FCA FINANCIAL CONDUCT AUTHORITY

Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Minor changes to our equity release rules CP16/21

Lead regulator: FCA

Date of assessment: 7/3/2017

Commencement date: 26/01/2017

Origin: Domestic

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? Whole of UK

Brief outline of proposed new or amended regulatory activity

In response to concern that our responsible lending rules may have contributed to the restricted development and take-up of lifetime products that allow a customer to make regular payments but switch to interest roll-up at any point we proposed amendments to our Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) to:

- disapply the requirement to conduct an affordability assessment where a lifetime mortgage customer has the option to switch to interest roll-up at any time;
- amend product disclosure requirements to ensure consumers receive information that is clear, fair and not misleading; and
- give firms the option of estimating the term used for illustrative purposes in the product disclosure on a different basis where their view is this would be more appropriate.

We also proposed to make consequential changes to the Glossary and the Supervision manual (SUP) to ensure a consistent description of interest roll-up lifetime mortgages and update mortality data referenced in MCOB for estimating the term of lifetime mortgages as these were out of date.

Before the introduction of affordability assessments after the Mortgage Market Review (MMR), lifetime mortgages where the consumer could pay interest and at a later date choose to switch to interest roll-up made up 15% of the lifetime mortgage market. After the introduction of affordability assessments this form of lending ceased. Although not specifically considered as part of the MMR CBA the cessation of this lending is consistent with the tightening expected as a result of the MMR. The MMR cost benefit analysis on the introduction of affordability assessments estimated it reducing lending across all mortgages by between 2.5% and 11.3%.[1]

Post-MMR, the lifetime mortgage market has focussed on providing solutions for 'asset-rich, cash-poor' consumers. As a result, products have tended to be structured as a loan whereby repayment of both capital and interest happens at the end – when the consumer dies or moves

[1] Mortgage Market Review: Feedback on CP11/31 and final rules, FSA, pA3:1.

into care – and is funded by sale of the property. This structure means that firms have never needed to invest in the systems, staff or resources necessary to judge if the consumer can afford to make regular repayments.

The market has identified that there are a number of potential additional customers who would like to release equity and who have a measure of existing income that would allow them to service interest payments. These consumers are not attracted to interest roll-up loans because of the ultimately expensive nature of interest roll-up as a charging approach, and the detrimental effect this will have on their housing equity. Several firms have told us that they believe that consumers would welcome a lifetime mortgage that allows them to make payments of interest for as long as this felt comfortable but also permits the consumer to choose to convert the loan to interest roll-up after this point. Pre-MMR offering of such loans confirms the market potential.

Without the rule change that is the subject of this IA any provider would need to assess the affordability of the lifetime for each individual borrower even though (i) the consumer would be under no contractual obligation to keep making the payments of interest and (ii) when opting to switch to interest roll-up the consumer would be rendering any consideration of their ability to make regular repayments irrelevant.

The costs involved in developing systems to assess affordability, and to recruit and train relevant staff to carry out this task has been a strong disincentive to lifetime mortgage providers having a lifetime mortgage that allows a customer to make regular payments but switch to interest roll-up. The market was first facilitated by a modification by consent from our existing rules that we published in 2016 and the subsequent rule changes hardwire this approach.

Which type of business will be affected? How many are estimated to be affected?

Lifetime mortgage providers. There are currently 11 such firms in the market.

Price base year	**Implementation date**	**Duration of policy (years)**	**Business Net Present Value**	**Net cost to business (EANDCB)**	**BIT score**
2017	26/1/2017	10	34.66	-3.6	-18.0

Please set out the impact to business clearly with a breakdown of costs and benefits

Costs		***Benefits***	
Amending KFI (one-off)	*£54,750*	*Additional profit (undiscounted)*	*£42,656,785*
		Disapplying requirement to conduct affordability assessment (undiscounted)	*£251,819*

Changes for lifetime mortgages that allow a customer to make regular payments but switch to interest roll-up at any point

Firms that offer relevant lifetime mortgages will incur costs updating their Key Facts Illustration (KFI). In order to minimise this cost, we have given firms flexibility about where they place the table displaying interest roll-up after the illustration of interest payments.

We asked the five firms that are offering or considering offering relevant lifetime mortgages about the costs that they had incurred, or anticipate incurring. We also asked them to estimate the additional volume of sales they expected, disregarding those sales that in the absence of the changes would have been made as a standard interest-only or interest roll-up product(i.e. so our assessment only reflected truly new sales arising from the changes).

Four of the five firms gave us information regarding the costs of amending the KFI. These costs ranged from zero (the firm had yet to start trading and was building their system for the purpose of offering these products) to £24,000 with an average of £10,950. We estimate the market cost of these changes to be £54,750.

This is within the range found in the Oxera study of costs of the implementation of MMR. The costs for amending the KFI in that study ranged from £845 (£977 today) for small firms, £1,200 (£1,388) for large firms and £170,000 (£196,621) for very large firms.

Given we are confident that the cessation of this form of lending was a direct consequence of our introduction of affordability assessments; we believe that the benefits accruing to firms from the disapplication of this requirement is a direct benefit.

One approach to quantifying this benefit would be to assume that after the disapplication of the requirement to conduct affordability assessments the market for these lifetime mortgages would return to its pre-MMR state of 15% of the lifetime mortgage market. In the last four quarters, the lifetime mortgage market lent £1,564,195,339. 15% of this is £234,629,301. We were concerned, however, that this would be overly optimistic, given that the products may be substitutable in some cases. Therefore, we have explored a different approach to estimating benefits by asking the firms that had expressed interest in launching such products what was the expected volume of additional lending (i.e. new demand that wouldn't be met by the firm's existing range of interest roll-up options). This provided a more conservative estimate of the sales in the market.

Three of the five firms gave us information about the additional sales they anticipated because of the rule changes. The three firms gave us estimates for the next five years. These ranged from zero to £40 million in year 1 rising to a range of £37 million to £97 million in year 5. In order to reach a ten year estimate, we have assumed no growth or fall in sales after the first five year period. Overall, we estimate sales of £64m, £107m, £146m, £166m and £194m from 2017 to 2021 respectively and £194m from then on.

The expected increase in lending volume is sizeable but, as described above, this is based on a view from firms that the target audience for lifetime mortgages will be considerably expanded if consumers with some retirement income can access products that allow them to pay interest while they are able to and therefore postpone the equity erosion that is a consequence of more traditional equity release products. Furthermore, we believe we have been appropriately conservative in our description of the benefits – using only the data from the three firms that gave us expected business volumes and not multiplying these up to reflect the whole market. The estimate on this basis is lower than if the market for these lifetime mortgages returns to its pre-MMR state of 15% of the lifetime mortgage market.

To estimate the additional profits that firms will earn as a consequence of the changes, we use an assumption that firms expect to make profit of at least 10% of the value of the loan, over the lifetime of the loan. This estimate is based on our broader supervisory knowledge of firms' business models and also on a number of supervisory conversations with firms about the impact of this rule change. For example, firms would expect to make £6.4m of profit from mortgages sold in 2017 (64x10%). However, to account for the profits, we need to amortise these profits over the life of the mortgages and only include profits that are received in the period of the reporting period. We do this by assuming that profits are spread over a period of

25 years, taking into account the fact that firm will have discounted these profits at their cost of capital. We use a conservative rate for the cost of capital, which reduces the size of the benefits, of 3.5%. The firms affected will have a higher cost of capital than this. Given we do not expect any growth in sales from 2021, and firms gave us the estimates of sales in nominal terms, we deflate profits using the GDP deflator. We therefore estimate profits to be £0.4m in 2017, increasing to £8.3m in 2026.

Disapplying the requirement to conduct affordability assessments will also bring a cost saving to firms. Based on the costs of introducing an affordability assessment for the second charge mortgage market estimated by KPMG, we estimate the cost saving to the market of disapplying this requirement as £9.35 per transaction (adjusted for inflation to £9.61). Using the predicted sales volumes given to us by firms and assuming the average loan size for these remains the same as for lifetime mortgages as a whole, we estimate the ongoing benefit of disapplying the requirement to conduct affordability assessments to be £251,819 over the ten year period.

Mortality data changes

After discussion with firms, we believe that updating the source of mortality data will have a minimal cost, as it does not involve any system changes.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

The CP is found here: https://www.fca.org.uk/publications/consultation-papers/quarterly-consultation-paper-no-14-cp16-21