

# **Secondary legislation for the regulation of Home Reversion and Home Purchase Plans: A final regulatory impact assessment**

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September 2006



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# REGULATORY IMPACT ASSESSMENT

## TITLE OF PROPOSALS

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The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2006 (the main Order)

The Terrorism Act 2000 (Business in the Regulated Sector) Order 2006

The Proceeds of Crime Act 2002 (Business in the Regulated Sector) Order 2006

## PURPOSE AND INTENDED EFFECT

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### Objective

**1.1** The principal purpose of the main Order is to amend the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) (which is made under the Financial Services and Markets Act 2000 (FSMA)), to specify and define activities relating to Home Reversion Plans and Home Purchase Plans (capturing Ijara home financing arrangements) to be regulated by the Financial Services Authority (FSA). This will create a level regulatory playing field with mortgage products that are already regulated and extend essential consumer protection to potentially complicated financial decisions affecting individuals' lives. The other Orders make consequential amendments to the Terrorism Act 2000 and the Proceeds of Crime Act 2002.

**1.2** Legislation relating to financial services is reserved to the UK Parliament so the Orders extend to England, Wales, Scotland and Northern Ireland.

### Policy Background

**1.3** The FSA currently regulates certain activities relating to first charge residential mortgages. The regime ensures that: mortgage borrowers receive clear and comparable information about the mortgages and mortgage services on offer in the market place; any mortgage advertising or marketing material is clear, fair and not misleading; when a firm advises borrowers, it must make sure that it recommends a suitable mortgage based on the borrowers' needs and circumstances; and charges are not excessive. The regime also sets standards providing protection should borrowers get into arrears with their mortgages.

**1.4** A decision to subject Home Reversion Plans to regulation was made following a consultation in November 2003, 'Regulating Home Reversion Plans', and announced on 10 May 2004 by the then Financial Secretary, Ruth Kelly.

**1.5** In the light of a further consultation in July 2004, 'Defining Home Reversions', it was decided that Ijara home financing arrangements and other flexible tenure schemes should also be brought within the scope of FSA regulation (and therefore included in primary legislation) along with Home Reversion Plans.

**1.6** HM Treasury published a consultation document, 'Secondary legislation for the regulation of Home Reversion and Home Purchase Plans', on 31st March 2006<sup>1</sup>. That consultation concluded on 23rd June 2006.

**1.7** The purpose of the consultation was to seek views on draft secondary legislation that will have the effect of bringing Home Reversion Plans, and Ijara and Diminishing Musharaka home financing arrangements within the scope of FSA regulation<sup>2</sup>. We also consulted on our partial regulatory impact assessment.

**1.8** A response to that consultation is being separately made available alongside this final regulatory impact assessment.

## Legislative Background

**1.9** Under the Financial Services and Markets Act 2000 (FSMA), only FSA authorised or exempt persons are allowed to carry on a regulated activity. In order for an activity to be regulated under FSMA it must be carried on by way of business and be specified in an Order made under section 22 of FSMA. Schedule 2 to FSMA sets out, in broad terms, a non-exhaustive list of the sorts of activities and investments that may be specified in such an Order.

**1.10** Before the enactment of the Regulation of Financial Services (Land Transactions) Act 2005, Schedule 2 covered contractual rights in respect of loans secured on land, but did not cover such rights in respect of other types of finance provided in connection with land transactions. The Land Transactions Act amended Schedule 2 to add rights in respect of financial arrangements in connection with the acquisition or disposal of land.

**1.11** The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) is the Order made under section 22 of FSMA (as read with Schedule 2 to FSMA), which sets out the specific activities that are subject to FSA regulation.

**1.12** This proposal makes use of the provisions in the Regulation of Financial Services (Land Transactions) Act 2005 and amends the RAO in order to specify and define the activities relating to Home Reversion Plans and Ijara home financing arrangements that will be subject to regulation, establishing a regulatory regime similar to the one in place for first charge residential mortgages.

**1.13** Although Schedule 2 to FSMA now also provides for the possible regulation of other flexible tenure schemes, a decision has been taken not to extend FSA regulation to these schemes at present. This is because we have not identified a significant commercial market for these schemes at this stage.

## Rationale for Government Intervention

**1.14** Equity release schemes allow homeowners to release the value of their property in return for all or a share of their interest in the home. There are two types

- Lifetime mortgages – where the consumer takes out a mortgage, but makes no repayments, as interest is rolled up by the lender and the loan is paid off when the property is sold. These are regulated by the FSA.

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<sup>1</sup> The HM Treasury consultation document is available at [http://www.hm-treasury.gov.uk/consultations\\_and\\_legislation/land\\_transaction/consult\\_landtransaction\\_index.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/land_transaction/consult_landtransaction_index.cfm)

<sup>2</sup> Generally references to Ijara products should be taken to include Diminishing Musharaka products.

- Home Reversion Plans (HRPs) – where the consumer sells all or part of their home but retains the right to live there. There are not yet regulated by the FSA.

**1.15** Interest-based home finance products do not comply with Islamic Law, but Islamic Law can accommodate contracts to facilitate house purchase. Again, there are two main types:

- Murabaha products – where an institution buys and re-sells the home to the consumer, accepting payment of the price over a lengthy period. These are regulated by the FSA.
- Ijara home financing products – where the institution combines a sale with renting the un-owned share of the property to the consumer - which we also define as Home Purchase Products (HPPs). These are not yet regulated by the FSA.

**1.16** Regulating HRPs will help people make informed choices, offer valuable consumer protection and ensure a level playing field in the equity release market. The regulation of Home Reversion Plans would protect consumers who may have complex advice needs and may be vulnerable to being sold a reversion plan that is unsuited to their needs.

**1.17** Ijara home financing arrangements have been developed to meet the same purpose as a ‘regular’ mortgage product whilst also complying with Islamic principles. Purchasing a house is potentially the largest financial transaction individuals will make during their lifetimes and requires a suitable degree of protection. Potential consumer detriment should be prevented through FSA rules.

**1.18** Regulating Ijara home financing arrangements will afford Muslim consumers equivalent protections to those afforded by existing FSA mortgage regulation, and ensure a level playing field in the Islamic Home Purchase Plan market. This is consistent with the Government’s general desire to support the development of Islamic financial services in the UK.

**1.19** Both industry and consumer groups have been supportive of regulation.

**1.20** The effect of not regulating activities in these markets would be to retain the current partial and distortive regulatory coverage and to exclude consumers of these products from the protections afforded by regulation.

## Consultation on the draft Regulatory Impact Assessment

**1.21** A draft of this RIA was published by HM Treasury as part of its consultation on “Secondary Legislation for the regulation of Home Reversion and Home Purchase Plans” on 31 March 2006.

**1.22** A separate response to that consultation is being published on the Treasury website which examines the issues considered and the government’s policy response. [www.hm-treasury.gov.uk/consultations\\_and\\_legislation/land\\_transaction/consult\\_landtransaction\\_index.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/land_transaction/consult_landtransaction_index.cfm)

**1.23** 24 responses were received, 6 from trade or professional bodies, 16 from firms active in the markets concerned, and replies from the Financial Services Consumer Panel and an Islamic finance consultancy.

**1.24** Comments on the RIA were supportive of the assumptions and costs. Additionally, in the light of the FSA's separate consultation in their CP 06/8 on the Regulation of Home Reversion and Home Purchase Plans, published in April 2006, we have looked again at the detailed assumptions that underlay our initial cost estimates. We have drawn in particular on Annex A of CP 06/8, the cost-benefit analysis of the FSA's regulatory proposals.

**1.25** That FSA analysis does not, in all cases, attribute costs amongst separate categories of firms or separate types of cost. But it provides clear indications of the overall levels of costs of regulatory measures and the total costs faced by firms.

## Results of the re-examination of the costs

**1.26** The main conclusions of our re-examination are that:

- Fewer firms may be involved – especially intermediaries. To the extent that intermediaries are involved their status may be such that they do not require to be directly regulated.
- Costs per firm may, in some cases, also be substantially lower than initially envisaged.

**1.27** The following table summarises the revised costs.

**Table 1: Summary of revised costs**

Summary of revised costs (£)	HRPs	HPPs	HRP + HPP
<b>One off costs</b>	1,492,000	340,000	1,832,000
<b>Recurring costs</b>	401,000	10,000	411,000
<b>Total first year costs</b>	1,893,000	350,000	2,243,000

## OPTIONS

### Option I

**1.28** Do nothing.

### Options for achieving the policy objective

**1.29** There are options for achieving the policy objective by other means. That could, for example, include building on the existing voluntary arrangements that several firms are involved in. But a voluntary system would involve significant questions about the governance and policing of a scheme, and how to achieve a high level of participation.

### Risks

**1.30** The risks of not subjecting Home Reversion Plans and Ijara home financing arrangements to FSA regulation include:

- Mis-selling; consumers may be advised to take out one type of equity release plan when they would be better off trading down to a smaller property or entering into another type of equity release plan;
- Unfair treatment; unregulated providers are under no obligation to treat their customers (often vulnerable people) fairly, consequently the consumer may be provided with a reversion of an unfairly low value, due either to a low valuation of their property, or to a low proportion of that valuation being offered as a reversion;
- Regulatory confusion; consumers may not understand the difference between the regulated and unregulated parts of the market. FSA regulation requires lifetime mortgage providers to consider both lifetime mortgages and reversions. Firms selling only reversions are not caught by FSA regulation. A similar situation exists with Murabaha and Ijara products; and
- Redress; consumers may be confused by the differences in redress arrangements between regulated and unregulated products.

### Issues of compliance and enforcement

**1.31** Compliance and enforcement would be major challenges in the context of a voluntary system, as by definition firms would be free to choose to whether to participate in such a scheme. A scheme that lacked significant compliance and enforcement functions would find it difficult to achieve or maintain a high level of public confidence.

### Unintended consequences

**1.32** By its vary nature it is difficult to envisage the unintended consequences which might flow from a decision not to regulate these activities. The foreseeable consequences, which are discussed elsewhere, are unattractive.

## Implementation and delivery plans

**1.33** Implementing other methods of delivering consumer protection, for example through voluntary measures, would still require significant investments by firms if it were to be effective. Many firms would be faced with additional complexities as a result of being subject to two separate approaches (regulation and voluntary systems) for adjacent areas of their business if they are involved across the full width of equity release markets for example by offering lifetime mortgages or home reversions.

### Option 2

**1.34** Give the FSA responsibility for regulating Home Reversion Plans and Ijara home financing products.

**This is our preferred option.**

## Options for achieving the policy objective

**1.35** Given the existence of mortgage regulation that is already delivered by the FSA the realistic and practical options for extending regulation are extremely limited. Regulation by an agency other than the FSA would be complex and confusing for firms and consumers. Adding responsibility for the regulation of activities in the HRP and Ijara home financing markets to the FSA commands support from the industry and consumers.

## Risks

**1.36** The risks of subjecting Home Reversion Plans and Ijara home financing arrangements to FSA regulation include:

- The FSA may focus its regulatory regime where it is not needed, particularly if there is no evidence of consumer detriment;
- Additional compliance and conduct of business costs for firms;
- These new arrangements may set a precedent for the FSA to regulate other sale and purchase arrangements.

## Unintended Consequences

**1.37** HM Treasury has not been able to identify any unintended consequences and none has been suggested to us during the consultations mentioned above or during informal engagement with stakeholders.

## Implementation and Delivery plans

**1.38** These proposals have been consulted on for three months and are being introduced now that the responses have been considered.

**1.39** The FSA has separately consulted on its rules for regulating Home Reversion Plans and Ijara home financing arrangements. The FSA will issue a policy statement on the new rules. Firms will need to apply for permission to engage in these regulated activities. Firms will be given approximately five months time to prepare for regulation before it becomes effective.

## COST AND BENEFITS

### Analysing the costs and benefits

#### Benefits of option 1

**1.40** The main benefit of doing nothing in these markets is:

- Avoiding the risk that regulation will act as a barrier to entry;

**1.41** Specifically in relation to Home Reversion Plans:

- The Government has already focused its regulatory regime on where there has been a proven need for regulation, and arguably there is no need to do more;
- Consumers already have access to a good deal of information. For example, charities such as Age Concern, and trade bodies such as the Council of Mortgage Lenders and Safe Home Income Plans (SHIP) publish consumer fact sheets that set out the pros and cons of lifetime mortgages and reversion plans (and indeed whether equity release meets individual needs). Arguably some consumers already have the wherewithal to take their own decisions on the basis of full information.

#### Costs of option 1

**1.42** This option does not result in any direct costs to industry, but due to the risks that consumers face, there is the possibility of a cost to consumers should things go wrong. It is very difficult to quantify this cost.

#### Benefits of option 2

**1.43** The main benefits of FSA regulation include:

- The regulation of all equity release products, and all Islamic-compliant home financing products respectively, creating a level regulatory playing field for firms;
- Greater clarity for customers wanting to make a fair comparison between products offering broadly similar benefits;
- Consumer access to redress procedures where appropriate;
- Avoidance of regulatory arbitrage.

**1.44** Specifically in relation to Home Reversion Plans:

- Advice during the sales process in relation to individuals' tax and benefit positions;
- Reduced information asymmetry between the plan provider and the consumer;
- Increased confidence in the home reversion market, which has seen a recent fall in lending that is attributed to uncertainty concerning the regulatory environment.

## Terrorism Act 2000 and Proceeds of Crime Act 2002 amendments

**1.45** At the same time we propose consequential amendments to the Terrorism Act 2000 and the Proceeds of Crime Act 2002. The effect of those changes will be to reduce the burdens on firms that undertake the activities of arranging or advising on investments consisting of rights under Home Reversion or Home Purchase Plans. These changes will bring the treatment of these transactions into line with the treatment of similar transactions under the existing regime for mortgage regulation.

### Costs of option 2

**1.46** The most significant cost of this option is the initial and ongoing regulatory compliance costs to industry. The precise nature of the regime that will apply will not be made clear until the FSA have published their rules and so these costs could still be subject to change.

**1.47** The costs in this RIA therefore remain estimates, although we have had the benefit of refining them in the light of the FSA's consultation and their detailed cost benefit analysis.

**The Markets** **1.48** There is a range of firms in the equity release market. These comprise providers, brokers (specialist equity release intermediaries) and reversion brokers (those that market reversionary properties to private investors).

**1.49** There are also intermediaries and Independent Financial Advisers (IFAs) selling equity release products, including home reversions as part of their range of business. The following table summarises the position of the firms that specifically target the equity release market, based on current information:

**Table 2: Number of firms currently in the equity release market**

	Providers	Intermediaries
Lifetime Mortgages <sup>3</sup>	35	13 <sup>4</sup>
Reversion plans <sup>5</sup>	6	54 <sup>6</sup>

**1.50** The current and future markets for Islamic finance are hard to quantify, as they are relatively under-developed. In relation to Ijara home financing arrangements, we have identified four current providers (all of which are currently regulated for mortgage business). We estimate there to be about 50 intermediaries active in this market.

**Calculating the costs** **1.51** In calculating the costs, we have followed closely the analysis produced by the FSA in their CP 06/8, Annex A (the cost-benefit analysis). We do not repeat here the full analysis published by the FSA.

<sup>3</sup> Source: FSA, latest reported data covering the period April – September 2005

<sup>4</sup> This excludes firms that helped arrange less than ten (and typically arranged one or two) lifetime mortgages.

<sup>5</sup> Source: Industry analysis

<sup>6</sup> Source FSA, CP 06/8, Annex A

**1.52** In the equity release market, intermediary firms that are not currently regulated by the FSA would face the most substantial costs of regulation. These include the one-off costs such as authorisation costs, setting up systems and training staff, as well as ongoing compliance costs. However, the costs for firms that are already regulated by the FSA, for example because they also sell lifetime mortgages or Murabaha products, would be less. They would already have received formal authorisation from the FSA and be subject to some rules governing the unregulated activities of regulated firms. They would need to apply to vary their permission, however, and it is likely there would be some systems, training and ongoing conduct of business costs associated with complying with FSA requirements governing the selling of home reversions or Ijara products, when the selling of these products becomes a fully regulated activity.

**1.53** We estimate the one-off incremental costs for individual firms to be:

**Table 3: Costs for individual firms**

	HRP Providers	HRP Intermediaries	HPP Providers	HPP Intermediaries
<b>Currently regulated for mortgage business</b>	£115,000	£8,500	£85,000	N/A
<b>Currently not regulated</b>	N/A <sup>7</sup>	£21,500	N/A	N/A

**1.54** The costs per provider (for Home Reversion and Home Purchase Plans) are based on small numbers of firms. They should accordingly be treated with a degree of caution.

**1.55** Ongoing total costs for home reversion providers and intermediaries have been estimated at approximately £2,500 and £7,000 respectively. In the light of its proposals for Ijara firms the FSA does not expect the costs to be significant (about £10,000 per annum in total, for all Ijara provider firms).

**Total Cost to Industry** **1.56** For the purposes of estimating the total cost to industry it has been assumed that regulation will not cause the number of providers or intermediaries to change.

**1.57** The estimated total one-off compliance cost to the industry for home reversions plans and Ijara home financing arrangements would be approximately £1.8million. It is estimated that the annual ongoing costs would total approximately £410,000.

<sup>7</sup> There are no unregulated firms that are expected to begin to provide HRPs or HPPs after regulation begins.

**1.58** The following table summarises the revised costs.

**Table 4: Summary of revised costs**

Summary of revised costs (£)	HRPs	HPPs	HRP + HPP
<b>One off costs</b>	1,492,000	340,000	1,832,000
<b>Recurring costs</b>	401,000	10,000	411,000
<b>Total first year costs</b>	1,893,000	350,000	2,243,000

## SMALL FIRMS IMPACT TEST

**1.59** When Home Reversion Plans and Ijara home financing arrangements are regulated there may be some reduction in the number of small firms in the market as these firms may be discouraged by the costs of compliance with FSA regulation.

**1.60** But regulation may improve consumer confidence in the home reversions market leading to more opportunities for new entrants, including small intermediary firms.

**1.61** The FSA has reported that regulation should act as a powerful marketing tool for existing firms, while further providers might enter the market as reputational risks are reduced. A larger and more vigorous market should create greater opportunities for intermediaries.

## COMPETITION ASSESSMENT

**1.62** Though the equity release market as a whole at present accounts for significantly less than 1% of total mortgage lending in the UK, it is a market that has seen considerable growth in recent years.

**1.63** Some reversion plan providers suggested at the time of our first consultation that regulation of lifetime mortgages would be a powerful marketing tool, and consumers may favour these products. Regulation could attract some of the larger lenders into the reversion market, as potential reputational risk from a lack of redress arrangements would be reduced.

**1.64** The Ijara market is still in its infancy and it is expected that regulation will increase confidence for product providers. We do not expect there to be many new entrants encouraged into the market by new products. Any further growth in the market for Ijara products is expected to result from individuals switching to these products from conventional mortgages. The extent to which the Islamic-compliant market grows will depend to large extend on how financially competitive these products are.

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## **ENFORCEMENT, SANCTIONS AND MONITORING**

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**1.65** Under our preferred option the FSA will undertake monitoring and enforcement activities and will have authority to apply proportionate and appropriate sanctions for regulatory breaches.

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## **IMPLEMENTATION AND DELIVERY PLAN**

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**1.66** The FSA will have responsibility for the operational delivery and implementation of regulation. The FSA has undertaken its own separate consultation, including cost-benefit assessment, of their proposals for regulation.

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## **POST IMPLEMENTATION REVIEW**

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**1.67** We will work with the FSA to undertake a post-implementation review of these measures. Our expectation is that review will be undertaken two years after these measures come into effect, that is April 2009.

## SUMMARY AND RECOMMENDATIONS

**1.68** We have concluded that option 2, of extending regulation to the activities defined in the main Order, is the most appropriate and effective way of responding to the risks that consumers face.

**1.69** The consequential amendments to the Proceeds of Crime Act and the Terrorism Act will reduce the burdens on firms in so far as they arrange or advise on investments in Home Reversions and Home Purchase Plans.

**1.70** Below is a detailed breakdown of the costs we have taken into account in estimating the total cost to industry of this initiative and also a list of the assumptions made.

COSTS	Home Reversion Plans			Home Purchase Plans	
	Providers (6 firms)	Authorised Intermediaries (27 firms)	Unauthorised intermediaries (27 firms)	Aggregate costs for all sectors	Aggregate costs for all sectors (4 providers) (a)
<b>One off costs</b>					
Application costs	7,000	12,500	12,500	32,000	5,000
Approved persons			40,000	40,000	
Training and	75,000		70,000	145,000	30,000
Disclosure	600,000	650,000		1,250,000	130,000
Advice and selling		25,000		25,000	
Financial reporting					85,000
Complaints, promotions, treating					90,000
<b>TOTAL</b>	<b>682,000</b>	<b>230,000</b>	<b>580,000</b>	<b>1,492,000</b>	<b>340,000</b>
<b>Recurring costs</b>					
Annual fees		25,000		25,000	10,000
Pll		33,750	47,250	81,000	
Reporting			35,000	35,000	
Complaints			95,000	95,000	
Financial promotions			160,000	160,000	
Advice and selling		5,000		5,000	
<b>TOTAL</b>	<b>16,000</b>	<b>40,000</b>	<b>345,000</b>	<b>401,000</b>	<b>10,000</b>
<b>Total year 1 costs (one off costs plus recurring costs)</b>	<b>698,000</b>	<b>270,000</b>	<b>925,000</b>	<b>1,893,000</b>	<b>350,000</b>

Summary	HRPs	HPPs	HRP + HPP
<b>One off costs</b>	1,492,000	340,000	1,832,000
<b>Recurring costs</b>	401,000	10,000	411,000
<b>Totals</b>	<b>1,893,000</b>	<b>350,000</b>	<b>2,243,000</b>

NOTES - Source of firm numbers and costs data : FSA CP 06/8, Annex A.

**1.71** The FSA analysis does not, in all cases, attribute costs amongst separate categories of firms or separate types of cost. But it provides clear indications of the overall levels of costs of regulatory measures and the total costs faced by firms. Accordingly certain costs are not separately attributed to particular classes of firms or of costs in this table.

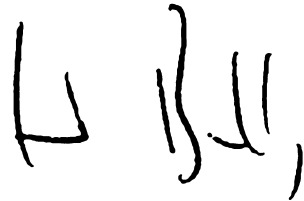
- (a) We assume that HPP intermediaries will not seek to be authorised by the FSA.

## MINISTERIAL STATEMENT

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I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by Economic Secretary to the Treasury



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Date 13 September 2006

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