HM TREASURY

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a consultation

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1 Introduction

Subject of the consultation

1.1 The Government is committed to ensuring mortgage markets in the UK are fair, stable and efficient. Mortgage markets with these characteristics deliver better outcomes for firms and consumers, and allow those active in these markets to have confidence in their decisions.

1.2 A robust and responsive regulatory system is a key element in ensuring mortgage markets are innovative and sustainable, offering products that suit the needs of a variety of borrowers while providing appropriate consumer protection.

1.3 In 2004, the Government extended the scope of Financial Services Authority (FSA) regulation to include first-charge residential mortgages. The FSA's regime provides important protections for borrowers, including requirements that lenders treat customers fairly and regard repossession always as a last resort. The regulatory regime also provides borrowers who experience problems with a means of redress through access to the Financial Ombudsman Service (FOS).

1.4 The regulation of other credit business, including second-charge mortgages, is set out in consumer credit legislation and is enforced by the Office of Fair Trading (OFT). The OFT's regime has been strengthened recently by the implementation of the Consumer Credit Act 2006 (CCA 2006). This Act introduced a strengthened licensing regime, improved powers for the OFT to investigate complaints and access for consumers to free dispute resolution via the FOS.

1.5 The Government is committed to ensuring that the regulatory framework remains robust and up to date. In July 2009, HM Treasury published *Reforming financial markets*, setting out the Government's proposals for the reform of the financial system.[1] This document made specific announcements in relation to the regulation of mortgages, namely that the Government would:

- review the case for FSA regulation of second-charge mortgages;
- review the case for FSA regulation of buy-to-let mortgages; and
- consult on measures to protect consumers when lenders sell on mortgage books.

1.6 This consultation document sets out the Government's proposals on each of these three issues, and seeks stakeholder views on these proposals. A draft Statutory Instrument, by which the Government could enact its proposals, is included with this document in Annex D, and the Government welcomes responses to the specific questions on this draft order.

Policy context

1.7 The world economy has been hit by a severe financial crisis, triggered by difficulties in the US housing market and spreading rapidly throughout global financial markets. Banking systems

[1] Reforming financial markets, *HM Treasury,* July 2009. Available at: http://www.hm-treasury.gov.uk/reforming_financial_markets.htm.

around the world were severely destabilised, and this has impacted on economic growth, prosperity and jobs throughout the world.

1.8 The Government has taken comprehensive action to restore stability to financial markets, so that savers and depositors are protected and lenders can continue to lend.[2] The Government's interventions share the common objectives of protecting ordinary customers of financial institutions from the consequences of financial instability and restricted access to credit, while safeguarding the interests of the taxpayer. These actions comprise targeted action for individual banks and building societies; and a comprehensive system-wide response, including action to ensure liquidity, strengthen bank capital, guarantee certain wholesale funding, deal with impaired assets, and support lending in the economy.

1.9 The Government is also taking action to reform banking and financial service regulation. On 8 July, the Government published *Reforming financial markets*, a paper setting out the Government's analysis of the causes of the financial crisis, along with a series of proposals to reform and strengthen financial regulation, and protect and support consumers. The consultation period for these proposals closed on 30 September, and on 19 November the Government published a document setting out its response to the consultation.[3]

1.10 On 2 July, the Government published a white paper on consumer rights, *A Better Deal for Consumers*.[4] This set out proposals to provide further help to people in difficulty with their finances and proposals to strengthen the UK's consumer credit regime, including measures to:

- tackle consumer protection issues in particular parts of the consumer credit market;
- raise standards in decision-making across all regulated consumer credit products; and
- make the regulatory regime for consumer credit effective for all consumers.

1.11 On 19 October, the FSA published a discussion paper on its approach to mortgage regulation and a package of proposals to improve its existing regime.[5] This paper also expresses the FSA's support for the proposals set out in this consultation document. Stakeholders may wish to view this paper, which is available on the FSA's website.

1.12 The Government remains committed to helping households through the downturn and ensuring that there is an appropriate framework of support for mortgage borrowers. The box below sets out key actions the Government has taken to strengthen the framework of support for homeowners.

[2] Details of the actions taken by the Government to support financial stability can be found in Budget 2009. Available at: http://www.hm-treasury.gov.uk/bud_bud09_repindex.htm.

[3] Reforming financial markets: summary of responses, *HM Treasury,* November 2009. Available at: http://www.hm-treasury.gov.uk/7644.htm.

[4] A Better Deal for Consumers, *Department for Business, Innovation and Skills,* July 2009. Available at: http://www.berr.gov.uk/whatwedo/consumers/consumer-white-paper/index.html.

[5] DP09/3 Mortgage Market Review, *Financial Services Authority*, October 2009. Available at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/140.shtml.

Box 1.A: Government action to support mortgage borrowers in difficulty

Homeowners receive important protection from FSA regulation of mortgages, which requires lenders to treat customers fairly and treat repossession as a last resort. The framework of mortgage regulation is supported by the mortgage pre-action protocol introduced in November 2008, which sets out the actions courts expect lenders to take before bringing a possession claim to court. The protocol applies to first- and second-charge residential mortgages. Over 116,000 households are benefiting from lender forbearance on their mortgages.

The Government is committed to ensuring that high quality debt advice is available for borrowers who need it. Since April 2006, the Government has invested over £130m in a face-to-face money advice project aimed at the most vulnerable households. At the 2009 Pre-Budget Report, the Government increased spending on debt advice, including a further £5.85 million for National Debtline between November 2008 and March 2011, to increase provision of free telephone debt advice.

Universal protection for borrowers from FSA regulation and the courts is supported by a number of Government schemes providing targeted help to specific groups of homeowners. For those who need direct assistance, the Government is helping through Support for Mortgage Interest. For those who have exhausted all other options, the Government has introduced the Mortgage Rescue Scheme and Homeowners Mortgage Support. Over 300,000 households have received help or advice in connection with their mortgage payments since April 2008.

On 8 September the Government launched a new national campaign to help struggling homeowners take control of their finances and make the most of the support available for them to avoid repossessions and stay in their homes. Concerned homeowners are able to go to www.direct.gov.uk/mortgagehelp, or contact the National Debtline on 0808 808 4000 for impartial advice, real life examples of people who have already benefited from support, and to develop a personal action plan tailored to their particular circumstances.

Structure of the consultation

1.13 The remainder of this consultation document is divided into six sections:

- Chapter 2 – sets out the Government's proposal to transfer the regulation of second-charge mortgages from the OFT to the FSA.
- Chapter 3 – sets out the Government's proposal for FSA regulation of buy-to-let mortgages.
- Chapter 4 – sets out the Government's proposal to introduce a new regulated activity, "managing" a regulated mortgage contract, to protect consumers when mortgages are sold on.
- Chapter 5 – provides information on how to respond to this consultation document and outlines the next steps the Government will take following this consultation.
- Annexes A, B and C – present Impact Assessments for the policy options proposed in Chapters 2, 3 and 4.
- Annex D – presents the draft Statutory Instrument that would make the Government's proposed changes to the regulatory framework for mortgages.

1.14 The Government recognises that not all stakeholders will be interested in all the proposals included in this consultation. Chapters 2, 3 and 4, which present these proposals, are intended to be accessible individually, and allow stakeholders to treat them as standalone consultations, without needing to read the other two chapters.

Responding to the consultation

1.15 This consultation began with the publication of this document and will last for a period of 12 weeks, closing on 15 February 2010. Information on how to respond to this consultation is provided in Chapter 5.

2 Regulation of second-charge mortgages

Second-charge mortgages

2.1 Second-charge mortgages are loans secured on property that is already acting as security for a first-charge residential mortgage. The terms first and second charge refer to the priority of securities held by the lenders. A second charge is subordinate to a first charge: in the event of default and the sale of a property a first-charge mortgage lender will recoup its money first and the second-charge mortgage lender's interests in the property are only activated after all liabilities to the first-charge mortgage lender have been settled.

2.2 In 2004, the Government extended the scope of Financial Services Authority (FSA) regulation to include first-charge residential mortgages. Regulation of other credit business, including second-charge mortgages, is set out in consumer credit legislation and is superintended and enforced by the Office of Fair Trading (OFT). Regulation of mortgages and credit provides important protections for consumers and helps to ensure that customers are treated fairly.

2.3 In March this year, the Government announced that it would review the current split of OFT and FSA regulation in relation to second-charge mortgages.[1] On 8 July, HM Treasury published *Reforming financial markets*, setting out the Government's proposals for the reform of the financial system, which announced that the Government would review the case for transferring regulation of second-charge mortgages to the FSA.[2]

2.4 The Government has considered the case for a transfer of regulation in the past, most recently in Budget 2006. However, in light of recent events that have shown how problems in mortgage markets can spill over into financial markets more generally and current considerations of the wider framework of financial services regulation, there is a case for considering again whether the split of responsibilities between the FSA and the OFT remains appropriate.

2.5 The Government does not intend to make fundamental changes to the wider institutional framework for the regulation of consumer credit at this time, while changes are being implemented as result of the Consumer Credit Directive. The Government remains open to looking at the case for a single regulator for credit in the medium term while recognising there are wider consumer protection implications of any shift that would need to be considered.

Market background

2.6 The second-charge mortgage market has grown rapidly over the last decade and according to industry estimates, by 2007, made up approximately 2 per cent of the total mortgage market. This growth has been driven by both demand- and supply-side factors.

2.7 Second-charge mortgages are typically shorter-term and much smaller than first-charge mortgages (the average outstanding balance on second-charge mortgages is around £28,000,

[1] The Government's statement of 17 March is available at: http://nds.coi.gov.uk/content/detail.aspx?NewsAreaId=2&ReleaseID=395627&SubjectId=16&AdvancedSearch=true.
[2] Reforming financial markets, *HM Treasury,* July 2009. Available at: http://www.hm-treasury.gov.uk/reforming_financial_markets.htm.

although the average new advance has fallen to around £14,000).[3] Second-charge mortgages can be used as a substitute for either unsecured credit or variations of first-charge mortgages.

2.8 In recent years, borrower demand has increasingly been for second-charge mortgages as debt consolidation loans, in particular by borrowers with impaired credit records. Borrowers experiencing problems with their existing unsecured loans have used second-charge mortgages to consolidate their debts into a single loan, typically benefiting from lower interest rates charged by lenders in return for greater security. Borrowers may have preferred this option to varying the terms of their first-charge mortgage or remortgaging for cost or availability reasons, or because of a desire to avoid longer-term debt.

2.9 On the supply side, although the market for second-charge mortgages has existed for some time, lenders were attracted to enter the market in recent years by the potential to take advantage of wider margins available, compared to the first-charge mortgage market where margins had been eroded. The emergence of alternative funding (such as wholesale funding) reduced the cost of lending, and by removing the need for a branch presence also enabled specialist lenders to enter the second-charge lending market. Around 50 lenders were active in the market in 2007.[4]

2.10 There is some evidence that the market has become increasingly competitive in recent years. The differential between average APRs and the Bank of England base rate fell from 5.1 per cent in August 2003 to 3.5 per cent in August 2007.

Impact of financial crisis

2.11 The disruption to financial markets has affected the second-charge mortgage market, as it has affected wider mortgage markets. As lenders' risk appetites have changed, many second-charge lenders have withdrawn their products, and others have exited the market completely. Lending has been concentrated in the major banks and their subsidiaries, as specialist lenders have virtually stopped lending and building societies have been constrained by increased requirements for liquidity and capital. There are now around 18 lenders overall, with only four lenders writing more than £1 million of new business in July 2009.[5]

2.12 As in the wider mortgage market, intermediaries in the second-charge market are affected by the withdrawal of products, and there have been moves by some lenders to bypass intermediaries with direct offerings.

2.13 . The financial crisis has also affected the demand for second-charge mortgages. Falling house prices, leading to lower equity, have caused a fall in demand for second-charge mortgages. Some lenders, including Barclays, have cited lower demand as their motivation for exiting the market.

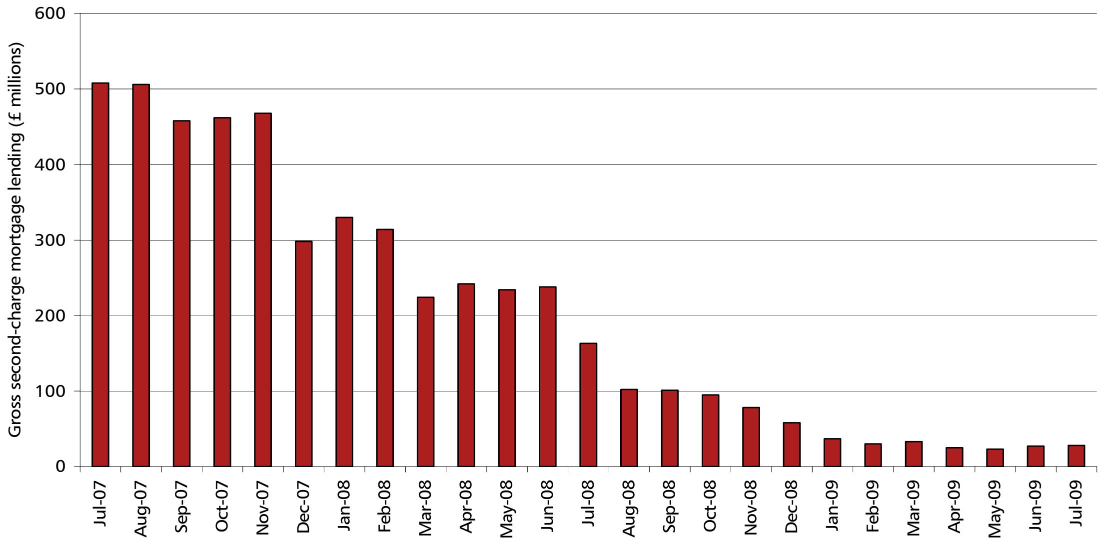
2.14 Activity in the second-charge mortgage market has fallen, with new business 84 per cent lower in the 12 months to July 2009 compared to the 12 months to July 2008. The chart below presents monthly gross second-charge mortgage lending from 2008 to 2009.

[3] Written evidence submitted to the Treasury Select Committee by the Finance and Leasing Association, as published in the committee's report on mortgage arrears and access to mortgage finance. Available at: http://www.publications.parliament.uk/pa/cm/cmtreasy.htm.

[4] Information provided by the Office of Fair Trading.

[5] Information provide by the Finance and Leasing Association.

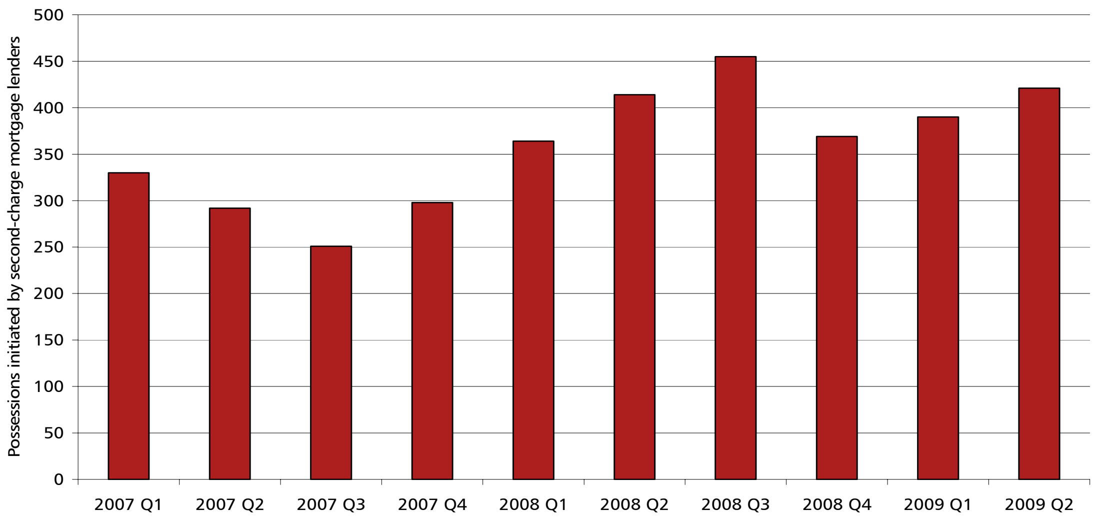
Chart 2.A: Monthly gross second-charge mortgage lending, 2008 - 2009



Source: Finance and Leasing Association (FLA)
Note: FLA membership accounts for roughly 85 per cent of second-charge mortgage lenders. This data therefore is likely to understate the volume of activity in the market.

2.15 It is unclear to what extent the wider economic downturn has affected the performance of loans. There is a lack of historical data on arrears and repossessions in the second-charge mortgage lending market. However, the Finance and Leasing Association (FLA), which represents around 85 per cent of second-charge mortgage lenders, has published data on arrears and repossessions supplied by its members since the first quarter of 2007. This data suggest that second-charge mortgage lending leads to relatively low levels of repossessions. There is a concern, however, that arrears and repossessions may be particularly concentrated in second-charge mortgage lenders that are not FLA members.

Chart 2.B: Quarterly repossessions initiated by second-charge mortgage lenders, 2007 - 2009



Source: Finance and Leasing Association (FLA)
Note: FLA membership accounts for roughly 85 per cent of second-charge mortgage lenders. This data therefore is likely to understate the volume of activity in the market.

2.16 Although the number of actual repossessions completed by second-charge mortgage lenders may not be disproportionate to second-charge mortgage lenders' share of the wider mortgage market, a number of respondents to the Treasury Select Committee's recent inquiry into mortgage arrears suggested that arrears management processes are worse among second-charge mortgage lenders than among first-charge mortgage lenders.[6]

Question 1: Do you agree with the analysis of the second-charge mortgage market?

Framework of regulation for second-charge mortgages

2.17 The current framework for the regulation of second-charge mortgage lending is set out in consumer credit legislation.[7] This legislation requires lenders to hold a consumer credit licence, issued by the OFT, and sets out rules to protect consumers, which the OFT, in partnership with local authority trading standards services and the Department for Commerce in Northern Ireland, is responsible for enforcing.

2.18 The OFT's regime has been strengthened recently by the implementation of the Consumer Credit Act 2006 (CCA 2006). This Act introduced a strengthened licensing regime, which allows for greater scrutiny of 'business competence'; improved powers for the OFT to investigate complaints and stronger sanctions in case of breach; improved rights for consumers, including access to free dispute resolution via the Financial Ombudsman Service (FOS); and a wide-ranging right for consumers to challenge before the courts any aspect of their relationship with a lender which they believe to be unfair (the 'unfair relationships test').

2.19 As a result of the reforms introduced by the CCA 2006, the OFT has new powers available to it when considering the 'fitness' of firms to enter and remain in consumer credit markets. The OFT has also been given greater powers to monitor the continuing fitness of traders through enhanced information gathering powers and, where there are concerns about the behaviour or activities of traders, has the ability to impose requirements on lenders to modify their conduct.

2.20 The OFT also publishes guidance, both sector specific and for the consumer credit market generally, setting out behaviours and activity which it considers may bring fitness into question. The OFT recently published guidance on the second charge mortgage market detailing the minimum standards required of those engaged in second-charge mortgage lending and has recently consulted on draft guidance on irresponsible lending.[8]

Case for maintaining the current framework

2.21 The measures to strengthen the framework of consumer credit regulation, together with proactive monitoring and enforcement activity by the OFT, will improve consumer protections in the second-charge mortgage market. This is particularly important in current market conditions, with higher levels of arrears and repossessions than in the recent past.

2.22 Some stakeholders have argued that second-charge mortgages are more equivalent to unsecured credit products than first-charge mortgages. Therefore, it is argued, an OFT regime – as part of the wider framework of regulation for consumer credit – is the most appropriate form of regulation for these products.

[6] For example, written evidence submitted by Which?, as published in the committee's report on mortgage arrears and access to mortgage finance. Available at: http://www.publications.parliament.uk/pa/cm/cmtreasy.htm.

[7] The Consumer Credit Act 1974, as amended by the Consumer Credit Act 2006.

[8] Second charge lending – OFT guidance for lenders and brokers, *Office of Fair Trading,* July 2009. Available at: http://www.oft.gov.uk/news/press/2009/88-09.

2.23 The OFT and FSA are working together to help ensure a joined-up approach to regulation of secured lending, and the OFT engaged fully with FSA when producing the aforementioned guidance with a view to ensuring that there was no marked inconsistency of approach between the two regulatory regimes. It may be argued that close working between the OFT and FSA could lead to equivalent outcomes without a formal transfer of responsibility.

Case for FSA regulation

2.24 Although the FSA and OFT's regimes seek to deliver similar outcomes, they differ in detail and in the way they are monitored and enforced. In contrast to OFT regulation of second-charge mortgages, for example, FSA regulation of first-charge mortgages includes detailed reporting obligations – both at the firm level and also on individual transactions, a rule-making function obviating the need for primary or secondary legislation and specific standards around advice provision. The great majority of secured loan sales are advised – for first-charge mortgages more than 90 per cent of intermediated sales involve advice – and consumers face the possible loss of their home in the event of default. Transferring regulation of second-charge mortgages to the FSA could potentially ensure that all mortgage regulation is aligned with the risks and ensure a consistent standard of consumer protection across the secured credit market. Consistent treatment is especially important when a borrower is in arrears or default on both mortgages, and could encourage coordination between lenders in such cases to minimise costs to borrowers. Consistent standards would also help others with an interest in debt issues, including consumer organisations, debt advisers and the courts.

2.25 At present firms selling both first- and second-charge mortgages have to engage with two different regulatory regimes with the attendant compliance costs. These include a large number of mortgage intermediaries. Transferring regulation of second-charge mortgages to the FSA could help reduce compliance costs for those firms who would otherwise be subject to both FSMA and CCA regimes. It would also remove any existing boundary confusion, or regulatory duplication, although the OFT and the FSA have taken action to tackle some boundary issues, and the Government has legislated to prevent potential instances of dual regulation.[9] It is also important to note, however, that a number of second-charge mortgage lenders are engaged in other credit or ancillary credit activities, and so would in any case continue to require a consumer credit licence.

2.26 The OFT's regime is aimed primarily at consumer protection. However, regulation also has a role to play in accounting for externalities. Mortgage markets have the potential to impose large costs on those who are not active participants in them, as recent events have shown. Concerns that lenders in the US sub-prime mortgage market had underestimated the real risks of their lending decisions spread quickly through financial markets and severely destabilised banking systems around the world. These risks posed by mortgage markets to the wider financial system, and the economy as a whole, can be mitigated by prudential regulation. Prudential regulation helps to protect the financial system against losses, and therefore minimises disruption across financial markets.

2.27 As a consumer-focussed regulator, the OFT does not set prudential requirements for lenders. The FSA, as a regulator of financial markets, does impose prudential requirements on those firms it regulates. Its regime helps ensure that firms hold sufficient capital to manage credit risk, so that sufficient resources exist to cushion against the potential disruption of a firm's failure for customers and for markets. FSA prudential regulation applies to non-deposit takers offering first-charge mortgages and also all deposit takers. The FSA currently already regulates a number of second-charge mortgage lenders because these lenders fall into one of these two

[9] For example, work on the regulation of modified credit agreements. Available at: http://www.hm-treasury.gov.uk/consult_regulation_credit.htm.

categories. There are, however, some firms that do not fall into these groups, and so are not subject to prudential regulation. It is also possible that as lending markets recover, other firms not regulated by the FSA may enter the second-charge mortgage market. This presents a risk that the failure of a firm may damage the market and, as a consequence may lead to damage to the wider economy.

2.28 On 19 October, the FSA published its Mortgage Market Review.[10] This discussion paper highlights the role that both prudential and conduct of business regulation has in ensuring a sustainable mortgage market that functions well for consumers. The paper sets out a strategic change in the FSA's approach to mortgage regulation. A consequence of the significant enhancements proposed is the risk that poorer quality lending might migrate to areas where these amendments are not proposed. This potential "gaming" might pose risks for firms, markets and consumers.

Proposal

2.29 Subject to the outcome of this consultation, the Government proposes to transfer the regulation of second-charge mortgages from the OFT to the FSA. The Government considers the level of consumer protection offered by the OFT's regime vital, and is determined that should any transfer of regulation occur, it should not result in a lower level of protection for consumers.

2.30 To transfer regulatory responsibilities from the OFT to the FSA, the Government proposes to extend the scope of FSA regulation to include the second-charge mortgage lending. Second-charge mortgage lending would be brought within the scope of the FSA's existing mortgage regime, and would be carved out from the scope of consumer credit legislation by the same exemption that applies currently to FSA-regulated mortgages.[11]

2.31 The exact details of the FSA's regime will be for the FSA to determine. As noted above, the FSA's recently published discussion paper sets out a number of proposed changes to the way in which the FSA regulates mortgages. Stakeholders may wish to view this paper, which is available on the FSA's website.

2.32 The European Commission is currently considering responsible lending and borrowing in the EU. Earlier this summer the Commission published a consultation on these issues, which closed on 31 August. The Government and the FSA submitted a joint response to this consultation and this is available to view on the FSA's website.[12] The Government has considered the Commission's work in developing its proposal, and will continue to be mindful of any action by the Commission when considering responses to the consultation.

2.33 The Government seeks views on two policy options under consideration. These options are:

- Option 1 – Maintain the existing framework. The Financial Services Authority continues to regulate first-charge mortgages only, with the OFT continuing to regulate second-charge mortgages as part of its consumer credit regime; and

- Option 2 – FSA regulation. The Government brings forward legislation to extend the scope of FSA mortgage regulation to include the second-charge mortgage market.

2.34 The costs and benefits of these options are set out in the Impact Assessment published with this document in Annex A, which should be read in conjunction with this consultation. The

[10] DP09/3 Mortgage Market Review, *Financial Services Authority*, October 2009. Available at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/140.shtml.
[11] By virtue of section 16(6C)(a) of the Consumer Credit Act 1974.
[12] Available at: http://www.fsa.gov.uk/pubs/international/response_lending_and_borrowing.pdf.

Impact Assessment considers qualitative, and where possible quantitative, costs and benefits of implementation.

Question 2: Do you agree that extending the scope of FSA mortgage regulation to include the second-charge mortgage market would support the Government's objective of ensuring a fair, stable and efficient market for second-charge mortgages?

Question 3: Do you consider that any further action would be necessary in order to ensure that any transfer of responsibility for regulating second-charge mortgages from the OFT to the FSA would not result in a loss of consumer protection?

Question 4: Do you believe there are any other ways to mitigate the potential future risks posed by second-charge mortgage markets?

Question 5: Do you agree with the costs and benefits of the options under consideration in relation to second-charge mortgages, as set out in the Impact Assessment?

Draft legislation

2.35 Secondary legislation would be required to extend the scope of FSA mortgage regulation to include the second-charge mortgage market. This consultation seeks views on the details of draft secondary legislation.

2.36 The scope of FSA regulation is established through the Financial Services and Markets Act 2000 (FSMA). The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) sets out a list of activities regulated under FSMA, and the FSA is the body responsible for regulating these activities. It sets the standards that firms must meet and can take action against firms if they fail to meet the required standards. Only authorised persons or exempt persons are legally permitted to carry on a regulated activity.

2.37 To extend the scope of FSA regulation to include the second-charge mortgage market, the Government would need to amend the RAO so that it included activities relating to second-charge mortgages. A copy of the draft Statutory Instrument (referred to in this section as "the draft order") by which the Government proposes to do this, subject to responses to this consultation, is published with this document in Annex D. Specific questions on the draft order are set out below.

2.38 In 2004 the Government introduced FSA regulation for first-charge residential mortgages. The Government considers that the most appropriate way to extend the scope of FSA regulation to include the second charge mortgage market would be to amend the definition of a regulated mortgage contract. The current definition of a regulated mortgage contract is set out in the box below.

Box 2.A: Current definition of a regulated mortgage contract

As set out in Article 61(3)(a) of the RAO:

> a contract is a "regulated mortgage contract" if, at the time it is entered into, the following conditions are met–
>
> (i) the contract is one under which a person ("the lender") provides credit to an individual or to trustees ("the borrower");
>
> (ii) the contract provides for the obligation of the borrower to repay to be secured by a first legal mortgage on land (other than timeshare accommodation) in the United Kingdom;
>
> (iii) at least 40% of that land is used, or is intended to be used, as or in connection with a dwelling by the borrower or (in the case of credit provided to trustees) by an individual who is a beneficiary of the trust, or by a related person;
>
> but such a contract is not a regulated mortgage contract if it is a regulated home purchase plan.

The term "first legal mortgage" is defined in Article 61(4)(a) as follows:

> a "first legal mortgage" means a legal mortgage ranking in priority ahead of all other mortgages (if any) affecting the land in question, where "mortgage" includes charge and (in Scotland) a heritable security.

2.39 The draft order includes a provision to replace the current definition with a proposed new definition of a regulated mortgage contract. This proposed new definition is presented in the box below.

Box 2.B: Proposed new definition of a regulated mortgage contract

The proposed new definition of a regulated mortgage contract, as set out in the draft order is that:

> a contract is a "regulated mortgage contract" if, at the time it is entered into, the following conditions are met–
>
> (i) the contract is one under which a person ("the lender") provides credit to an individual or to trustees ("the borrower");
>
> (ii) the contract provides for the obligation of the borrower to repay to be secured by a legal mortgage of land (other than timeshare accommodation) in the United Kingdom;
>
> (iii) at least 40% of that land is used, or is intended to be used, as or in connection with a dwelling;
>
> but such a contract is not a regulated mortgage contract if it is a regulated home purchase plan.

The provision defining "first legal mortgage" will be replaced by a definition of "mortgage" as follows:

> "mortgage" includes charge and (in Scotland) a heritable security.

2.40 The definition provides that a contract is a regulated mortgage contract if the conditions in (i), (ii) and (iii) are met, and the contract is not a home purchase plan, at the time it is entered into. This means that if, after being entered into, the contract is amended and one of these conditions is no longer met, it will still be considered a regulated mortgage contract. This enables greater certainty as it means that judgements are not required about whether possible variations might have led or will lead to change in the regulatory position. One important effect of this will be that a loan secured on property by means of a charging order would not be captured by the definition, as this was not a regulated mortgage contract at the time it was entered into.

2.41 The condition in paragraph (i) specifies that a regulated mortgage contract can only exist where the contract is between a lender and an individual or trustees. This means that the scope of regulation would include lending to individual landlords, including businesses constituted as sole traders or unincorporated partnerships, but not businesses established as limited companies. This mirrors the existing regime for first-charge residential lending, which excludes business-to-business lending.

2.42 The condition in paragraph (ii) of the proposed new definition specifies that a regulated mortgage contract provides for the borrower's obligation to repay to be secured by a legal mortgage of land (other than timeshare accommodation) in the United Kingdom. This condition is broader than the existing condition, and by removing the requirement that the mortgage must be a "first legal mortgage" would include second-charge mortgage lending, or indeed any lending subsequent to a second-charge mortgage, within the scope of the definition.

2.43 The condition in paragraph (iii) of the proposed new definition extends the definition to include mortgages used to purchase property in which a person who is not necessarily the borrower is resident. The Government proposes this amendment in order to include buy-to-let mortgages within the scope of FSA mortgage regulation. This proposal is covered in more detail in Chapter 3 of this consultation.

2.44 The definition of a regulated mortgage contract excludes regulated home purchase plans. Home purchase plans are regulated by the FSA as set out in section 63F of the RAO. The Government considers that it remains appropriate to distinguish regulated mortgage contracts and regulated home purchase plans for the purpose of legislation.

2.45 The Government proposes that the regulated activities in relation to regulated mortgage contracts (entering into, administering, arranging or advising on a regulated mortgage contract), and, if agreed, the new regulated activity of managing a regulated mortgage contract detailed in Chapter 4 of this consultation, would apply to all regulated mortgage contracts captured by the proposed new definition. This would mean that only authorised persons or exempt persons would be legally permitted to engage in these activities in relation to second-charge mortgages. The Government is not proposing to amend the exemptions or exclusions that apply in relation to regulated mortgage contracts at this time.

2.46 The draft order includes reference to a commencement date, which would be determined following consultation. The Government proposes that FSA regulation would apply to all mortgages meeting the new definition of a regulated mortgage contract entered into after this date. The new definition would not have retrospective force, however, and mortgages meeting this new definition that were entered into before this date would continue to be subject to whatever regulatory arrangements applied before this date. In practice, this would mean that a number of second-charge mortgages would continue to be subject to consumer credit legislation after the transfer of regulatory responsibilities, although this number would decrease over time as these mortgages expired. The Government proposes that responsibility for regulating second-charge mortgages which continue to be subject to the provisions of consumer credit legislation remains with the OFT, as the regulator of consumer credit agreements.

Question 6: Do you agree that FSA regulation of second-charge mortgages should be limited to lending to individuals and trustees?

Question 7: Do you agree that the proposed new definition of a regulated mortgage contract would include second-charge mortgages and continue to include first-charge residential mortgages in its scope?

Question 8: Do you agree that the regulated activities in relation to regulated mortgage contracts should apply to second-charge mortgages?

Question 9: Do you agree that the exemptions and exclusions that apply in relation to regulated mortgage contracts are appropriate for second-charge mortgages?

Question 10: Do you agree with the proposed arrangements for dealing with second-charge mortgages entered into before the date specified in the draft order?

3 Regulation of buy-to-let mortgages

Buy-to-let lending

3.1 The buy-to-let mortgage market plays an important role in providing funding to the private rented sector. Over the last decade it has become a major driver of overall supply in the private rented sector, as the chart below shows. It therefore plays an important role in financing a sector which is of increasing significance in the overall housing market. Buy-to-let mortgages are loans designed for the purchase of property that is, or will be, let to tenants. Borrowers taking out these mortgages are landlords, rather than owner-occupiers.

Chart 3.A: Contribution of buy-to-let mortgage finance to the private rented sector

Source: Council of Mortgage Lenders, Department of Communities and Local Government

3.2 Market developments, including the global financial crisis that has shown how problems in mortgage markets can spill over into financial markets more generally, have highlighted that there is a case for considering whether the Government should give the Financial Services Authority (FSA) the powers to apply conduct of business and prudential regulation to all buy-to-let mortgage lending. Regulation of buy-to-let mortgages could provide important protections for borrowers, improve confidence in the buy-to-let mortgage market and strengthen the resilience of the market.

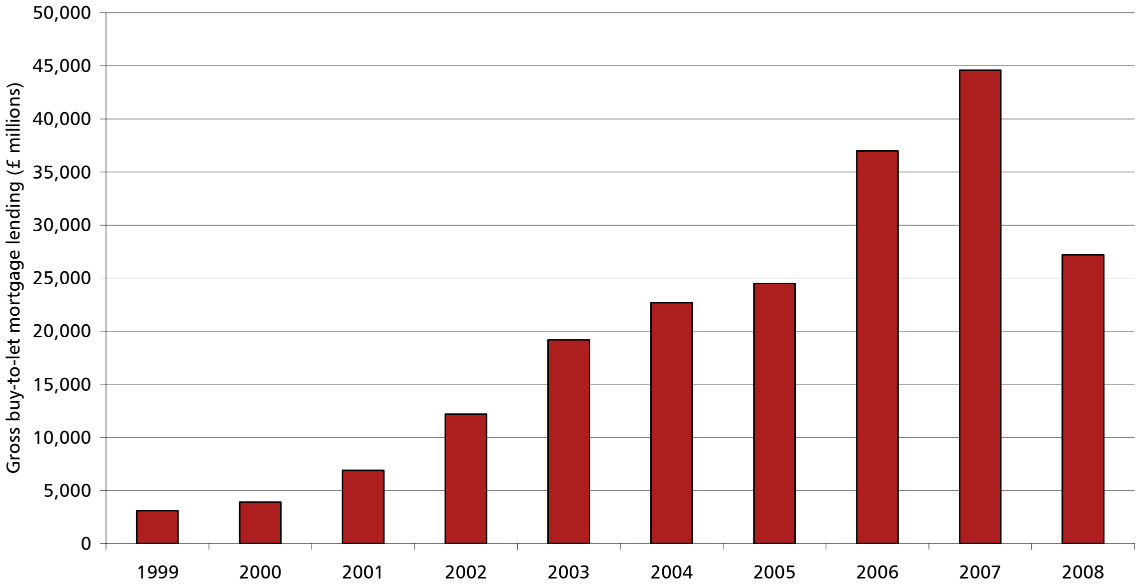
3.3 On 8 July, HM Treasury published *Reforming financial markets*, setting out the Government's proposals for the reform of the financial system, which announced that the Government would review the case for FSA regulation of the buy-to-let mortgage market.[1]

[1] Reforming financial markets, *HM Treasury,* July 2009. Available at: http://www.hm-treasury.gov.uk/reforming_financial_markets.htm.

Market background

3.4 The buy-to-let mortgage market has grown very rapidly over the last decade, as the chart below shows. This growth has been driven by both demand- and supply-side factors.

Chart 3.B: Annual gross buy-to-let mortgage lending, 1999 - 2008



Source: Council of Mortgage Lenders (CML)

3.5 There has been high demand for buy-to-let mortgages due to the attractiveness of investing in the private rented sector. Sustained house price appreciation during the years to 2007 reduced rental yields and encouraged entry by investors seeking short-term capital appreciation. The emergence of the buy-to-let mortgage over the period since the first of these products were offered in 1996 also increased flexibility for existing landlords, enabling many to expand their portfolios and professionalise their rental activities.

3.6 For all classes of investor, investment in the private rented sector has been facilitated by high demand for private rented accommodation, driven by socio-economic and socio-demographic changes, including:

- greater labour mobility and positive net immigration;
- increased student numbers;
- later family formation and subsequent entry into homeownership;
- increased relationship breakdown (leading to households requiring temporary or permanent alternatives to homeownership); and
- financial incentives to rent, as rent levels lag behind total cost of homeownership.

3.7 On the supply side, the emergence and growth of wholesale funding markets reduced the cost of lending, and enabled specialist lenders to enter mortgage markets, including the buy-to-let mortgage market. Eighty-five lenders were active in the buy to let market in 2007.

3.8 Competition in the market may have been supported by the strong presence of intermediaries in the market. Intermediaries, including specialist brokers and independent financial advisors (IFAs), played an active part in the market, allowing lenders with no branch presence to bring products to market and providing borrowers with advice before entering into specialist lending agreements. Industry estimates suggest intermediaries represented around 85 per cent of new buy-to-let mortgage business in 2008. The activity of IFAs may have also contributed directly to the demand for buy-to-let mortgages, by advising clients to consider investment in property as an alternative to other classes of investment.

Impact of financial crisis

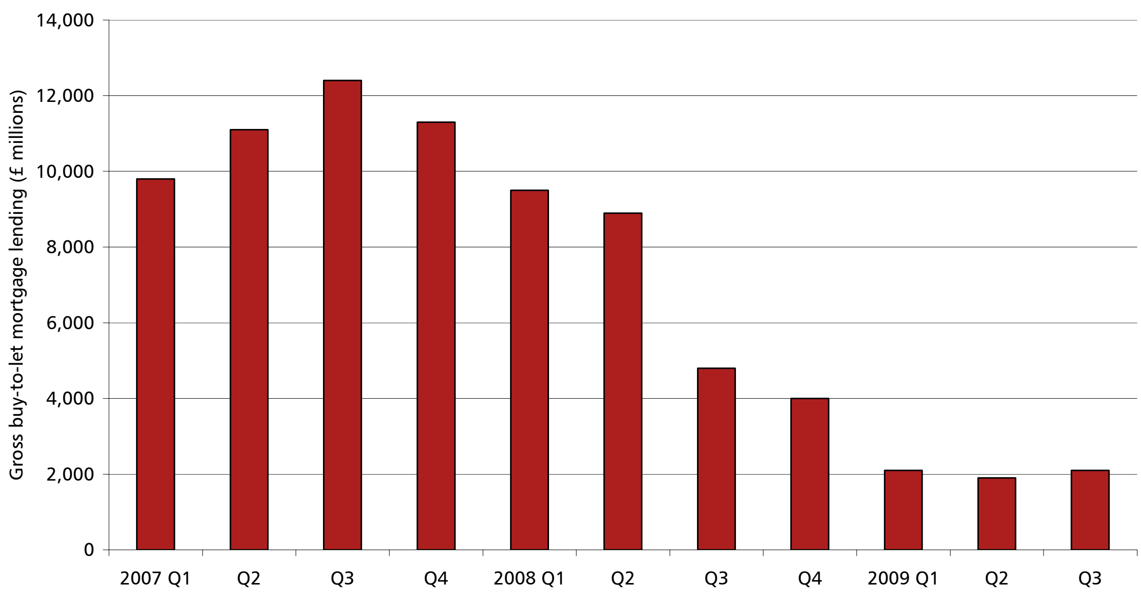
3.9 The disruption to financial markets has affected the buy-to-let mortgage market, as it has affected wider mortgage markets. Many buy-to-let mortgage lenders have withdrawn their products, and others have exited the market completely. Lending has concentrated in the major banks and their subsidiaries, as specialist lenders have virtually stopped lending and building societies have been constrained by increased requirements for liquidity and capital. The number of buy-to-let mortgage products available has fallen from a high of 3,662 in September 2007 to 185 in September 2009.[2] Credit conditions for buy-to-let mortgage lending have tightened, with most lenders reducing the amount they are willing to lend relative to the value of property and increasing the minimum rental income requirements.

3.10 As in the wider mortgage market, intermediaries in the buy-to-let market are affected by the withdrawal of products, and moves by some lenders to bypass intermediaries with direct offerings.

3.11 The demand for buy-to-let mortgages has also decreased during the downturn. A landlord's total return on a property comprises both the rental yield and capital appreciation. Although rental yields on new purchases have tended to rise, as house prices have generally fallen faster than rents, prospects for capital appreciation have worsened as conditions have deteriorated in the wider housing market. This, coupled with stricter mortgage lending criteria, has led to reluctance on the part of less equity-rich landlords to invest in new rental properties.

3.12 As a result, lending in the buy to let market has fallen, and in 2008 the level of gross advances was almost half the level of the 2007 peak in lending.

Chart 3.C: Quarterly gross buy-to-let mortgage lending, 2007 - 2009

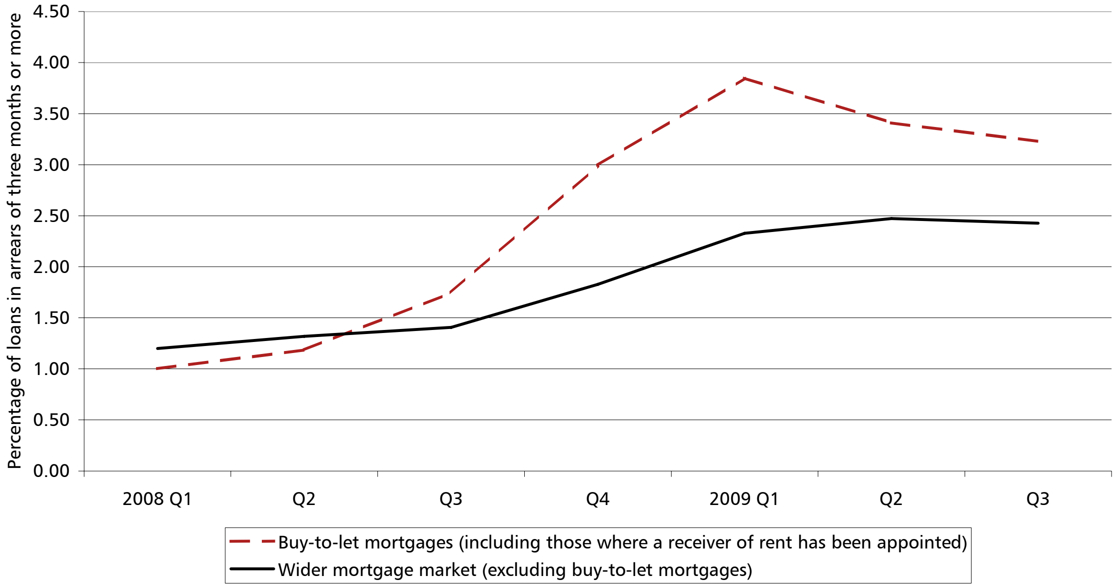


Source: Council of Mortgage Lenders (CML)

[2] Moneyfacts Treasury Report, *Moneyfacts*, September 2009.

3.13 The wider economic downturn has also affected the performance of loans. Before 2008, buy-to-let mortgages performed better than mainstream mortgages, with arrears and repossessions levels increasing at a rate below that of the total market level. Buy-to-let mortgage arrears plus receivership appointments are now higher than the wider market, and buy-to-let mortgage possessions have also overtaken the wider market.[3]

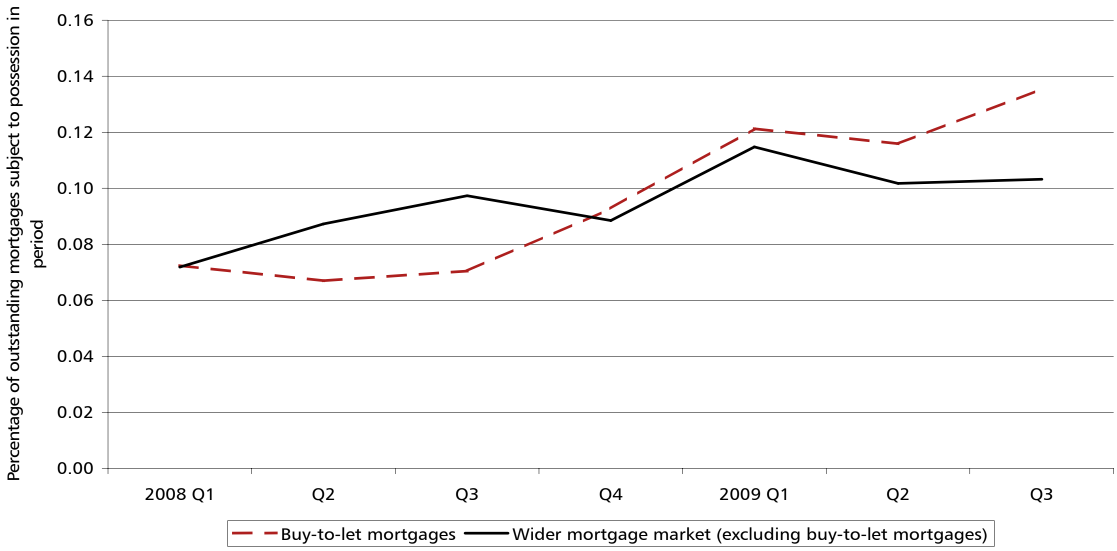
Chart 3.D: Quarterly arrears, buy-to-let mortgages and residential mortgages, 2008 – 2009



Source: Council of Mortgage Lenders (CML)

Notes: This chart uses figures published by the CML based on the number of mortgages in arrears of three months or more, as these are more directly comparable with figures for the number of buy-to-let mortgages where a receiver of rent has been appointed (see footnote 3 of this Chapter). The CML also publishes data on the number of mortgages in arrears by the percentage of total loan balance in arrears

Chart 3.E: Quarterly repossessions, buy-to-let mortgages and residential mortgages, 2008 – 2009



Source: Council of Mortgage Lenders (CML)

[3] Where a buy-to-let mortgage is in arrears, a lender may apply to the courts to appoint a receiver of rent as an alternative to moving to possession. A receiver of rent takes receipt of rental income relating to properties where the mortgage is in arrears, and pays it to the lender.

3.14 A number of reasons lie behind the increased arrears and repossessions in the buy-to-let mortgage market. Significantly, statistics relating to arrears and repossessions produced during a period of significant portfolio growth will always appear more benign than the underlying story because of the time it takes for arrears to grow (forming the numerator) and the growth that has occurred in that time in the total portfolio (the denominator). With the current reduction in lending levels, the masking effect of portfolio growth has been removed.

3.15 Buy-to-let mortgages are typically interest-only products, meaning interest rate changes have a large effect on the cost of meeting payments. The average buy-to-let mortgage variable rate increased from May 2007 to June 2008, causing some borrowers to struggle to meet repayments. Although this rate has decreased following decreases in the Bank of England base rate, borrowers coming to the end of fixed term deals face reduced choice. Large numbers of borrowers are facing higher rates than expected, because in the pre-crisis market little regard was had to the "revert to" rates as intermediaries and borrowers assumed that cheaper deals would be available at the point of reversion.

3.16 Falling rents has seen some landlords experiencing difficulty in covering mortgage payments, a trend which is exaggerated by the lower minimum rental income requirements of the years before 2007, which mean there is less of a safety margin. Non-payment of rent may also be an increasing difficulty as some tenants find incomes reduced.

3.17 The business models of some investors may have led to more pronounced effects of payment difficulty, as portfolio investors struggling with one property have tended to default across their whole portfolios. Investors struggling to meet payments on their own residential mortgages are likely to prioritise this debt, to the detriment of their buy-to-let mortgage accounts.

3.18 Finally, mortgage fraud has also played a part in driving up arrears. As noted in the FSA's Mortgage Market Review, several investigations have highlighted the scope for collusion between developers, estate agents, valuers and intermediaries, and there are a number of recent public examples of this kind of activity.

Risks of market failure

3.19 These significant market changes and their likely impacts on borrowers, lenders, and housing and financial markets more widely, have highlighted the need to consider whether the buy-to-let mortgage market is working well and to review the case for regulatory intervention. The Government is committed to ensuring that mortgage markets are based on responsible lending and sustainable borrowing, and that borrowers in these markets can have confidence in their decisions.

3.20 The global financial crisis, triggered by difficulties in the US housing market, has shown how difficulties in mortgage markets can spill over into financial markets more generally. Concerns that lenders in the US sub-prime mortgage market had underestimated the real risks of their lending decisions spread quickly through financial markets and severely destabilised banking systems across the world. Mortgage markets have the potential to impose large costs on others outside these markets, through their effects on connected markets, and the buy-to-let mortgage market is no exception. Problems in the buy-to-let mortgage market could threaten institutions the failure of which would present systemic risk.

3.21 As noted above, a portion of the increasing arrears and repossessions in the buy-to-let mortgage market may be attributed to the effects of mortgage fraud. Mortgage fraud, like other financial crime, harms financial institutions and consumers and the proceeds may be used to finance other criminal or terrorist activity, imposing further costs on the UK economy.

3.22 Buy-to-let mortgages are important not only for borrowers and lenders active in the market, but also for the tenants of properties on which these mortgages are secured. Tenants may lose their homes if a property is repossessed, and so the buy-to-let mortgage market has the potential to impose significant costs on this group, at least during the period until a new accommodation can be found.

3.23 On 19 October, the FSA published its Mortgage Market Review.[4] This paper highlights the role that both prudential and conduct of business regulation has in ensuring a sustainable mortgage market that functions well for consumers. The paper sets out a strategic change in the FSA's approach to mortgage regulation. A consequence of the significant enhancements proposed is the risk that poorer quality lending might migrate to areas where standards are lower. This potential "gaming" might pose risks for firms, markets and consumers.

> Question 11: Do you agree with the analysis of the buy-to-let mortgage market and the risks of market failure?

Existing regulatory framework

3.24 In 2004, the Government introduced FSA regulation of first-charge residential mortgages. When the Government introduced mortgage regulation in 2004, it drew a distinction between owner-occupiers who face losing their home if things go wrong, and buy-to-let landlords, whose properties are investments and who do not face the same risks. Buy-to-let mortgages were therefore not included in the definition of a regulated mortgage contract.[5]

3.25 A small number of mortgages designed for the purchase of property that is, or will be, let to tenants are regulated by the FSA, either because the mortgage is secured on another property which is the borrower's own home or because the borrower or a relative intends to occupy the property at some time. Examples of the latter may include parents buying a property for their children while at university or a member of the armed forces serving overseas buying a home in the UK and letting it out before their return to the country. For clarity, references to buy-to-let mortgages in this consultation exclude these mortgages, and include only those which are not currently regulated by the FSA.

3.26 A lender offering buy-to-let mortgages does not need to be authorised unless it also engages in a regulated activity, for example offering regulated mortgages. In this case, the lender must comply with prudential requirements and the FSA's high level Principles for Business in relation to all its activity. Conduct of business rules will apply to regulated actitivies in which the lender engages, but not to unregulated activities, including those relating to buy-to-let mortgages.

3.27 Buy-to-let mortgage borrowers, and tenants of those with buy-to-let mortgages, benefit from the regulatory framework in place across the wider private rented sector. The Housing Act 1988 (as amended by the Housing Act 1996) establishes the basic framework, with further landlord responsibilities set out in the Landlord and Tenant Act 1985. The Housing Act 2004 introduced further targeted regulation of landlords. On 13 May 2009, the Government published a consultation on proposed changes to the framework of regulation for the private

[4] DP09/3 Mortgage Market Review, *Financial Services Authority*, October 2009. Available at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/140.shtml.

[5] Buy-to-let mortgages do not fall within the scope of Office of Fair Trading (OFT) regulation of consumer credit. The Government brought forward a Legislative Reform Order in 2008 which clarified the law to ensure that buy-to-let mortgages were not inadvertently brought within the scope of OFT regulation as a result of changes made through the Consumer Credit Act 2006.

rented sector.[6] This consultation closed on 7 August, and the Government will publish a summary of responses to the consultation shortly.

3.28 On 5 August the Government published a consultation on proposed legislative changes to address concerns about a gap in legal protections for the tenants of some borrower landlords facing repossessions.[7] This consultation closed on 14 October and the Government will publish a summary of responses to the consultation shortly.

Proposal

3.29 In light of the risks of market failure outlined above, the Government proposes to extend the scope of FSA mortgage regulation to include buy-to-let mortgages. The FSA's existing mortgage regime combines prudential regulation with conduct of business rules. Prudential regulation helps to protect the financial system against losses, and therefore minimises disruption across financial markets. Conduct of business rules provide borrowers with important protections regarding their mortgages, including the requirement that lenders treat their customers fairly. The regulatory regime also provides means of redress for consumers who experience problems through access to the FOS.

3.30 The exact details of the FSA's regime will be for the FSA to determine. As noted above, the FSA's recently published discussion paper sets out a number of proposed changes to the way in which the FSA regulates mortgages. Stakeholders may wish to view this paper, which is available on the FSA's website.

3.31 The Government seeks views on its proposal to bring forward legislation to extend the scope of FSA mortgage regulation to include the buy-to-let mortgage market. The costs and benefits of this proposal are set out in the Impact Assessment published with this document in Annex B, which should be read in conjunction with this consultation. The Impact Assessment considers qualitative, and where possible quantitative, costs and benefits of implementation.

Question 12: Do you agree that FSA regulation will mitigate the risk of market failure in the buy-to-let mortgage market?

Question 13: Do you agree with the costs and benefits of the options under consideration in relation to buy-to-let mortgages, as set out in the Impact Assessment?

Draft legislation

3.32 The framework of financial services regulation in the UK is established through the Financial Services and Markets Act 200 (FSMA). The activities which are regulated under FSMA are set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO).

3.33 The FSA is the body responsible for regulating these activities under FSMA. It sets the standards that firms must meet and can take action against firms if they fail to meet the required standards. Only authorised persons or exempt persons are legally permitted to carry on a regulated activity.

[6] The private rented sector: professionalism and quality – The Government response to the Rugg Review Consultation, *Department for Communities and Local Government*, May 2009. Available at: http://www.communities.gov.uk/publications/housing/responseruggreview.

[7] Lender repossession of residential property: protection of tenants – Consultation, *Department for Communities and Local Government,* August 2009. Available at: http://www.communities.gov.uk/publications/housing/lenderrepossessionconsult.

3.34 To extend the scope of FSA regulation to include the buy-to-let mortgage market, the Government would need to amend the RAO so that it includes activities relating to buy-to-let mortgages. A copy of the draft Statutory Instrument (referred to in this section as "the draft order") by which the Government proposes to do this, subject to responses to this consultation, is published with this document in Annex D. Specific questions on the draft order are set out below.

3.35 In 2004 the Government introduced FSA regulation for first charge residential mortgages. The Government considers that the most appropriate way to extend the scope of FSA regulation would be to amend the definition of a regulated mortgage contract. The current definition of a regulated mortgage contract is set out in the box below.

Box 3.A: Current definition of a regulated mortgage contract

As set out in Article 61(3)(a) of the RAO:

> a contract is a "regulated mortgage contract" if, at the time it is entered into, the following conditions are met–
>
> (i) the contract is one under which a person ("the lender") provides credit to an individual or to trustees ("the borrower");
>
> (ii) the contract provides for the obligation of the borrower to repay to be secured by a first legal mortgage on land (other than timeshare accommodation) in the United Kingdom;
>
> (iii) at least 40% of that land is used, or is intended to be used, as or in connection with a dwelling by the borrower or (in the case of credit provided to trustees) by an individual who is a beneficiary of the trust, or by a related person;
>
> but such a contract is not a regulated mortgage contract if it is a regulated home purchase plan.

3.36 The draft order includes a provision to replace the current definition with a proposed new definition of a regulated mortgage contract. This proposed new definition is presented in the box below.

Box 3.B: Proposed new definition of a regulated mortgage contract

The proposed new definition of a regulated mortgage contract, as set out in the draft order is that:

> a contract is a "regulated mortgage contract" if, at the time it is entered into, the following conditions are met–
>
> (i) the contract is one under which a person ("the lender") provides credit to an individual or to trustees ("the borrower");
>
> (ii) the contract provides for the obligation of the borrower to repay to be secured by a legal mortgage of land (other than timeshare accommodation) in the United Kingdom;
>
> (iii) at least 40% of that land is used, or is intended to be used, as or in connection with a dwelling;
>
> but such a contract is not a regulated mortgage contract if it is a regulated home purchase plan.

3.37 The definition provides that a contract is a regulated mortgage contract if the conditions in (i), (ii) and (iii) are met, and the contract is not a home purchase plan, at the time it is entered into. This means that if, after being entered into, the contract is amended and one of these conditions is no longer met, it will still be considered a regulated mortgage contract. This enables greater certainty as it means that judgements are not required about whether possible variations might have led or will lead to change in the regulatory position.

3.38 The condition in paragraph (i) specifies that a regulated mortgage contract can only exist between a lender and an individual or trustees. This means that the scope of regulation would include lending to individual landlords, including businesses constituted as sole traders or unincorporated partnerships, but not businesses established as limited companies. This mirrors the existing regime for first charge residential lending, which excludes business-to-business lending.

3.39 Individual landlords dominate the private rented sector: according to the Rugg Review, 73 per cent of all landlords are private individuals or couples.[8] Assuming that the wider private rented sector is representative of the subset of landlords who use buy-to-let mortgages to finance their investment, the condition in paragraph (i) would include the majority of buy-to-let lending. This definition would exclude business-to-business lending.

3.40 The condition in paragraph (ii) of the proposed new definition extends the definition to include mortgages which are secured by a second charge on a property. The Government proposes this amendment in order to include second-charge mortgages within the scope of FSA mortgage regulation. This proposal is covered in more detail in Chapter 2 of this consultation.

3.41 The condition in paragraph (iii) would extend the definition of a regulated mortgage contract to include buy-to-let mortgages by replacing the requirement that the land on which the mortgage is secured is used by the borrower (or a related person) as a dwelling with the requirement that the land on which the mortgage is secured is used as a dwelling (by any person). The proposed new definition would include all those mortgages included by the current definition, and also mortgages secured on property that is let to tenants. The requirement that

[8] Julie Rugg, David Rhodes: Review of Private Rented Sector Housing, *Centre for Housing Policy, University of York,* October 2008. Available at: http://www.york.ac.uk/inst/chp/Projects/PRSreview.htm.

at least 40 per cent of the land is used as a dwelling is intended to exclude lending secured against property where only a small proportion is used for residential purposes.

3.42 The definition of a regulated mortgage contract excludes regulated home purchase plans. Home purchase plans are regulated by the FSA as set out in sections 63F to 63I of the RAO. The Government considers that it remains appropriate to distinguish regulated mortgage contracts and regulated home purchase plans for the purpose of legislation.

3.43 Subject to the proposal in Chapter 4 of this consultation, the Government proposes that the regulated activities that currently apply in relation to regulated mortgage contracts (entering into, administering, arranging or advising on a regulated mortgage contract) should apply to all regulated mortgage contracts in future. This would mean that only authorised persons or exempt persons would be legally permitted to engage in these activities in relation to buy-to-let mortgages. The Government is not proposing to amend the exemptions or exclusions that apply in relation to regulated mortgage contracts at this time.

3.44 The draft order includes reference to a commencement date, which would be determined following consultation. The Government proposes that FSA regulation would apply to all mortgages meeting the new definition of a regulated mortgage contract entered into after this date. The new definition would not have retrospective force, however, and mortgages meeting this new definition that were entered into before this date would continue to be subject to whatever regulatory arrangements applied before this date. In practice, this would mean that unregulated buy-to-let mortgages would continue as unregulated mortgages, although this number would decrease over time as these mortgages expired.

Question 14: Do you agree that FSA regulation of buy-to-let mortgages should be limited to lending to individuals and trustees?

Question 15: Do you agree that the proposed new condition relating to the use of the property as a dwelling would include buy-to-let mortgages and continue to include residential mortgages?

Question 16: Do you agree that the regulated activities in relation to regulated mortgage contracts should apply to buy-to-let mortgages?

Question 17: Do you agree that the exemptions and exclusions that apply in relation to regulated mortgage contracts are appropriate for buy-to-let mortgages?

4 Protecting borrowers when mortgages are sold on

Sale of mortgage books

4.1 Concerns have been raised with Government that a growing number of mortgage lenders in distress are selling their mortgage books (portfolios of mortgages), as a way of limiting losses or raising funds. These sales are typically discounted, as the seller is looking to complete the deal quickly. The buyers in these cases are typically hedge funds and private equity firms, attracted by the possibility of purchasing assets at a discount.

4.2 At present, the scale of this activity remains limited. The Government is aware that unregulated firms have purchased somewhere between 4,000 and 17,000 mortgages with a total balance of between £66 million and £1,685 million. However, this market may grow as the effects of recent market conditions feed through. Indeed, some lenders may be looking to carry out a number of deals of this nature in the near future.

4.3 In 2004, the Government extended the scope of Financial Services Authority (FSA) regulation to include first-charge residential mortgages. The FSA's regime provides consumers with important consumer protections regarding their mortgages, including requirements that lenders treat customers fairly and treat repossession as a last resort.

4.4 The activities that are regulated by the FSA are set out in legislation, and include entering into, administering, arranging or advising on a regulated mortgage contract.[1] The bulk of most lenders' mortgage books will be made up of regulated mortgage contracts. The sale of a lender's mortgage book therefore is likely to involve the onward sale of regulated mortgage contracts.

Consumer detriment when mortgages are sold

4.5 Firms will not be subject to FSA regulation simply because they buy a lender's mortgage book. They will be subject to regulation if they carry out an activity described in the legislation. Some of mortgage lenders' customer-facing activities fall within the definition of "administering a regulated mortgage contract", which is a regulated activity. Many of the firms currently active in this market outsource customer handling to third-party firms, meaning that they do not engage in this regulated activity. In order to administer a regulated mortgage contract this third party must be authorised, but the owner of the regulated mortgage contract will not be subject to FSA regulation.

4.6 Firms not engaging in a regulated activity are not bound by the requirements of FSA regulation including, importantly, the requirement to treat customers fairly. Non-regulated owners of regulated mortgage contracts may seek to maximise margins by raising interest rates and charges, potentially to levels that are unaffordable to borrowers. In some cases, the lack of regulation and the possibility of acting in this way to extract profit may be a contributing factor to firms' desire to purchase these mortgages.

[1] The complete list of activities regulated by the FSA is set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO).

4.7 Such activity clearly has the potential to cause severe harm to borrowers. These borrowers are not agents in the market where mortgages are sold on, and the costs imposed on them can be seen as a negative externality of this market. The onward sale of regulated mortgage contracts may also be seen as unfair, as it leads to a reduction in protections for some consumers, both in absolute terms and relative to other borrowers who have purchased similar financial services.

Question 18: Do you agree with the analysis of potential consumer detriment in the market for the onward sale of mortgage books?

Proposal

4.8 The Government is concerned that borrowers may be treated unfairly because their mortgage has been sold to an unregulated firm as part of a mortgage book sale. On 8 July, HM Treasury published *Reforming financial markets*, setting out the Government's proposals for the reform of the financial system, which announced that the Government would consult on the best way to protect consumers when lenders sell on mortgage books.[2]

4.9 The Government proposes to extend the scope of FSA regulation to include the managing of regulated mortgage contracts as a regulated activity, so that borrowers will continue to benefit from the important protections provided by FSA regulation when lenders sell on mortgage books. Firms that have the power to exercise or to control the exercise of any of the rights of a lender of a regulated mortgage contract (where a regulated mortgage contract is sold on, this is likely to be the owner of the mortgage) will be subject to the requirements of FSA regulation, including the requirements to treat customers fairly and treat repossession as a last resort.

4.10 The Government seeks views on its proposal to bring forward legislation to extend the scope of FSA mortgage regulation to make managing a regulated mortgage contract a regulated activity. The costs and benefits of this proposal are set out in the Impact Assessment published with this document in Annex C, which should be read in conjunction with this consultation. The Impact Assessment considers qualitative, and where possible quantitative, costs and benefits of implementation.

Question 19: Do you agree that borrowers should continue to benefit from the protection of FSA regulation in the case that their mortgage is sold on by their lender?

Question 20: Do you agree with the costs and benefits of the options under consideration in relation to protecting borrowers when mortgages are sold on, as set out in the Impact Assessment?

Draft legislation

4.11 Extending the scope of FSA mortgage regulation to make managing a regulated mortgage contract a regulated activity would require secondary legislation. This consultation seeks views on a detailed proposal to create a new regulated activity.

4.12 The scope of FSA regulation is established through the Financial Services and Markets Act 2000 (FSMA). The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) sets out a list of activities regulated under FSMA, and the FSA is the body responsible for

[2] Reforming financial markets, HM Treasury, July 2009. Available at: http://www.hm-treasury.gov.uk/reforming_financial_markets.htm.

regulating these activities. It sets the standards that firms must meet and can take action against firms if they fail to meet the required standards. Only authorised or exempt persons are legally permitted to carry on a regulated activity.

4.13 The Government proposes to amend the RAO to introduce a new regulated activity of managing a regulated mortgage contract. A copy of the draft Statutory Instrument (referred to in this section as "the draft order") by which the Government proposes to do this, subject to responses to this consultation, is published with this document in Annex D. The proposed definition of this new regulated activity is set out in the box below.

Box 4.A: Proposed definition of "managing" a regulated mortgage contract

For the purposes of legislation, the Government proposes that:

> "managing" a regulated mortgage contract means having the power to exercise or to control the exercise of any of the rights of a lender under a regulated mortgage contract.

4.14 This proposed definition is intended to include firms' activities that are material to the borrower, but which are not included within the definition of administering a regulated mortgage contract. This would include changing interest rates or charges connected to the mortgage, or exercising the right to take action for the purpose of enforcing the contract.

4.15 Firms would need permission to engage in the new regulated activity. This requirement would apply to firms that acquire regulated mortgage contracts from lenders as a result of mortgage book sales as well as to existing lenders and those who currently engage in offering regulated mortgages. The Government proposes transitional provisions in respect of existing lenders under regulated mortgage contracts, which will deem them to have permission for the new activity provided that they already hold permission for article 61(1) activity (entering into a regulated mortgage contract), unless they have notified the FSA that they do not wish to carry on the new activity and have received acknowledgement of this. Consequently, introduction of a new activity would likely have little practical impact on these lenders that already have FSA permission in relation to other regulated activities and are subject to FSA regulation. It is likely, however, that non-regulated firms that manage regulated mortgage contracts would incur costs in seeking and obtaining FSA authorisation and complying with the requirements of FSA regulation.

4.16 The proposed definition of managing a regulated mortgage contract is not intended to bring into the scope of regulation firms that own or hold a regulated mortgage contract but do not carry out any activity that is material to the borrower. Special purpose vehicles (SPVs) and other vehicles used in securitisation, for example, may own or hold regulated mortgage contracts but have no role in any decision-making process which affects borrowers. Decision-making powers are delegated by these bodies to a mortgage third party, for example the originating mortgage lender. The Government considers that arrangements of this type should be allowed to continue, and in such arrangements, authorisation will be required by the firm that has the ability to make decisions that will materially affect the borrower, and not by the firm that owns or holds the mortgage. In cases where the firm that owns or holds the mortgage instructs or directs the firm with the ability to make decisions to act in a certain way, this firm will require authorisation.

Question 21: Do you agree that the proposed definition of "managing a regulated mortgage contract" would include the activities that have the potential to cause harm to borrowers when mortgages are sold on?

Question 22: Do you agree that a mortgage owner's ability to delegate this activity to a third party means that only those firms engaging in activity with the potential to cause harm to borrowers will be subject to regulation?

5 Responding to the consultation and next steps

Issues for consideration

5.1 The Government is seeking views on three proposed changes to the framework of Financial Services Authority (FSA) regulation of mortgages. Chapters 2, 3 and 4 of this consultation document cover each of these issues in turn, and pose questions to stakeholders.

Regulation of second-charge mortgages

5.2 Chapter 2 presents the Government's proposal to transfer regulation of second-charge mortgages from the Office of Fair Trading (OFT) to the FSA. The questions the Government raises in connection to this policy are set out in the box below.

Question 1: Do you agree with the analysis of the second-charge mortgage market?

Question 2: Do you agree that extending the scope of FSA mortgage regulation to include the second-charge mortgage market would achieve the Government's objective of ensuring a fair, stable and efficient market for second-charge mortgages?

Question 3: Do you consider that any further action would be necessary in order to ensure that any transfer of responsibility for regulating second-charge mortgages from the OFT to the FSA would not result in a loss of consumer protection?

Question 4: Do you believe there are any other ways to mitigate the potential future risks posed by second-charge mortgage markets?

Question 5: Do you agree with the costs and benefits of the options under consideration in relation to second-charge mortgages, as set out in the Impact Assessment?

Question 6: Do you agree that FSA regulation of second-charge mortgages should be limited to lending to individuals and trustees?

Question 7: Do you agree that the proposed new definition of a regulated mortgage contract would include second-charge mortgages and continue to include first-charge residential mortgages in its scope?

Question 8: Do you agree that the regulated activities in relation to regulated mortgage contracts should apply to second-charge mortgages?

Question 9: Do you agree that the exemptions and exclusions that apply in relation to regulated mortgage contracts are appropriate for second-charge mortgages?

Question 10: Do you agree with the proposed arrangements for dealing with second-charge mortgages entered into before the date specified in the draft order?

Regulation of buy-to-let mortgages

5.3 Chapter 3 presents the Government's proposal to extend the scope of FSA regulation to include buy-to-let mortgages. The questions the Government raises in connection to this policy are set out in the box below.

Question 11: Do you agree with the analysis of the buy-to-let mortgage market and the risks of market failure?

Question 12: Do you agree that FSA regulation will mitigate the risk of market failure in the buy-to-let mortgage market?

Question 13: Do you agree with the costs and benefits of the options under consideration in relation to buy-to-let mortgages, as set out in the Impact Assessment?

Question 14: Do you agree that FSA regulation of buy-to-let mortgages should be limited to lending to individuals and trustees?

Question 15: Do you agree that the proposed new condition relating to the use of the property as a dwelling would include buy-to-let mortgages and continue to include residential mortgages?

Question 16: Do you agree that the regulated activities in relation to regulated mortgage contracts should apply to buy-to-let mortgages?

Question 17: Do you agree that the exemptions and exclusions that apply in relation to regulated mortgage contracts are appropriate for buy-to-let mortgages?

Protecting borrowers when mortgages are sold on

5.4 Chapter 4 presents the Government's proposal to create a new regulated activity, "managing a regulated mortgage contract", to protect borrowers when mortgages are sold on. The questions the Government raises in connection to this policy are set out in the box below.

Question 18: Do you agree with the analysis of potential consumer detriment in the market for the onward sale of mortgage books?

Question 19: Do you agree that borrowers should continue to benefit from the protection of FSA regulation in the case that their mortgage is sold on by their lender?

Question 20: Do you agree with the costs and benefits of the options under consideration in relation to protecting borrowers when mortgages are sold on, as set out in the Impact Assessment?

Question 21: Do you agree that the proposed definition of "managing a regulated mortgage contract" would include the activities that have the potential to cause harm to borrowers when mortgages are sold on?

Question 22: Do you agree that a mortgage owner's ability to delegate this activity to a third party means that only those firms engaging in activity with the potential to cause harm to borrowers will be subject to regulation?

Cumulative effect of measures

5.5 The Government considers that it is also important to have regard to the potential cumulative effect of these measures.

> Question 23: Do you consider that there will be further costs and benefits of the options under consideration when these options are combined, which are not reflected in the Impact Assessments?

Other comments

5.6 In addition to the specific questions above, the Government would welcome any other comments relating to the measures under consideration, and the details of the draft order.

Responding to the consultation

5.7 This consultation began with the publication of this document and will last for a period of 12 weeks, closing on 15 February 2010. This formal consultation represents part of a wider process of discussion and engagement with stakeholders. In particular, HM Treasury has met with market participants and consumer groups.

5.8 Comments on the specific questions raised in the consultation are welcome. Where possible, stakeholders are encouraged to provide evidence to support specific points. Stakeholders do not need to respond to all the questions in the consultation and, where they do not have an interest in all the issues considered in this consultation, should feel free to limit their response to those questions which are of interest to them (a stakeholder may, for example, chose to answer only those questions relating to the proposal for FSA regulation of buy-to-let mortgages).

5.9 Responses should be sent by email if possible to:

Mortgageconsultation@hmtreasury.gsi.gov.uk. Or by post to:

Mortgage regulation consultation

c/o Michael Cornford

Banking and credit

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

5.10 Please note our preference is to receive responses in electronic format only (all email responses will be acknowledged).

5.11 This document can be found on the website of HM Treasury (www.hm-treasury.gov.uk). When responding, please state whether you are responding as an individual or as part of an organisation. If responding on behalf of a larger organisation, please make it clear who the organisation represents and, where applicable, how the members' views were assembled.

Consultation disclosure

5.12 All written responses may be made public on the Treasury's website unless the author specifically requests otherwise in writing.

5.13 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regime. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act (DPA) and the Environmental Information Regulations 2004.

5.14 If you would like the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of information we will take full account of your explanation, but we cannot give an assurance that confidentiality will be maintained in all circumstances.

5.15 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response.

5.16 Subject to the previous two paragraphs, if you wish part (but not all) of your response to remain confidential, please supply two versions – one for publication on the website with the confidential information deleted, and another confidential version for use by the Treasury.

5.17 Any Freedom of Information Act queries should be sent by email to:

public.enquiries@hm-treasury.gov.uk. Or by post to:

Correspondence and Enquiry Unit

Freedom of Information Section

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Code of practice for written consultation

5.18 This consultation is being conducted in line with the Code of Practice for written consultation, which sets down the following criteria:

- formal consultation should take place at a stage when there is scope to influence the policy outcome;
- consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible;
- consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals;
- consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach;

- keeping the burden of consultation to a minimum is essential if consultation are to be effective and if consultees' buy-in to the process is to be obtained;
- consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation; and
- officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.[1]

5.19 If you feel that this consultation does not fulfil these criteria, please contact:

Angela.Carden@hmtreasury.gsi.gov.uk. Or by post:

Angela Carden

Better Regulation Unit

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Next steps

5.20 As stated above, this consultation began with the publication of this document and will last for a period of 12 weeks, closing on 15 February 2010. After the consultation period has closed, the Government will consider the responses to the consultation.

5.21 In line with the Code of Practice for written consultation the Government will publish a summary of responses to the consultation, giving feedback regarding the responses received and how the consultation process influenced the policy. This summary of responses will also set out which of the policy options under consideration the Government considers most appropriate in light of the consultation, and how the Government proposes to pursue this option.

5.22 If, following consultation, the Government proceeds with changing the framework of Financial Services Authority (FSA) regulation, the next steps will be as follows:

- the Government will lay before Parliament secondary legislation to introduce a new regulated activity, "managing a regulated mortgage contract", and bring the activities relating to second-charge mortgages and buy-to-let mortgages into FSA regulation;
- subject to Parliamentary approval, the FSA will draw up and consult on rules in relation to managing a regulated mortgage contract, and for regulatory regimes for second-charge mortgages and buy-to-let mortgages; then

subject to the FSA's further consultation, the FSA will publish these rules and commence regulation of managing a regulated mortgage contract, second-charge mortgages and buy-to-let mortgages on a date or dates to be set in secondary legislation.

[1] A full version of the Code of Practice is published by the Department for Business, Innovation and Skills (BIS), and is available at: http://www.berr.gov.uk/whatwedo/bre/index.html.

5.23 The Government aims to minimise any disruption to firms and existing consumers as a result of regulation. The Government will open discussions with lenders, consumer groups and other stakeholders to discuss how best to manage any regulatory change.

A Impact Assessment for Chapter 2 proposal

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	Impact Assessment for Financial Services Authority regulation of the second charge mortgage market	
Stage: Consultation	**Version:** Final	**Date:** 16 November 2009

Related Publications:

Mortgage Regulation: a Consultation, *HM Treasury,* November 2009

Available to view or download at: http://www.hm-treasury.gov.uk

Contact for enquiries: Michael.Cornford@hmtreasury.gsi.gov.uk

What is the problem under consideration? Why is government intervention necessary?

Second-charge mortgages are loans secured on property that is already acting as security for a first-charge residential mortgage. The terms first and second charge refer to the priority of securities held by the lenders. In 2004, the Government extended the scope of Financial Services Authority (FSA) regulation to include first-charge residential mortgage. Regulation of other credit business, including second-charge mortgages, is set out in consumer credit legislation and is overseen and enforced by the Office of Fair Trading (OFT). The Government is considering the case for transferring regulation of second-charge mortgages to the FSA, giving the FSA powers to apply conduct of business and prudential rules to all second-charge mortgage lending. In doing so, the Government has identified risks of future market failure in the second-charge mortgage market.

What are the policy objectives and the intended effects?

The policy objective is a fair, stable and efficient market in second-charge mortgages. The Government has identified risks of future market failure in the second-charge mortgage market. In addition, the proposed transfer of regulation may reduce the potential for future problems arising as a result of the regulatory framework. The intention is to mitigate the risks of future market failure in order to achieve the policy objective.

What policy options have been considered? Please justify any preferred option.

The following options are being considered:

- Option 1 – maintain the existing framework; and
- Option 2 – FSA regulation.

The costs and benefits of both options, insofar as it has been possible to ascertain these, are set out in the relevant sections below.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Government keeps all legislation under review, and in line with good practice would expect to review the policy within three years.

<u>Ministerial Sign-off</u> For Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Sarah McCarthy-Fry

Date: 16 November 2009

Summary: Analysis & Evidence

Policy Option:	Description:
2. FSA regulation	Extend the scope of Financial Services Authority regulation to include the second-charge mortgage market

COSTS			
ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' Cost to FSA (£1 m – £5 m one-off, £0 - £7.6m annual). Cost to lenders (£0 - £26.7 m one-off, £0 – £8.7 m annual). Cost to intermediaries (£0 - £36.9 m one-off, £0 - £29.1	
One-off (Transition)	Yrs		
£ 1 m – 68.6 m	1		
Average Annual Cost (excluding one-off)			
£ 0 – 45.4 m	10	**Total Cost** (PV)	**£ 0 - 459.39 million**
Other **key non-monetised costs** by 'main affected groups'			

BENEFITS			
ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' Better outcomes in the market.	
One-off	Yrs		
£ N/A	0		
Average Annual Benefit			
£ 0 – 22.4 million	10	**Total Benefit** (PV)	**£ 0 – 192.81 million**
Other **key non-monetised benefits** by 'main affected groups' Reduced risk posed by market to financial stability, benefits to firms, consumers and Government of better outcomes in the market, increased clarity for those dealing with debt issues.			

Key Assumptions/Sensitivities/Risks

It is expected that the combined monetised and non-monetised benefits will outweigh the combined monetised and non-monetised costs.

Price Base Year 2009	Time Period Years 10	**Net Benefit Range** (NPV) **- £ 459.39 m – 192.81**	**NET BENEFIT** (NPV Best estimate) **£ 0 – 78.81 m**

What is the geographic coverage of the policy/option?	UK			
On what date will the policy be implemented?	Subject to			
Which organisation(s) will enforce the policy?	FSA			
What is the total annual cost of enforcement for these	£ 0 – 7.6 m			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	N/A			
What is the value of changes in greenhouse gas emissions?	N/A			
Will the proposal have a significant impact on competition?	Yes			
Annual cost (£-£) per organisation (excluding one-off)	Micro £0 – 2,910	Small £0 – 2,910	Medium £0 –	Large £0 –
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase	£ unknown	Decrease	£ unknown	**Net**	£ unknown

Key: **Annual costs and benefits:** **(Net) Present Value**

Evidence Base (for summary sheets)

Introduction

This Impact Assessment should be read in conjunction with HM Treasury's consultation, *Mortgage Regulation: a Consultation*, which is available at: http://www.hm-treasury.gov.uk.

Second-charge mortgages are loans secured on property that is already acting as security for a first-charge residential mortgage. The terms first and second charge refer to the priority of securities held by the lenders. In 2004, the Government extended the scope of Financial Services Authority (FSA) regulation to include first-charge residential mortgage. Regulation of other credit business, including second-charge mortgages, is set out in consumer credit legislation and is overseen and enforced by the Office of Fair Trading (OFT).

In March this year, the Government announced that it would review the current split of OFT and FSA regulation in relation to second-charge mortgages.[1] On 8 July, HM Treasury published *Reforming Financial Markets*, which announced that the Government would review the case for transferring regulation of second-charge mortgages to the FSA.[2] In doing so, the Government has identified risks of future market failure in the second-charge mortgage market.

The Government is consulting on transferring the regulation of the second-charge mortgage market from the OFT to the FSA, to mitigate the risks of future market failure. The Government is considering two policy options:

- Option 1 – maintain the existing framework; and
- Option 2 – FSA regulation.

This Impact Assessment presents the Government's estimates of the incremental costs and benefits of Option 2. HM Treasury's consultation seeks stakeholder views on these estimates.

The following sections of this Impact Assessment provide the evidence base for the summary sheets above. This comprises:

- a summary of the second-charge mortgage market,
- a market failure analysis,
- analysis of the incremental costs and benefits of Option 2; and
- specific impact tests for Option 2.

Market summary

This market summary presents a brief overview of market trends and the current state of the market, in terms of the volume of activity in the market. This market summary presents the volume of activity in terms of the value and number of transactions in the market, and the number of agents (lenders, borrowers and intermediaries) active in the market. Analysis of the market forces behind this activity is provided in HM Treasury's consultation, and this market summary should be considered alongside this analysis.

[1] The Government's statement of 17 March is available at: http://nds.coi.gov.uk/content/detail.aspx?NewsAreaId=2&ReleaseID=395627&SubjectId=16&AdvancedSearch=true.

[2] Reforming Financial Markets, HM Treasury, July 2009. Available at: http://www.hm-treasury.gov.uk/reforming_financial_markets.htm.

The second-charge mortgage market has grown rapidly in the last decade. This growth has been driven by both demand- and supply-side factors, which are considered in the Treasury's consultation. The world economy has been hit by a severe financial crisis, triggered by difficulties in the US housing market and spreading rapidly throughout global financial markets. In the UK, the disruption to financial markets has affected the second-charge mortgage market, as it has affected wider credit markets. The Treasury's consultation sets out how second-charge mortgage lending has fallen.

At its peak in 2007, there were roughly 50 lenders active in the market, of which roughly 45 held FSA authorisation (because they engaged in FSA-regulated activities) in addition to a consumer credit licence.[3] There are now roughly 18 lenders in the market, with only four lenders writing more than £1 million of new business in July 2009.[4]

The number of second-charge mortgage borrowers is unclear, as borrowers may have more than one loan secured on a property (this Impact Assessment follows the convention of the Government's consultation in referring to all second- and subsequent-charge mortgages as "second-charge mortgages"). This Impact Assessment calculates aggregate costs and benefits to consumers, rather than costs and benefits for consumers at an individual-level.

The second-charge mortgage market pre-crisis was characterised by a high level of intermediary activity. There are roughly 10,000 intermediaries active in the second-charge mortgage market, of which the majority are financial advisers or mortgage brokers, and so hold FSA authorisation (because they engage in FSA-regulated activities).

Market failure analysis

This section of the Impact Assessment presents a market failure analysis of the second-charge mortgage market. This analysis suggests that in future negative externalities may arise in the second-charge mortgage market.

The systemic risk to wider financial markets and the economy presented by the second-charge mortgage market may be seen as a negative externality. The global financial crisis, triggered by difficulties in the US housing market, has shown how difficulties in mortgage markets can spill over into financial markets more generally. Concerns that lenders in the US sub-prime mortgage market had underestimated the real risks of their lending decisions spread quickly though financial markets and severely destabilised banking systems around the world. Economic growth, prosperity and jobs have been affected in economies throughout the world. Mortgage markets have the potential to impose large costs on others outside of these markets, through their effects on connected markets, and the second-charge mortgage market is no exception. Problems in the second-charge mortgage market could threaten systemically important firms or damage confidence in the decisions of a number of financial firms, and threaten wider financial stability.

The potential for this future market failure may justify transferring regulation of the second-charge mortgage market from the OFT to the FSA. In addition, such a transfer may reduce the potential for future problems to occur as a result of the regulatory framework. There may be other potential future market failures in the second-charge mortgage market. As set out in the Government's consultation, transferring the regulation of second-charge mortgage markets from the OFT to the FSA may reduce the risk of inconsistent treatment of consumers in similar circumstances and help reduce compliance costs for some firms.

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[3] Information provided by the Office of Fair Trading.

[4] Information provide by the Finance and Leasing Association.

Option 2 – FSA regulation

If the Government decides, following consultation, that this is the most appropriate option, it will bring forward legislation to extend the scope of FSA mortgage regulation to include the second-charge mortgage market. HM Treasury's consultation sets out the detail of this proposal, including draft secondary legislation.

This section of the Impact Assessment considers the incremental costs and benefits of transferring regulation of second-charge mortgages from the OFT to the FSA. In order to determine incremental costs, it is necessary to establish a counterfactual scenario. This may be considered the scenario that would hold if, following consultation, the Government decides that Option 1 is more appropriate and maintains the existing the framework. As set out above, however, second-charge mortgage lending activity has fallen since 2008 and the future levels of activity in this market are unclear.

For the purposes of estimating the incremental costs and benefits of FSA regulation of the second-charge mortgage market, this Impact Assessment uses a counterfactual scenario based on the level of activity in 2008. This scenario does not represent a Government forecast for the future volume of second-charge mortgage lending activity. This scenario assumes 196,850 transactions per year, and an active market of 50 lenders and 10,000 intermediaries.[5] Ninety per cent of the lenders and 90 per cent of the intermediaries hold FSA authorisation for regulated activities unconnected to second-charge mortgages.

Costs

Extending FSA regulation to the second-charge mortgage market might be expected to impose direct costs on the FSA as regulators and compliance costs on firms (lenders and intermediaries).

In regulating a new market, the FSA would be likely to require extra resources in terms of designing, monitoring and enforcing regulations. These costs would likely include staff, training, systems and IT costs. FSA regulation of the first charge residential mortgage market may provide some guide to the costs that the regulator would incur if it also regulated the second-charge mortgage market. The one-off costs to the FSA of introducing regulation of first charge residential mortgages were estimated at £5 million, and the annual ongoing costs estimated at £7.6 million.[6] Some of the costs of introducing regulation, including systems change costs, are fixed costs. These costs are estimated to be around £1 million. There may also be one-off policy costs to the FSA from developing further regulation and rules applicable to second-charge mortgage lenders. It is possible, however, that both one-off costs and annual ongoing costs of regulation of the second-charge mortgage market might be significantly smaller, because economies might be derived from using the framework for first-charge mortgages. In addition, many lenders and intermediaries in the second-charge mortgage market are already authorised by the FSA and so will impose lower incremental costs on the regulator in terms of supervision and enforcement. The incremental cost to the FSA of regulating the second-charge mortgage market is therefore estimated at £1 million - £5 million (one-off) and £0 - £7.6 million (annual).

The incremental compliance costs which would be incurred by firms are likely to be similar in type to those incurred by firms when the FSA introduced regulation of first charge

[5] The number of transactions is derived from the Finance and Leasing Association's figures for the volume of new business activity in the 12 months to July 2008 (£3,937 million) divided by a typical loan advance of £20,000.

[6] Figures taken from the FSA's impact assessment for its first-charge residential mortgage regime. Available at: http://www.fsa.gov.uk/pubs/cp/cp186_vol1.pdf.

residential mortgages. These would include staff, training, systems and IT costs, and the ongoing costs of meeting specific prudential requirement and conduct of business rules. For firms which are authorised by the FSA in connection with other regulated activities (lenders, for example, that are already authorised in connection with first charge residential mortgage lending), the incremental costs would likely be lower, as these firms might be able to modify existing systems, rather than create new ones, and would not have to comply with further prudential requirements.

In order to estimate the incremental compliance costs which would be incurred by firms, this Impact Assessment uses the estimated incremental compliance costs of FSA regulation of first charge residential mortgage produced for the FSA by National Economic Research Associates (NERA) prior to the introduction of the FSA's regime. Subtracting costs for the lifetime mortgage regime (which would not be applicable in this case) produces one off-costs of £82.7 million for lenders and £50.7 million for intermediaries, and annual costs of £27.8 million for lenders and £39.9 million for intermediaries. These figures were based on a market population of 155 lenders and 13,725 intermediaries. Scaling these figures down for a market of 50 lenders and 10,000 intermediaries produces one-off costs of £26.7 million for lenders and £36.9 million for intermediaries, and annual costs of £8.7 million for lenders and £29.1 million for intermediaries.

These figures represent an upper bound to a range of costs to firms. Many lenders and intermediaries active in the second-charge mortgage market are also active in the first-charge mortgage market, and are already subject to FSA authorisation. For these firms the incremental compliance costs are likely to be at or close to £0. The compliance costs to firms are therefore presented as a range.

It is likely that a portion of the costs which would be incurred by firms would be passed on to consumers in the form of higher prices. This Impact Assessment does not attempt to estimate the costs which would be passed on to consumers (for the purpose of the summary sheets these costs are included in the compliance costs for firms).

Market impacts

If firms pass on some portion of their compliance costs to consumers, this might deter some consumers from taking out a second-charge mortgage, and the total number of second-charge mortgages advanced will fall. Given the size of incremental compliance costs, it is likely that any increase in price is small relative to the size of payments made by the borrower over the duration of the mortgage. Therefore it is not likely that the impact of increased prices on the total number of second-charge mortgages advanced would be significant.

Some firms might exit the market rather than meet the incremental compliance costs, which would lead to a reduced variety of quality of service, but as the majority of firms are already subject to FSA prudential regulations it is not expected that large numbers of firms will exit, and so this would not lead to consumer detriment.

The exit of firms from the market would increase market concentration, but does not necessarily mean a reduction in competition. Although some firms may exit the market, the number of second-charge mortgages advanced is not expected to decrease significantly and, therefore, the exit of some firms would result in other firms growing their market share. The effect on competition will depend on which firms grow their market share. The growth of market shares could be concentrated in a small number of firms, to the detriment of competition in the market. Alternatively, the growth of market shares could be spread amongst a larger number of firms leading to more firms capable of competing strongly in the market.

It is possible that changes in the regulatory framework in the second-charge mortgage market would have impacts in markets for substitute products (for example, the first-charge mortgage market or the unsecured credit markets). This Impact Assessment does not attempt to quantify these potential impacts.

Benefits

As noted in the market failure section above, the second-charge mortgage market has the potential to impose large costs on others outside of this market. The risks posed by mortgage markets to the wider financial system, and the economy as a whole, can be mitigated by prudential regulation.

The OFT's regime is aimed primarily at consumer protection and, as a consumer-focussed regulator, the OFT does not set prudential requirements for firms. The FSA, as a regulator of financial markets, does impose prudential requirements on those firms it regulates. Prudential regulation helps to protect the financial system against losses, and therefore minimises disruption across financial markets. The main benefit of prudential regulation will be reduced risks pose by the market to financial stability. Due to the difficulty of estimating and costing these risks, this Impact Assessment notes these as a major non-monetised benefit of transferring regulation of second-charge mortgages from the OFT to the FSA.

Any transfer of regulation for second-charge mortgages from the OFT to the FSA may produce benefits for firms and consumers. Prudential requirements which work together with conduct of business rules give regulators another tool to improve outcomes in markets. This Impact Assessment takes as a proxy for the value of improved outcomes in the market the value of minimising repossessions initiated by second-charge mortgage lenders. As an upper bound to the range only, the value of preventing all repossessions initiated by second-charge mortgage lenders is considered. An estimate for this figure is produced by multiplying the potential cost of a repossession to a lender by the number of repossessions initiated by second-charge mortgage lenders in 2008 (1600). Using the average advance of £14,000 as the upper bound for the costs to a second-charge mortgage lender of a repossession (which may occur, for example in the case where there is no remaining equity in the property after the first-charge mortgage has been discharged) produces a range for the annual monetised benefit of this proposal of £0 - £22.4 million.

Applying FSA conduct of business regulation to second-charge mortgages would ensure a consistent standard of consumer protection across the secured credit market. Consistent treatment is especially important when a borrower is in arrears or default on both mortgages, and could encourage coordination between lenders in such cases. Consistent standards would also help others with an interest in debt issues, including consumer organisations and the courts. This Impact Assessment does not attempt to quantify these benefits, but they are noted as non-monetised benefits of Option 2. It is expected that the combined monetised and non-monetised benefits will outweigh the combined monetised and non-monetised costs.

Specific Impact Tests for Option 2

Option 2 – FSA regulation would involve significant Government intervention, and so Specific Impact Tests have been performed for this option.

Small Firms Impact Test

A large number of the intermediaries active in the second-charge mortgage market are small firms. The incremental compliance costs might impact disproportionately on small firms. It is therefore possible that there would be some restructuring and consolidation of the market in response to regulation. Some firms might exit, and these would most likely be those undertaking only a small amount of second-charge mortgage business. Others may merge, or in the case of independent intermediaries, join with a larger firm.

However, as the majority of intermediaries active in the second-charge mortgage market are independent financial advisors (IFAs) and already subject to FSA regulation, the incremental costs to intermediaries are likely to be negligible. Further to this, the experience of the introduction of FSA regulation of first charge residential mortgages, however, would suggest that the number of small firms exiting the market would not be significant.

Competition Assessment

Option 2 would likely directly limit the number of suppliers in the market, by requiring firms to obtain FSA authorisation before engaging in regulated activities. As noted above, it might also indirectly limit the number of suppliers by raising the cost of acting in the market (by incremental costs of compliance). The impact of FSA regulation on the ability of suppliers to compete, and their incentives to do so, would depend on the effects of firm exits and any subsequent effects on market share growth. However, in light of the experience of the introduction of FSA regulation of the first charge residential mortgage market, which had little detrimental effect on competition in that market, the Government does not anticipate that FSA regulation of the second-charge mortgage market would significantly reduce competition in the second-charge mortgage market.

Gender Equality Impact Test

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of their gender.

Disability Equality Impact Test

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of any disability.

Race Equality Impact Test

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of their ethnicity.

Specific Impact Tests: Checklist

Type of testing undertaken	*Results in Evidence Base?*	*Results annexed?*
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	No	No
Rural Proofing	No	No

B Impact Assessment for Chapter 3 proposal

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	Impact Assessment for Financial Services Authority regulation of the buy-to-let mortgage market	
Stage: Consultation	**Version:** Final	**Date:** 16 November 2009

Related Publications:

Mortgage Regulation: a Consultation, *HM Treasury,* November 2009

Available to view or download at: http://www.hm-treasury.gov.uk

Contact for enquiries: Michael.Cornford@hmtreasury.gsi.gov.uk

What is the problem under consideration? Why is government intervention necessary?

Buy-to-let mortgages are secured loans designed for the purchase of property that is, or will be, let to tenants. Borrowers taking out these mortgages are landlords, rather than owner-occupiers. When the Government introduced mortgage regulation in 2004, it drew a distinction between owner-occupiers, who face losing their home if things go wrong, and buy-to-let landlords, whose properties are investments and who do not face the same risks. Recent events have shown how problems in mortgage markets can spill over into financial markets more generally. The Government is considering the case for extending Financial Service Authority (FSA) regulation to include the buy-to-let mortgage market, giving the FSA powers to apply conduct of business and prudential rules to all buy-to-let mortgage lending. In doing so, the Government has identified risks of market failure in the buy-to-let mortgage market.

What are the policy objectives and the intended effects?

The policy objective is a fair, stable and efficient market in buy-to-let mortgages. The Government has identified risks of market failure in the buy-to-let mortgage market. The market failures identified are information asymmetries and negative externalities. The intention is to mitigate the risks of market failure in order to achieve the policy objective.

What policy options have been considered? Please justify any preferred option.

The following options are being considered:

- Option 1 – maintain the existing framework; and
- Option 2 – FSA regulation.

The costs and benefits of both options, insofar as it has been possible to ascertain these, are set out in the relevant sections below.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Government keeps all legislation under review, and in line with good practice would expect to review the policy within three years.

Ministerial Sign-off For Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Sarah McCarthy-Fry

Date: 16 November 2009

Summary: Analysis & Evidence

Policy Option:	Description:
2. FSA regulation	Extend the scope of Financial Services Authority regulation to include the buy-to-let mortgage market

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Cost to FSA (£1 m - £5 m one-off, £0 - £7.6 m annual).
£ 1 m – 84.6 m	1	Cost to lenders (£0 – 42.7 m one-off, £0 - £26.2 m annual).
Average Annual Cost (excluding one-off)		Cost to intermediaries (£0 - £36.9 m one-off, £0 - £29.1
£ 0 – 62.9 m	10	**Total Cost** (PV) **£ 1 m - 626 m**

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	Better outcomes in the market.
£ N/A	0	
Average Annual Benefit		
£ 0 – 414.8 m	10	**Total Benefit** (PV) **£ 0 – 3570 m**

Other **key non-monetised benefits** by 'main affected groups'

Reduced risk posed by market to financial stability, benefits to firms, consumers and Government of better outcomes in the market.

Key Assumptions/Sensitivities/Risks

It is expected that the combined monetised and non-monetised benefits will outweigh the combined monetised and non-monetised costs.

Price Base Year 2009	Time Period Years 10	**Net Benefit Range** (NPV) **- £ 626 m – 3569 m**	**NET BENEFIT** (NPV Best estimate) **£ 0 – 3507 m**

What is the geographic coverage of the policy/option?		UK		
On what date will the policy be implemented?		Subject to		
Which organisation(s) will enforce the policy?		FSA		
What is the total annual cost of enforcement for these		£ 0 – 7.6 m		
Does enforcement comply with Hampton principles?		Yes		
Will implementation go beyond minimum EU requirements?		No		
What is the value of the proposed offsetting measure per year?		N/A		
What is the value of changes in greenhouse gas emissions?		N/A		
Will the proposal have a significant impact on competition?		Yes		
Annual cost (£-£) per organisation (excluding one-off)	Micro £0 –2,910	Small £0 – 2,910	Medium £0 –	Large £0 –
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase	£ unknown	Decrease	£ unknown	**Net**	£ unknown

Key: **Annual costs and benefits:** **(Net) Present Value**

Evidence Base (for summary sheets)

Introduction

This Impact Assessment should be read in conjunction with HM Treasury's consultation, *Mortgage Regulation: a Consultation*, which is available at: http://www.hm-treasury.gov.uk.

Buy-to-let mortgages are secured loans designed for the purchase of property that is, or will be, let to tenants. Borrowers taking out these mortgages are landlords, rather than owner-occupiers. When the Government introduced Financial Services Authority (FSA) mortgage regulation in 2004, it drew a distinction between owner-occupiers, who face losing their home if things go wrong, and buy-to-let landlords, whose properties are investments and who do not face the same risks.

Recent events have shown how problems in mortgage markets can spill over into financial markets more generally. There is a case for considering whether the Government should give the FSA powers to apply conduct of business and prudential rules to all buy-to-let mortgage lending. On 8 July, HM Treasury published *Reforming financial markets*, which announced that the Government would review the case for FSA regulation of the buy-to-let market.[1] In doing so, the Government has identified risks of potential market failure in the buy-to-let mortgage market.

The Government is consulting on extending the scope of FSA regulation to include the buy-to-let mortgage market, to mitigate the risks of market failure. The Government is considering two policy options:

- Option 1 – maintain the existing framework; and
- Option 2 – FSA regulation.

This Impact Assessment presents the Government's estimates of the incremental costs and benefits of Option 2. HM Treasury's consultation seeks stakeholder views on these estimates.

The following sections of this Impact Assessment provide the evidence base for the summary sheets above. This comprises:

- a summary of the buy-to-let mortgage market,
- a market failure analysis,
- analysis of the incremental costs and benefits of Option 2; and
- specific impact tests for Option 2.

Market summary

This market summary presents a brief overview of market trends and the current state of the market, in terms of the volume of activity in the market. This market summary presents the volume of activity in terms of the value and number of transactions in the market, and the number of agents (lenders, borrowers and intermediaries) active in the market. Analysis of the market forces behind this activity is provided in HM Treasury's consultation, and this market summary should be considered alongside this analysis.

[1] Reforming financial markets, HM Treasury, July 2009. Available at: http://www.hm-treasury.gov.uk/reforming_financial_markets.htm.

The buy-to-let market has grown very rapidly over the last decade, with gross buy-to-let mortgage advances increasing from £3.1 billion in 1999 (2.7 per cent of gross mortgage advances) to a peak of £45.3 billion in 2007 (12.3 per cent of gross mortgage advances). This growth has been driven by both demand- and supply-side factors, which are considered in the Treasury's consultation.

The world economy has been hit by a severe financial crisis, triggered by difficulties in the US housing market and spreading rapidly throughout global financial markets. In the UK, the disruption to financial markets has affected the buy-to-let mortgage market, as it has affected wider mortgage markets.

As a result, new lending in the buy-to-let mortgage market has fallen, and in the first half of 2009, the value of gross advances had fallen to less than 20 per cent of the value in the first half of 2007. In the first half of 2007 there were 169,500 gross advances, and in the first half of 2009 there were 44,000 gross advances. There were 1,179,700 buy-to-let mortgages outstanding at the end of the first half of 2009, with a value of £140.6 million. At its peak in 2007, there were roughly 85 lenders active in the market. There are now roughly 45 lenders active in the market.

The number of buy-to-let mortgage borrowers is unclear, as landlords may own portfolios containing a number of properties financed through buy-to-let mortgage borrowing. It is possible to estimate the number of buy-to-let borrowers, by assuming that the structure of the subset of the private rented sector that is funded through buy-to-let mortgages is similar to the structure of the wider private sector. A survey for the Rugg Review of the private rented sector concluded that 35 per cent of private rented accommodation is owned by landlords with portfolios of just one property, and a further 28 per cent is owned by landlords with between two and five properties.[2]

The buy-to-let mortgage market pre-crisis was characterised by a high level of intermediary activity. Intermediaries represented around 85 per cent of new business in 2008, compared to around 60 per cent in the wider mortgage market.

Market failure analysis

This section of the Impact Assessment presents a market failure analysis of the buy-to-let mortgage market. There is evidence of information asymmetries and negative externalities in the buy-to-let mortgage market.

Increased levels of arrears and repossessions in the buy-to-let mortgage market suggest that borrowers have not purchased suitable products. A number of the drivers of increased arrears and repossessions highlighted in HM Treasury's consultation (exaggerated effect of interest rate changes, non-payment of rent, structure of property portfolios) suggest that borrowers have not understood the risks presented by buy-to-let mortgage borrowing. This would imply that borrowers possess imperfect information at them time the transaction was entered into.

Some stakeholders have voiced concerns that mortgage fraud may be a partial cause of increased arrears and repossessions. Recent announcements by some lenders confirm they have been victims of criminal activity in the buy-to-let mortgage market. Mortgage fraud, like other financial crime, harms financial institutions and consumers and the proceeds may be used to finance other criminal or terrorist activity, imposing further costs on the wider

[2] Julie Rugg, David Rhodes: Review of Private Rented Sector Housing, *Centre for Housing Policy, University of York,* October 2008. Available at: http://www.york.ac.uk/inst/chp/Projects/PRSreview.htm.

economy. These further costs may be seen as negative externality of the market, as they affect parties other than agents in the market.

By definition, buy-to-let mortgages affect parties other than the lender and borrower. Buy-to-let markets are important also to the tenants of the properties on which these loans are secured. Tenants may lose their homes if a property is repossessed, and so the buy-to-let mortgage market has the potential to impose significant costs on this group, at least during the period until a new accommodation can be found. This risk of eviction therefore may be seen as a negative externality of the buy-to-let mortgage market.

The systemic risk to wider financial markets and the economy presented by the buy-to-let mortgage market is another negative externality. The global financial crisis, triggered by difficulties in the US housing market, has shown how difficulties in mortgage markets can spill over into financial markets more generally. Concerns that lenders in the US sub-prime mortgage market had underestimated the real risks of their lending decisions spread quickly though financial markets and severely destabilised banking systems around the world. Economic growth, prosperity and jobs have been affected in economies throughout the world. Mortgage markets have the potential to impose large costs on others outside of these markets, through their effects on connected markets, and the buy-to-let mortgage market is no exception. Problems in the buy-to-let mortgage market could threaten systemically important firms or damage confidence in the decisions of a number of financial firms, and threaten wider financial stability.

These market failures may justify regulation of the buy-to-let mortgage market.

Option 2 – FSA regulation

If the Government decides, following consultation, that this is the most appropriate option, it will bring forward legislation to extend the scope of FSA mortgage regulation to include the buy-to-let mortgage market. HM Treasury's consultation sets out the detail of this proposal, including draft secondary legislation.

This section of the Impact Assessment considers the incremental costs and benefits of FSA regulation of the buy-to-let mortgage market. In order to determine incremental costs, it is necessary to establish a counterfactual scenario. This may be considered the scenario that would hold if, following consultation, the Government decides that Option 1 is more appropriate and maintains the existing the framework. As set out above, however, buy-to-let lending activity has fallen since 2008 and the future levels of activity in this market are unclear.

For the purposes of estimating the incremental costs and benefits of FSA regulation of the buy-to-let mortgage market, this Impact Assessment uses a counterfactual scenario based on the level of activity in 2008. This scenario does not represent a Government forecast for the future volume of buy-to-let mortgage lending activity. This scenario assumes 220,000 transactions per year, and an active market of 80 lenders and 10,000 intermediaries. Ninety per cent of lenders and intermediaries hold FSA authorisation for regulated activities unconnected to buy-to-let mortgages.

Costs

Extending FSA regulation to the buy-to-let mortgage market might be expected to impose direct costs on the FSA as regulators and compliance costs on firms (lenders and intermediaries).
In regulating a new market, the FSA would be likely to require extra resources in terms of designing, monitoring and enforcing regulations. These costs would likely include staff,

training, systems and IT costs. FSA regulation of the first charge residential mortgage market may provide some guide to the costs that the regulator would incur if it also regulated the buy-to-let mortgage market. The one-off costs to the FSA of introducing regulation of first charge residential mortgages were estimated at £5 million, and the annual ongoing costs estimated at £7.6 million.[3] Some of the costs of introducing regulation, including systems change costs, are fixed costs. These costs are estimated to be around £1 million. There may also be one-off policy costs to the FSA from developing further regulation and rules applicable to buy-to-let mortgage lenders. It is possible, however, that both one-off costs and annual ongoing costs of regulation of the buy-to-let mortgage market might be significantly smaller, because economies might be derived from using the framework for first-charge mortgages. In addition, the majority of lenders and intermediaries in the buy-to-let mortgage market are already authorised by the FSA and so will impose lower incremental costs on the regulator in terms of supervision and enforcement. The incremental cost to the FSA of regulating the second-charge mortgage market is therefore estimated at £1 million - £5 million (one-off) and £0 - £7.6 million (annual).

The incremental compliance costs which would be incurred by firms are likely to be similar in type to those incurred by firms when the FSA introduced regulation of first charge residential mortgages. These would include staff, training, systems and IT costs, and the ongoing costs of meeting specific prudential requirement and conduct of business rules. For firms which are authorised by the FSA in connection with other regulated activities (lenders, for example, that are already authorised in connection with first charge residential mortgage lending), the incremental costs would likely be lower, as these firms might be able to modify existing systems, rather than create new ones, and would not have to comply with further prudential requirements.

In order to estimate the incremental compliance costs which would be incurred by firms, this Impact Assessment uses the estimated incremental compliance costs of FSA regulation of first charge residential mortgage produced for the FSA by National Economic Research Associates (NERA) prior to the introduction of the FSA's regime. Subtracting costs for the lifetime mortgage regime (which would not be applicable in this case) produces one off-costs of £82.7 million for lenders and £50.7 million for intermediaries, and annual costs of £27.8 million for lenders and £39.9 million for intermediaries. These figures were based on a market population of 155 lenders and 13,725 intermediaries. Scaling these figures down for a market of 80 lenders and 10,000 intermediaries produces one-off costs of £42.7 million for lenders and £36.9 million for intermediaries, and annual costs of £26.2 million for lenders and £29.1 million for intermediaries.

These figures represent an upper bound to a range of costs to firms. Many lenders and intermediaries active in the buy-to-let mortgage market are also active in the first-charge residential mortgage market, and are already subject to FSA authorisation. For these firms the incremental compliance costs are likely to be at or close to £0. The compliance costs to firms are therefore presented as a range and the best estimate of costs in the summary sheet reflects this.

It is likely that a portion of the costs which would be incurred by firms would be passed on to consumers in the form of higher prices. This Impact Assessment does not attempt to estimate the costs which would be passed on to consumers (for the purpose of the summary sheets these costs are included in the compliance costs for firms).

[3] Figures taken from the FSA's impact assessment for its first-charge residential mortgage regime. Available on the FSA's website at: http://www.fsa.gov.uk/pubs/cp/cp186_vol1.pdf.

Market impacts

If firms pass on some portion of their compliance costs to consumers, this might deter some consumers from taking out a buy-to-let mortgage, and the total number of buy-to-let mortgages advanced will fall. Given the size of incremental compliance costs, it is likely that any increase in price is small relative to the size of payments made by the borrower over the duration of the mortgage. Therefore it is not likely that the impact of increased prices on the total number of buy-to-let mortgages advanced would be significant.

It is also possible that changes in other impact areas (quality of transactions, variety of transactions and efficiency of competition) would have longer-term impacts on the number of buy-to-let mortgages advanced. This Impact Assessment does not estimate these longer-term impacts to the quantity of transactions, as it assumed that these would not be significant.

The introduction of FSA regulation of buy-to-let mortgages would likely increase the average quality of service in buy-to-let mortgage market. Increases in quality are likely to arise in part by the imposition of conduct of business rules, compliance with which is likely to require some firms to increase their standards. Some firms might choose to exit the market, rather than meet the costs of compliance with regulation. It is likely that these would be firms with a low level of service quality (these would be the firms for which compliance would be most onerous), and their exit from the market will further drive up the average quality of service. This Impact Assessment does not estimate the value of the benefit to consumers that would result from this, but this is noted as a non-monetary benefit of Option 2.

As noted above, some firms might exit the market, which would lead to a reduced variety of quality of service, but as this would be concurrent with an increase in the average quality of service, this would not lead to consumer detriment.

The exit of firms from the market would increase market concentration, but does not necessarily mean a reduction in competition. Although some firms may exit the market, the number of buy-to-let mortgages advanced is not expected to decrease significantly and, therefore, the exit of some firms would result in other firms growing their market share. The effect on competition will depend on which firms grow their market share. The growth of market shares could be concentrated in a small number of firms, to the detriment of competition in the market. Alternatively, the growth of market shares could be spread amongst a larger number of firms leading to more firms capable of competing strongly in the market.

Benefits

As noted in the market failure section above, the buy-to-let mortgage market has the potential to impose large costs on others outside of this market. The risks posed by mortgage markets to the wider financial system, and the economy as a whole, can be mitigated by prudential regulation.

The FSA, as a regulator of financial markets, imposes prudential requirements on those firms it regulates. Prudential regulation helps to protect the financial system against losses, and therefore minimises disruption across financial markets. The main benefit of prudential regulation will be reduced risks pose by the market to financial stability. Due to the difficulty of estimating and costing these risks, this Impact Assessment notes these as a major non-monetised benefit of FSA regulation.

FSA regulation is likely to improve outcomes in the buy-to-let mortgage market. This Impact Assessment takes as a proxy for the value of improved outcomes in the market the value of minimising repossessions initiated by buy-to-let mortgage lenders. As an upper bound to the range only, the value of preventing all repossessions initiated by buy-to-let mortgage lenders is considered. An estimate for this figure is produced by multiplying the potential cost of a repossession to a lender by the number of repossessions initiated by buy-to-let mortgage lenders in 2008 (3400). Using the average advance of £122,000 as the upper bound for the costs to a buy-to-let mortgage lender of a repossession produces a range for the annual benefit of this policy of £0 - 414.8 million.[4]

It is expected that the combined monetised and non-monetised benefits will outweigh the combined monetised and non-monetised costs.

Specific Impact Tests for Option 2

Option 2 – FSA regulation would involve significant Government intervention, and so Specific Impact Tests have been performed for this option.

Small Firms Impact Test

A large number of the intermediaries active in the buy-to-let mortgage market are small firms. The incremental compliance costs might impact disproportionately on small firms. It is therefore possible that there would be some restructuring and consolidation of the market in response to regulation. Some firms might exit, and these would most likely be those undertaking only a small amount of buy-to-let mortgage business. Others may merge, or in the case of independent intermediaries, join with a larger firm. The experience of the introduction of FSA regulation of first charge residential mortgages, however, would suggest that the number of small firms exiting the market would not be significant.

Competition Assessment

Option 2 would likely directly limit the number of suppliers in the market, by requiring firms to obtain FSA authorisation before engaging in regulated activities. As noted above, it might also indirectly limit the number of suppliers by raising the cost of acting in the market (by incremental costs of compliance). The impact of FSA regulation on the ability of suppliers to compete, and their incentives to do so, would depend on the effects of firm exits and any subsequent effects on market share growth. However, in light of the experience of the introduction of FSA regulation of the first charge residential mortgage market, which had little detrimental effect on competition in that market, the Government does not anticipate that FSA regulation of the buy-to-let mortgage market would significantly reduce competition in the buy-to-let mortgage market.

Gender Equality Impact Test

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of their gender.

Disability Equality Impact Test

[4] Average advance of buy-to-let mortgage derived from CML figures for value and number of loans in 2008.

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of any disability.

Race Equality Impact Test

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of their ethnicity.

Specific Impact Tests: Checklist

Type of testing undertaken	*Results in Evidence Base?*	*Results annexed?*
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	No	No
Rural Proofing	No	No

C Impact Assessment for Chapter 4 proposal

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	**Impact Assessment for Financial Services Authority regulation of managing a regulated mortgage contract**	
Stage: Consultation	**Version:** Final	**Date:** 16 November 2009

Related Publications:

Mortgage Regulation: a Consultation, *HM Treasury,* November 2009

Available to view or download at: http://www.hm-treasury.gov.uk

Contact for enquiries: Michael.Cornford@hmtreasury.gsi.gov.uk

What is the problem under consideration? Why is government intervention necessary?

There is evidence that a growing number of mortgage lenders in distress are selling their mortgage books (portfolios of mortgages), as a way of limiting losses or raising funds. These sales are typically discounted, as the seller is looking to complete the deal quickly. The buyers in these cases are typically hedge funds and private equity firms, attracted by the possibility of purchasing assets at a discount. These firms are typically not subject to regulation. The Government is concerned that borrowers may be treated unfairly because their mortgage has been sold on to an unregulated firm as part of a mortgage book sale. The Government has identified risks of market failure in the market for the onward sale of regulated mortgage contracts, and is consulting on the best way to protect consumers when lenders sell on mortgage books.

What are the policy objectives and the intended effects?

The policy objective is a fair, stable and efficient market in mortgages. The Government has identified in the market for the onward sale of mortgages risks of negative externalities impacting on mortgage borrowers. The intention is to mitigate the risks of market failure in order to achieve the policy objective.

What policy options have been considered? Please justify any preferred option.

The following options are being considered:

- Option 1 – maintain the existing framework; and
- Option 2 – amend Financial Services Authority (FSA) regulation.

The costs and benefits of both options, insofar as it has been possible to ascertain these, are set out in the relevant sections below.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Government keeps all legislation under review, and in line with good practice would expect to review the policy within three years.

Ministerial Sign-off For Impact Assessments:

> ***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister: Sarah McCarthy-Fry

Date: 16 November 2009

Summary: Analysis & Evidence

Policy Option:	Description:
2. Amend FSA regulation	Create a new regulated activity, "managing a regulated mortgage contract", to be regulated by the FSA

COSTS			
ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' Cost to FSA (£1 million - £1.1 million one-off). Costs to firms (£0 – £10.7 million one off, £0 - £3.5 million annual).	
One-off (Transition)	**Yrs**		
£ 1 m – 11.8 m	1		
Average Annual Cost (excluding one-off)			
£ 0 – 3.5 m	10	**Total Cost** (PV)	**£ 1 m – 41.9 m**
Other **key non-monetised costs** by 'main affected groups'			

BENEFITS			
ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' Better outcomes in the market.	
One-off	**Yrs**		
£ N/A	0		
Average Annual Benefit			
£ 0 – 66 m	10	**Total Benefit** (PV)	**£ 568.1 m**
Other **key non-monetised benefits** by 'main affected groups' Increased protection for consumers, reduced costs to Government of repossession.			

Key Assumptions/Sensitivities/Risks

Price Base Year	Time Period Years 10	**Net Benefit Range** (NPV)	**NET BENEFIT** (NPV Best estimate)
		- £ 41.9 m – 567.1 m	**£ 1 m – 567.1m**

What is the geographic coverage of the policy/option?	UK			
On what date will the policy be implemented?	Subject to			
Which organisation(s) will enforce the policy?	FSA			
What is the total annual cost of enforcement for these	£ 0			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	N/A			
What is the value of changes in greenhouse gas emissions?	N/A			
Will the proposal have a significant impact on competition?	Yes			
Annual cost (£-£) per organisation (excluding one-off)	Micro £N/A	Small £N/A	Medium £N/A	Large £0 – 3.5m
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)					(Increase - Decrease)
Increase	£ unknown	Decrease	£ unknown	**Net**	£ unknown

Key: **Annual costs and benefits:** **(Net) Present Value**

Evidence Base (for summary sheets)

Introduction

This Impact Assessment should be read in conjunction with HM Treasury's consultation, *Mortgage Regulation: a Consultation*, which is available at: http://www.hm-treasury.gov.uk.

A growing number of mortgage lenders are selling on mortgage books (portfolios of mortgages). The Government has identified risks of market failure in the market for the onward sale of regulated mortgage contracts.

In 2004, the Government extended the scope of Financial Services Authority (FSA) regulation to include first-charge residential mortgages. The FSA's regime provides consumers with important protections regarding their mortgages, including requirements that lenders treat customers fairly and treat repossession as a last resort. FSA regulation applies to firms that engage in regulated activities, which are set out in legislation. Firms that acquire a regulated mortgage contract as a result of a mortgage book sale will not necessarily engage in a regulated activity, and so may not be subject to FSA regulation.

The Government is concerned that borrowers may be treated unfairly because their mortgage has been sold on to an unregulated firm as part of a mortgage book sale. On 8 July, HM Treasury published *Reforming financial markets*, which announced that the Government would consult on the best way to protect consumers when lenders sell on mortgage books.[1] The Government is consulting on introducing a new regulated activity of managing a regulated mortgage contract, to mitigate the risks of market failure. The Government is considering two policy options:

- Option 1 – maintain the existing framework; and
- Option 2 – amend FSA regulation.

This Impact Assessment presents the Government's estimates of the incremental costs and benefits of Option 2. HM Treasury's consultation seeks stakeholder views on these estimates.

The following sections of this Impact Assessment provide the evidence base for the summary sheets above. This comprises:

- a summary of the market for the onward sale of mortgages,
- a market failure analysis,
- analysis of the incremental costs and benefits of Option 2; and
- specific impact tests for Option 2.

Market summary

This market summary presents a brief overview of the market for mortgage books in terms of the volume of activity in the market. This market summary presents the volume of activity in terms of the value and number of transactions in these markets, and the number of agents active in these markets.

This is a new market, and there is limited information about the volume of activity and number of participants in the market. The FSA has presented to the Government evidence

[1] Reforming financial markets, HM Treasury, July 2009. Available at: http://www.hm-treasury.gov.uk/reforming_financial_markets.htm.

that indicates unregulated firms had by the second quarter of 2009 purchased between 4,000 and 17,000 mortgages with a total balance of between £66 million and £1,685 million. The FSA has also reported that the volume of activity is likely to increase.

There are thought to be around 20 actual or potential buyers of mortgage books that are not currently regulated by the FSA for mortgages activity.

Market failure analysis

This section of the Impact Assessment presents a market failure analysis of the market for mortgage books. In this market, lenders sell on mortgage books to other firms. These sales are typically discounted, as the seller is looking to complete the deal quickly. The buyers in these cases are typically hedge funds and private equity firms, attracted by the possibility of purchasing assets at a discount.

Borrowers whose mortgages are owned by an FSA-regulated mortgage lender benefit from important protections, including the requirements of FSA regulation that lenders treat customers fairly and treat repossession as a last resort. In the case that a mortgage is sold on, however, borrowers will not necessarily benefit from the protection of FSA regulation. Acquiring a regulated mortgage contract is not an FSA-regulated activity, and firms that do not require FSA authorisation in relation to any other regulated activity will not be subject to regulation. Non-regulated owners of regulated mortgage contracts may seek to maximise margins by raising interest rates and charges, potentially to levels that are unaffordable to borrowers. This means that some mortgage book sales may result in severe harm to borrowers. As these borrowers are not agents in the market in which these mortgage books are sold, this harm may be seen as a negative externality of the market for the onward sale of mortgages.

This market failure may justify Government intervention.

Option 2 – FSA regulation

If the Government decides, following consultation, that this is the most appropriate option, it will bring forward legislation to create a new regulated activity: managing a regulated mortgage contract. HM Treasury’s consultation sets out the detail of this proposal, including draft secondary legislation.

This section of the Impact Assessment considers the incremental costs and benefits of this proposed new regulated activity. In order to determine incremental costs, it is necessary to establish a counterfactual scenario. This may be considered the scenario that would hold if, following consultation, the Government decides that Option 1 is more appropriate and maintains the existing the framework.

For the purposes of estimating the incremental costs and benefits of this proposed new regulated activity, this Impact Assessment uses a counterfactual scenario based on the level of activity that has so far taken place in this market. This scenario does not represent a Government forecast for the future volume of activity in this market. This scenario assumes 4,000 regulated mortgage contracts with a total balance of £66 million are sold on by lenders per year, to an active market of 20 buyers. This Impact Assessment assumes that none of these buyers holds FSA authorisation prior to the introduction of the new regulated activity.

Costs

Creating a new regulated activity might be expected to impose direct costs on the FSA as regulators and compliance costs on firms. The FSA would incur costs in considering applications for permissions from the introduction of a new regulated activity. The Government's proposal is that only firms without existing permissions to engage in regulated activities relating to mortgages would be required to apply for the new permission. The authorisation fee currently payable for a moderately complex case is £5,000 and is intended to be reflective of the costs incurred by the FSA. If 20 firms sought authorisation, the estimated cost to the FSA would be £100,000. The FSA would also incur costs relating to systems changes. These costs are estimated to be around £1 million. There may also be one-off policy costs to the FSA from developing further regulation and rules applicable to managers of regulated mortgage contracts. The overall estimate for one-off costs to the FSA is therefore £1.1 million.

As the new regime will run alongside the existing mortgage regime and the active market is relatively small, it is anticipated that most of the ongoing costs will be managed within the FSA's existing resources, and the ongoing cost to the FSA is £0.

In order to estimate the incremental compliance costs which would be incurred by firms, this Impact Assessment uses the estimated incremental compliance costs of FSA regulation of first-charge residential mortgages produced for the FSA by National Economic Research Associates (NERA) prior to the introduction of the FSA's regime. Subtracting costs for the lifetime mortgage regime (which would not be applicable in this case) produces one-off costs of £82.7 million and annual costs of £27.8 million for lenders. These estimates were based on a market population of 155 lenders. Scaling these figures down for a market of only 20 firms (as only 20 firms would be required to apply for permission and incur incremental compliance costs) produces one-off costs of £10.7 million and annual costs of £3.5 million.

These costs represent an upper bound to a range of costs to firms that might be as low as zero, if firms chose to exit the market rather than apply for FSA authorisation. It is likely that a large number of firms exiting the market would not wish to be subject to FSA regulation and so would exit the market. It is therefore unlikely that this upper bound would be reached. The possibility that firms would exit the market would also impact on the authorisation costs to the FSA, which is reflected in the summary sheet for Option 2.

Market impacts

If firms chose to exit the market rather than apply for authorisation to the FSA, the number of buyers in the market would decrease. This might result in a decrease in the number of transactions in the market. The probability of this potential impact is unclear, however, as authorised buyers might increase their individual volume of purchases.

The potential impact on competition in the market is also unclear. Some buyers might choose to exit the market rather than seek FSA authorisation. The supply of buyers might also be limited by the increase in the cost of acting in the market (by incremental costs of compliance). If a large number of firms exit the market, the market power of the buyers that remain might increase. This could impact on the pricing of transactions, and result in worse outcomes for sellers.

Benefits

The Government proposes to amend legislation in order to protect consumers when lenders sell on mortgage books. The protection provided to consumers by regulation also leads to better outcomes in the market. This Impact Assessment uses as a proxy for the value of better outcomes in the market the value of minimising repossessions of mortgages which have been sold on. As an upper bound to the range only, the value of preventing all repossessions of mortgages that have been sold on is considered. An estimate for this figure is produced by considering the potential costs to the firms that have purchased the mortgages if these mortgages are repossessed. Using the total value of the mortgages which have been sold on produces a range for the annual benefit of this policy of £0 - £66 million. It is unlikely that the potential costs at this upper bound would materialise, as this would require all those mortgages which have been sold on to be repossessed, and for these repossessions to result in a net income to the firms which have purchased these mortgages to equal £0.

This Impact Assessment does not estimate the value of the wider benefits of consumer protection, including fairer treatment, reduced stress incurred through poor treatment, and the costs to Government incurred as a result of repossession. These are likely to be substantial, and are noted as a key non-monetised benefit in the summary sheet.

Specific Impact Tests for Option 2

Option 2 – amend FSA regulation would involve significant Government intervention, and so Specific Impact Tests have been performed for this option.

Small Firms Impact Test

The firms active in the market for the onward sale of regulated mortgages are typically mortgage lenders, hedge funds and private equity firms. These are not likely to be small firms. It is not thought that there will be any possibility of small firms being disproportionately affected by this proposed option.

Competition Assessment

Option 2 would likely directly limit the number of suppliers in the market, by requiring firms to obtain FSA authorisation before engaging in regulated activities. As noted above, it might also indirectly limit the number of suppliers by raising the cost of acting in the market (by incremental costs of compliance). The impact of introducing a new regulated activity on the ability of suppliers to compete, and their incentives to do so, would depend on the effects of firm exits and any subsequent effects on market share growth.

Gender Equality Impact Test

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of their gender.

Disability Equality Impact Test

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of any disability.

Race Equality Impact Test

This has been considered and it is not thought that there will be any possibility of consumers being excluded from benefiting from any potential changes on the ground of their ethnicity.

Specific Impact Tests: Checklist

Type of testing undertaken	*Results in Evidence Base?*	*Results annexed?*
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	No	No
Rural Proofing	No	No

D Draft Statutory Instrument

Order made by the Treasury and laid before Parliament under paragraph 26 of Schedule 2 to the Financial Services and Markets Act 2000 (c.8) for approval by a resolution of each House of Parliament within twenty-eight days beginning with the day on which the Order is made, subject to extension for periods of dissolution, prorogation or adjournment for more than four days.

S T A T U T O R Y   I N S T R U M E N T S

2010 No.

FINANCIAL SERVICES AND MARKETS

The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. X) Order 2010

Made - - - -	***
Laid before Parliament	***
Coming into force in accordance with article 1(2)	

In the opinion of the Treasury, one of the effects of the following Order is that activities which are not regulated activities (within the meaning of the Financial Services and Markets Act 2000(**a**)) will become regulated activities.

The Treasury, in exercise of the powers conferred by section 22(1) and (5) of, and paragraph 25(1)(f) of Schedule 2 to, that Act, make the following Order:

Citation and commencement

1.—(1) This Order may be cited as the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. X) Order 2010.

(2) This Order comes into force —

(a) for the purposes of articles 11 to 13 on [*a date 6 months before the date in (b)*];

(b) for all other purposes on [*date*].

(3) In this Order—

"the Act" means the Financial Services and Markets Act 2000;

"the principal Order" means the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(**b**).

Amendments of the principal Order

2. Articles 3 to 8 amend the principal Order is amended as follows.

Exclusion of arrangements made in the course of management by authorised person

3. After article 29A (arrangements made in the course of administration by authorised person)(**c**) insert—

"**Arrangements made in the course of management by authorised person**

(**a**) 2000 c.8; Schedule 2 was amended by the Dormant Bank and Building Society Accounts Act 2008 (c.31), section 15 and Schedule 2.
(**b**) S.I. 2001/544
(**c**) Article 29A was inserted by SI 2003/1475.

29B. A person who is not an authorised person ("A") does not carry on an activity of the kind specified by article 25A(1)(b) as a result of—

(a) anything done by an authorised person ("B") in relation to a regulated mortgage contract which B is managing pursuant to an arrangement of the kind mentioned in article 62A(a); or

(b) anything A does in connection with the management of a regulated mortgage contract in circumstances falling within article 62A(b).".

Exclusion of advice given in the course of management by authorised person

4. After article 54A (advice given in the course of administration by authorised person)(**a**) insert—

"**Advice given in the course of management by authorised person**

54B. A person who is not an authorised person ("A") does not carry on an activity of the kind specified by article 53A by reason of—

(a) anything done by an authorised person ("B") in relation to a regulated mortgage contract which B is managing pursuant to an arrangement of the kind specified in article 62A(a); or

(b) anything A does in connection with the management of a regulated mortgage contract in circumstances falling within article 62A(b).".

Regulated mortgage contracts

5. In article 61 (regulated mortgage contracts)(**b**)—

(a) after paragraph (2) insert—

"(2A) Managing a regulated mortgage contract is also a specified kind of activity.";

(b) in paragraph (3)—

(i) for sub-paragraphs (a)(ii) and (iii) substitute—

"(ii) the contract provides for the obligation of the borrower to repay to be secured by a legal mortgage of land (other than timeshare accommodation) in the United Kingdom;

(iii) at least 40% of that land is used, or is intended to be used, as or in connection with a dwelling;";

(ii) after sub-paragraph (c) insert—

"(d) "managing" a regulated mortgage contract means having the power to exercise or to control the exercise of any of the rights of a lender under a regulated mortgage contract.";

(c) for paragraph (4) substitute—

"(4) For the purposes of paragraph (3)(a)—

(a) "mortgage" includes charge and (in Scotland) a heritable security;

(b) the area of any land which comprises a building or other structure containing two or more storeys is to be taken to be the aggregate of the floor areas of each of those storeys; and

(c) "timeshare accommodation" has the meaning given by section 1 of the Timeshare Act 1992(**c**).".

Exclusion of arranging management by authorised person

6. After article 62 (arranging administration by authorised person) insert—

"**Arranging management by authorised person**

62A. A person, who is not an authorised person ("A") does not carry on an activity of the kind specified by article 61(2A) in relation to a regulated mortgage contract where A—

(**a**) Article 54A was inserted by SI 2003/1475.
(**b**) As amended by SI 2001/3544, SI 2006/2383 and SI 2005/2114.
(**c**) 1992 c.35.

(a) arranges for another person ("B"), being an authorised person with permission to carry on an activity of that kind, to manage the contract in circumstances where B has power to exercise or control the exercise of all of the rights of the lender under the contract; or

(b) manages the contract during a period of not more than one month beginning with the day on which any such arrangement comes to an end.".

Exclusion of management pursuant to agreement with authorised person

7. After article 63 (administration pursuant to agreement with authorised person) insert—

"M**anagement pursuant to agreement with authorised person**

63ZA. A person who is not an authorised person ("A") does not carry on an activity of the kind specified by article 61(2A) in relation to a regulated mortgage contract where A manages the contract pursuant to an agreement with an authorised person who has permission to carry on an activity of that kind.".

Exclusion of trustees, nominees and personal representatives

8. In article 66(6A) (trustees, nominees and personal representatives) for "article 61(1) or (2)" substitute "article 61(1), (2) or (2A)".

Amendment of the Financial Services and Markets Act 2000 (Professions) (Non-Exempt) Activities Order 2001

9.—(1) The Financial Services and Markets Act 2000 (Professions) (Non-Exempt) Activities Order 2001(**a**) is amended as follows.

(2) For "article 61(1) or (2)" substitute "article 61(1), (2) or (2A)".

Transitional provisions

10.—(1) A person who fulfils the condition in paragraph (2) also has permission to carry on an activity of the kind specified by article 61(2A) of the principal Order (as inserted by article 5(a) of this Order).

(2) The condition is that the person has permission on [*the date in article 1(2)(b)*] to carry on an activity of the kind specified by article 61(1) of the principal Order.

11.—(1) In this article and in article 13 an "early Part 4 application" means—

(a) a completed application for a Part 4 permission which—

(i) is made by a person who is not an authorised person;

(ii) is made before [*a date three months before the date in article 1(2)(b)*]; and

(iii) relates to any of the activities which (on the coming into force of article 5 of this Order) are of a kind specified by article 25A (arranging regulated mortgage contracts), 53A (advising on regulated mortgage contracts), 61(1), (2) or (2A) of the principal Order; or

(b) an application under section 44 of the Act (variation etc at request of authorised person) which—

(i) is made by an authorised person who has a Part 4 permission which does not relate an activity of the kind specified by article 61(1) of the principal Order;

(ii) is made before [*a date three months before the date in article 1(2)(b)*]; and

(iii) seeks to add to those activities for which the authorised person has permission, any of the activities which (on the coming into force of article 5 of this Order) are of a kind specified by article 25A, 53A, 61(1), (2) or (2A) of the principal Order.

(2) Section 52(1) of the Act (determination of applications) does not apply to an early Part 4 application.

(3) The Authority must determine all early Part 4 applications before [*the date in article 1(2)(b)*].

(**a**) SI 2001/1227 as amended by SI 2001/3650 and 2003/1475; there are other amending instruments but none is relevant.

12.—(1) In this article an "early Part 5 application" means an application under section 59 of the Act (approval for particular arrangements) which—

(a) is made before [*a date three months before the date in article 1(2)(b)*]; and

(b) relates to the carrying on of any of the activities which (on the coming into force of article 5 of this Order) are of a kind specified by article 25A, 53A, 61(1), (2) or (2A) of the principal Order.

(2) Section 61(3) of the Act (determination of applications) does not apply to an early Part 5 application.

(3) The Authority must determine all early Part 5 applications before [*the date in article 1(2)(b)*].

13.—(1) In this article an "early section 148 application" means an application under section 148 of the Act (modification or waiver of rules) which—

(a) is made by a person who—

(i) has permission to carry on an activity of the kind specified by article 61(1) of the principal Order; or

(ii) has made an early Part 4 application which has been determined by the Authority; and

(b) is made before [*the date in article 1(2)(b)*].

(2) The Authority may determine an early section 148 application before [*the date in article 1(2)(b)*].

(3) Any determination made in accordance with paragraph (2) comes into force on [*the date in article 1(2)(b)*].

Name
Name
Date — Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

This Order amends the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544) ("the principal Order") so as to specify the activity of managing a regulated mortgage contract as a regulated activity for the purposes of the Financial Services and Markets Act 2000 ("the Act"). It also amends the definitions in article 61 of the principal Order of a "regulated mortgage contract" and "mortgage" to include buy to let mortgages and mortgages subsequent to the first legal mortgage.

Articles 3, 4 and 6 insert new articles into the principal Order which provide exclusions for special purpose vehicles from the regulated activities of arranging mortgages, advising on mortgages and managing mortgages.

Article 5 amends article 61 of the principal Order by inserting a new article 61(2A), which specifies the new regulated activity of "managing a regulated mortgage contract" and by amending certain definitions.

Article 7 inserts a new article 63ZA into the principal Order to clarify that an unauthorised person is not to be treated as managing a regulated mortgage contract where they are doing so pursuant to an agreement with an authorised person.

Articles 8 and 9 make minor consequential amendments.

Articles 10 to 13 make transitional provision. Under Article 10, persons with an existing Part 4 permission in respect of the activity of entering into a regulated mortgage contract will also have permission for the new article 61(2A) activity. Articles 11 to 13 allow certain early applications to be made under the Act.

An impact assessment of the effect that this instrument will have on the costs of business is available from the Payments, Credits and Inclusion Team, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ and is annexed to the Explanatory Memorandum which is available together with the instrument on the OPSI website (www.opsi.gov.uk).

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This document can be found in full on our website at:
hm-treasury.gov.uk

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