workers
- an American academic expert.

Interviews were conducted either face to face or by telephone; notes were taken of the interviews and made available to the interviewees for verification. This was not intended to be a comprehensive survey of all those with relevant expertise in relation to the research questions, nor a representative sample of those in the industry. Instead, it was intended to gather the information necessary to provide a broad overview of the way in which the sector had developed historically, its contemporary operation and future development. Lenders were all part of the Council of Mortgage Lenders (CML) panel and therefore tend to have the greatest knowledge about the 'near prime' end of the market; similarly, it emerged that brokers' activities are also somewhat segmented and, again, willing interviewees tended to be closer to the 'prime' end of activities. In all, 12 interviews were undertaken, somewhat in excess of the initial target.

In addition, the national office of the Citizens' Advice Bureaux (CABx) kindly provided the researchers with access to its relevant files, where clients have raised particular issues involving sub-prime lenders. These reports are sent in by local offices, where the case appears to the adviser to raise new issues or be notable in some other way. Thus, they do not represent a systematic overview of all cases that are brought into

CABx, and certainly not of all customers of sub-prime lenders, but do provide some interesting insights into the perspective of some customers of sub-prime lenders who find themselves in need of advice.

Data review

A re-examination of a broad range of publicly available datasets was conducted to ascertain what could be learned about contemporary patterns of borrowing and debt, with particular regard to sub-prime activities. Datasets reviewed included household survey data such as Survey of English Housing, MFS's (MORI Financial Omnibus Survey) survey and data reported by the industry such as CML, Mintel and Fitch Rating reports. Ultimately, given the relatively recent appearance of sub-prime activities, they are not well reflected in most large-scale surveys and the information on borrowing and debt generally lacks detail.

Web-based searches

Searches conducted on the web were used to gather a more comprehensive picture of the lenders and brokers involved in the business and the terms and conditions that are available to potential borrowers. Although useful information on the structure of the industry was gathered in this way, the highly individualised approach to establishing risk premiums means that many lenders require a personal application to establish exactly what will be offered to any particular borrower.

In sum, these approaches were intended to bring together in a systematic way the information that is already available about the industry and its borrowers, but which is currently spread across a broad range of disparate sources. It was not intended to contain significant original survey material, although an important aspect of the final evaluation of the evidence that it has been possible to draw together in this way will be to consider whether there are gaps in the evidence base that would require some dedicated survey or other approaches.

The report first considers the broader context of evolving debt and credit, and mortgage markets; there are then two chapters that chart first the development of the sub-prime sector and then what is known about the more detailed operation of the contemporary sector. In Chapter 5, evidence concerning the perspectives of the borrowers is drawn together and the final chapter concludes.

2 Changing context: borrowers and debt

This chapter will set the context for the work by outlining recent changes in mortgage behaviour and the incidence of debt more generally. The significant underlying growth in owner-occupation is also an important element of the context, but is not rehearsed in detail here. The broad trajectory of this growth is well known (and more fully described in Forrest *et al.*, 1993; Cole and Furbey, 1994; Bramley *et al.*, 2004 among others). Now, owner-occupation has become the majority tenure, enjoyed by over 70 per cent of households in Britain in 2004 (Wilcox, 2003). Its perceived advantages are so great (in terms of the possibility of financial gain, access to better quality houses and neighbourhoods, and less tangible values of ‘freedom’, ‘independence’, etc.) that even more people aspire to own their home than currently do so (over 80 per cent according to CML figures), and it has become common to characterise renting, and particularly social renting, as residualised – a tenure of last resort for those with no other options.

The Right to Buy has been an important mechanism in the transformation of Britain’s housing scene as, since 1980, it has allowed over two million households to purchase as sitting tenants of their social rented landlord. It is also an important factor underpinning the increasing diversity of households in owner-occupation, as a significant number of those buying through this route were households on fairly modest incomes who would have been unable to buy in the open market.

Within the population of owner-occupiers, 40 per cent own outright (and these are disproportionately older and less affluent households) and 60 per cent are repaying a mortgage. It is evident that the amount buyers are willing to borrow has been growing, so that the average loan to income ratio for first-time buyers reached 2.92 and for trading owners 2.80 (Quarter 3, 2004 – CML, 2004a). This is no doubt a reflection of the rapid recent house price inflation, as people will be obliged to borrow more to fund higher prices, and the relatively lower interest rates that have made higher borrowing multiples affordable. One of our interviewees (Broker 1) had an interesting interpretation of the impact that the growth and ‘normalisation’ of owner-occupation has had on demand for sub-prime borrowing. He perceives a growing sense of *entitlement* to owner-occupation and, within that, more particularly of a desirable property. This, he perceives, leads more people to seek to find ways of borrowing what they need to fulfil this desire (rather than what might be a more traditional approach of working out a borrowing budget and choosing a property within that limit). Sub-prime lenders might then be approached by such ambitious buyers as they are more willing to ‘stretch income multiples’. We consider evidence on the growth and various functions of the sub-prime sector in the following chapter.

What is of particular significance for this work, however, is that most owner-occupiers have some 'free' (unmortgaged) equity in their property. Generally rising prices create such equity over time, as does the gradual repayment of principal outstanding, where the loan is a repayment mortgage. Many second-time or subsequent buyers put a significant deposit into their purchase, typically taken from the capital gain on their previous home. And, of course, the discount given to buyers under the Right to Buy immediately endowed such buyers with equity in their property. The main group of buyers who would be expected to have relatively little equity are recent first-time buyers, who have not yet benefited from any house price inflation and who may have had little of their own savings to put into their first home. Interestingly, though, recent data suggest that the average first-time buyer is also putting a substantial equity sum as a deposit – nearly £12,000 in 2003 (CML, 2004a).

While some owners will be content simply to let housing equity accumulate, as the next section demonstrates, there has been an increasing tendency to see such money as a financial resource that can be drawn down and spent by consumers, by extending mortgage or other secured borrowing.

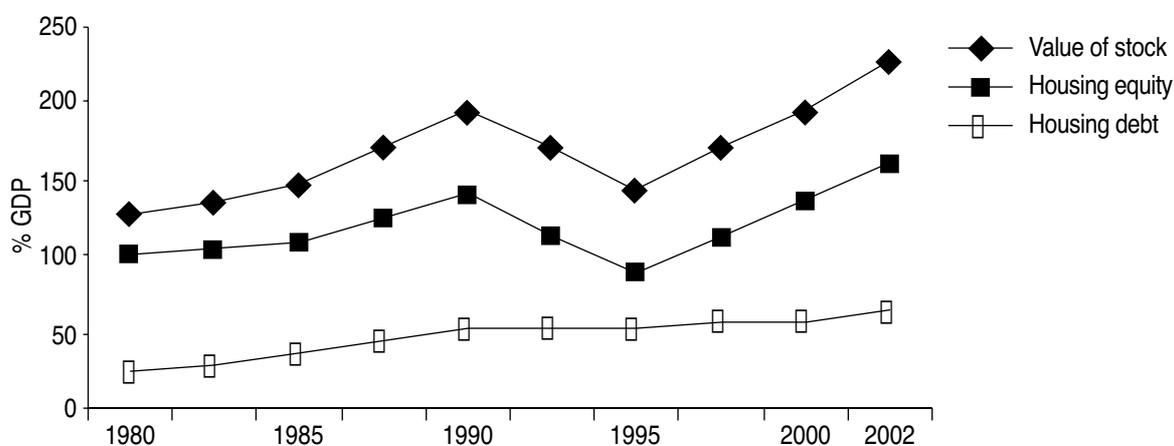
Mortgaging and remortgaging

In the tightly controlled mortgage markets that existed before the 1980s, accumulated housing equity was strictly contained within the housing market. Mortgage finance could be taken only for house purchase and some restricted repairs and improvement activities – reflecting the special status of the circuits of mortgage funding. Financial deregulation swept the protected funding circuit and its associated restrictions away. Now, mortgage funders no longer have to take any interest in the leakage of equity that occurs when someone borrows more than they 'need' to buy a house, or whether such excess is used for house improvement or redecoration, or for a holiday and a car. Further, as mortgage lending has become an increasingly competitive business, more and more people remortgage *in situ* to get a better deal on their loan, say after an initial discount or fixed-rate period has ended, and indeed doing so is often the first recommendation in the 'financial health checks' of finance advice columns. Remortgaging has now become nearly as big business for lenders as mortgaging for purchase; CML (2004a) shows that a full 43 per cent of all lending is for this purpose (Quarter 1, 2004). But, clearly, this also creates an opportunity for borrowers to extract some equity from their house, as does the range of 'flexible' mortgages, which (subject to restrictions that are particular to each product) allow much more routine access to the equity that has been accumulated (and again which can be used for any purpose). Early evidence suggested that

borrowers were eager to take advantage of such features, although, most commonly, borrowers were using the flexibility to *overpay*, at least in these early years (Smith *et al.*, 2003).

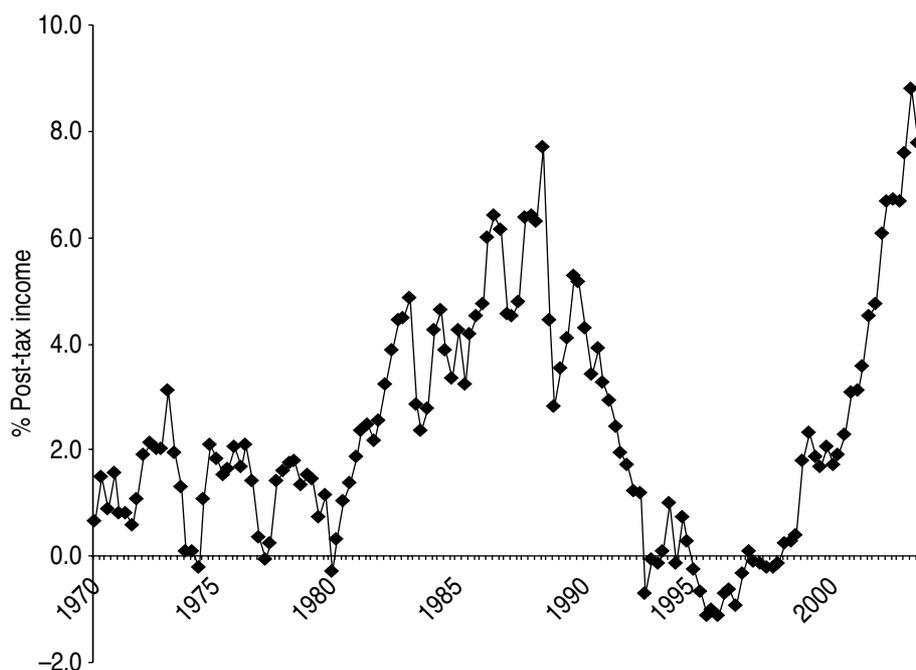
Overall, there has been a great increase in both the potential for equity withdrawal from housing markets and, in practice, an increasing amount of equity withdrawn in this way – much of which is associated with increased secured lending (see Figures 1 and 2).

Figure 1 Housing equity and debt (per cent GDP)



Source: Bank of England data, 2004.

Figure 2 Mortgage equity withdrawal, 1970–2004



Source: Bank of England data, 2004.

As Figure 2 shows, mortgage equity extraction is linked closely to the fortunes of the housing market, so that it is significantly less and even becomes negative in the slump of the early 1990s, since which time it has increased rapidly both as a proportion of post-tax income (i.e. the amount that consumers have available to spend) and, in absolute terms, reaching £15.6 billion in Quarter 2, 2004 (Bank of England, web site).

Indebted Britain

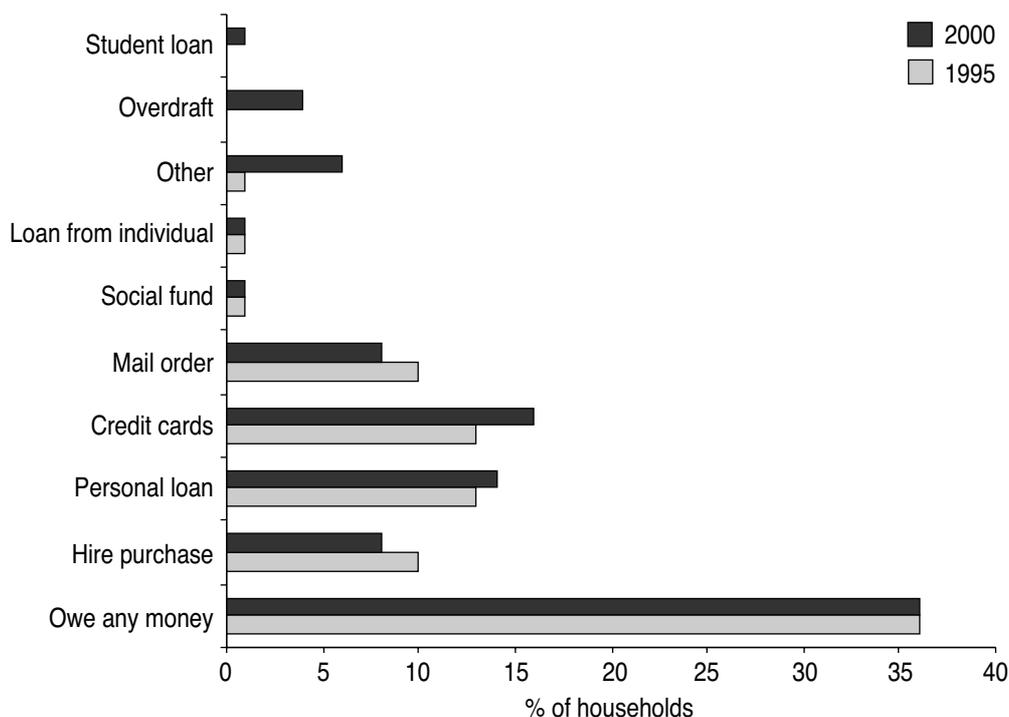
Clearly, the growth in owner-occupation has created greater indebtedness for many people (by virtue of most buyers having to take out mortgage funding). It is hard to know whether the increase in owner-occupation itself *causes* greater tolerance of debt, for, although there is evidence that people become more debt tolerant once they have experienced taking credit, it is also evident that many do not consider a mortgage 'real' debt in the same way that taking out a loan for a car or buying on HP might be perceived. However, there has been increasing policy concern expressed about the general rise of indebtedness in Britain, particularly highlighted in the recent evidence that consumer debt topped £1 trillion for the first time in August 2004 and in other evidence that, for instance, outstanding balances on credit cards in 2004 were £52 billion and borrowing on credit cards is estimated to have increased fivefold since the early 1990s (FSA, 2004).

The main reason for concern about levels of debt rests on the serious difficulties caused for households whose debts become unmanageable and who therefore struggle to make ends meet. More implicit within public debate is a worry that easy access to credit is a 'temptation' for people in an increasingly consumerist society so that they may get 'sucked into' an unmanageable position (suggesting that consumers do not or cannot make wholly 'rational' decisions, or are unable to judge risks accurately, in this arena – or at least that there is a significant minority of people who are vulnerable to such temptation). Of particular concern has been the position of low-income households, whose access to credit is restricted and the cost of available credit high, thus placing particularly onerous burdens on the most financially vulnerable households. Work by Kempson and colleagues (Kempson and Whyley, 1999a, 1998b; Collard and Kempson, 2003; Kempson and Collard, 2005) has been particularly significant in highlighting the very high cost of lending such as that operated by doorstep collection lenders or pawnbrokers, or hidden through inflated prices and hidden charges by mail order catalogues or high street white goods retailers such as Bright House. This work has also shown how mainstream lending can be inappropriate for the poorest households (e.g. in offering too large minimum loans or requiring bank accounts), even though interest rates would be lower, creating a significant problem of financial exclusion for poorer households.

Although protection of the poorest households has, quite justifiably, been of the highest priority in policy debate, the concern in this research is with the debt among households that might be financially vulnerable, but are not the poorest. Kempson *et al.*'s (2004) overview of indebtedness in Britain provides valuable contextual information. Using the British Household Panel Survey (BHPS) data, they found that 36 per cent of all households in 2000 had some consumer credit commitments (i.e. excluding mortgages), a proportion that had not changed since 1995 (though the type of debt had – see Figure 3). Although at first sight this does not seem consistent with the macro-evidence on increasing levels of debt, it is explained by the increase in the average amount owed by households. In 1995, the average debt was less than £1,000 and the top 10 per cent of debtors owed £5,000; in 2000, the comparable figures were over £2,000 and £9,000 respectively.

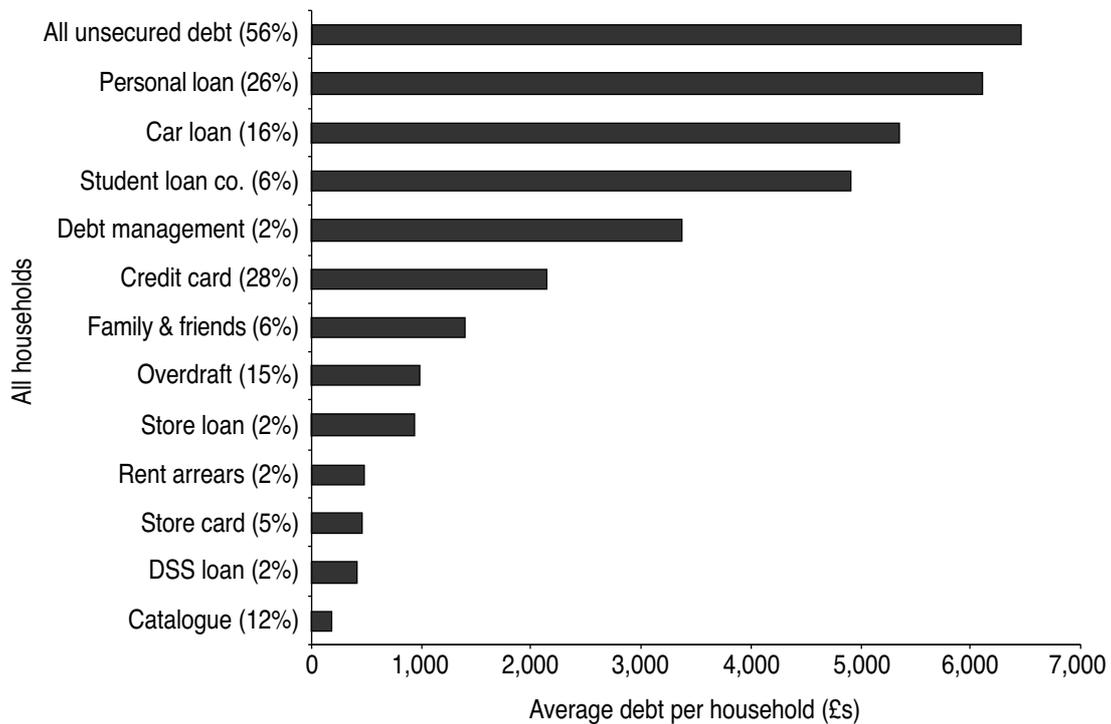
The Financial Services Authority (FSA, 2003, p. 40) estimated that, among the 3 per cent of households with a second charge home loan, the average amount owed was £11,504. In 2004, it reports that just over half of all families had unsecured debt, owing £6,500 on average, which is distributed among various products, as shown in Figure 4 (Nuttall, 2004). This shows that the most significant single-debt burdens for households are personal loans, car loans and then student debts.

Figure 3 Outstanding credit commitments in 1995 and 2000



Source: Kempson *et al.*, (2004).

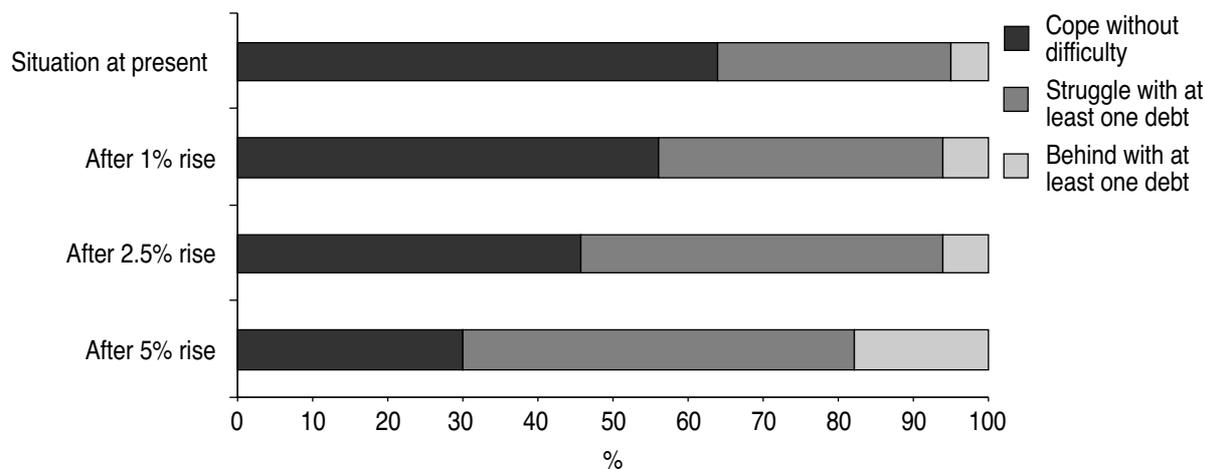
Figure 4 Unsecured household debts, 2004



Source: derived from Nuttall (2004).

These averages arguably represent sizeable amounts, but the particular focus of analysis has been on ‘problematic’ debt, i.e. with those who find their debts difficult to afford. In mid 2002, Kempson *et al.* (2004, p. 13) found that ‘around three in ten families with children (31 per cent) said they were in financial difficulty compared to two in ten (20 per cent) of all households’. Five per cent of all households, and 10 per cent of families, were estimated to spend more than 25 per cent of their gross income on consumer credit repayments. And the extent to which households are vulnerable to changes in underlying economic conditions is revealed in the DTI’s ‘Overindebtedness’ research (FSA, 2004), which asked people how the manageability of their financial commitments would change if interest rates were to change. As Figure 5 shows, although the great majority estimated that they were able to manage their debts at the time of the survey, the proportion who estimated they could manage without difficulty falls to just 44 per cent if interest rates were to increase by 2.5 per cent – a high figure, notwithstanding the difficulty that people are likely to have in estimating accurately the impact on their repayments of such an increase.

Figure 5 Problems with debt and possible effects of interest rate rises



Summary

As the FSA (2004) report showed, household borrowing has continued to grow strongly over recent years, at a record rate of 14.1 per cent to October 2003, and has reached record absolute and relative levels. However, interest rates are low and the economic climate benign, which means that, despite this high borrowing, overall arrears are relatively low. The growth in owner-occupation plays a significant role in increasing households' debts – overall mortgage debt has grown, but, as argued above, the increasingly competitive and diverse financial products market is allowing a growth of remortgaging and other secured lending, whereby owners can access some of the equity in their property for other consumer spending. And here, too, the favourable economic and housing market conditions mean that arrears and possessions are low. What is not clear from the data on consumer debt available and reviewed here, however, is the extent to which remortgaging activity is undertaken as a strategy to deal with financial difficulties, such as debt consolidation, nor how much of this activity (either for first or second charge borrowing) takes place in the 'sub-prime' sector. The remainder of this report examines what is known about the sub-prime financial market, its lenders and borrowers.

3 The evolution of the sub-prime lending sector

The development of sub-prime lenders

The systematic literature review showed that the term 'sub-prime lending' first came into use in the UK in the late 1980s and early 1990s. Initially, in 1984, financial deregulation loosened access to home ownership by bringing into the market a wider range of lenders, some of whom provide finance for borrowers seen historically as too risky by traditional lenders. More recently, the Office of Fair Trading (OFT, 2002) has provided a definition of the kind of borrower who will be using the sub-prime market:

... those with impaired or low credit ratings and who would find it difficult generally to obtain finance from traditional sources on normal terms and conditions.

The term 'non-status lending'/'non-status borrower' is often used interchangeably with 'sub-prime lending'/'borrowing' (DTI, 1999).

Such loans carried a risk premium. During the mid and later 1980s, a series of policy interventions, including increases in interest rates, led to rising unemployment and periods of increasing payment difficulty. In a proportion of cases, typically where borrowers had prime loans, once their circumstances had improved, lenders 'capitalised' the arrears on the existing mortgage. However, other responses emerged including borrowers seeking a further loan to enable them to manage their increased payments or to roll up their existing payments and debts into a single new loan. In many instances, these 'debt consolidation' loans were made available by non-traditional lenders at higher rates of interest and with more stringent terms and conditions or, in other words, by the emerging sub-prime lenders.

These episodes of mortgage arrears, and particularly possession of a property, frequently resulted in an adverse credit record. But other developments in the late 1980s and 1990s have fuelled this process, including the deliberate non-payment of poll tax¹ and the expansion of default consumer credit and utilities bills (these being more aggressively pursued by many privatised utilities companies). Those seeking new credit (including a mortgage) while in possession of an adverse credit record often found themselves having to approach sub-prime lenders, particularly as credit scoring became more stringent and automated. All these developments brought more sub-prime lenders into the market, particularly in the mid and late 1990s (Cottell, 2001). Some sub-prime lenders specialise in mortgage loans, but other types of loans were also offered, including loans primarily for consumer items but secured on property (second charge loans), limited debt consolidation loans (also available as secured loans) and unsecured loans (for any purpose).

Kempson and Whyley (1999a) identify a number of reasons why the numbers of people without access to mainstream credit have grown, including: industrial restructuring creating long-term joblessness; increased numbers of lone parents on long-term benefit; and because the recession and housing market slump of the early 1990s left hundreds of thousands of people with CCJs against them. They note that, between 1990 and 1998, 454,280 households had their home repossessed as a result of mortgage arrears – compared with just 140,280 over the whole of the 1980s (and, of course, often such an event will impair the credit rating of two individuals). Between 1990 and 1998, 650,000 households were taken to court by their mortgage lenders and many more owners will have received CCJs for debts – in 1990 alone, 1,188,282 new Judgements were made (although some are against the same person).

Other estimates suggest that the number of people who fall outside of the mainstream lenders' criteria was nearly eight million adults in 2001, representing approximately 23 per cent of the adult population in the UK aged 18–65 (Royal Bank Of Scotland, 2002) – this implies exclusion from the prime market of nearly one-quarter of the adult population.

Clearly, many of the factors that contribute to individuals facing circumstances that impair their credit rating are closely related to wider economic and housing market factors and, as Table 1 shows, the relatively benign conditions in the UK economy over recent years have tended to reduce the number of people experiencing such events.

Between 1991 and 2001, unemployment has decreased from 11 per cent to about 6.1 per cent and the Office of National Statistics' estimates also show that the self-employed population has shrunk by 1.5 per cent compounded annual growth rate between 1997 and 2001. People with County Court Judgements (CCJs) on record have declined from 8.5 million in 1995 to approximately 5.1 million in 2001. The

Table 1 Trends in some factors that affect credit status in the UK, 1991–2003

Indicators	1991	1993	1995	2000	2001	2003
Unemployment (per cent)	11.2	12.1	8.3	6.6	6.1	5.0
CCJ (million people)	6.3	7.8	8.5	5.4	5.1	N/A
Repossessions (no.)	75,540	58,540	49,410	22,870	17,310	7,830 ^a
Bankruptcy (thousand people)	N/A	30.9	21.1	20.8	24.2	N/A

a CML notes that 'material revisions' have been made to the figures from 2003 onwards.

Source: UK Registrar Trust; ONS; CML web site; Department of Constitutional Affairs web site; Department for Work and Pensions web site last consulted 27 October 2004 (<http://www.dwp.gov.uk/publications/dwp/2003/autumnreport/workingage/target3b.asp>).

number with repossessions on record also shows a declining trend from 0.4 per cent in 1991 to around 0.1 per cent in 2001. The number of people registered bankrupt shows a fluctuating trend but in absolute terms it is roughly 24,000, or 0.05 per cent of the adult population. There is, therefore, on the basis of these figures, no reason to suppose that there is a rapidly increasing number of credit-impaired, potential sub-prime borrowers. However, as noted above, these factors are very sensitive to the underlying economic and housing market conditions and an economic downturn would sharply increase these numbers. In addition, the imminent changes in the UK bankruptcy laws are expected by at least some commentators to increase the propensity to use bankruptcy as a way of dealing with business or personal debt problems, perhaps not fully appreciating the impact that this will have on credit ratings. It is also probable that some people who could, in fact, access credit from the high street lenders may suspect that they cannot and would therefore, approach lenders in the sub-prime sector first. The tone of many of the newspaper, television and internet advertisements (emphasising friendly, positive and quick responses; a non-judgemental approach; that lenders do not need to be told what the loan is for, etc.) may have a particular appeal for consumers who have had few dealings with financial institutions and find them somewhat intimidating.

Drivers of growth in the sub-prime sector

The literature, particularly that from within the industry, identifies many of the drivers of the growth of the sector in terms of its *functionality* – the provision of specialist services well adapted to the changing nature of contemporary social and economic conditions. Such conditions include: the pent-up demand for mortgage credit among non-traditional borrowers; the growth in credit use; the rise of indebtedness and default. Innovative products, for example, the self-certification mortgage, are also presented as well adapted to the emergence of flexible employment, variable incomes and particularly self-employment. This functional adaptation is also argued with respect to the emergence in the late 1990s of the focus on debt consolidation products.

In contrast, literature from consumer groups and academics concerned with the analysis of poverty and social exclusion points to other factors driving the development of the sub-prime market: the growth of inequality, the restructuring of welfare provision and, specifically, the curtailment of a number of funding streams (for example, the Social Fund) used by poor people to help them meet basic needs, and the continuing exclusion of many poor people from the mainstream credit market (FSA, 2000). This vacuum was filled, in part, by the already existing alternative credit market (pawnbrokers, moneylenders and loan sharks, etc.) but also by the emergence of the sub-prime sector in the UK (including such unsecured lending as

offered by 'payday' loans companies, for example). The literature on financial exclusion draws attention to exclusion from mainstream lenders and the vulnerability of the excluded to exploitation in the 'less respectable' end of the sub-prime market and secondary lenders (Social Exclusion Unit, 1999).

The policy of widening access to home ownership, especially the policy of Right to Buy (RTB), increased the number of poor home owners but also ensured that, on average, those home owners had some equity against which they could borrow further (Forrest and Murie, 1990; Burrows and Wilcox, 2000), so enabling lenders to take greater risks. Some lenders, though, do not see this as a significant part of their business – Lender 1 estimates that only 2 or 3 per cent of their loans are towards RTB properties.

The interviews with lenders and brokers strongly echo and amplify the theme of the functionality of sub-prime lending. For instance, Broker 2 argued that, when he started in business in 1991, it was difficult to obtain mortgages for those with less than perfect credit records. Although there were some lenders involved in selling such products, it was unusual for mainstream brokers or advisers to be able to access sub-prime products. Lender 2 considers that brokers were actually somewhat reluctant to become involved in the sub-prime sector at the time (perhaps worried about its reputation), so that emerging sub-prime lenders formed alliances with particular brokers to help roll out the products and establish a reputation, which in turn has influenced the overall structure of the market, which still relies heavily on intermediaries and brokers for the sale of products. The shortage of choice for potential borrowers was identified by Lender 1 as lasting late into the 1990s. He says that, in 1998, sub-prime customers could be characterised as *grateful* to be offered any sort of loan, whereas now, in the increasing competitive market, customers are much more likely to have shopped around, to be better informed and to expect a choice of possible products with features (such as fixed or discounted rates) that mirror those available in the prime market.

But, at the same time, Broker 2 highlights how a significant surge in 'credit-impaired' borrowers was created by the poll tax and privatised utility companies. These events increased the number of both deliberate non-payers and 'inadvertent' defaulters: 'Respectable people suddenly found themselves with an impaired record'.² Broker 1 agrees that the growing use of credit and the actions of utilities companies (which record a huge number of default notices – i.e. where payment has been late – with credit reference agencies) has increased the likelihood of an adverse record. Such notices can be placed on an individual's record without their knowledge – unlike a CCJ for instance. In addition, the recession of the early 1990s left many people with mortgage arrears or house repossessions on their credit records.

Lender 2 stressed that sub-prime lending does a 'great job' in providing a service for those who would not be able to access mainstream finance. Interestingly, he estimates that around 40 per cent of their borrowers do not actually have any credit impairment – rather, they have difficulty proving sufficient income – citing taxi drivers or restaurant owners without accounts as classic examples. Lender 1 similarly notes that the majority of their customers are self-employed, or ex-self-employed. He notes that, while someone may have had a failed business venture behind them, and the credit impairment that that brings, if they are now in employment they are likely actually to be a rather low-risk customer. For these lenders, an important part of their business model is not to have any mechanistic 'two CCJs OK, nine CCJs unacceptable' type of approach, but to understand at an individual level what has caused people to get into difficulty in the past and to convince themselves of that individual's current ability and willingness to repay. Lenders can undertake a Credit Account Information Sharing (CAIS) search, on which database are individual records of credit card and most other lenders' repayments. They explained that they are chiefly concerned to see a good, steady recent history of repayment – suggesting that people have got themselves back on their feet and are managing their money well. This individualised approach is reflected in the brokers' perspective that often the databases and software available to identify the best deal for particular customers are not fine-grained enough to distinguish all relevant factors and characteristics.

Some interviewees highlight changes in the activities of the mainstream lenders as one significant element of the drivers for growth. So Lender 1 described how the fallout from the market recession in the early 1990s meant that many mainstream lenders sought to be very cautious in lending and they became less confident about managing risk or pricing for it. Skills in underwriting for unusual cases became lost as processes became ever more centralised and automated, and the mainstream lenders wanted nothing but 'vanilla business'. Lender 2 also concurs that the highly competitive nature of mainstream lending has now squeezed margins to unsustainably low levels, while the sub-prime sector continues to offer some opportunity for profit, thus continuing to attract lenders to operate in the sector. Increased data sharing and data availability is also of relevance; once a potential borrower has experienced rejection of an application from a high street lender, the scope for remaining within the prime sector may be limited because of the increasing extent to which lenders share information either informally or through credit referencing agencies.

An important aspect of the service that lenders perceive themselves to offer borrowers is that of credit repair. As noted above, lenders and brokers we spoke to could offer many instances of how people might end up having to turn to the sub-

prime sector, while having the means and motivation to repay a loan. Other examples include younger people, who may not have had time to develop any history of credit repayment and may have additional 'adverse' characteristics such as not being on the electoral role, or in stable employment for a sufficient period. As Lender 2 described, they see themselves as selling a three-year product, where the process is of rehabilitation and credit repair, allowing the borrower a route back to the mainstream once a sound repayment record has been established. Lender 1 estimates that the average life of a loan is just three-and-a-half to three-and-three-quarters years and Lender 4, 39 months. There are some products that offer a discounted rate after a year of consistent repayment, again helping customers towards mainstream conditions (Lender 3). Fitch Ratings' evaluation of securitised sub-prime portfolios (termed 'non-conforming RMBS' – residential mortgage-backed securities) found that 'Mortgage redemptions in the UK sub-prime market have generally been very high for a number of years, averaging over 35 per cent p.a.', which it explains as having been caused by 'intensified competition, greater price transparency, increasing house prices and a reduction in the prevalence of extended redemption penalties' (Fitch Ratings, 2003, p. 2). It argues that, given the current economic conditions, prepayments are more likely to be caused by credit repair and buyers finding a better deal than by repossession, although its data do not allow this to be confirmed.

Industry evolution

The systematic literature review established that sub-prime lending is a long-standing business in the USA and the early business sub-prime entrants to the UK were US companies. The late 1980s saw the first attempts to establish centralised mortgage lenders to originate mortgages for securitisation, which until recently have remained the preserve of specialised mortgage lenders. The first attempt was made by US companies such as The Mortgage Company, Bear Stearns Home Loans, National Home Loans and others. But the subsequent recession and downturn of the UK mortgage market in the late 1980s and early 1990s impacted adversely on these lenders and progress came to a standstill. Some of the companies' practices had also begun to attract adverse comment from the OFT and others. Some of the early (and most criticised) entrants to the market withdrew in the mid 1990s. There is a perception (Lender 4) that those small early entrants to the market that had the most exploitative practices have largely been squeezed out as the bigger, respectable companies have become dominant. The perception that the most exploitative practices have been squeezed out, however, is challenged by organisations such as CABx.

When the economy, and the property market in particular, began to recover from the downturn in the mid 1990s, various lenders were encouraged to re-enter or enter the sub-prime market. The fundamental structure for sub-prime lending was still in existence and some of the early pioneers returned to the market in different guises. John Maltby, CEO of Kensington Finance, a significant pioneer of the contemporary business, argues that, when they joined the market in 1995, there was relatively little competition, but that other specialist lenders (such as iGroup, GMAC), similar to themselves, established shortly afterwards (although some have subsequently been sold) (Maltby, 2003). By the late 1990s, it was becoming clear to lenders that there was scope for a viable, reputable industry and others began to enter the market. The range of specialist lenders began to increase and with this growth came increased product innovation and price competition, which delivered better choice and value for customers. By 2001, the mainstream lenders, whose margins were still under great pressure, saw the advantages in the higher margins and opportunities for growth in the sub-prime sector.

As specialist entrants to the mortgage-lending scene, and without any branch network to generate savings, these businesses have to securitise their loan book – that is, they raise money for future lending by selling their loan portfolio to an investor. The specialist lenders describe this as an important part of their business model – securitisation imposes an important market discipline, as the risks and returns of their portfolio will be independently reviewed, assessed and audited. To persuade an investor that it represents a solid investment proposition requires that the risks of loans are clearly understood and properly priced, and that the portfolio shows balance – no overexposure to particular property sectors or localities for instance. They are subject to regular, close scrutiny by the ratings agencies, such as Moody's and Fitch, who provide detailed information on performance for potential investors as well as summary ratings of the quality of the portfolio. The fact that there have been plenty of willing investors in the sector has underpinned its continuing growth. Perhaps unexpectedly a significant source of that funding has come from the commercial banking sector, so that Barclays provides funding, Lehman Brothers has funded Southern Pacific, Stroud and Swindon BS also provides funding, and Skipton BS has funded Amber (Broker 1).

Lender 4 noted that there are benefits that make securitisation and balance sheet lending a common option. From the lender's perspective, selling a loan book reduces risk – it allows the lender to take most of the return up front. From the buyer's perspective, it allows (controlled and limited) exposure to the higher margins available in the non-conforming sector. Some do not have a non-conforming business while others prefer to purchase only fairly mature sub-prime loan books. Although Lender 3 (a subsidiary of a mainstream mortgage lender) has not yet taken

this option, he describes how securitisation is definitely on the agenda – they will consider it, though are not doing so at the moment. He believes that the savings behaviour in the UK means that all lenders will have to face this issue eventually. And there has been a natural evolution – just as it has taken a while for lenders to feel confident in the sector, so more financial institutions are now coming to see sub-prime loan portfolios as simply another type of asset whose risks have to be correctly priced.

Today, as well as competing with subsidiaries of high street banks, Kensington competes against ‘two very large independent or pseudo independent multinational finance companies, GE Capital and GMAC RFC ... [and] Britannia Building Society which owns a non-conforming mortgage lender’ [Platform] (Maltby, 2003, p. 2). Maltby (2003) views the entry of more mainstream lenders as a mixed blessing in some ways; they have helped raise the profile of the market and the appearance of some familiar names helps ‘grow the space’ for introducers. But, on the other hand, he believes that they tend to operate at the lowest risk end. Whereas Kensington has introduced practices specialised for the sub-prime sector, these lenders continue to do business in the same way as in the prime market, helped by benign conditions. This produces a cost advantage, as the more specialised procedures are more labour intensive.

In the early days it is argued that the product offering was fairly unsophisticated – really just one type of product with a relatively high cost compared to the mainstream (Lender 3). Such products still offered a much better deal to someone in this situation when the only alternative was exorbitant secondary or even unsecured lending (Lender 1). Subsequently competition has led to an explosion in the variety of sub-prime products available.

Although the business was in some senses ‘imported’ from the US, there is a consensus that it is less well developed in the UK, which Lender 4 ascribes largely to better data capture. In the US, he argues that credit-scoring agencies can access 80–90 per cent of people’s credit history. However, in the UK, only about 30–40 per cent of information is actually available through the credit-score databases. The US has also had longer to develop the business. In the States, the sub-prime sector goes back to the late 1960s but has been particularly well developed since the mid 1980s. Lender 3 argues that the sub-prime lenders have learned from the US model – particularly in a more realistic approach taken towards pricing for risk, though he would argue that the UK has not gone so far in terms of finding a price for *any* type of risk.

Although the sub-prime sector has a relatively short history in the UK, dating from the late 1980s, there are clear signs that it is growing in strength. Table 2 shows some of the largest UK lenders by mortgage assets in 2003. Fierce competition has put pressure on profit margins for mainstream lending, but the sub-prime markets represent sources of higher profitability, though at a cost of higher risk and volatility. Table 2 shows that, while the sub-prime lenders are still relatively small, they are tending to move up the rankings.

Table 2 Total mortgage balances outstanding, 2003

Rank 2003	Rank 2002	Name of group	£ billion	Est. market share (%)
1	[1]	HBOS	171.7	22.5
2	[2]	Abbey National	88.2	11.5
3	[5]	Nationwide BS	70.8	9.3
4	[3]	Lloyds TSB	70.8	9.3
5	[4]	Barclays	62.0	8.1
6	[6]	The Royal Bank of Scotland	48.1	6.3
7	[7]	Northern Rock	36.8	4.8
8	[8]	Alliance & Leicester	25.6	3.4
9	[9]	HSBC Bank	25.3	3.3
10	[10]	Bradford & Bingley	22.6	3.0
11	[11]	Bristol & West	16.0	2.1
12	[12]	Britannia BS	14.2	1.9
13	[13]	Yorkshire BS	10.8	1.4
14	[14]	Portman BS	10.6	1.4
15	[15]	Standard Life Bank	8.7	1.1
16	[16]	Coventry BS	7.3	1.0
17	[17]	National Australia Bank (UK)	6.1	0.8
18	[18]	Chelsea BS	5.9	0.8
19	[20]	Igroup*	5.6	0.7
20	[19]	Skipton BS	5.2	0.7
21	[23]	GMAC-RFC*	5.0	0.7
22	[21]	Paragon/Mortgage Trust*	4.3	0.6
23	[22]	Leeds & Holbeck BS	4.2	0.5
24	[26]	West Bromwich BS	3.3	0.4
25	[29]	Kensington Mortgage*	3.1	0.4
26	[24]	Derbyshire BS	3.0	0.4
27	[25]	Cheshire BS	3.0	0.4
28	[27]	Principality BS	2.6	0.3
29	[28]	Newcastle BS	2.5	0.3
30	N/A	Co-operative Bank	2.2	0.3

Notes (continued overleaf):

Table 2 Total mortgage balances outstanding, 2003 (continued)

Notes

- All figures are shown on a financial services group basis for financial years ended during the 1 May–30 April period. Specialist sub-prime lenders are marked *, but note that group figures, e.g. for HBOS, contain their subsidiary Birmingham Midshires' earnings.
 - All 2003 figures relate to calendar year 2003 except year ended: September 2003; November 2003; March 2004; April 2004.
 - Figures relate to loans secured on residential property in the UK, including staff mortgages, and are normally gross of any provisions. Building society figures exclude other lending on land.
 - Earlier figures are adjusted to reflect mergers, acquisitions or disposals of businesses where restated figures are available. Some figures are best estimates by Thedata or may include small amounts of non-residential lending.
 - Mortgage balances outstanding include on balance sheet and securitised assets that are managed (shown on a gross basis).
 - Gross mortgage lending includes all loans drawn down in the year, whether subsequently securitised or not, but excludes assets purchased from other lenders wherever identifiable.
-

Source: Thedata Ltd (accessed from CML web site, 2004).

Summary

What this review has established, then, is that a range of factors operating both on the demand and the supply side have created a climate, over the last ten years or so in particular, in which sub-prime lending can flourish – in terms of finding willing customers and in relation to developing a business model that can work profitably. The relatively rapid establishment of the sector has also seen an increasing range of lenders and products available, which will be considered in the next chapter.

4 The contemporary sub-prime sector

Segmentation and differentiation

The systematic review of the trade literature identified in particular a great deal of discussion and analysis of an observed trend towards diversification of the sub-prime market, and the emergence of market segmentation and market hierarchy, particularly since the mid 1990s. The literature provides descriptive information as to *how* this segmentation is developing but also suggestions as to *why* segmentation occurred (issues taken further in the interviews with lenders and regulators in the sector). Segmentation and hierarchy have come about in two key ways.

- 1 By prime lenders diversifying, moving 'down market', 'creating niche markets' (see below), through the takeover of other organisations or the creation of wholly owned subsidiaries. Examples include the Halifax takeover of Birmingham Midshires (which has become a 'sub-prime' subsidiary), the decision by Bristol and West to move into the niche market of self-certification and adverse credit lending, and the acquisition by the Britannia Building Society of Platform Home Loans in 2002 so that it could lend to borrowers to whom it declined a mainstream mortgage.
- 2 By the increasing differentiation *within* the sub-prime sector into lenders who see themselves, or are described by commentators, as 'mainstream' sub-prime, 'respectable', 'well regulated' and 'transparent', and those organisations whose practices are less transparent, whose costs are significantly higher, and who market themselves as debt consolidators and as the 'solution' to those with credit problems. Not surprisingly, the literature identifying the latter group tends to be in the form of reports from advice agencies (NACAB, 2000), non-governmental organisations (Palmer and Conaty, 2002; NCC, 2003), regulators (OFT, 2004) and government departments concerned with specific consumer issues. For example, contained within the DTI (1999) report on extortionate credit is information that relates to sub-prime or non-status lending. To differing degrees, this literature suggests that, at the bottom end of the sector, lenders' terms and conditions and practices are oppressive and even unregulated, although there are some suggestions that the scope for unregulated business is likely to continue to diminish as the regulatory framework becomes more tightly drawn (see below).

The literature indicates that segmentation and hierarchy are driven by a number of processes:

- the increasingly competitive prime market and the search by prime lenders for new, adjacent markets (FSA, 2004)

Lending to higher risk borrowers

- the adoption of tighter and more mechanistic credit-assessment procedures that exclude people from prime markets on relatively insignificant grounds and thus create a ready, but still relatively high quality, pool of borrowers seeking loans
- the growth of indebtedness and the number of households with serious adverse credit records
- the increasingly ready availability of wholesale funding to lenders, securitisation, enabling mortgage debt to be sold and funds realised for further lending
- inadequate regulation of extortionate credit
- the profitability of sub-prime lending (Collinson, 2000).

What this suggests, then, is that there are different 'niches' available for sub-prime lenders where a spectrum of customers can be targeted, from the very low risk and near prime, through a classic 'sub-prime' group, to a much more risky group who may be more vulnerable to less scrupulous lenders.

The lenders we interviewed anticipated the business closest to the 'prime' being increasingly dominated by large mainstream lenders who can compete on brand image and low cost, and more specialist and niche lenders who deal in higher cost, more risky business. One Lender (2) also noted that prime lenders had changed their attitudes, so that, while in 1995 they would not have considered offering a loan to a borrower with a small CCJ, even some years previously (say for a £200 gas bill), such a borrower would now be considered as mainstream. Mainstream lending practices are also changing, so that, for instance, some noted that the very mechanistic assessment procedures that helped open up a niche for sub-prime lending are now being superseded by more flexible techniques that can draw on better data on credit repayment profiles to assess the riskiness of borrowers. The new Basel II regulations have been argued to reinforce more general moves to risk-based pricing across the lending sector. These examples highlight how both prime and sub-prime lending have to adapt continuously to a changing, but highly competitive, business environment.

A further important feature of the structure of the sub-prime market identified in the literature review is the significant reliance on brokers to introduce business and to effect the sale. Indeed, a number of so-called sub-prime lenders are in fact brokers, and the borrower may have some uncertainty as to who their lender really is (OFT, 2004).

Non-status loans are often arranged by a third party ... With secured loans this is usually a broker ... unsecured loans tend to be arranged by the organisation that provides the goods or services being supplied on credit.

(OFT, 1999)

This brokerage/introduction system is itself subject to a hierarchy, as seen, for example, in the emergence of master brokers or packagers who stand between the individual broker and the lenders. Packagers work on behalf of a small number of sub-prime lenders, preparing the case for lenders (valuations, references, etc.), and, in turn, individual brokers pass applicants to the packagers, as well as dealing with lenders directly.

Packagers can perform a useful function in the middle of the mortgage application chain ... For brokers they may help find the best deal and process some of the paperwork in preparing applications for underwriting. For lenders, packagers provide an intermediary-facing distribution and administrative process to reduce the work that they have to do in-house.

(CML, 2004b, p. 3)

Such specialisation is growing across the mortgage industry where, particularly since the mid 1990s, the drive to reduce costs has led to the 'unbundling' of the traditional lending functions – of originating, funding and servicing mortgages – with specialist firms emerging that concentrate only on providing the service at which they are most efficient. Such activities are perhaps of particular relevance to the sub-prime sector, because the individualised nature of the risk assessment can mean that it is more difficult, and thus take more work, for a broker to find a willing lender for any particular potential borrower and the lenders may require more comprehensive documentation and checks on potential sub-prime borrowers. There are indications that the number of packagers has been falling as the business consolidates (to around 45 firms), with some predicting that the number will fall further as such pressures continue and regulation becomes more onerous. For lenders in this increasingly segmented market, therefore, it becomes important to pursue a consistent approach to decisions and to build relationships with intermediaries, which enables packagers, brokers and independent financial advisers (IFAs) to be clear about who is 'their' sort of borrower and to pass them business that they want to take (Lender 1). Lender 2 also notes that brokers play a strong part in keeping the market competitive – they would be the first to respond to a new product launch with a comment that someone else was offering something cheaper. Lenders and brokers noted that exclusive products can be offered to brokers or packagers in some instances. However, Lender 4 further noted that the role of brokers is also driven by

consumer demand, because, when most applicants have had, say, two refusals on the high street, they will then actively prefer and seek out a mortgage adviser for help. Mainstream lenders without their own subsidiaries will also refer borrowers to whom they will not lend to particular sub-prime lenders – this allows them to offer a better service to a customer who may well already be a customer in a different part of their business, but may also mean that the customer is not offered the best sub-prime loan for their circumstances (Broker 1).

Where brokers use a packager, the borrower's choice is being restricted. Because of the niche pressures, brokers may know of only one or two lenders that deal with the particular circumstances of the person seeking the loan and this restricted competition within the market may be detrimental to consumers (OFT, 1999). The general complexity of the industry may leave a borrower uncertain as to what choices are available, or even what they have ultimately chosen. The complexity of the 'public face' of the industry, operating largely through specialised, independent or tied brokers, means that some of the major lenders have little public profile. Borrowers in such circumstances will have to place great trust in the advisers they contact. Given that commission rates for brokers are greater for sub-prime products than for prime loans, there is, however, a clear in-principle opportunity for brokers to take advantage of unwary or poorly informed borrowers by selling a (more expensive) sub-prime loan. While recognising that any profession might have some 'bad apples' on its fringes, the industry interviewees were certain that such bad practice is not common.

Regulation of the sub-prime industry

The regulatory interest in, and framework for, the sub-prime sector has evolved alongside that of the whole financial services industry over the last decade or so. In October 2004, a major change took place whereby the previously rather complex web of regulation was replaced by clear regulation of all mortgage provision and mortgage advice agencies by the FSA. The FSA actually became the single regulator for financial services in the UK in the second half of 2001, when the Financial Services and Markets Act 2000 (FSMA) was implemented, but full compliance in mortgage lending and advice was to be attained by 31 October 2004, and general insurance products by January 2005. Across the whole financial services industry there has been a great deal of work in anticipation of this change, and there is a widespread view that it quickly squeezed out some of the worst offenders against the voluntary codes that previously applied to mortgage lending.

At the same time, there has been a radical review of the framework for regulating other loans. The Consumer Credit Act (1974) (CCA) in the UK regulates loans of up

to £25,000 and lenders require a licence to engage in lending such amounts. Such sums are more likely to apply to a second mortgage or second charge lending than to first charge mortgages, but many of the sub-prime mortgage lenders are also licensed to provide loans under the CCA. The fact that mortgages of £25,000 or more were not subject to the CCA has created a clear gap where unscrupulous lenders may have been able to operate in the past.

In July 2001 the government announcement of plans to review the Consumer Credit Act was followed by the publication of the White Paper *Fair, Clear and Competitive – The Consumer Credit Market in the 21st Century* in December 2003 (DTI, 2003). Among the proposals were a measure to abolish the rule of 78¹ and the limiting of charging 28 days' interest for early settlement. There were also concerns over operation of CCJs. In particular, charging orders can be used by lenders to convert an unsecured loan into a secured debt, which right is triggered when a borrower defaults on repayments set by a CCJ. In these circumstances, the lender also has the right to demand repayment of the entire loan amount (a practice associated particularly with First National, which accounted for 25 per cent of all Charging Orders made in England and Wales in 2001). Lenders also have the technical right to charge interest on debts even after a CCJ has set the maximum the borrower can afford to repay. This loophole permits lenders to snowball borrowers' debts even when they are adhering to the CCJ and paying the maximum set by the court.

Amendments to the CCA were placed before Parliament in June 2004 and will come into force on 31 May 2005. Most significantly, these rules will now apply to all loans, not just those of less than £25,000. Among the other changes are:

- replacement of rule of 78 with an actuarial method of calculating based on compound interest principals, although existing agreements will not be affected for two years
- changed rules about how agreements are to be presented and worded, intended to improve clarity for consumers and to enable simpler comparisons to determine the best deal through provision of a 'key facts' document
- APRs must be included in adverts when the advert indicates the availability of credit to people who might consider their credit rating impaired
- limitations on how quickly lenders can increase interest rates (mainly to prevent lenders from raising interest rates when a borrower signals intention to settle early)

Lending to higher risk borrowers

- online adverts to be regulated so that applications are not possible before key facts and figures and illustrations are viewed
- explicit statement of brokerage fees
- a ban on telephone cold calling.

In addition, the Office of Fair Trading (OFT) will be given the power to fine and conduct surprise raids on moneylenders and debt companies – intended to increase the effectiveness of enforcement of compliance with the new regulation. This is to address the criticism of the previous system in which the OFT was not empowered to take action on consumers' behalf. Further, the main sanction that the OFT has had against lenders engaging in bad practice is to revoke their credit licence – arguably rather a blunt instrument for encouraging better practice.

As indicated, these changes will apply across the whole of the financial services industry and, at the time of writing, it is too early to speculate on what the impacts might be. The clear intention is that the framework should encourage greater fairness between lenders and their borrowers, and that borrowers should be given good, clear and accurate information on which to make their decisions. It is also clear that, as the new regulatory framework has developed since the early 1990s, the sub-prime industry has been a particular focus of concern. This is partly because of the nature of sub-prime lending, as OFT (1998) argues:

... individuals with impaired credit ratings or who might otherwise find it difficult to obtain finance on normal terms and conditions from high street banks and building societies and other traditional lending institutions ... they may be less knowledgeable or experienced in financial matters than the generality of consumers, and on the whole they are more vulnerable.

Given the rather poor reputation of some of the early US entrants to the sector in the early 1990s, an important element of securing the 'respectability' of the industry for some of the lead entrants, such as Kensington, was to sign up to this voluntary CML code. The CML has evolved a panel of sub-prime lenders who have agreed to follow this voluntary code, including many of the major players, although not all lenders have joined.²

Evidence of poor practice in the sub-prime sector emerged as early as September 1991, when an OFT report *Unjust Credit Transactions* identified particular concern about abuses affecting the secured lending market, where non-status borrowers were induced to borrow on excessive or oppressive terms against the security of

their homes, without regard to their ability to repay. Examples of practices that would 'point towards an unjust credit transaction' were:

- marketing loans explicitly at those in debt
- limited or no enquiries about income
- preoccupation with the value of the security rather than the borrower's credit worthiness ('equity lending')
- brokers' or other advance fees, often substantial, not explained
- very high interest rates
- increasing interest when a loan was in arrears.

Examples of breaches of the duty to act in the best interest of the borrower were:

- illegal canvassing of agreements in consumers' homes
- irregular documentation – including failure to quote or misquoting interest rates and APRs
- improper tying in of insurance
- falsifying information concerning borrowers' incomes or other financial circumstances
- misrepresentation as to the form, nature, purpose or long-term implications of loan agreements
- unacceptably high-pressure sales techniques.

The OFT, in issuing revised guidance on non-status lending in 1997, argued that there were greater problems in the unregulated sector (i.e. where the loan was above the £25,000 limit of the Consumer Credit Act). It again noted that 'non-status, non-conforming, or sub-prime borrowers may be less knowledgeable or experienced in financial matters and on the whole be more vulnerable'. The guidance sets out a series of general principles, which are expanded in more explicit guidance to the conduct of brokers and lenders, concerning the transparency of the agreements, no use of high-pressure selling, no misleading advertising, transparency with respect to fees and any links between brokers and lenders.

The 1999 report *Vulnerable Consumers and Financial Services: The Report of Director General's Inquiry* (OFT, 1999), which, although not specifically about sub-prime lending (focusing instead on money transmission, home contents insurance, short-term consumer credit and longer-term savings), highlighted research that argued that many consumer problems were due to deficiencies in consumer information and understanding, and to limitations in the goods and services that are available, which, as argued above, are likely to apply disproportionately to users of sub-prime credit.

As noted, the new legislation provides a much more complete regulatory framework and was clearly designed to solve some of the problems identified in these earlier investigations. Some concern has been expressed that, while all second charge lending will be subject to the amended CCA, it will not be subject to mortgage regulation under the FSA. There is no doubt consumers should enjoy greater protection under this legislation, but it is also presumably impossible to ensure that people will always make the best decisions where products are so very complex and consumer understanding can be limited.

Evidence on the structure of sub-prime products

In principle, information on the terms and conditions of sub-prime products can be assembled from the marketing literature produced by lenders and from application packs. In practice, this is more difficult to achieve, certainly on a systematic basis, because of the central role of brokers and introducers in the sub-prime sector, the backroom function and thus invisibility of a proportion of lenders, and the fact that, in a proportion of cases, terms and conditions are specified only once an application has been accepted.

Nevertheless, a wide range of more informal sources identified in the systematic literature review (trade articles, reports from borrowers or debt counselling agencies) do provide a guide to the structure of products and identify some of the features that distinguish the sub-prime from the prime market. The most significant identified are the following.

- Higher interest rates (reports indicate a range from 3–4.5 per cent over base rates, or 1.25 per cent above standard variable rates).
- Tiered interest rates depending on the level of adverse credit experience.
- Widespread use of redemption penalties.

- Frequent requirement for Mortgage Indemnity Guarantee (MIG).
- Greater use of single-premium Mortgage Payment Protection Insurance (MPPI).
- Significant arrangement and commission fees. The literature indicates a broker commission charge of up to 1 per cent in the sub-prime sector compared to 0.35 per cent for introductions to the prime sector. In addition, brokers who work with mortgage 'packagers' may charge an additional arrangement fee of up to 1 per cent. Introductions for self-certification loans are reported to carry commission charges of 0.8 per cent.
- Higher loan-to-value ratios than in the prime sector.³

An important feature of the overall cost of sub-prime products is also how any failure to repay consistently is penalised. Of course default and arrears charges are common across all mainstream financial products (as anyone who has missed a credit card payment or dipped into overdraft will know). However, Policis (2004), in their analysis of the effect of interest rate ceilings on credit products for lower-income and sub-prime borrowers internationally, argued that such default charges are becoming more significant:

The expansion of the risk pool has rested on a move away from rates toward behaviour driven pricing as the key component of credit cost.
(Policis, 2004, p. 18)

This allows products to charge (and advertise) relatively attractive headline APRs, but the actual customer cost is driven to a greater extent by 'charging events' – such as the way that the sub-prime credit card is used – but particularly significant are charges for arrears, late or insufficient payments, etc. This type of pricing shifts customer costs from 'front-end rates' to 'back-end charges' (which are inevitably less transparent).

Within the sub-prime framework, there are gradations of cost and constraint. In particular, sub-prime lenders associated with prime lenders (for example, Birmingham Midshires), or the more mainstream sub-prime lenders (for example, Kensington) tend not to offer annual MPPI, offer interest rates closer to prime rates and have lower arrangement fees than do sub-prime lenders outside these categories. Lower rates of commission may be charged by brokers for introductions in the mainstream sub-prime than in the less mainstream sector.

The web-based search was able to review some guide tables produced for brokers, indicating the risk premiums in terms of higher interest rates, that various lenders attach to borrowers with different characteristics who wish to borrow for different purposes and who wish to borrow a relatively high or low amount. It was not possible to do this for all sub-prime lenders, but it does allow some corroboration of the broad features identified in the literature review as characterising sub-prime products.

Defining degrees of adversity and risk

There is no doubt that there is differential pricing for different degrees of assessed adversity. As will have been evident from the lenders' accounts above, assessment of, and pricing for, risk lie at the heart of a successful lending business (particularly in the sub-prime, but also in the prime sector). A review of the brokers' information shows that factors taken into account when assessing borrowers' risk include:

- CCJs and defaults (and sometimes amounts, when they were incurred, and current status)
- previous bankruptcy, Individual Voluntary Arrangements (IVAs)⁴ (and, when these were incurred, current status)
- arrears with mortgage repayments (amounts, when incurred)
- whether a borrower's house has been repossessed
- references/payment history of rent or of other secured loans
- employment status, including length of time with employer
- whether first-time buyer (FTB) or not
- review of recent bank statements
- accounts when self-employed or affordability statement
- affordability calculation
- residency/electoral roll registration.

In some cases, characteristics of the property and/or the loan are taken into account, such as:

- whether or not the property is of standard construction
- whether it is RTB, ex-council, rent to mortgage
- buy to let property loans are priced separately
- minimum and maximum loan values
- remortgaging vs. buying for purchase
- some lenders restrict property types, e.g. excluding studio flats, flats above shops or business
- there can be (lower bound) restrictions on the property's value
- limits on length of remaining leasehold
- loan-to-value (LTV) ratio required.

Of course, prime lenders will also use indicators such as those above in making their lending decisions. What the lenders' information reviewed showed, though, was that these factors combine in different and complex ways across sub-prime lenders and across products, so that, for many of these features, it is possible to find quite opposing treatment – some lenders, for example, will not lend on Right to Buy purchases while others make a feature of charging no premium for such purchases. This is consistent with the brokers' comments about the complexity of finding exactly the right loan for a borrower and the lenders' description of having 'their' type of customer.

To give an example of how these risk categories can be defined, one lender reviewed in the web-based material defined the risk rating of different full-status (i.e. not self-certified income) customers as described in Table 3. Another produced tables with finer gradations, distinguishing those cases where credit was deteriorating from non-deteriorating (Table 4, again showing full-status borrowers).

Table 3 Defining degrees of adversity, example 1

Adversity	CCJs	Defaults (last 12 months)	Arrears (last 12 months)	IVA	Bankruptcy	Repossession	Tenure history
Light adverse	3 (0 in last 12 months)	0	0	No	No	No	All
Medium adverse	5 (0 in last 12 months)	1–3	2 or 3 (1 in last 6 months)	Satisfied over 12 months	Discharged over 12 months	3 years and settled	12-month rent/mortgage history
High adverse	Unlimited	Unlimited	Unlimited	Satisfactorily conducted	Discharged	Yes	All

Table 4 Defining degrees of adversity, example 2

Adversity	Deteriorating?	CCJs	Arrears	IVA	Bankruptcy
Light adverse	No	£2,500	Max. 1 month (not deteriorating in last 6 months)	Satisfied more than 12 months ago	Discharged, more than 24 months ago
	Yes	£2,500	Max. 1 month	Satisfied more than 12 months ago	Discharged, more than 24 months ago
Medium adverse	No	£5,000	Max. 3 month (not deteriorating in last 6 months)	Satisfied more than 12 months ago	Discharged, more than 12 months ago
	Yes	£5,000	Max. 3 month	Satisfied more than 12 months ago	Discharged, more than 12 months ago
Heavy adverse	No	£10,000	Any amount (not deteriorating in last 6 months)	Satisfactorily maintained (complying) for the last 6 months	Discharged
	Yes	Any	Any amount	Satisfactorily maintained (complying) for the last 6 months	Discharged

Tables 3 and 4 are clearly only indicative because, as noted both in the lenders’ literature reviewed in this web search and in the interviews, there is a significant role for individual underwriting throughout the sub-prime business model, but it gives a flavour of the factors that are used to distinguish better from poorer risks and the extent to which, at the most adverse end, potential borrowers who have quite troubled financial histories and indeed ongoing difficulties will be considered. The loan offer received will discriminate for higher risk by charging a higher price for a given LTV ratio and often also limiting the maximum LTV that will be considered for a loan. Remortgaging sometimes also carried a premium over mortgaging for

purchase, which again may be applied only when the LTV is relatively high, or where the customer is considered to be a relatively high risk. Table 5 gives the rates that are charged for the risk categories defined in Table 4.

So, for the lender shown in Table 5 (in September 2004), after a year's discount period, rates for a full-status borrower revert to rates that vary by three percentage points depending on borrowers' circumstances and required LTV. Where the mortgage is self-certificated, the rate after the discount period varies from Bank of England Base Rate (BBR) + 2.50 per cent to BBR + 5.35 per cent over the same table (and with the same 0.25 per cent premium for remortgaging applicable). For this lender, it is clear that the risk loading is considerably greater for cases where the credit position is considered to be deteriorating, supporting the comments made by lenders in the interviews that an important element of evaluating a case is to see evidence of people 'getting back on their feet' (while of course also demonstrating that this is not essential to securing a loan).

This would support the finding from the literature that some interest rates are high, but it is also clear that there are rates available that are not much above prime rates where adversity is judged to be less. The review of the web-based material also confirmed that there is a broadening range of products available, including discounts, trackers, discounted trackers, fixed rates and mortgages that allow penalty-free repayment of part of the principal annually (ie 'flexible' options), again particularly for 'lighter adverse' customers. This again is consistent with the lenders' argument that there is an increasingly competitive sub-prime market (which drives prices down and the worst products out of the market). Discount rates can be found (early September 2004) of under and only a little above 5 per cent, and longer-term rates of London Interbank Offered Rate (LIBOR) + 2 per cent, or less than 2 per cent above the standard BBR.

At the most adverse end, though, it is possible to find examples of much higher interest rates (e.g. second charge products advertised at 19.90 per cent APR) and a

Table 5 Premiums above BBR for different degrees of adversity

Adversity BBR+	Deteriorating?	LTV 70%	LTV 85%
Light	No	1.85	2.25
adverse	Yes	2.40	3.15*
Medium	No	1.85	2.25
adverse	Yes	2.80	3.55*
Heavy	No	1.95	2.50
adverse	Yes	3.35	4.85*

**Add 0.25 per cent for remortgaging.*

Lending to higher risk borrowers

target consumer group who are of (and therefore *at*) high risk. A lender who was mentioned by some respondents as operating at the more 'adverse' end of the sub-prime market is offering a mortgage loan in its most adverse case with the following characteristics (although indicating that any decision in such a case would have to be referred to an underwriter).

- *Borrower*: CCJs – no maximum; arrears in the last 12 months – no maximum (though there is a note that indicates that, where the lender is 'non-conforming', a full 12-month repayment history would be required); bankruptcy; annulment, discharge required; income from employment, self-employment, employer pension or DSS accepted; age + term of loan, not to exceed 85th birthday (solicitor required to advise and witness agreements where person is 65+ or on disability benefit).
- *Property*: minimum value £25,000, standard construction houses and flats, or non-standard construction, high-rise flats, low/poor valuation, etc.; RTB and rent to mortgage OK.
- *Loan*: minimum £5,000; maximum LTV 55 per cent, affordability calculation allowing 45–65 per cent of net income to be mortgage payment.
- *Cost*: 15.9 per cent APR; 4.5 per cent legal and documentation fee.

Another lender, identified as operating at the lower end of the sub-prime market, offered the following as its most 'adverse case' mortgage product.

- *Borrower*: unlimited arrears in last 12 months; CCJs – up to £10,000; bankruptcy/IVA – discharged/operating satisfactorily; self-certification with accountant's letter.
- *Property*: includes non-standard, high-rise – no floor limit; RTB; ex-council.
- *Loan*: minimum £15,000 to maximum £150,000; maximum LTV 70 per cent.
- *Cost*: LIBOR + 7.55 per cent.

These loans are undeniably expensive, remembering that they are secured against the borrowers' properties, and it would be anticipated that borrowers meeting these requirements will inevitably be in some considerable financial difficulty.

Perhaps another indicator of the growing diversity and choice in the market is that many lenders offer either repayment or interest-only mortgages, and some offer part and part too⁵. It has not, though, been possible to discover the mix of products actually bought. Although there might be a concern that an interest-only loan might potentially be storing up future problems for sub-prime borrowers (as they have to find the means to cover the principal at the end of the loan period), Lender 4 suggested that:

Most sub-prime mortgages are interest only. Consumers are fairly well educated and do not view the mortgage as a loan for life. They are aware that it [*sub-prime borrowing*] is more expensive and that they will be able to access a better deal in the mainstream sector once they have a couple of years of good credit history behind them. Often mortgage advisers contact people after they have had their non-conforming mortgage for a couple of years in order to see whether they are ready to change to another mortgage.

Other interviewees, though, thought that repayment mortgages were more common.

Redemption penalties

The web-based information reviewed usually contained information on redemption penalties, though, perhaps significantly, this was not so for the two more adverse lenders used in the previous examples. Penalties of 6 or 5 per cent are common during an initial fixed or discount period, paralleling practice in the prime sector (though more expensive). For other 'normal' sub-prime loans, most had declining penalties for the first two or three years. Only a very few were longer and it was hard to find any with no such penalties. Some described different conditions applying to regulated loans (i.e. loans up to £25,000), including redemption penalties of 'the lower of a rule of 78 settlement' or a 'slider, which is six months' interest in the first 36 months reducing by one month for every full or part year thereafter' – i.e. penalties effectively in place for seven years.⁶ While sometimes there were lower charges at the very lightest adverse end of a company's product range, again indicating sharp competition at the near prime end of the market, these rates appeared generally to be applied equally to more and less adverse lending across a lender's range. These penalties are therefore generally higher than available in the prime sector.

Other charges

It was not generally possible to identify the full range of fees and charges from the available literature. MIG⁷ was fairly widely applied, at between 6 and 7 per cent for loans of LTV greater than 75 per cent, and there were a couple of examples of higher charges – 9 per cent for LTV of 85+ per cent and 11 per cent for LTV of 90+ per cent. There were, however, prominent examples of companies promoting ‘No MIG on any of our products’, suggesting that competitive pressures are being brought to bear here too. Arrangement fees of £300–400 were standard.

The interviews with lenders and brokers also cast some light on the importance of fees in this market. Lender 3 described how, when the market started to develop, fees were fairly high – between 5 and 9 per cent, which he considers *not* to be a simple reflection of the higher costs or risks of these products. He argues that, in general, fees have since got lower – typically 1–2 per cent – and brokers will argue that these high fees are justified because of the extra work involved in the sub-prime sector. His company, though, is strongly of the view that such fees are *not* justified and would like to see rates driven below 1 per cent. It is trying to push fees down but is finding it difficult to do; brokers have good margins on this business and he suspects that some brokers may receive fees in ‘non standard’ ways – e.g. lender covering some parts of costs such as advertising. A lot of business also comes via packagers, so fees can involve 1 per cent to the packager and 1 per cent to the broker.

Lender 2 also considered that high fees were probably a feature of the secured lending business operating at the ‘lower end’ of the market, even up to 10 per cent, but he clearly distanced himself and his company from practices in that sector.

Unfortunately, the terms and conditions available for review do not provide details of the way in which charges are levied for late or missed payments, or on arrears, which, as Policis (2004) argue, are an increasingly important element of the overall cost of sub-prime products to many of the borrowers, given the generally higher risk they present and the shift in the pricing structure of the products. In 2002, the OFT issued guidelines for non-status (sub-prime) lending that identified general principles that should be met (but not the detailed terms and conditions of a loan). The guidelines focus on transparency, appropriate selling methods, ensuring responsible lending, etc. Thus, the guidelines allow for risk pricing but within an appropriate framework. Breaches of these guidelines will at best constitute problematic lending but are potentially evidence of extortionate credit (see below).

LTV ratios

In contrast to suggestions in the literature, the available web-based evidence did not reveal routinely high LTV ratios in the sub-prime sector, although it is still possible to find loans of 125 per cent in the prime sector and there may be sub-prime lenders willing to do this that have not been identified in this work. However, as suggested in the examples above, the maximum LTV tends to *reduce* as the degree of adversity increases. This presumably reflects the lenders' views that repayment efforts are likely to be most strenuous where people have an equity stake in their property and also of course reduces the risk to them if there should be default and ultimate repossession of the property.

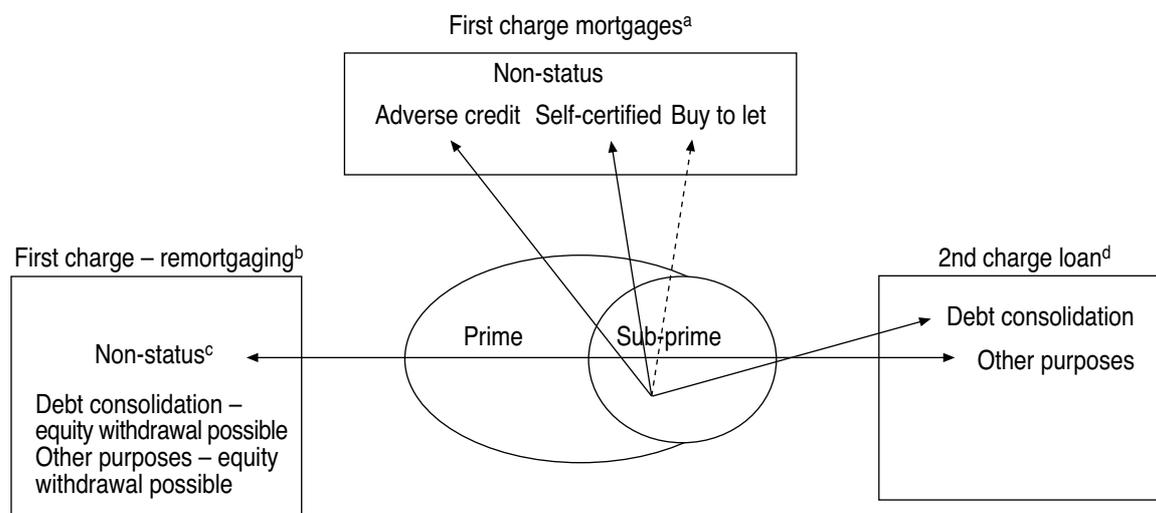
Lender 2 describes how overall LTV ratios are an important part of their asset 'health check', which requires that their average LTV remains below 75 per cent. They typically seek to maintain a profile where a small proportion of lending is 90–95 per cent, slightly higher 85–90 per cent, slightly more again 80–85 per cent, etc., so that current average LTV is 72 per cent. If LTVs got too high they would look at restructuring products and pricing. The Fitch Ratings' evidence from portfolios that have been securitised shows that the average LTV is typically between 70 and 80 per cent (though it also notes that this has fallen quite rapidly over recent years because of the very rapid house price inflation).

Sub-prime niche markets

The systematic literature review found that much of the recent reporting on the sub-prime sector has emphasised its significance as a source of debt consolidation loans, although it is not the only provider, as some prime lenders also offer this facility (and, of course, wherever the purpose of the loan does not have to be disclosed to the lender, some unknown proportion of secured and unsecured lending is likely to be used this way). As indicated above, there have been concerns about targeting advertising particularly to those already in debt.

There are, however, a number of other niche markets where sub-prime lenders operate, of which the main ones are self-certified loans and mortgages, and remortgages for those with adverse credit records. In addition, sub-prime lenders have recently entered the buy-to-let market, again for borrowers with the kinds of characteristics described above. Some of these categories may overlap or cross-cut. Figure 6 presents schematically the range of sub-prime activity. Below we detail further the major niche products.

Figure 6 Schematic representation of the sub-prime sector



- a An initial mortgage on a property.
- b Remortgaging is when borrower remains in the same property but changes the mortgage loan, typically changing lenders and often withdrawing equity.
- c Undertaken largely by those with poor credit ratings or needing to self-certify.
- d A further loan is taken from same or different lender and secured on property.

Figure 6 indicates the potential complexity of identifying and measuring the activities of the sub-prime sector. It shows how the range of activities has grown to parallel those in the mainstream sector, but where the distinctiveness of the activity is due to the nature of the borrower (being credit impaired, etc.). In other cases, such as debt consolidation, the sub-prime sector is more distinctive in terms of the products it offers being explicitly for this purpose.

Debt consolidation

The most recent source of information on debt consolidation is a report commissioned by the OFT, published in 2004. Debt consolidation is defined by the OFT as ‘a process whereby a consumer takes out a loan or other credit agreement in order to pay off two or more existing debts’ (OFT, 2004). A number of different types of credit can fulfil this purpose: unsecured loans, advances on existing mortgages, second charge mortgages and credit cards. (In this study we are principally concerned with secured sub-prime lending. Unsecured lending will be considered only in passing where relevant.) The advantages of debt consolidation are that borrowers have to deal with fewer creditors; they are offered a ‘fresh start’ and generally lower monthly payments. The disadvantages, however, include the fact that, although unsecured, short-term, higher interest rate loans may be rolled up into secured loans at a lower interest rate; they are spread over a longer period of time, which then results in higher overall payments.

The OFT report indicates that most of the secured loans used for debt consolidation purposes are issued by sub-prime lenders. These loans may be sought by 'status' and 'non-status' borrowers (i.e. those who verify their income and those who do not), and those with and without impaired credit records (which will also have degrees of seriousness). Debt consolidation is also frequently a repeating process, as noted by the OFT (2004) where they report that, in a telephone survey of 250 borrowers who had consolidated their debts in the last two years, 38 per cent had done so previously, two-thirds of them on two or more occasions. Almost half of all consolidators took their most recent loan to pay off previously consolidated debts. However, 'solving' debt by recourse to further credit potentially fuels further default and the need for further, higher priced, riskier credit. The FSA (2004) risk report notes that, despite some attractions in such loans:

... the borrower also runs the risk of having their home repossessed in the event of default. Interest rates for these types of products are not as competitive as conventional re-mortgages ... and broker fees can be high.

The sector has evolved to meet just this spiral of debt-consolidation events. Thus, in addition to the growth of the sub-prime sector being related intimately to the growth of indebtedness *per se*, the relationship between further credit and further debt also fuels the evolution of a hierarchically organised sector through which borrowers flow, in many cases downwards through a hierarchy of not prime or nearly prime, to mainstream sub-prime, to sub-sub-prime, carrying an increased debt burden at each stage.

However, this is not an inevitable trajectory. One lender interviewed noted that there might be instances where a borrower prefers not to remortgage with their main lender (perhaps fearing adverse consequences if they admit to, for example, large accumulated credit card debts), but will instead approach someone in the sub-prime sector, for a second charge loan. This is still cheaper than, for example, credit card rates and thus allows a route out of credit problems. Broker 2 commented that he has examples of a first remortgage in the prime market to reduce costs but before any defaults (often following unemployment and growing credit card debts), which, when arrears developed, resulted in a further remortgage in the sub-prime sector. The lenders interviewed for this study were aware of, but distanced themselves from, what they saw as the less reputable end of the debt consolidation market. So that Lender 1 commented that they are happy to operate in the remortgaging for debt consolidation market, which they would judge sometimes to be a sensible move for borrowers and to provide a fresh start. They do, however, look for a lower LTV ratio, maximum 70 per cent, and they would be concerned if there was a pattern of

repeated remortgaging for this purpose, which tends to suggest an inability to manage money and debt. However, an indication of the existence of a downward path through lenders was given by Lender 4's characterisation of the lenders at the very riskiest end of the sub-prime spectrum as those who are prepared to remortgage lending made by other sub-prime lenders and who will consider borrowers with 'unlimited CCJs, mortgage arrears, a possession order and with self-certified income' – noting that very few lenders would consider this end of the market.

Self-certified loans

Self-certified loans are directed to borrowers who cannot meet key credit-scoring criteria such as a regular income or three years' audited accounts (if self-employed). In many cases, self-certified borrowers can provide substantial deposits and so reduce the risk to lenders through the equity in their property. Self-certified loans have also been associated with circumstances whereby borrowers seek loans in excess of the conventional income multiples. The expressed fear is that the reliance on self-certification allows borrowers to be economical with the truth, over-optimistic, or in some cases openly fraudulent about their level of income (and of course to take on a larger and potentially unmanageable loan).

Adverse credit lending – first entry and remortgages

As described above, a core part of the sub-prime business lies in mortgage lending to those who have defaulted on either mortgage or consumer credit payments, who have CCJs or who otherwise have an 'adverse' credit ratings. Such lending is available for first-time buyers (including RTB and rent to mortgage), traders in the market and remortgages.

Buy to let

Buy to let has expanded hugely in recent years, so that, by 2004, half 1, it was estimated that there were 473,000 such loans outstanding, amounting to £46,800 million (an average loan of nearly £100,000). In the same period, 119,800 new loans were made, a total of £12 million. The total size of the market has grown from just £2,000 million in 1998 and nearly ninefold since the beginning of 2000 (CML web site, 2004). A number of lenders specialise in mainstream buy-to-let products, charging a higher interest rate and requiring a larger deposit than is the case for the purchase of a borrower's domestic residence. The take-up of buy to let has resulted

in a segmentation of the prime market but a similar process may now be under way in the sub-prime sector with the advent of a sub-prime buy-to-let sector for those unable to meet the entry criteria in the prime market or who need to remortgage as a result of payment difficulties on an existing buy-to-let mortgage.

In this dynamic and competitive market, the searching for niches to exploit is a continual process as shown in the recent advent of the first sub-prime shared ownership product offered by Preferred Mortgages:

Preferred Mortgages saw a niche market opportunity to support the government in its low cost housing initiative by offering a solution to those who could not get a mortgage through a high street lender.

(Quoted in *Non-conforming Introducer*, June 2004)

The size of the sub-prime market

There are no routine administrative data available on the size of the sub-prime market. Where sub-prime lenders belong to the CML and contribute to their statistics on mortgage lending or arrears, these are not disaggregated by prime and sub-prime. But, as Figure 6 makes clear, the sub-prime sector is not concerned just with lending on a first mortgage. To estimate the size of the sector, data on the extent of lending on second charge loans and unsecured lending are required, and also to distinguish such lending into prime and sub-prime segments. Information on the size of the sub-prime sector has had to be pieced together from the available studies/reports and is not a straightforward exercise. A further issue is that it is not possible to identify the size of all the different niches within the sub-prime sector and of course the market niches overlap – for example, a buy-to-let mortgage may also be self-certified, as could a debt consolidation loan or a remortgage, for instance. When figures are stated for various sectors, the source, its accuracy and precise definitions are often not available. This makes collating reliable information about the sector very difficult.

The systematic literature review identified a range of measures by which to assess the size of the sub-prime sector. Some relate to *potential* market size – the number with an adverse credit rating or the number of mortgage applicants refused a loan in the prime sector – while others seek to identify *actual* market size via responses to survey questions or statements from sub-prime lenders on the number of borrowers/value of borrowing on their books. All of these measures are incomplete; they often relate to different dates/periods and are typically used in an uncritical manner.

The potential market

The potential market is sometimes measured as all those with an adverse credit record. The figure of 8.4 million is often used but rarely justified. It is not clear to what period of time the figure refers, or whether the adverse credit identified relates only to mortgages (although it is close to the estimate of the total number of people with CCJs). However, even assuming that this figure is accurate, reports also indicate that borrowers without adverse credit records can seek loans in the sub-prime market. They may be borrowers with less secure incomes, or who simply like the ease with which a sub-prime loan can be obtained, or who need to self-certify for reasons other than an adverse credit rating (see below). For example, a report from Kensington in 2001 pointed out that only 41 per cent of their borrowers had CCJs against them, although a further (unknown) proportion may have adverse credit records short of a CCJ. Of six sub-prime portfolios analysed by Fitch (2003), the proportion of borrowers with CCJs ranges from 30 to 55 per cent.

A further measure of the potential market is the number of applicants denied a 'high street' mortgage (assumed to signify rejection by prime lenders). Estimates range through one in four, one in six and three out of ten in different reports. Of these, one report in 1998 (which is now rather dated) noted that 75 per cent of those refused a mortgage in the prime sector were then offered a loan in the sub-prime sector.

The 'actual' market

There are a number of figures that purport to refer to the sub-prime market *per se*. For example, a Mintel survey (2001) estimated that the UK sub-prime market (although what exactly this includes is not clearly defined) was 2.5 per cent by value (presumably of total mortgage lending) in 2000 (in that year, the total outstanding 'house loans' were £539.5 billion and total *new* advances £30,398 million [Wilcox, 2003] – of which 2.5 per cent is around £13.5 billion and £760 million respectively). A further Mintel survey (2002) noted that one in ten applicants for mortgages were in the sub-prime sector, and that currently 20 per cent of all mortgages were sub-prime products – in 2002, 1,406,000 mortgage advances were made (Wilcox, 2003) of which 20 per cent is 281,200. By contrast, Datamonitor (2002) estimated that the sector loaned £6 billion in 2001 and predicted that, by 2005, sub-prime mortgages would reach £17 billion and would account for 5–6 per cent of the market by value.

Potentially, a more useful way to try and gauge the size of the operative market from the literature is to consider each of the niches identified in turn in Figure 6. Later we summarise the available data (see Table 6 later in this chapter) and indicate where there are specific gaps in understanding the size of the market.

Remortgaging

Remortgaging has become a major part of the business of prime lenders – CML data show that, in 2003, £123,600 million was lent in remortgages – 45 per cent of the total business. It is not known whether sub-prime lenders have a similar or different division between purchase and re-mortgage loans.

Second charge lending

Debt consolidation

Using a number of industry sources, some of which are unpublished, the OFT estimated that, in 2003, 418,000 households had taken a loan for debt consolidation purposes – 313,000 via a remortgage and 105,000 via a second charge loan against their property.

Although debt consolidation is primarily a recent development, the recent in-year figures will not account for all debt consolidation loans in force. The best guide to total debt consolidation lending is probably the MORI financial omnibus survey (MFS), which indicates that 0.8 per cent of adults (340,000) hold a second charge mortgage. Given that these are secured loans, the most appropriate baseline figure is not all adults but all home-owner households (with and without a first mortgage). On this basis, 2 per cent of home owners have used their property to secure a debt consolidation loan, mainly through the sub-prime lenders.

Debt consolidation may also take place via the remortgaging process. This may be for the same-sized loan but at a cheaper rate, but, as shown above, it has increasingly become the case that borrowers withdraw equity as part of the remortgaging process. MFS estimates that about 5 per cent of adults have withdrawn equity at some point (or 13 per cent of all home owners/19.5 per cent of mortgagors) with about 14 per cent of them doing so in full or in part for debt consolidation purposes. Not dissimilar figures are given by the CML (2001), which, following a survey, indicated that 18 per cent of those increasing their mortgage had used this to pay off debts, including credit card debt.

Only a proportion of this lending is likely to be made by sub-prime lenders, but the size of that proportion is difficult to judge.

If we consider value rather than number of borrowers of all second charge mortgages and remortgages taken in 2002 (£14.4 billion), 60 per cent (£8.8 billion) was taken for debt consolidation purposes. A comparison with the previous year's figures, derived using the same methodology, suggests that the number and value of debt consolidation loans rose in 2003 (FSA, 2004).

Second charge (secured) non-mortgage lending

A National Opinion Poll (NOP) survey in 1998/99 noted that 1 per cent of adults (450,000) had a loan secured on their property but not in the form of a mortgage. The proportion of these loans that is provided by the sub-prime sector is not known.

Self-certification mortgages

One source of information on the size of the self-certified sector is a communication from the FSA. Measuring size in terms of value, it estimates that 'genuine' self-certification accounts for 6 per cent of all mortgage balances and 8 per cent of new lending (FSA, 2004, web site). It is, however, estimated from the responses of only 15 major lenders, all of whom are members of the CML.

Other reports (such as that by Datamonitor) broadly concur with figures of around 5 per cent (of value) quoted. Reports also stress the recent growth in self-certification, some reports suggesting a growth of a third over the last five years. One report noted that the average self-certified loan was £122,400. If this estimate is correct, and the value of the self-mortgage market is correctly estimated at 6 per cent of all mortgage balances – i.e. £40.3 billion,⁸ this suggests that the number of borrowers self-certifying is in the order of 329,000.

Adverse credit borrowers

No estimates noted in literature.

Unsecured lending

While it is possible to identify the value of unsecured lending, it is not possible to estimate how much of it comes from the sub-prime sector.

Table 6 draws together the information discussed above to provide a summary overview.

What is most striking about this discussion and the attempt to pull together the evidence in a more systematic way is that quantitative evidence on many of the key features of this important sector is very sparse. This may be partly a consequence of commercial confidentiality, so that lenders would not wish too much detail about their precise business activities to be in the public domain. It is also, though, likely that data capture has simply not kept pace with this growing and fast diversifying sector. It is encouraging that CML plans to produce a return for the non-conforming sector for the beginning of next year (which is also intended to include information on 'lifetime mortgages' or equity release products). This will be a valuable and systematic addition to information on the sector.

Table 6 Estimated size of the sub-prime credit sector – new activity in 2003/04

	Whole market		Sub-prime	
	No.	Value	No.	Value
<i>First mortgages</i>				
Adverse credit	Not Known	Not Known	All	All
Self-certify	329,000 (total)	5–6%	Majority	Majority
Buy to let	130,000	8% new lending	Not Known	Not Known
<i>Remortgages</i>	45% – 640,000 (2002)	£14.4bn (shared with 2nd charge lending)	Not Known	Not Known
Debt consolidation	313,000	Not Known	Not Known	Not Known
Other purposes	Not Known	Not Known	Not Known	Not Known
<i>All mortgages</i>	1,421,000 (2002)	£121.7bn (2002)	Not Known	£6bn (2001)
<i>Second charge loan</i>	Not Known	£14.4bn (shared with remortgages)	Not Known	Not Known
Debt consolidation	105,000	£8.8bn	? Significant proportion	Not Known
Other purposes	450,000	Not Known	? Significant proportion	Not Known
<i>Unsecured lending</i>	Not Known	£656bn (2002) ^a	Not Known	Not Known
<i>Total</i>				2.5%

a Of which £32 billion is used for debt consolidation.

5 Sub-prime borrowers' perspectives

This research was not designed to attempt to interview borrowers themselves, but, in this chapter, the available information on borrowers' perspectives is brought together from the systematic literature review and from the interviews with professionals in the field. It is perhaps on this issue that the polarised view of sub-prime lending is most sharply brought into focus. Those interviewed from the industry were keen to distance themselves from bad practice or any exploitative activities. The systematic literature search identified a range of key issues in relation to the sub-prime market as it impacts on consumers. A wide range of organisations (DTI, NCC, OFT, CABx, etc.) have identified issues that they believe characterise at least a part of sub-prime lending and which are argued to constitute consumer detriment and instances of very poor practice. Inevitably, cases that come to light in this way tend to be at the most problematic end and are not necessarily a good reflection of the generality of borrowers' experiences. Whether these issues are merely *problematic* features of an otherwise satisfactory loan or amount to *extortionate lending per se* is discussed at the end of this section.

Responsible lending

Consistent mention is made of the use of unduly high APRs and of discounted rates that are withdrawn following a single late payment (increasing the interest rate on default is a breach of the Consumer Credit Act, but some sub-prime lenders 'circumvent' this legislation by charging a discount rate, which reverts to a so-called 'normal' rate on default; see OFT [1998]; *New Law Journal*, [1999]). For example, NACAB (2000) details interest rates of 30–40 per cent on secured debt consolidation loans and 57 per cent on secured loans for goods. The same report gives examples of interest rates of 95–214 per cent on initial unsecured loans and 50–365 per cent on unsecured debt consolidation loans. The examples are drawn from different time periods but at no stage in the past 20 years has the base rate risen above 12 per cent.

There is also concern expressed about the basis for lending decisions, particularly where the amount lent relates primarily to the equity available in the property rather than income considerations. Equally, the growing practice whereby borrowers can access 125 per cent loan to value creates a vulnerability to negative equity if property prices fall, but is particularly problematic if used in relation to debt consolidation, which reduces the equity available and is likely to be undertaken by those whose income (and hence affordability) is already under pressure. A further concern about lending relates to the practice of some lenders in making payment of debt consolidation loans directly to borrowers rather than to their creditors.

Lenders cannot therefore be certain that the loan will be used for debt consolidation, so consumers may use the additional borrowing capacity to become even more heavily over-indebted.

(FSA, 2004)

The discussions held with regulators and advisers echoed these concerns. Some examples from the files scrutinised at CABx illustrate the points.

South West region: couple, 25–34, with four children, were offered mortgage of £187K, by *[a sub-prime lender]*, despite having a total income of just £26K – lender knew this and unsurprisingly they found themselves quickly in difficulty – forced to sell house.

North: in 2003 the client, aged 64, separated woman, took out secured *[sub-prime]* loan of £20K – costing £220 per month, although lender knew that her income was just £324 per month – rate 8.5 per cent over BBR – client now falling deeper into debt as fees when in arrears £30 per month +1 per cent.

Consumers' knowledge of sub-prime terms and conditions

A repeated theme in studies outlining consumers' experiences of the sub-prime sector (e.g. NACAB, 2000; FSA, 2004) is the borrowers' lack of knowledge of the terms and conditions of loans entered into. This is attributed to the absence of transparency in the selling process as well as to the vulnerability and desperation of some borrowers, which leads them to focus on obtaining a loan rather than on its terms and conditions. Key features that are often not realised are the annual rate of interest being charged, the level of redemption penalties, commission and arrangement charges (including volume overrides) and the possibility that default on a unsecured loan can lead to it being secured. The OFT (2004) report on debt consolidation, which commissioned a telephone survey of 250 consumers, noted that around a quarter reported not being told about commission or fee levels, 16 per cent did not know whether they had purchased through a broker or directly from a lender or been subject to a volume override. There is also limited knowledge about payment protection insurance (see below).

Our review of recent NACAB evidence was able to confirm that these problems persist. For instance, the following examples illustrate misunderstanding of the most basic and fundamental nature of loans taken out.

In 1991 client took out a secured loan for £7.5K. Because of ill health he defaulted on some of the early payments but has been making regular contractual payment since then. When he considered redemption in 2001 he found that he owed over £30K including additional interest and charges. He had never been informed that his contractual payment did not cover the accruing interest although [*sub-prime lender*] has been in regular contact. CAB managed to negotiate settlement down to £21K.

Client took out a secured loan with [*sub-prime lender*] for £10K – with insurance, fees, etc. total initial borrowing £11,950 – client has paid £179.42 per month, never missed payment, after 14 years (i.e. after paying over £30K) was told that he still owed £12,010 – despite term being 15 years – loan had been interest only, client unaware. He is now retired on grounds of ill health, unlikely to be able to pay outstanding amount.

These last two examples are also illustrative of a wider issue identified in the NACAB files and with the money advisers, which is that there is an overhang of problems as older loans, bought when the sub-prime market was not well developed and was less regulated and less competitive, are coming to term. Money adviser 1 commented that he was seeing the consequences of sub-prime loans taken out in the early 1990s ‘when interest rates could be as high as 40 per cent and conditions very punitive’. (He also noted his impression that sub-prime lenders never reduce the interest rates they charge to borrowers, although they increase them when base rates increase – as seen above, this does not appear to be true of most contemporary products that are linked to a bank rate, but may have been true in the past.)

Arrears and possessions

A proportion of borrowers are in the sub-prime sector because of adverse credit records. A not unreasonable hypothesis might be that, given the risk premium associated with such loans, sub-prime lenders might experience higher levels of default than high street lenders. This suggestion was supported in a series of annual surveys of mortgage arrears undertaken between 1985–96 and published in *ROOF*. The Fitch Ratings non-conforming index suggests arrears plus cumulative losses settling between 10 and 15 per cent in securitised portfolios in the five years after issue (although some individual RMBSs show much higher delinquency rates – of over 30 per cent). Other studies (Ford, 1988, 1993; Ford *et al.*, 1995) also noted that,

in general, sub-prime lenders (many holding second charges) were much quicker to instigate court proceedings following default than were prime lenders and more likely to repossess. More contemporary, but anecdotal, accounts suggest this is still the case (including the money advisers interviewed here) and, because there has been no systematic study, the extent to which sub-prime lenders adhere to the CML voluntary code of conduct when managing mortgage arrears and possessions cannot be confirmed.

It is possible that court data could be used to provide evidence of the extent to which sub-prime lenders feature in house possession actions and some insights to the potential for using Sheriff/District Court records for assessing the scale of sub-prime lending, and particularly the scale of repossessions, can be gained from McCallum and McCaig (2002). The authors review the type of information held in Sheriff Court records. Court Registers contain summaries of court cases (names of parties, nature of the case, outcome and dates) while Court Processes are detailed accounts of cases. The McCallum and McCaig study carries out an analysis of repossession hearings based on a database constructed from 3,667 repossession cases heard in Aberdeen, Edinburgh, Falkirk and Glasgow Sheriff Courts in 2001. The authors also constructed a 'market share' database by logging the number of standard securities (mortgages) registered by different lenders. This has the potential for allowing identification of sub-prime lenders with high incidence of repossession cases and certainly the preliminary evidence from this work is that sub-prime lenders feature in a disproportionate number of repossession cases.

However, the literature also raises a question as to whether higher arrears and limited lender forbearance applies equally to all niches within the sub-prime sector. For example, the FSA (2004), in reporting on mortgage application fraud in the self-certification sector, noted that, among the 15 lenders it considered, arrears were no different to the general population of mortgage holders, although its sample did not include the bottom end of the sub-prime market (non-CML members). Official data also show that arrears on buy-to-let mortgages are lower than arrears on first residential mortgages. Whether this is the case for sub-prime buy-to-let mortgages is not reported in the literature, although the lenders that were interviewed estimated that they had current arrears levels of 'around 5–7 per cent' (Lender 4); 'around 5 per cent' (Lender 1); '10–15 per cent' (Lender 2) and Lender 3 estimates a 'sector average of 5–10 per cent' while his own company has arrears 'much below the 5 per cent level'. This is clearly in excess of levels in the prime sector (as would be expected) but it is not known how often such arrears lead to house possession.

The perspective of CABx and the money advisers interviewed is that there are sub-prime lenders who 'unreasonably' pursue action for possession, i.e. for relatively

small amounts of arrears, and with little forbearance or room for negotiation. Some advisers suspect that there is, in effect, equity lending taking place (where the lenders' main interest and expectation of return lies in the strong likelihood of eventual possession). Again, a few cases brought to the attention of NACAB illustrate such concerns.

[Sub-prime lender] approached clients by phone to encourage them to exercise their Right to Buy and gave them a mortgage of £45K on house valued at £125K. The interest rate on the loan is 8 per cent (taken out three years ago) – no negotiations only repossession procedures when arrears of four months accumulated.

London: female pensioner aged 64, ill health, borrowed £60K from *[sub-prime lender]* two years ago – has arrears now of £3,127.74 and is threatened with court to possess home.

The imposition of higher interest rates following default has also been singled out for comment in the literature. This practice was publicised, for example, in the case of the City Mortgage Corporation (CMC), which, following a challenge from the OFT, agreed no longer to impose an interest rate of 18 per cent on any borrower whose account was late. Rather a rate of 12.4 per cent was imposed (at three months' arrears) compared to the usual concessionary rate of 9.8 per cent. CMC also withdrew its operation of 'the rule of 78' and a six-month penalty charge for early redemption (or possession following default on a secured loan) on an unregulated loan of over £15,000.

Payment protection insurance

The OFT (2004) notes that the sale of payment-protection insurance with respect to second charge mortgages (often used for debt consolidation purposes) is much higher than found in relation to remortgages. This may indicate a pressurised sales process. More generally, the OFT provides anecdotal evidence that borrowers were unaware of the high costs of single-premium insurances or that they were costed over the life of the loan while routinely offering protection for only five years. Claims of inappropriate selling are also noted – to people with characteristics that will preclude a claim (but this is also an outcome not unknown in the prime market). Selling of payment-protection insurance is also to be more closely regulated in the new mortgage regulation framework.

Regulation

The nature of the varied regulatory regimes that govern sub-prime lending was outlined above. A key theme in much of the consumer literature concerns the inadequacy of the regulatory framework, not surprisingly in view of the issues of detriment outlined earlier (OFT, 1998, 2004; NACAB, 2000). Some particulars frequently mentioned include the £25,000 limit to the Consumer Credit Act, the arm's-length regulation proposed for brokers in the mortgage market and the lack of effective regulation of payment-protection insurance. While some regulatory matters may be improved by the introduction in October 2004 of statutory regulation of mortgage selling and mortgage advice by the FSA, as described in Chapter 3, second charge mortgages and buy-to-let mortgages are currently excluded from the regulatory framework and, as such, there will be no holistic regulation of secured loans in the sub-prime sector.

Other issues

Further issues relate to terms and practices, and include: marketing and advertising standards and in particular the targeting of vulnerable groups; 'hidden' fees and charges that increase the costs; the practice of deducting fees and charges from loans (hence reducing the amount borrowed); and unsecured loans that on default are automatically converted to secure loans. Here, again, the consumer should benefit from greater clarity and transparency within the new regulatory framework.

Sub-prime credit as extortionate credit?

The DTI report on extortionate credit (DTI, 1999) draws a distinction between the very small proportion of borrowers whose loans *in every respect* would be regarded as extortionate and loans where some features may be problematic but others are not. In particular the report notes that those with severe adverse credit ratings often have to turn to 'the less reputable end of it [the sub-prime market] dealing in secured loans with punitive terms and conditions'. However, there is also recognition of a much larger group of borrowers (several millions) who have loans with 'specific terms and conditions that could be considered extortionate even though they are dealing with respectable companies', and a number of these problematic issues have been considered above.

However, it is not possible to say with confidence how much of the sub-prime sector is extortionate *per se*. The DTI report (1999) notes five procedural factors, all of which can also be illustrated from other reports and web sites (e.g. [53](http://www.home-</p></div><div data-bbox=)

repo.org or www.namv.com), which characterise the practices of many at the bottom end of the sub-prime market. These are: targeting loans to particular groups of which those with adverse credit ratings are a particularly vulnerable group; aggressive sales and marketing practices; the lack of transparency in the agreements presented to borrowers; the role of brokers; and debt recovery practices. As such, it is this bottom end of the market that is likely to offer loans characterised by all these features and therefore deemed to be extortionate.

In October 2004, a couple's loan from sub-prime lenders London North Security was found by the courts to be extortionate when, at the end of a 15-year term, an initial loan of £5,750 had spiralled to £384,000. It was not the interest rate of 34.9 per cent that was judged to make the loan extortionate; rather it was the way that penalty charges and arrears were compounded at this same rate and the lack of clear information given to the borrowers. It was noted that there had been other cases that had not been upheld, though, and the lender was given leave to appeal. At the same time, there are suggestions of other borrowers taking a class action against the broker who had sold them similar loans.

Elsewhere in the market aspects of detriment are likely to pertain. The relatively high legal hurdle that has had to be cleared to establish conditions as 'extortionate' has been a clear motivation in the new FSA approach, described above, to instead seek a presumption of fairness and clarity in the relationship between lender and borrower.

Selling sub-prime loans

A particular concern expressed by the money advice workers is that the loans are targeted towards vulnerable people and that they are persuaded to take out more borrowing than they can really afford, or to take out a new loan or remortgage inappropriately. In essence, what are perceived to be 'non-priority loans' – such as credit cards and store cards, on which CABx workers would hope to be able to negotiate reasonable and manageable deals (or even debt write-offs) with creditors – are converted to loans secured on property, turning them into 'priority loans', as the risk is now that the person loses their house. Again, this can be illustrated by a case from the CABx files, although it is clear in such cases that the sub-prime loan is only part of the problem.

North, Clients – couple aged 61, 59; jointly owned ex-local authority house ... had unsecured bank loan of £5K and four credit card accounts with outstanding balances for which they could not meet payments. In February 2004 took loan from [*sub-prime lender*] – secured against home to pay some of the credit card balances ... the accounts are frozen, with no interest being added and clients have agreed to repay £100 per month, but clients cannot afford this as well as mortgage, secured loan and bank loan.

A review of the advertising approach to consumers tends to support some of these concerns. Many newspaper, television and internet adverts targeted explicitly to those with credit problems, or those who feel that their debts are unmanageable, suggest that they can offer a simple solution. They often emphasise that cash or a loan can be had very quickly and that the lenders are sympathetic and non-judgemental. It is also very striking that it is often hard to distinguish exactly what types of business are advertising these services – with brokers and lenders looking similar, and with debt management companies and insolvency advisers mingled in. It is easy to imagine that someone in a desperate financial position would be tempted by such offers, and that they would not undertake careful research and ‘shop around’ for the best deal. However, we have no direct evidence of how consumers make choices in this market.

A somewhat different perspective on consumers’ actions in this market is given in Policis (2004). They examine the use of credit by low-income consumers in the USA, Germany and France, and compare this to the UK and argue:

One of the most striking features of the research undertaken ... was the absolute consistency of demand across territories ... Demand appears to be constant irrespective of the regulatory or cultural context, with low income households having an irreducible need for credit.

(Policis, 2004, p. 10)

Although they find somewhat lower use of credit among low-income households in Germany, they argue that it is because a relatively tight regulatory framework has constrained credit supply for lower-income households – not because households don’t want to borrow (with the consequence that there may be a greater resort to unregulated and illegal moneylenders). They argue that, generally, consumers are able to make fairly sensible choices about the sorts of products that suit them, so that:

There is a clear trend at the top end of the sub prime market in both the US and UK towards a new generation of modern sub prime products. Banked borrowers are choosing sub prime products which are scaled to fit need, readily accessible, facilitated by electronic channels and supplied by large national and international suppliers. Mainstream and sub prime credit cards are being used alongside dedicated high rate sub prime models such as Pay day loans, typically for different reasons ... for the unbanked, who have fewer credit choices [i]n the US Title loans and RTO (rent to own) are gaining ground at the expense of pawn broking while home credit companies are losing customers to sub prime credit cards in the UK.

(Policis, 2004, p. 14)

From this perspective, then, some argue consumers are in general fairly astute in seeking out products that suit them best, and (for the most part) their decisions are not based on an irrational 'temptation' offered by apparently easy money, but in response to a basic need for credit. Although there are households who end up with unmanageable debt, it is certainly not the case that all sub-prime borrowers have fallen in this trap, nor that such debts are the 'fault' of the suppliers of credit.

The industry perspective: serving sub-prime customers

Markets work to the benefit of consumers – and this is a very competitive market, delivering a valuable service.

(Lender 2)

The lenders have a very different perspective to that of the money advisers on the experience of sub-prime borrowers (the latter of course see only those in trouble). From the lenders' standpoint, a critical element in the sub-prime business model is pricing and managing risk, which involves both a careful evaluation of the customer's riskiness at the point of offering (or not) a loan and effective methods of dealing with loans that do start to fall into arrears. So, lenders describe how they would not do 'credit scoring' but take a more individual approach to underwriting. Lenders that we interviewed are clear that they are not involved in 'equity lending' but that the main focus of the application and approval process is to ascertain a customer's ability and willingness to pay.

At the 'front end' of their business they seek to deliver a good service – especially focusing on a quick decision time (which Kempson and Collard's [2005] work confirmed as a very important feature for lower-income people seeking credit). So, Lender 1 said the 'decisions are made and conveyed to the customer in 24 hours –

and often within the same day' and another said they had a 'one-minute mortgage' offer. And, as discussed above, the advertising approach is clearly meant to convey a non-judgemental approach and an understanding of the bad luck, rather than the mismanagement, that might leave someone with an impaired credit record.

But the approach to gauging and pricing for risks is founded on a recognition that they are dealing with an inherently more risky client group than mainstream lenders and, consequently, lenders seek to manage those risks actively once the mortgage is agreed. Some lenders provide a close and personal service to their new borrowers. Having offered a loan, Lender 1 describes how their customer service keeps in active contact with a new borrower over the first three months, and less frequently over the whole life of the loan, providing a personal contact to whom the borrower is encouraged to report quickly any change in their circumstances that will impact on the ability to repay. Lender 3 describes his company as having a 'very customer-focused approach' – they try to make the customer understand that they are 'on their side' and want to help keep them 'on the straight and narrow' and certainly out of repossession. On mortgage completion, they send a debt counsellor to borrowers, to talk through the agreement, approaches to budgeting, etc. He notes that sometimes small changes – e.g. to ensure that the direct debit comes out close after salary is paid in – can help people 'stay out of trouble'. Their borrowers are given a personal contact to phone if their circumstances change. Lender 2's company phones new borrowers as soon as the mortgage is agreed to explain what and when the first payment is, and that it will come by direct debit from the bank, to ensure that people are happy with what they are taking on; he is adamant that he 'does not want customers who have been sold the wrong product or do not understand what they are taking on'.

But, by definition, these companies are operating with higher-risk customers and therefore have well-developed procedures for dealing with people who begin to falter in their repayments. Generally, there is an emphasis on fast action compared to mainstream lenders, to try and come to some new arrangement quickly where that is appropriate and to make sure that the arrears that are accumulating do not escalate out of control. This typically involves phone contact from the lender and possibly a face-to-face visit; as Lender 2 argues, 'there's no point in sending letters to people – they have been in debt before, and are more likely to get in trouble again, letters are stressful and generally ignored'. He stresses that they are absolutely *not* in the business of repossession which he described as 'horrible, horrible'. Where the counsellor who contacts clients in arrears has to come to the view that the present loan/house is unaffordable, they would rather work with people to encourage a move to somewhere more suitable. Lenders do not believe that such approaches are generally found to be intrusive for customers and they may help borrowers avert, or

deal quickly with, any situation that might otherwise build towards unmanageable debt and repossession. However, this swift action may be interpreted by advisers and borrowers as constituting 'too fast' a move towards ultimate repossession.

In summary, these lenders would argue that they are delivering a service that people *want*, at a competitive price, and in a way that is sympathetic to their particular needs. Although a minority may get into trouble, for the great majority, sub-prime lending offers a service that was previously not available – access to home ownership – and may provide a route out of debt problems and back to the mainstream.

6 Conclusions

Overall, we would argue that this research project has succeeded in its central aim of ‘scoping’ the sub-prime sector, to bring together in a way that has not been done before a range of information about the sector’s evolution and operation. It will be evident that there are some sharply polarised views about the sector, not all of which it has been possible to reconcile in this work, partly because the fragmentation of the market makes it hard to make generalisations about either lenders or borrowers in the sector (a factor that perhaps had not been so clear previously) and perhaps partly because there have been so many significant changes to the sector even within the relatively short time that it has been in operation in the UK.

The more formal, systematic literature review undoubtedly identified a strong focus on a range of problematic issues within sub-prime lending (excessive charges, inappropriate lending, aggressive practices, lack of transparency, etc.). In the absence of a considered and systematic analysis of the market, it is often left to the industry and trade press, as well as to individual lenders/brokers, to make the case for the benefits of the sector. To summarise, the following are some of these key benefits, as perceived by the industry.

- An adverse credit episode (often caused by events outside the individual’s control) need not preclude exclusion from home ownership or the credit sector.
- Access to the mortgage and credit market is widened for borrowers within the flexible labour market, with beneficial consequences in terms of choice and lifestyle.
- Individuals are making a free choice to take these products – a demand that, without this sector, would go unmet or be diverted to other (perhaps less favourable) products.
- Competition in the industry is creating an increasingly diverse range of products for consumers to choose from, on improving terms.
- A successfully managed sub-prime loan can be a way of resolving immediate financial difficulties.
- Successful management of a sub-prime loan can provide a route for credit repair and back to access the mainstream credit market.

However, it is ultimately not clear how widely these possible benefits are enjoyed, nor how they should be weighed against charges of expensive and inappropriate lending, ultimately leading to arrears and repossessions.

Market differentiation

A strong theme to emerge from this research is the growing diversity of the sector. This makes it important to be careful about trying to generalise about sub-prime lending activities. First, (i.e. as against second-charge lending) charge lending for house purchase is probably the least problematic part of the market. It is subject to increasingly strong regulation in any case, and it can be seen to provide opportunities for owner-occupation for those who would otherwise be excluded. But, even so, the range of borrowers who can find mortgage finance in the sector – including those with very adverse and deteriorating debt experience, or on very low incomes – emphasise the likelihood that some borrowers will get into (deepening) trouble, while others will be able quite quickly to establish a sound record of repayment and move towards the mainstream.

Remortgaging was shown to be a growing feature of financial markets generally and is also included in the new regulatory framework. However, whereas remortgaging in the prime market allows access to lower-cost products, although people may also choose to release some equity for other purposes, in the sub-prime sector, the primary motivation for remortgagors must be to release equity. As many people turning to the sub-prime sector have some adverse credit history, this suggests that, while not all sub-prime remortgaging will involve debt consolidation, much of it will. The alternative is possible, but perhaps not common that, for instance, someone currently repaying a prime mortgage but who could not access further funds in the prime sector would turn to a remortgage in the sub-prime sector to finance home improvements or to buy a car. This would seldom make good financial sense, as the whole mortgage repayment would become more expensive. Similarly, for someone already repaying a sub-prime mortgage, remortgaging in this sector would make sense only where credit problems and debt were continuing – otherwise the borrower should be looking at repaired credit and a move back towards the mainstream. While acknowledging that remortgaging can provide a ‘fresh start’ financially, with lower consolidated payments, there is also evidence that this becomes a repeating process for many. And, as argued, there is a hierarchy within the sub-prime sector where even remortgaging an existing sub-prime loan will be considered.

Second charge lending is likely to be used disproportionately by those in the greatest difficulty. Again, it may on occasion provide a more cost-effective way of dealing with credit problems, or making an essential purchase than, for instance, credit cards or unsecured lending. But securing such debts against the home increases borrower vulnerability. This sector is not included in the mortgage code, although it will be subject to the amended CCA.

Sub-prime lending and sustainable home ownership

One of the issues that in part motivated this research was a concern to understand the implications of the sub-prime sector for sustainable home ownership. The meaning of sustainable home ownership is often unclear although, in some instances, its use is restricted to indicate that home ownership is affordable at the point of entry. In contrast, we are using the term 'sustainable home ownership' to mean the ability of individual home owners to retain their property over the economic cycle and in the face of risk experiences, at least in the short to medium term (Maclennan *et al.*, 1997). What the scoping exercise makes clear is that the relationship between the sub-prime market and sustainable home ownership is not necessarily straightforward and indeed sub-prime can both promote sustainability and undermine it.

The ability to sustain home ownership is a function of several factors including: entry characteristics (e.g. affordability); exposure to risk (e.g. unemployment, interest rate rises, etc.); and lender forbearance. The evidence on affordability and responsible lending in the sub-prime sector is mixed. For example, at the least adverse end, loan-to-income and loan-to-value criteria are not very different from many lenders in the prime sector. Further, as the creditworthiness of applicants worsens, often the loan to value available falls. This might be seen as responsible lending. However, there is also evidence of at least some equity lending, up to 125 per cent of value lending, relatively high proportions of net income permissible in affordability calculations and self certification (with mixed evidence on the extent to which it pushes up loan-to-income ratios).

For all sub-prime borrowers, the higher interest rates that are charged (reflecting risk premiums) inevitably worsen affordability. Loans whose duration extends beyond retirement age also bring about deteriorating affordability as do loans that carry significant charges and commission fees, all of which have been demonstrated to characterise the sub-prime sector. Willingness to lend against benefit income (which is not usual in the prime sector) could also create circumstances where households face affordability difficulties. Affordability sets the context in which externally generated risk has to be managed and, in the sub-prime sector, affordability is likely to be worse than in the prime sector. On this basis, the sub-prime sector at least has the potential to undermine sustainable home ownership to a significant extent.

It is also probable that some (presently unknown) proportion of those who borrow in the sub-prime sector have personal characteristics that make them 'unsustainable home owners'. This would be the case for those who find it impossible to manage money, or to keep under control their use of credit or their spending, as well as the

(presumably smaller) number who have no commitment to repaying their debts. The former group would not in the past have been generally able to access home ownership and both groups would always have fallen out of owner-occupation in the end, but the extent to which the availability of lending in the sub-prime sector leaves such people in a worse or better financial state than they would otherwise have been is unknown.

To the extent that sub-prime loans are more expensive, it is more likely that external changes will impact adversely, whether these are in the form of an interest rate rise, unemployment or relationship breakdown. These factors are all outwith the influence of the sub-prime sector and are driven by macrosocial and economic trends. However, if home ownership is to be sustained in circumstances that increase risk, the key issue becomes the evidence as to how the sub-prime sector forbears.

The literature review and evidence from consumer and advice organisations give a fairly consistent account of the nature of forbearance, which is identified, on balance, as being limited and costly. Thus, for example, interest rates typically increase once an account goes into arrears and charges are incurred, and the preliminary evidence available indicates that sub-prime lenders are characterised by a disproportionate percentage of arrears cases and certainly a disproportionate percentage of possessions. There is little evidence to argue that, across the sector as a whole, forbearance acts to support sustainable home ownership, although there are clearly 'better' and 'worse' sub-prime lenders in this respect and some do abide by the CML voluntary code of conduct on forbearance. But risk, in the context of tighter affordability and limited forbearance (and where forbearance itself increases costs), is likely to undermine sustainability.

The other side of the picture, however, is that the sub-prime sector can and does provide a 'safety net' for home owners, allowing them to remain in the sector. Thus, repossession and a CCJ is a key criterion for lending in the sub-prime sector rather than a reason for exclusion as is the case in the prime sector. Without the sub-prime sector facilitating remortgaging and debt consolidation among those with adverse credit records we might speculate that *prime* lenders would have higher levels of arrears and possessions. But this sustainability comes at a price that can itself increase the likelihood that any further risk will be difficult to manage to a sustainable conclusion.

Policy issues

Any overall assessment of the sector is not straightforward. In policy terms, with respect to securing a sub-prime sector that delivers greater sustainability, a key

question is: can pricing/charges/lending on the one hand and forbearance on the other be addressed so as to remove the excesses that challenge sustainability? What is likely to happen should there be an economic downturn? Sub-prime lenders cannot be changed into prime lenders and still play their current role in the market but is there room for some limitations on them that still ensure a commercial operation? These are the issues that regulation is, or should be, addressing. For example, what are legitimate premiums for risk? How long should a lender be expected to forbear and in what ways? Are the higher commission levels to brokers for sub-prime than prime introductions fair, given that the broker is not bearing the risk (though may need to do some additional work)?

Research issues

While we believe this research has brought together data on the sub-prime sector in a way not previously available, it has also highlighted some significant gaps in our knowledge.

Size and composition of the sector

As Table 6 shows, sound evidence on the size of the sector, and the distribution of lending across a range of purposes and individual characteristics, is not available. Part of this is the problem that large-scale survey data often lags market developments by a very considerable distance. There is scope for questions to be developed in the Survey of English Housing, the Family Resources Survey, etc. to allow the sector to be described and monitored more effectively. (Consider the parallel discussions on flexible mortgages or mortgage insurance, which were well established in the market place before adequate questions were placed on the major surveys.) Because the sector is an evolving one, and one whose success depends on the continual generation of niche products, ongoing monitoring is important. And monitoring is particularly important given the strong cyclical nature of risks in the housing market – an economic downturn would both impose difficulties on many already in the sub-prime sector and increase the demand from borrowers who are currently ‘prime’ for sub-prime services.

Linked to the above, survey data would also provide the basis for identifying the characteristics of different groups of sub-prime users. For example, what are the characteristics of those who self-certify in the sector, what is the socio-economic distribution of those with adverse credit records, what proportion of borrowers are turned down by the prime sector or how many prime borrowers nevertheless borrow in the sub-prime market and why? How many prime borrowers are sustaining their

home ownership by remortgaging/consolidating via the sub-prime sector? Although it should be possible to improve data capture from some of the major surveys, it may only be possible to explore some of the more detailed questions of interest through dedicated research with sub-prime borrowers.

Motivation, choice and decision making

Other key gaps also concern the motivations of borrowers and the processes whereby they decide to use a sub-prime lender. The literature review and interviews indicate multiple motivations and influences that range from lack of knowledge and/or lack of alternatives, to active choice following a well thought through process leading to particular desired outcomes. However, none of these situations is well understood and in-depth work could reveal much about borrowers' use of the sector and the consequences of the decisions they make. Although it would probably be difficult to get good samples of sub-prime borrowers, a study focused on these issues within a longitudinal framework would be very productive (see below).

Another gap in the work that it was possible to do here relates to the more adverse end of the market, as the industry experts we identified who were willing to be interviewed were concentrated in the near prime and mainstream sub-prime sectors of the market. There is less systematic evidence available about lenders and brokers operating at the most adverse end of the market, though repeatedly there are allusions to pockets of poorer practice at this end and anecdotal evidence that emerges from the 'worst' cases that pass before advice agencies and appear in the courts. There are hints, for example, that sub-prime lending is playing an important role in persuading people, perhaps unwisely, to take up their Right to Buy, but the extent of this is also unknown. The impact of the new regulation on the industry would also be an interesting avenue to explore.

The dynamics of sub-prime borrowing

There is no information that enables a longer-term perspective on sub-prime borrowers. A more longitudinal exploration of the extent to which people find themselves on the 'virtuous circle' of credit repair and a move towards the mainstream or the 'vicious cycle' of repeated refinancing and migration 'down' through the spectrum of lenders to the increasingly sub-prime end would be extremely valuable, and also cast light on the complex interrelation between sub-prime lending and the sustainability of owner-occupation.

Sub-prime forbearance

It is a considerable time since any independent research on lender forbearance was undertaken. To our knowledge, there has never been a survey of sub-prime forbearance. Consequently, at the moment, the nature of forbearance is revealed through those cases that come to public attention at the most punitive end of the spectrum but which may not be representative of some or a majority of sub-prime lenders. There is scope to undertake more systematic work using court records and this approach could also provide samples of sub-prime borrowers who have faced possession proceedings. The lack of knowledge in this area can be linked to the likely impact of regulation and further work on how regulation will impact on the sub-prime sector would be timely. The impact of regulation on brokers and introducers in the sub-prime sector is also a key topic.

Sub-prime broking?

There has been a great rise in the extent to which brokers and other intermediaries play a critical role in advising potential borrowers and matching them to the complex range of products available across all mortgage lending. The impact that this has had on the choices that people make generally has not been subject to research scrutiny. The work reported here, however, also indicates that brokers play a particularly significant role in sub-prime lending – both because sub-prime mortgages are often supplied only through intermediaries and because of the suggestion that sub-prime borrowers are particularly likely to seek the services of a broker given that they cannot directly access high street lenders. This raises interesting questions about transparency in the market. Given that the names of even the best established sub-prime lenders remain largely obscure to potential borrowers, there will not be any development of general ‘public’ information about the reputation or niche operations of the different lenders – relying always instead on the advice of honest brokers to ensure that borrowers get the best deal given their particular circumstances.

Notes

Chapter 1

- 1 In this report, the term 'sub-prime' is used for the sector, as it is arguably becoming the most recognised and established term – it is, however, also noted that some prefer 'non-conforming' lending, as having a less pejorative tone.

Chapter 3

- 1 Although non-payment of poll tax is often asserted to have impaired many credit ratings, in fact the impact is rather less than commonly believed, because most actions in England and Wales were pursued by credit agencies in the Magistrates' Courts and did not result in formal CCJs.
- 2 For example, in York, following water privatisation, householders received two bills, one for water and one for sewage. A huge number of people paid the first and thought the second one was a mistake. The company was aggressive in debt recovery and issued hundreds of CCJ summons.

Chapter 4

- 1 The rule of 78 is a way in which lenders calculate how much interest should have been paid at any stage during the repayment period of a fixed-rate instalment loan when a loan is settled early. The '78' derives from the 12 monthly parts of a one-year period. The sum of those parts ($12 + 11 + 10 + 9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1$) is 78. Thus, for a loan with a one-year duration, the lender expects payment of $12/78$ ths of the interest in month one, $11/78$ ths in month two and so on down to $1/78$ th in month 12. The key point is that, especially for long loans, the outstanding principal will reduce very slowly at the beginning of the term, and in fact repayments can even be *negative* in the early years of a long loan. This is a manageable way of calculating interest when computational capacity is limited but is arguably unnecessary now computers are ubiquitous.
- 2 At the time of the research, the CML working group on sub-prime lending had representatives from Bank of Scotland, Birmingham Midshires, First National, Future Mortgages, GMAC-RFC, Kensington, Mortgages PLC, Southern Pacific Mortgage Ltd, Platform, The Mortgage Business, Woolwich.
- 3 Although this was identified in the systematic literature review, as argued below, the evidence suggests that actually loan-to-value ratios tend to be lower where the degree of adversity is greater.

- 4 IVA (Individual Voluntary Arrangement) is a legally binding arrangement, supervised by a Licensed Insolvency Practitioner, which allows a debtor (an individual, or sole trader, or partner) to avoid bankruptcy by entering a formal agreement with creditors that a regular, manageable amount of money will be paid and shared pro rata amongst them. Creditors will generally need to be assured that they will receive greater repayments than would have been the case had the debtor been made bankrupt. This usually involves a longer repayment period – five years rather than three – and will often require housing equity to be released should it be available (at the end of the agreement). It can allow a debtor to continue earning income from a business, where this is in the best interests of the creditors. Any default is likely to result in bankruptcy.
- 5 This means it is possible to borrow £100,000, have £50,000 as a repayment and £50,000 on interest only. You are expected to invest in an endowment or other savings policy to cover the principal at the end of the loan period.
- 6 That is, the pattern of the penalties is: 6 per cent/6 per cent/6 per cent/5 per cent/4 per cent/3 per cent/2 per cent and then 1 per cent thereafter.
- 7 MIG is the additional insurance fee paid by a borrower taking out a relatively higher loan-to-value ratio loan, to cover the lender against any loss should they fail to cover their loan in the event of repossession and sale – it is also widely applied in the prime mortgage market.
- 8 Calculated as 6 per cent of the £671.3 billion outstanding ‘house loans’ figure for 2002 (Wilcox, 2003).

Bibliography

- Anderson, S. (ed.) (2004) *The CML Mortgage Market Manifesto: Taking the Past into the Future*. London: CML
- Bramley, G., Munro, M. and Pawson, H. (2004) *Key Issues in Housing Policy*. Basingstoke: Palgrave
- Burrows, R. and Wilcox, S. (2000) *Half the Poor: Low Income Home Owners*. London: CML
- CML (Council of Mortgage Lenders) (2001) *Mortgage Equity Withdrawal*. London: CML
- CML (Council of Mortgage Lenders) (2002) *Housing Finance*. London: CML
- CML (Council of Mortgage Lenders) (2004a) *Housing Finance*. London: CML
- CML (2004b) 'Mortgage packagers, the market and statutory regulation', *CML News and Views*, No. 13, July
- Cole, I. and Furbey, R. (1994) *The Eclipse of Council Housing*. London: Routledge
- Collard, S. and Kempson, E. (2003) *Pawnbrokers and their Customers*. London: National Pawnbrokers Association
- Collinson, P. (2000) 'Kensington Mortgage Company', *The Guardian*, 11 May
- Cottell, C. (2001) 'Hey, I'm sub-prime not sub human', *The Guardian*, 2 September
- Datamonitor (2002) *UK Non-standard and Sub-prime Lending*. London: Datamonitor
- DTI (Department of Trade and Industry) (1999) *Extortionate Credit in the UK*. London: DTI
- DTI (Department of Trade and Industry) (2003) *Fair, Clear and Competitive – The Consumer Credit Market in the 21st Century*. London: DTI
- Fitch Ratings (2003) *Structured Finance. UK Non Conforming RMBS: Performance Reviewed Q2 2003*. www.fitchratings.com
- Ford, J. (1988) *The Indebted Society*. London: Routledge
- Ford, J. (1993) *Problematic Home Ownership*. Loughborough: Loughborough University
- Ford, J., Kempson, E. and Wilson, M. (1995) *Mortgage Arrears and Possessions; Perspectives from Borrowers, Lenders and the Courts*. London: HMSO
- Forrest, R. and Murie, A. (1990) *Selling the Welfare State*. London: Routledge
- Forrest, R., Murie, A. and Williams, P. (1993) *Home Ownership: Differentiation and Fragmentation*. London: Unwin Hyman

FSA (Financial Services Authority) (2000) *In or Out? Financial Exclusion: A Literature and Research Review*. London: FSA

FSA (Financial Services Authority) (2003) *Financial Risk Outlook, 2003*. London: Financial Services Authority

FSA (Financial Services Authority) (2004) *Financial Risk Outlook, 2004*. London, Financial Services Authority

Kempson, E. (2002) *Over-indebtedness in Britain*. London: DTI

Kempson, E. and Collard, S. (2005) *Affordable Credit: The Way Forward*. Bristol: The Policy Press

Kempson, E. and Whyley, C. (1999a) *Extortionate Credit in the UK: A Report to the Department of Trade and Industry*. <http://www.dti.gov.uk/topics1/extortionate.htm>

Kempson, E. and Whyley, C. (1999b) *Kept out or Opted out? Understanding and Combating Financial Exclusion*. Bristol: The Policy Press

Kempson, E., McKay, S. and Willitts, M. (2004) *Characteristics of Families in Debt and the Nature of Indebtedness*. Research Report No. 211. London: Department for Work and Pensions

McCallum, E. and McCaig, E. (2002) *Mortgage Arrears and Repossessions in Scotland*. Edinburgh: Scottish Executive Social Research

Maclennan, D., Meen, G., Gibb, K. and Stephens, M. (1997) *Fixed Commitments, Uncertain Incomes: Sustainable Owner Occupation and the Economy*. York: Joseph Rowntree Foundation

Maltby, J. (2003) 'CE of Kensington Group outlines core competencies in UK specialist mortgage market', interviewed on Yahoo Finance, 29 December, <http://uk.biz.yahoo.com/031229/114/ei0d1.html> (accessed 26 January 2004)

Mintel (2001) *Subprime Lending, Finance Intelligence*. London: Mintel

Mintel (2002) *Subprime Lending, Finance Intelligence*. London: Mintel

Miles, D. (2004) *The UK Mortgage Market: Taking a Longer View*. London: HM Treasury

NACAB (National Association of Citizens' Advice Bureaux) (2000) *Daylight Robbery*. London: NACAB

NCC (National Consumer Council) (2003) *Response to DTI Consultation Paper 'Tackling Loan Sharks'*. London: NACAB

New Law Journal (1999) Vol. 149, p. 7

Nuttall, S. (2004) 'Household borrowing: impact of interest rate rises', *Housing Finance*, Vol. 61, Spring, pp. 20–33

OFT (Office of Fair Trading) (1991) *Unjust Credit Transactions*. London: OFT

OFT (Office of Fair Trading) (1997) *Non-status Lending: Guidance for Lenders and Brokers*. London: OFT

OFT (Office of Fair Trading) (1998) Press release on City Mortgage Corporation

OFT (Office of Fair Trading) (1999) *Vulnerable Consumers and Financial Services: The Report of Director General's Inquiry*. London: OFT

OFT (Office of Fair Trading) (2002) *Non-status Lending Guidelines*. London: Office of Fair Trading

OFT (Office of Fair Trading) (2004) *Debt Consolidation*. London: OFT

Palmer, H. and Conaty, P. (2002) *Profiting from Poverty. Why Debt is Big Business in Britain*. London: New Economics Foundation

Policis (2004) *The Effect of Interest Rate Controls in Other Countries*. DTI: London

Royal Bank of Scotland (2002) *Asset Backed Fixed Income Research, Financial Markets*. Edinburgh: Royal Bank of Scotland

Social Exclusion Unit (1999) *Policy Action Team 14, Access to Financial Services*. London: HMSO

Smith, S.J., Ford, J. and Munro, M. (2003) *Flexible Lending?* London: CML

Wilcox, S. (2003) *UK Housing Finance Review*. Coventry: JRF/CIOH/CML

Appendix: Sub-prime search strategy

A range of web sites and databases were searched using a variety of search terms. Most of the web sites do not offer sophisticated searching and so single terms were generally used in the searches of those web sites and the results were sifted visually for relevance.

Search terms used, unless otherwise stated, were:

- sub-prime or subprime
- extortionate credit
- self-certified or selfcertified or self-certification or selfcertification
- adverse credit
- County Court Judgements
- predatory lending
- premium rates
- credit refusal
- debt consolidation
- niche lending
- non-status or nonstatus
- impaired credit
- secured lending
- credit repair
- fringe lending.

Resources searched are listed below:

- DTI web site: <http://www.dti.gov.uk>, searched 3 March 2004
- OFT web site: <http://www.offt.gov.uk/default.htm>, searched 3 March 2004
- FSA web site: <http://www.fsa.gov.uk>, searched 3 March 2004
- Hansard online on the web, searched 3 March 2004

- NACAB web site: <http://www.nacab.org.uk>, searched 3 March 2004
- Council of Mortgage Lenders website: <http://www.cml.org.uk>, searched 3 March 2004
- *Financial Times* 1998–2003, searched 3 March 2004.

This is a series of databases provided by the University of York Library.

- Newsbank database, searched 3 March 2004. The University of York Library provides access to this large database covering all the UK national newspapers.
- Business Periodicals Index, searched 3 March 2004. The University of York Library provides access to this database. It is almost totally US in its coverage.

Marketing databases on the Dialog database service

A cross-database search of marketing databases on Dialog was conducted on 4 March 2004 using the following search terms:

- S1 46882 SUB()PRIME OR SUBPRIME
- S2 73 SELF()CERTIF.? OR SELFCERTIF?
- S3 13 ADVERSE()CREDIT()RECORD? ?
- S4 2903 COUNTY()COURT()JUDG?
- S5 10106 PREDATORY()LENDING?
- S6 46024 PREMIUM()RATE? ?
- S7 144 ADVERSE()CREDIT()HISTORY?
- S8 18 CREDIT()REFUSAL
- S9 5732 DEBT()CONSOLIDATION
- S10 667 NICHE()LENDING
- S11 157 EXTORTIONATE()CREDIT
- S12 565 NON()STATUS OR NONSTATUS

S13 1140 IMPAIRED()CREDIT

S14 1681 CREDIT()REPAIR?

S15 55 FRINGE()LEND?

S16 1601816 HOME()LOAN? ? OR HOME()OWN? OR MORTGAGE? ?

S17 15438508 UK OR UNITED()KINGDOM OR GREAT()BRITAIN OR ENGLAND
OR SCOTLAND OR WALES OR IRELAND

S18 4776 SELF()CERTIF?

S19 115001 S1:S15 OR S18

S20 5669 S19 AND S16 AND S17

S21 4212 S20/1999-2004

The Dialog mktres group of databases was searched and this group includes:

- Business & Industry(R) Jul/1994–2004/Mar 03
- ABI/Inform(R) 1971–2004/Mar 03
- Gale Group PROMT(R) 1990–2004/Mar 04
- Gale Group F&S Index(R) 1988–2004/Mar 04
- Dialog Global Reporter 1997–2004/Mar 04
- FOODLINE(R): Market Data 1979–2004/Mar 01
- TableBase(R) Sep 1997–2004/Feb W4
- UBM Industry News 1998–2004/Jan 27
- Gale Group Trade & Industry DB 1976–2004/Mar 04
- Gale Group PROMT(R) 1972–1989
- Industry Trends & Anal. 1997/Jun
- Chemical Economics Handbook 2000/Jul
- Specialty Chemicals Update Program 2000/Q2

- DELPHES Eur Bus 95–2004/Feb W4
- Periodical Abs Plustext 1986–2004/Feb W5
- Investext(R) 1982–2004/Mar 03
- Wilson Bus. Abs. FullText 1982–2004/Jan
- Key Note Market Res. 1986–2001/Aug 03
- Decision Res Pharm Ind Rpts 1998/Aug 03
- Gale Group MARS(R) 1984–2004/Mar 04
- Gale Group Globalbase(TM) 1986–2002/Dec 13
- FI Defense Market Intelligence 2004/Feb 26
- KR/T Bus.News. 1992–2004/Mar 04
- Gale Group New Prod.Annou.(R) 1985–2004/Mar 03
- McGraw-Hill Publications 1985–2004/Mar 03
- Business Dateline(R) 1985–2004/Mar 03
- DIALOG Telecom. Newsletters 1995–2004/Mar 03
- Investext(R) PDF Index 1999–2004/Feb W5

SIGLE

SIGLE was searched on the WebSPIRS interface on the 28 July 2004 using the following strategy:

(debt* with consolidat*) or (credit with refusal) or (credit refusal) or (premium rates) or (predatory with lending) or (county court judgement*) or (adverse with credit) or (self-certifi* or self certif* or selfcertif*) or (extortionate with credit) or (sub-prime or sub-prime or subprime) or (fringe lending) or (credit repair*) or (secured with lending) or (impaired with credit)