Financial Conduct Authority

Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Implementation of the Mortgage Credit Directive and consequential changes in second charge mortgage regulation (FCA CP14/20 and subsequent amendments in FCA CP15/28)

Lead regulator: FCA

Date of assessment: 16 August 2016

Commencement date: 21 March 2016

Origin: Domestic

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

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

Brief outline of proposed new or amended regulatory activity

The Mortgage Credit Directive (MCD) introduced a European framework of conduct rules for firms selling both first and second charge mortgages. First charge lending comprises traditional mortgages; second charge lending is lending secured by a subsequent legal charge on residential property.

In implementing the MCD, we chose to rely on our existing rules for firms with mortgage permissions (which in some cases already went beyond the MCD requirements) and, where this was not possible, copied out the Directive into our rules. As first charge firms were already subject to our rules, this approach to implementation did not see them incur costs that fall in scope of an Enterprise Act (EA) impact assessment.

Second charge firms were not subject to our mortgage regime prior to 21 March 2016. As a consequence, we expected those firms to incur some additional cost in complying with our modified rules, minus any costs that would have been incurred had we copied out the MCD into our rules (costs which therefore would not be subject to an EA impact assessment). These costs are set out in **section A**, below, and can be summarised as follows[1].

- Responsible lending – this required second charge lenders to conduct an affordability assessment, largely required by MCD. In addition, we require second charge lenders to stress test higher priority mortgage payments.

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[1] Note some of the costs associated with MCD implementation were addressed in a separate HMT impact assessment

- Arrears handling – some aspects of our mortgage arrears handling rules go beyond what is required by the MCD (e.g. telephone call recording).

- Service disclosure – our rules require oral disclosure, in addition to disclosures required by the MCD.

Aside from the MCD, we also made second charge firms subject to rules that already applied to first charge firms, given that first and second charge mortgage customers are subject to similar risks. The costs of these requirements are set out in **section B**, below, and can be summarised as follows.

- Advice – requiring almost all sales to be carried out on advised basis, with mortgage sellers holding a relevant Level 3 qualification.

- Data reporting – requiring firms to report transaction-level and aggregate data to the FCA.

- Approved persons requirements

- A ban on the automatic rolling-up of fees and charges

- Debt consolidation – arranging for consolidated debt payments to be made directly to creditors.

In addition, we also took the opportunity to make changes to our rules that did not involve implementing the MCD, and to which both first and second charge firms would be subject. The proposal that we expected to result in firms incurring the most significant costs was the requirement for lenders to share information with other charge holders in the event of taking possession – see **section C**.

Aspects that have not been costed on proportionality grounds are set out in **section D**.

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

Second charge mortgage lenders and intermediaries are variously impacted by those changes set out in sections A-D. At the time of the consultation, there were estimated to be 20-25 active second charge mortgage lenders. However, around 50 lenders have applied for mortgage permissions since April 2015 following publication of our rules implementing MCD and second charge mortgage regulation. Where we rely on cost estimates per firm to scale up approved persons costs, we have done so using this new figure.

The number of second charge intermediaries was not estimated at the time of consulting. However, this would be a subset of the approximately 5,500 intermediaries that already held mortgage permissions. Approximately 50 mortgage intermediaries were granted mortgage permissions in 2015-16.

Annual levels of second charge lending in 2013 were around £0.5bn. This represents a tenth or less of second charge lending before the economic crisis. In 2015, second charge lending had risen to approximately £0.8bn. Pre-crisis, around half of all loans went into arrears, compared with 10-15% in 2014.

Around 200 first charge firms would also be affected by the change set out in **section C**.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2014	21 March 2016	10	-£122.8m	£12m	£60.25m

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

Section A

A1 – responsible lending

The introduction of responsible lending rules for second charge loans required lenders to conduct an affordability assessment and an interest rates stress test of new borrowers. In testing affordability, the lender must verify the borrower's income and be able to demonstrate that the loan is affordable, taking into account credit and other contractual commitments, cost of living and quality of life expenditure. Second charge lenders are also required to stress test affordability of the second charge mortgage and the higher priority mortgage(s) to account for a higher interest rate environment.

The costs for firms of the policy are (i) compliance costs associated with carrying out more stringent affordability assessments and interest rate stress tests, and (ii) impacts on revenue and profitability as a consequence of a projected reduction in lending volumes. The counterfactual was taken to be no responsible lending requirements, although at least some of the measures would have been necessary under the MCD (see caveats below).

Impacts were estimated primarily using sales and performance data from loan providers, and a survey of second charge loan providers and intermediaries. Full details of the modelling approach and results can be found in the cost-benefit analysis and an accompanying KPMG report.

(i) Compliance costs. In total across firms in the market, compliance costs were estimated to be around £330k one-off and £225k on-going annually for lenders, and around £85k one-off and £35k on-going annually for brokers. On the basis of firm responses to the KPMG/Ignition House survey, firms were estimated to incur compliance costs arising from making changes to IT systems, developing new sales processes, HR / training costs and additional time to process loans. KPMG's estimates accounted for the percentage of firms who previously applied some form of affordability assessments to second charge borrowers.

(ii) Impacts on revenue and profitability as a consequence of reduced volumes of lending. The modelling approach estimated how past second charge loans would have been different if the responsible lending proposals had been in place, using the methodology used in the Mortgage Market Review (MMR). Based on the post-crisis period only, between 10 and 17% of consumers were estimated to be no longer able to borrow, and between 22% and 30% of consumers would be lent less (averaging one quarter to one third less). Together, these impacts would indicate a reduction in second charge lending volumes of around 20%, implying a reduction in around £100 million of lending using 2013 lending volumes. Since the KPMG survey estimated an average profit margin of 11% in 2013, this reduction would result in an ongoing annual cost to business of £11 million.

Any impact would not be equivalent across firms but depend on differences in behaviour. Firms with narrow profit margins and in particular firms with worse post-lending outcomes may be at some risk of exit, though the ability to pass through costs through higher prices may temper this. As such, there may be a differential effect on firms of different sizes as a function of firms' profit margins.

There are a number of caveats to these estimates. Firstly, the counterfactual in the original CBA was taken to be a situation with no affordability assessment required by second charge lenders. Importantly; however, implementation of the MCD would have required a similar, though less precisely defined, creditworthiness assessment, though the MCD assessment would not have required a stress test of higher priority loans. The estimates, both compliance costs and reduction in lending, were therefore considered to be a significant overestimate of the true costs.

Secondly, the CBA stated that the expected reduction in volumes to be materially smaller because the analysis was influenced by high pre-crisis lending levels, whereas unaffordable lending has materially decreased since the cut-off point for the analysis (2011). On the other hand, however, subsequent data have shown that total lending volumes rose approximately 60% from 2013 to 2015, potentially increasing the impact of the 2016 changes. Industry commentators have also subsequently cited the requirement to stress test higher priority loans, a requirement that is additional to MCD, as a main reason why lending volumes might fall by around 20%. For consistency with the original CBA, no adjustment for these factors has been made for this impact assessment.

In addition, the greater alignment between the regulation of first charge and second charge lenders would be expected to encourage responsible entry into the second charge lending market, improving competition in the market. However, any such effects have not been quantified.

A2. Arrears handling

We chose to apply our arrears handling rules (MCOB 13) in their entirety to second charge firms to ensure customers in payment difficulties are treated fairly and that firms offer appropriate forbearance based on the customer's circumstances, requiring more of firms in considering alternatives to repossession. These rules also protect customers when their property is repossessed, and when there is a sale shortfall.

Although broadly aligned to the high-level requirements of the MCD, MCOB 13 does go further in places, notably in relation to telephone call recording. As part of the KPMG work, second charge lenders estimated that compliance with MCOB 13 would cost approximately £600k in one-off costs, and £700k thereafter. However, they did so against a baseline of CCA requirements that they were already subject to, rather than a baseline of what MCD would have required had we chosen copy out rather than relied on existing rules. In theory, the costs presented here should be an overestimate. However, we think this theoretical overestimate is offset by firms actually underestimating the costs of complying with MCOB versus the CCA. Compared to MCD, our MCOB requirements are clearly additional in terms of call recording (CP10/2 estimated £6.1m one-off for first charge lenders in CP10/2 – spread across 275 firms = £22k/firm in 2010). As such, we think it's reasonable to take the entire CP14/20 figure as reflecting the discretionary burden of applying MCOB.

A3. Service disclosure

In addition to MCD service disclosure requirements, we applied the existing MCOB requirements around service disclosure to second charge mortgages. This required firms responsible for the sale (intermediaries in the case of >90% of second charge mortgages) to make an initial disclosure covering two key messages about their scope of service and remuneration, so that consumers can form a view about the service on offer.

These key messages have to be clear and prominent, and made orally where there is spoken contact with the consumer, as there would be in the majority of second charge sales. There is no other prescription about the format of the information.

Although not quantified in CP14/20, such disclosures were costed as part of the MMR (CP10/28), which estimated a transaction cost of £11. Re-inflated to 2014 values, this amounts to £12.59. Assuming 20,000 second charge loans per year (based on 2015 lending), would give an annual cost of approximately £250k. However, there would be some double counting of costs given the other changes to firms' disclosure processes brought about by the MCD.

Section B

B1. Advice

Since April 2014, we have required advice to be given in first charge mortgage sales where there is spoken or other interactive dialogue with the consumer. Prior to that, research found that many consumers assume that they are receiving advice when taking out a mortgage, even where they have been told that they are receiving a non-advised service. We applied our mortgage sales standards to second charge firms so that consumers buy products that they understand and that are appropriate for their circumstances.

A key component of the mortgage sales standards is the requirement for mortgage sellers (those staff giving advice or designing 'execution-only' sales scripts) to hold a relevant Level 3 qualification. Our rules allow mortgage sellers a period of 30 months to achieve the qualification. As part of the KPMG work, second charge lenders and intermediaries estimated that the one off costs would be £1.1m (£0.4m for lenders and £0.7m for intermediaries – although >90% of second charge mortgage sales are intermediated, those brokers who also sell first charge mortgages would already need to hold a Level 3 qualification).

Oxera estimated an incremental cost of £35 per loan for both affordability and suitability tests in its analysis for the MMR (FSA CP10/28). Ongoing costs for affordability are set out in section A, but we acknowledge there would be further smaller incremental costs for the advice part. Taking the £35 figure as a whole, adjusting it to 2014 prices and applying it to an assumed market total of 40,000 loans equates to annual ongoing costs of £1.6m.

In September 2015, we also consulted on imposing the Level 3 qualification requirement on intermediary firms providing branch services in the UK under an MCD passport (FCA CP15/28). In CP14/20, KPMG estimated that obtaining the Level 3 qualification can cost between £1k and £6k per member of staff. As yet, no intermediary firms have passported into the UK under the MCD, and so we are not aware of any reliable estimate of how many firms this could affect. In addition, before the MCD brought about a passporting regime for intermediaries, an incoming firm wishing to do branch business would have needed to establish itself in the UK, obtain FCA authorisation and become subject to the costs of the Level 3 requirement and the rest of our rules. For these reasons we have not estimated costs associated with this proposal.

B2. Data reporting

The FCA gathers and uses a wide range of data, information and intelligence to help us identify and assess risks in financial markets. In particular, we collect data from mortgage lenders and intermediaries to help us identify and assess risks to consumers, make robust quicker decisions so the market keeps functioning well, and enhance our ability to monitor the market.

- We applied rules to second charge firms that are broadly similar to those that apply to first charge firms, given the risks inherent in secured lending irrespective of whether a mortgage is secured as a first or subsequent charge. Product Sales Data (PSD) – applicable to second charge lenders, with effect, and for loans entered into, from 1 April 2017.
    - Sales data – transaction level data on all regulated second charge mortgage sales made by a firm within the reporting period.
    - Performance data – transaction level data on the performance of second charge regulated mortgages, giving a snapshot of the mortgage characteristics and whether borrowers have experienced payment difficulties. This report would also apply to regulated firms that act as a lender, such as mortgage book purchasers.
- Mortgage Lenders and Administrators Return (MLAR) – applicable to second charge lenders, aggregated data covering a firm’s regulated mortgage activity, including second charge.
- Retail Mediation Activities Return (RMAR) – applicable to second charge intermediaries, aggregated data covering a firm’s regulated mortgage activity, including second charge.

In response to the KPMG survey, second charge lenders estimated one-off costs of £500k and ongoing annual costs of £300k. For second charge intermediaries – and using the analysis conducted for the reporting requirements for mortgage, insurance and investment firms, set out in FSA CP197 as a proxy – the one-off costs per firm would be approximately £200 and the annual ongoing costs would be approximately £800 (£40k one-off costs and £10k annual ongoing when grossed up by the number of new mortgage intermediaries intermediaries). However, the costs for intermediaries could represent an overestimate as firms were already required to submit similar information to the FCA on their consumer credit activity. Those firms who already submitted RMAR returns by virtue of holding mortgage permissions would only be subject to small incremental change.

We originally proposed applying the PSD requirements from 21 March 2016, but delayed implementation by a year in recognition of the extent of change faced by second charge lenders.

B3. Approved persons

The approved person requirements in the mortgage market are a means of ensuring that firms undertaking business that results in debt secured on a customer’s home have robust senior management controls to support consumer protection from poor lending or sales practices.

Previously, under the consumer credit regime, the controlled functions for fully authorised second charge lenders were governing functions, systems and controls functions, and Money Laundering Reporting Officer functions. Under the mortgage regime, second charge firms would instead be subject to more extensive requirements, covering all governing functions, Apportionment and Oversight (CF8) and AML functions (CF11), and often Systems and Controls (CF28) and Significant Management (CF29).

Europe Economics on the FCA’s behalf conducted analysis in 2013 on the costs to a comparable subset of consumer credit firms (approximately 3,500 non-bank lenders and 15-17,000 intermediaries) in adopting the controlled functions required by the consumer credit regime. By averaging those costs across the relevant population of second charge firms that would be new to our mortgage regime, we estimate potential incremental one-off costs of around £500 per second charge lender and £150 per second charge intermediary. This equates to industry costs of £20k.

This is an upper cost bound for firms being required to authorise the additional controlled functions required under the mortgage regime, as governing and systems and controls functions should already be in place. Compared to the requirements under the consumer credit regime, the compliance costs to firms of securing the relevant permissions for a greater range of functions will be smaller.

B4. A ban on the automatic rolling-up of fees and charges

Our existing rules prohibited fees and charges (such as lender and broker fees) being automatically 'rolled-up' into the loan at the point of origination We were aware that it was common practice in the second charge market for fees and charges to be automatically rolled-up. In some cases this can be in a customer's best interests - but not where the customer has the funds available to pay the fees up-front, thereby incurring less interest.

This would lead to some compliance costs for firms arising from systems and controls requirements. Extrapolating from the 2010 estimate Oxera made as part of the MMR, we estimate one-off costs of the proposal of around £150k across all second charge lenders in the market. There may additionally be small on-going costs from ensuring explicit consent for each loan, but these are not expected to be material.

B5. Debt consolidation

Our rules already required first charge lenders advancing debt consolidation mortgages to either take reasonable steps to ensure the debts to be consolidated are repaid, or include them in the affordability assessment as if they were not repaid. Given the high propensity for second charge mortgages to be taken out for debt consolidation purposes (approximately two thirds), we applied this requirement to all second charge mortgages.

In response to the KPMG survey, second charge lenders estimated one-off compliance costs of £700k and ongoing annual costs of £200k. Industry respondents provided these estimates assuming that lenders would be required to make payments direct to creditors, rather than channel payments through the customer in line with market practice. This was not the case and so these costs are an overestimate of the actual impact of our rules.

Section C

C1. Information sharing between charge holders

The lack of timely information sharing between mortgage charge holders when one is seeking possession did not best enable firms to work together in the customer's interests, potentially leading to separate litigation actions and costs to the customer. We introduced requirements for charge holders to share information at set points in the process, building upon a voluntary code operated by lender trade bodies.

As part of the KPMG work, second charge lenders estimated that this requirement would result in one off compliance costs of £100k. First charge lenders recognised that the requirement could be factored into existing processes. Scaling up the second charge costs to the first charge lending market (approximately 200 lenders) would have resulted in one-off compliance costs of £1m.

Having consulted, we modified specific aspects of our proposals to minimise the burden on lenders. In addition, it is possible that, in being given greater opportunity to challenge first charge holders' sales of repossessed property, second charge lenders could have a greater ability to recover their debt in marginal equity cases – however, this has not been quantified.

Section D

The following aspects have not been quantified on proportionality grounds.

Disclosure of alternative finance options - applied to first charge and, for the first time, second charge lenders. This requires firms to inform customers of potential alternatives to the finance they are looking to obtain – e.g. notifying a customer that a second charge may be more appropriate when considering a further advance and vice versa. We do not prescribe the form of this disclosure, nor the level of depth that firms need to go into to meet the requirement. It can form part of a firm's existing sales process – for example, verbally where the initial contact with the customer is interactive, and, for non-interactive sales, separately from messages in the firm's written or electronic communication with the customer. The requirement does not place an obligation on firms to advise on those options, but firms can choose to. A similar provision was introduced for first charge firms as part of MMR. The consultation on this noted that this proposal would not introduce new costs beyond those Oxera estimated for an advised or execution-only sale (FSA CP10/28). Similarly, we do not envisage additional costs for second charge firms.

Fair treatment of vulnerable customers in payment shortfall – copied across from our Consumer Credit sourcebook (CONC), to which second charge lenders were already subject, to apply to first charge lenders. Based on similar changes, firms were not expected to incur significant costs (FSA CP98).

Arrears charges – the MCD requires arrears charges to be a reflection of costs to the creditor arising from the consumer's default greater. We implemented this requirement through our existing rules, which include more prescription than the MCD on which costs can be recovered through charges where a customer is in payment shortfall. First charge firms were already subject to these rules, but they were new to second charge lenders. In response to the KPMG survey, 80% of firms felt they were already meeting the new rules, given pre-existing requirements under CONC 7.7. As such, we did not envisage significant costs for second charge lenders.

Customer's interests – the MCD requires firms to act 'honestly, fairly, transparently and professionally' when providing credit. We implemented this requirement through an existing rule that requires firms to act in customers' best interests. First charge firms were already subject to this, but second charge firms were not. The relevant burden for second charge firms is only that between regard to the customer's interest and the customer's *best* interest which is likely to a minor incremental addition. Although CP10/28 gave a cost for the analogous appropriateness requirement as £35 per transaction, there is considerable overlap with the cost of advice requirements estimated elsewhere (given that MCOB requires advice in the great majority of cases).

Following publication of our policy statement (PS15/9), we made some changes to our final rules. Most of these changes involved corrections to properly implement the MCD (including to remove unintentional gold plating) and/or reflect government's legislation, which fall outside the scope of an EA impact assessment.

Aside from these, as detailed in FCA CP 15/19 and Handbook Notice 31, we made changes to MCOB 1 to clarify that the MCOB provisions listed as applicable to back book second charge loans[2]:

- are not exhaustive; and
- apply only to regulated mortgage contracts which had previously been regulated credit agreements.

Both of these amendments were necessary to reflect our original policy intent as detailed in CP14/20 and PS15/9. We do not believe that firms will have incurred costs as a result of these two changes.

We also amended our post-sale disclosure rules to enable firms to issue either a KFI or an ESIS (as opposed to only a KFI in our original drafting) when making a further advance on non-MCD mortgages[3]. This correction increased flexibility for firms, in line with our policy intent to minimise disruption for firms, and so would not have resulted in increased costs to firms. Having been made aware of this issue, we consulted on the change as soon as practicable thereby minimising any regulatory uncertainty.

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

N/A

[2] FCA CP15/19 and Handbook Notice 31
[3] FCA CP15/28