

Regulatory Impact Assessment

Purpose and intended effect of the measure

(i) Objective

The purpose of the legislation is to amend the Financial Services and Markets Act 2000, to bring home reversion plans, Ijara products and flexible tenure arrangements into the scope of FSA regulation. It will create a level regulatory playing field with already regulated mortgage products and extend essential consumer protection to potentially complicated financial decisions affecting individual's lives.

Legislation relating to financial services is reserved to the UK Parliament and as with FSMA, the Bill extends to England, Wales, Scotland and Northern Ireland.

(ii) Background

On 31 October 2004, the Financial Services Authority (FSA) gained responsibility for regulating first charge mortgage loans. The need for statutory regulation was accepted by the Government in 2001, when the Julius Review of the Banking Code recommended the regulation of mortgage advice.

The Financial Services and Markets Act 2000 ("FSMA") provides consumer protection by, amongst other things, allowing only authorised or exempt persons (as those terms are defined in FSMA) to carry on a "regulated activity" in the United Kingdom. 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 the kinds of activities and investments which can be specified in an order under section 22. Whilst it covers contractual rights in respect of loans secured on land (e.g. first charge mortgages), it does not cover such rights in respect of finance provided in connection with the sale or purchase of property (e.g. reversion schemes and Ijara products).

The Government's Pensions' Green Paper¹ stated that the Government would be 'looking at options to create a level playing field for the regulation of equity release and home reversion plans to protect consumers and make the market work better.' Treasury officials held a number of discussions with stakeholders in the first half of 2003.

The consultation document "Regulating home reversion plans" was published on 11 November 2003. The Treasury received 53 responses, 46 of which supported the introduction of regulation. On 10 May 2004 the Financial Secretary to the Treasury announced the Government's intention to bring home reversion schemes into the scope of FSA regulation.

During the process described above, it was recognised that Ijara² products and flexible tenure products³ share many features of home reversion schemes and are similarly

¹ Simplicity, Security and Choice: Working and Saving for Retirement (Department for Work and Pensions - December 2002)

² Shari'a law prohibits transactions that involve interest, gambling, speculation or unethical investment. For customers who want to maintain their adherence to Shari'a law, this rules out financial products that result in either payment or receipt of interest. Financial institutions in the UK are now offering Shari'a compliant products that are economically equivalent to existing banking products but do not involve interest or speculative returns. There are currently two broad types of Shari'a-compliant arrangements available in the UK: Murabaha and Ijara.

unregulated. A further consultation document 'Defining Home Reversions' was published on 26 July 2004 and consulted on the content of the definition, including whether Ijara products and flexible tenure products should be included.

A consultation response document was published on 16 December 2004. The vast majority of responses called for both Ijara products and flexible tenure products to be brought within the scope of FSA regulation as well, to create a level playing field between these products and mortgages and also to increase consumer protection.

The steps necessary to bring home reversions, Ijara and flexible tenure products into FSA regulation are as follows:

- (i) Primary legislation is required to amend Schedule 2 to FSMA to make it clear that these types of products are within the scope of potential FSA regulation;
- (ii) Secondary legislation is required to amend the Regulated Activities Order⁴ (made under section 22 of FSMA) to bring these products into FSA regulation;
- (iii) The FSA draws up and consult on rules regarding the sales of these products.

The legislation will achieve the first of the steps above, by extending the existing delegated power in section 22 of FSMA so as to enable financial arrangements involving the sale or purchase of land to be specified as "regulated activities" and brought under FSA regulation.

A partial RIA covering home reversions was included in both consultation documents. There were very few comments received on the RIA during either of the consultations. This final regulatory impact assessment covers the regulation of home reversions, Ijara products and the flexible tenure schemes.

(iii) Risk Assessment

Home reversion schemes are aimed at older consumers who have paid off their mortgages (or have substantial equity, notwithstanding a mortgage) and require additional income or a cash lump sum. This money may be used to supplement pensions, or meet expenses such as home repairs or maintenance, and long-term care. In informal discussions with the Government, stakeholders raised concerns about a projected rapid expansion of the equity release market and the potential for consumer detriment of reversion plans remaining outside the FSA regime. The regulation of Home Reversion schemes would protect consumers who may be vulnerable to being sold a reversion plan that is unsuitable to their needs.

Ijara products have been developed to meet the same purpose as a 'regular' mortgage product whilst also meeting Islamic principles. Purchasing a house is potentially the largest financial transaction an individual will make during their lifetime and requires an appropriate degree of protection. Potential areas of consumer detriment could be prevented through FSA rules and remedies.

Regulation of flexible tenure products will provide essential consumer protection to individuals where they wish to release equity from their house. The decision may be

³ Flexible Tenure arrangements enable a homeowner to increase or decrease their equity ownership by transferring interests in a property to and from a finance provider, such as a local authority.

⁴ S.I. 2001/544.

complex and potential detriment could arise if unscrupulous profit-seeking lenders enter the market in the future.

Options

Option 1 – do nothing.

Option 2 – give the FSA responsibility for regulating reversion plans, Ijara products and flexible tenure arrangements

Risks of each option

Option 1 – do nothing

The risks of not subjecting home reversion plans and flexible tenure arrangements to FSA regulation include:

- *mis-selling*: for example, consumers being advised to take out one sort of equity release plan when the consumer would be better off trading down to a smaller property or taking out another type of equity release plan;
- *pricing*: the consumer being offered 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;

Further risks that apply to home reversion plans and Ijara products include:

- *regulatory boundary*: 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 will not be caught by FSA regulation. A similar situation exists with Murabaha and Ijara products.
- *Redress arrangements*: Consumers may be confused by the differences in redress arrangements.

Option 2 – give the FSA responsibility for regulating reversion plans, Ijara products and flexible tenure arrangements

The risks include:

- that the FSA could be focusing its regulatory regime where it may not be needed, particularly if there is no evidence of consumer detriment;
- additional compliance and conduct of business costs for firms;
- setting a precedent for the FSA to regulate other sale and purchase arrangements or non-financial services activities.

Analysing the benefits

Option 1

The main benefit of doing nothing in these markets is:

- avoiding the barrier to entry of regulation;

Specifically in relation to Home Reversion plans:

- the Government has already focused its regulatory regime on where there is a proven need for regulation following past problems, 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 CML and SHIP publish consumer fact sheets that set out the pros and cons between lifetime mortgages and reversion plans (and indeed whether equity release meets individual needs). It has been argued that some consumers already have the wherewithal to take their own decisions on the basis of full information.

Option 2

The main benefits of FSA regulation include:

- all equity release products, and all Islamic-compliant products respectively, will be subject to the same regulatory regime, creating a level regulatory playing field for firms;
- reducing confusion to customers wanting to make a fair comparison between products offering broadly similar benefits;
- consumers would have access to the Financial Ombudsman and Financial Services Compensation Schemes;
- regulatory arbitrage would be avoided.

Specifically in relation to Home Reversion plans:

- advice would be received during the sales process in relation to individual's tax and benefit position;
- information asymmetry between the reversion provider and the consumer will be reduced;
- the FSA might stipulate the providers ensure an accurate, independent property valuation;
- regulation could increase confidence in the market, which has seen a recent fall in lending believed to be due to uncertainty concerning the regulatory environment.

The Market

Equity Release

We have been able to trace fifty-seven firms in the equity release market, which represents an increase on those identified in our previous consultation. These comprise:

- providers
- brokers (comprising specialist equity release intermediaries)
- reversion brokers (those that market reversionary properties to private investors).

There are likely to be many more 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:

	Providers	Brokers	Reversion brokers
Lifetime mortgages	30	2	-
Reversion plans	6	2	7

Both types of equity release	2	8	-
Total	38	12	7

Table 2: Number of firms currently in the equity release market⁵

Islamic and Flexible Tenure

The current and future markets for Ijara and flexible tenure products are hard to quantify, as they are relatively under-developed. The Islamic Finance market is small - approximately 25 to 30 alternative property finance agreements were being taken out each month towards the end of 2004. Whilst the growth trend has been upwards, it has been levelling out. Flexible tenure products are currently only offered by a few Registered Social Landlords and some firms operating for zero profit in the low cost housing market.

Calculating the costs

In calculating the costs, this RIA assumes that the FSA will adopt a similar regime for reversions and Ijara products to that it has introduced for lifetime mortgages and Murabaha products respectively. Whilst we cannot anticipate the exact regime that the FSA might apply, we assume that the regime would cover the regulation of firms, advice and advisers, the disclosure regime, financial promotions, and other conduct of business issues as well as providing access to the Financial Ombudsman Service (FOS).

In the equity release and Islamic-compliant markets, 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 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 sell lifetime mortgages or Murabaha products as well, would be less. They would not need to apply for formal authorisation from the FSA and would already 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.

The overall cost of regulation will depend on whether the equity release, Islamic compliant and flexible tenure markets expand. It is not possible to assess or predict the total costs with any degree of accuracy, not least because we have no way of knowing how many new firms would sell reversions, Ijara or flexible tenure products in the future.

In calculating the costs for individual firms, we have attempted a read across to the arrangements that the FSA has put in place for firms that sell lifetime mortgages under mortgage regulation that came into force on 31 October 2004. We have used the cost

⁵ The CML published lifetime mortgage figures based on returns from 27 lenders (www.cml.org.uk) for full year 2004. Of the twelve SHIP members that provide lifetime mortgages only, ten are also CML members and are therefore included within the total of 27 lifetime providers. One other, internet based, firm offers a lifetime mortgage product with the intention of investing the equity in overseas land or property to provide an income. Eight internet-based brokers were found to sell both reversions and lifetime mortgages and two providers offer both types of product. Seven brokers currently advertise on the internet, aimed at the investor rather than the consumer. They seek funds from private and corporate clients to invest in reversions. Two were found to advertise properties for sale in the same way as estate agents do for the ordinary selling of properties – one of which appeared to be a member of the National Association of Estate Agents. One firm is apparently intending on entering the reversion market in the near future (not included in figures).

benefit analyses that the FSA carried out for this purpose in CP 1746 and CP 1867. These papers are available from the FSA website – www.fsa.gov.uk.

We have chosen to look at implications for types of individual firm. We are assuming that the one-off costs for year one for each type of firm are (Annex A):

- pure reversion providers that are not already regulated by the FSA - £475,000;
- providers already regulated by the FSA for lifetime mortgages - £233,000;
- intermediaries and property firms that are currently unregulated by the FSA - £11,000;
- intermediaries already regulated by the FSA for lifetime mortgages -£6,000

On-going costs for lenders and intermediaries have been estimated at approximately £180,000 and £3,000 respectively.

Small firms impact test

When home reversions are regulated there may be some reduction in the number of small firms in the market as such firms may be discouraged by the costs of compliance with FSA regulation. However the estimated costs of compliance (see above) are much lower for a small firm than for a larger one, and therefore we do not expect many firms to exit the market. Also, regulation may improve consumer confidence in the home reversions market leading to more opportunities for new entrants, including small firms.

Competition Assessment

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.

Whilst there has been a year on year increase in the outstanding equity release balance, there has been a slow down in reversion lending through 2004, falling from £129 million in 2003 to just £40 million in 2004. We have been told that the predominant factor for this fall in lending is due to uncertainty in the market surrounding the regulatory treatment of these products and the fact they currently remain unregulated. In addition, 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. These figures also lend support to this point of view. 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.

The Ijara and flexible tenure markets are still in their infancy and it is expected that regulation will increase confidence for product providers. It is estimated that under two percent of the Muslim population will take up such a product and it seems unlikely that there will 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

⁶ Prudential and other requirements for mortgage firms and intermediaries – FSA March 2003.

⁷ Mortgage regulation: draft conduct of business rules and feedback on CP 146 – FSA May 2003.

Islamic-compliant market grows will depend on how well the banks can sell the products.

Enforcement, sanctions, monitoring and review

It would be for the FSA to enforce and monitor compliance. The FSA will have a number of sanctions available if lenders and intermediaries fail to comply including fines, and ultimately withdrawal of permission to carry on the business. But firms have the safeguard of the right of appeal to an independent tribunal against FSA decisions.

Total Cost to Industry

For the purposes of estimating the total cost to industry the following assumptions have been made: no companies currently operating in the equity release market decide to leave (the number of market players has not changed significantly since the partial RIA was carried out); 4 new firms enter the pure reversion market (based on growth expectation in the market); 10 providers currently regulated for lifetime mortgages decide to also offer reversion products; the number of unregulated intermediaries advising on home reversions remains small as mortgage regulation is already in place; regulation prompts an increased uptake for intermediaries to advise on these products⁸.

A future market structure for home reversions could therefore be as follows:

- 10 providers, currently unregulated
- 10 providers, currently regulated for lifetime mortgages
- 20 unregulated intermediaries
- 600 regulated intermediaries

The one-off costs to each type of individual firms are identified in Annex A, and the on-going costs in Annex B. Using the figures above and the estimated costs of FSA regulation, the total one-off compliance cost to the industry for home reversions would be approximately £11million. It is estimated that ongoing costs would total approximately £5.4 million.

It is anticipated that the costs for providers and any intermediaries of Ijara and flexible-tenure products would be similar to those identified for Home Reversion providers. The FSA's regulatory rules would be tailored to each product but similar standard requirements to those identified for home reversion plans would probably apply. These markets are undeveloped at present, and the immediate cost of regulation to these markets would therefore be small.

⁸ In response to the consultation document, it was suggested that the total number of firms in the market may be 'hundreds'. A figure of 600 regulated intermediaries has been chosen as an illustrative number for the purposes of this calculation.

Declaration

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

[Signed]

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Annex A - The estimated one-off costs of FSA regulation of home reversions to individual firms

	Reversion provider – unregulated	Reversion provider – regulated for lifetime mortgages	Unregulated intermediary	Intermediary – regulated for lifetime mortgages
	£	£	£	£
Compliance costs				
Authorisation				
Application	622	-	476	-
Variation of permission	-	311	-	238
Application fees	15,000	7,500	1,200	600
Total	15,622	7,811	1,676	838
Conduct of business				
IT Systems	235,000	Minimal	5,000	500
Training and competence	25,000	25,000	2,500	2,500
Management and supervision	200,000	200,000	2,000	2,000
Total	460,000	225,000	9,500	5,000
Grand total	475,622	232,811	11,176	5,838
(Rounded)	475,000	233,000	11,000	6,000

Notes

1. The figures used assume that the FSA will regulate home reversion schemes in a similar way to lifetime mortgages and therefore firms will incur similar kinds of costs. The precise costs will, of course, depend on the regime the FSA decides based on consultation and its own cost benefit analysis.
2. The figures are year 1, one-off costs.
3. Estimates based on FSA cost benefit analyses in CP 174⁹ and CP 186¹⁰.
4. Application fees based on the FSA policy statement on consultation paper CP 180¹¹.
5. The unregulated reversion provider is assumed to be the equivalent of a medium-sized mortgage lender with annual gross advances of between £10 and £100 million.
6. The provider regulated for lifetime mortgages is assumed to be the equivalent of a medium-sized mortgage lender with annual gross advances of between £10 and £100 million.
7. The unregulated intermediary is assumed to be a small mortgage broker.

⁹ Prudential and other requirements for mortgage firms and intermediaries – CP 174 – FSA March 2003

¹⁰ Mortgage regulation: Draft conduct of business rules and feedback on CP 186 – FSA May 2003

¹¹ Fees for mortgage firms and insurance intermediaries – FSA October 2003

8. The intermediary regulated for lifetime mortgages is assumed to be a small mortgage broker.
9. The costs of completing the application for the first time are based on the figures in CP 174 – large mortgage lender = £622, and a small intermediary = £476.
10. The costs of completing the application to vary permission are based on the figures in CP 174 – large mortgage lender = £311, and small intermediary = £238.
11. Application fees based on the FSA policy statement in response to comments on CP 180. We have assumed that the unregulated reversion provider would pay £15,000 for a medium-sized mortgage lender, and the unregulated broker would pay the maximum of £1,200 for a small mortgage broker. Those firms that are already regulated would pay 50% of these fees.
12. The costs of IT systems for an unregulated reversion provider are estimated to be £235,000. This is based on the average cost of mortgage lenders set out in CP 186. (£36.4 million divided by 155 lenders.) We do not think that there would be any significant additional IT costs for reversion providers that are already regulated for lifetime mortgages. As to an unregulated intermediary, and a regulated intermediary, we have assumed there would be costs of £5,000 and £500 respectively. This is based on an estimate of the need for an unregulated intermediary to set up new IT systems from scratch, and for minimal adjustments to a regulated intermediary's IT systems.
13. On training and competence, we have assumed that 100 advisers in both the unregulated reversion and regulated providers would require training which is assumed to cost £250 each. Similarly, each of the 10 advisers in the unregulated and regulated intermediaries will require similar training.
14. The management and supervision time is assumed to be £200,000 for unregulated and regulated reversion providers, which is the approximate average cost of mortgage lenders as set out in CP 186 (£31.2 million divided by 155 firms.)
15. We assume that management and supervision time for unregulated and regulated intermediaries would be £2,000, which is the approximate average cost of mortgage intermediaries as set out in CP 186 (£23.9 million divided by 13,725 firms rounded).

Annex B – The estimated on-going costs of FSA regulation of home reversions to individual firms

Lenders	£
Management and supervision time	40,000
Initial disclosure	23,226
Advice and selling standards	8,387
Pre-sale disclosure	65,806
Offer stage disclosure	29,677
Fair treatment measures	6,452
Redress	1,290
Post-sale variations	5,161
Total lenders (value)	180,000
Intermediaries	£
Management and supervision time	1,974
Initial disclosure	189
Advice and selling standards	153
Pre-sale disclosure	488
Redress	102
Total intermediaries	2,907

1. These figures have been calculated from cumulative figures, taken from the FSA's consultation paper, CP186. The following are the cost breakdowns for lenders as estimated by NERA for each of the categories identified above. Management and Supervision time £6.2m, Initial Disclosure £3.6m, Advice and selling standards £1.3m, Pre-sale disclosure £10m, Offer stage disclosure £4.6m, Fair treatment measures £1m, Redress £0.2m, Post-sale variations £0.8m. For intermediaries the costs identified were: Management and Supervision time £27m, Initial Disclosure £2.6m, Advice and selling standards £2.1m, Pre-sale disclosure £6.7m, Redress £1.4m.
2. The costs to individual firms have been calculated based on 13,725 intermediaries¹² and 155 lenders operating in the mortgage market - the number of firms operating in the market at the time of the FSA consultation¹³.

¹² MCCB Annual Report 2002, pg.10. As at August 2002, there were 12,739 MCCB-registered intermediaries covering around 90 per cent of the entire UK market.

¹³ registered with the MCCB