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Financial Services Authority

Mortgage Market Review:

Arrears and Approved Persons

January 2010

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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 30 April 2010.

You can submit your comments electronically using the form on the FSA's website (www.fsa.gov.uk/pages/library/policy/CP/2010/cp10_02); or you can respond by email: cp10_02@fsa.gov.uk

If you wish to respond by letter, please send your comments to the person named at the end of each chapter and set out below:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure. A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, you can obtain paper copies by calling the FSA order line: 0845 608 2372.

1 Introduction

- 1.1 In October 2009 we published our *Mortgage Market Review* Discussion Paper (DP) 09/3¹, where we set out the case for regulatory reform of the mortgage market. In the DP we raised a number of issues that we believe have resulted in consumer detriment in the market and the options for addressing them. There were areas of the DP where we stated our intention to move quickly to consult and this Consultation Paper (CP) addresses two of those issues: strengthening of our arrears rules and the extension of the approved persons regime.
- 1.2 The first part of this CP sets out our proposals to strengthen the current arrears rules. An active review programme of lenders' compliance with our arrears rules has been carried out over the last two years, covering a cross section of the mortgage market. It is clear from this work that consumers are not being treated fairly when they fall into payment difficulties, resulting in poor outcomes for consumers. Some of those outcomes were so poor that we have already taken enforcement action against one firm² with another six firms referred to our enforcement division. To address these issues, these proposals clarify the requirements already in place with the addition of some new measures.
- 1.3 In Chapter 5 of the DP, we outlined the research conducted by the Association of Chief Police Officers (ACPO) in 2008, showing the extensive involvement of organised crime in property and mortgage fraud. While we recognise there will be many honest mortgage intermediaries in the market, the distribution and advice channel has had a key role to play in fraud. For this reason, the second part of this CP sets out our proposals to extend the approved persons regime (the regime) to home finance business. We consider those individuals advising and/or arranging, to the extent they are 'bringing about a transaction', to be conducting key functions and as such we propose to bring them within the scope of the regime. We believe this will have a positive impact on consumer protection by improving standards and increasing transparency within the industry. The proposals aim to reduce the risk of unsuitable individuals operating within the industry and to make individuals undertaking the relevant activities accountable for their actions, allowing us to sanction those that fail to meet our requirements.

1 DP09/3: *Mortgage Market Review* (October 2009): www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

2 We fined GMAC-RFC £2.8 million and required it to pay customers redress of up to £7.7 million for unfair arrears charges: www.fsa.gov.uk/pubs/final/gmac_rfc.pdf A further six enforcement cases are pending.

Part 1

Proposed changes to current mortgage arrears rules

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Part 1 – Appendix 1: Draft rules

2 Overview

- 2.1 Chapter 7 of our *Mortgage Market Review* Discussion Paper (DP) dealt with arrears and repossessions and we set out a number of our concerns about firms' arrears practices and charges.
- 2.2 As we explained in the DP, our review of lenders' compliance with our arrears-handling rules³ indicated that our high level approach has not sufficiently protected consumers. Some of the outcomes were poor enough that we felt it necessary to take immediate action to strengthen our rules.
- 2.3 Part 1 of this paper sets out and seeks views on some proposed enhancements to the current arrears rules, and includes the draft rules and guidance in line with our proposals.

Regulatory proposals

- 2.4 The proposed changes to the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) are:
 - clarifying our existing requirements in respect of the continued application of a monthly arrears charge where a customer has entered into an Arrangement to Pay (AtP);
 - converting MCOB 13 forbearance guidance into rules and introducing a reference to the various government schemes in place to help borrowers in payment difficulties;
 - clarifying our existing requirements in relation to the practice of charging Early Repayment Charges (ERCs) on arrears fees and charges and the interest levied on the arrears charges;
 - adding a new rule to require telephone calls to form part of the arrears records kept by firms and extending the overall record keeping period from twelve months to three years; and

³ Thematic review into lenders compliance with arrears-handling rules (2008/09): www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/mortgage_arrears_1/index.shtml

- clarifying our existing requirements that payments from customers be allocated to clearing missed monthly payments, leaving charges to be paid later.
- 2.5 The government is consulting on the future regulation of second charge mortgages. Subject to the views it receives, the proposal is that responsibility should pass from the Office of Fair Trading (OFT) to us. In this event, we would consult on the appropriate regime for the second charge mortgages we would regulate. As part of this, we would consider what requirements may be appropriate for arrears handling, which could include similar proposals to those contained in this CP.

Pre-consultation

- 2.6 We discussed the proposals in paragraph 2.4 with a range of stakeholders, including the relevant trade bodies, consumer groups and firms. We have also consulted the FSA Consumer Panel, Practitioner Panel and Smaller Businesses Practitioner Panel. We would like to thank all those who have contributed to these discussions, which have helped to inform our proposals.

Who should read this paper?

- 2.7 Part 1 of this CP will be of interest to mortgage lenders, mortgage administrators, relevant trade bodies and consumer representatives.

Next steps

- 2.8 This consultation will close on 30 April 2010. We will then finalise our proposals in light of the responses received with a view to publishing a Policy Statement in June 2010.

CONSUMERS

These proposals will be of interest to consumers who have an FSA-regulated mortgage and consumer bodies representing the interests of these consumers. In particular, consumers should note the forbearance options that we require firms to consider when dealing with customers in financial difficulty and the continuing prohibition of some arrears-charging practices.

3 Background

- 3.1 Mortgage regulation came into force on 31 October 2004, when firms became subject to the requirements of the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB).⁴
- 3.2 Our existing mortgage arrears rules require firms to have a written policy and procedures in place to ensure that consumers in financial difficulties are treated fairly. The rules set out the factors that we consider central to such policy and procedures. These include using reasonable efforts to reach agreement with the consumer, adopting a reasonable approach to the time over which any shortfall in payments can be made good and only taking repossession action where all other reasonable attempts to resolve the position have failed.
- 3.3 The aims behind our rules were:
 - to improve the information provided to consumers by setting minimum standards (for example, on the type and frequency of information to be provided); and
 - to consolidate a number of voluntary good practice standards existing in the market when mortgage regulation was introduced.
- 3.4 Those practice standards had been developed in response to the adverse impact of the high levels of repossessions in the late 1990s on market and consumer confidence. We thought it appropriate to require firms, at a high level, to follow rules based on those good practice standards. This was to allow firms to adopt alternative approaches that were fair and meet the reasonable needs of both the consumer and the firm, recognising there would be cases where the consumer had no reasonable prospect of getting back on track and that dealing with the inevitable sooner rather than later was in everyone's best interests. Also there would be cases where flexibility and forbearance would lead to much better outcomes for both the consumer and lender.
- 3.5 When regulation was introduced, the market was relatively benign and the number of consumers in arrears was low. Worsening market conditions, however, gave us cause for concern about the way borrowers were being treated by firms and in December 2007 we commissioned a review of lenders' compliance with our rules.

⁴ Mortgage and Home Finance: Conduct of Business Sourcebook (including rules on dealing with arrears): <http://fsahandbook.info/FSA/handbook/MCOB.pdf>

That review has been expanded and continues, but our initial work found that the high level, flexible nature of the rules was being exploited by some firms resulting in poor outcomes for consumers. As part of our response we published guidance on good and poor practice and have issued other material (for example speeches and press releases) to help clarify the standards we expect of firms.

- 3.6 Despite this we continue to see evidence of poor outcomes. As a result, we have referred seven firms to our enforcement division.⁵ To help ensure better outcomes for consumers we propose to strengthen the current arrears-handling rules. We are also proposing changes to the arrears-charging rules.

⁵ We fined GMAC-RFC £2.8 million and required it to pay customers redress of up to £7.7 million for unfair arrears charges: www.fsa.gov.uk/pubs/final/gmac_rfc.pdf A further six enforcement cases are pending.

4 Proposed changes

- 4.1 Here we set out our proposals for strengthening the current rules in the Mortgages and Home Finance: Conduct of Business Sourcebook (MCOB). The proposed amendments are set out in Part 1 – Appendix 1.

Clarifying our existing requirements in respect of the continued application of a monthly arrears charge where a customer has entered into an Arrangement to Pay the arrears

- 4.2 The current provisions within MCOB require arrears charges to be a fair reflection of the additional administration costs faced by lenders and not a way to increase profits or offset costs from other parts of the business. Some firms are charging customers for being in arrears even though the customer has made an arrangement to repay the outstanding arrears over a period of time. These charges (which are typically between £30 and £50 a month) do not reflect the extra costs of administration, as once the direct debit is set up to collect the extra payments no further work is necessary.
- 4.3 As the thematic review found that not all lenders had recognised that this is inappropriate, we propose to add further clarification to our existing high level requirements through an evidential provision.⁶ This will make it clear firms should not levy an arrears charge where customers have a performing arrangement to repay the arrears in place.
- 4.4 We recognise that some customers will agree to an arrangement and pay by means other than a direct debit, which presents a certain level of administration work on the part of the lender. Any charge levied in these circumstances should represent the cost of the additional administration work in accordance with our requirements to treat customers fairly.
- 4.5 The Mortgage Market Review proposes a more interventionist and robust approach to excessive and unfair charging practices. As part of this we are conducting a review of charging and pricing structures, to help us develop a better understanding and to allow us to identify and challenge unfair and excessive practices.

⁶ For further information regarding evidential provisions see FSA Handbook: Readers Guide: an introduction to the handbook: <http://fsahandbook.info/FSA/pdf/rguide.pdf>

Q1: Do you agree with our proposal to clarify our requirements to prohibit lenders from levying an arrears charge where customers have a performing arrangement to repay the arrears in place?

Converting MCOB 13 forbearance guidance into rules

- 4.6 The findings from our thematic reviews demonstrated that firms were often too quick to take repossession action, focusing too strongly on recovering arrears without reference to the borrower's individual circumstances. In addition, some firms explored very few forbearance options before taking legal action against borrowers. We observed these poor practices across the mortgage market, though it was more prevalent among specialist lenders and third-party administrators.
- 4.7 We expect firms to take care to consider the individual circumstances of borrowers in payment difficulties and we have found that in a large number of cases lenders are not doing this. This proper consideration is crucial to arriving at the most suitable forbearance options for a borrower. Equally this information is important in establishing whether repossession is in fact the best solution. In such cases it is clearly better for both parties to deal with the inevitable sooner rather than later to avoid consumers ending up with the same outcome and a large amount of additional costs and charges to repay.
- 4.8 Currently MCOB 13.3 consists of rules, guidance and evidential provisions. We propose to change most of the evidential and guidance provisions into rules to help ensure better outcomes for consumers.
- 4.9 This means that we intend to change MCOB 13.3.2E so that firms ensure they not only have a written policy and procedure on fair customer treatment but also deliver on these standards when dealing with customers in payment difficulties. This proposal will help ensure that firms are adopting a reasonable approach to borrowers in payment difficulties in practice and not just including these requirements within their policy and procedures.
- 4.10 In addition firms will be required to consider the various government schemes in place to help borrowers in payment difficulties.⁷ There will of course be cases where a firm may not be participating in certain schemes and we do not expect firms to consider those. But they must consider other relevant and appropriate schemes that are available to help borrowers in arrears, including Support for Mortgage Interest (SMI). We believe these changes should help ensure that borrowers in financial difficulties are treated fairly and are offered a range of solutions to help them to manage their way out of arrears.
- 4.11 This change will also address a concern identified by our thematic work about the impact of securitisations on the treatment of customers in arrears. Some lenders told us that they felt constrained in the options they could offer to distressed borrowers due to restrictions set out in securitisation covenants. As the rules will require firms to

⁷ Details of current government schemes:
http://direct.gov.uk/en/MoneyTaxAndBenefits/ManagingDebt/DebtsAndArrears/DG_10013261

consider forbearance options, any firms entering into securitisation agreements that prevent this will be acting in breach of their regulatory obligations.

- 4.12 We have also found evidence of lenders automatically capitalising arrears. We therefore propose to change MCOB 13.3.5G from guidance to a rule within 13.3.4. We believe that turning this into a binding rule will help ensure firms are not automatically capitalising arrears. This is a practice that prevents borrowers from being given the opportunity to resolve their payment difficulties. Capitalisation can also hinder the accurate reporting of arrears figures.

Q2: Do you agree with our proposals to convert current MCOB guidance to rules?

Q3: Do you agree that regard to government schemes should be included as a potential forbearance option?

Clarifying our existing requirements in relation to the practice of charging Early Repayment Charges (ERCs) on arrears charges and the interest levied on the arrears charges

- 4.13 We require any arrears charges to be a fair reflection of the cost of additional administration and not a way to increase profits or offset costs from other parts of a firm's business. Currently, many firms are including arrears charges, and the interest levied on these charges, in ERC calculations. In this situation the customer has already incurred a charge, is subsequently charged interest on that charge and then, in addition, subjected to an ERC. This is adding to the borrower's indebtedness at a time when they are least capable of paying.

- 4.14 The table below illustrates two poor practices in the market currently and the approach that reflects our current high level requirements and principles on calculating an ERC in line with our requirements.

Elements included in the ERC			
	Poor practice example 1	Poor practice example 2	Regulatory expectation
Original loan	✓	✓	✓
Further advance	✓	✓	✓
Missed payments	✓	✓	✓
Arrears charges	✓	✗	✗
Amount accrued in interest on arrears charges	✓	✓	✗

✓ = ERC charged

✗ = ERC not charged.

Q4: Do you agree with our proposal to use guidance to clarify our current requirements prohibiting the inclusion of arrears charges and accrued interest on the charges within ERCs?

Additional record keeping rule for recording telephone calls and extending the overall record keeping period from twelve months to three years

- 4.15 The current rules require firms to keep an adequate record of their dealings with a borrower in payment difficulties for at least one year after the arrears have been cleared.
- 4.16 In our review of firms' arrears-handling practices, we discovered that some firms did not keep recordings of telephone calls, while others made recordings but had difficulty in retrieving them. Because the telephone calls give such important information about the way in which frontline staff actually interact with customers, they are essential to understanding whether the customer has been treated fairly. So we propose to require lenders to record telephone calls as part of these record-keeping requirements.
- 4.17 In addition, we propose to require firms to keep all arrears records (telephone calls, paper and electronic) for longer. While it may be argued that, unlike the consequences of poor pension or investment advice, the detriment from inadequate arrears handling should become apparent fairly quickly, borrowers may not realise for some time that they have been treated unfairly. So we think the minimum record-keeping period should be three years from the date on which the relevant payment shortfall or sale shortfall has been cleared. That would also make it easier for firms and the FSA to review outcomes over an extended period, which seems appropriate given the poor customer outcomes we have seen in many firms.

Q5: Do you agree with our proposals to implement record-keeping requirements for telephone calls?

Q6: Do you agree with the extension of the period for all arrears records from twelve months to three years?

Clarifying our existing requirements that payments from customers be allocated to clearing missed monthly payments, leaving charges to be paid later

- 4.18 Customers who are in severe financial difficulty, or in occupations where their earnings are irregular, may not feel able to commit to an arrangement to pay. Instead customers tend to pay arrears off as and when surplus money is available. In these cases some firms levy a monthly arrears charge, together with other associated charges, which erode the extra amount the customer has paid. As a result they remain in arrears over a longer period. Where these charges are added to the arrears balance, customers take longer to recover from an arrears position, which means they are in arrears for many

more months, attracting more charges, and often end up stuck in a cycle of only managing to pay the charges. This can also affect their credit rating and, in the long term, subject them to less choice when re-mortgaging or subsequently applying for credit.

- 4.19 Under Principle 6 we require the fair treatment of consumers in payment difficulties. Consequently, firms must not add arrears charges to the mortgage arrears balance, leaving the payment of charges until the customer has recovered from their arrears position, or repossession has taken place and the loan has been cleared. The thematic review found that not all lenders had recognised this practice as unfair. Therefore we propose to further clarify our existing requirements by adding a rule to ensure firms understand our current requirements.

Q7: Do you agree with our proposal to clarify our current requirements for borrower payments to be allocated to paying off arrears before charges?

Arrears statements

- 4.20 As part of the thematic review of firms' arrears practices, we assessed how firms provided information to borrowers, as required under MCOB 13.4 and 13.5. We found that a number of firms' arrears statements were difficult to understand. For example they:

- included descriptions of fees that are inconsistent with the tariff of charges;
- had multiple debit and credit entries for one fee when it is being added to the mortgage account; or
- did not make clear whether the outstanding debt figure on the statement includes the arrears and associated charges.

- 4.21 We published these findings as part of the good and bad practice review in August 2008 and, as a result, we expect firms to be reviewing the information that consumers receive.

Q8: Would our proposals to change MCOB affect firms' ability to improve consumer understanding of the arrears statement?

Transitional arrangements

- 4.22 We have not included transitional provisions within the draft rules as the majority of these proposals are just adding clarification to the existing requirements. However, the new requirement of recording telephone calls and the extension of the current period that arrears records should be kept (from twelve months to three years) may require a transitional period. Therefore we invite firms to provide information about the time they would need to comply with these new requirements, while recognising the importance of early implementation.

Q9: What should the timescales be for implementing call recording and retention?

Contact

Comments should reach us by 30 April 2010. Please send them to:

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5 Consultation questions

- Q1: Do you agree with our proposal to clarify our requirements to prohibit lenders from levying an arrears charge where customers have a performing arrangement to repay the arrears in place?
- Q2: Do you agree with our proposals to convert current MCOB guidance to rules?
- Q3: Do you agree that regard to government schemes should be included as a potential forbearance option?
- Q4: Do you agree with our proposal to use guidance to clarify our current requirements prohibiting the inclusion of arrears charges and accrued interest on the charges within ERCs?
- Q5: Do you agree with our proposals to implement record-keeping requirements for telephone calls?
- Q6: Do you agree with the extension of the period for all arrears records from twelve months to three years?
- Q7: Do you agree with our proposal to clarify our current requirements for borrower payments to be allocated to paying off arrears before charges?
- Q8: Would our proposals to change the rules affect firms' ability to improve consumer understanding of the arrears statement?
- Q9: What should the timescales be for implementing call recording and retention?
- Q10: Do you have any comments on our CBA?
- Q11: Do you agree with the compatibility statement?

6 Cost benefit analysis

- 6.1 Sections 155 and 157 of FSMA require us to perform a cost benefit analysis (CBA) of our proposed requirements and to publish the results. Specifically, we are required to publish ‘an estimate of the costs together with an analysis of the benefits’. While two proposals (b and c below) are new requirements for firms, the remaining proposals (a, d and e below) are clarifications of existing requirements. Since these do not introduce new requirements, these should not have incremental impacts. However, in practice, firms currently not interpreting the regime in this way will need to make changes and costs will materialise for them as a result. Similarly benefits will accrue from the changes these firms make. However, these costs and benefits are not incremental since these should have been brought about when the MCOB regime was first implemented.
- 6.2 The proposals analysed are:
- a. clarifying our existing requirements in respect of the continued application of a monthly arrears charge where a customer has entered into an Arrangement to Pay (AtP);
 - b. converting MCOB 13 forbearance guidance into rules and including reference to the various government schemes in place to help borrowers in payment difficulties;
 - c. adding a new rule to require telephone calls to form part of the arrears records kept by firms and extending the overall record keeping period from twelve months to three years;
 - d. clarifying our existing requirements in relation to the practice of charging (ERCs) on arrears charges and the interest levied on the arrears charges; and
 - e. clarifying our existing requirements that payments from customers be allocated to clearing missed monthly payments, leaving charges to be paid later.
- 6.3 Firms that administer mortgage lending will be impacted by the rules. This includes banks, building societies, specialist lenders and third-party administrators. Firms that carry out outsourced mortgage handling for mortgage lenders will also be affected. We estimate up to 275 firms may be affected.⁸

⁸ This figure is calculated from the number of firms with the regulated permission for ‘mortgage administration’, taken from the FSA’s register.

- 6.4 To assess the impact on firms, a questionnaire was sent to a sample of 20 firms to collate relevant costs that might be incurred as a result of our proposals. We have received 11 responses from firms at this stage (from banks, building societies and mortgage outsourcing firms, representing a total of about 30 mortgage providers).

Clarifying our existing requirements in respect of the continued application of a monthly arrears charge where a customer has entered into an Arrangement to Pay

Compliance costs

- 6.5 In our survey, most respondents indicated they do not impose a monthly arrears charge on customers that have an arrangement to pay. This clarification would not have any significant cost implications for them. Only two respondents indicated the clarification would have costs.
- 6.6 For the two firms that indicated a cost, the first indicated that, although it waives such fees at the moment, the clarification might require changes to their terms and conditions (leading to one-off costs of £50,000 for legal costs). They indicated reprint costs of around £10,000 and, more significantly, costs of mailing new terms and conditions to all customers of around £0.5m. They noted that these costs would be minimised if sufficient lead time were given to run down stocks. However since this proposal clarifies what is already a requirement no transitional period is envisaged. The second respondent indicated a large total costs figure without giving further details, making it difficult to assess its reliability. We are following up on this to obtain more information.
- 6.7 For firms currently imposing an arrears charge for consumers with an Arrangement to Pay, if any, the clarification would impose an ongoing cost in the form of lost revenue. Arrears charges vary between £30 and £50, so for an average arrears charge of £40 per month, a firm would incur an ongoing cost of £480 per customer in an AtP per year. This cost would be a transfer to affected consumers.

Benefits

- 6.8 Our survey indicates that most firms no longer apply a monthly arrears administration charge. From our thematic review in 2007, we are aware that some firms, particularly specialist lenders, did charge such fees. The fact that many firms do not now apply the monthly charge, may be in part due to our focus on arrears handling in the last two years.
- 6.9 Firms that did not respond to our questionnaire may still be charging an arrears fee. Consumers of these firms would benefit from the receipt of the transfer from the firm of the amount of the arrears fee that is no longer charged (estimated at £480 per year per customer with an AtP, see paragraph 6.7). This would also lessen the probability of default and of the negative impacts that can follow from this.

- 6.10 For consumers of firms that have already discontinued the practice, there are no short-term benefits from the clarification. However, despite widespread current compliance, without material changes in consumers' behaviour, firms' incentives and continued FSA attention, we might expect the re-emergence of the targeted practices in the longer term. The clarification provides a longer-term benefit to consumers by acting to prevent this.

Converting MCOB 13 forbearance guidance into rules and including reference to the various government schemes put in place to help borrowers in payment difficulties

Compliance costs

- 6.11 Most respondents indicated that they currently discuss with customers all options in MCOB 13.3.4G and mention available government schemes where this is relevant to customers' circumstances. Despite the fact that not all firms are participating in current government schemes, all of them are aware of their existence and are able to refer customers to sources of further information where this is appropriate.
- 6.12 Although firms indicated that they are currently covering options in MCOB 13.3.4G with customers, a few respondents stated that they will incur costs as a result of this proposal because of the additional time needed to comply with MCOB 13.3.4G forbearance rules and include a reference to the various government schemes.
- 6.13 Estimates of an additional 3 – 15 minutes per customer were provided. Depending on the firm's requirements, this can include changes to documentation and record-keeping, as well as the incremental time needed to respond to borrowers being more aware of various government schemes. Most of this additional work will be done by administrator level employees whose hourly rate has been estimated as £10 (i.e. average £16,000 p.a.) including a standard overhead of 30% in accordance with the Standard Cost Model (SCM).⁹ Therefore, we estimate the cost to firms to be £0.50 – 2.50 per customer in arrears. Given the latest available data on arrears (as of Q3 2009), there were approximately 210,000 mortgages in arrears. Although it is very difficult to gauge how much interaction a firm will have with customers due to differing levels of consumer engagement, we have assumed each customer in arrears has one discussion per year. So, as a result of this proposal, the overall costs to the industry will be in the region of £105,000 – £525,000 per year. However, these estimates represent an upper bound for compliance costs as not all customers in arrears would be affected by the proposal.
- 6.14 Furthermore, three respondents indicated that they will have other costs as a result of the proposal. One-off costs for firms varied between £10,000 and £150,000, with total one-off costs for firms responding amounting to about £213,000. Depending on the firm's requirements, one-off costs could be for either staff training, printing documentation and/or updating procedures.

9 Real Assurance 2006 study on administrative burdens.

- 6.15 Further to the additional time required, other ongoing costs of the proposal for respondent firms were estimated at between £1,000 and £44,000 per firm per year, with the total for firms responding amounting to about £70,000 per year. Depending on the firm's requirements, ongoing costs could be for either monitoring and/or record-keeping.
- 6.16 The estimates of the total costs for firms responding to the questionnaire are £213,000 for one-off costs and £175,000 – £595,000 for ongoing costs.
- 6.17 Extrapolating a cost for all firms in the market yields expected one-off costs of £590,000 and £485,000 – £1.65m for ongoing costs.¹⁰
- 6.18 In addition, one respondent indicated one-off costs out of line with other firms without giving further details, making it difficult to assess the reliability of these figures. We are following up on this to obtain more information.

Benefits

- 6.19 This proposal will ensure that firms are adopting a reasonable approach to borrowers in payment difficulties in practice and are not just including these requirements in their policy and procedures.
- 6.20 The proposal aims to ensure that more people are able to receive help in dealing with payment difficulties by reaching an agreement over a method of shortfall repayment and/or by increasing participation in the various government schemes where this is relevant to customers' circumstances. This would lessen their probability of default and of the negative impacts that can follow from this.
- 6.21 By making it explicit in the rules that firms must, as a minimum, be prepared to use a particular range of hardship tools, the proposal will make it much more difficult for firms to conclude securitisation deals that are at odds with their duty to treat customers fairly.
- 6.22 The proposal will also help ensure firms are not automatically capitalising arrears and preventing borrowers from being given the benefit of arrears management to understand the underlying reason for arrears and the possible forbearance options available. Capitalisation can also hinder the accurate reporting of arrears figures.
- 6.23 Converting the guidelines to rules may also facilitate enforcement, therefore increasing compliance by firms through deterrence effects.

10 Respondent firms had 36.1% of the share of arrears in the market (Q3 2009). Throughout this cost benefit analysis, we use this figure to extrapolate total costs to the entire affected population of firms in the market from total respondent firm costs.

Adding a new rule to require telephone calls to form part of the arrears records kept by firms and extending the overall record keeping period from twelve months to three years

Compliance costs

- 6.24 From our survey, respondents noted significant one-off costs from the introduction/modification of systems for recording and retaining telephone calls. Some respondents have systems already in place, but would need to extend these to cover all necessary calls, and some would need to modify existing systems to keep calls for the proposed period of three years. For respondents not already in line with the proposed change, one-off costs for institutions varied from between £60,000 and £1m per firm, with total one-off costs for the population of firms affected amounting to about £6.1m. A few firms mentioned that they are planning to or are in the process of introducing such systems for their own purposes, so costs here should be read as an upper bound for the incremental one-off costs of the proposal. Depending on the firm's requirements, one-off costs could be for either recording a greater numbers of calls and/or for keeping the calls for the three-year period. Costs were of similar magnitude for both.
- 6.25 Ongoing costs of the proposal were estimated to be lower by respondents, varying between £6,000 and £100,000. However, it is not very clear from responses how these costs would be incurred. Extrapolating ongoing costs for the whole market from this gives expected costs of £17,000 – £277,000.
- 6.26 One respondent is already in line with the proposed change and would not incur significant costs. Another, despite already recording calls and keeping them for over three years, expressed that it would incur significant costs, without providing an estimate, to ensure its recorded calls are easily retrievable.
- 6.27 A few other respondents indicated that they would require further significant investment in the IT system to allow full and readily retrievable call recordings. But none provided an estimate of costs.
- 6.28 Our thematic review indicated that lenders retain files on arrears cases for internal purposes for at least three years from the date on which the relevant payment shortfall or sale shortfall has been cleared. This indicates that the requirement to extend the record-keeping period from one to three years should impose de minimis incremental costs on firms.
- 6.29 With improved record-keeping of telephone calls by firms, costs could be imposed on our supervision and enforcement teams from additional searching and processing time. Our staff, however, indicated to us that this should not impose incremental costs, as they should be able to reallocate current resources to absorb the additional burden.

Benefits

- 6.30 Our supervision and enforcement divisions indicated that full and readily retrievable call recordings of interactions between supervised firms and their customers would have helped supervisors test (and if necessary take further action to enforce) fair

treatment of mortgage borrowers in arrears. FOS also indicated that if telephone records were available they would use these in their decisions on validity of customers' complaints.

- 6.31 By way of example, a few firms were recently the subject of an FSA supervision visit and detailed review of arrears cases, including comparison of recorded telephone calls with the written record on borrowers' files. In these cases, recordings provided ample evidence of poor practice that would not have been captured by review of the written records alone. As a result of those visits, supervisors are in the process of finalising an extensive notice covering the firms' arrears handling, culture, systems and controls. An enforcement investigation is likely to follow. It would have been more difficult to make these cases in the absence of call recordings.
- 6.32 The addition of this rule should facilitate effective supervision and enforcement and therefore incentivise greater compliance by firms. This should provide long-term ongoing benefits to customers in arrears from improved treatment by firms.

Clarifying our existing requirements in relation to the practice of charging Early Repayment Charges (ERCs) on arrears charges and the interest levied on the arrears charges

Compliance costs

- 6.33 Respondents to our survey are all currently charging an ERC on at least some of their mortgage products. ERCs vary between 0.5% and 8% depending on the product and the time remaining in the fixed/introductory period when the ERC is triggered. The average ERC charged by respondents is in the region of 3%. Most respondents indicated that they charge an ERC on arrears charges and the interest levied on these. A few respondents (four out of 11 respondents) indicated that they are not applying ERC to arrears charges or the interest levied.
- 6.34 For firms that would need to discontinue ERCs on arrears charges and interest as a result of the proposal, the clarification of this requirement would impose an ongoing cost in the form of lost revenue. However, this would be a transfer to affected consumers. We calculate an upper bound for the size of this transfer to be £0.8m per year. Details of the calculation are provided in the benefits section.
- 6.35 Respondents not already in line with the current requirement indicated that costs will be incurred as a result of changes to the terms and conditions and the IT systems.
- 6.36 A few respondents indicated that one-off costs to change their terms and conditions varied between £10,000 and £250,000 per firm, with total one-off costs for firms responding to the questionnaire amounting to about £440,000. One respondent indicated that these costs would be significant without providing further details. Depending on the firm's requirements, one-off costs could be for either reprinting documentation and/or notifying customers about changes by post.
- 6.37 One-off costs to change IT systems varied from between £150,000 and £10m per firm, with total one-off costs for firms to the questionnaire amounting to £10.65m – £15.65m.

However, one respondent cost figure here was disproportionately large relative to others. As a result total figures are significantly impacted by this. Four other respondents indicated that these costs would be significant without quantifying these costs. Depending on the firm's requirements, one-off costs could be either for software development or upgrades.

Benefits

- 6.38 Consumers in arrears can pay ERCs in two situations, where they are defaulting on a mortgage or where they are remortgaging during a period subject to ERC.
- 6.39 There are two ways consumers should benefit from clarification. First, it will lead to a transfer from affected firms to consumers who would otherwise have paid the ERC on arrears and second, it should help those consumers in this group who are remortgaging to leave arrears more quickly. Thus, for these customers it should lessen their probability of default and of the negative impacts that can follow from this.
- 6.40 The size of the transfer from firms to customers will depend on the number of customers affected by the proposal and the average saving per customer. In the period Q4 2008 – Q3 2009, there were 37,907 repossessions.¹¹ The size of transfer will also depend on:
- the number of repossessions occurring outside the fixed-term/introductory period and so not incurring ERC (since we do not have data at this level of granularity, in our calculation we assume that all repossessions are subject to an ERC, and treat the resulting figure as an overestimate);
 - the number of customers of banks that do not charge ERCs on arrears fees and charges (extrapolating results from our survey to the whole population of customers in arrears we estimate 53% of customers would expect to pay an ERC charge on arrears if repossessed¹²); and
 - the number of mortgages in which customers in arrears switched providers and so incurred ERC on arrears fees and charges (since we did not have data at this level of granularity, we use only repossession figures without adjustment to take remortgages while in arrears into account).
- 6.41 From this we calculate an upper bound of $20,090 = 0.53 \times (37,907)$ for the number of repossessions that would have been subject to ERC on arrears from Q4 2008 to Q3 2009. It is important to note that this repossession figure depends on the business cycle. Since this figure is from a period of crisis, it should lie at the upper end of the range of possible values over the cycle.
- 6.42 In our calculation of benefits we consider a typical scenario (based on the £100,000 original loan, 20-year mortgage term, interest-only, 6% interest rate, £50 monthly arrears charge, 3% ERC). The saving for a consumer in this scenario is estimated to

11 Repossessions of regulated mortgages only (within the UK), as evidenced by FSA Mortgage Lending and Administration Return (MLAR) – summary statistics are available at http://www.fsa.gov.uk/pages/Doing/Regulated/Returns/IRR/pdf/mlar2_stats_dec09.xls.

12 Among firms that responded, four stated they do not charge ERC on arrears. Their market share accounts for 47% of repossessions (in Q3 2009). From this we extrapolated that 53% of consumers in the general population would expect to pay an ERC charge on arrears if repossessed.

be £40. This provides a rough estimate of the order of the savings per customer per case (where ERC is charged on arrears) from this proposal.

- 6.43 An illustrative upper bound for the overall benefits to consumers is £0.8m per year (number of relevant cases per year (20,090) x average saving per case (£40)). This is an upper bound figure, based on an illustrative 'typical' consumer.
- 6.44 There is a risk that this proposal may reduce consumer detriment only in the short term because over a longer term, firms may recover lost revenue by introducing new or increasing existing charges and fees for the same or other consumers, unless competitive or regulatory pressures are sufficient to prevent this.
- 6.45 In summary, compliance costs for firms as a result of this proposal are likely to be significant but largely one-off. Benefits although relatively small per customer could outweigh the significant one-off costs in the longer term.

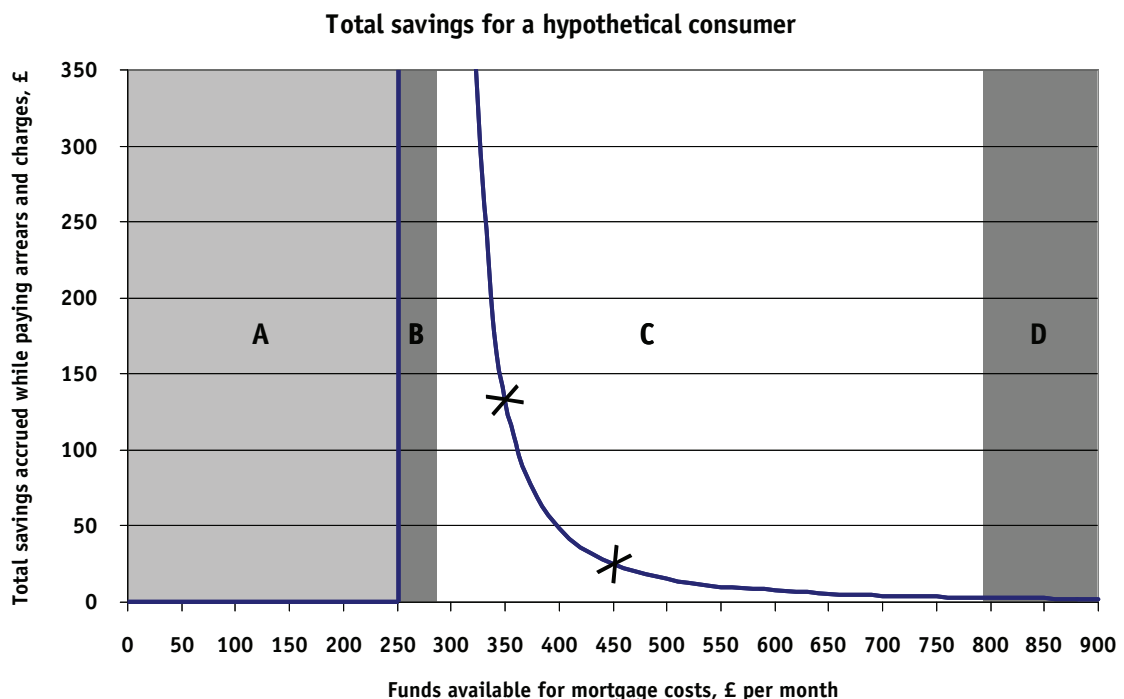
Clarifying our existing requirements that payments from customers be allocated to clearing missed monthly payments, leaving charges to be paid later

Compliance costs

- 6.46 Some firms indicated that they currently add arrears charges and the interest levied on these to the arrears balance, and so would be required to make changes as a result of the clarification. From replies of other respondents, who add arrears charges to the outstanding balance, we were not able to identify the priority of repayment and estimate where these firms would require changes to their systems to comply.
- 6.47 In replying to the questionnaire, most firms provided estimates for costs to changes to their IT systems similar to those provided for the clarification regarding ERCs on arrears charges. However, we believe that taking these cost figures literally might be an overestimation of costs due to economies of scale in making changes to IT systems for two proposals.
- 6.48 Respondents not already in line with the clarified requirement indicated that they will incur significant costs as a result. To change their IT systems varied between £150,000 and £10m per firm, with total one-off costs for firms responding amounting to £12.15m – £16.65m. However, one respondent cost figure here was disproportionately large relative to others. As a result total figures are significantly impacted by this. Four additional respondents indicated that these costs would be significant without quantifying these costs. Depending on the firm's requirements, one-off costs could be for either developing or upgrading software.
- 6.49 One respondent indicated a large figure for ongoing costs without providing details, making it difficult to assess reliability. We are following up on this to obtain more information.

Benefits

- 6.50 Our proposed clarification would result in payments from customers being allocated to the arrears balance without charges being added. This should help consumers to leave arrears more quickly by prioritising payments from the borrower to the arrears balance rather than to arrears charges and the interest levied on these. By leaving arrears earlier, the borrower would save on arrears charges and lessen the probability of default and all the negative impacts this implies.
- 6.51 The extent of the savings for consumers depends on the number of customers affected and the average saving for a customer. It is difficult to quantify benefits for customers due to the diversity of repayment schedules for different borrowers (i.e. funds available). We do not have data at this level of granularity on this and consequently have to limit our analysis of benefits to an illustrative example to show potential savings for a hypothetical customer.
- 6.52 For illustrative purposes, consider a typical scenario (£100,000 original loan, 20-year mortgage term, interest-only, 6% interest rate, £40 monthly arrears charge).¹³ For this mortgage, the consumer faces a £250 monthly contractual mortgage payment. We assume a consumer has missed two payments, thus, accruing arrears of £500. The graph below represents the total savings for this consumer if payments in excess of the monthly contractual payment are directed towards missed payments rather than arrears charges. The saving depends on the amount of monthly funds he has available to devote to mortgage payments. The greater the funds available the sooner the consumer can exit arrears.¹⁴



¹³ This scenario does not represent a customer who has entered into an Arrangement to Pay (AtP).

¹⁴ The graph assumes that arrears charges are imposed in continuous time to simplify the presentation. It also ignores interest accrued on arrears and arrears charges as this is relatively small. These simplifications do not affect the key analytical points made.

- 6.53 If the consumer is unable to pay the monthly contractual payment, he has no excess income for arrears or charges. Thus, changes in the allocation of payments to the arrears balance from arrears charges, will not benefit him (region A). Equally, he would not save if he has sufficient funds to pay the monthly contractual payment, accumulated arrears, arrears charges and the interest levied without delay (region D). This is because regardless of how payments are allocated, he will incur the minimum amount of arrears charges.
- 6.54 The greatest savings will occur if the consumer has enough funds to pay the monthly contractual payment and has income in excess of, but less than, the monthly arrears charge (region B). Where excess income is allocated to missed payments first, the customer can clear arrears earlier. After which he can (eventually) pay off the arrears charges once he is back on track, reducing the number of monthly arrears charges incurred.
- 6.55 In region C monthly income is in excess of the contractual payment and the monthly arrears charge combined (without the customer being able to pay off the total arrears balance in full without delay). In this case the benefit is reduced, and will further decrease the more income he has.
- 6.56 For example, if the consumer has £350 monthly income to pay to mortgages (the first X in the graph), he pays £250 to the monthly payment and has £100 per month left to pay towards arrears and arrears charges. If this £100 is directed first to the monthly arrears charge (£40 per month), then he has £60 left per month to pay off accrued arrears. With £500 in accumulated arrears, it will take him $500/60 = 8\frac{1}{3}$ months to clear the arrears. During this time he will be charged a total of $£40 \times 8\frac{1}{3} = £333.33$ in arrears charges. In contrast, if the £100 is directed first to clearing arrears, then he spends $500/100 = 5$ months clearing arrears, during which time he is charged a total of $£40 \times 5 = £200$ in arrears charges. Thus, this consumer saves a total £133.33 by having payments directed first to arrears.
- 6.57 Now consider if the consumer has £450 monthly income (the second X in the graph), then he has £200 left after the monthly payment. If this payment goes first to arrears charges he has £160 per month to devote to clearing arrears. This will take $500/160 = 3.125$ months, during which time he is charged $£40 \times 3.125 = £125$ in arrears charges. In contrast, if his payments go first to the arrears balance then it takes $£500/200 = 2.5$ months to clear the arrears, during which time he is charged $£40 \times 2.5 = £100$ in arrears charges. Thus, the total saving for this consumer is £25.
- 6.58 There is a risk that this proposal may reduce consumer detriment only in the short term because over a longer term, firms may be expected to recover lost revenue by introducing new or increasing existing charges and fees for the same or other consumers, unless competitive or regulatory pressures are sufficient to prevent this.
- 6.59 Benefits depend on distribution of the individual financial situations of borrowers and this may change with time.

Q10: Do you have any comments on our CBA?

7 Compatibility statement

- 7.1 This chapter sets out our assessment of the compatibility of the proposals outlined in the arrears chapter of this CP with our general duties under section 2 of the Financial Services and Markets Act 2000 (FSMA) and with the regulatory objectives set out in sections 3 to 6.

Compatibility with our statutory objectives

- 7.2 Our four statutory objectives are set out below, along with a description of how our proposals take account of and are compatible with these objectives.

Consumer protection

- 7.3 Consumers who are in financial difficulties have limited scope to move to another lender. This increases the need for a borrower's current lender to demonstrate good arrears-handling practices. The strengthening of the current arrears requirements will help ensure that more consumers in arrears are treated fairly.
- 7.4 Our clarification of our requirements in respect of unfair arrears-charging practices will help consumers who are experiencing financial difficulties. We have identified arrears charging practices (as detailed in Chapter 3) as particularly unfair and have the effect of increasing a customer's level of overall indebtedness at a time when they are least capable of paying. This is especially relevant at this point in the economic cycle, when greater numbers of consumers are experiencing financial difficulties.

Market confidence

- 7.5 The clarification and strengthening of our current arrears rules supports our market confidence objective by helping consumers to be more confident about the way firms in the mortgage market deal with consumers who are in financial difficulties.

Reducing financial crime

- 7.6 Our proposal to retain and improve records of call recordings may increase opportunities to identify incidences of financial crime.

Promoting public awareness

- 7.7 The proposals to strengthen the current arrears provisions, particularly the proposal to promote awareness of government schemes, are likely to go some way to improving public awareness of entitlements in arrears situations.

Compatibility with the principles of good regulation

- 7.8 Section 2(3) of FSMA requires that, in carrying out our general functions, we have regard to the principles of good regulation.

The need to use our resources in the most efficient and economic way

- 7.9 There will be limited additional costs to us associated with the strengthening of arrears-handling practices, as detailed in our Cost Benefit Analysis (CBA). Most of the proposals in this CP should have minimal impact on our resources. The proposals to change MCOB 13 forbearance guidance to rules, and the proposals to strengthen telephone record-keeping, may have some costs to us, but we would benefit from greater effectiveness of supervision and enforcement processes.

The responsibilities of those who manage the affairs of authorised persons

- 7.10 The proposals in this CP places responsibility on Boards, Chief Executives and senior management teams for determining how to deploy their resources in the most effective way to achieve defined regulatory outcomes. This is consistent with our existing emphasis on senior management responsibilities.

The restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions

- 7.11 We have undertaken a CBA to help inform this consultation, which is detailed in Chapter 6. The CBA outlines the expected costs of our proposal to both firms and the FSA, and the resulting benefits we expect. This work has been informed by pre-consultation with industry through a questionnaire.
- 7.12 These proposals should increase the level of compliance with our requirements bringing benefits to consumers. In terms of proportionality, indications from firm questionnaires suggest that set up costs are high with ongoing costs significantly lower, which should lead to proportionate benefits in the longer term.

The desirability of facilitating innovation in connection with regulated activities

- 7.13 Our strengthened requirements will help ensure that firms deal fairly with consumers in arrears. The strengthened arrears proposals target harmful practices and, as such, are not expected to unduly inhibit future beneficial product innovations for the industry.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

- 7.14 The standards proposed apply to all firms operating in the UK retail mortgage market. As such, they are not expected to damage the competitive position of the UK relative to other countries.

The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions

- 7.15 We do not expect the proposals in this CP to have material adverse effects on competition.

The desirability of facilitating competition between those who are subject to any form of regulation by the FSA

- 7.16 Targeting unfair arrears practices should facilitate competition on desirable product features. Generally, however, the impact of the proposals on competition is expected to be limited.

Acting in a way that we consider most appropriate for the purpose of meeting our statutory objectives

- 7.17 The scope for market solutions to the problems that we have identified is limited, partly for reasons of consumer behaviour. Thematic work that has been carried out in respect of firms' arrears-handling practices over the last two years. This review has identified certain areas of consumer detriment that we believe must be addressed.
- 7.18 It is clear that some firms have not recognised the inappropriateness of some aspects of their arrears and charging practices. We believe these proposals will help improve standards within the industry. In addition, the enhanced record keeping requirements should further improve arrears-handling practices and our ability to supervise them. On this basis we believe these proposals are more appropriate than, and preferable to, the status quo.

Q11: Do you agree with the compatibility statement?

Draft rules

MORTGAGE ARREARS INSTRUMENT 2010

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 138 (General rule-making power);
 - (2) section 149 (Evidential provisions);
 - (3) section 156 (General supplementary powers); and
 - (4) section 157(1) (Guidance).
- B. The rule-making powers listed above are specified for the purposes of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [*date*].

Amendments to the Handbook

- D. The Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Mortgage Arrears Instrument 2010.

By order of the Board
[*date*]

Annex

Amendments to the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB)

In this Annex, underlining indicates new text and striking through indicates deleted text.

12.3 Early repayment charges: regulated mortgage contracts

12.3.1 R A firm must ensure that any *regulated mortgage contract* that it enters into does not impose, and cannot be used to impose, an *early repayment charge* other than one that is:

- (1) ...
- (2) a reasonable pre-estimate of the costs as a result of the *customer* repaying the amount due under the *regulated mortgage contract* before the contract has terminated.

12.3.1A G *MCOB 12.4.1R prohibits arrears charges except where they are a reasonable estimate of the cost of the additional administration required as a result of the customer being in arrears. Accordingly, neither arrears charges, nor any interest added in respect of those charges, should be included within the calculation of an early repayment charge.*

...

12.4 Arrears charges: regulated mortgage contracts

12.4.1 R (1) A firm must ensure that any *regulated mortgage contract* that it enters into does not impose, and cannot be used to impose, a charge for *arrears* on a *customer* except where that charge is a reasonable estimate of the cost of the additional administration required as a result of the *customer* being in *arrears*.

(2) Paragraph (1) does not prevent a firm from entering into a *regulated mortgage contract* with a *customer* under which the firm may change the rate of interest charged to the *customer* from a fixed or discounted rate of interest to the firm's standard variable rate if the *customer* goes into *arrears*, providing that this standard variable rate is not a rate created especially for *customers* in *arrears*.

12.4.1A E The imposition of a charge for *arrears* on a *customer* who is adhering to an arrangement under which the *customer* agrees to repay, or make payments towards the repayment of, a payment shortfall by a set amount per month (or other agreed period) may be relied upon as tending to show contravention of *MCOB 12.4.1R*.

12.4.1B R When a *customer* has a payment shortfall in respect of a *regulated mortgage contract*, a firm must ensure that any payments received from the *customer*

are allocated to paying off the balance of the shortfall (excluding any interest or charges on that balance).

...

~~Policy and procedures: content~~

- 13.3.2 ~~E~~ (1) ~~A firm should ensure that its written policy and procedures include~~
~~R~~ must, when dealing with any customer in payment difficulties, take into consideration the customer's individual circumstances. In so doing, a firm must:
- (a) ~~using~~ make reasonable efforts to reach an agreement with a *customer* over the method of repaying any payment shortfall or *sale shortfall*, in the case of the former having regard to the desirability of agreeing with the *customer* an alternative to taking possession of the property;
 - (b) ~~liaising~~ liaise, if the *customer* makes arrangements for this, with a third party source of advice regarding the payment shortfall or *sale shortfall*;
 - (c) ~~adopting a reasonable approach to the~~ allow a reasonable time over which the payment shortfall or *sale shortfall* should be repaid, having particular regard to the need to establish, where feasible, a payment plan which is practical in terms of the circumstances of the *customer*;
 - (d) ~~granting~~ grant, unless it has good reason not to do so, a *customer's* request for a change to:
 - (i) the date on which the payment is due (providing it is within the same payment period); or
 - (ii) the method by which payment is made;
 and ~~giving~~ give the *customer* a written explanation of its reasons if it refuses the request;
 - (e) ~~giving~~ give consideration, where no reasonable payment arrangement can be made, to the *customer* being allowed to remain in possession to effect a sale; and
 - (f) ~~repossessing~~ not repossess the property ~~only where~~ unless all other reasonable attempts to resolve the position have failed.
- (2) ~~Contravention of (1) may be relied on as tending to show~~
~~contravention of MCOB 13.3.1R(2). [deleted]~~

...

- 13.3.4 ~~G~~ In relation to ~~using~~ making reasonable efforts to reach an agreement with a

R *customer* over the method of repaying any payment shortfall or *sale shortfall*, ~~customers:~~

- (1) ~~should be given a firm must give customers~~ a reasonable period of time to consider any proposals for payment that are put to them; in addition, and depending on the individual circumstances, a *firm may wish to do* must, as a minimum, consider whether it would be appropriate to do one or more of the following in relation to the *regulated mortgage contract* or *home purchase plan* with the agreement of the *customer*:
 - (a) extend its term; or
 - (b) change its type; or
 - (c) defer payment of interest due on the *regulated mortgage contract* or of sums due under the *home purchase plan* (including, in either case, on any *sale shortfall*); or
 - (d) treat the payment shortfall as if it was part of the original amount provided (but a firm must not automatically capitalise a payment shortfall); or
 - (e) make use of any Government forbearance initiatives in which the firm participates;
- (2) ~~should be given a firm must give customers~~ adequate information to understand the implications of any proposed arrangement; one approach may be to provide information on the new terms in line with the *annual statement provisions*; and
- (3) a firm must give customers adequate information about any applicable Government schemes to assist borrowers in payment difficulties in relation to regulated mortgage contracts.

13.3.5 G ~~In relation to using reasonable efforts to reach an agreement with a customer over the method of repaying any payment shortfall or sale shortfall, a mortgage lender should not automatically capitalise arrears. [deleted]~~

...

Record keeping: arrears and repossessions

13.3.9 R (1) A *mortgage lender* or *administrator* must make and retain an adequate record of its dealings with a *customer* whose account is in *arrears* or who has a *sale shortfall*, which will enable the *firm* to show its compliance with this chapter. That record must include a recording of all telephone conversations between the firm and the customer.

- (2) *A mortgage lender or administrator must retain the record required by (1) for ~~a year~~ three years from the date on which the relevant payment shortfall or *sale shortfall* was cleared.*

...

Schedule 1 Record keeping requirements

...

Sch 1.3 G

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
...				
<i>MCOB</i> 13.3.9 <u>R</u>	Dealings with <i>customers</i> in <i>arrears</i> or with a <i>mortgage shortfall debt</i>	Details of all communication (including a <u>recording of all telephone conversations</u>) with the <i>customer</i> ; information relating to any repayment plan; date of issue of any legal proceedings; arrangements made for sale of a <i>repossessed</i> property; and the basis of any tailored information where the loan is for a business purpose.	The date on which the <i>customer's</i> account first falls into <i>arrears</i>	One year <u>Three years</u> from the date on which the relevant payment shortfall or <i>mortgage shortfall debt</i> is cleared

Proposed extension of the approved persons regime to mortgage advisers and arrangers

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Part 2 – Appendix 1: Draft rules

8 Overview

- 8.1 Our *Mortgage Market Review* (the Review), as outlined in Discussion Paper 09/3 (DP09/3), set out the case for regulatory reform of the mortgage market. It identified several issues and causal drivers that we believe have resulted in consumer detriment in the market, and options for addressing these. The Review also articulated concerns in relation to mortgage fraud, unsuitable advice and our current inability to track individuals in this sector.
- 8.2 When firms providing home finance were brought within the scope of the Financial Services and Markets Act (FSMA) in 2004, we decided it would be proportionate only to apply the approved persons (AP) regime (the regime) to this sector in a limited way. In light of the issues addressed in DP09/3, we believe our risk appetite has changed and that this limited application is no longer appropriate. So we are consulting on extending the regime by applying a new customer function to those who are advising, arranging (bringing about) and/or entering into a contract for home finance business. We also propose to extend the compliance oversight function (CF10) to this sector.¹⁵

Structure of this consultation

- 8.3 This part of the Consultation Paper (CP) contains proposals to extend the regime by:
- introducing a new CF31 customer function (home finance business) for the activities defined in 10.2; and
 - applying the required function CF10 (the compliance oversight function) to home finance activities.
- 8.4 This CP describes how we intend to manage the process for individuals applying for CF31 approval, including the transitional arrangements for those currently performing a relevant activity.
- 8.5 In addition, this CP outlines the approach that we intend to adopt for individuals seeking approval for CF10.

¹⁵ Following consultation on Sale and Rent Back (CP09/22) we intend the extension of the AP regime to also include individuals undertaking Sale and Rent Back activities.

Who should read this CP?

- 8.6 This paper will be of particular interest to firms and individuals undertaking home finance activities.

Next steps

- 8.7 Consultation on these proposals will close on 30 April 2010. We then aim to complete the proposals and publish the final rules in a Policy Statement in June 2010. We hope to begin accepting applications at the end of 2010 or the beginning of 2011.

CONSUMERS

We expect these proposals to generate a number of benefits for consumers. This includes increased transparency to enable them to identify which individuals have been approved to carry out these activities. The proposals will also enable us to identify and sanction those undertaking certain home finance activities and make this information publicly available on the FSA Register.¹⁶

¹⁶ The FSA Register is a public record of all authorised financial services firms, individuals and other bodies which fall under the FSA's regulatory jurisdiction.

9 Background

- 9.1 The Review identified a number of issues related to the functioning of the mortgage market in the context of the financial crisis. In particular, it articulated the concern that our current approach to regulating mortgage intermediaries is not sufficiently robust.
- 9.2 In Chapter 5 of DP09/3, we outlined research by the Association of Chief Police Officers (ACPO) in 2008, showing the extensive involvement of organised crime in property and mortgage fraud. While we recognise there will be many honest mortgage intermediaries in the market, the distribution and advice channel has had a key role to play in this fraud. Additionally, an important feature of organised mortgage fraud is that one corrupt individual cannot conduct fraud on their own; a network of corrupt individuals would need to be involved at each stage of the mortgage process (from introduction to completion).
- 9.3 In DP09/3, we also described the evidence our review found of unsuitable recommendations, with consumers suffering as a result.
- 9.4 Currently individuals do not need to be approved under the regime in order to carry out the activities described in paragraph 10.2. As a result, rogue individuals are able to move, relatively unnoticed, around the industry leading to a greater incidence or likelihood of fraud occurring. Our rule requiring a firm to provide a reference about a former employee to another firm considering employing that individual, only applies where that individual will be an AP. Similarly, access to spent criminal record information is not currently available for these individuals because they are not APs (see para 9.17 below).
- 9.5 The lack of transparency in the market also means that consumers have no assurance about the honesty and integrity of individuals from whom they receive advice or through whom they complete a non-advised sale.
- 9.6 Although we are able to sanction home finance firms and APs performing significant influence functions at those firms, we do not have the mandate to take action directly against those carrying on the activities described in paragraph 10.2, who act fraudulently or provide poor or unsuitable advice, because they are not APs.
- 9.7 We do not currently require named individuals to be responsible or accountable for compliance and compliance oversight relating to a firm's home finance activity. This reduces our ability to ensure these firms comply with our regulatory requirements.

The regime

- 9.8 Section 59 of the Financial Services and Markets Act (FSMA) sets out the conditions under which we can require a function to be a controlled function (CF). Anyone who is asked by their firm to carry out such a function must be assessed by us as ‘fit and proper’ first.
- 9.9 CFs are those roles or responsibilities within a business that have a particular regulatory significance. They include customer functions for example CF30, which, in broad terms applies to individuals who either arrange or give advice to customers, and significant influent functions (SIFs), which describe roles that we deem to have a significant influence over a firm and its operations. This includes the CF10 role, which applies to individuals with responsibility for compliance oversight.
- 9.10 The regime is implemented through our Handbook, and in particular the sections governing the Fit and Proper test for APs (FIT) and the Statements of Principle and Code of Practice for APs (APER). Under the regime, individuals who are approved have a responsibility for complying with both APER and FIT.
- 9.11 Once approved, an AP must continue to comply with FIT and APER. Where APs fail to comply we can take enforcement action against them.
- 9.12 Currently home finance firms must seek approval for individuals carrying out some SIFs, for example some of the governing and required functions including CF1 (director function) and CF4 (partner function).

The recruitment and approval process

- 9.13 Our requirements on firms when recruiting staff are set out in the Handbook.¹⁷ We expect firms to perform their own due diligence before submitting an application to us to approve an individual.
- 9.14 Our vetting process is designed to complement the firms’ own recruitment practices and firms should not see it as a substitute.
- 9.15 We expect senior management to use a risk-based approach when vetting their applicants. SUP 10 Annex 1 Frequently Asked Questions in our Handbook underlines the responsibility on firms and senior managers to carry out due diligence on prospective employees and highlights our policy on criminal records checks.
- 9.16 We expect senior management to take responsibility for managing the risks in their firms properly and ensuring they have systems and controls to mitigate those risks. Failure to do so may result in disciplinary action against the individuals responsible, as well as the firms.

17 SUP 10 Annex 1

Use of criminal records

- 9.17 Firms and the FSA have access, under an exceptions order¹⁸ to the Rehabilitation of Offenders Act 1974, to spent criminal records information about an individual who is, or is applying to be, an AP. This is called a standard disclosure and is available from the Criminal Records Bureau¹⁹ at a cost of £40 per check.
- 9.18 In addition, any member of the public can access unspent criminal record information about themselves from Disclosure Scotland²⁰ for £23 per check. We refer to this as a basic disclosure.

18 SI 1975/1023

19 The website is as follows: <http://www.crb.homeoffice.gov.uk/>

20 The website is as follows: <http://www.disclosurescotland.co.uk/>

10 Proposed changes

- 10.1 A home finance transaction is defined as a regulated mortgage contract, a home purchase plan, a home reversion plan or a regulated sale and rent back agreement.

Who is included?

- 10.2 To address the issues that the review identified, we propose to create a new customer function, CF31, which will apply to all individuals who currently:

- advise on home finance transactions or will do so in the future, whether on behalf of an intermediary firm or a provider; and/or
- bring about home finance transactions or will do so in the future, whether on behalf of an intermediary firm or a provider (in the case of the latter this will apply to bringing about the sale of another provider's home finance product rather than their own – for which see the following paragraph).
- We are also considering bringing into the regime individuals who, on behalf of home finance providers, perform similar activities to those for home finance intermediaries. Article 28A of the Regulated Activities Order²¹ states that a home finance provider does not arrange a transaction to which they are a party. So our draft rules propose bringing into the regime the home finance providing activity of entering into:
 - o a regulated mortgage contract;
 - o a regulated sale and rent back agreement;
 - o a home purchase plan; and
 - o a home reversion plan.

But not the activity of agreeing to carry on a regulated activity. We would particularly welcome comments on this proposal (Q13).

- 10.3 We refer to the activities in paragraph 10.2 for the remainder of this CP as 'relevant activities'.

21 http://www.opsi.gov.uk/si/si2003/uksi_20031676_en.pdf

Who is excluded?

- 10.4 Individuals excluded from our proposals are arrangers who do not bring about a home finance activity. For example, customer service staff who only ‘make arrangements’ but stop short of bringing about a transaction are excluded from these proposals. For example, an individual who only gathers information to complete the mortgage application would be excluded from our proposals.

Further clarification

- 10.5 Our proposals include all individuals as defined in paragraph 10.2, which include individuals working for bank branches or intermediary firms. This is because the ACPO report concluded that all those involved, including lenders, have a role to play in reducing opportunities for fraud and providing a consistent level of protection for consumers.
- 10.6 Where individuals acting on behalf of lenders arrange for customers to purchase another lender’s products, they are undertaking the activity of arranging (bringing about). Where individuals on behalf of lenders are involved in dealing with a mortgage application from the lender’s own product range, this is referred to as ‘entering into’.
- 10.6a However, our proposals relating to those individuals engaged in the home finance activity of ‘entering into’ (as referred to in paragraph 10.2), only apply to all those involved in the upfront sales process. Those engaged in processing, underwriting or administration activities are not caught unless they are also involved in the sales process. In other words, the customer function CF31 is not intended to capture individuals who are involved after the customer makes the application, unless a new contract is involved. For example, those involved in switching products or arrears handlers dealing with forbearance measures, such as changing from capital repayment to interest only, would not be caught by our proposals provided this does not lead to a new contract. However, where a new mortgage contract is required – for example because a customer wishes to move house – then this function will be captured by CF31.
- 10.6b If an individual’s functions cover both the period before and after the customer makes the application, then all those functions are captured within the CF31. In other words, in this case APER would apply to all these functions the individual undertakes, both before and after the application is made by the customer.
- 10.7 Once the rules come into force, individuals currently carrying on one or more of these activities will be required to seek approval as a CF31 in order to continue to undertake them. Those new to these activities will need approval before undertaking them.

Currently approved individuals vs. those new to the AP regime

- 10.8 There are two groups of individuals currently carrying on relevant activities:
- those who are not currently approved under the regime (i.e. they do not currently hold any CF); and

- those who are already approved for one or more CF (e.g. CF30, CF1 and CF4). (This group would include individuals who are currently approved to provide investment and/or pension advice and who also provide advice and/or arrange home finance transactions.)
- 10.9 We will tailor the approvals process for these groups (in line with existing process) to ensure it is both efficient and proportionate to the potential risk.
- 10.10 We also propose to extend CF10 to home finance activities. Firms will be required to have in place a named individual, likely to be a director or senior manager, who is responsible for compliance and compliance oversight of the firm's regulated activities. That person will be required to seek approval as a CF10 within the timescales set out in paragraph 11.20.

Purpose of our proposals

- 10.11 We believe that extending the regime, to include a new customer function, CF31 and the compliance oversight function (CF10) to firms undertaking home finance business will do the following:
- Strengthen our gateway and allow us to prevent unfit or rogue individuals from entering the industry.
 - Make individuals responsible and accountable for their actions and suitably cautious about the advice they provide. Both firms and individuals will be answerable to us and the individuals, as APs will be subject to the requirements of FIT and APER for as long as they remain APs. Where they breach these requirements, our proposals will give us the power to sanction the individual where appropriate. We anticipate our proposals will improve the quality of advice offered, raising standards in the industry.
 - Introduce greater transparency in the industry by making it clear which individuals are approved. This will allow us, as well as employers and consumers, to trace those doing relevant activities and allow new employers to require former employers who are authorised firms to provide a reference. We anticipate that this will limit the movement of problematic individuals through the industry as individuals will be more easily traceable. It will also allow us to take swift and robust action against those advisers, arrangers and firms that fail to meet our standards and expectations. Consumers will benefit both from dealing with individuals required to comply with those standards and the knowledge that they are dealing with someone who has been approved by us.
 - Enable firms and us to check whether an applicant has any spent criminal records: while a spent criminal conviction is not necessarily a barrier to operating in the industry, transparency relating to a criminal record is essential. Further details on our approach to criminal convictions are outlined in the Handbook under COND and FIT.²²

22 <http://fsahandbook.info/FSA/html/handbook/COND> and <http://fsahandbook.info/FSA/html/handbook/FIT>

- And, overall, we anticipate that these measures will help reduce the level of fraud and increase the levels of individual accountability within the industry.
- 10.12 We believe that extending CF10 to firms undertaking home finance business will:
- strengthen the obligation on, and the ability of, firms to ensure that they comply with our regulatory requirements on home finance transactions and therefore strengthen the standards of probity within the market; and
 - introduce explicit responsibility for named individuals to ensure compliance, further strengthening our approach.
- 10.13 We do not believe these proposals will place a disproportionate burden on either firms or individuals operating in the industry. These proposals will have the least impact on firms and individuals who already conduct their business in an appropriate manner. The impact will be felt most by individuals and firms who do not currently demonstrate acceptable standards and on individuals who will be obliged to improve their conduct to gain and maintain AP status.
- 10.14 The proposals are in line with our more intrusive approach to supervision throughout the industry. They will help us to ensure that inappropriate or non-compliant behaviour is sanctioned swiftly and fairly. By reinforcing adherence to our rules, the scope for committing financial crime will be reduced and the honest consumer will benefit.
- 10.15 The timing and process for implementation are outlined in the following chapter.
- Q12: Do you agree with our proposal to extend the regime, specifically a new customer function CF31, to include all individuals who currently, or in the future, advise, on home finance transactions?
- Q13: Do you agree with our proposal to extend the regime, specifically a new customer function CF31, to include those individuals who currently, or in the future, arrange (bring about) home finance transactions whether on behalf of an intermediary firm or a home finance provider as described in paragraph 10.2?
- Q14: Do you agree that it is appropriate to extend the regime, specifically a new customer function CF31, to include those individuals who currently, or in the future, arrange (enter into) home finance transactions on behalf of a provider, as described in paragraph 10.2?
- Q15: Do you agree with our proposal to extend the compliance oversight function (CF10) to home finance activities?

11 Approval process

- 11.1 This chapter outlines our proposed process for individuals to become approved, and the proposed timescales for implementing the new rules. It applies both to individuals currently performing a relevant activity and to those who wish to start doing so once the proposed rules come into force.
- 11.2 Our approach to bringing the relevant individuals into the regime stems from our assessment of the potential risk they pose. Successful applicants will be subject to the regime set out in FIT and APER.

Transitional approach for individuals (not existing APs) currently carrying out a relevant activity

- 11.3 We propose to require all individual applicants, who are not currently APs, to apply for individual approval accompanied by an up-to-date criminal record disclosure documentation, either standard or basic, as described in paragraphs 9.17 and 9.18 as follows:
- all sole traders and single directors will be required, on application, to provide a standard disclosure from the Criminal Records Bureau, showing spent and unspent convictions; and
 - all other individual applicants will be required, on application, to provide a basic disclosure from Disclosure Scotland²³, which will show all unspent convictions.
- 11.4 We expect the authorised firm or appointed representative, as employer²⁴, to take responsibility for carrying out the necessary due diligence and checks at recruitment stage, as described in paragraphs 9.13 – 9.16. With sole traders and single director firms, the authorised firm is often the individual itself, and therefore a higher level of independent check is warranted. This is the reason why we are proposing a different criminal record check requirement between sole traders/single directors and other individuals.

²³ Basic disclosures are available to anyone, throughout the UK, for any purpose.

²⁴ While an appointed representative will undertake the initial due diligence as the employer, the responsibility for the due diligence of an AP should always be with the authorised firm.

Q16: Do you agree that our proposals to require criminal record disclosures are proportionate?

- 11.5 Firms will be required to submit a modified Long Form A²⁵ for individuals seeking approval for the first time as new APs. The Form must be completed by the individual seeking approval. The existing version is on our website.²⁶
- 11.6 To speed up the approval process, we propose to request additional information in relation to the criminal record disclosure. We will ensure the Long Form A is modified to include any additional questions we need to routinely ask in relation to home finance activities.

Transitional approach for APs currently carrying out a relevant activity

- 11.7 There is a continuing obligation on all firms to inform us of any change, since our last assessment, to an AP's fitness and propriety (as set out in SUP 10.13.7R and SUP 10.13.14R of the FSA Handbook) and APs are required to comply with APER and FIT throughout the life of their approval.
- 11.8 Against this background, we are proposing a streamlined approach: if this is followed, it will result in the approval already given to the AP for its other CF also covering CF31 for that individual and that firm. The firm should tell us who will require the new CF31. We will provide a short automated notification form for this, which will be available to view beforehand. This information will be enough to identify the firm and the approved person. The system will generate an acknowledgement.
- All those who are currently carrying out one or more relevant activity but who are not APs must complete the (modified) Long Form A.
 - Firms with existing APs, who are currently carrying out one or more relevant activities, must notify us of the individuals who will require the CF31.

Transitional approach for CF10 (compliance oversight function)

- 11.9 Those who are selected by their firms to take responsibility for compliance and compliance oversight will need to become a CF10. Firms will be required either to:
- submit the modified Short Form A²⁷ (if the individual is currently acting as home finance business compliance officer and approved for a CF that does not include CF10); or

25 We plan to review the Approved Persons Individual Approval forms. Please note that these forms in the future may be modified as a part of this review. Any changes will be published on our website at least one month before they come into effect.

26 www.fsa.gov.uk/Pages/Doing/Regulated/Approved/persons/process/index.shtml

27 We will ensure the Short Form A is modified to include any additional questions we need to routinely ask in relation to home finance activities.

- submit the modified Long Form A (if the individual is currently acting as home finance business compliance officer but not an AP).
- take no action regarding an individual who is already a CF10 and currently acting as home finance business compliance officer as they will already have the necessary approval.

Applications not eligible for the transitional arrangements – business as usual

- 11.10 Firms with individuals ineligible to benefit from the transitional arrangements and who wish them to undertake relevant activities will need to apply for approval for a CF31 or CF10 in the usual way through the individual approval process. So, for example, an individual who is an existing AP and whose firm decides they should become a CF31 will need to complete the Short Form A. An individual who is not approved for any CF and is new to the regime will need to complete the Long Form A.
- 11.11 As a part of our review of the individual forms (see para 11.5) we will consider whether to incorporate the modifications made for transitioning purposes (paragraphs 11.6 and 11.9) into our standard forms. We will publish any new versions at least one month in advance of their coming into effect.
- 11.12 Our current practice is to ask (at our expense) for CRB standard disclosures for all sole traders and single directors and to use a sample risk-based approach for other applicants. This policy is described on our website²⁸ and any change will be reflected on our website.
- 11.13 Applicants who are new to the market on or after the first start date, and whose firms wish them to carry out relevant activities must be approved before they operate.
- 11.14 The following table illustrates these requirements:

Applicant	Required form
Currently carrying out one or more relevant activity but not an AP	(Modified) Long Form A
Currently carrying out one or more relevant activity and already an AP	Notification
Currently carrying out one or more relevant activity and already an AP, but whose fitness or propriety has changed since previous submission of Long Form A	(Modified) Long Form A
Currently an AP but new to the relevant activities	(Modified) Short Form A
Individuals new to the relevant activities and not currently an AP	(Modified) Long Form A
Individuals who are currently acting as a home finance business compliance officer and currently approved for CF10 for investment business	None
CF10 applicants who are currently acting as home finance business compliance officers and approved for a CF that does not include CF10	(Modified) Short Form A
CF10 applicants who are currently acting as home finance business compliance officer but not an AP	(Modified) Long Form A

28 www.fsa.gov.uk/pubs/other/approval.pdf

Q17: Do you agree with the principle of using our (modified) Long and Short Form A approach?

Q18: Do you agree with our proposed notification approach for individuals who are currently APs?

Q19: Do you agree the way we intend to use these forms for the different groups is proportionate?

11.15 Firms (other than credit unions) will submit applications to us electronically through our Online Notifications and Applications system, as described in our Quarterly CP CP09/20.²⁹ We intend to make these forms available for firms to view in advance, so firms can arrange for the relevant individuals to complete them.³⁰

Transitional arrangements

11.16 We recognise that a large number of individuals will be affected by these proposals. So to ensure that we meet our statutory duty to determine applications within three months of receiving them, and to impose as little disruption as possible to the industry, we propose to process applications from those currently carrying on one or more of these activities in two groups. These will be determined, both for applications for CF31 and CF10 as follows:

- Group 1 will consist of individuals who, before the first start date, have no CF, but who have been deemed competent by their firm to carry on a relevant activity.
- Group 2 will consist of individuals who, before the first start date, are approved as a CF30 (or other CF) and the firm has assessed them as competent to carry out the relevant activities and that assessment was current at that date.

11.17 Individuals falling into Group 1 will be able to submit their applications for CF31 or CF10 from the first start date. To take advantage of the transitional arrangement they must submit their applications within the specified time period, which will be no less than three months.

11.18 Individuals falling into Group 2 will be able to submit their notifications for CF31 or applications for CF10 from the second start date. To take advantage of the transitional arrangement they must submit them within the specified time period, which will be no less than three months.

11.19 We intend to publish the name of each individual that has been approved for CF31 on the FSA Register as they are determined. In addition, once the application period has come to an end and the rules come into force for Group 1, we aim to publish a list of every individual on whose behalf a firm has applied to us for approval, where a decision has not yet been taken. We will ensure this information is available to consumers. We will publish regular updates on the number of individuals we have approved.

29 http://www.fsa.gov.uk/pages/Library/Policy/CP/2009/09_20.shtml

30 In the unlikely event the mandatory reporting system is not available in the 7 days prior to the end of the relevant end date; we will publish an announcement on the FSA website allowing firms to submit their applications/notifications through conventional paper-based channels. This is the only circumstance in which we will accept manual submissions.

11.20 The table below illustrates these transitional arrangements.³¹

	Group 1	Group 2	Group 0*
Applications (Groups 1 & 2)/ Notifications (Group 2) may be submitted	First start date	Second start date (3 months after first start date)	First start date
Date by which applications (Groups 1 and 2)/ notifications (Group 2) must be submitted	3 months after first start date	3 months after second start date	Ongoing
Date after which individuals may not practise	1) 3 months after first start date if application not submitted 2) If application refused ³²	3 months after second start date if no notification submitted, or, in case of CF10 applicants, application not submitted or application refused ³³	First start date

* Group 0 consists of those individuals who, on the day before the first start date, have not been deemed competent by a firm to perform a relevant activity.

Q20: Do you agree with the timescales that we are proposing?

Q21: Do you have any comments on our proposed changes to the Handbook (Part 2 – Appendix 1)?

Contact

Comments should reach us by 30 April 2010. Please send them to:

Kaajal Shah
Operational Reporting and Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Telephone: 020 7066 3068
Fax: 020 7066 3069
Email cp10_02@fsa.gov.uk

31 The earliest date for implementation to begin will not be before December 2010: we need to ensure the readiness and robustness of the automated system. The periods between the start date and end date could be extended for the same reason.

32 See draft rules SUP TP 8PR (2) for further clarification.

33 See footnote 18 above.

12 Consultation questions

- Q12: Do you agree with our proposal to extend the regime, specifically a new customer function CF31, to include all individuals who currently, or in the future, advise, on home finance transactions?
- Q13: Do you agree with our proposal to extend the regime, specifically a new customer function CF31, to include those individuals who currently, or in the future, arrange (bring about) home finance transactions whether on behalf of an intermediary firm or a home finance provider as described in paragraph 10.2?
- Q14: Do you agree that it is appropriate to extend the regime, specifically a new customer function CF31, to include those individuals who currently, or in the future, arrange (enter into) home finance transactions on behalf of a provider, as described in paragraph 10.2?
- Q15: Do you agree with our proposal to extend the compliance oversight function (CF10) to home finance activities?
- Q16: Do you agree that our proposals to require criminal record disclosures are proportionate?
- Q17: Do you agree with the principle of using our (modified) Long and Short Form A approach?
- Q18: Do you agree with our proposed notification approach for individuals who are currently APs?
- Q19: Do you agree the way we intend to use these forms for the different groups is proportionate?
- Q20: Do you agree with the timescales that we are proposing?
- Q21: Do you have any comments on our proposed changes to the Handbook (Part 2 – Appendix 1)?

13 Cost benefit analysis

Market Failure Analysis

- 13.1 One concern in the mortgage intermediation market is that rogue/unsuitable individuals are able to move, relatively un-noticed around the industry which could contribute to an increase in mortgage fraud. A report³⁴ published by ACPO identified mortgage intermediaries as playing a central role in organised mortgage fraud. The report highlighted that mortgage fraud was around £700 million in 2007³⁵ at the peak of the housing boom.
- 13.2 There are potential problems of information asymmetry between the lenders and mortgage intermediaries: the mortgage intermediaries could withhold important information regarding the borrower or they could present false information regarding the borrower in order to ensure the transaction between the lenders and borrowers is completed (so that mortgage intermediaries can get their commissions). This information problem could be further exacerbated by lenders' incentives to take on excessive risks.³⁶ It is widely acknowledged that cheap credit and lax underwriting standards during the housing boom made it easier for fraudsters to target the mortgage sector.
- 13.3 There are also potential problems of information asymmetry between the mortgage intermediaries and borrowers: the mortgage intermediaries could recommend unsuitable products to borrowers in order to ensure the transaction takes place (so that they can be compensated financially). This information problem could be further exacerbated by borrowers' incentives to over-extend themselves, especially during the boom years.
- 13.4 However, the lenders would have some incentives to ensure they lend to responsible borrowers as their shareholders' capital will take any first loss. This incentive was however, severely weakened during the last housing boom as banks thought that they could lay off significant parts of the risk through securitisation (which they could until the market froze). Since then, there have been several regulatory initiatives to

34 http://www.acpo.police.uk/pressrelease.asp?PR_GUID=%7B7F278B1E-CA47-4C00-AFD2-CC599E4BA786%7D

35 The total mortgage lending in 2007 was £370 billion.

36 Given lenders' limited liability, they have an incentive to over-extend themselves as any gains (from the over-extending) belong to shareholders, while any losses are limited by the shareholders' capital.

ensure lenders' incentives are more properly aligned with the risks they are taking (e.g. additional prudential requirement for securitisation, liquidity requirements, and making lenders ultimately responsible for verifying affordability).

- 13.5 Initiatives aimed at addressing lenders' incentives to over-extend themselves will also go some way to reduce the information problem between intermediaries and borrowers as over-borrowing will be less likely to happen when/if lenders are less willing to over-extend themselves.
- 13.6 In addition, the FSA cannot discipline individuals who give unsuitable advice through authorised firms. This is because they are not APs at these authorised firms. However, the FSA currently can prohibit home finance advisers and arrangers who commit the very worst offences, (for example, for knowingly being involved in mortgage fraud). The FSA has indeed prohibited 76 mortgage intermediaries since 2007 and have referred some of these mortgage intermediaries to the police; mortgage fraud is punishable by custodial sentences.³⁷ In addition, the FSA can take action against the authorised firms for poor management of these individuals or failing to prevent these individuals from committing mortgage fraud. The owners and directors of those authorised entities should, in turn, have an incentive to monitor their employees and discipline poor behaviour.

The proposal

- 13.7 This CP proposes:
- To introduce a new customer function CF31 for those undertaking the relevant home finance activities. This proposal creates central registration of individuals undertaking the relevant home finance activities. Specifically:
 - o During the transitional period, for individuals who are currently not approved for any CFs, the proposal requires them to undergo the full (modified) individual approval process for the newly created customer function CF31; for individuals who are already approved for a CF (e.g., CF1, CF4 but mainly CF30), and who wish to conduct the relevant home finance business activities, the proposal requires them to notify us.
 - o After the transitional period, everyone (including everyone who has been approved for CF30) who applies for the CF31 will undergo the usual individual approval process.³⁸
 - To apply the CF10 to home finance activities. Specifically, the proposal requires:
 - o all those who are APs (but not for CF10) – most people who are currently acting in the capacity of home finance business compliance officer are likely to be APs already – to submit the modified Short Form A; and
 - o those who are not APs to submit the modified Long form A.

37 http://www.sfo.gov.uk/news/prout/pr_365.asp?id=365, and more recently: http://www.sfo.gov.uk/news/prout/pr_631.asp?id=631

38 In the usual process, CRB checks are required for all sole traders/single director firms, while CRB checks are done on a sample basis for other applicants.

Costs and Benefits

CF31 (home finance business)

Costs

- 13.8 Extending the regime to cover the relevant activities will result in one-off and ongoing costs both to the FSA and the industry.
- 13.9 The first element of the proposal to approve individuals who are currently not approved for any CF (approximately 20,000 – based on information provided to us by firms) is estimated to incur a one-off cost of £3.8m³⁹ for the FSA, and a one-off cost of £8.9m⁴⁰ for the industry. The second element of the proposal (i.e. the AP's existing approval will cover the new customer function CF31, if our transitional notification rules are followed), is estimated to give rise to a one-off cost of £150k⁴¹ for the FSA, and £500k⁴² for the industry. So the total one-off cost associated with extending the AP regime to cover the relevant activities will be £4.0m for the FSA, and £9.4m for the industry.
- 13.10 In addition, assuming 20%⁴³ annual turnover, the requirement that all future applicants will need to undergo the usual approval process will incur an on-going cost of about £640k⁴⁴ per annum for the FSA, and £1.6m⁴⁵ per annum for the industry.
- 13.11 The scale of the costs will also depend on how much effort we will spend on policing and taking enforcement action against relevant individuals.
- 13.12 It is important to note that while those costs initially may be born by the firms, some of the costs may well be passed onto consumers in the form of higher fees/commissions. However, we do not expect this increase to be significant: the compliance costs during the transitional period will be £25 for the APs and £450 for individuals who are not already FSA approved; after the transitional period, the compliance costs will be £200.⁴⁶ In addition, with the introduction of CF31, some intermediaries may withdraw or be rejected from home finance business: to the extent that the withdrawal or rejection is due to FSA's disapproval, this is a benefit of preventing unsuitable people entering the home finance intermediation market, which could contribute to an improvement in quality of mortgage advice in the market. We do not expect that compliance costs will create a significant barrier to entry into the home finance business.

39 £600k IS cost, £320k fixed cost and the rest £2.9m are variable cost (i.e., depending on number of applicants)

40 This includes the cost of providing the criminal record disclosure: the cost of the time it will take to complete the criminal records disclosure forms including the cost of the check itself. It also includes the cost of firms' time to complete the individual approvals Long Form A.

41 IS cost was included in the £600k estimate above. $£7.5 \times 20k = £150k$.

42 £25 per notification, $20k \times £25 = £500k$

43 This estimate is based on our MI for existing CF30 (designated investment advisers/arrangers): there are about 130k CF30, and we received 29k applications in 2009.

44 At the end of the transitional period, all new applicants – whether from currently APs or not – will undergo the usual AP procedure. It is estimated to cost the FSA £25 per application, and then on top of this, it is estimated an additional £44 x 21hrs = £924 for 5% cases, additional £44 for 20% of cases: $20\% \times 40k \times (100\% \times £25 + 20\% \times £44 + 5\% \times 924) = £640k$ (based on FSA estimate)

45 $20\% \times 40k \times £200 = £1.6m$ (based on Real Assurance study)

46 The difference is due to the fact that the criminal records disclosure is not mandatory for every individual during the usual FSA approval process.

- 13.13 This proposal could raise the risk that firms may over-rely on the FSA to keep rogue individuals out as opposed to carrying out their own due diligence checks. This proposal could also raise the risk that consumers may over-rely on the “FSA Approved” label while in fact not all APs operate to the same high standards.

Benefits

- 13.14 To approve individuals who are currently not approved for any CFs (both during and transitional period, and in the future), there would be some benefits associated with a vetting and approval system. However, in the case of re-approving individuals who have been approved by the FSA already (albeit for a different function) after the transitional period, most of the benefit associated with a vetting and approval process would have been realised when these people were first approved. Because some people were approved before the introduction of criminal record checks for all sole traders and single directors, the introduction of these mandatory checks in the approved person process, and our more intrusive supervisory approach is expected to improve its effectiveness. In addition, this would bring transparency to the population of individuals conducting home finance activities to the FSA, lenders and consumers. This, in turn, could facilitate the FSA’s supervision and enforcement work.
- 13.15 The proposal may successfully either deter rogue individuals from entering the home finance business market, or stop rogue individuals from continuing to operate in it. This would contribute to reducing the amount of fraud in the mortgage sector.
- 13.16 In addition, to the extent that our fitness and propriety criteria is sufficiently effective at identifying in advance those who are likely to provide poor advice, then this could lead to improved advice in the mortgage sector.
- 13.17 As APs appear on the FSA Register, this would bring transparency to the FSA, lenders, and consumers: employers and consumers can search for individuals, which would provide them with a record of the individual’s regulatory history including any disciplinary action that may have been taken. We recognise that employers are more likely to search the register than consumers. However consumers would indirectly benefit from the employers’ search.
- 13.18 Moreover, the regime would make those APs personally accountable for any misconduct and for any unsuitable advice that they provide to customers through appropriate supervision and enforcement actions. This, in turn, should have a deterrent effect. The magnitude of this would, however, depend on our effort on policing and taking enforcement action against relevant individuals.

CF10

Costs

- 13.19 To apply CF10 to home finance activities will result in one-off and ongoing costs both to the FSA and the industry. However, it is thought that most people who are currently acting in the capacity of home finance business compliance officer are/will already be APs in some capacity already. So the costs for both us and the industry will be limited.

13.20 Specifically, during the transitional period, if we assume that:

- 3500 firms conducting home finance activities and who already have a CF10 for investment business will choose to put the responsibility of CF10 for home finance business with their existing CF10⁴⁷, and
- the remaining 2300⁴⁸ home finance firms will put forward some approved persons (albeit in different SIF) for CF10 for home finance business through short form A,

this will incur a one-off cost of £260k⁴⁹ for the FSA and one-off cost of £230k⁵⁰ for the industry.

13.21 In addition, if we assume 20% annual turn over of CF10 for home finance business, the proposal will incur an annual ongoing cost of £36k⁵¹ for the FSA, and £46k⁵² for the industry.

Benefits

13.22 There will be limited benefits as most of the benefit associated with a vetting and approval process would have been realised when these people were first approved.

13.23 We hope that by making the CF10 personally responsible for the compliance of home finance business, the proposal would have a deterrent effect. The scale of this would, however, depend on our effort on policing and taking enforcement action against relevant individuals.

47 There will be no additional costs for this group.

48 Total home finance businesses: 5800

49 It is estimated to cost the FSA £25 per application, and then on top of this, it is estimated an additional £44 x 21hrs = £924 for 2% cases, additional £44 for 20% of cases:
 $2300 \times (100\% \times £25 + 20\% \times £44 + 5\% \times 924) = £184k$ (based on FSA estimate).
In addition, the FSA will incur £80k one-off fixed cost.

50 It is estimated to cost a firm £100 to submit a short form A: $£100 \times 2300 = £230k$

51 Assuming 20% turnover, and the same split of existing CF10 and new to CF10:
 $20\% \times 2300 \times (100\% \times £25 + 20\% \times £44 + 5\% \times 924) = £36.8k$

52 $20\% \times 2300 \times £100 = £46k$

14 Compatibility statement

Introduction

- 14.1 As required under Sections 155 and 157 of FSMA, here we set out how our proposals in this CP are compatible with our general duties under section 2 of FSMA and the regulatory objectives set out in sections 2 – 6 of FSMA. We also outline how our proposals are consistent with our principles of good regulation to which we must have regard.

Compatibility with our statutory objectives

Consumer protection

- 14.2 Our proposals are designed to ensure that individuals who work in the home finance business are fit and proper, and we anticipate that the effects of this could be reinforced by the introduction of a CF10 to the industry, which will ensure compliance with our standards and regulations. This could directly benefit consumers to the extent our proposals deter or stop rogue individuals from entering the home finance business market. The increase in transparency on the population of individuals conducting home finance business that the proposals generate could also benefit consumers by enabling employers and consumers to identify specifically which individuals have been approved for the relevant activities and helping us to identify, and sanction, unfit individuals.

Market confidence

- 14.3 We expect our proposals to have a positive impact on market confidence by strengthening our approach to fitness and propriety in the home finance sector. We anticipate that our proposals could reduce the risk of unfit/improper individuals operating in the industry.

Reducing financial crime

- 14.4 Our proposals are designed to assess the suitability of candidates and their fitness and propriety to perform a certain controlled function. This along with the increased

transparency on the population of individuals conducting home finance activities will help a) reduce the risk of unsuitable individuals operating in the industry b) keep criminals and their associates out of the regulated community c) reduce the possibility that regulated businesses are used for a purpose connected with financial crime, therefore reducing overall levels of and exposure to financial crime. This is a key aim of our proposals.

Promoting public awareness

- 14.5 Part of this exercise will be to reinforce further the message that consumers should ensure the individuals with whom they are conducting home finance activities have been approved by us.

Compatibility with the principles of good regulation

- 14.6 Section 2(3) of FSMA requires us to consider certain principles when carrying out our general functions. We set out below how our approach supports these principles.

The need to use our resources in the most efficient and economic way

- 14.7 We have adapted our approach for the two groups of individuals currently conducting home finance activities to ensure it is proportionate. We also intend to use existing processes and take advantage of electronic submission.

The responsibilities of those who manage the affairs of authorised persons

- 14.8 As we state in paragraphs 9.13 – 9.16, the AP process is not designed to second guess or remove the need for robust employment checks by firms.

The restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions

- 14.9 The extent of the benefits arising from these proposals will depend on the effectiveness of the regime. However we do not expect that compliance costs will create a significant entry barrier to the home finance business.

The desirability of facilitating innovation in connection with regulated activities

- 14.10 We do not believe that our proposals will restrict innovation.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

- 14.11 We have no evidence that the regime hinders the competitive position of the UK.

The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions

- 14.12 The AP regime could act as a deterrent to rogue individuals from entering into the home finance sector, and make individuals who operate in this sector more accountable. To the extent that the proposals successfully stop or deter rogue individuals from entering the home finance business market, we believe that our proposals will have a positive effect on competition.

The desirability of facilitating competition between those who are subject to any form of regulation by the FSA

- 14.13 The AP regime could act as a deterrent to rogue individuals from entering into the home finance sector, and make individuals who operate in this sector more accountable. To the extent that the proposals successfully stop or deter rogue individuals from entering the home finance business market, we believe that our proposals will have a positive effect on competition.

Acting in a way which we consider most appropriate for the purpose of meeting our statutory objectives

- 14.14 We consider our proposals to be an appropriate means of tackling the issues addressed in the Mortgage Market Review, and proportionate to the risks that the industry faces.

Draft rules

APPROVED PERSONS (HOME FINANCE ACTIVITIES) INSTRUMENT 2010**Powers exercised**

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 59 (Approval for particular arrangements);
 - (2) section 60 (Applications for approval);
 - (3) section 64 (Conduct: statements and codes);
 - (4) section 138 (General rule-making power);
 - (5) section 156 (General supplementary powers); and
 - (6) section 157(1) (Guidance).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on *[date]*.

Amendments to the Handbook

- D. The modules of the FSA’s Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2) below:

(1)	(2)
Glossary of definitions	Annex A
Senior Management Arrangements, Systems and Controls sourcebook (SYSC)	Annex B
Statements of Principle and Code of Practice for Approved Persons (APER)	Annex C
Fees manual (FEES)	Annex D
Supervision manual (SUP)	Annex E
Credit Unions sourcebook (CRED)	Annex F

Citation

- E. This instrument may be cited as the Approved Persons (Home Finance Activities) Instrument 2010.

By order of the Board
[date]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

<i>customer-facing function</i>	either of the <i>controlled functions</i> 30 or 31 in the <i>table of controlled functions</i> .
<i>customer function (home finance business)</i>	the <i>controlled function</i> 31 in the <i>table of controlled functions</i> , described more fully in SUP 10.10.8R.

Amend the following as shown.

<i>customer function (designated investment business)</i>	the <i>controlled function</i> 30 in <u>the</u> <i>table of controlled functions</i> , described more fully in SUP 10.10.7AR.
---	---

Annex B

Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)

In this Annex, underlining indicates new text and striking through indicates deleted text.

3.2 Areas covered by systems and controls

...

The compliance function

...

- 3.2.8 R (1) A *firm* which carries on *designated investment business* with or for *retail clients or professional clients*, or home finance business with or for a *client*, must allocate to a *director or senior manager* the function of:
- (a) having responsibility for oversight of the *firm's* compliance; and
 - (b) reporting to the *governing body* in respect of that responsibility.
- (2) In (1) “compliance” means compliance with the *rules* in:
- (a) *COBS* (the Conduct of Business sourcebook);
 - (b) *COLL* (the Collective Investment Schemes sourcebook); ~~and~~
 - (c) *CASS* (the Client Assets sourcebook); and
 - (d) *MCOB* (the Mortgages and Home Finance: Conduct of Business sourcebook).

...

6.1 Compliance

...

- 6.1.4A R (1) A *firm* which is not a *common platform firm* and which carries on *designated business* with or for ~~retail clients~~ *retail clients* or ~~professional clients~~ *professional clients*, or home finance business with or for a *client*, must allocate to a *director or senior manager* the function of:

- (a) having responsibility for oversight of the *firm's* compliance; and
 - (b) reporting to the *governing body* in respect of that responsibility.
- (2) In ~~SYSC 6.1.4AR~~(1) “compliance” means compliance with the ~~rules~~ rules in:
- (a) *COBS* (the Conduct of Business sourcebook);
 - (b) *COLL* (the Collective Investment Schemes sourcebook) ~~and~~ *CIS* (~~Collective Investment Schemes sourcebook~~) (where appropriate);
 - (c) *CASS* (the Client Assets sourcebook); ~~and~~
 - (d) *ICOBS* (the Insurance: Conduct of Business sourcebook); and
 - (e) *MCOB* (the Mortgages and Home Finance: Conduct of Business sourcebook).

...

Annex C

Amendments to the Statements of Principle and Code of Practice for Approved Persons (APER)

In this Annex, underlining indicates new text and striking through indicates deleted text.

4.5 Statement of Principle 5

...

Temporary vacancies

- 4.5.15 G In organising the business, the *approved person* performing a *significant influence function* should pay attention to any temporary vacancies which exist (see *APER* 4.5.9E(3)). He should take reasonable steps to ensure that suitable cover for responsibilities is arranged. This could include taking on temporary staff or external consultants. The *approved person* performing a *significant influence function* should assess the risk that is posed to compliance with the requirements and standards of the *regulatory system* as a result of the vacancy, and the higher the risk the greater the steps he should take to fill the vacancy. It may be appropriate to limit or suspend the activity if appropriate cover for responsibilities cannot be arranged. To the extent that those vacancies are in respect of one of the *customer-facing functions*, they may only be filled by *persons* approved for that function.

...

Annex D

Amendments to the Fees manual (FEES)

In this Annex, underlining indicates new text and striking through indicates deleted text.

4 Annex 1R Activity groups, tariff bases and valuation dates applicable

...

Part 2

This table indicates the tariff base for each fee-block. The tariff base is the means by which we measure the ‘amount of business’ conducted by a firm. Note that where the tariff base is the number of *approved persons* it may be that a particular firm has *permission* for relevant activities as described in Part 1 but the type of activity that the firm undertakes is not one requiring a person to be approved to undertake ~~a relevant~~ the customer function (*designated investment business*) (CF30) (for example firms only giving *basic advice on stakeholder products*). In these circumstances, the firm will be required to pay a minimum fee only (see FEES 4 Annex 2R Part 1).

...

Activity group	Tariff base
...	
A.12	<p>APPROVED PERSONS</p> <p>The number of <i>persons</i> approved to perform the <i>customer function (<u>designated investment business</u>) (CF30)</i>, but excluding those <i>persons</i> who work solely in the <i>firm’s MTF</i> operation or solely acting in the capacity of an <i>investment manager</i> or solely advising <i>clients</i> in connection with <i>corporate finance business</i> or performing functions related to these.</p>
A.13	<p>APPROVED PERSONS</p> <p>The number of persons approved to perform the <i>customer function (<u>designated investment business</u>) (CF30)</i>, but excluding those <i>persons</i> who work solely in the <i>firm’s MTF</i> operation or solely acting in the capacity of an <i>investment manager</i> or solely advising <i>clients</i> in connection with <i>corporate finance business</i> or performing functions related to these.</p>
A.14	APPROVED PERSONS

	The number of persons approved to perform the <i>customer function (designated investment business)</i> (CF30), who advise <i>clients</i> in connection with <i>corporate finance business</i> or perform related functions.
...	

...

5.8 Joining the Financial Ombudsman Service

...

Application of FEES 5.8.2R

- 5.8.3 G The table below sets out the period within which a *firm's* tariff base is calculated ("the data period") for second year levies calculated under *FEES* 5.8.2R. The example is based on a *firm* that acquires *permission* on 1 November 2009 and has a financial year ending 31 March. Where valuation dates fall before the *firm* receives *permission* it should use projected valuations in calculating its levies.

References in this table to dates or months are references to the latest one occurring before the start of the *FSA's* financial year unless otherwise stated.

Type of permission acquired on 1 November	Tariff base	Valuation date but for FEES 5.8.2R	Data period under FEES 5.8.2R
...			
Advisory <i>arrangers</i> , dealers or brokers holding and controlling <i>client money</i> and/or assets	Number of relevant <i>persons</i> approved to perform the <i>customer function (designated investment business)</i> (CF30), with certain exclusions.	Relevant <i>approved persons</i> as at 31 December	Relevant <i>approved persons</i> as at 31 December

...

5 Annex 1R Annual Fees Payable in Relation to 2009/10

...

Part 2: Fee tariffs for general levy

Industry block	Tariff base	General levy payable by firm
...		
8 – Advisory arrangers, dealers or brokers holding and controlling <i>client money</i> and/or assets.	Number of relevant <i>persons</i> approved to perform the <i>customer function (designated investment business)</i> (CF30), but excluding those <i>persons</i> solely acting in the capacity of an <i>investment manager</i> or solely advising <i>clients</i> in connection with <i>corporate finance business</i> or performing functions relating to these.	£45 per relevant <i>approved person</i> subject to a minimum levy of £45
9 – Advisory arrangers, dealers or brokers not holding and controlling <i>client money</i> and/or assets	Number of relevant <i>persons</i> approved to perform the <i>customer function (designated investment business)</i> (CF30), but excluding those <i>persons</i> solely acting in the capacity of an <i>investment manager</i> or solely advising <i>clients</i> in connection with <i>corporate finance business</i> or performing functions relating to these.	£40 per relevant <i>approved person</i> subject to minimum levy of £40
...		

Annex E

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

10.1 Application

...

Overseas firms: UK establishments

- 10.1.7 R Only the following *controlled function* apply to an *overseas firm* which maintains an establishment in the *United Kingdom* from which *regulated activities* are carried on:

...

- (7) the *customer-facing functions*.

...

Incoming EEA firms: passported activities from a branch

- 10.1.13 R Only the following *controlled functions* apply to an *incoming EEA firm* with respect to its *passported activities* carried on from a *branch* in the *United Kingdom*:

...

- (6) the *customer-facing ~~function~~ functions* other than where this relates to the function in *SUP 10.10.7AR(4)*.

...

Incoming EEA firms etc with top-up permission activities from a UK branch

- 10.1.14 R In relation to the activities of a *firm* for which it has a *top-up permission*, only the following *controlled functions* apply:

...

- (4) the *customer-facing ~~function~~ functions*.

...

Appointed Representatives

- 10.1.16 R The descriptions of the following *controlled functions* apply to an *appointed*

representative of a firm, except an introducer appointed representative, as they apply to a firm:

- (1) the *governing functions*, subject to SUP 10.1.16AR and except for a *tier agent* of an EEA MiFID investment firm; and
- (2) the *customer-facing ~~function~~ functions* other than in relation to acting in the capacity of an *investment manager* (see SUP 10.10.7AR(6)).

...

10.4 Specification of functions

...

Table of Controlled Functions

10.4.5 R

Type	CF	Description of controlled function
...		
<i>Customer-facing functions</i>	21	[deleted]
	22	[deleted]
	23	[deleted]
	24	[deleted]
	25	[deleted]
	26	[deleted]
	27	[deleted]
	30	<i>Customer function (<u>designated investment business</u>)</i>
	<u>31</u>	<i>Customer function (<u>home finance business</u>)</i>

...

10.6 Governing functions

...

- 10.6.3 G The effect of SUP 10.6.2R is that a *person* who is *approved* to perform a *governing function* (other than the *non-executive director function* and the function described in SUP 10.6.4R(2)) will not have to be specifically

approved to perform the *systems and controls function* or the *significant management function*. A person who is approved to perform a *governing function* will have to be additionally approved before he can perform any of the *required functions* or the *customer-facing function functions*.

...

10.10 Customer-facing functions

- 10.10.1 R *SUP 10.10 (~~Customer function~~)* applies with respect to activities carried on from an establishment maintained by the *firm* (or by its *appointed representative*) in the *United Kingdom*.
- 10.10.2 G Without *SUP 10.10.1R* the description of the *customer-facing function functions* would extend to ~~this function~~ these functions wherever ~~it was~~ they were performed. The effect of *SUP 10.10.1R* is that the description is limited, in relation to *regulated activities* with an overseas element, in a manner which is broadly consistent with the scope of conduct of business regulation.
- 10.10.3 G The *customer-facing function functions* ~~has~~ have to do with giving advice on, *dealing* and arranging deals in and *managing investments* or home finance activities; ~~it has~~ they have no application to banking business such as deposit taking and lending, nor to *general insurance business*.

The customer conditions (the second and third conditions)

- 10.10.4 R The *customer-facing function functions* ~~is one which~~ will involve the *person* performing it in dealing with *clients*, or dealing with property of *clients*, of a *firm* in a manner substantially connected with the carrying on of a *regulated activity* of the *firm*.

...

Customer function (designated investment business) (CF30)

- 10.10.7A R The *customer function* (designated investment business) is the function of:

...

- 10.10.7B R The *customer-facing function functions* ~~does do~~ not extend to an individual who is performing the functions in *SUP 10.10.7AR*(1) to (2) or *SUP 10.10.7AR*(5) to (6) and who is based overseas and who, in a 12 *month* period, spends no more than 30 *days* in the *United Kingdom* to the extent that he is appropriately supervised by a *person* approved for this function.

...

- 10.10.7D G The *customer function* (designated investment business) in *SUP 10.10.7AR*(5) does not extend to the individual who, on the instructions of the *customer*, simply inputs the *customer's* instructions into an automatic execution system where no discretion is or may be exercised by the

individual performing the activity. Nor does it extend to merely introducing a *customer* to a firm or distributing advertisements.

...

Customer function (home finance business) (CF31)

- 10.10.8 G ~~[deleted]~~ The customer function (home finance business) is the function of:
R
- (1) advising on a home finance transaction; or
 - (2) arranging (bringing about) regulated mortgage contracts; or
 - (3) arranging (bringing about) a home purchase plan; or
 - (4) arranging (bringing about) a home reversion plan; or
 - (5) arranging (bringing about) regulated sale and rent back agreements;
or
 - (6) home finance providing activities; or
 - (7) performing other functions related to any of these.
- 10.10.9 G ~~[deleted]~~ SUP 10.10.8R(6) does not cover the functions of a person that
R would otherwise fall under SUP 10.10.8R(6) if the functions relate only to
the period following the application by the client for a home finance
transaction.
- 10.10.10 G ~~[deleted]~~ The purpose of SUP 10.10.9R is to exclude certain activities from
the customer function (home finance business). There are various features.
- (1) The exclusion only relates to SUP 10.10.8R(6). That means that a
person who carries on arranging or advisory activities will come
within the customer function (home finance business). This is the
case whether his functions relate to the period before or after the
application by the client for a home finance transaction.
 - (2) The customer function (home finance business) does not apply to a
person if his client-facing functions only come within SUP
10.10.8R(6) and only relate to the period following the application
by the client for the home finance transaction. SUP 10.10.4R
explains what client-facing function means in this context.
 - (3) If a person's functions coming within SUP 10.10.8R(6) cover both
the period before and after the application, all those functions come
within the customer function (home finance business). That means
for example that APER will apply to what the person does both
before and after the application by the client.

...

10 Annex 1G Frequently asked questions

	Question	Answer
	Requirements of the regime	
...		
2	What are the procedures for 'emergency situations'?	Individuals may perform the <i>significant influence function</i> for up to 12 weeks in any consecutive 12 <i>month</i> period without requiring approval. When it becomes clear that a <i>person</i> will be performing the function on a permanent basis, then an application for approval should be made. However, there is no provision for individuals to perform the <i>customer-facing function functions</i> on a continuing basis without approval. See SUP 10.5.5R.
...		
21	How long will the FSA take to process an application for <i>approved person</i> status?	Generally the FSA will handle this within seven <i>business days</i> for <i>significant influence functions</i> and four <i>business days</i> for <i>customer-facing functions</i> . However, if information is missing, or the information provided gives the FSA cause for concern, processing time will almost always be longer. In each case, the FSA will notify the <i>firm</i> of any extension to the processing time.
...		

...

How does the customer-facing function functions relate to the training and competence requirements?

Activity	Products / sectors in TC Appendix 1	Controlled Function	SUP
<u>Designated investment business carried on for a retail client</u>			
Advising only;	2-9	<u>customer-facing function</u> (CF 30) <u>functions</u>	10.10.4R
Undertaking an activity;	10-11	<u>customer-facing function</u> (CF 30)	

Advising and dealing	12-13	<u>functions</u> <u>customer-facing function (CF 30)</u>	
Managing investments	14	<u>functions</u> <u>customer-facing function (CF 30)</u> <u>functions</u>	
<i>Regulated mortgage activity and reversion activity carried on for a customer</i>			
<u>Advising</u>	<u>20 – 21</u>	<u>customer-facing functions</u>	
<i>Regulated sale and rent back activity carried on for a customer</i>			
<u>Advising</u>	<u>25</u>	<u>customer-facing functions</u>	

...

12.2. Introduction

...

Introducers and representatives: what do these terms mean and what is the relationship with an appointed representative?

...

12.2.14 G (1) ...

- (2) If a *firm* appoints an *appointed representative* who is an individual in (1), that *appointed representative* will also be a *representative*. The individual may need to be approved to perform the *customer-facing function functions*, (see *SUP* 12.6.8G and *SUP* 12.6.9G). In these circumstances, in addition to complying with the requirements of *SUP* 12 and other regulatory requirements, the *firm* should ensure that the rules for *representatives* in *COBS* 6 (Information about the firm, its services and remuneration) are complied with.

...

12.6 Continuing obligations of firms with appointed representatives or EEA tied agents

...

Obligations of firms under the approved persons regime

12.6.8 G (1) Some of the *controlled functions*, as set out in *SUP* 10.4.1R, apply to an *appointed representative* of a *firm*, other than an *introducer appointed representative*, just as they apply to a *firm* (see *SUP* 10.1.16R). These are the *governing functions* and the *customer-facing function functions*. As explained in *SUP* 10.1.16AR and *SUP* 10.3.2G respectively:

- (a) ...
- (b) although the *customer-facing function functions* ~~applies~~ apply to an ~~appointed representative~~ *appointed representative*, the descriptions of the functions themselves do not extend to *home finance mediation activity* or *insurance mediation activity*; and

...

...

...

Insert the following new rows in the SUP Transitional Provisions. The text is not underlined.

TP 1 Transitional provisions

...

TP 1.2

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
...					
8K	SUP 10.7.8R	R	(1) This <i>rule</i> deals with the extension of the <i>compliance oversight function</i> through the amendment to SYSC 3.2.8R and SYSC 6.1.4AR to cover <i>home finance activities</i> by the Approved Persons (Home Finance Activities) Instrument 2010.	Not applicable	Not applicable
			(2) This <i>rule</i> applies to a <i>person</i> who meets the following conditions on the first application period start date: (a) he is performing the part of the <i>compliance oversight function</i> described in (1) for a <i>firm</i> because of the extension described in (1); and (b) he was approved to perform the <i>compliance oversight function</i> for that <i>firm</i> .		
			(3) The approval for carrying out the <i>compliance oversight function</i> covers the extension referred to in (1) as respects that <i>person</i> and that <i>firm</i> .		
			(4) SUP TP 8PR contains various supplemental provisions applicable to this <i>rule</i> .		

8L	SUP 10.7.8R	R	<p>(1) This <i>rule</i> deals with the extension of the <i>compliance oversight function</i> through the amendment to SYSC 3.2.8R and SYSC 6.1.4 AR to cover <i>home finance activities</i> by the Approved Persons (Home Finance Activities) Instrument 2010.</p>	[Date instrument comes into force] – [3 months later]	[3 months later]
			<p>(2) This <i>rule</i> applies to a person who meets the following conditions on the first application period start date:</p> <ul style="list-style-type: none"> (a) he would otherwise have been performing the part of the <i>compliance oversight function</i> described in (1) for a <i>firm</i> because of the extension described in (1); (b) he was not approved to perform any <i>controlled function</i> for that <i>firm</i>; and (c) (to the extent that TC 2.1.1R applied to him in relation to the activities in (a)), the <i>firm</i> has assessed him as competent to carry on the activities in (a) and that assessment was current at that date. 		
			<p>(3) The functions relating to the <i>home finance activities</i> described in SYSC 3.2.6R and SYSC 6.1.4AR, as respects that <i>person</i> and that <i>firm</i>, are not treated as forming part of the <i>compliance oversight function</i>.</p>		
			<p>(4) If this transitional <i>rule</i> has not already expired under column (5), this <i>rule</i> comes to an end as respects that <i>person</i> and that <i>firm</i> if and when an application is made for the person to perform the <i>compliance oversight function</i> for that <i>firm</i> and that application is granted.</p>		

			(5) If the <i>FSA</i> has received a completed application for that <i>person</i> to perform the <i>compliance oversight function</i> before the first application period end date and that application has not been finally decided by the time that the transitional period in column (5) would otherwise have come to an end, that transitional period is extended until the application has been finally decided.		
			(6) <i>SUP TP 8PR</i> contains various supplemental provisions applicable to this <i>rule</i> .		
8M	<i>SUP 10.7.8R</i>	R	(1) This <i>rule</i> deals with the extension of the <i>compliance oversight function</i> through the amendment to <i>SYSC 3.2.8R</i> and <i>SYSC 6.1.4AR</i> to cover <i>home finance activities</i> by the Approved Persons (Home Finance Activities) Instrument 2010.	[Date instrument comes into force] – [6 months later]	[6 months later]
			<p>(2) This <i>rule</i> applies to a person who meets the following conditions on the first application period start date:</p> <p>(a) he would otherwise have been performing the part of the <i>compliance oversight function</i> described in (1) for a <i>firm</i> because of the extension described in (1);</p> <p>(b) he was not approved to perform the <i>compliance oversight function</i> for that <i>firm</i> but was approved to perform any of the other <i>controlled functions</i> for that <i>firm</i>;</p> <p>(c) (to the extent that <i>TC 2.1.1R</i> applied to him in relation to the activities in (a)), the <i>firm</i> has assessed him as competent to carry on the activities in (a) and that assessment was current at that date.</p>		

			(3) The functions relating to <i>home finance activities</i> described in SYSC 3.2.6R and SYSC 6.1.4 AR, as respects that <i>person</i> and that <i>firm</i> , are not treated as forming part of the <i>compliance oversight function</i> .		
			(4) If this transitional <i>rule</i> has not already expired under column (5), this <i>rule</i> comes to an end as respects that <i>person</i> and that <i>firm</i> if and when an application is made for the person to perform the <i>compliance oversight function</i> for that <i>firm</i> and that application is granted. However, this transitional <i>rule</i> does not expire before the second application period start date.		
			(5) If the FSA has received a completed application for that <i>person</i> to perform the <i>compliance oversight function</i> between the second application period start date and the second application period end date and that application has not been finally decided by the time that the transitional period in column (5) would otherwise have come to an end, that transitional period is extended until the application has been finally decided.		
			(6) SUP TP 8PR contains various supplemental provisions applicable to this <i>rule</i> .		
8N	SUP 10.10.8R	R	<p>(1) This <i>rule</i> deals with a <i>person</i> who meets the following conditions on the first application period start date:</p> <p>(a) he would otherwise have been performing the <i>customer function (home finance business)</i> for a <i>firm</i>;</p> <p>(b) he was not approved to perform any <i>controlled function</i> for that <i>firm</i>; and</p> <p>(c) (to the extent that TC 2.1.1R applied to him in relation to the activities in (a)), the <i>firm</i> has assessed him as competent to carry on those activities and that assessment was current at that date.</p>	[Date instrument comes into force] – [3 months later]	[3 months later]

			(2) The <i>customer function (home finance business)</i> , as respects that <i>person</i> and that <i>firm</i> , is not treated as a <i>controlled function</i> .		
			(3) If this transitional <i>rule</i> has not already expired under column (5), this <i>rule</i> comes to an end as respects that <i>person</i> and that <i>firm</i> if and when an application is made for the person to perform the <i>customer function (home finance business)</i> for that <i>firm</i> and that application is granted.		
			(4) If the FSA has received a completed application for that <i>person</i> to perform the <i>customer function (home finance business)</i> between the first application period start date and the first application period end date and that application has not been finally decided by the time that the transitional period in column (5) would otherwise have come to an end, that transitional period is extended until the application has been finally decided.		
			(5) SUP TP 8PR contains various supplemental provisions applicable to this <i>rule</i> .		
8O	SUP 10.10.8R	R	(1) This <i>rule</i> deals with a <i>person</i> who meets the following conditions on the first application period start date:	[Date instrument comes into force] – [6 months later]	[6 months later]
			(a) he would otherwise have been performing the <i>customer function (home finance business)</i> for a <i>firm</i> ;		
			(b) he was approved to perform any <i>controlled function</i> for that <i>firm</i> ; and		
			(c) (to the extent that TC 2.1.1R applied to him in relation to the activities in (a)), the <i>firm</i> has assessed him as competent to carry on those activities and that assessment was current at that date.		

			(2) The <i>firm</i> must notify the <i>FSA</i> of each <i>person</i> falling into (1). The <i>firm</i> must give that notification between the second application period start date and the second application period end date.		
			(3) The the <i>customer function (home finance business)</i> , as respects that <i>person</i> and that <i>firm</i> , is not treated as a <i>controlled function</i> between the first application period start date and the first application period end date and thereafter until the earlier to occur of the date on which the <i>firm</i> gives the notification under (2) and the second application period end date.		
			(4) If the notification in (2) is given in accordance with that paragraph, the approval for carrying out the other <i>controlled function</i> covers the <i>customer function (home finance business)</i> as respects that <i>person</i> and that <i>firm</i> .		
			(5) <i>SUP TP 8PR</i> contains various supplemental provisions applicable to this <i>rule</i> .		
8P	<i>SUP TP 8LR</i> to <i>SUP TP 8OR</i>	R	(1) This <i>rule</i> defines various terms used in <i>SUP TP 8LR</i> to <i>SUP TP 8OR</i> and sets out various other supplemental matters.	Not applicable	Not applicable
			(2) An application for a <i>person</i> to perform a <i>controlled function</i> is finally decided on the earliest of the following dates: (a) when the application is withdrawn; (b) when the <i>FSA</i> grants approval; (c) where the <i>FSA</i> has refused the application and the matter is not referred to the <i>Tribunal</i> , on the date on which the right to refer the matter to the <i>Tribunal</i> expires;		

			<p>(d) where the <i>FSA</i> has refused the application and the matter is referred to the <i>Tribunal</i>, when the reference is determined by the <i>Tribunal</i> and the time for bringing an appeal has expired;</p> <p>(e) if the application is determined by the court, when the court makes that determination.</p>		
			(3) The first application period start date is [date rules come into force].		
			(4) The first application period end date is [3 months later].		
			(5) The second application period start date is [three months after rules come into force].		
			(6) The second application period end date is [three months later].		
			(7) The notification under <i>SUP</i> TP 8OR must contain (a) the <i>person's</i> full name, (b) his individual register reference number and (c) the <i>firm's</i> register reference number. The register means the register maintained by the <i>FSA</i> under section 347 of the <i>Act</i> (The record of authorised persons etc).		
			(8) The <i>firm</i> must submit a notification referred to in (7) by electronic means made available by the <i>FSA</i> .		
			(9) If the <i>FSA's</i> information technology systems fail and online submission under (8) is unavailable for 24 hours or more, until such time as facilities for online submission are restored, a <i>firm</i> must submit the notification in the way set out in <i>SUP</i> 15.7.4R to <i>SUP</i> 15.7.9G (Form and method of notification). However, this <i>rule</i> only applies to a failure that exists in the week ending on the date by which that notification must have been made.		

8Q	SUP 10.7.8R and SUP 10.10.8R	G	(1) The effect of SUP TP 8KR(3) is that a <i>person</i> who is already approved to perform the <i>compliance oversight function</i> , the original grant of approval by the FSA to carry out the <i>compliance oversight function</i> will remain valid in relation to the extension of the <i>compliance oversight function</i> and no new approval to perform that <i>controlled function</i> will be required.	Not applicable	Not applicable
			(2) The effect of SUP TP 8OR(4) is that if the <i>firm</i> for which an <i>approved person</i> performs a <i>controlled function</i> complies with the notification requirements of that <i>rule</i> the grant of approval by the FSA to carry out that <i>controlled function</i> will cover the <i>customer function (home finance business)</i> and no new approval to perform that <i>controlled function</i> will be required.		
			(3) A notification is not made in accordance with SUP TP 8OR if the <i>firm</i> gets an automatic response from the FSA's or the <i>firm's</i> systems to say that the notification was not delivered.		
			(4) An application for approval to carry out a <i>controlled function</i> to which SUP TP 8LR to SUP TP8NR applies should be made electronically in accordance with SUP 10.12 (Application for approval and withdrawing an application for approval).		
...					

Annex F

Amendments to the Credit Unions sourcebook (CRED)

In this Annex, underlining indicates new text and striking through indicates deleted text.

6.3 Approved Persons

...

Controlled functions

- 6.3.4 G *SUP 10.3 provides, in this context, that a function is a controlled function only when it is undertaken by a *credit union* in relation to a *regulated activity*. *Controlled functions* fall within two groups. The *significant influence functions* describe the roles performed by the *governing body* and *senior managers* of the *firm* who exert a significant influence over the *regulated activities* of the *firm*. The *customer-facing functions* describe the roles of individuals who deal with *customers* or with the property of *customers*. These *customer-facing functions* do not extend to activities in relation to accepting *deposits* or general insurance and therefore will not be relevant to *credit unions* with *permission for accepting deposits* only.*

...

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