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## FINAL NOTICE

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To: **Rainbow Homeloans Limited**

Of: **London House  
12-14 Bank Street  
Newquay  
Cornwall TR7 1JF**

Dated: **26 June 2006**

**TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS (“the FSA”) gives you a final notice about a requirement to pay a financial penalty:**

### **1. THE PENALTY**

1.1 The FSA gave Rainbow Homeloans Limited ("RHL/the firm") a decision notice dated 20 June 2006 which notified RHL that pursuant to section 206 of the Financial Services and Markets Act 2000 (“the Act”) the FSA had decided to impose a financial penalty of £35,000 on RHL in respect of breaches of the following FSA Principles for Businesses and rules, which occurred between 31 October 2004 and 1 November 2005 (“the period in issue”):

- (1) **FSA Principle 2 (due skill, care and diligence),**
- (2) **FSA Principle 3 (management and control),**
- (3) **FSA Principle 6 (customers’ interests).**

1.2 The following rules are also relevant:

- (1) FSA Rules 2.1.1 R and 3.1.1 R in the part of the FSA Handbook (“the Handbook”) entitled Senior Management Arrangements, Systems and Controls (“SYSC”);

- (2) FSA Rules 4.7.2 R, 4.7.4 R, 4.7.6 R and 5.5.1 R in the part of the Handbook entitled Mortgages: Conduct of Business (“MCOB”); and
- (3) FSA Rules 1.2.1 R and 1.2.22 R in the part of the Handbook entitled: Dispute Resolution: Complaints (“DISP”).

1.3 For the reasons set out below and having agreed with RHL at an early stage of proceedings the facts and matters relied on, the FSA imposes a financial penalty on RHL in the amount of £35,000. Having achieved settlement at an early stage, RHL qualified for a 30% (stage 1) reduction in penalty<sup>1</sup>. Were it not for this discount, the FSA would have imposed a penalty of £50,000 on RHL.

## 2. REASONS FOR THE ACTION

2.1 The FSA imposes the financial penalty on RHL in respect of breaches of the FSA Principles and rules identified in section 1 above that occurred during the period in issue.

2.2 The failings which are described in detail in paragraphs 3.7 to 4.18 below relate to RHL's failure to take reasonable steps to put in place effective senior management arrangements and systems and controls that were appropriate to its business and to exercise due skill, care and diligence and treat customers fairly in connection with the sale of regulated mortgage contracts and the handling of customer complaints.

2.3 In summary RHL's failings are as follows:

- (1) RHL failed to take reasonable care to establish and maintain appropriate systems and controls and maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers in such a way that the business and affairs of the firm could at all times be adequately monitored and controlled (**Principle 3**).
  - (i) The firm failed to adequately apportion significant responsibilities, in particular, responsibility for compliance oversight, among its senior management. Rather, the firm relied to an inappropriate extent on the services of an external consultant for compliance-related matters and ensuring the fair treatment of customers.
  - (ii) While the firm had a management structure and oversight arrangements, it did not ensure that it had an appropriate governing body in the form of FSA-approved directors performing, in particular, the controlled function of Director (CF1).

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<sup>1</sup> Guidance on discounts for early settlement is contained in Chapter 3.7 of the Enforcement Manual (part of the FSA's Handbook of rules and guidance).

- (iii) Some key decisions relating to the firm's business and affairs, and which impacted on the treatment of customers, were taken by the firm's individual controllers, who live abroad, and not by the firm's directors who by virtue of their positions as directors should have exercised such responsibility.
  - (iv) The firm used the services of an unauthorised marketing company to gather information about customers' financial and other circumstances. The firm's administrative staff would then use this information to make an initial product recommendation, prior to the customer having any contact with, or receiving advice, from a qualified adviser.
- (2) RHL failed to take reasonable steps to ensure the suitability of recommendations to customers to enter into, or to vary, regulated mortgage contracts (**Principle 2 and Principle 6**). For example, RHL failed to gather and/or record sufficient information about customers financial and other circumstances to demonstrate that customers could afford to enter into a recommended regulated mortgage contract, that the contract was appropriate to their needs, and that it was the most suitable of those available.
  - (3) RHL failed to provide customers with appropriate product information in the form of a key facts illustration before completing and submitting their mortgage applications to lenders (**Principle 2 and Principle 6**).
  - (4) RHL failed to ensure that it handled complaints fairly and adequately (**Principle 2 and Principle 6**).

2.4 RHL's failings are considered serious for the following reasons.

- (1) The failings resulted from serious weaknesses in the firm's senior management arrangements and systems and controls, such that customers were exposed to the risk of being recommended unsuitable products.
- (2) In the absence of an appropriate governing body with clear responsibility, amongst other matters, for compliance oversight, RHL relied on the services of an external consultant for all regulatory and compliance matters. The firm's senior management failed to demonstrate to the FSA a sufficient understanding of the firm's obligations under the regulatory system.
- (3) A significant proportion of RHL's business concerned the sale of regulated mortgage contracts to customers who were seeking to consolidate debts on account of payment difficulties. The FSA could not be satisfied that the firm had taken into account all relevant factors when providing advice to this financially vulnerable type of customer or had therefore taken reasonable steps to ensure the suitability of its recommendations.
- (4) RHL failed to mitigate the risk of customers receiving unsuitable advice and suffering detriment by failing to maintain appropriate and effective control over its complaint-handling which was undertaken by an external compliance consultant.

2.5 RHL's failures are mitigated by the following factors.

- (1) The firm accepts that in the period in issue its systems and controls were not wholly adequate, and it ceased conducting all regulated activities to avoid any further risk of consumer detriment.
- (2) As part of its investigation, the FSA carried out a customer contact exercise in respect of a sample of the firm's mortgage sales. No customer in that sample expressed dissatisfaction with the service provided by RHL.
- (3) As there was nevertheless a risk of consumer detriment, the firm has agreed to carry out a review of regulated mortgage business transacted in the period in issue and to provide redress where appropriate.
- (4) RHL has been open and co-operative with the FSA and has agreed the facts quickly ensuring efficient resolution of the matter and has received full credit for settlement at an early stage.

### 3. **FACTS AND MATTERS RELIED ON**

#### *Background*

- 3.1 RHL was a specialist sub-prime mortgage broker, which provided advice in relation to mortgage products offered by a panel of four different product providers.
- 3.2 RHL has two individual controllers who live abroad. The firm currently has two directors who were appointed on 1 April 2004 and 6 June 2004 respectively. These directors were approved by the FSA to perform the CF1 function of Director on 1 November 2005.
- 3.3 RHL's head office and administration function is based in Newquay, Cornwall. Until October 2005, the firm employed up to 30 mortgage advisers based in various locations around the UK. During the period in issue, the firm provided advice in relation to the sale of approximately 1,000 regulated mortgage contracts.
- 3.4 RHL has been regulated by the FSA since 31 October 2004. Prior to this date, it was supervised by the Mortgage Code Compliance Board.

#### *FSA Supervision Visit - 21 September 2005*

- 3.5 The FSA's Small Firms Division ("SFD") visited RHL in September 2005 as part of a wider project to assess the quality and suitability of advice.
- 3.6 The purpose of the visit was to review RHL's selling practices and compliance arrangements and to assess the extent to which the firm was treating customers fairly and, more specifically, complying with the FSA's Principles for Businesses in relation to the quality and suitability of advice. SFD interviewed RHL's key senior staff and reviewed a number of the firm's client files. SFD identified the following concerns.

### ***Senior management arrangements, systems and controls***

- 3.7 According to the FSA's records at the time of the visit, the firm had a single FSA approved CF1 director in place. However, it became clear that this person was no longer performing the role of director or carrying out any other controlled functions in relation to the firm, although they remained an individual controller. RHL's external compliance consultant informed SFD that change of controller applications had been submitted to the FSA in April 2005, although the FSA has no record of receiving any such applications. The firm did not follow up the matter and therefore operated since 31 October 2004 without any FSA-approved governing body in place.
- 3.8 In the context of the absence of an approved CF1 director with responsibility for oversight of the way in which RHL carried on regulated activities, it relied on the services of an external consultant for all compliance matters and for handling customer complaints and visits from its controllers one week per month. When questioned about the firm's sales process and its systems and controls for compliance, the firm's directors, apparently acting on the advice of the external compliance consultant, did not provide SFD with an adequate explanation of all aspects of the firm's marketing and sales process (in particular, an explanation of the services provided by an unauthorised marketing company) and were not able to produce any compliance reports for the firm.

#### ***RHL's sales process***

- 3.9 RHL relied extensively on the services of a marketing company for the referral of customers. To this end, the marketing company provided RHL not only with contact details for customers but also information about their personal and financial circumstances. It therefore appeared that RHL was relying on an unauthorised marketing company to gather information about customers as part of an initial fact-finding process. RHL explained that, while the marketing company would gather some initial information from customers, any information obtained as part of this process would subsequently be reviewed by a qualified mortgage adviser.
- 3.10 Having received this information, RHL's administrative staff would use this information to make an initial product recommendation and produce a relevant key facts illustration containing information about the costs, features and risks of the mortgage. A sales pack, containing the information gathered by the marketing company and the initial mortgage recommendation, would then be passed to an adviser for the purpose of conducting a pre-arranged interview with the customer. In circumstances where the firm's advice resulted in a different recommendation the customer typically completed and submitted an application form before receiving a further key facts illustration.
- 3.11 In relation to the client file sample, SFD found insufficient or no evidence that RHL had carried out any product research in relation to the recommendation of regulated mortgage contracts.
- 3.12 SFD was also concerned that, in relation to RHL's complaint handling, the firm's decision letters did not appear to fully address all aspects of the customers' complaints.

- 3.13 As a result of the above information obtained during the visit, RHL was referred by SFD to the FSA's Enforcement Division ("Enforcement") in December 2005 as there was a risk that customers may have been treated unfairly in terms of the advice they were given and, accordingly, may have suffered detriment.

#### ***Enforcement investigation***

- 3.14 As part of its investigation, Enforcement reviewed a wider sample of client files which represented approximately 8% of RHL's mortgage sales in the period since 31 October 2004. The purpose of the review was to establish whether the issues identified by SFD were indicative of more widespread failings and had resulted in any consumer detriment.
- 3.15 From its review of client files, Enforcement identified the following concerns:
- (1) sales of sub prime regulated mortgage contracts where there was variously no or insufficient evidence on file of any adverse credit history or payment difficulties;
  - (2) sales of regulated mortgage contracts running beyond normal retirement age, where there was variously no or insufficient evidence as to how the customer would be able to afford the mortgage repayments into retirement;
  - (3) the relevant key facts illustrations dated and issued after completion of mortgage application forms;
  - (4) sales of regulated mortgage contracts where the total fees and costs in connection with the sales were at a similar level to or in excess of the sums that the customers were seeking to raise; and
  - (5) sales of regulated mortgage contracts where there was variously no or insufficient information about the customers' financial circumstances, in particular their income and expenditure.

## **4. BREACHES OF FSA PRINCIPLES FOR BUSINESSES**

### **Failure to establish and maintain effective systems and controls and senior management arrangements**

- 4.1 During the period in issue, RHL was required by virtue of **Principle 3** to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems and failed to do so.

#### Facts and matters relied on

- 4.2 During the period in issue, RHL did not have in place an appropriate governing body in the form of FSA approved directors performing the controlled function of Director (CF1).

- 4.3 In the context of the absence of an appropriate governing body the firm failed to apportion, amongst its senior management, clear lines of responsibility for such significant matters as maintenance of the firm's systems and controls and compliance oversight. The firm relied to an inappropriate degree on the services of an external consultant for all regulatory and compliance related matters, including complaint handling.
- 4.4 When questioned during the SFD visit about the firm's systems and controls for compliance, the firm's directors could not produce any of the firm's compliance reports or provide any information about its compliance record. The firm's senior staff did not demonstrate a complete understanding of the firm's obligations under MCOB or the regulatory system, generally.
- 4.5 As part of its systems and controls for compliance, the firm explained that during the period in issue its external compliance consultant would routinely review a random sample of 10% of all mortgage business transacted by the firm in order to monitor the quality and suitability of advice. Despite this claim, the FSA found no evidence that any such reviews had been documented or how such a system operated in practice.
- 4.6 To the extent that the firm did operate such a system, this failed to operate as an effective control as the firm failed to identify or take corrective action in respect of the failings identified subsequently by either SFD's or Enforcement's review of files, which represented approximately 8% of the total business transacted by the firm in the period in issue.
- 4.7 In addition to the arrangements above, the firm explained that its national sales manager carried out routine client file checks in order to monitor the quality and suitability of advice. While the firm was able to provide training and competence records for each of its advisers, the FSA found no documentary evidence of client file reviews or reporting of issues of concern to senior management.
- 4.8 As part of its sales process, the firm relied on the services of an unauthorised marketing company to gather information about customers financial and other circumstances as part of an initial fact-finding process. The firm's administrative staff would then rely on this information to make an initial product recommendation prior to the customer having any contact with a qualified adviser. This created the risk that the firm's advisers could rely on this information for the purpose of advising customers rather than obtaining first hand and discussing information about the customer's needs/objectives and their personal and financial circumstances.

#### **Failure to exercise due skill care and diligence and treat customers fairly**

- 4.9 During the period in issue, RHL was required by virtue of **Principle 2** to conduct its business with due skill care and diligence and by virtue of **Principle 6** to pay due regard to the interests of its customers and to treat them fairly. However, for the reasons set out in paragraphs 4.10 to 4.18 below RHL failed to do so.

### *Failure to demonstrate suitability of advice*

- 4.10 A firm must take reasonable steps to ensure that it does not make a personal recommendation to a customer to enter into a regulated mortgage contract, or to vary an existing regulated mortgage contract unless the regulated mortgage contract is, or after the variation, will be suitable for the customer (MCOB 4.7.2 R).
- 4.11 A regulated mortgage contract will be suitable if, having regard to the facts disclosed by the customer and other relevant facts about the customer of which the firm is, or should reasonably be aware, the firm has reasonable grounds to conclude that:
- (1) the customer can afford to enter into the regulated mortgage contract;
  - (2) the regulated mortgage contract is appropriate to the needs and circumstances of the customer; and
  - (3) the regulated mortgage contract is the most suitable of those that the firm has available to within the scope of the service provided to the customer (MCOB 4.7.4 R).
- 4.12 Where a firm makes a personal recommendation to a customer to enter into a regulated mortgage contract, where the main purpose is to consolidate existing debts, it must also take account of the following, where relevant, in assessing whether the regulated mortgage contract is suitable for the customer:
- (1) the costs associated with increasing the period over which a debt is to be repaid;
  - (2) whether it is appropriate for the customer to secure a previously unsecured loan; and
  - (3) where the customer is known to have payment difficulties, whether it would be more appropriate for the customer to negotiate an arrangement with his creditors than take out a regulated mortgage contract (MCOB 4.7.6 R).
- 4.13 For the reasons set out below, in the period in issue RHL failed to comply with the above requirements.

### Facts and matters relied on

- 4.14 As described above, the FSA reviewed a sample of the firm's sales of regulated mortgage contracts, which represented approximately 8% of the total mortgage business transacted by the firm in the period in issue. In connection with this sample, the FSA identified the following failings.
- (1) RHL did not always gather and/or record sufficient information about customers' personal and financial circumstances, to demonstrate the suitability of the mortgage contracts recommended.



- (2) While RHL's fact-find document prompted the adviser to carry out an affordability assessment there was frequently little or no information recorded about the customers' income or expenditure, such that RHL was unable to demonstrate that the customer could afford to enter into the regulated mortgage contract.
- (3) RHL could not demonstrate on client files that it had variously paid any or sufficient attention to whether there was likely to be any change in the customer's income or expenditure such that the customer would be able to afford the repayments throughout the full term of the mortgage. This was a particular issue in cases where customers were relying on receipt of tax credits and/or other benefits in order to meet affordability requirements as there was frequently no record on file as to how long these benefits were likely to continue.
- (4) RHL recommended a number of regulated mortgage contracts with terms running beyond the normal retirement age. In such cases reviewed by the FSA, the firm failed to gather sufficient or any information to demonstrate that it had considered and discussed with the customer whether they would be able to afford the repayments post retirement.
- (5) The majority of RHL's recommendations concerned the sale of "sub-prime" mortgages. Sub-prime mortgages generally refer to those mortgages which are targeted at customers with impaired or low-credit ratings such that they can often find it difficult to obtain finance from other more traditional sources. Because of the increased risk in lending to this type of customer, sub-prime mortgages generally involve higher lending rates and offer less favourable terms than prime mortgages. Despite the particular features of this type of mortgage product, it was not clear in a number of cases why the firm had recommended a sub-prime product, particularly when the customer had an existing prime mortgage and did not appear to have an adverse credit history or be experiencing any payment difficulties.
- (6) There was little or no evidence of any product research being carried out, with the majority of customers being recommended products with the same sub-prime lender despite the fact the firm dealt with four different mortgage lenders. The firm's compliance consultant had also identified this as a potential area of concern and had raised the possibility of the firm moving to an information-only service. The FSA found no evidence that the firm had considered or acted upon this advice.

***Failure to issue Key Facts Illustrations in an appropriate and timely manner***

- 4.15 A firm must provide the customer with an illustration for a regulated mortgage contract before the customer submits an application for that particular regulated mortgage contract to a mortgage lender (MCOB 5.5.1. R). During the period in issue, RHL failed to comply with this requirement.

#### Facts and matters relied on

- 4.16 In a significant number of cases reviewed by the FSA, it was evident that the firm had failed to disclose, in a timely and appropriate manner, key information about the product recommended. For example, the FSA found cases where the relevant key facts illustration, containing information about the costs and risks associated with a mortgage contract, was dated and issued to the customer after completion and submission of the mortgage application form.

#### ***Failure to handle complaints fairly and adequately***

- 4.17 A firm must have in place and operate appropriate and effective internal complaint handling procedures (DISP 1.2.1 R) and put in place appropriate management controls and take reasonable steps to ensure that it handles complaints fairly, consistently and promptly (DISP 1.2.22 R). During the period in issue RHL failed to comply with these requirements.

#### Facts and matters relied on

- 4.18 During the period in issue RHL received 10 complaints from customers, all of which were handled by the firm's external compliance consultant. Eight of the 10 complaints concerned the sale of regulated mortgage contracts and/or or payment protection insurance. In respect of these complaint files, the FSA identified the following issues:
- (1) In general, the firm's complaint files contained no evidence of the steps taken by the firm's external compliance consultant to investigate the complaint and reach an appropriate conclusion (other than a copy of the decision letter). For example, there was no evidence to show if the external compliance consultant had considered the original sales documentation or, in circumstances where this information was not available, had attempted to establish what took place at the time of the sale by, for example, contacting the complainant for further information or by obtaining an adviser's report.
  - (2) As a result of the above, the firm failed to adequately investigate complaints and reach a conclusion based on a balanced assessment of the evidence. For example, in two cases, the external compliance consultant rejected the complaints on the basis that, as he had not been present at the point of sale, he could not offer a view about the merits of the complaints. In two further cases, the external compliance consultant rejected the complaints on the grounds that there was no evidence on the sales file to support the customer's complaint without, apparently, taking any further investigative steps.
  - (3) The firm's external compliance consultant appears to have interpreted complaints too narrowly in that not all aspects of the customer's complaint were fully addressed, and no action appears to have been taken to identify and/or remedy any potential systemic issues.

## 5. ANALYSIS OF PENALTY

- 5.1 In deciding to impose the financial penalty above, the FSA has had regard to the policy on the imposition of financial penalties contained in Chapter 13 of the Enforcement Manual (“ENF”), which is part of the FSA’s Handbook of rules and guidance. The principal purpose of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefits of compliant behaviour.
- 5.2 ENF 13.3.3 sets out the factors that may be of particular relevance in determining the level of a financial penalty. The factors set out are not exhaustive (ENF 13.3.4). For the avoidance of doubt, this analysis of the level of penalty was undertaken before applying the 30% (stage 1) discount (ENF 13.7.3).

### *ENF 13.3.3(1): The seriousness of the misconduct or contravention*

- 5.3 The FSA has had regard to the seriousness of the contraventions, including the nature of the requirements breached, the number and duration of the breaches and the number of customers affected and/or placed at risk. Details of the breaches are set out above. For the reasons set out below the FSA considers that the breaches in this case are of a serious nature.
- (1) The firm's failings resulted from significant weaknesses in the firm's senior management arrangements and systems and controls. During the period in issue the firm carried on regulated business without persons in place occupying FSA-approved governing functions. Also, the firm failed to maintain a clear and appropriate apportionment of significant responsibilities among its directors, such that the business and affairs of the firm could be adequately monitored and controlled.
  - (2) The firm's senior management failed to demonstrate a sufficient understanding of the firm's obligations under the regulatory system.
  - (3) The failings identified above resulted in deficiencies in the firm's sales process and systems and controls for compliance, with the result that customers were exposed to the risk of being given unsuitable advice in relation to mortgage contracts. During the period in issue the firm provided advice in relation to the sale of approximately 1,000 regulated mortgage contracts.
  - (4) A significant proportion of these sales concerned the sale of regulated mortgage contracts to customers who were seeking to consolidate debts on account of payment difficulties. In cases reviewed by the FSA it was not evident that the firm had taken account of all relevant factors when providing advice to this financially vulnerable type of customer and or had taken sufficient steps to demonstrate and ensure the suitability of its recommendations.

***ENF 13.3.3(2): The extent to which the contraventions were deliberate or reckless***

5.4 The FSA has not concluded that the contraventions were deliberate or reckless.

***ENF 13.3.3(3): The size, financial resources and other circumstances of the firm and the amount of profit accrued or loss avoided***

5.5 In determining the level of penalty, the FSA has taken full account of the firm's financial resources particularly in light of the fact that the firm is no longer conducting any regulated business. The FSA has also been mindful of the need to ensure that the interests of customers are protected. In such circumstances, a financial penalty should not be fixed at a level that would effectively prohibit the firm from carrying out a past business review and providing redress where appropriate. Taking full account of these factors, and having considered and discussed with the firm its latest financial statements, the FSA considers that a penalty of £50,000 (subsequently discounted by 30% to £35,000 for early settlement) is appropriate.

***ENF 13.3.3(5): Conduct following the contravention***

5.6 RHL ceased conducting all regulated activities after the FSA made clear its concerns and has agreed in principle to review client files to ensure that customers are treated fairly. The firm has co-operated fully with the FSA's investigation.

***ENF 13.3.3(6): Disciplinary record and compliance history***

5.7 RHL has no previous disciplinary record.

***ENF 13.3.3(7): Previous action taken by the FSA in relation to similar behaviour***

5.8 In determining the level of penalty, the FSA has taken into account penalties imposed by the FSA on other authorised persons for similar behaviour.

**6. DECISION MAKER**

6.1 The decision which gave rise to the obligation to give this Final Notice was made by the Executive Decision Makers on behalf of the FSA.

**7. IMPORTANT**

7.1 This Final Notice is given to RHL in accordance with section 390 of the Act.

**Manner of and time for Payment**

7.2 The financial penalty above must be paid in full by RHL to the FSA by no later than 10 July 2006, 14 days from the date of the Final Notice.

**If the financial penalty is not paid**

7.3 If all or any part of the financial penalty is outstanding on 11 July 2006, the FSA may recover the outstanding amount as a debt owed by RHL and due to the FSA.

### **Publicity**

- 7.4 Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.
- 7.5 The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

### **FSA Contacts**

- 7.6 For more information concerning this matter generally, you should contact Chris Walmsley at the FSA (direct line: 020 7066 5894 /fax: 020 7066 5895).

Jonathan Phelan  
Head of Department – Retail 3  
Enforcement Division