HM TREASURY

Mortgage regulation:

summary of responses

March 2010

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Contents

1 Summary

1.1 *Mortgage regulation: a consultation* was published in December 2009 to seek views on three changes to the regulation of residential mortgages. These changes were:

- Transferring responsibility for the regulation of second charge mortgage lending from the Office of Fair Trading (OFT) to the Financial Services Authority (FSA);
- Extending the scope of FSA mortgage regulation to include buy-to-let mortgages; and
- Ensuring that consumers with regulated mortgage contracts continue to benefit from the same levels of consumer protection if their mortgages are sold on to an unregulated firm.

1.2 The consultation closed on 15th February 2010. The Government received a total of 51 responses from a range of organisations, including industry bodies, consumer groups, and a number of individual firms. Respondents represented lenders, borrowers, financial advisers, legal advisers, and property professionals. Treasury officials also held numerous meetings with a variety of organisations. The Government is grateful for respondents' engagement with the consultation process and has carefully considered the responses in deciding how to proceed.

Second charge mortgages

1.3 Overall, most respondents were supportive of the changes proposed in relation to second charge lending. A number of specific concerns were raised, which the Government has sought to address in this document and in minor changes to the proposed legislation. As a result of the consultation the Government has also decided to include existing second charge loans in the transfer of responsibilities to the FSA.

1.4 Subject to these changes, the Government intends to proceed with legislation to implement the proposals. This will lead to the creation of a single regulator for all residential mortgage lending, ensuring there is more consistent regulation that will make it easier for consumers to understand the protections available and simplify compliance burdens for lenders. The inclusion of existing loans will allow lenders to realise these benefits sooner, and ensure that existing as well as new borrowers benefit from the consistent approach.

1.5 The commencement date of legislation will be suitably aligned with changes to the FSA's regulation of first charge mortgages that may follow from its *Mortgage Market Review*.

Buy-to-let mortgages

1.6 Regarding the regulation of buy-to-let lending, the majority of respondents, representing both lenders and borrowers, agreed that some sections of the buy-to-let sector had been the source of significant consumer detriment that could be prevented through regulation. However, many lenders and property professionals expressed concerns that the form of regulation proposed could impose unnecessary burdens on the operation of the private rented sector. They and a number of consumer groups also argued that the proposed regulation may need further refinement to protect consumers fully from recent harmful practices.

1.7 The Government does not agree with those respondents who argued that these considerations mean that the buy-to-let sector should remain unregulated. A large number of respondents agreed with the Government that there is overwhelming evidence that the operation of some of the buy-to-let market has suffered from significant market failure and that this demands Government intervention. The Government remains committed to action to address these failures.

1.8 However, to address respondents' concerns and in view of the importance of the private rented sector, the Government has decided to explore changes to the form of regulation proposed. Further consultation on such changes will follow after the conclusion of the current Treasury consultation on investment in the private rented sector, which closes on 28 April.

Onward sale of mortgage portfolios

1.9 Respondents were overwhelmingly in favour of the objective of protecting consumers from possible detriment when portfolios of mortgages are sold on to unregulated entities such as hedge funds. The Government is committed to achieving this objective.

1.10 Technical aspects of the proposals, however, raised issues relating to interactions with mortgage securitisation markets. The Government is continuing to explore these issues, which will need to be resolved before further action can be taken, and is grateful for respondents' assistance in this regard. It intends to publish revised proposals later this year.

2 Second charge mortgages

2.1 Second charge residential mortgages are loans secured on the borrower's property when that property is already acting as security for a first charge mortgage. Second charge lending represented around two per cent of the total mortgage market in 2007, but has since declined and in 2009 represented around one quarter of one percent of gross mortgage lending[1].

2.2 In the consultation, the Government noted that the sector had experienced rapid growth and then decline as a result of a combination of both supply and demand factors. Increased demand was driven by the rising use of second charge mortgages for debt consolidation, and as a substitute for unsecured consumer credit. Supply was driven by the entry of many new non-deposit-taking lenders, attracted by higher margins than those available in first charge lending and by readily available wholesale funding. The financial crisis led to a dramatic change in lenders' risk appetite and the withdrawal of wholesale funding, with the result that the market has been largely dormant since late 2008.

2.3 Most respondents to the consultation agreed with this analysis. A number of banks noted that this analysis did not include the market for secured commercial lending, for instance where a loan to a small business is secured on a company director's own home. This market, some respondents argued, has not been subject to the same rapid growth and then contraction as the retail market for secured lending. As the Government is not proposing regulation of these forms of business-to-business lending, these issues are out of the scope of this consultation, but the Government has noted the points raised. Some related concerns about lending to individuals for business purposes were also raised by a number of lenders. These are discussed in paragraph 2.19 and subsequently.

2.4 Second charge lending is currently regulated by the Office of Fair Trading (OFT) under the Consumer Credit Act 1974. In the consultation, the Government proposed transferring responsibility for the regulation of second charge lending to the Financial Services Authority (FSA), which is already responsible for regulating first charge lending. Two main factors lie behind this proposal:

- The creation of a single regulator for all residential mortgage lending will make it easier for consumers to understand the protections available to them and simplify compliance burdens for lenders. It will lead to more consistent regulation across first and second charge lending, which will help customers choose the form of lending that is most appropriate for them. Consistent regulation will also be helpful in situations when borrowers are in arrears or default on both a first and a second charge mortgage, for lenders, borrowers, and other organisations involved in debt issues.

- The rapid withdrawal of products and lenders from the second charge market suggests that the market may not have been operating on a sustainable footing. Many firms' business models were heavily reliant on short-term wholesale funding, leaving them vulnerable to financial shocks. Sudden contractions in lending and

[1] Finance and Leasing Association, Bank of England.

uncertainty about firms' futures have the potential to cause insecurity for borrowers and generate wider market disruption. The transfer of regulation to the FSA would allow prudential requirements to be imposed on all second charge lenders, helping to ensure that firms have robust business models and can play a sustainable role in the market.

2.5 Respondents were broadly in agreement with these objectives and a large majority supported the Government's proposal. A small number of respondents disagreed, arguing that second charge mortgages displayed relatively low levels of arrears and repossessions, which showed that lending had been prudent and that lenders only pursued repossession as a last resort. However, this was matched by continuing concerns from numerous respondents representing consumer groups that some second charge lenders' practices had led to consumers being over-burdened with debt, and that some lenders were too quick to pursue repossession action rather than display forbearance and explore more proportionate options.

2.6 The Government remains convinced that a transfer of regulation to the FSA would bring significant benefits, and has decided to proceed with its proposal. Some details of the proposal have been amended in light of responses to the consultation, and the Government will act to address some of the wider concerns raised. These issues are discussed below.

Levels of consumer protection

2.7 Some respondents noted that there are differences in the terms of the specific consumer protections available under the existing OFT second charge regime and the current FSA first charge regime. The Government recognises that the formulation of protections differs, but believes a number of the specific concerns raised about potential differences in levels of consumer protection relate more to differences in the regulatory framework under the Consumer Credit Act 1974 and the Financial Services and Markets Act 2000 than to the ultimate outcomes for consumers.

2.8 Some specific concerns were founded on a misunderstanding of the FSA's powers. For example, some respondents suggested that FSA regulation would remove the ability of courts to make time orders in the case of mortgage arrears. Such orders allow borrowers more time to repay a loan when they have fallen into arrears. However, the Government believes the courts already have these powers for first charge mortgages, and would still have them for second charge mortgages following a transfer of regulation to the FSA. The FSA has published guidance on this issue[2].

2.9 Both the OFT and the FSA are committed to working with Government and stakeholders to ensure that the existing strong levels of consumer protection are maintained or enhanced following the transfer of responsibilities. The FSA is currently reviewing its approach to first charge mortgage regulation, and is considering adopting a targeted degree of product regulation and taking a more prescriptive approach on arrears and repossessions. The FSA will consult on its regulatory regime for second charge mortgages, when it will seek stakeholders' views on how best to maintain and enhance the existing levels of consumer protection.

Regulation of existing loans

2.10 In the consultation, the Government proposed excluding existing second charge loans from the transfer of regulation to the FSA, leaving regulatory responsibility for the ongoing management of these loans with the OFT. Several respondents representing consumer groups were concerned about this proposal, arguing that it would undermine the Government's

[2] See the Regulatory Guide section of the FSA Handbook, at PERG 4.17.2G (http://fsahandbook.info/FSA/html/handbook/PERG/4/17).

objective of ensuring there is a consistent regulatory framework for all mortgage lending and could lead to consumer confusion. Excluding existing loans from the transfer could also deprive existing borrowers who fall into arrears on both a first and a second charge loan from some of the benefits a single regulator for all mortgages could bring. This may be a particular concern if a disproportionate number of borrowers took out unaffordable loans in the run-up to the financial crisis.

2.11 Most lenders, however, were content with the Government's proposal not to transfer existing loans, arguing that the transitional costs of a transfer would be greater if it included existing loans. Even so, many noted that leaving responsibility for existing second charge loans with the OFT, while new loans are regulated by the FSA, would create a complex and unusual regulatory environment. A small number suggested that this complexity means that regulatory change should not be pursued at all, as any benefits to lenders from a more consistent regulatory approach to new loans would be outweighed by the administrative consequences of managing existing loans under a different regulator.

2.12 The Government has carefully considered respondents' views on its initial proposal. The purpose of transferring the regulation of second charge lending to the FSA is to ensure there is a consistent regulatory approach to all mortgages that will make it easier for consumers to understand the protections available and simplify compliance burdens for lenders. The Government has decided that this objective would not be met, at least in the medium-term, by leaving regulatory responsibility for existing second charge loans with the OFT. Existing borrowers would not benefit from the consistent approach a transfer is intended to create, and it could be many years before the backlog of existing loans expired and lenders could realise the benefits of a single regulatory framework. The Government has therefore decided to include existing second charge loans in the transfer to the FSA.

2.13 This will be achieved by ensuring the scope of the regulated activity of 'administering' a regulated mortgage contract extends to existing second charge loans. 'Administering' a second charge mortgage will be a regulated activity from the commencement date of the relevant legislation even if the mortgage was entered into prior to the commencement date.[3]

2.14 Following consultation, the FSA will make rules that will cover the administration of a second charge mortgage, including but not limited to rules regarding the exercise of forbearance. The Government will also amend the relevant provisions of the Consumer Credit Act 1974 where necessary to avoid dual regulation. The Government does not expect there will be any need for lenders to novate or amend existing second charge mortgage contracts as a result of these changes, since the scope of FSA regulation will be limited to the ongoing administration of these contracts.

2.15 The Government is mindful of many lenders' concerns about the transitional costs of regulatory change, especially as a result of the transfer of existing second charge loans to the FSA. The Government has considered these costs in the updated Impact Assessment included in Annex A. The Government remains convinced, however, that the medium-term benefits of creating a single regulatory framework for all residential mortgage lending outweigh the transitional costs of the changes required to achieve this.

2.16 However, to ensure lenders face a change of regulatory framework and the associated transitional costs only once, it is the Government's intention that the timing of the transfer of second charge mortgage regulation to the FSA will be suitably aligned with the implementation of changes to the FSA's regulatory regime for first charge mortgages that may follow from the

[3] The only second charge mortgages not covered by the 'administering' activity would be those entered into before 31 October 2004, the date on which the FSA became responsible for regulating first charge mortgages. Because the term of a second charge mortgage is typically around five years, the Government does not expect there to be many, if any, such mortgages by the time the legislation comes into force.

Mortgage Market Review. The Government understands the FSA will consult lenders on suitable arrangements for the transition, and the Government will ensure sufficient notice is given of commencement for lenders to prepare for the changes.

Details of regulation

2.17 A number of respondents representing both borrowers and lenders said it was important that the FSA's regime for second charge lending was appropriately tailored to the market, and that not all aspects of the current regime for first charge lending were appropriate for second charge lending. Others suggested the FSA should take the opportunity of acquiring responsibility for second charge lending to enforce greater co-operation and consistency between first and second charge lenders in their handling of customers, particularly in cases of arrears. Many also suggested that the FSA should collect detailed data on second charge lending, arrears and repossessions.

2.18 The details of the regulatory regime for second charge lending are for the FSA to determine, but the Government understands that the FSA is already considering these and other issues, which will be discussed in its consultation.

Charges for purposes other than consumer lending

Lending to individuals for business purposes

2.19 Lenders often seek additional security on loans to individuals for businesses purposes, by taking out a charge on the borrower's own home. Such a charge may be used to secure a fixed term loan, a business overdraft, or for other purposes. A number of respondents drew attention to the fact that the drafting of the proposal to transfer second charge mortgage lending to the FSA would have the effect of extending the FSA's mortgage regulation regime to include second charges applied in these circumstances. OFT regulation currently exempts business loans in excess of £25,000.

2.20 It is not the Government's intention to apply consumer protection regulation to business-to-business lending, and the draft regulation is specifically limited to loans extended to individuals. While this includes sole traders and unincorporated partnerships, the Government believes that, just as with first charge mortgage regulation, it is appropriate that these unincorporated small business borrowers benefit from consumer protection. Not all these businesses will be financially sophisticated and in all cases an individual's own home is at risk.

2.21 Nevertheless, the Government is aware that some large and sophisticated businesses operate as sole traders or unincorporated partnerships. In addition, the Government notes that some respondents were concerned that while loans to 'high-net worth' borrowers are currently exempt from OFT regulation, the proposed transfer of regulation to the FSA would remove this exemption.

2.22 While the Government recognises that the protections appropriate for these groups of borrowers may differ from other consumers, it is not persuaded that a specific exemption from FSA regulation is required. The FSA has the power to choose how best to apply conduct of business regulation, and already accommodates first charge lending to sole traders, unincorporated businesses, and high-net worth individuals. There are, for example, specifically tailored versions of many of its rules where a firm is dealing with a business borrower. In addition, if the business borrower has a group annual turnover of more than £1 million then it is entirely excluded from the conduct of business rules. The Government expects that the FSA will consider similar flexibility in its regulation of second charge lending.

Shared equity schemes

2.23 Several respondents noted that shared equity schemes often involve the use of second charges. A homebuyer using a shared equity scheme will typically take out a first charge mortgage from a lender to fund their share of the purchase, and be offered an additional second charge loan from a third party to cover the remaining equity in the property. The second charge on the property may be used to recover the shared equity provider's share of the purchase price in the event of a sale or re-mortgage, to secure the repayment of the loan at a discounted interest rate or after an interest-free period, or a combination of the two.

2.24 Schemes sponsored or run by the Government, including those that involve developers (such as HomeBuy Direct), involve second charge loans with controlled terms and conditions. The Government believes this provides sufficient protection for consumers, and that the additional burden that regulation would impose on developers participating in such schemes would not be justified. The Government therefore intends to exclude loans offered by developers through such schemes from FSA regulation.

2.25 Some developers operate private shared equity schemes with no Government involvement. These schemes are not necessarily designed to promote low cost home ownership, and are run on a purely commercial basis. While the Government believes such schemes have their place in assisting homebuyers, it is only right that they should be regulated in accordance with the rules governing the rest of second charge lending. Developers operating such schemes will therefore need to be FSA authorised and regulated.

Charges used to secure recovery of Government support

2.26 A small number of respondents queried whether the use of charges to secure recovery of Government support, such as legal aid or discounts when tenants exercise their right to buy social housing, may fall within the scope of the proposed FSA regulation. The Government does not intend to subject such charges to FSA regulation and will, where necessary, create exclusions to ensure this.

Private arrangements

2.27 Some respondents noted that individuals may sometimes arrange between them to secure a debt against an individual's home. For example, parents assisting their children with a deposit on a house may take out a second charge on the home to secure recovery of the deposit in the event of a sale. Occasional private arrangements, such as the above, would be exempt from FSA mortgage regulation because this regulation is limited to firms entering into such arrangements 'by way of business'[4].

2.28 On the other hand, where any form of credit or financial accommodation is provided on a commercial basis and secured against a person's home, it would be subject to regulation. The Government sees no case to exempt such arrangements from regulation since they expose consumers to risks very similar to those in more conventional second charge lending. Unregulated firms engaged in entering into such arrangements will need to seek FSA authorisation if they are not covered by existing exemptions.

Conclusion

2.29 The consultation showed that the case for the transfer of regulation of second charge lending from the OFT to the FSA is strong and carries the support of a majority of those whom it will affect. The Government is grateful to respondents for drawing attention to a number of

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[4] See http://fsahandbook.info/FSA/html/handbook/PERG/2/3 for guidance on the 'business' element.

issues in consultation. Some of these issues will be addressed through the changes to legislation discussed above, while on others the Government has concluded that no changes are required.

2.30 The Government has decided to proceed with the transfer of the regulation of second charge lending to the FSA, and intends to proceed with legislation to that effect, subject to Parliamentary approval. The commencement of this legislation will be suitably aligned with changes to the FSA's regulation of first charge mortgages that may follow from its *Mortgage Market Review*.

3 Buy-to-let mortgages

3.1 Buy-to-let mortgages are loans to fund the purchase of property that is or will be let to tenants. Buy-to-let lending has come to play an important role in financing the Private Rented Sector (PRS), and outstanding buy-to-let loans financed 35% of PRS stock in 2007[1]. The onset of the financial crisis saw a very rapid contraction in new lending accompanied by a sharp rise in arrears and repossession rates to levels above that in the wider mortgage market.

3.2 The Government's case for regulating buy-to-let lending in the consultation was fourfold:

- A small element of the buy-to-let sector has been the source of significant consumer detriment. A number of firms encouraged people to enter the PRS as landlords with limited understanding of the risks and responsibilities involved and often burdened with unaffordable loans. These people may now be suffering considerable financial hardship. The proportion of landlords new to the sector has been growing: 11% of landlords had been operating for under two years in 2001, rising to 16% in 2003, and by 2006 27% of landlords had joined the sector in the last five years.[2]
- Poor decisions by inexperienced buy-to-let landlords may not only damage their own financial positions, but also have knock-on effects on tenants, whose homes are at risk if their landlord is unable to keep up repayments on a mortgage. According to the Council of Mortgage Lenders, 5,700 buy-to-let properties were repossessed in 2009, constituting 12.4% of all repossessions.
- The FSA is currently reviewing its mortgage regulation regime, as set out in the *Mortgage Market Review*, and is considering changes to enhance prudential oversight and strengthen consumer protections in the mortgage market. If buy-to-let lending remains unregulated, poorer quality mortgage lending might move into the buy to market. This could take the form of poorer quality lenders entering the buy-to-let market, or lenders misrepresenting ordinary residential mortgages as buy-to-let mortgages to avoid regulation. Such 'gaming' could harm consumers and the mortgage market.
- The failure of buy-to-let lenders as a result of unsustainable business models has the potential to cause market disruption in just the same way as the failure of lenders in the wider mortgage market. Buy-to-let lending has become increasingly significant, and made up 11.2% of outstanding mortgages at the end of 2009[3]. The top two firms by market share in the buy-to-let mortgage market in 2007 were subsidiaries of firms that experienced considerable difficulties in the financial crisis[4].

[1] CML, CLG *Survey of English Housing*
[2] CLG *Private Landlords Survey*
[3] CML
[4] CML

3.3 The majority of respondents agreed that sections of the buy-to-let market had generated large consumer detriment. Most agreed this could be avoided through regulation designed to help consumers make a full and informed assessment of the risks of buy-to-let.

3.4 Responses were more mixed on the extent to which the failure of buy-to-let lenders could pose a threat to the wider markets, including the housing market, and on their role in the financial crisis. Some respondents noted that certain buy-to-let lenders had very poor lending practices and that these may have contributed to distortions in certain sections of the property market. Others argued that over the longer-term the majority of lending has been targeted at professional landlords and showed lower arrears rates than the wider mortgage market. The Government agrees that further work may be needed to clarify the role of buy-to-let in the financial crisis.

3.5 Alongside differing views on the systemic importance of buy-to-let, a majority of respondents were concerned about the effectiveness and the wider impacts of the precise form of regulation proposed. While most supported regulation to protect consumers, two concerns were raised, about the impact of regulation on professional landlords and about the role of advice in recent harmful practices. These are discussed below.

Impact on professional landlords

3.6 It is not the Government's intention to impose unnecessary restrictions on business-to-business lending in the buy-to-let market, and the proposed legislation sought to exclude such lending by limiting regulation to lending to individuals. However, many respondents noted that experienced, professional landlords with large portfolios often operate as individuals, and so would be brought within the scope of regulation. 74% of landlords in 2006 were individuals and couples, of which 17% reported that letting was their main business and 16% owned 10 properties or more[5]. Respondents argued that many such landlords may not need consumer protection and that their businesses could be hampered by the proposed regulation.

3.7 Some respondents raised the converse concern about limiting regulation to individuals. They noted that some potentially new buy-to-let landlords who would benefit from consumer protection may establish a company to manage their property and loans, perhaps on the advice of a lender, and so would not be covered by the regulation proposed.

Role of advice

3.8 The regulation proposed would regulate buy-to-let as a form of mortgage lending, limiting the scope of regulation to the advice and decision to take out a loan. Some respondents were concerned that this regulation may not be sufficiently broad in scope to capture the full range of financial decisions facing a potential new landlord. A large majority of respondents, for example, argued that the activities of property investment clubs should be regulated, including their overall advice to potential landlords on issues such as the kind of property to purchase.

3.9 Some respondents also believed that regulation should extend to the investment decision involved in buy-to-let. They noted that some new landlords fund property purchases from their savings rather than by taking out a loan, and that some consumers consider buy-to-let alongside or as an alternative to purchasing financial products such as equities and pension plans.

[5] CLG *Private Landlords Survey*.

Next steps

3.10 The Government is grateful for contributions to the consultation, and has carefully considered respondents' views. These views have informed the decision about how to proceed.

3.11 The Government remains convinced that it is right to introduce regulation of buy-to-let, to better protect consumers from the harmful practices seen in recent years and society from the potential wider impact of those practices on the financial markets. However, the Government is mindful of concerns about the regulation proposed in the consultation, especially in view of the importance of the private rented sector, and has decided to reconsider the scope and form of the regulation to address these issues.

3.12 The Government will examine how to ensure the impact of regulation on the buy-to-let market is proportionate, particularly for individual professional landlords. It will also consider how best to protect consumers from the range of possible causes of detriment that may result from buy-to-let including, if appropriate, the consequences of poor investment decisions as well as unaffordable borrowing.

3.13 The current Treasury consultation on investment in the private rented sector[6] seeks views on the respective roles of individual and institutional investors in the sector. The Government will reflect on the responses to that consultation, which closes on 28 April 2010, before any further consultation on regulating buy-to-let.

[6] *Investment in the UK private rented sector*, http://www.hm-treasury.gov.uk/consult_investment_private_rented_sector.htm.

4 Sale of mortgage books

4.1 The financial crisis has left a number of lenders under financial strain, and a growing number of distressed lenders are selling their mortgage portfolios (or 'mortgage books') as a way of limiting losses or raising additional funds. The sale of mortgage books also offers an avenue for non-distressed lenders to restructure their loan portfolio. The acquirers of mortgage books will not necessarily be subject to FSA regulation under the current framework, potentially leaving consumers exposed to unfair treatment that would not be permissible if their mortgage had remained with a regulated firm.

4.2 The Government believes the current situation represents a weakness in the existing regulatory regime, and creates a risk of consumer detriment. It is difficult to justify a reduction in the level of consumer protection following the sale of a mortgage book to an unregulated firm, especially since the consumer has no say in the matter. Respondents unanimously agreed with this view.

4.3 A small number of respondents noted that they were not aware of any unregulated purchasers of mortgage books currently exploiting the absence of FSA regulation to the detriment of consumers. Even if these respondents are correct that no such situation has yet arisen, the risk remains real and the Government believes it is right to address it before such a situation arises.

4.4 A significant number of respondents were concerned that the proposed new activity of 'managing' a mortgage contract was drawn too widely, and would include the activities of Special Purpose Vehicles (SPVs), including those used in mortgage securitisation. SPVs are legal structures separate to a lender that are created to ring-fence a portfolio of mortgages for investment purposes, which typically contract out the day-to-day administration of the mortgages to a third party.

4.5 It is not the Government's intention to require SPVs used in the wholesale mortgage markets to be FSA regulated if they are not responsible for decisions that may have a material impact on borrowers. The Government also agrees with respondents that a situation in which all SPVs were subject to regulation could hamper the operation of securitisation markets and of secondary markets for mortgage portfolios.

4.6 The Government is continuing work to explore how the proposed regulation would affect such markets, in light of the concerns raised in consultation. These markets are complex. Legal ownership is often separate from beneficial ownership that carries decision-making authority, and the legal structures deployed frequently involve many parties with highly dispersed rights and powers. The Government remains committed to addressing the potential for consumer detriment that has been identified, but further work is needed to resolve these issues. Revised proposals will be published later this year.

A Impact Assessment for Chapter 2

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	Impact Assessment for Financial Services Authority regulation of the second charge mortgage market	
Stage: Decision	**Version:** Final	**Date:** 26 March 2010

Related Publications:

Mortgage Regulation:Summary of Responses, *HM Treasury,* March 2010

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

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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. 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 overseen and enforced by the Office of Fair Trading (OFT). The Government intends to transfer regulation of second charge mortgages to the FSA, for both new and existing mortgages, giving the FSA powers to apply conduct of business and prudential rules to all mortgage lending. The change is intended to address market failure in the second charge mortgage market, which could harm consumers and financial markets.

What are the policy objectives and the intended effects?

The policy objective is a fair, stable and efficient market in second charge mortgages, including mitigation of the risks of market failure that the Government has identified. The transfer of regulation may also reduce the potential for problems arising from the different regulatory frameworks currently applying to first and second charge loans.

4.7 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: 26 March 2010

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:
One-off (Transition)	**Yrs**	FSA: £1 m - £5m one-off, £0 - £7.6m annual
£ 1 m – 95.3m	1	Lenders: £0 - £53.4m one-off, £0 - £12.2m annual
Average Annual Cost (excluding one-off)		Intermediaries: £0 - £36.9m one-off, £0 - 29.1m annual
£ 0 – 48.9m	10	**Total Cost** (PV) **£ 0 – 497.3 million**

Other **key non-monetised costs** by main affected groups: N/A

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by main affected groups:
One-off	**Yrs**	Better outcomes in the market: £0 - 22.4m annual
£ N/A	1	Freeing-up resources in the Office of Fair Trading: £1m annual
Average Annual Benefit (excluding one-off)		
£ 1 – 23.4m	10	**Total Benefit** (PV) **£ 0 – 201.4 million**

Other **key non-monetised benefits** by main affected groups:
Reduced risk 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) **- £ 497.3 m – 201.4m**	**NET BENEFIT** (NPV Best estimate) **£ 88.3m**

What is the geographic coverage of the policy/option?	UK			
On what date will the policy be implemented?	Subject to consultation			
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?	N/A			
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 – 192,000	Large £0 – 192,000
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* and the summary of responses, which are 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 November 2009, the Government consulted 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 considered 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. The Impact Assessment has been revised since the initial consultation to reflect the outcome of the consultation process.

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.

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.[1] There are now roughly 18 lenders in the market, with only four lenders writing more than £1 million of new business in July 2009.[2]

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 different regulatory frameworks currently applying to first and second charge mortgages. 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.

Option 2 – FSA regulation

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 the Government decided that Option 1 were more appropriate and maintained the existing the framework. As set out above, however,

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

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

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.[3] 90 per cent of the lenders and 90 per cent of the intermediaries hold FSA authorisation for regulated activities unconnected to second charge mortgages.

The Impact Assessment uses high upper bounds on the monetised costs of FSA regulation for lenders and intermediaries, but the Government expects the actual costs faced by businesses to be well below these limits. Since 90 per cent of firms affected by these changes are already FSA authorised, the best estimate of the aggregate costs faced by firms is around 10 per cent of the upper bounds discussed below. In contrast, the benefits of FSA regulation are largely non-monetised, because they consist in improved financial stability and better outcomes in the market. The best estimate of the benefits of FSA regulation is therefore taken to be the full monetised benefits calculated below, not because these specific benefits will necessarily be realised in full, but because they are the best monetary proxy for the expected non-monetised benefits. These assumptions are used to calculate the best estimate of the Net Present Value of the proposal in the summary sheet.

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.[4] 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 - £5 million (one-off) and £0 - £7.6 million (annual).

[3] 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.

[4] 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.

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 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.

The NERA estimates of the cost of FSA regulation did not include estimates of the cost to firms of bringing their practices in relation to existing first charge mortgages into line with FSA regulation. Since there was no legal requirement to change practices in relation to existing mortgages, NERA assumed firms would only make changes if they were financially beneficial, and so no costs to firms would arise. In relation to second charge mortgages, however, the Government intends to require firms to comply with FSA regulation in their administration of existing loans as well as new ones. This may lead to some firms making changes to their existing practices that result in costs to the firm. These costs will fall on lenders rather than intermediaries, since the latter are not involved in the administration of loans.

To estimate the potential size of the fixed costs of these changes, the Impact Assessment assumes as a worst case that lenders would incur the fixed costs that arise from changing practices for new loans again in full when changing their practices for existing loans. This is an upper bound on the likely costs, since there will be considerable duplication between the two sets of changes.

To estimate the potential incremental annual costs for existing loans, the Impact Assessment uses NERA's estimates of the incremental annual costs of administering first charge loans following FSA regulation. These costs amount to £2m a year, and relate to fair treatment and redress provisions and post-sale variations. Scaling these costs down to the second charge market gives an annual cost of £0.6m a year. The Impact Assessment then assumes that the average term of a second charge loan is approximately five years[5]. This means that in the first year following the regulatory change, there will be roughly five times as many existing loans to be administered as there will be new loans, and so the £0.6m annual cost above, which relates to new loans, could be incurred five times over in relation to existing loans. In the second, there will four times as many loans, and so on. This yields a profile of incremental administrative costs for the first five years following the change of £3m in the first year, falling to £0.6m in the fifth year and zero thereafter.

[5] Information provided by the Finance and Leasing Association

All these figures represent an upper bound to a range of costs to firms. 90 per cent of lenders and intermediaries active in the second charge mortgage market are already subject to FSA regulation. 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 Government expects the actual costs will lie near the bottom of this 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 posed 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.

A transfer of regulation for second-charge mortgages from the OFT to the FSA will free up resources in the OFT which are current deployed on regulating second charge mortgages. The annual cost of these resources is estimated to be around £1m[6], and this is recorded as a monetised benefit of Option 2.

A transfer may also 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, especially in light of the transfer of existing as well as new second charge loans to FSA regulation. 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.

[6] Information supplied by the Office of Fair Trading.

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.

The summary sheets show an estimate of the range of costs per firm of the proposal, broken down by size of firm. The costs faced by intermediaries are used as a proxy for the costs faced by small and micro firms, and the costs faced by lenders are used as a proxy for the costs faced by medium and large firms. The Government expects the actual costs faced by firms to lie near the bottom end of the ranges, for the reasons explained in the 'Costs' section of the Impact Assessment

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 List of respondents

B.1 The Government is grateful to the following organisations for their contributions to the consultation process:

Advertising Association

Advertising Standards Agency

Allen & Overy LLP

Association of Finance Brokers

Association of Independent Financial Advisers

Association of Mortgage Intermediaries

Association of Residential Letting Agents

Association of Short-term Lenders

Bank of Ireland

Barclays

Bradford and Bingley

British Bankers Association

British Property Federation

Building Societies Association

Citizens Advice

City of London Law Society

Clydesdale Bank

Consumer Credit Counselling Service

Consumer Focus

Co-operative Financial Services

Council of Mortgage Lenders

Exact Mortgage Experts

Finance and Leasing Association

Financial Services Consumer Panel

Glasgow City Council

Home Builders Federation

Homes for Scotland

Housing Rights Service

Institute of Credit Management

Intermediary Mortgage Lenders Association

Irwin Mitchell LLP

Joseph and Hepple-Wilson

Leeds Building Society

Legal and General Group

Lloyds Banking Group

Lovells LLP

Money Advice Trust

National Association of Commercial Finance Brokers

National Landlords Association

Nationwide Building Society

Paragon

Residential Landlords Association

Royal Bank of Scotland

Shelter

Skipton Building Society

Southampton University

The Law Society

Travers Smith LLP

Which?

Yorkshire Building Society

Respondents who wished to remain anonymous are not listed here.

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This document can be found in full on our website at:
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