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Cost benefit analysis of policy proposals for second charge lending

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1 Introduction

In order to develop its policy proposals for future regulation of the second charge lending market, the FCA appointed KPMG and Ignition House to undertake a cost benefit analysis (CBA) of the proposed regulatory changes.

Second charge loans are loans secured against the borrower's property. These are loans in addition to the borrower's mortgage (the first charge). The term 'second charge' reflects the legal ranking of the loan and is also commonly used to refer to loans that are technically third and subsequent charges on the borrower's property.

Our study was designed to cover both:

- those regulatory changes relating to the implementation of the Mortgage Credit Directive (MCD); and also
- the additional rules for mortgage lending that the FCA is considering applying to the second charge market.

The FCA is keen to understand the potential impacts of the changes in policy in order to ensure it meets its intended objectives in a proportionate manner. It, therefore, requested that our analysis focus predominantly on the proposed regulatory changes arising from applying aspects of the current mortgage regime to second charge lending. This is the area for which the FCA has discretion over whether and how to regulate the second charge market. However, MCD requirements must be implemented regardless of the results of this analysis, including in some of those areas where the FCA proposes to rely on existing mortgage regime rules.

We collected evidence on the one-off and on-going costs and benefits associated with the proposed changes in regulation in seven main areas:

- disclosure;
- charges (pre- and post-contractual);
- arrears handling;
- knowledge, competency and performance;
- responsible lending;
- sales processes (including advertising, sales targets, broker remuneration, debt payments and reflection periods); and
- data reporting.

Where possible, our CBA was designed to quantify the costs and benefits, although the FCA recognised that this would be more challenging in some areas, particularly on the benefits side. In this case, it was agreed with the FCA that a qualitative assessment be undertaken.

Our study was designed to capture evidence through:

- interviews with a sample of lenders and brokers to provide qualitative evidence on the impact of proposed regulatory changes;
- an online survey of lenders and brokers to provide quantitative evidence on the impact of proposed regulatory changes; and
- interviews with a small sample of customers who had taken out second charge loans to understand their borrowing experience and what some of the benefits of the proposed regulatory changes might be.

The findings set out in this report are based on the evidence collected from all of these sources. Unless stated otherwise, the data and information collected was not verified by KPMG or Ignition

House and the analysis is based on the responses from participants which may not be representative of the market as a whole.

In this report, we include a number of verbatim comments. These are respondent quotations based on interview recordings. The respondents' quotations demonstrate their own views and perceptions and may not always be factually correct. Neither do they necessarily coincide with the views of KPMG, Ignition House or the FCA.

Further details of the methodology and approach used for the information/data collection for this report are outlined in Section 6.

Furthermore, whilst the FCA requested that we collect evidence through our study on the costs of the proposed regulations in relation to responsible lending, the FCA is carrying out a separate CBA of responsible lending. The FCA recognised that responsible lending is an integral part of the proposed second charge lending regime, but this area was to remain outside the scope of our work. In that sense, for a full understanding of the likely impact of regulatory change on the second charge lending market, readers should consider this report in tandem with the FCA's own CBA.

Throughout our work we met regularly with the FCA to understand its policy proposals and how regulation of the market may change and to agree the scope of our interview and survey questions. We also agreed the approach taken to measuring the costs and benefits of the proposed regulatory changes. This approach is detailed in Section 6.

The remainder of this report is structured as follows:

- Section 2 is an Executive Summary;
- Section 3 sets out how the second charge lending market has developed over recent years, the current state of the market and the outcomes observed, for example in relation to arrears rates;
- Section 4 considers the potential market failures in the second charge lending market and how these could potentially be addressed through regulatory changes;
- Section 5 sets out the current regulation of the market (which forms the baseline for the CBA) and the proposed regulatory changes to be introduced in 2016;
- Section 6 details the approach taken for the CBA and the methodology employed for collecting evidence to inform the analysis;
- Section 7 reports the results of the CBA considering each main area of proposed regulatory change in turn;
- Section 8 summarises the total quantified costs and benefits of the proposed regulatory changes and potential implications for the market; and
- Section 9 sets out industry costs and benefits based on alternative scenarios for the market in 2016.

2 Executive summary

2.1 Overview of findings

In 2016, there will be a fundamental change in the regulation of second charge mortgage activity. The Government has confirmed its intention to move second charge mortgages to the same regulatory regime as first charge mortgages. This will take place when the UK implements the Mortgage Credit Directive (MCD), given that the MCD applies to first and second charge mortgages.

MCD imposes a maximum harmonising requirement for second charge lenders and brokers selling second charge loans to disclose key information (e.g. on contract terms, conditions and rates) in a written form and following the format of the European Standardised Information Sheet (ESIS). Where the MCD does not impose maximum harmonising obligations, the FCA intends to rely on existing Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) rules and, in some instances, 'copy out' of relevant MCD Articles in order to implement the MCD. The FCA is also considering implementing discretionary aspects of its existing mortgage regime for first charge mortgages in addition to the MCD requirements.

KPMG and Ignition House were appointed by the FCA to conduct a cost benefit analysis (CBA) for all these proposed regulatory changes. To conduct our CBA, we have relied primarily on both qualitative and quantitative data collected from lenders and brokers through a series of interviews and an online survey.

The indicative costs and benefits, scaled up to the industry level, are summarised below. These are estimates based on survey responses. Given that the policy proposals are still being developed, respondents interviewed suggested that they only able to provide initial estimates of the potential costs of the proposed regulations.

- The costs associated with the MCD's maximum harmonising requirement are the largest in terms of one-off and ongoing costs. The estimated one-off costs are approximately **£5.3 million** for active lenders and approximately **£1 million** for brokers respectively. Ongoing annual costs are estimated to be approximately **£1.9 million** and approximately **£1 million** for active lenders and brokers respectively. It is expected that the proposed regulations relating to disclosure of information via the ESIS would lead to benefits from the improved provision of information to consumers, enabling them to make better-informed borrowing decisions. This could also drive greater competition in the market if consumers use the information to seek out and compare products. These benefits could help address the market failures of information asymmetries and market power.
- The costs associated with the implementation of the MCD requirements through existing MCOB requirements and Directive copy-out are significantly lower than those for the MCD's maximum harmonising requirement. The estimated one-off costs are approximately **£1.4 million** for active lenders and approximately **£0.7 million** for brokers. The data we received indicated an ongoing cost of approximately **£1.2 million** for active lenders and no ongoing costs for brokers as the requirements which fall under this category that impose ongoing costs for lenders do not apply to brokers. The main expected benefit from these changes is the improved provision of information to customers, the potential for increased competition, potential cost savings for customers and a lowering of the proportion of customers entering arrears. These benefits should help to address the current market failures of information asymmetries and market power.
- The estimated one-off costs associated with the implementation of the FCA's discretionary mortgage regime requirements are approximately **£1.4 million** for active lenders and approximately **£0.1 million** for brokers. The data we received indicated an ongoing cost of approximately **£0.6 million** for both active lenders and brokers. The main expected benefits from these proposals are a lowering of costs and better information for customers. It is

expected that the reporting proposals could enhance these benefits to consumers by ensuring compliance with the regulations.

It was also suggested that the proposed regulatory package would have an impact on the market in terms of the volumes of lending, competitive dynamics and the range of lenders in the market:

- The majority of survey respondents considered that the proposed regulations would lead to a decline in new lending volumes. 21% thought that it would fall by more than 20%, a further 21% thought that would fall by between 11% and 20% and 14% thought it would fall by less than 10%. Firms interviewed suggested that the decline in volumes would be driven by the proposed responsible lending regulations. Whilst fewer potential customers may result in more vigorous competition between lenders to attract them, conversely, it may force lenders out of the market as it would no longer be profitable to service a significantly reduced volume of loans, particularly when facing the incremental costs of the proposed regulatory requirements.
- There is evidence to suggest that the cost burden of the regulations may fall disproportionately on smaller lenders in the market, thus having a greater impact on their profit margins, and potentially resulting in market exit. However, even if smaller firms were to make losses as a result of the proposed regulations and exit the market, it may not have a significant effect on competition given that the six largest lenders accounted for approximately 84%[1] of new lending in 2013.
- Competition may be stimulated by the entry of first charge lenders to the market when the regulatory regimes are aligned.

2.2 Chapter summaries

Development of the second charge lending market

The second charge lending market has changed substantially since the financial crisis, resulting in a shift in some of the outcomes observed in the market. Key developments have been:

- the value of new second charge lending at approximately £445 million is around a tenth of its peak in 2007/8;
- a number of key lenders active in the market in the "boom period" have exited and there is a lack of expectation that the market will return to previous levels;
- evidence of a general improvement in lender business practices. Also, lenders are reportedly focusing more on prime customers, now accepting fewer credit impaired customers; and
- lower arrears rates in the market, with fewer loans now going in to arrears, although rates remain relatively high compared to the first charge market.

Potential market failures

There are a number of potential market failures in the second charge lending market that may be addressed, at least to some extent, through the proposed regulatory changes. Whilst there is some evidence of improved lending practices, without intervention these market failures may persist and the scale of detriment could increase were lending levels to increase in future.

Key potential market failures include:

- Behavioural biases: whereby borrowers may have overestimated their ability to repay the loan; have suffered over-optimism about their future use of credit; and/or suffered present bias, placing more emphasis on their current spending needs without sufficient emphasis on the likely consequences of living beyond their means which could explain the historic high arrears rate in the market. There may also have been biases in assessing the risk of loans as buyers

[1] The FLA estimates that of its members, the largest six accounted for approximately 99per cent of new lending in 2013 (and also 2012). It also estimates that its members account for approximately 85per cent of the second charge lending.

may have suffered an inability to process or understand the information made available to them.

- Information asymmetries: where borrowers may have poor information about the specific risks associated with a second charge loan and so not make a fully informed decision. This may also arise from informational asymmetries between customers and lenders/brokers about the range of alternative, potentially more suitable, products available. Information asymmetries can also mean that borrowers cannot assess and compare second charge loan characteristics and thus achieve suboptimal outcomes.
- Market power: whereby a possible lack of effective competition between lenders and between brokers in the second charge market may result in customers being given bad advice and, provided with insufficient information to make informed decisions.
- Principal agent problems: where the incentives of the brokers and customers are unlikely to be aligned if brokers' loan recommendations for customers are driven by sales targets and/or commission.
- Regulatory failures: where the market has been shaped, to some extent, by the regulatory regime in operation and the regulation has failed to address existing market failures. Furthermore, the evidence of negative outcomes in the market (for example, high arrears rates), suggests that the regulatory regime has not been fully effective and that further measures are required.

These market failures can lead to undesirable market outcomes, for example, in terms of high arrears rates and a higher cost of arrears poor borrowing decisions and the possibility of an increase in the default rate.

Approach to conducting the CBA of the proposed regulations

The CBA was conducted following the approach specified in the HM Treasury *Green Book for Appraisal and Evaluation in Central Governments* with some modifications made to meet the FCA's requirements for this work. We used a largely quantitative approach to estimating the costs of the regulations, supplemented by qualitative insights. As explained in the main report, a largely qualitative approach was taken to assessing the benefits due to a lack of data and information to quantify impacts. Analysis was conducted wherever possible, however, to support the assessments.

The baseline position against which the costs and benefits of proposed regulatory changes have been assessed is the current regulatory framework, i.e. FCA regulation under the consumer credit regime or, in the case of advertising, the existing rules in MCOB. In reality, however, this is not an "option" for the FCA given that the MCD must be implemented in the UK in March 2016. For those aspects covered by the MCD, the *real* counterfactual would be MCD copy-out. As such, some of the estimated compliance costs and benefits overestimate the *truly* incremental impacts of FCA discretionary proposals.

For the purpose of conducting our assessment, we drew on six main sources of data and information:

- interviews with a sample of lenders and brokers – qualitative;
- an online survey of lenders and brokers – quantitative;
- interviews with a small sample of customers – qualitative;
- sales and loan performance data collected by the FCA – quantitative;
- the FCA's policy proposals; and
- other publicly available sources of data.

Although the overall response rate to our online survey was relatively low compared to the total number of firms estimated to be operating in the market, we estimate that a reasonable share of active lenders (we estimate that the respondents accounted for 43% of existing loans in the market and 69% of new loans advanced in 2013) were represented. Dormant lenders and intermediaries were much less well represented. Additionally, response rates for certain questions, particularly those asking for cost estimates of the proposed regulatory changes which were then used to form the quantification of costs, were considerably lower in most instances. Therefore, the quantitative results can be only viewed as indicative.

Results of the CBA – costs

Our analysis suggests that the combined measures are estimated to cost industry in the region of **£9.9 million** in one-off costs, and **£5.4 million** in on-going costs per year[2]. This excludes some less quantifiable costs of the regulation, although the majority of respondents believed these individually would be negligible.

The table below sets out the total costs, on a one-off and on-going basis, scaled to the industry level based on firms' responses to our survey. In the table:

- the row highlighted in grey denotes the MCD's maximum harmonising requirement;
- rows highlighted in orange denote MCD requirements where FCA proposes to implement the Directive using a combination of existing MCOB requirements and Directive copy-out; and
- rows highlighted in purple denote discretionary aspects of the mortgage regime, separate to MCD requirements.

[2] Given the response rate to certain questions and from dormant players to our online survey was relatively low the quantitative results can be only viewed as indicative.

Figure 1: Total costs incurred (scaled to industry size), one-off and ongoing

£ million	One-off: Lender[3]	One-off: Inter-mediary[4]	Ongoing: Lender	Ongoing: Inter-mediary
Disclosure via ESIS	5.3	1.0	1.9	1.0
Disclosure of remuneration	0.1	-	0.4	-
Arrears charges	<0.1	-	<0.1	-
Affordability assessment	0.2	<0.1	0.2	-
Interest rate stress test	0.1	0.1	0.1	0.6[5]
Arranging for consolidated debt payments to be made directly to creditors[6]	0.7	-	0.2	-
Data reporting requirements[7]	0.5		0.3	
Advertising	0.1	-	-	-
Arrears management	0.6	-	0.7	-
Arrears management – information sharing	0.1	-	**-**	**-**
Knowledge and Competency and sales standards[8]	0.4	0.7	-	-
Total costs	**8.1**	**1.8**	**3.7**	**1.7**

Our CBA indicates that the relative impact of the various individual proposed regulations may also differ across lenders and brokers. In particular:

- disclosure via the ESIS, as required by the MCD, was reported by both lenders and brokers to account for the greatest proportion of costs (both one-off and ongoing);
- data reporting regulations and arranging for consolidated debt payments to creditors[6], both FCA discretionary requirements, were reported to be among the largest one-off costs for lenders. However, these were each estimated to be less than 15% of the estimated costs for disclosure via the ESIS;
- arrears management, which the FCA is proposing to implement through MCOB 13 in order to comply with both the Directive and introduce additional standards to the second charge market,, was the second largest ongoing cost reported for lenders, at just over a quarter of the estimated cost of disclosure via ESIS; and

[3] Active in the market (currently advancing new loans)

[4] Broker/Packager

[5] This estimate is largely driven by an estimate of £120,000 from a broker to comply with this requirement. This is discussed further in section 7.5.1. If this particular estimate was excluded this figure would fall to £36,005. We also note that the Oxera report for the FSA assessing the costs of complying with the MMR assumed the costs of an interest rate stress test would likely be low as most lenders' existing affordability models would already allow for some form of interest rate stress testing.

[6] We note that the FCA proposals will not require lenders to make payments direct to creditors but the current practice adopted by most lenders to provide the borrower with cheques payable to their other creditors will suffice. Therefore, these estimated costs are an overestimate of the actual impact of the proposed regulations.

[7] The FCA is also proposing that second charge intermediaries submit Retail Mediation Activities Returns (RMAR). 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.

[8] We note that an Oxera report prepared for the FSA in 2010 (http://www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf) estimates an incremental cost of £35 per loan for both affordability and suitability tests in its analysis for the MMR. We estimate on-going costs for affordability but acknowledge there would be further smaller incremental costs for the advice part.

- overall, the estimated costs are much lower for brokers than for lenders. Total one-off costs for brokers are reportedly 22% of the costs to lenders, while total ongoing costs for brokers were estimated to be 46% of the costs to lenders.

In addition to being asked in the survey for estimates of cost for the individual components of the proposed regulatory package, firms were also asked about the impact of package in total. The qualitative and quantitative information gathered suggests that, while half of the lenders that responded expect costs will increase by between 11% and 20%, large lenders believed the effect on overall costs would be negligible, particularly for current mortgage lenders. The impact on brokers' costs is less certain as an equal proportion (21%) expect costs to either stay the same or to increase by less than 10% and 26 per expect an overall increase of between 11% and 20%. There was some concern that the costs may fall disproportionately on smaller brokers. Although there was uncertainty as to the overall cost across the market, there was agreement that the key issue would be the time required to implement the changes. There was some concern the changes were going too far in a short space of time.

Putting the results in context - costs

We note that these costs appear high in comparison to the estimate of costs for implementing the Mortgage Market Review (MMR) reforms in the first charge market (£40-65 million one-off and £47-170 million on-going)[9]. There would be higher incremental costs on second charge firms due to the scale of changes that they would be required to make to their operations compliant with the proposed regulations and as there are some additional requirements, such as those relating to disclosure via the ESIS which are not included in the MMR impact for the mortgage market. However, given the size of the second charge lending market compared to the first charge market, the costs do appear large relative to the size of the market and thus could be overestimated.

Analysing the estimated costs as a proportion of industry profits also puts the figures in context and provides a high level, indicative view of the potential scale of impact:

- According to FLA estimates provided to the FCA for a sample of its members, we have estimated that there were approximately 14,650 new loans written by FLA members in 2013. FLA members are estimated to cover 85% of the market so total number of new loans is estimated at 17,240. Based on lenders' survey responses scaled up to the industry level, the annual cost in 2013 of providing these loans was approximately £30 million. Estimated annual ongoing costs of the proposed regulations for the industry are approximately £3.7 million, represent around a **12% increase in annual costs.**
- Based on lenders' survey responses, on average they achieved an approximate 11% profit margin, which suggests that for the industry lenders' profits in 2013 were in the region of £3.6 million.
- The increased annual ongoing costs represent around 103% of these lenders' profits[10]. However, these costs are only indicative and are presented at the industry level based on the responses to our surveys. Respondents were only able to given their initial estimates of the potential costs of the proposed regulations. A number of firms we interviewed highlighted that they had not considered the proposals in detail or undertaken a full assessment of the likely compliance costs.
- There is evidence to suggest that the cost burden of the regulations may fall disproportionately on smaller lenders in the market, thus having a greater impact on their profit levels and a lesser impact on large lenders' profit margins. This is assessed further in Section 8.1.

[9] Oxera, Assessment of compliance costs and indirect costs as a result of the MMR lending reforms (2010): http://www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf

[10] We note that intermediaries active in the market also make profits from second charge lending. Very limited data on the profit level of intermediaries associated with second charge lending was provided by firms. Therefore, it was not possible to accurately estimate total industry profits (i.e. lenders' and brokers' profits).

- These larger lenders account for the majority of the second charge lending market. The six largest lenders accounted for approximately 84%[11] of new lending in 2013, as was the case in 2012. Therefore, even if smaller firms were to exit the market it may not have a significant effect on competition in the market.
- Although there was concern about the effect the regulation would have on the volume of new lending in the market, no respondents to the qualitative survey indicated that there was likely to be large scale market exit as a result of the planned regulation. It is likely that there would be some degree of cost pass-through to consumers, through increased prices, thus allowing some of the existing profit margin to be maintained.

Results of the CBA – benefits

In terms of the benefits of the proposed regulatory package, for the purposes of the CBA we took a largely qualitative approach due to in inherent difficulties in respondents estimating the potential scale and exact value of benefits.

The impacts of the responsible lending proposals are covered in the FCA's CBA so these potential benefits are not considered in our analysis.

Our analysis, based on the information we obtained from lenders, brokers and customers, as well as based on economic insights into the market suggests that, for the disclosure of information on ESIS:

- there may be benefits from the improved provision of information to consumers, enabling them to **make better-informed decisions** about borrowing. This could also **drive greater competition** in the market if consumers use the information to seek out and compare products. However, these benefits may not be realised fully given behavioural biases and as the limited customers we interviewed suggested that they had already received helpful and understandable information.

For other areas, our analysis suggests that:

- there could be a **potential lowering of costs** to consumers if they enter arrears as a result of cost reflective arrears charges as the MCOB rules should help to ensure that the benefits are realised for all customers;
- **arrears management processes** under the FCA's proposed regulations would benefit the large proportion of customers going into arrears by ensuring that greater forbearance measures are taken than observed in the market at present. Further benefits (albeit small) will also arise from cost savings to borrowers from reduced direct debit reprocessing changes and proposed requirements to improve the sharing of information between first and second charge lenders at the point of commencing litigation action. Charges disclosure may improve not only the provision of information to borrowers, but also competition in charges;
- there may be **improved transparency** on post contractual fees resulting in customers being able to make better informed decisions. However, the balance between those customers that may pay higher and lower Early Redemption Charges (ERCs) when they are calculated based on costs is unclear and will depend on the extent to which lenders choose to levy ERCs going forward;
- **the knowledge and competency proposal** for sales staff, specifically the Level 3 qualification requirements, coupled with the proposed move to advised (and execution only) sales for second charge firms may **improve the quality of information and advice** given to potential borrowers to help them better understand the product being offered, its risks and the potential alternatives. This, along with the suitability tests and responsible lending regulations are likely to help mitigate the risk of customers suffering detriment from taking out second charge loans where this is not appropriate for them;

[11] The FLA estimates that of its members, the largest six accounted for approximately 99% of new lending in 2013 (and also 2012). It also estimates that its members account for approximately 85% of the second charge lending.

- the proposed requirement for lenders to take reasonable steps to ensure payments are made directly to previous creditors (e.g. by making cheques payable to them) where debts are being consolidated may yield some benefits by ensuring that the money is used for the intended purpose, counteracting behavioural biases that may result in borrowers making poor choices, and helping to facilitate payments being made promptly without further costs being incurred. However, evidence suggests that the majority of lenders already adopt this practice;
- more information-rich advertisements as a result of the proposed advertising requirements may allow more information up front to be gathered by the consumer to improve their decision making. However, much of the evidence suggests that a lot of the business now originates from price comparison websites. It is, therefore, unlikely that traditional advertising regulation will have a large impact on the majority of consumers; and
- the data reporting requirements should help to support the realisation of benefits from the other proposed regulations by increasing compliance and ensuring that the FCA is able to effectively monitor firms' behaviour and market outcomes to ensure that the regulation is fit for purpose.

Industry costs and benefits based on alternative scenarios

Our CBA assumed total industry costs on the basis of the current volume of loans in the market. However, if there is growth in the market between now and 2016 (when the regulations are implemented) this assessment changes. Costs of the proposed regulations will not change in direct proportion to the change in volumes of second charge loans as not all the costs of regulation compliance are incurred on a per-loan basis. The costs of regulation will increase at a slower rate than any increase in the volumes of new lending.

The potential benefits would also be expected to change depending on the development of the second charge lending market before 2016. Growth in the market would be expected to lead to a proportionate increase in the total expected benefits given that the benefits identified are likely to be linked to an increase in the volume of loans (and number of customers) in the market.

3 Characteristics, and the evolution of, the second charge lending market

In developing any regulatory policy, it is vital to have a clear view of the current state of the market and, in particular, the market outcomes that should be addressed through regulation. To assess the costs and benefits of proposed changes in regulation, it is also important to understand the dynamics of the market. This is particularly important for second charge lending, a market that has been in decline in recent years and where the business model of firms has changed. At its peak, in 2006/07, new loans in the market were around £5 billion-£7 billion. This shrank considerably after the financial and economic crises; according to the Finance and Leasing Association (FLA), gross secured charge lending for its members totalled just £445 million in 2013.

By studying how the market has evolved into its current state, we can start to understand what the market may look like in 2016 when the proposed regulatory changes would be introduced and, in turn, how these changes may then affect the market going forward.

Through our interviews with lenders and brokers in the market and with the key trade body for the industry, the FLA, we obtained insights into both the state of the market in the "boom period" (prior to the financial crisis) and its current state. Data obtained by the FCA from lenders also informed our analysis.

The issues we considered relating to both the pre- and post- financial crisis periods included:

- the drivers for growth, including the extent to which the market was driven by the property market, regulation, advertising and the availability of wholesale funding;
- profitability levels;
- business models in place and the key drivers for profitability;
- the role of brokers and any changes in the distribution models;
- the general quality of underwriting and levels of affordability checks
- the ease of entry and exit to/from the market and the potential for future growth;
- the level of competition in the market; and
- key opportunities and threats in the market going forward.

Stakeholders in the market are also likely to be affected by the proposed regulations in different ways. There are three main stakeholders in the second charge lending market:

- **borrowers** are property owners/mortgage payers seeking to borrow amounts secured against their property. In recent years the average loan size has been approximately £25,000-£30,000[12];
- **lenders** provide the facility for borrowers to borrow against the value of their property and typically attain business through brokers, although some lend directly to customers; and
- **brokers** are the customer-facing side of the second charge lending market, advertising to potential borrowers, carrying out the application process and then receiving commission on completion from the lenders and fees from the borrower.

By understanding the role each stakeholder has in the market and how this has changed over time, this will provide insights in to how regulation is likely to affect them.

[12] Sales and loan performance data collected by the FCA from second charge lenders

Through the interviews with firms, we also sought to understand the profile of customers in the pre- and post-financial crisis periods, including:

- whether different lenders targeted different types of borrowers;
- how the profile of borrowers has changed over time;
- loan purposes and alternatives available; and
- average length of loan and the extent to which loans were passed between lenders.

3.1 Second charge lending in the pre-financial crisis period

Before the financial crisis, second charge lenders included the following types:

- **high street banks** offering mortgages to their existing customers under their own brand;
- **specialist second charge lenders;**
- **finance houses**;
- **specialist mortgage lenders**; and
- **sub-prime specialists.**

On the broker side, the largest brokers focused on direct to customer (D2C) business, primarily through direct advertising in the press and on television. From 2006/07 onwards, there was significant growth in broker to broker (B2B) origination via mortgage brokers and online aggregators.

Evidence suggests that a number of factors defined the second charge lending market pre-financial crisis:

- The focus on D2C lenders, supported by extensive television, press and direct mail advertising and later a growth in introducer business from the likes of the price comparison websites;
- high lender profits, which for some lenders was driven by PPI sales and high early settlement charges (prior to Consumer Credit Act (CCA) changes);
- affordability models based predominately on debt-to-income ('40% DTI across most lenders');
- high loan to value ratios (LTVs) – many lenders were offering 100%+, some up to 110% or 125% and lenders offering products right down the credit curve;
- high prevalence of self-certification;
- wide scale use of wholesale funding/securitization;
- significant role for Master Brokers who sold and packaged the loans;
- high broker commissions, both for selling the loan and for selling PPI, and no explicit broker fees;
- rapid completion of loans of £25,000 plus (prior to abolition of CCA maximum).

> *"[The industry] was driven by high commissions – 4-5% for selling a loan and a further 10% if you sold PPI. So commission was 5%-12% per loan and there was no broker fee. The finance houses made most of their income from PPI and about half was passed to the broker for doing the sale."*
>
> **Lender**

Respondents to the qualitative interviews reported that many of the specialist second-charge lenders in the market pre-crisis were effectively selling loans at a loss to facilitate the **sale of Payment Protection Insurance (PPI)**, while also generating additional income through **early settlement fees**.

Respondents have told us that, while brokers were receiving commission on their lending volumes, they could earn substantially more commission through PPI sales and were often targeted by the lenders to sell PPI to a very high proportion of their customers (often in excess of 65%). Respondents suggested that no brokers charged a broker fee, although this changed when Early Repayment Charge limits were introduced and later when PPI income dried up, drastically reducing lender profits and, therefore, the commission they paid to brokers. However, the transaction data collected by the FCA indicates that broker fees have been added to just over 90% of loans since 2006, but the amount charged, on average, has increased by almost 250% over the period.

> *"A lot of re-financing. The average customer was on the books for 6 months – either they would go for new debt consolidation or the broker would phone them up and re-broke them to get the fees again. It was very prevalent. It still happens a bit, but on a much smaller scale. Usually now it is because the customer wants more finance."*
>
> **Broker**

Respondents to our surveys also told us that there was a significant amount of **re-broking** taking place in the market, driven either by the broker in order to generate additional commissions or by the customer to further consolidate their debts. Anecdotal evidence also suggested that lenders initiated the process by passing details of customers they wanted to get off their books to brokers to re-package elsewhere.

Lenders and brokers tended to specialise in different segments of the market. Most of the **large specialists indicated to us that they focused on prime or near-prime business**[13], while smaller specialists served the sub-prime end of the market. Others created niches for themselves, such as specialising in self-employed customers, or flexing their lending criteria in 'innovative ways' such and not taking unsecured debt into account when calculating Debt to Income ratios (DTI). Typically those lending at a higher risk had more conservative LTV restrictions.

Borrowers predominantly borrowed for debt consolidation purposes. Over 60% of loans were for this primary purpose according to FCA's lender data, with the remainder of loans advanced for home improvement or other purposes. A high proportion of debt consolidation loans included an element of new lending. Indeed, brokers often **'upsold'** customers. For example, a customer that approached them for a debt-consolidation loan might have been asked whether they wanted to borrow additional sums for a home improvement project, or a customer approaching the broker for a home improvement loan might be asked whether they had any other debts that could be consolidated into the loan as well.

3.2 The current market for second charge lending

The second charge market today is less than a tenth of its peak in 2007/8 in terms of the value of new lending.

FLA data shows that gross secured charge lending for its members totalled £445 million in 2013. Data collected by the FCA also demonstrates the significant decline in the market over the period 2007 – 2009, with lending only having marginally increased over the last few years.

[13] We note that the sales and performance data collected by the FCA from lenders indicates that there are high arrears rates for second charge loans, including for those loans from the large specialist lenders. This may call in to question the extent to which they were focussing on prime or near-prime business.

Figure 2: Estimate of new second charge mortgage market lending between 2005 and 2013[14]

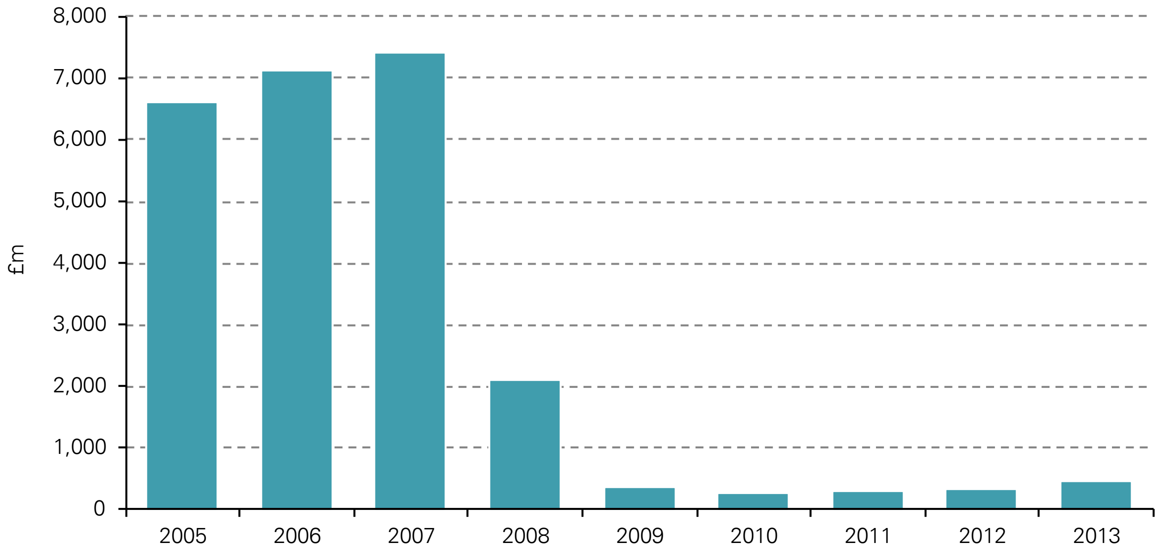


Figure 2 shows the size of new lending in the second charge lending market based on FLA data for 2008-2013 and Mintel data for secured lending prior to this.

The financial crisis precipitated both a significant decline in lending and the exit of major lenders, including GE Money and Paragon. The exit of these major lenders has changed the structure of the market considerably with the leading six firms now representing more than 85% of new second charge lending in 2013. In 2007, these firms represented less than 50% of new second charge lending.

> *"The market is 10% of what it was at peak. The last 2 years or so, where you have started to see growth, the numbers are still… not that good you know."*
>
> **Broker**

Whilst the FCA collected comprehensive information on the lenders in the market through its registration process when it took over regulation of the market from the Office of Fair Trading in April 2014, there is some evidence to suggest that the information provided by lenders was not reliable. Although around 1,400 firms applied to the FCA for a second charge lending interim permission, according to respondents there are perhaps 20 to 25 active lenders in the market today. A number of respondents to our survey also indicated that although they had applied for interim permissions with the FCA, they were not active in the second charge market and did not plan to be in the foreseeable future.

Three main factors were identified by respondents as drivers of the decline in the market and the change in the composition of market participants in the post-financial crisis period. These were:

- changes to the CCA regulations relating to early repayment charges meaning that high charges could no longer be applied;
- a reduction in potential profits after tighter regulation of supplying PPI; and
- a lack of wholesale finance to the market.

[14] Source: Mintel estimate of secured lending for 2005-2007 (Secured Lending Products (2009)). Data for these years cover a wider suite of products than just second charge mortgages including, for example, loans secured against vehicles, and so overestimates the second charge market size. FLA members' data on second charge loans from 2008 to 2013 (estimated to cover approximately 85% of the second charge market).

There are four key players in the market currently and it was indicated in our interviews that these four active lenders focus on prime customers, i.e. those customers with reasonable credit worthiness and who would be expected to be able to meet their agreed repayment schedules. Indeed, respondents reported that the vast majority of lending in the market today is focused on the prime segment. We note, however, that the sales and performance data collected by the FCA for these lenders indicates that arrears rates for some of these firms remain high. For example, for one lender, of the loans issued in 2012, 22% went in to arrears in the first year.

A second tier of lenders appears to operate in the near-prime segment. It was also suggested that a few small lenders appear to focus more on credit impaired customers.

The business models for lenders and brokers have also changed significantly compared to the pre-financial crisis period.

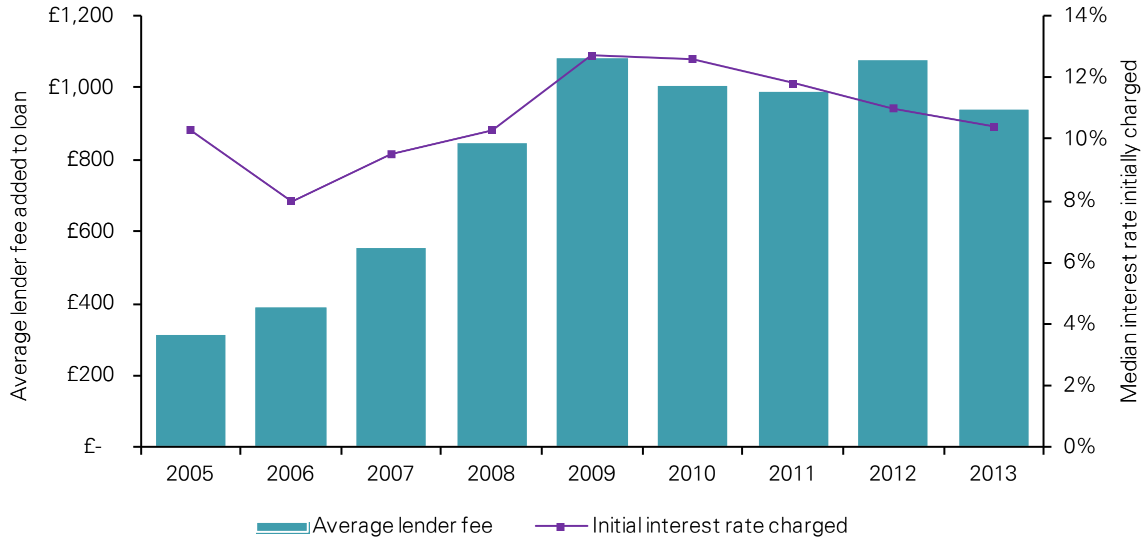
Anecdotal evidence obtained through the interviews suggests that the level of commission paid by lenders to brokers has decreased from 5-6% down to 1-2%. As a result of this, from a broker business model perspective, they introduced higher fees to compensate for this lost commission revenue and to cover the costs associated with selling and packaging the loans, including valuation fees and abortive costs. Brokers suggested that they charge a fee of 10%-12.5% of the loan value, but this is often capped (either by the broker themselves or because they are required to do so by the lenders). Broker fees are generally added to the loan rather than paid upfront by the borrower.

Anecdotal evidence from our interviews with firms also suggests that lenders have increased margins to account for the loss of PPI income. It was suggested that this, coupled with lower rates of commission paid to brokers, has helped lenders to remain profitable. Data collected by the FCA suggests that the median interest rate initially charged on loans has remained in the region of 9–13%, although up to 2012 some lenders were charging median rates of over 17%. This analysis does not account for lenders' margins (funding costs), however, or the fact that rates are likely to have been influenced by the shift in lending towards more prime customers.

As shown in the figure below, sample data provided to the FCA suggests that where fees are charged, average lender fees added to loans increased sharply between 2005 and 2009 but have remained relatively stable since. However, the data also suggests that the proportion of loans on which a lender fee is levied has fallen significantly (from over 75% of loans in 2006-2008 to around 20% in 2013)[15].

[15] The FCA considers, however, that the lower proportions observed in the data in recent years, may be an underestimate due to data gaps.

Figure 3: Average lender fees added to loan and the median interest rate initially charged



Second charge lenders reported that the market is very different today compared to at its peak pre-crisis because the average customer profile has moved considerably towards the prime end of the spectrum. Lenders appear to have significantly improved the quality of their lending, with:

- more stringent affordability criteria;
- lower maximum LTV ratios;
- no self-declaration of income; and
- fewer accepting credit-impaired customers.

It was suggested that the move towards lending to prime customers has, in part, been driven by growing demand from '**prime mortgage prisoners'**. These are customers who are either unable to remortgage due to changes in first charge lenders' lending criteria or unwilling to do so in order to avoid lose their existing mortgage deal.

> *"The lenders are more closely packed into a narrower segment of the market. Everything is super-prime, super clean. All the lenders are concentrating there."*
>
> **Broker**

In addition, it was suggested by survey respondents that the contraction of the second charge lending market coincided with a significant increase in the use of debt advice. Given that the majority of loans tend to be for debt consolidation purposes, consumers may have been pursuing alternative methods for dealing with their debts, rather than opting for a second charge loan. Lenders' lack of appetite to lend to less creditworthy individuals and their steps to improve the quality of lending books through tighter restrictions on lending, in line with other credit sectors following the financial crisis, is also likely to have contributed to the contraction in the market.

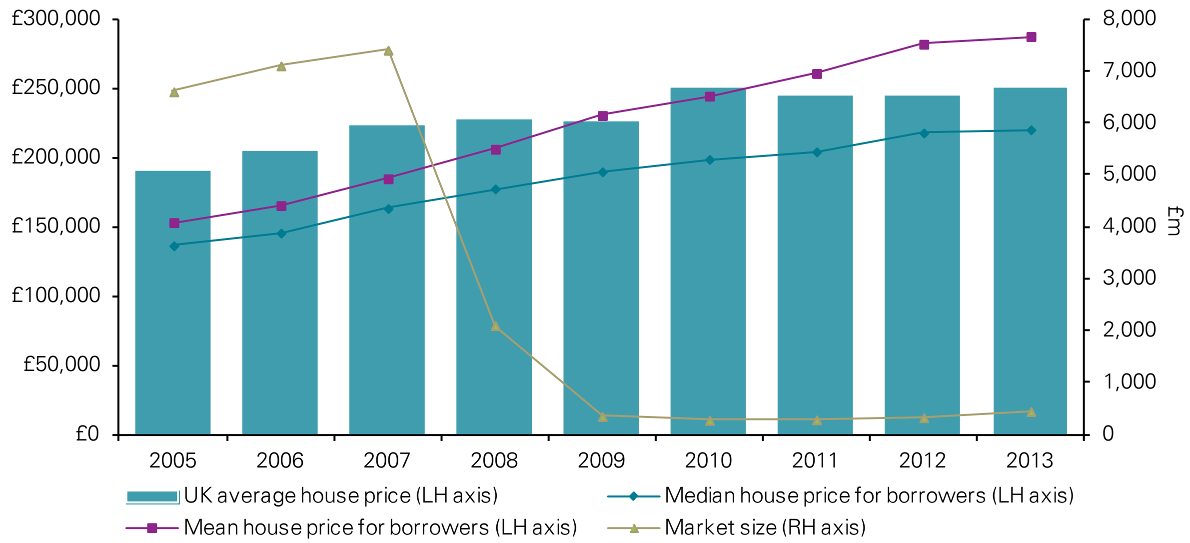
Our survey respondents reported that changes in second charge firms' lending criteria, coupled with a more benign interest rate environment, has resulted in lower arrears rates. Lenders also reported that they are much quicker to contact and work with customers in arrears, which has further reduced arrears and repossessions. Data collected by the FCA from lenders also suggests that after 2008 there has been a sharp drop in the proportion of loans going in to arrears in their first year. Whilst data from a sample of second charge lenders suggests that the average percentage of loans going in to arrears in the first year after origination was over 35% in 2005, this has fallen to under 15% in the years since 2011-12[16]. These estimates are based on the FCA's definition of arrears (which is 2 or more months in arrears), which may differ from the industry's definition of arrears.

Although the market remains considerably smaller than before the financial crisis, as shown in Figure 2, there has been some growth in the level of new lending in the market over recent years. Those firms interviewed also reported that the market today is starting to show signs of some growth, but that this was being driven more by an increase in average loan size than by an increase in volumes. The data collected by the FCA from lenders, however, suggests that there has not been an increase in average loan sizes across the industry as a whole, although this does vary by firm.

It may be expected that the demand for second charge lending would be affected by conditions in the housing market, with a period of rising house prices resulting in an increased number of applicants for second charge loans due to increased equity meaning individuals may want to borrow from future earnings (the eventual sale of the home) to fund a better lifestyle today. Additionally, an increase in the equity in potential borrowers' properties also increases second charge lenders' willingness to lend. Recent house price growth has been concentrated and most significant in London and the South East. However, data we were shown from one of the larger lenders indicated that the South East region accounted for approximately only 20% of new business, meaning that house price growth in these regions has had a minimal impact on its overall business levels. Whilst data from this one large lender is not necessarily representative of the geographical focus of the second charge lending industry as a whole, firms we interviewed did not attribute the higher average loan size to any recent house price growth.

Analysis set out in Figure 4 below helps to corroborate lenders' views that house prices have not been fuelling the second charge lending market. Whilst UK average house prices are higher now than they were in 2009, and the lender reported mean and median prices of borrowers' property have steadily risen despite the financial crisis, the second charge lending market declined considerably and has not recovered.

Figure 4: Median value of borrowers' properties and size of second charge lending market[17]



The second charge lenders we spoke to suggested that larger loan sizes for some customers today are due to a market shift towards prime customers who could be expected to meet repayments on

[16] Source: FCA data collected from second charge lending firms.

[17] Source: Analysis of FCA data collected from second charge lending firms and UK average house price data from ONS, http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=House+Price+Indices#tab-data-tables

larger loans rather than being driven by rising house prices. It was generally reported that although most loans continue to be for debt consolidation purposes, fewer of these borrowers are borrowing in addition to that required only for debt consolidation. The sales and performance data collected from lenders by the FCA, however, does not indicate there has been a significant change in the amount lent for debt consolidation purposes. This has only increased from approximately 65% in 2006 to 69% in 2013 (peaking at 72% in 2010).

3.3 The role of brokers in the market and loan distribution models

The role of brokers in the second charge lending market and the distribution model of lending has changed over the last ten years. We were told that this is due largely to a change in technology and consumer behaviour, not as a result of the financial crisis.

In 2005 and earlier, lending was frequently driven through significant direct advertising in the press, direct mailing and on television, with some lenders and the largest brokers reportedly spending in the range of £10 million to £20 million per year on advertising. However, evidence from lenders and brokers suggests that from 2006/07 onwards, there was significant growth in B2B origination via mortgage brokers and online aggregators. This remains the case now. Whilst aggregator sites may account for the majority of referrals to some of the larger brokers at present, in general there are three key sources for leads as shown in the figure below which outlines common distribution models for the current market.

Figure 5: General distribution model for second charge lending

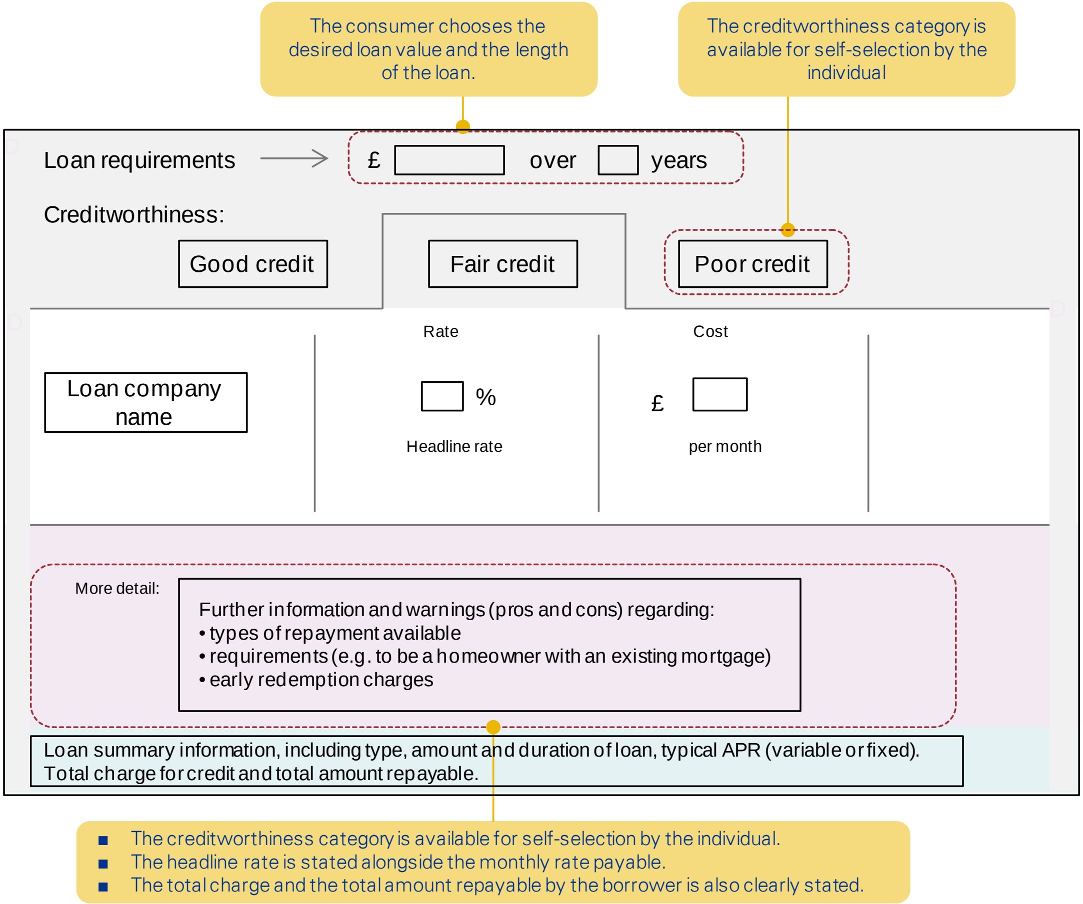
- **Online Aggregators:** online introducers such as the price comparison websites invest in adverts designed to attract customers to their websites and in turn, introduce these customers to master brokers in return for a commission.
- **Introducers:** some high-street lenders act as introducers to brokers, directing customers to them where appropriate. Also, some brokers have introducer relationships with other credit/ mortgage brokers.
- **Master Brokers:** there are three or four main master brokers who buy business from the online aggregators and arrange loans for the lenders. Some customers are also directed towards these brokers though their general advertising in the media and online.

> *"It was mainly D2C (direct to consumer), now it is more aggregator sites or use of the internet. The early 2000s the largest brokers were spending a fortune on TV advertising. The economics are not there now. There is a massive drop out from application to completion, so abortive costs are significant."*
>
> **Broker**

- **Lenders:** as already evidenced, there are a few large participants in the second charge lending market, who have a significantly reduced D2C business element and originate most of their business from brokers. A small proportion of customers are lent to directly, however, and are directed towards their lender by general advertising.

Below is a depiction of the information typically included on aggregators' websites. This is the primary entry point to the market for many second charge loan customers.

Figure 6: Example of information available to potential borrowers through an online aggregator



By using online aggregators, customers are able to readily view information about second charge loans available in the market on the basis of a range of criteria. In terms of the information available and the way in which customers access information, it is notable that:

- the consumer chooses the desired loan value and the length of the loan. This restricts the influence that a broker has on deciding the terms of the loan, as the borrower expresses their preference first;
- the creditworthiness category is available for self-selection by the individual. This allows the borrower to understand the potential charges and repayments required depending on their individual circumstances. In most cases this would then be assessed by the lender/broker before determining the terms of a loan;
- the headline rate is stated alongside the monthly rate payable; and
- the total charge and the total amount repayable by the borrower is also clearly stated; the borrower does not need to make any calculations or spend time/effort searching for this information.

The implications for the benefits of changes in the information available to borrowers as result of the FCA's proposed changes in regulation are discussed in Section 7.

Brokers acquire borrowers by targeting a large population of potential customers through advertising or via arrangements with online aggregators, and then guide borrowers through an application process right through to completion.

Brokers are generally on lender panels, providing a range of alternative second charge loans for prospective borrowers. Some respondents, however, reported that their broker panels are smaller than those that existed pre-crisis and that they have stringent **due-diligence processes** in place prior to accepting a new broker to their panel. A few brokers also suggested that they have **referral arrangements with high-street lenders** whereby the high-street lenders pass on rejected customers to the broker, who in turn places them with either an unsecured loan provider or, more likely, a second charge lender. Brokers today do not advertise directly to consumers in the same volume as they did pre-crisis. Respondents reported that the **return on investment from direct advertising is much worse than investing in relationships with the online aggregators.**

It is only on completion that brokers receive a return on their investment in the prospective customer. This investment from the broker is made up of the following elements:

- the cost of advertising;
- the cost of the application process and checks; and
- the cost of overheads.

The revenues made from these transactions by the brokers are:

- broker fees;
- commission (based on loan size); and
- ancillary services (such as PPI).

The realisation of these revenues is based on the:

- the number of applications; and
- the completion rate (i.e. the number of completed applications as a percentage of the total number of applications).

Respondents were mixed on the profit margins earned by brokers in the market at present. Although the majority indicated that after a period of decline, they are starting to make some profit again, others indicated that profit margins are now similar to pre-crisis levels with the broker fee completely compensating for lost PPI and lender commissions. However, some brokers indicated that profit levels are significantly lower than pre-crisis, but this is largely due to lower volumes rather than lower margins.

3.4 Potential future trends in the second charge lending market

Although it was very difficult for any of the survey respondents to whom we spoke to imagine the second charge lending market returning to the level of lending seen in the pre-financial crisis, in general, respondents were positive about the future prospects for the market.

The reasons that nobody we spoke to thought that the market would return to anything like its pre-crisis peak included improved lender business practices, more stringent regulatory control and a lack of appetite for wholesale funding.

There has been a lack of available and affordable capital funding in the market in recent years as funding in business involving securitised loans fell dramatically after the financial crisis. Generally, lenders felt that the market was currently constrained, largely due to a lack of supply rather than a lack of demand from customers for second charge loans.

> *"As people innovate there may be a slight increase. You are not going to see a sudden boom. Everyone is very conscious now that we don't want that huge spike in business. It needs to be gradual"*
>
> **Lender**

However, it is unclear whether the required capital funding to meet this demand will or will not return. There appears to be some evidence of renewed interest from a funding perspective, for example, there was the first successful securitization in Q4 2013[18], there are stories of credit lines being extended[19] and there is a small number of cases where lenders have successfully originated and sold on loans[20]. There are also indications of a general growth in retail funding, for example one lender has now become a bank and has started taking deposits.

There were indications of some new entry to the market. It was reported by the industry body we interviewed that it has experienced increased enquiries about entering the market. Equally, a number of respondents had heard anecdotally of new entrants. Additionally, existing lenders indicated that they are starting to lend on higher LTVs again and down the credit spectrum. For example, new products are being launched for 95% LTV.

"It is only in the last few years where the banks have wanted to lend money to our sector again."

Lender

Whilst it appears that there are some signs of growth in supply in the market, it remains unclear whether the market will return to a level of lending even close to the pre-financial crisis levels. The proposed rules may also have an impact on this. Differing views were given about the potential impact of the proposed regulatory changes on the number of market entrants. This is discussed in Section 8.

[18] The recent issuance from OneSavings Bank and Aldermore shows that investor appetite is increasing and the secured loan market can be accessed.
[19] Spring Finance announced a £100m funding line from a bank in Q1 2014. Masthaven Secured Loans (MSL) has also recently set up its first bank funding line.
[20] The Principality summary financial statement 2011 indicates that it reduced the book slightly with sales of loan portfolios to a major investment bank.

4 Potential market failures in the second charge lending market

The FCA's overarching operational objectives are to:

- secure an appropriate degree of protection for consumers;
- protect and enhance the integrity of the UK financial system; and
- promote effective competition in the interests of consumers.

In order to meet these objectives, the FCA has a range of powers, including the regulation and supervision of firms it authorises to provide financial services. It aims to use forward-looking and judgment based regulation, with a view to understanding firms' business models and future strategies. Where the FCA considers that there are unacceptable risks to the fair treatment of customers or the integrity of the market it seeks to intervene.[21]

A key way in which the FCA identifies the economic drivers of consumer detriment is through market failure analysis.

Governments and regulators often intervene in markets to address market failures in order to drive more efficient outcomes and to protect vulnerable consumers. The proposed changes to the regulatory framework in 2016 with the implementation of the MCD and application of parts of the wider mortgage regime, seek to address the market failures that are currently observed in the second charge lending market.

In this section of the report, we set out the market failures that typically arise in financial services credit markets. We then go on to set out the specific issues that arise in the second charge lending market and develop our hypotheses about how the undesirable market outcomes observed in the market arise as a result of these market failures. The purpose of this market failure analysis is to understand how the risks identified in the second charge lending market may be addressed by the changes in regulation. These hypotheses were tested as part of qualitative information gathering exercise and the findings form part of the CBA of the regulatory policy changes.

4.1 Market failures typically observed in financial services credit markets

Each individual market, be that in financial services or otherwise, displays differing outcomes as a result of the specific market failures arising which influence the way in which consumers and firms operating in that market act. However, in retail credit markets, there are a number of market failures that typically arise.

4.1.1 Behavioural biases

The FCA has undertaken significant work to understand how lessons from behavioural economics can be used to understand better how consumers and firms act in financial services markets and how this can lead to undesirable market outcomes. As set out in its Occasional Paper, *'Applying behavioural economics at the Financial Conduct Authority'*[22], the FCA has identified a number of behavioural biases that it considers can be used to understand how the errors people make when choosing and using financial products arise, why they persist and what action can be taken to address them.

[21] http://www.fca.org.uk/about/what/regulating/how-we-supervise-firms.

[22] Occasional Paper No. 1, Applying behavioural economics at the Financial Conduct Authority, (April 2013).

The FCA has identified a number of reasons why behavioural problems persist in financial services markets and why consumer choice may be particularly prone to errors. These factors include:

- **Financial products being inherently complex for the majority of people and more so than for other products.** Products can have a range of complex features and charging structures which means it is difficult to understand them and assess their value for money. Even where information is provided about products, the complexity of this can mean that decisions are simplified, and consumers are also vulnerable to framing bias and manipulation of information by firms. Also, where decisions are required involving an assessment of risk and uncertainty, consumers are often prone to systematic errors and misjudge uncertainties, leading to poor decisions.
- **Products requiring trade-offs to be made between the present and future.** Consumers often suffer from present bias and hyperbolic discounting meaning that they value the immediate reward of the additional credit without placing sufficient emphasis on the longer term consequences of their actions. This can lead to over borrowing, especially as consumers are often over confident about the likelihood of being able to repay debts.
- **Decisions can be emotional.** Rather than accurately assessing the costs and benefits or a certain financial product, such as a new loan or insurance, consumers' decisions can be driven by stress and fear of losses. This can lead to inappropriate decisions being made and products selected that do not represent good value for customers. Equally, search time may be reduced as a result of borrowers needing to quickly secure finance.
- **Lack of opportunity to learn about financial products.** Some financial products are purchased infrequently, such as mortgages and the consequences of the decision may not transpire for some time, for example in the case of pension plans. Therefore, consumers have limited opportunities to learn and as a result may make inferior decisions. Consumers can be vulnerable to their own poor decisions or self-serving advice.

Financial services firms may be in a position to exploit these behavioural problems and the preferences, beliefs and weak decision making skills of consumers. For example, firms can frame the way in which a product is presented, highlighting benefits, such as the headline rate whilst underemphasising charges, in order to encourage consumers to take the product. This exploits the fact that consumers often have limited attention and find it difficult to process large amounts of complex information. Therefore, presenting too little, or too much, information and framing this to bias the response can inhibit consumers from making rational choices.

4.1.2 Information asymmetries

Information asymmetries are a common feature of many markets. Indeed, many markets exist in order to help consumers overcome these problems. In financial services, it is likely to always be the case the financial services firms have far superior knowledge of the range of products available to consumers, the relative merits of each, and the likelihood of customer default. Intermediaries, such as brokers, exist in order to help consumers better access the products available to meet their specific needs. Information asymmetries do not, in themselves, imply the existence of market failure.

It is only when market mechanisms fail to ensure that there is sufficient discipline on firms operating in the market, be that lenders or intermediaries or both, such that consumer detriment arises from these information asymmetries that they become problematic and require regulatory intervention.

Information asymmetries on the supply-side may mean that:

- firms know more about the borrower's probability of going into arrears and/or default than the borrower does;
- firms have a better insight in to the appropriateness of the product being offered to the borrower and the range of alternative products that may be available and more suitable; and
- firms have a better understanding than borrowers of the long-term price of the credit being provided (including fees, rates of interest and charges for any arrears).

Conversely, in some instances consumers may have superior knowledge over firms. For example, self-certifying borrowers may provide false information to lenders about their income and level of expenditure thus making the lenders unable to accurately assess the ability of the borrower to repay the credit provided.

These information asymmetries can also lead to a higher level of arrears than would otherwise be the case as, unless lenders undertake sufficient checks of creditworthiness before providing credit, the borrower may be in a better situation to assess their ability to make the required repayments. As noted above, behavioural biases can perpetuate these problems as borrowers suffer optimism bias and hyperbolic discounting and tend to over borrow as a result.

4.1.3 Principal agent problems

Principal agent problems can also arise when two parties have different interests and asymmetric information exits between the two parties (with the agent having more information) which means that the principal cannot directly ensure that the agent is always acting in its best interests.

In financial services markets, lending is often conducted via an intermediary. The lender hires agents to perform sales on its behalf. However, the way the fees are shared between the two parties and any commission provided to the broker for issuing new loans on the lenders behalf can mean that incentives are misaligned. Whilst it may be in a broker's interest to achieve the highest level of lending possible to generate maximum commission (and so not properly assess the credit worthiness of individuals being granted loans), this is not necessarily in the lender's best interest if it leads to a higher incidence of payment difficulty.

4.1.4 Market power

The existence of market power can lead to consumer detriment and inefficiencies as a lack of effective competition means that firms have the ability to influence quantity (the availability of lending), price and quality of services and not provide the optimal outcomes for consumers.

Market power can arise as a result of structural as well as conduct reasons. The presence of high barriers to entry and economies of scale (structural features of the market) can explain high levels of concentration. A number of factors can contribute to this, including:

- the availability and cost of funding to support lending, in which larger firms may have an advantage;
- cost advantages of offering credit services on a large scale to recoup the initial set up costs and diversifying the risks over a sufficiently large portfolio of customers;
- the importance of brand recognition and reputation to attract customers; and
- the ability to cross subsidise certain products at the expense of others as a result of economies of scope (selling payment protection insurance (PPI) is one example).

Firms' conduct can also lead to ineffective competition. Where firms are able to exploit the behavioural traits of customers, for example through the way in which products are presented, or through inappropriate information provision, such practices can also potentially distort competition. If consumers are hindered in their ability to make decisions in their best interests, this can lead to firms facing reduced incentives to compete on price and quality of service.

Low rates of customer switching can also exacerbate the problem and lead to entrenched market power. In many financial services markets low switching is observed. This can arise from costs levied by firms for switching as well as consumer inertia. Evidence suggests that switching for some financial products, such as current accounts, is particularly low, whilst for other products such as mortgages it is higher.

4.2 Market failures in the second charge lending market

Having identified the market failures that typically arise in financial services markets, and specifically in credit markets, in order to understand the potential costs and benefits of the proposed regulatory changes in the second charge lending market it is important to understand:

- the specific market outcomes that are observed in this market;
- how these result from market failures; and
- how the changes to regulations may address these issues.

Consumers taking second charge loans can be split into two market segments:

- individuals taking second charge loans for debt consolidation purposes with potentially an element of new lending in addition to this; and
- individuals taking on second charges loans as a new form of lending, to aid budgeting of existing or new (e.g. home improvements) commitments.

Customers in the first market segment typically have no alternative forms of credit left available to them. Whilst the second segment of customers may be able to access alternative forms of finance, potentially including unsecured lending.

Both sets of customers are likely to face detriment as a result of the market failures in second charge lending. However, the particular failures which affect them and the likely detrimental effects differ. Therefore, in this section we assess the undesirable market outcomes we hypothesise arise in relation to each of these segments of customers and the related market failures that they stem from.

4.2.1 Second charge loans for debt consolidation purposes

Market data shows that approximately 66% of second charge loans in 2013 were for debt consolidation purposes. It has also been the case historically that the majority of second charge loans were for debt consolidation. In addition to consolidating existing debt, when second charge loans are granted, lenders in some cases provide borrowers with a proportion of additional new lending (i.e. the size of the loans is greater than that required to cover all existing debts which are being consolidated). Just under half of those customers interviewed as part of our study, however, indicated that they had borrowed additional amounts to that required for the primary purpose of their loan and this was typically at the suggestion of their broker.

There are a number of potential undesirable market outcomes that we hypothesise are related to lending to customers taking loans for debt consolidation purposes.

Whilst being able to access credit can be an important way in which customers can fund their expenses, customers taking out second charge loans for debt consolidation purposes may face risks from accessing this new credit as they are more likely to be in some form of debt spiral and be suffering from, or on the path towards, borrowing unaffordable amounts. Compared to unsecured credit, second charge lending poses a greater risk to consumers given that the property is at risk should they fall into arrears. In addition, these borrowers may have relatively poor credit scores and/or have exhausted all other available mainstream credit.

The hypothesis that customers taking out second charge loans for debt consolidation purposes are borrowing unaffordable amounts appears to be supported by the market data on arrears to some extent, although as discussed previously, lending practices appear to have improved since the financial crisis. Historically, when the second charge lending market was at its peak and all forms of credit were much more readily available to customers, second charge lenders would typically take on borrowers who were then unable to meet the repayments and so fall in to arrears. However, given that house prices were rising and borrowers had remaining equity in their property this meant that the loans could be repackaged in to a new larger loan and also passed on to a new lender who equally knew that if the lender went in to arrears again that the same 'solution' could be used. It was only when equity no longer remained in the property against which the second charge loan was secured that this became problematic for the lender.

Data collected by the FCA from lenders suggests that there has been a clear shift in the profile of second charge borrowers, with the typical borrower now being more affluent than in the past, based on Experian categories of affluence. Before the financial crisis, 61% of borrowers used to come from the six least affluent groups. This has now dropped to 38%. The proportion of loans going in to arrears quickly (within the first year) has declined in recent years which may reflect tighter lending standards. However, this still remains relatively high at an average of 13% in the first year after origination. Arrears rates vary across lenders, however, which may be a result of the customers that they target and the lending criteria adopted.

Any over borrowing in the second charge lending market, and the higher costs associated with servicing any arrears on the new loan, is likely to arise from two key market failures:

Behavioural biases

- Borrowers may have overestimated their ability to repay the loan and those taking on new lending (in addition to the requirements for debt consolidation purposes) may have suffered over optimism about their future use of credit. This may explain the high level of arrears observed in the market.
- Borrowers may also have suffered an inability to process or understand the information made available on the rates and arrears charges. Heavy advertising has typically been used in the second charge lending market (although this is less prominent in the market at present). Whilst there are regulations in place to ensure that consumers are not misled, advertising tends to focus on the monthly repayments required for a loan with a long term. Given that the terms of loans advertised are in general longer than those borrowers take out, this framing can mean that behavioural problems arise as borrowers are unable to assess the repayments they would be required to make and the charges they would incur. This can lead to borrowers overestimating the value of a second charge loans to them because it has been presented in an attractive way, highlighting the benefits but not the costs.
- A lack of financial capabilities and failure to understand charges may also mean that borrowers taking out a second charge loan may be taking out a product which represents poor value for money for them. Borrowers taking out second charge loans for debt consolidation purposes with an element of new lending will incur a higher charge for the larger loan size (larger than that required for debt consolidation purposes only). If this represents over borrowing it is likely that the customer will then also incur a higher cost of arrears when the repayments cannot be met.
- Also, present bias means that borrowers place more emphasis on their current spending needs without placing sufficient emphasis on the likely consequences. Where there is not a proper assessment of affordability and/or sufficient information disclosed to borrowers about the risks, lenders may be able to exploit this through providing a second charge loan.

Information asymmetries

- Borrowers may have poor information about the specific risks associated with a second charge loan and so not make an informed decision. In its 2004 report on debt consolidation, the OFT noted that: *"loans that are advertised specifically as being for debt consolidation are often second charge mortgages that turn several unsecured debts into one larger, secured debt. Although most advertising of secured loans is required to include warning statements about borrowers' homes being at risk if they default, consumers may not realise the full implications of turning unsecured debts into one secured debt. For example, not only could they lose their home if they fail to keep up payments, but they could also face possible difficulties if they want to move house, in which case they may have to pay off the loan in one go. In our survey of* *consumers who had consolidated debts, approximately a third of those with secured loans said that the status of the loan was not explained at all or was explained poorly."* [23]

- Lenders are likely to have more information about the ability of the borrower to repay the second charge loan. By lending additional amounts and/or providing new, potentially unaffordable loans for debt consolidation purposes the lenders may have been prolonging and worsening the situation that the borrower would ultimately face. Whilst a borrower going in to arrears may not necessarily be in a lender's interest (unless there is sufficient equity in the property that would remain once the first charge loan had been met), lenders may be in a position to exploit the informational asymmetries to profit from fees levied on late payments and additional charges when a borrower goes in to arrears.
- Information asymmetries can also mean that borrowers cannot assess the quality and price of the loan. Their more risky customer profile may also mean that borrowers may be vulnerable to getting poor-value credit and services, particularly if there is a lack of competition in the second charge lending market, as substitute forms of credit in other markets are not available to them or because consumers do not seek debt advice.

4.2.2 Second charge loans as a means to raise additional funds

Most customers take out second charge loans for debt consolidation purposes.

Although advertising at the peak of the market typically communicated the benefits of second charge loans for home improvement purposes, only approximately 31% of second charge loans in 2013 were taken out by customers to raise additional funds for such purposes.

And even for these customers, we cannot rule out that a portion of these loans potentially also included an element of lending for debt consolidation. Therefore, whilst the potential undesirable market outcomes for customers taking out loans as a means of raising funding for home improvement (or similar) projects may differ in some ways to those for debt consolidation customers, in some cases we hypothesise that they are linked to the same market failures.

The key detriment we hypothesise for these customers is that they may be sold a second charge loan when there may be alternative, more suitable products available to them. This was tested as part of our CBA – the results of which are reported in Section 7. The market failures leading to this potential outcome are:

Information asymmetries

- Consumers taking out second charge loans are likely to have imperfect information about the range of alternative forms of credit that may be available to them. This may lead to them taking out a second charge loan when it may not be the best value or the most suitable for them. Unsecured credit, for example, may be a viable alternative for credit worthy customers and be less risky for them given that the credit is not secured against their home. However, if borrowers are not made aware of the full range of products available to them and the value for money of each, or advised to the specific risks associated with a second charge loan, they may make suboptimal decisions.

Behavioural biases

- Behavioural biases can mean that consumers may choose credit products that are not the most suitable for them. This may be the case in the second charge lending market where customers choose these loans rather than alternative forms of credit in order to 'jam jar' their borrowing. This type of 'mental accounting' means that people treat money allocated to different purposes differently, rather than treating it all the same. This may mean that borrowers taking out second charge loans for a specific purpose, such as to fund home

[23] OFT, 2004, debt consolidation, paragraph 1.23.

improvements or a wedding, may be willing to accept a lower value for money product and change their behaviour because this form of credit is labelled differently.

Market power

- A lack of effective competition between lenders and between brokers in the second charge market may result in customers being given bad advice and, as noted above, not being provided with sufficient information to make an informed decision. Evidence suggests that there are a limited number of firms operating in the market and that brokers compete to be placed on a small panel of lenders (and vice versa). Brokers then present customers with second charge loan options from this limited pool of lenders, thus restricting choice. The incentives of the brokers and customers are unlikely to be aligned as brokers will seek to offer loans where the commission they receive is highest. Furthermore, as brokers receive fees and commission for each new second charge loan agreed they are incentivised to maximise the number of loans granted and so may be providing poor advice to customers in order to ensure the loan is agreed rather than encouraging them to consider alternative forms of credit.

4.2.3 Regulatory failures in the second charge lending market

In addition to the market failures that may result in undesirable outcomes in the second charge lending market, regulatory failures may have also been shaping the market and leading to consumer detriment. We hypothesise that the second charge loans market is shaped by regulation and the design of the regulatory requirements under the CCA has influenced the range of players in the market and the products they provide.

For example, Section 155 of the CCA requires that where customers pay a fee for an introduction by a broker with a view to entering into a second charge mortgage, they cannot be charged more than £5 where the introduction does not result in them entering into a mortgage within six months. This regulation has shaped the way in which charges are levied on customers with only those customers who do go on to take out a loan paying fees, which are higher than may otherwise be the case if the regulations did not prevent all customers being charged fees for the service they received.

Furthermore, although the market has been regulated by the OFT under the CCA, and very recently by the FCA, the persistence of the market failures outlined above, and the evidence of negative outcomes in the market (for example, high arrears rates), suggests that the regulatory regime has not been fully effective and that further measures are required to address the problems observed in the market. As our CBA of the proposed new regulatory requirements demonstrates, there are likely to be benefits arising from a change in regulation (detailed in Sections 7 and 8) which indicates that further regulation can be introduced to improve market outcomes and to address either directly or indirectly the market failures.

4.2.4 Summary of second charge market outcomes and market failures

Having developed our hypotheses about how the potential undesirable second charge lending market outcomes for different customer segments are linked to market failures, we summarise below our assessment and a high level overview of how future regulatory changes may help address these problems. This is the first step toward understanding the potential costs and benefits of the proposed regulatory changes in the second charge lending market.

Figure 7: Summary of hypothesised suboptimal market outcomes, underlying market failures and how regulatory change to second charge lending may help

	Hypothesised suboptimal market outcomes	Underlying market failures	How future regulatory changes could help
Customers who use second charge loans for debt consolidation	▪ Consumers who need to consolidate loans are afforded the chance to borrow even more and potentially struggle to repay loans secured on their home. ▪ When the property market stops increasing and equity no longer remains in the property against which the loan is secured, consumers face difficulties in refinancing and struggle to repay and may default. ▪ Incremental borrowing causes the total cost of arrears to be above what it would have been.	▪ Linking loan repayments to property prices leads to over-optimism bias. ▪ Borrowers are misled by headline rates and are unable to understand complex information on rates and arrears charges and the risks involved. ▪ Borrowers' personal discount rate is excessively low (i.e. they suffer from present bias).	▪ More stringent affordability requirements may cap incremental borrowing and, thus, the additional costs of default/arrears. ▪ Better disclosure requirements reduce the chance of borrowers inadvertently taking out poor quality products. ▪ An interactive sale carried out by a qualified mortgage seller on an advised basis results in a product suitable for the customer.
Customers who use second charge loans for new lending	▪ Consumers could borrow using a better, lower cost, product.	▪ Consumers lack sufficient information to choose the best product for themselves. ▪ Behavioural biases lead customers to choose suboptimal products. ▪ Lack of effective competition between brokers and a misalignment of incentives of customers and brokers (who are commission driven) may result in consumers being given bad advice.	▪ Better disclosure may direct customers to more appropriate products.

5 Proposed regulation of the second charge market

The FCA assumed responsibility for regulation of the second charge lending market in April 2014 from the OFT. Whilst the market is currently regulated under the Consumer Credit rules, in 2016 there will be a fundamental change in the regulation of second charge lending as a result of the implementation of the MCD. In addition to the MCD, the FCA is considering how to apply the wider requirements of the mortgage regime to the second charge lending market. Details of the regulatory frameworks for the second charge lending market are outlined in the FCA's Consultation Paper.

5.1 Key regulatory changes to be tested in the CBA

Having reviewed the current regulatory requirements placed on second charge lending firms and intermediaries, and understood the FCA's regulatory proposals for implementation in 2016, we worked with the FCA to determine the key regulatory changes that should be analysed in the CBA. It was recognised that when collecting data, particularly through interviews with firms and online surveys there is a balance between the coverage of the information requested and the quality of responses.

The proposed changes in regulation will, in general, place additional and/or more stringent regulatory requirements on lenders and intermediaries in the market than at present. However, if some proposed aspects of the FCA's mortgage regime did not apply, relevant MCD provisions would instead. Given this, the CBA had to be broad-ranging to cover each of the proposed regulatory changes. However, we agreed with the FCA the areas to cover and the level of detail required.

The figure below sets out the proposed new regulatory requirements to be analysed in the CBA. In the figure:

- the row highlighted in grey denotes the MCD's key maximum harmonising requirement;
- rows highlighted in orange denote where the FCA is intending to rely on existing/new MCOB rules to implement MCD requirements or, in some instances, 'copy out' relevant MCD Articles; and
- rows highlighted in purple denote discretionary aspects of the mortgage regime, separate to MCD requirements.

Figure 8: Summary of proposed new regulatory requirements.

Regulations	Summary of proposed requirements
Disclosure via the ESIS	The European Standardised Information Sheet (ESIS) will apply to second charge lenders and brokers advising on these loans may need to disclose key information (e.g. on contract terms and conditions and rates) via a 'durable medium'.
Disclosure of remuneration	A requirement on brokers and lenders that sell directly to consumers to provide information on the basis of their remuneration, as well as their product range and fees and commission.
Disclosure of Charges	A requirement to provide information to borrowers (incl. back book) on any change in charges and interest rates through a durable medium.
Arrears Charges	A requirement that default charges should be limited to covering the lender's costs. If adopted, lenders would not be permitted to charge arrears fees as a percentage of the arrears or the loan balance. These requirements would apply to back-book and current loans.
Post Contractual	A requirement for lenders to ensure that their post-contractual fees are not

Regulations	Summary of proposed requirements
Fees	excessive and Early Repayment Charges are aligned to MCOB 12.3.
Arrears Management: Adopting MCOB 13	A requirement for second charge lenders to adopt practices set out in MCOB 13.
Arrears Management: Information Sharing	A requirement for lenders to share information with other charge holders once a case gets to the litigation stage.
Sales process and staff qualifications	Under the mortgage regime, there are requirements for sales on an advised or execution-only basis and certain staff must have the Level 3 qualification.
Knowledge & Competency	A requirement that the staff of creditors and intermediaries know and be up to date in manufacturing, offering of credit agreements, carrying out credit intermediation activities and advisory services. Where relevant, this will apply to both front and back office staff (including management that fulfil an important role in the credit agreement process), but not to support functions unrelated to the credit agreement process.
Affordability Assessment	Mortgage regime affordability assessments before granting loans, taking into account verified income and: ■ **Committed expenditure** – credit and other contractual commitments which will continue after the second charge is entered into; ■ **Basic essential expenditure** – incl. housekeeping, utilities, council tax, buildings insurance, ground rent & service charge (leasehold), essential travel; ■ **Basic quality of living costs** – hard to reduce expenditure which gives a basic quality of living beyond the absolute essentials (e.g. household goods, clothing, basic recreation, child care).
Interest Rate Stress Test	A requirement to apply an interest rate stress test when considering affordability.
Broker Remuneration	A requirement that will allow second charge brokers to charge all consumers fees for the work they undertake, not just those who take out a second charge loan.
Advertising	A requirement that any promotional material containing the cost of credit to the consumer should include: standard information on the identity of the creditor/intermediary; rate information; total amount of credit; annual percentage rate of cost (APRC); information on the duration of the agreement and the instalments payable by the consumer.
Arranging for Consolidated Debt Payments to be Made Directly to Creditors	Where a borrower is consolidating their debts, a requirement for lenders to take reasonable steps to ensure that the debts being consolidated are repaid as expected.
Sales Targets	A requirement that lenders and brokers would not be allowed to have sales targets as a basis for remuneration.
Reflection Period	A requirement that lenders/brokers give the consumer a reflection period before the conclusion of the credit agreement, or a period for exercising a right of withdrawal after the conclusion of the credit agreement, or a combination of the two.
Data Reporting Requirements	If reporting requirements similar to those for first charge are introduced, lenders will need to report transaction level data on sales of regulated mortgage contracts (Product Sales Data, PSD) and submit the Mortgage Lenders and Administrators Return (MLAR). PSD on a six-monthly basis, will require: Sales data: info on the characteristics of the loan (size, type of interest rate, info on affordability such as income and expenditure, etc.).

Regulations	Summary of proposed requirements
	Performance data: details of ongoing characteristics of the loan (outstanding balance, type of interest rate, info about payment difficulties/ forbearance). MLAR will require lenders to provide data on their lending activities on a quarterly basis. In addition, FCA authorised intermediaries would provide data as part of the Retail Mediation Activities Return (RMAR)

6 Approach and methodology

6.1 Information and data collection

To inform our assessment of the costs and benefits of the FCA's regulatory policy proposals for the market, we collected primary data and information through three main routes:

- interviews with a sample of lenders and brokers to provide qualitative evidence on the impact of proposed regulatory changes;
- an online survey of lenders and brokers to provide quantitative evidence on the impact of proposed regulatory changes; and
- interviews with a small sample of customers who had taken out second charge loans to understand their borrowing experience and what some of the benefits of the proposed regulatory changes might be.

In addition, we drew on the data collected by FCA from lenders in the market and on data and information available publicly.

The approach taken to collecting the data in each area and the types of information sought are explained below.

6.1.1 Interviews with second charge firms

Given the complexity of some of the regulatory changes and the quality of research information required for the CBA, qualitative research was conducted to deliver insights on behavioural responses to the regulatory proposals and to provide a greater depth of information.

After careful consideration about the most appropriate research methodology, we chose to conduct face to face interviews held in interviewees' offices. This approach tends to deliver more robust results as it allows a deeper rapport to be built with the interviewees; there is the potential for several participants from the same firm to be present at the meeting to give their input; and co-moderation by members of Ignition House and the KPMG team adds richness to the insights obtained.

All interviews were conducted by Ignition House directors, after having worked closely with KPMG to develop the interview discussion guides. Interviews were qualitative in nature, lasted between 60 and 120 minutes and were conducted face-to-face between 7 and 20 May 2014. In total we spoke to:

- **6 active lenders:** We interviewed a mix of larger and smaller lenders currently active in the second charge lending market. Some focus on the prime customers, others more on the near-prime or sub-prime segments. Some had a first charge mortgage business in addition to second charge; others were specialist second-charge lenders.
- **6 active brokers:** We included a mix of large, mid-sized and small broker firms currently active in the market. Brokers in our sample had a range of business models, with some serving consumer directly and some originating their business from online aggregators or from other credit and mortgage brokers.
- **2 dormant lenders:** We included a couple of lenders that are now dormant in the second charge market (no longer advancing new loans), but still maintain and service significant back books of business.
- **1 Industry Association** representing the second charge market.

All interviews were recorded but it was made clear to respondents that comments would not be attributed in the report or disclosed to the FCA.

6.1.2 Online survey of second charge firms

Detailed information on the impact of the changes on firms in the second charge market was collected via an online survey. In total the survey was sent out to 641 contacts. 74 firms responded to the survey, but 20 were screened out because they are not involved in second charge lending. Of the remainder, we received responses from:

- 15 lenders currently active in the second charge market;
- 3 lenders currently dormant in the second charge market;
- 16 brokers/packagers; and
- 20 other organisations (including introducers and service organisations).

Respondents were asked to estimate the impact (costs) on their business for each policy proposal under review as well as provide a raft of background data (such as the volume and value of their second charge lending or broking business, headcounts and average salary information, and cost/ profitability information). In addition, respondents were asked open ended questions to gather information on current practices, whether there are any issues with meeting the requirements being considered, and what impacts these might have on the wider industry and consumers.

The survey was constructed to allow multiple respondents in the same firm to access the survey as we were aware that inputs may have be needed from several departments. Respondents were able to access the survey for a period of two weeks, which allowed firms time to collate their thoughts.

6.1.3 Consumer interviews

In addition to obtaining information from firms in the second charge lending market, we also interviewed a small number of consumers to understand their experiences of second charge lending and how consumers may be affected by the proposed regulatory changes.

Ignition House conducted 12 in-depth interviews, lasting for approximately 45 minutes each, with consumers who currently hold a second charge loan. Discussions were held face to face in London between 27 May 2014 and 2 June 2014.

Respondents were recruited on the basis that they had taken out a second charge loan either in the last two years or where there was still an outstanding balance on a loan if it had been taken out over two years ago. This approach was taken to ensure that the respondents had recent experience of the second charge lending market and lenders' handling of loans.

The recruitment process contained multi-stage screening questions to ensure that respondents genuinely had a second charge loan and were not confusing this product with an unsecured loan or a further advance. Specifically, we asked respondents to specify with whom they had taken out the loan (the broker), who they are making repayments to at the moment (the lender), the year that they took out the loan, and then checked this information against industry information.

Broad quotas were set to cover a range of consumers and consumer experiences:

- **Primary loan purpose**: Four had primarily taken out their loan to consolidate existing debts, seven had primarily taken it out for a home improvement, and one had taken it out for a divorce settlement.
- **When the loan was taken out:** Four had taken their loan out in the last year and a further three had taken their loan out a year to two years ago. Five had taken their loan out more than two years ago, with the oldest dating back to 2007 (prior to the collapse of the market).
- **Loan size:** Four loans were for £20,000 or less, five for £20,000-£49,000, and three for £50,000 or more.
- **Arrears Experience**: Six had experienced some payment difficulties, six had not.
- **Gender:** Eight men, four women

However, having conducted only 12 interviews with second charge loan customers, the findings from the interviews and these borrowers experience cannot be expected to be representative of the market.

6.1.4 Additional sources

To inform the CBA, we also drew on a number of additional sources. These included:

- lenders' sales and performance data collected and analysed by the FCA;
- FCA policy papers relating to the proposals for regulation of the market;
- online information available to customers, for example, through online aggregators;
- data available from the Institute of Financial Services[24] to estimate the typical cost per individual of a Level 3 qualification;
- the FSA's cost benefit analyses for MMR proposals; and
- data available from the Joint Costing and Pricing Steering Group on the annual number of hours worked[25].

6.2 Cost Benefit Analysis methodology

Cost Benefit Analysis (CBA) is used by the Government and other organisations to determine the costs incurred and benefits generated by an intervention or proposed policy. CBA is one of the tools available to Government for the appraisal of policy options. Given that the purpose of our CBA is to help the FCA understand the potential impact of proposed regulatory changes, as well as to fulfil the legal requirement the FCA has to carry out a CBA before any change in regulation,[26] the CBA methodology we adopted followed the principles of *HM Treasury Green Book for Appraisal and Evaluation in Central Government*.

The baseline position against which the costs and benefits of proposed regulatory changes are assessed is the current regulatory framework, i.e. FCA regulation under the consumer credit regime. In reality, however, this is not an "option" for the FCA given that the MCD must be implemented in the UK in 2016. The FCA does have some discretion, however, in terms of applying the wider mortgage regime (over and above the MCD) to the second charge lending market.

The real practical options for the FCA are for it to consider the regulatory regime that will be required by the MCD and what additional measures might be required to remedy the market failures identified. As outlined in Section 5.1, the FCA has developed a range of policy proposals for the second charge lending market, which it wishes to understand the potential costs and benefits of.

The CBA tests the current regulatory framework (the baseline position) against the regulatory scenario in which the MCD requirements and the FCA's proposed wider mortgage regime requirements are imposed. For some of the proposed aspects of the mortgage regime, the *real* counterfactual would be where the FCA is otherwise required to rely on implementing MCD provisions. As such, some of the estimated costs and benefits overestimate the truly incremental impacts of FCA discretionary proposals.

[24] http://institute.ifslearning.ac.uk/Qualifications/QualificationsinMortgageAdvice/CeMAP.aspx

[25] http://www.jcpsg.ac.uk/guidance/part5_c0C

[26] FSMA Section 138: http://www.legislation.gov.uk/ukpga/2000/8/part/X/chapter/I FSMA Section 138: http://www.legislation.gov.uk/ukpga/2012/21/part/2/crossheading/rules-and-guidance/enacted; see also FSA (2000) Practical Cost-Benefit Analysis for Financial Regulators
http://www.fsa.gov.uk/pubs/foi/cba.pdf

Understanding the different regulatory scenarios allows us to define what the additional impact of the MCD and the proposed wider mortgage regime is. This follows the Green Book principle of *additionality*[27].

In order to assess the additional costs and benefits of the regulatory changes, rather than capture information and data on the total costs and benefits associated with the current (baseline) regulatory requirements, we framed the analysis to focus on those areas where there would be regulatory change and obtained information and data on the incremental impact.

For the majority of proposed regime changes, we expected that costs would be incurred in the following areas:

- setting up a new IT system;
- making changes to an existing IT system;
- developing new sales processes;
- HR/training;
- spending additional time processing each loan;
- appointing additional legal and compliance staff; and
- appointing additional sales staff.

Given the difficulty we anticipated firms would face in estimating these impacts, the questionnaire allowed for respondents to estimate the costs of each regulatory policy proposal in terms of total costs, additional staff effort required or additional unit cost per loan. Where total costs were not reported by respondents, other survey response data inputs were used to calculate these, specifically:

- additional staff hours *x* average hourly wage = total staff cost impact; or
- additional cost per loan *x* total volume = total cost impact.

There is a range of potential benefits that may arise from the change in the regulatory proposals. Given the uncertainty of consumer reactions to individual regulatory actions, the quantification of benefits is not possible in full. Where feasible, benefits were quantified in the analysis. By their very nature these quantifications are less complete than on the cost side. However, benefits in the form of cost savings to customers, for example from reduced charges or repossessions, were quantified drawing on the available data. Where quantification was not feasible, the approach was to undertake a qualitative assessment. This assessment was based on the survey data and interview responses as well as drawing on our understanding of the dynamics of the markets and the market failures and extent to which we considered that they may be addressed though proposed regulatory changes.

In general, CBAs usually assess the costs and benefits over a certain period of time, with costs and benefits discounted over time to reflect time preference and the net present value (NPV) of the proposed regulatory changes measured. The Green Book sets out that costs and benefits should normally be extended to cover, *"the period of the useful lifetime of the assets"*.[28] In line with FCA practice, rather than conduct an NPV analysis we present the costs and benefits (one-off and ongoing) at a snapshot in time in 2016 when the proposed regulatory changes will be implemented.

As a result of this, the quantitative analysis does not capture dynamic effects that occur in the market over time following the change in the regulatory framework. However, we obtained views from second charge lenders on some of the dynamic effect in the interviews and through the online survey. These findings are included within the report.

[27] HM Treasury Green Book for Appraisal and Evaluation in Central Government, Annex 1, page 52.

[28] HM Treasury Green Book for Appraisal and Evaluation in Central Government, paragraph 5.10.

Typical dynamic effects that may arise as a result of regulatory changes include:

- changes in market entry, exit and the competitive dynamic in the market;
- changes in the products offered by second charge lenders and brokers;
- changes in pricing and quality of service, for example as a result of cost-pass through, changes in competition and through addressing market failures;
- changes in demand, for example by restricting the availability of lending to customers; and
- changes in investment, innovation and employment levels.

Additionally, for the CBA we have run scenarios based on how the market may evolve between now and 2016 to understand the implications of this on total industry costs and benefits. The baseline analysis assumes that the market is the same size as at present. Furthermore, all quantified costs and benefits are expressed in current (2014) terms rather than in real terms, so inflation between now and 2016 is not factored in.

Further technical assumptions made in the CBA are detailed in Section 10.1.

7 Cost Benefit Analysis of proposed regulatory changes

This section of the report sets out our CBA, following the approach, and drawing on the data sources, detailed in Section 6. The quantitative analysis draws predominantly on the online survey results.

Whilst the overall number of respondents was relatively low compared to the total number of firms registering with the FCA for interim permissions for second charge lending, as shown in Figure 9 below, we estimate that the active lenders responding to the survey accounted for a substantial share of the total market by number and value of loans. Dormant lenders and intermediaries in the market were much less well represented.

Figure 9: Profile of quantitative survey respondents and estimated response rates[29]

£	Lenders: Active in the market (currently advancing new loans)	Lenders: Dormant (managing a book of business but not advancing new loans)	Intermediaries: Brokers/Packagers
Number of responses	17	3	18
Total size of respondents			
by total number of existing loans	46,335	74	N/A
by total number of loans advanced in 2013	11,878	N/A	3,080
Estimated market size			
by total number of existing loans	106,985	199,868	N/A
by total number of loans advanced in 2013	17,240	N/A	15,536
Estimated response rate			
by estimated total number of existing loans in the market	43%	0.04%	N/A
by estimated total number of loans advanced in the market	69%	N/A	20%

It should be noted that in the majority of cases, survey responses were not complete. In particular, the dormant lenders that responded to the survey did not provide any quantification of the costs of the proposed regulations.

By nature, the CBA is dependent on the representativeness and quality of the data set, both of which are limited because of the coverage of the survey and the level of detail provided by firms that did respond. The survey results, however, were also supplemented by the qualitative information obtained through the interviews with firms and additional sources where appropriate. This

[29] The assumptions used to scale up to the industry and to calculate the proportion of the back book that is dormant is are outlined on the technical appendix (section 10.1).

information is also drawn on in the CBA set out in this section, although this cannot feed in to the calculations.

We consider that the results of the analysis should be viewed as only indicative of the potential scale of costs and benefits rather than a precise estimate.

This is also the case as most firms expressed some difficulties in attempting to understand, and then go on to quantify, the potential costs associated with the proposed regulations given there remains uncertainty as to how exactly the proposed regulations would be implemented by the FCA in their final form. Some respondents also indicated that they were not fully aware of the proposed changes and so had not fully considered how they would impact on their business.

In the remainder of this section we set out the CBA for each of the individual regulatory policy proposals before presenting a summary of the total costs and benefits in Section 8.1.

7.1 Disclosure

7.1.1 Disclosure via the ESIS (a maximum harmonising requirement of the MCD)

The MCD requires second charge lenders and brokers selling second charge loans to disclose key information (e.g. on contract terms, conditions and rates) in a written form and following the format of the European Standardised Information Sheet (ESIS).

Costs

In the qualitative interviews, many respondents highlighted this policy as an area which may result in large upfront costs. This was particularly the case for lenders.

In general, we found that the magnitude of these impacts depends on what activity is already undertaken by the firm in the mortgage market. First charge mortgage lenders currently use the KFI (Key Facts Illustration) to meet regulatory obligations around disclosure and may continue to do so until 2019. Some lenders reported that the lack of scale in developing an ESIS system for second charge loans whilst keeping a 'KFI plus' system for first charge mortgages would result in inefficiencies and a lack of economies of scale. However, most firms who already have a KFI system in place reported that there will be lower one-off costs, as the information required for ESIS is already on their existing systems.

> *"Big impact. We will have to change systems, change education, help brokers."*
>
> **Lender**

Of our respondents, only the larger brokers suggested that they would consider the issuing of the ESIS from their own in-house systems. Therefore, they would incur a significant one-off cost in adapting current systems to enable the information output to be consistent with the ESIS. Other brokers indicated that they would use the systems created by the lenders in order to issue the ESIS, and therefore reported that this regulation would not severely impact their business. Two brokers went as far as to say the only costs would be the printing of the actual ESIS. One lender questioned whether it would actually be the broker's responsibility to create the ESIS or that of the lender.

> *"We will have to undertake some significant development of our technology which is a cost. So we are at the stage of scoping that now. It is difficult to put a figure on it, But it will be a significant bit of spend."*
>
> **Broker**

One large lender explained that because there would be the requirement for maximum APRCs over the last 20 years to be stated, lenders who have existed for longer and served customers who were more risky pre-financial crisis would be penalised for having had that history. Newer lenders were likely to have only lent at lower rates, and would therefore have to state a lower maximum APRC over the last 20 years.

Where lenders or brokers indicated that they expected to incur one-off costs, the majority of this cost was reported to be associated with amending existing IT systems. There were some inconsistencies in the likely timeframes reported to be required to create a system capable of creating an ESIS – firms indicated lead times in the range of two weeks to six months, leading to large variations in the amount quoted for costs incurred. Given that the costs and timeframes generally related to changes to existing IT systems the differences reported by firms is not entirely surprising as it is very much dependent on the scale of changes required to meet the ESIS requirements.

Whilst most of the discussion in the qualitative interviews focussed on amending IT systems, the quantitative survey results also highlighted that firms expected significant costs to be incurred in developing new sales processes, training and additional time spent processing loans. For all those lenders who attempted to quantify the costs, the costs relating to these items exceeded the costs of amending the IT systems.

There were 25 respondents to this question in the quantitative survey, of which approximately 70% expected to incur costs relating to five different categories:

- making changes to existing IT systems;
- developing new sales processes;
- HR and training costs;
- additional time processing each loan; and
- additional legal and compliance staff.

Approximately 40% reported the need to appoint additional legal and compliance staff. One broker did not expect to incur any costs as a result of ESIS, and another broker only expected to incur some costs from the additional time in processing each loan.

Figure 10: Response to quantitative questionnaire: Cost impact of disclosure via the ESIS

	One-off				Ongoing			
£	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Cost to set up a new IT system	5,000	20,000	12,500	2	1,800	10,000	5,900	2
Cost of making changes to your existing IT system	388	200,000	27,291	18	776	30,000	7,066	9
Cost of developing new sales processes	48	100,000	11,238	17	48	20,000	3,162	9
HR/Training costs	69	100,000	9,991	17	92	50,000	12,213	11
Cost of spending additional time processing each loan	2	100,000	10,238	13	10	100,000	18,758	12
Cost of appointing additional legal and compliance staff	582	100,000	21,220	9	582	100,000	33,108	10
Cost of appointing additional sales staff	14,000	50,000	32,000	2	14,000	50,000	32,000	2
Other	12,500	50,000	27,125	4	17,018	25,000	21,009	2

The cost impacts reported by the respondents were generally one-off. The largest impact on a broker was £60,000, but other brokers expected to spend less than £20,000 in making changes to IT and appointing additional legal and compliance staff. One lender, who reported the cost associated with these requirements in aggregate, estimated costs of £2 million – this was the highest overall estimate for this requirement provided in response to the quantitative survey. Other large lenders reported costs between £500,000 and £1.5 million, whereas small lenders expected costs of £30,000-£60,000.

Benefits

The suggested benefit from the ESIS is the improved provision of information to consumers, enabling them to make better-informed decisions about borrowing. Some lenders interviewed, however, believed that the structure of the ESIS will make it less likely for the consumers to read it, for example, compared to the written information they currently provide to customers. One broker believed that any opposition to ESIS was only because other brokers are less keen to incur this cost early in the application process, and that it would actually benefit the consumer to see this information earlier on as opposed to the end of the process where the current credit agreements are currently given out.

As explained in Section 4.2 one of the market failures that may exist in the second charge lending market (like most financial markets) is informational asymmetries. Whilst increased disclosure of information to borrowers, through the provision of written information in the form of the ESIS, may address this there are two key considerations for assessing the benefits.

First, as previously explained, the market is now such that a large proportion of customers access the market through online aggregators. Comparison websites, in general, provide potential borrowers with a reasonable level of information about the loans that may be available to them, the headline rates, monthly repayments and the total cost of the credit. Whilst this is only indicative information and will vary dependent on the actual loan a customer goes on to take out, it suggests that customers may be relatively well informed at present.

Second, the level of benefit that borrowers will derive from having access to more information is questionable. Behavioural economics suggests that borrowers in financial markets may suffer from an inability to understand the information made available to them on rates and arrears charges, for example.

By providing information in the ESIS on the actual monthly repayments required, this may help borrowers to better judge if they are able to meet the repayments, although, this is unlikely to address the issue of optimism bias. However, given the level of detail covered in the ESIS it is questionable whether borrowers will be able to process and understand all the details and in so doing derive benefits from it. The FCA has recognised that there is evidence that extra information may lead consumers to make poorer decisions, for example by distracting them.[30] There are a range of studies indicating this. For example, Chater, Huck and Inderst (2010)[31], find that, *"consumers are often ill-prepared to make sound decisions about increasingly complex retail financial products. The inability to benefit fully from this market is in part due to limited financial literacy or asymmetric information, but it may also be directly related to instincts driving consumers towards choices which are inconsistent with their long- term preferences. Recent evidence shows that consumers often have limited time to fully understand complex retail financial products."*

Evidence from our consumer interviews indicated that the borrowers *already* felt that they receive helpful information and are able to understand it. When asked to score the information they received prior to taking out the loan from 1 (unable to understand the information, not helpful) to 10 (fully able to understand and helpful in choosing the right loan), scores given were between 7 and 10. Apart from the use of some jargon, no other difficulties were raised with the literature they received from their lender. Although these responses are unlikely to be representative of all borrowers, on the basis

[30] FCA Occasional Paper No. 1, Applying behavioural economics at the FCA, April 2013.
[31] Chater, N., Huck, S. And Inderst, R. (2010). Consumer decision-making in retail investment services. Report to the European Commission (SANCO).

of all the evidence available, the incremental benefit of disclosure of information via the ESIS is likely to be limited.

If customers do use and understand the information provided to them, however, there may be benefits as a results of reduced search costs (to the extent to which customers search for a product offering them the best value for money). The ESIS would allow customers to benefit from comparable information on products offered to them for a range of creditors. This may lead to increased customer mobility and, therefore, increased competition between second charge lenders and brokers. This does rely on customers seeking and/or being offered a range of alternative products to make these comparisons using the ESIS.

Whilst the evidence we have reviewed suggests that there may not be significant benefits from the disclosure of information via the ESIS, we note that the European Commission's Impact Assessment of the MCD[32] estimated that these could be significant (in the range of EUR 124 million to EUR 436 million for the EU). It considered that adopting the ESIS would have a significant impact in terms of improving the quality of the information provided, enabling consumers to understand the features and risks connected with different products and so use this knowledge to compare products and make an informed choice. It was recognised, however, that given financial literacy levels, providing consumers with additional information does not mean that this would help them to better choose among credit products and that evidence suggests that the majority of EU citizens find it difficult to understand information on the way their mortgages work and the risks involved.

Given the evidence available on the extent to which consumers may use and understand additional information disclosed to them in the ESIS, and the fact that consumers in the UK generally considered that they received sufficient information on their second charge loan already, we would not expect benefits of the scale anticipated by the EU to materialise in the UK market.

7.1.2 Disclosure of Remuneration

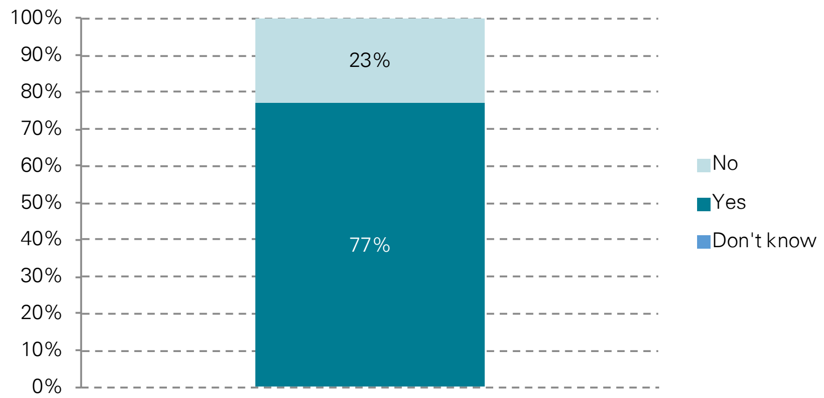
The MCD requires brokers and lenders that sell directly to consumers to provide information on the basis of their remuneration, as well as their product range and fees and commission.

"No extra burden – we already do this".

Broker

As shown in the figure below, of those firms responding to our survey, the majority indicated that they already provided this information to customers. Therefore, it would not be anticipated to have a significant impact on the market.

Figure 11: Proportion of respondents providing information to customers on remuneration, product range, fees and commission



[32] http://ec.europa.eu/internal_market/finservices-retail/docs/credit/mortgage/sec_2011_356-ia_en.pdf

In line with these responses, this proposed regulatory change did not alarm the lenders and brokers participating in the qualitative interviews. All respondents in the qualitative interviews already disclose to their borrowers any remuneration paid. As a result, no respondent suggested that the regulation would create any cost impact on the market.

One respondent explained that the further disaggregation of broker remuneration into: payments relating to advice; and payments not relating to advice would be covered under the ESIS. Therefore, it was not envisaged that this extra requirement would cause any further costs because of the introduction of the ESIS.

There were 4 individual respondents to this question on the quantitative survey. The areas where they thought costs of the regulation would be incurred varied somewhat, although 3 of the 4 respondents reported that there would be one-off costs associated with developing new sales processes and HR/training costs. Two respondents also thought there would be one-off and on-going costs associated with additional time processing each loan.

Figure 12: Response to quantitative questionnaire: Impact of disclosure of remuneration on costs

	One-off				Ongoing			
£	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Cost to set up a new IT system	-	-	-	-	-	-	-	-
Cost of making changes to your existing IT system	136	136	136	1	-	-	-	-
Cost of developing new sales processes	272	15,250	5,507	3	1,000	1,000	1,000	1
HR/Training costs	81	4,000	2,027	3	2,000	2,000	2,000	1
Cost of spending additional time processing each loan	2	1,000	501	2	499	2,000	1,249	2
Cost of appointing additional legal and compliance staff	-	-	-	-	-	-	-	-
Cost of appointing additional sales staff	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-

Disparities in the type and scale of costs likely to be incurred as a result of the proposed requirement for disclosure of remuneration as well as inconsistencies in views expressed by respondents to the online survey and the firms interviewed, suggests that there is uncertainty about whether there will be any incremental costs associated with a change in regulation. Even if there were, the total reported costs appear to be relatively limited (a maximum of £29,000 one-off cost and £134,000 in on-going costs[33]).

[33] These costs were reported by a lender as overall costs for the disclosure of remuneration requirements. The costs were not split out in to the various components set out in Figure 12.

The FCA is proposing that the mortgage regime requirement on oral disclosure of key messages applies to the second charge market, where the customer and firm have spoken interaction. Firms were not asked specifically about this as part of our study, however, a number of respondents did indicate that there would be costs related to the additional time required to process each application under the proposal to provide information to customers on remuneration, product range, fees and commission. The sales time required to make these disclosures may be factored in to these cost estimates. We also note that as part of the MMR consultation on distribution and disclosure[34], Oxera estimated that, where the firm already speaks to the consumer (in person or over the phone), firms indicated that oral disclosure would require an industry average of eight minutes. It estimated that the industry cost per sale would be approximately £11. However, these costs were scoped on the basis of oral disclosure of the Initial Disclosure Document (IDD) in its entirety. Given that the actual requirements in the mortgage regime focus on oral disclosure of key messages as opposed to the full IDD, we would expect the associated costs to be considerably lower than this and only marginally incremental.

Benefits

The expected benefit from disclosure of remuneration is the improved provision of information to consumers, enabling them to make better-informed decisions about borrowing, and addressing any informational asymmetries. As noted above, it could also be the case that increased disclosure may lead to increased competition between brokers, leading to a fall in broker remuneration levels over time.

However, as shown in Figure 11 above, the large majority of respondents indicated that they already provide the information to customers that they would be required to under the proposed regulations. All those firms we interviewed also indicated that they already do. If this is representative of the entire market, it suggests that, although there would be little incremental benefit from this proposed regulation to consumers, formalising the requirement for oral disclosure will ensure that benefits are realised consistently. Oral disclosure is an established feature of investment, insurance and mortgage markets and designed to improve customer understanding.

Furthermore, as discussed in relation to the benefits of disclosure of information via the ESIS, customers can currently access a range of information about products via online aggregators which allow them to compare a variety of information on second charge loans, including fees. For the potentially small proportion of customers who do not currently access this information and are not provided it directly by their lender or broker, there may be benefits from the disclosure regulations.

7.1.3 Disclosure of Charges resulting from MCD requirements

The MCD requires lenders to: provide information to borrowers (including on the loan back book) on any change in charges and interest rates through a durable medium; ensure that indices/ reference rates used to calculate a variable rate are "clear, accessible, objective and verifiable"; and, where used, maintain a historical record of the indices for calculating the borrowing rates.

Costs

In the qualitative interviews, lenders generally did not expect to incur costs as a result of these requirements. All lenders interviewed indicated that they already used a durable medium to convey reference rates and changes in charges. One lender stated that it sends an annual statement to all customers regardless of whether any rates or charges have changed.

Whilst lenders generally reported that they do not currently use publicly available benchmark rates such as LIBOR to determine rates, the majority did not envisage problems in reporting reference rates. Lenders often either saw this as a minor change or a communications exercise.

[34] Financial Services Authority Consultation paper 10/28 (2010): http://www.fsa.gov.uk/pubs/cp/cp10_28.pdf

One lender commented that if it were to use a first charge index rate and this rate increased, it would probably prefer to maintain its current second charge rate as borrowers may already be struggling with the increase in their first charge mortgage repayments. Another lender explained that it considered that there is unlikely to be an issue around the disclosure of a reference rate, but that the Annual Percentage Rate of Charges (APRCs) quoted in ESIS will be higher under the use of a managed rate than under the use of a reference rate, potentially leading to the market wanting to switch away from this.

In terms of costs incurred, only two lenders suggested minor increases in costs. One reported cost was that of keeping track of the reference rate for 20 years due to the ESIS obligation to generate a 20 year worst-case scenario. The other area of cost was linked to the potential adaptation to the internal IT system to change to reporting third party reference rates, expected to cost less than £100,000.

Benefits

The expected benefit from charges disclosure is the improved provision of information to borrowers and the potential for more competition in charges as a result of any increase in transparency. However, given that many of the lenders indicated that they are already disclosing charges information through a written statement, there is unlikely to be a large incremental impact on improved information provision arising from the proposed regulations. The potential impact on charges is difficult to estimate. However, as lenders generally stated that charges would not move significantly as a result of moving towards benchmarking against a third party base rate, there may be limited benefits, other than for current practice to be codified. Equally, as charges may increase or decrease over the term of a loan if benchmarked to a reference rate it is not possible to predict how charges on average over the lifetime of a loan would compare to those at present where alternative means of varying rates are used by lenders.

7.1.4 Industry costs associated with disclosure requirements

Taking the costs for the two MCD regulations relating to disclosure via ESIS and disclosure of remuneration outlined above, we have scaled these up to estimate the costs for the industry as a whole based on the responses provided[35]. These are set out in the figure below. As is shown, disclosure via ESIS is estimated to have a large effect on the costs of both brokers and lenders, considerably higher than that estimated for the MCD requirements for the disclosure of remuneration.

Figure 13: Summary of estimated industry costs associated with the disclosure requirements

	One-off		Ongoing	
£ million	Lender: Active in the market (currently advancing new loans)	Intermediary: Broker/Packager	Lender: Active in the market (currently advancing new loans)	Intermediary: Broker/Packager
Disclosure via ESIS	5.3	1.0	1.9	1.0
Disclosure of remuneration	0.1	-	0.4	-
Disclosure of charges resulting from arrears	<0.1	-	<0.1	-

[35] Details of the approach we have taken to scale up respondents estate costs to the industry level are set out in the Technical Appendix.

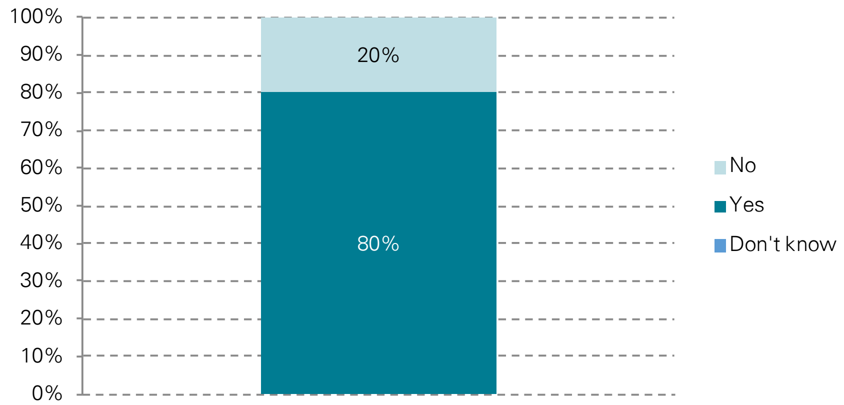
7.2 Arrears

7.2.1 Arrears Charges

MCD Article 28(2) sets out how firms are expected to treat arrears charges. The FCA's existing mortgage regime requires that firms' arrears charges are limited to recovering the administrative cost incurred (MCOB 12.4). A similar provision also exists in the FCA's Consumer Credit Rules (CONC 7.7.5R), although the MCOB rules are more prescriptive on how arrears charges can and cannot be calculated.

As shown in the figure below, when asked about their current practices and whether systems are already in place to demonstrate that arrears charges are cost reflective, the majority of lenders indicated that they already met this requirement. 20% of firms, however, indicated that they do not which suggests that they would need to take measures to ensure that they could comply with the proposed rules about the calculation of arrears charges if the MCOB requirements were to be applied to the second charge market.

Figure 14: Proportion of respondents with systems already in place (e.g. a cost model) to demonstrate that arrears charges are cost reflective



Costs

There was a generally positive reaction to any move towards regulation similar to the first charge market (MCOB) in the second charge market. This is because most lenders indicated that they were already ensuring that their arrears charges were cost reflective. Only one respondent reported that it charged more than once a month for direct debit re-presentations where one attempt has already failed.

> *"We have an annual review of our fees and our tariff to make sure we are satisfied they reflect our underlying cost and benchmark them against the FCA guidance that has been issued."*
>
> **Lender**

Some respondents commented on how MCOB is more prescriptive, but also believed that due to their involvement in the first charge lending business, they would have no issues moving over to MCOB calculations. One respondent said that there may even be savings from moving to MCOB as it allows their first and second charge system to align.

One large lender anticipated a required change to its collections costs system, but suggested that it would not be a significant cost compared to those incurred under other proposed regulations.

The quantitative survey saw three respondents broadly agree with the responses given by other firms in the qualitative interviews. Only one respondent envisaged system management costs of £5,000. This is significantly smaller than the £50,000 estimated by the abovementioned large lender in the qualitative interviews.

Figure 15: Response to quantitative questionnaire: Impact of arrears charges regulation on costs

£	One-off Min	One-off Max	One-off Average	One-off Non-zero answer	Ongoing Min	Ongoing Max	Ongoing Average	Ongoing Non-zero answer
Cost to set up a new IT system	-	-	-	-	-	-	-	-
Cost of making changes to your existing IT system	500	5,000	2,750	2	1,000	3,000	2,000	2
Cost of developing new sales processes	-	-	-	-	-	-	-	-
HR/Training costs	-	-	-	-	-	-	-	-
Cost of spending additional time processing each loan	-	-	-	-	-	-	-	-
Cost of appointing additional legal and compliance staff	-	-	-	-	-	-	-	-
Cost of appointing additional sales staff	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-

Benefits

The expected benefit from cost reflective arrears charges should be the lowering of costs to consumers if they enter arrears. Given that many of the lenders are already following MCOB or general FCA principles in arrears cost calculations, there is unlikely to be a large impact for borrowers on arrears charges, but hardwiring what is apparently existing practice for some firms will ensure that these benefits are realised consistently. One respondent suggested that arrears charges may increase as a result of the regulation, as costs incurred will be passed on. However, little evidence was shown for exactly which of these costs could be passed on to the consumers if MCOB was implemented. Whilst there is some uncertainty as to whether there will be any change in arrears charges as a result of the proposed change in regulation, if the 20% of firms indicating that they do not currently have systems in place to demonstrate their charges are cost reflective reduce their arrears charges as a result of introducing such systems following the proposed regulatory change, this could have a relatively large overall benefit given the large proportion of borrowers that go in to arrears at some point during the lifespan on the loan.

Another benefit for consumers could be the cost savings generated from reduced Direct Debit charges. Lenders are not permitted to attempt to process a Direct Debit more than twice if a customer's attempt to pay a monthly instalment by Direct Debit has failed. The table below shows that of the 8 responses received in relation to this, 7 reported reprocessing Direct Debit once only (in compliance with regulation), while one reported reprocessing twice. Thus, there was only one lender in this very small sample through which the restrictions on Direct Debit reprocessing could yield cost savings for consumers (of £6.68 per person).

Figure 16: Benefits to consumers of Direct Debit reprocessing restrictions

£	Min	Max	Average	Non-zero answer
Number of times Direct Debit reprocessed when a customer's attempt to pay a monthly instalment by Direct Debit has failed	1	2	1.25	8
Charge to customer for reprocessing a Direct Debit	12	35	26.4	5
Assumed proportion of customers in arrears	19%	19%	19%[36]	125
Average cost saving to borrowers from direct debit charge	£6.65	£6.65	£6.65	1

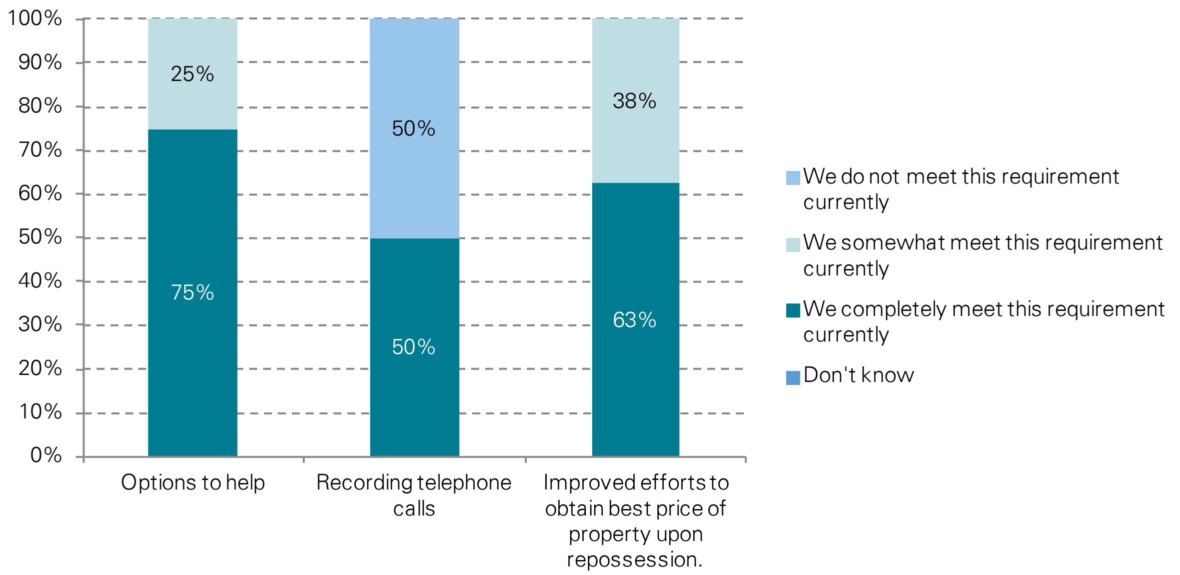
7.2.2 Arrears Management: Adopting MCOB 13

The MCD Article 28 covers arrears and foreclosure. The FCA proposes that its arrears handling rules in MCOB 13 should apply to second charge, including:

- options to help borrowers in arrears to remedy the situation before any possession claim is issued;
- recording of all telephone discussions with customers in arrears; and
- improved efforts to obtain best price of property upon repossession.

The majority of lenders indicated that, currently, they fully meet the first of the key requirements. The remaining respondents indicated that they somewhat meet this requirement. Full compliance with the proposed requirement to monitor property markets and obtain the best price for the property on repossession was less common among lenders, however, and only half of respondents indicated that they record all calls with customers in arrears.

Figure 17: MCOB 13 adoption by respondents[37]



[36] This reflects data shared by the FLA which indicates around 19% of all existing 2c loans are currently in arrears (snapshot at Aug 2013). The probability of going into arrears for a loan over its lifetime is estimated to be higher than this snapshot figure.

[37] MCOB 13 includes, among others, requirements to: i) provide options to help borrowers in arrears to remedy the situation before any possession claim is issued; ii) record all telephone discussions with customers in arrears; and iii) obtain best sale price of a property upon repossession.

Costs

In the qualitative interviews, lenders were very supportive of moves towards MCOB 13 because of restrictions under the CCA on forbearance options.

One lender interviewed considered that the CONC rules are more involved than MCOB rules applied to first charge lending, and therefore suggested there would be minimal cost increases as a result of the proposed regulation.

> *"We do it already. We are supportive of the change. We have got all that in place (for first charge)."*
>
> **Lender**

Other lenders believed that there would be minimal or no costs associated with the regulation as it is business as usual. One lender went as far as to say that it would achieve cost savings as a result of the proposed change in regulation as it would be able to consolidate systems used for first charge and second charge lending.

The quantitative survey respondents to questions relating to these policy proposals, of which there were eight, also indicated that they either completely or somewhat met requirements relating to helping borrowers in arrears remedy the situation before possession claim. They also reported that this was the case for the monitoring of property markets and improved efforts to obtain the best price of property upon repossession. However, some smaller lenders (50% of the respondents) indicated that they do not currently record telephone discussions with customers in arrears. However, all respondents except one (who indicated it would face ongoing costs for administration and compliance) indicated that there would not be costs incurred in meeting these requirements.

Figure 18: Response to quantitative questionnaire: Impact of adopting MCOB 13 on costs

	One-off				Ongoing			
£	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Cost of complying with MCOB 13	2,000	100,000	36,000	3	3,000	100,000	51,500	2

Benefits

Any measures that have the potential to either reduce arrears rates or help borrowers deal with repayment problems are likely to yield benefits.

As noted above, lenders interviewed were generally very supportive of moves towards MCOB 13 because of restrictions under the CCA on forbearance options. Lenders spoke about the difficulties and inflexibility of CCA rules on arrears handling. In particular, one spoke of the inability to modify credit agreements under forbearance. It was reported that the process under the CCA usually involves re-entering the full initiation process, including the consideration period and documentation. Lenders also spoke about difficulties under the FCA's consumer credit sourcebook (CONC) rules. These included a lack of clarity on part prepayment limits per month.

Sales and performance data collected by the FCA suggests that lifetime arrears rates for loans originated prior to the financial crisis were around 50%. More than a third of all loans would go into arrears in the first year after origination. Whilst this has declined materially, a significant proportion of loans still go into arrears early (around 10-15%). Among the sample of firms that the FCA collected data for, the median time to arrears is approximately 300 days.

The majority of borrowers taking out second charge loans do so for the primary purpose of debt consolidation. This suggests that they may have previously faced difficulties in meeting repayments on these debts. Of the 12 consumers interviewed for our study, three had taken out their loan solely to consolidate existing debts. For all three their need was triggered by a major life event – divorce, redundancy and running up considerable credit cards bills trying to maintain a lifestyle in retirement following bereavement. All three said they were struggling to make interest payments (typically on credit/store cards) and that this was impacting upon their credit score, and they were unable to make ends meet. Second charge loans were seen as a way out of their predicament. Whilst there is evidence that these borrowers were seeking a more manageable solution, the fact that respondents reporting that they had gone into arrears tended to be debt consolidation cases suggests that they had not been successful in managing their debts.

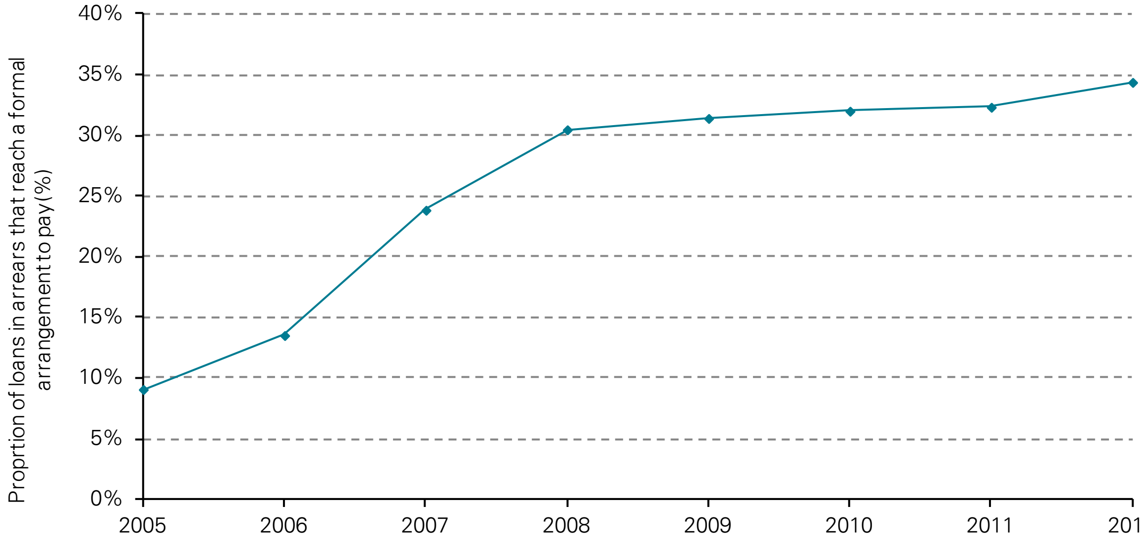
Although the high arrears percentages do not translate into high repossession rates, with data collected by the FCA indicating that perhaps around 2% of loans leading to repossession orders initiated by second charge lenders for borrowers' properties, the proposed arrears management requirements (under MCOB 13) would benefit both those borrowers who go in to arrears that ultimately face repossession and those borrowers going in to arrears but not reaching this point.

A lender not taking possession where a customer is in arrears does not necessarily mean that: litigation has not already commenced; or the lender is working with the customer in an effort to resolve the period of financial difficulty.

In terms of the scale of benefits that could be expected to result from the proposed requirements, this is dependent on the current practices of second charge lenders. Although the majority of respondents indicated that they already fully meet the requirement to have options to help borrowers in arrears to remedy the situation before any possession claim is issued, the sales and performance data collected by the FCA from lenders suggests that there may still be scope for improvement in arrears management practices.

Analysis of the transaction data for three large lenders for over 100,000 loans they issued between 2005 and 2012 shows what action was taken when a customer had fallen in to arrears. This indicates that of those borrowers who fell in to arrears, an increasing number were reaching formal arrangements to pay these loans. As shown in the figure below, by 2012, 34% of those in arrears had reached such agreements.

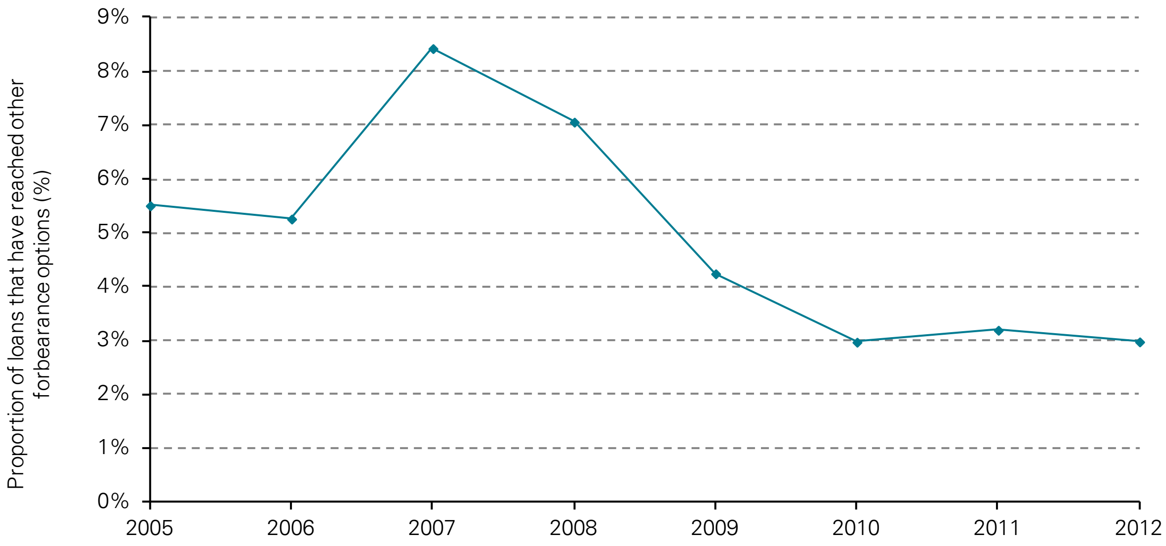
Figure 19: Proportion of borrowers in arrears reaching formal repayment arrangement with their lender (sample of three large lenders)[38]



[38] The year refers to the year the loan account was opened; the formal arrangement to pay the loan was not necessarily reached in the same year.

However, other than these formal arrangements to pay, there is evidence to suggest that other forbearance options[39] were not being used. The proportion of customers who had reached other forbearance agreements has decreased since 2007, as shown in the figure below. By 2012, only 3% of those in arrears had reached another forbearance agreement meaning 63% of customers in arrears had not reached any forbearance agreement at all.

Figure 20: Proportion of borrowers in arrears reaching alternative forbearance agreements with their lender (sample of three large lenders)



If the transaction data for these three large lenders is representative of the market as whole, it suggests that a potentially large pool of borrowers that go in to arrears could benefit from the proposed regulatory changes to improve arrears management. For example, under MCOB 13, when dealing with any customer in payment difficulties a firm must make reasonable efforts to reach an agreement with a customer over the method of repaying any payment shortfall and allow a reasonable time over which the payment shortfall should be repaid, having particular regard to the need to establish, where feasible, a payment plan which is practical in terms of the circumstances of the customer.

The benefits of this would be an increased likelihood that the borrower could resolve the arrears problems and make the repayments required without facing further arrears charges. The overall benefits of the regulatory changes, therefore, might be relatively significant given the high proportion of loans that go in to arrears.

Additionally, even though only a very small proportion of arrears result in repossessions it would be expected that the proposed regulations would reduce this further, given that under MCOB lenders are required to consider a range of forbearance options before taking repossession action. Also, where repossession did still arise, the detriment may be reduced given that the MCOB regulations require the lender to allow the customer to remain in possession for a reasonable period to effect a sale and also to take measures to achieve the best price for the property.

We note, however, that the scale of benefits associated with the arrears management proposals may be reduced to some extent following the introduction of the entire proposed regulatory package, in

[39] Other forbearance options captured in the data collected by FCA from lenders include: temporary interest only payments; payment holidays; reduced payments other than interest; term extensions and 'others'. MCOB 13.3.4AR sets out the range of options that the firm must consider the appropriateness of based on the circumstances of the individual customer.

particular the responsible lending requirements. This is because it is anticipated that the affordability checks and interest rate stress test requirements will reduce arrears rates in the market. The FCA conducted a separate CBA for these proposed regulations and estimated that the requirements may mean that around 10-17% of borrowers may be excluded from the market and 22-30% lent lower amounts. Around a third of these borrowers would have gone in to arrears. Given changes in the market since then, the FCA considers the immediate impact of its responsible lending proposals will be materially smaller than these estimates.

7.2.3 Arrears Management: Information Sharing

The FCA is considering requiring all lenders to share information once the customer is placed in repossession litigation. This might include sharing information about the court date, the eviction date, the planned sales price for a repossessed property and whether the customer has been placed in an assisted voluntary sale scheme. A requirement already exists in the FCAs' consumer credit rules at a high level, but this does not currently apply to mortgage lenders.

Costs

Many lenders in the qualitative interviews noted that the proportion of borrowers who face repossession is very low. One smaller lender quoted only two such cases in recent years, others quoted between 0.25% and 1% of borrowers. One large lender quoted 20 such cases in total. However, it should be noted that a larger proportion of customers will go through the litigation process than those who will ultimately face repossession.

> *"A negligible proportion of our loans lead to repossession – around 0.25%, 0.5%."*
>
> **Lender**

FLA data suggests that there were between 827 and1602 repossessions a year initiated by second charge lenders over the period 2007 to 2011. Analysis of the data collected by the FCA from second charge lenders indicates that on an annual basis around 2% of loans originated in 2005-09 led to repossession orders initiated by second charge lenders.

It has been suggested that some lenders in the second charge market have both been actively pursuing such a regulation and are keen for it to be implemented by the FCA. One lender indicated that it has been frustrated with cases where both it and the first charge lender have pursued possession proceedings at the same time. The same lender, however, explained that information sharing at the application stage is generally at a good level.

Two of the larger lenders were surprised at the suggestion that there is the possibility of both the first charge and second charge lenders taking action at the same time. One said that this was a very rare occurrence, and that the issue is more on the consumer side, where customers may fail to communicate with the lender. The other explained that good arrears management would always ensure that they are on top of information issues. It is unlikely, for example, that a borrower would fall into arrears with a first charge lender and not fall into arrears with a second charge.

There were eight respondents to the quantitative survey question on this issue. Those that recorded their expected one-off costs did not record any additional ongoing costs for this regulation and vice versa. The range of cost estimates was quite large: for the one-off costs, two large lenders expected costs of £30,000 or higher, and one expected significantly lower costs at £1,000. For the ongoing costs, again two expected costs of £30,000 or higher and three expected lower costs (ranging from £1,714 to £6,000).

Figure 21: Response to quantitative questionnaire: Impact of complying with information sharing requirements

£	One-off				Ongoing			
	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Costs of complying with information sharing requirements	1,000	36,000	22,333	3	1,714	36,000	15,343	5

Benefits

Information sharing is expected to generate savings in the costs relating to going to court, and initiating proceedings. One second charge lender charges borrowers £60 for the initiation of a repossession claim, but solicitor costs incurred by borrowers thereafter are invoiced directly to the borrower. One mid-size lender suggested that these could cost between £800 and £1000. A report by Shelter[40] suggested costs of £700 per litigation are incurred by the lender and passed on to the borrower.

As mentioned above, evidence suggests that only a very small proportion of borrowers face repossession. However, from the evidence presented above, it is not clear what proportion of second charge borrowers are subject to litigation action and would therefore benefit from information sharing with regards to avoiding duplicate court costs.

The table below shows the results from the quantitative survey. It must be noted however, that the number of non-zero responses is relatively low, and thus limited inferences can be made based on this data. Of the three respondents that provided all the data necessary to estimates the cost savings to consumers of going to court, it can be seen that the range of benefits is broad, although relatively low in all cases. For one lender, the total benefit to all consumers (i.e. all borrowers taking out second charge loans and not only those facing repossession orders) came to just £0.30 per loan, while another lender's response suggested an aggregate cost saving of £40 per loan for those going through repossession proceedings.

Figure 22: Benefits to consumers of information sharing requirements

£	Min	Max	Average	Non-zero answer
Proportion of loans resulting in possession claim	0.05%	20.00%	5.51%	5
Proportion of cases where litigation action taken by the second charge lender is action already being taken by another charge holder	1.00%	90.00%	36.40%	5
Average charge/cost, per loan, to consumers for taking litigation action	£150	£3,000	£1,275	11
Average benefit to consumers	£0.30	£40.00	£22.88	3

Another area in which there may be benefits from the proposed regulations is those related to obtaining the best price for a repossessed property. Some lenders had significant first charge lending businesses. These lenders pointed to issues around the room for negotiation on sale price. They suggested that this could lead to delays in achieving a sale of a repossessed property quickly and efficiently. Some second charge lenders, on the other hand, suggested that information sharing

[40] Unchartered territory? Managing mortgage arrears and possessions (July 2009).

would ensure that sale prices of repossessed properties could be checked before the sale was made to ensure that creditors, and borrowers, get a better outcome from repossession sales.

It is difficult to quantify the potential differences in sale prices as a result of this regulation and the qualitative evidence on this is mixed. To the extent to which there would be any increase in the sale value of repossessed properties resulting from the change in regulation, the overall benefits would be limited given the very low total number of repossessions – although firms would be incentivised to work in the best interests of the customer, as opposed to the potential surplus/shortfall position driving firm behaviour.

7.2.4 Industry costs associated with arrears requirements

Taking the costs for the FCA mortgage regime requirements relating to the arrears requirements outlined above, we have scaled these up to estimate the costs for the industry based on the responses provided. These are set out in the figure below. As is shown, the FCA mortgage regime proposal regarding arrears management is estimated to be the costliest for lenders on both a one-off and on-going cost basis.

Figure 23: Summary of costs associated with arrears requirements

	One-off		Ongoing	
£ million	**Lender: Active in the market (currently advancing new loans)**	**Intermediary: Broker/Packager**	**Lender: Active in the market (currently advancing new loans)**	**Intermediary: Broker/Packager**
Arrears management	0.6	-	0.7	-
Arrears management – information sharing	0.1	-	-	-

7.3 Other Charges

7.3.1 Broker Fees

The FCA is considering options on broker fees, including the removal of Section 155 of the CCA which relates to the right to recover broker fees. Under this Section, brokers are not permitted to charge fees in excess of £5 to those customers seeking an introduction for a loan who then did not go on to enter in to a relevant agreement within the six months following that introduction[41]. The proposed removal of this requirement would allow brokers to charge fees to all customers obtaining information and advice in relation to a second charge loan regardless of whether they went on to take out that loan.

Costs

In the qualitative interviews, brokers were generally uncertain about the impact of the proposed regulation on their business and the industry as a whole. This hinged on how the market moved in reaction to the removal of Section 155 of the CCA.

Whilst at least one lender suggested that it could have a significant impact on the market, many brokers suggested that following any change in regulation:

- they would not charge fees upfront as a standard;
- borrowers are unlikely to choose to pay fees up front if offered as they were already in a position where cash flow is likely to be an issue;

[41] http://www.legislation.gov.uk/ukpga/1974/39/section/155

- larger brokers and lenders would remain largely unchanged in their business models; and
- smaller brokers may be tempted to charge up front, but would potentially be restricted in doing so by competition from those that do not change their business models

> *"It will radically change the market. With an upfront fee you can improve your conversion rates because you can find out who is really interested in your product."*
>
> **Lender**

Some brokers would consider charging upfront fees to all applicants if the rest of the market moved in the same way. One larger lender suggested that the system would create innovation and allow brokers to charge certain fees up front, as these would not necessarily exceed the cost of a monthly instalment, and would therefore not put potential customers off.

The main additional cost stated was the need for a credit card payment system should there be the ability to pay fees upfront. These come in two elements. The first is the one-off cost to install the credit card payment system. One broker suggested that, as it has a certain type of telephone system, the upfront cost would be a low cost add-on (in the region of £5,000), but there would be the ongoing cost of 4% maximum per transaction for a credit card swipe. However, it should be noted that this is not the only means of making payment and it would be at the brokers' discretion as to how to charge fees to customers, if at all. The proposed regulation would not force brokers to charge upfront fees or stipulate the means of collecting fees. The same lender also suggested that only certain elements, such as valuation fees, would be charged up front following any change in regulation.

Benefits

The ability to charge some broker fees up front could potentially change the prices faced by customers at different points of the sales process. There is a hypothesis that borrowers who currently take out a loan subsidise applicants who are not successful. This is because all applicants incur costs for the broker, such as valuation fees, before a loan is completed. The costs associated with unsuccessful applicants are therefore priced into broker fees charged to those customers where the loan is completed.

However, given the apparent reluctance of brokers, evidenced in the qualitative survey, to change their business model in the face of this regulatory policy, it is unlikely that the market will see broker charges from major brokers being charged up front and so limited, if any, benefits that would be might be expected. Furthermore, it could be the case that any move to charging broker fees upfront and so applying them to all potential borrowers not just those completing loans would simply be a redistribution of costs and benefits between these customers, with little overall incremental effect but which would make the apportionment of broker costs and disbursements fairer.

7.3.2 Post Contractual Fees

Under the MCD, Member States may allow creditors to impose early repayment charges (ERCs) only where they are fair and objective, and directly linked to the early repayment; and the compensation must not exceed the financial loss to the creditor. To effect this requirement, FCA proposes to apply rules, including MCOB 12.3 that would require lenders to ensure that their post-contractual fees are not excessive.

Costs

The current situation as described by the respondents to the qualitative interviews is varied with regards to these fees. Respondents focussed predominantly on ERCs. Some lenders do not charge ERCs on their second charge loans, and would therefore not be impacted by any regulation of these fees.

The majority of lenders questioned charge less than the maximum allowed under the CCA, which is for one month's interest plus one month's notice (1+1), although at least one lender charged for both months. However, in some cases, this charge is supplemented by a further fee of between £125 and £195 to remove the charge. In other cases, however, lenders indicated that they do not charge ERCs at all or only charged a one off fee without any additional interest.

> *"We charge £150 to remove the charge and the normal 1 month interest. We only do 1 month compared to 1+1."*
>
> **Lender**

Benefits

Although data collected by the FCA from lenders suggests that the average agreed loan term in 2013 was 165 months (13 years 9 months), we understand that the majority of loans are repaid early and repackaged in to a new second charge loan. For example, when a borrower's first charge mortgage is renegotiated the second charge loan is often also changed. We do not have data, however, on the actual average loan term of the exact proportion of loans repaid early. It is expected to be relatively large however. Therefore, given that our interviews suggested that the majority of lenders indicated that they charge some form of ERC and that by making ERCs cost reflective (to the extent that they are not currently) this would have an impact on the level of charges incurred by customers redeeming early.

The impact on the level of charges is uncertain and would vary for each individual customer depending on the point at which during the life of their loan it was repaid (and so when the ERC was levied):

- Some customers would pay higher ERCs compared to the amounts paid at present.
- However, some customers may benefit from lower ERCs when they are calculated based on costs.

The balance between those that would pay more and those that would pay less than at present is unclear and also depends on the extent to which firms will levy ERCs going forward.

Some lenders we interviewed saw the proposed change in regulation as an opportunity for them to be able to charge higher fees. However, much like the proposed regulation on broker fees, the proposed regulation on post contractual fees could be expected to allow for greater product differentiation in the market.

Fixed rate products are rare in the second charge market at present. However, by allowing firms to recover appropriate costs through ERCs, this type of product may become a more viable proposition, increasing consumer choice. Firms may also be able to offer lower product rates, as they wouldn't have to price in breakage costs that they cannot currently recover through ERCs.

There are likely to still be low ERC products available to consumers after the introduction of the proposed regulations. In the first charge mortgage market variable rate mortgages are available with no or low ERCs.

Some lenders interviewed felt that it may introduce more competition in the market on fees and some lenders may adopt different approaches to fees by potentially choosing to absorb the costs incurred as a result of ERC regulation rather than pass these on to customers directly. This may be done indirectly, through borrowing rates, however, which would benefit those customers repaying early who would pay lower fees overall due to being cross subsidised by the higher rates across all loans (including for those customers not repaying early).

7.4 Knowledge, Competency & Performance of staff and the sales process

7.4.1 Knowledge and competency of staff

The MCD will require the staff of creditors and intermediaries to demonstrate appropriate knowledge and competency in the role they are undertaking. The MCD has specific requirements on underwriting staff and those responsible for designing products/rates. The requirements do not impose a formal qualification, just a set of pre-defined criteria that the staff must meet. For example underwriting staff must be able to undertake an affordability assessment and assessment of the customer's creditworthiness. The requirements will also apply to senior managers who are involved in the underwriting process (e.g. if the Chief Executive is required to sign off loans at a certain level) and if they are involved in the governance process for releasing new products/rates to the market.

Costs

In the qualitative interviews, there were two significant pieces of feedback from the lenders and brokers. Lenders and brokers were already undertaking competency training for their staff. Those processing cases (underwriters) were mentioned in particular as undergoing competency training, but for some lenders, even larger lenders, it was suggested that these staff might require further training to comply with the proposed regulations. One firm explained that it was already employing an approved persons examination process for its underwriting staff. Another smaller lender explained that training and ongoing performance appraisals ensure that these requirements are met already.

> *"We work hard to ensure they are all knowledgeable and competent. We do training, we have ongoing measurement internally as part of performance appraisals and compliance monitoring procedure – we review cases and so on."*
>
> **Lender**

A medium-sized broker explained how feedback is received through a training & competence[42] scheme. In addition, this broker added that, since interactions with the prospective borrower are all recorded on a system in terms of questions answered, there is no room for error in the process. For brokers that don't have this system, this may be a harder requirement to meet.

The training gap for some of the respondents was for management and other senior staff. One major lender explained that approximately five to six people in a firm are not currently assessed for competence but would be required to be under the proposed regulations. These individuals would undertake a few hours of training every quarter, approximately 10-12 hours a year. In addition, a day would be required for a one individual to design and write the test. Another major lender suggested that eight senior staff, plus five underwriting staff and two compliance staff members would need to undertake such training. With a contractor, the lender estimated a £10,000-£15,000 cost.

One small broker estimated that a new compliance member of staff would be required to ensure that the broker is able to report competency requirements to the FCA. This may cost up to £50,000, including a £35,000 per annum salary and £15,000 in one-off associated costs.

Benefits

The proposed benefit of this proposal is the improvement of non-sales processes at second charge lenders and brokers. It is difficult to estimate the benefits to consumers which would be derived from the better management of their loans. Increased training and competency could be expected to improve the quality of products and advice offered to borrowers and to help them to make more informed decisions and achieve better outcomes. However, there is little information on lenders'

[42] http://www.fca.org.uk/firms/being-regulated/meeting-your-obligations/Training-and-Competence.

current level of competence of loan management, and therefore no benchmark on which to measure any improvements. The FCA, however, has undertaken some analysis of impairment risk due to poor underwriting as part of its CBA of responsible lending.

7.4.2 The sales process: knowledge and competency qualifications for sales staff

The FCA is also proposing that sales staff hold a relevant Level 3 qualification, whether or not they give advice, to strengthen the sales process as per the mortgage regime. It is proposed that this requirement would also apply to staff designing scripts for the sales calls.

Under the mortgage regime there are specific sales requirements in place for firms advising a particular customer on regulated mortgage contracts. In the second charge market, sales are generally made on a non-advised basis. Given the risks inherent in the second charge market and the potential for customers to avail themselves of alternative solutions, the FCA proposes to extend the mortgage regime requirements to the second charge lending market, requiring that second charge sales follow an advised or execution-only process and, for equity loan products, sales must proceed on an advised basis.

An advised sale means that advice must be given where there is spoken or interactive dialogue during the sale (with very limited exceptions[43]). Under the MMR, firms are not prohibited from providing pre-contract or preliminary information (which does not amount to advice to the particular customer), but advice must be given before a firm enters into or arranges a regulated mortgage contract, or particular variations of such a contract.

Costs

All respondents considered the CeMAP (Certificate in Mortgage Advice and Practice) Level 3 to be a typical requirement for sales staff in this question. Five brokers questioned the suitability of CeMAP for the second charge market, stating that it was largely irrelevant to the second charge market as it is a qualification designed for mortgages. All of these respondents were concerned with the cost per individual. Three brokers estimated the cost per advisor to be between £1,000 and £1,500, with the latter estimate including study leave. One large broker estimated an increase in salary from £24,000 to the 'later £20,000s, early £30,000s' as a result of having and recruiting better qualified staff than at present.

One broker who also arranges loans in the first charge market has had experience in putting people through the CeMAP process. In addition to the £1,000 per advisor, the broker described failure rates of three times for some individuals costing £100 per failed attempt. A smaller exam with the Institute of Financial Services was suggested as an alternative to CeMAP costing £100. Estimates for study leave were put at approximately 40 hours per module, equalling 120 hours in total for CeMAP Level 3.

The number of staff affected by the proposed regulation was correlated with the size of the firm. All three sales staff at a small broker would be affected, and the costs, therefore, would potentially be a drain on that business. A medium-sized broker explained how 80 – 85% of staff would be impacted, with only 75% expected to pass first time. A large broker only expected 10 – 15% of its staff to require the qualification. It highlighted the difference in the composition of the staff roll at different brokerages, however.

Lenders suggested that on the whole they do not have large sales departments and thus explained that the impact would be small or that there would be no impact. However, one lender who sponsors existing staff to complete CeMAP estimated the average cost to put one sales staff through the qualification as £5,000 to £6,000. This was materially higher than other estimates.

[43] Exceptions include sales to high net worth individuals, professional customers and loans solely for business purposes.

Figure 24: Response to quantitative questionnaire: Impact of Level 3 sales training

	One-off			
£	Min	Max	Average	Non-zero answer
Sales staff	2,408	74,663	18,195	20
Staff who design scripts	2,374	46,909	8,668	15
Total cost	2,408	85,091	22,451	22

In addition to the costs associated with the Level 3 qualification, firms will incur costs as a result of the proposed requirement that second charge sales follow an advised or execution-only process. We were not asked to test this through our CBA. However, based on the Oxera report[44] on the costs incurred as a result of the MMR sales and advice process reforms (CP10/16), the FCA considers that the upper bound cost of an advised sales process would be £35 per loan. Whilst many second charge firms may not be offering advice or conducting a suitability assessment at present, the expected costs associated with this specific requirement are limited as the on-going costs of the affordability assessments are factored in to our CBA separately.

Benefits

In providing advice to a particular customer to enter into a contract, the firm must adhere to regulations relating to the suitability of the product. This means that there must be an assessment of whether a product or a number of products meets the customer's individual needs and circumstances. In doing so, firms are required to consider a number of factors, including whether:

- the customer's requirements appear to be within the lender's known eligibility criteria for the contract;
- it is appropriate for the customer to take out a contract for a particular term;
- it is appropriate for the customer to have stability in the amount of required payments, especially having regard to the impact on the customer of significant interest rate changes in the future;
- it is appropriate for the customer to have their payments minimised at the outset;
- it is appropriate for the customer to make early repayments;
- the contract is appropriate, based on the information provided by the customer as to his/her credit history; and
- it is appropriate for the customer to pay any fees or charges in relation to the contract up front, rather than adding them to the sum advanced.

Given the requirements that second charge firms will face in relation to these sales standards, the FCA proposal to require sales staff to hold a relevant Level 3 qualification can be expected to significantly strengthen the sales process and thus yield benefits.

As noted above in relation to the compliance costs of meeting the proposed requirements, respondents generally indicated that their staff do not currently meet the requirements and thus would need to undertake the training to obtain the required qualification. The FCA will be working with qualification providers to seek that existing Level 3 qualifications adequately address the second charge lending market in a way that improves the skills, knowledge and competency of sales staff advising customers on second charge loans.

[44] Oxera, Assessment of compliance costs and indirect costs as a result of the MMR lending reforms (2010): http://www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf

There could be several benefits arising from the improved knowledge and competency of sales staff. In particular, the Level 3 qualifications will improve the expertise of second charge loan sellers. This should ensure that all sellers have the requisite understanding of secured lending, so they are in a better position to understand whether or not it is suitable for the customer and meets his/her requirements. The knowledge and competency requirements will allow the benefits of the proposed sales standards to be fully realised.

The provision of advice to potential second charge borrowers should help them to make more informed decisions and thus achieve better outcomes. As outlined in Section 4, there are a number of potential market failures in the second charge lending market, which the advised sales process, supported by more competent and qualified sales staff, may go some way towards addressing:

- The requirement to provide advice whenever there is dialogue between the consumer and firm aims to mitigate the risks that consumers do not understand the service they are receiving and take out loans that are inappropriate for them.
- Customers taking out loans can suffer from behavioural biases and information asymmetries which can be addressed by providing the customer with more information before the loan is agreed. As explained in Section 7.1.1, there is evidence to suggest that providing customers with written information, for example the written disclosure via the ESIS, may not yield significant incremental benefits if customers are not able to understand or process all the information provided to them or if they simply discard it. However, accompanying this with greater sales standards from suitably skilled sales staff should help mitigate these risks and should mean that customers taking out a second charge loan (approximately 17,000 in 2013) will make better choices and hence benefit overall.

Ideally, impacts and differences in outcomes brought about by an advised sales process would be analysed between a control and treatment group of second charge applicants. Where:

- the control group consists of applicants seeking their loans via intermediaries whose sales process includes very few, or no, elements of the proposed advice requirements; and
- the treatment group consists of applicants seeking their loans via intermediaries whose sales processes are closely aligned to the proposed advice requirements.

However, this is impractical for second charge loans for the following main reasons:

- Although some firms appear to adopt some of the proposed requirements, there is no evidence that there are intermediaries with sales processes very closely aligned to the proposed advice requirements to enable us to form a treatment group for the purposes of analysing potential impacts.
- The transaction level data that the FCA gathered from lenders for borrowers had quality issues. It is very likely that data on loan applicants (including those who did not get loans) would have even greater gaps, in which case results of any analysis would be spurious.
- To disentangle the effects of advice from that of affordability tests would prove difficult.

At present, second charge lending is conducted on a non-advised basis, although there is some evidence to suggest that some firms may be conducting some of the suitability tests (i.e. assessing whether the loan is appropriate for the customer’s needs and circumstances). During our interviews with firms, some indicated that during the sales process they already disclose that there may be alternative products available to customers. For example, one broker indicated that it disclosed that there are other types of products available, and that it found the most fit for purpose product for that client.

The high arrears rates observed in the second charge market suggest that products are not suitable for some customers they are issued to at present (either because those customers would be better off with an alternative product or if they were to not take out the loan at all). Whilst lending standards may have been tightened in recent years, as part of its CBA for the proposed responsible lending requirements, the FCA estimated that these requirements may mean that around 10-17% of borrowers might be excluded from the market and 22-30% lent lower amounts. Around a third of the affected borrowers would have gone in to arrears. These estimates are calculated using data which ends in 2011. Given changes in the market since then, the FCA considers the immediate impact of its responsible lending proposals will be materially smaller than these estimates. Although the responsible lending requirements will mean that second charge firms would no longer be able to issue loans to customers where it is unaffordable, the suitability requirements should strengthen appropriate outcomes given that there will be some customers who meet the affordability criteria but for whom a second charge loan is not the most appropriate product[45].

Alternative options available to some customers may include:

- increased first charge mortgage lending;
- unsecured lending; and
- debt advice and solutions.

The alternative products available will differ depending on the firm's own product offering and the individual circumstances of the customer (for example, whether they need the loan for debt consolidation or other purposes). Applying the mortgage regime sales standards to the second charge market may help facilitate a consistent secured lending market, increasing the products on offer to customers when applying for a second charge loan.

The 31% of borrowers taking out loans for the primary purpose of home improvements may be able to secure additional mortgage lending or unsecured lending as alternatives. Whilst the interest rates on unsecured lending may be higher than for a second charge loan in some cases[46], this would avoid the borrower's home being put at risk. Sufficient information and advice provided by qualified sales staff would help the borrower to assess these trade-offs.

For the 66% of loans that are primarily for debt consolidation purposes, these borrowers may have fewer alternatives (due to impaired credit histories) and may exhibit behavioural biases meaning that they overestimate their ability to repay the loan and hence fall in to arrears. Debt advice and no additional new lending may be more suitable for some of these borrowers. In the course of an interactive sale, requiring second charge loan sellers to provide advice to customers who may still meet the affordability criteria but would not pass the suitability tests would improve outcomes in the market.

Of the small sample of customers we interviewed, most believed that they could not get a loan elsewhere. There was little consideration of alternative products by these customers. Also, there was limited evidence that brokers presented alternatives to a second charge loan, although it was reported that brokers had provided "a couple" of quotes for second charge loans with a recommendation for the best for them (usually based on the lowest interest rate and/or repayment amount). Alternative products were not discussed in any detail however.

This suggests that there could be significant benefits from the combination of the advised sales process and the knowledge and competency requirements that would improve the quality and relevance of the advice provided to customers. However, if it were the case that:

- the majority of customers taking out second charge loans to consolidate debts – and especially those going into arrears – had no alternative type of loan available to them, whether or not brokers' advice was substantially improved; and

[45] We note that in the qualitative interviews, firms clearly indicated that the impact of the responsible lending proposals would have the most significant impact on the market and on the volume of loans that they would be able to issue going forward.

[46] Borrowers may also choose a second charge loans rather than remortgaging in order to maintain their existing mortgage deal. Some brokers indicated that customers had been referred to them from mortgage lenders as the borrower was currently on a low rate mortgage deal which they did not want to lose.

- without customers taking out second charge loans to consolidate debts, an even greater number of customers would have gone into arrears on their existing loans;

then the benefits associated with a better advised sales process would be more limited.

Since the control/ treatment analysis explained above cannot reasonably be conducted and no other sufficient data sources are available we have no other means of estimating benefits. Therefore, it is not possible to assess the extent to which each customer did, in fact, have better (or any) alternative options available to them or to quantify the difference in outcomes[47]. We note that at one end of the scale, a number of customers could benefit from advice. At the other end of the scale, second charge loans are the last resort for borrowers who have already overextended themselves and the second charge loan may help some (though by no means all) to avoid defaulting on unsecured debts.

That said, we consider that it is reasonable to argue that efforts to provide advice and transparency in *all* forms of secured lending can help to deal with market failures associated with behavioural biases and information asymmetries.

For shared equity loan products, there is a set of specific risks that will not necessarily be addressed through existing parts of the mortgage regime. For example, a customer may:

- need to repay more than they borrowed as a result of an increase in house prices; and
- be unable to repay the loan where the value of the property decreases and the loss is not 'shared' with the equity loan provider;

For these specific risks to be addressed through an advised sales process, the needs and circumstances assessment would need to be amended to reflect the nature of the shared equity lending.

7.4.3 Industry costs associated with knowledge and competency requirements

Taking the costs for the requirements relating to the requirements outlined above, we have scaled these up to estimate the costs for the industry based on the responses provided. These are set out in the figure below.

Figure 25: Summary of costs associated with the knowledge and competency requirements

	One-off		Ongoing	
£million	Lender: Active in the market (currently advancing new loans)	Intermediary: Broker/Packager	Lender: Active in the market (currently advancing new loans)	Intermediary: Broker/Packager
Knowledge and Competency requirements[48]	0.4	0.7	-	-

7.4.4 Sales Performance Targets

From March 2016, the MCD will prohibit lenders and brokers from having sales targets as a basis for remuneration.

[47] Section 138I(8)(a) FSMA.

[48] We note that an Oxera report prepared for the FSA, 2010 (http://www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf) estimates an incremental cost of £35 per loan for both affordability and suitability tests in their analysis for the MMR. We estimate on-going costs for affordability but acknowledge there would be further smaller incremental costs for the advice part.

Costs

In the qualitative interviews, brokers in particular highlighted their concerns at the cancellation of sales targets in totality.

Both brokers and lenders shared a view that sales targets should remain, but that other factors such as regulatory compliance and quality of service should also play an important part in performance targets set for sales staff. The most common view was that the size of any bonus earned should be based on sales, but that the eligibility for this bonus should be based on passing regulatory compliance requirements, including call monitoring to ensure that staff have been selling loans fairly. Most of the firms we interviewed already adopted this approach.

Some brokers discussed the ability to link the size of commissions to both sales achieved and regulatory compliance scores- adopting a balanced scorecard approach. Some firms already adopt practices where the pay the sales person receives for a sale is a relatively small part of their total and is balanced against regulatory compliance, customer service and quality of advice.

However, the MCD does not permit remuneration to be contingent on sales targets. This applies even where the sales target is a small part of a "balanced scorecard". Therefore, whilst most firms we interviewed indicated that the cost would be low or non-existent if sales volumes could be used to a limited extent in determining pay as this would not be permitted the costs could be considerable given that the majority of firms would have to change their current practices. One broker suggested that a third of its client-facing staff could move on if it no longer paid sales based bonuses, others cited an increase in basic salary (to compensate for a loss of sales based bonuses) if profit margins allowed for it. These were the only attempts by firms to quantify the potential costs.

Benefits

Sales targets in place for brokers and lenders and staff commissions based on the level of sales can create adverse incentives and result in misaligned interests between lenders/brokers and borrowers. Removing these adverse incentives could result in benefits for consumers, for example through the improved provision of information on which product would suit them best, rather than being offered an unsuitable loan.

> *"I had not considered it before he mentioned it to me, but it seemed to make sense."*
>
> **Customer**

Additionally, sales targets could be driving brokers to recommend customers to borrow larger amounts. From our interviews with customers, it appears that it is standard practice amongst brokers to up-sell. Eight of the 12 respondents said that their broker had asked them whether they would like to borrow additional funds over and above the amount initially requested. For example, one respondent who had taken out a second charge loan for debt consolidation purposes was also encouraged to take out a further £15,000, at the suggestion of the broker, for home improvements and a holiday. Some of the respondents to whom it had been suggested by their broker that they borrow larger sums, did not do so. However, there is a risk that these broker practices could lead to over borrowing and be perpetuating time preference behavioural biases. Removing sales targets, alongside the introduction of advised sales, may address these problems. The prevention of over borrowing, however, is more likely to be addressed through responsible lending regulations that those on sales targets.

Also, given that brokers and lenders are already incentivising staff with some form of reward or requirement for compliant sales techniques, the potential for further benefits may be limited if these checks in place to prevent adverse incentives are already sufficient.

The impact of banning sales targets altogether for consumers is unclear. The complete removal of sales targets may lead to a reduction in the extent to which sales staff give biased advice to consumers, ensuring that they are less pressurised during the sales process and are advised on a suitable product that meets their needs and circumstances. However, it could also lead to an unmotivated staff group of sales staff, who will no longer have the same incentives to offer a good quality service.

7.5 Responsible Lending

7.5.1 Affordability Assessments and Interest Rate Stress Tests

The FCA's mortgage regime requires that lenders conduct an affordability assessment before granting a loan, taking into account verified income and:

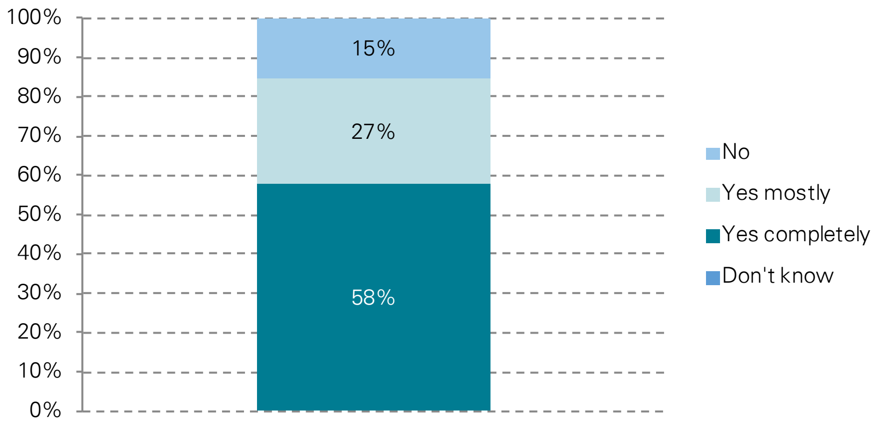
- committed expenditure – credit and other contractual commitments which will continue after the mortgage is entered into;
- basic essential expenditure – including housekeeping (food and washing) gas, electricity & other heating, water, telephone, council tax, buildings insurance, ground rent and service charge for leasehold properties and essential travel (to school or work); and
- basic quality of living costs – hard to reduce expenditure which gives a basic quality of living beyond the absolute essential expenditure (e.g. clothing, household goods (such as furniture and appliances)), personal goods (such as toiletries), basic recreation and child care).

The FCA is proposing introducing these requirements to the second charge lending market. However, if it were not to adopt the mortgage regime requirements, similar measures would have to be put in place under the MCD.

As noted previously, the FCA is undertaking its own CBA for responsible lending. However, for completeness, it requested that the reported costs associated with these regulatory proposals be included in our report.

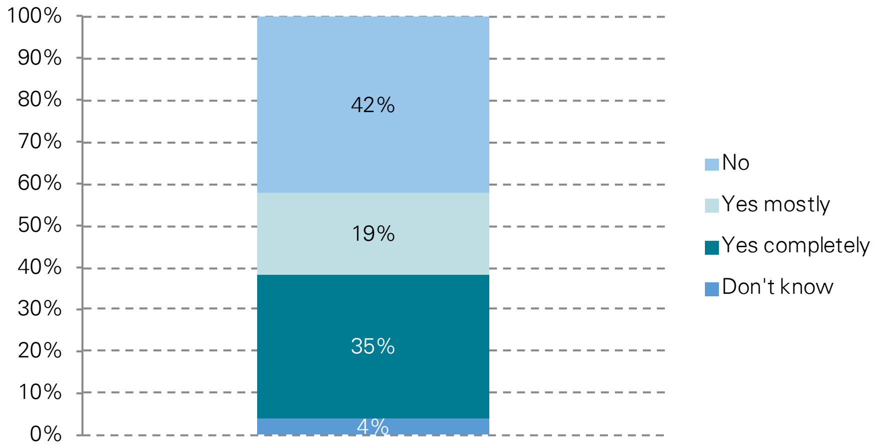
To understand the potential impact of the proposals, as part of our survey, we asked firms about their current levels of compliance with the FCA's current responsible lending requirements. As shown in the figure below, more than half of respondents indicated that they met the requirements completely already, with a further 27% indicating that they mostly met the requirements. Around 15% of respondents indicated that they do not meet the proposed requirements.

Figure 26: Proportion of respondents applying the proposed affordability assessment standards to their second charge lending



The FCA's mortgage regime already requires an interest rate stress test to be applied when considering affordability. However, the survey responses indicate that the application of the interest rate stress test may have a larger impact on the second charge market as only 35% of respondents indicated that they completely meet this requirement at present. A further 19% indicated they mostly met the requirement but 42% said they did not.

Figure 27: Proportion of respondents applying an interest rate stress test to their second charge business



Costs

Most respondents interviewed reported that they already undertake income and expenditure affordability assessments as well as interest stress tests or in the process of implementing these changes. However, this does not necessarily imply that these checks would be compliant with the proposed new regulations. Some lenders interviewed indicated that they still work on a Debt-to-Income Ratio (DTIR).

> *"It will be a big compliance expenditure to others. We have invested a lot of time and effort in these models."*
>
> **Lender**

One lender highlighted that the interest stress test could be a problem, depending on whether rules prescribed a detailed and onerous process for how a firm must stress test the first charge loan in addition to the second charge loan. One lender also mentioned that these regulations would require a significant compliance expenditure to those lenders and brokers that had not yet developed the affordability assessment and stress testing models. A large lender put the cost of putting in a new income and expenditure affordability assessment system in place between £250,000 and £500,000.

The table below shows the responses to the quantitative online survey. In total, there were seven respondents to these questions. The costs of complying with the proposed affordability assessment regulations is focused around making changes to IT systems, developing new sales processes, HR/ training costs and additional time to process loans. Of these, on average, the largest one-off cost is that of making changes to existing IT systems. The largest ongoing costs are HR/training costs and the cost of spending additional time processing each loan. The sample size, however, is very limited and, therefore, the results cannot be taken to be indicative of the entire market. Furthermore, the survey responses did not capture the potential impact of the proposed regulations on volumes of lending. This is the key concern of the industry, rather than the costs of implementation. It was felt that the proposed requirements could push a significant number of customers out of the market. We have not examined this further within the scope of our work given that the FCA is conducting a separate CBA for responsible lending.

Figure 28: Response to quantitative questionnaire: Impact of affordability assessment on costs

£	One-off				Ongoing			
	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Cost to set up a new IT system	-	-	-	-	-	-	-	-
Cost of making changes to your existing IT system	543	50,000	20,909	5	1,000	1,000	1,000	1
Cost of developing new sales processes	272	10,000	2,954	5	1,000	1,000	1,000	2
HR/Training costs	81	50,000	13,520	4	2,000	20,000	11,000	2
Cost of spending additional time processing each loan	2	40,000	8,404	5	499	40,000	10,875	4
Cost of appointing additional legal and compliance staff	-	-	-	-	-	-	-	-
Cost of appointing additional sales staff	-	-	-	-	-	-	-	-
Other	50,000	50,000	50,000	1	-	-	-	-

The table below shows the survey responses for costs of complying with interest stress test regulations. The cost structure is similar to that for the affordability assessment regulations: of the 13 respondents, 11 reported on average their highest one-off cost would be making changes to their existing IT system. The highest ongoing cost for the majority of lenders was that of spending additional time processing each loan. HR/training costs were not as large as for the affordability assessment regulation. The basis on which the respondents estimated the impacts of interest stress tests on costs is unclear. In the qualitative interviews, a number of respondents expressed concerns about how the stress tests would be applied and the data that they would be required to obtain in relation to first charge loans held by customers. It may be that case that, given their estimates of cost impacts, firms factored in a detailed process and collection of information from the first charge lender and/or customer.

Figure 29: Response to quantitative questionnaire: Impact of interest stress test on costs

£	One-off				Ongoing			
	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Cost to set up a new IT system	1,500	1,500	1,500	1	1,800	1,800	1,800	1
Cost of making changes to your existing IT system	194	25,000	5,133	11	194	3,000	1,199	6
Cost of developing new sales processes	48	5,000	1,384	11	78	2,500	1,046	6
HR/Training costs	81	2,000	931	7	92	1,000	594	3
Cost of spending additional time processing each loan	1	1,500	361	7	10	6,000	1,372	8
Cost of appointing additional legal and compliance staff	-	-	-	-	1,000	1,000	1,000	1
Cost of appointing additional sales staff	-	-	-	-	-	-	-	-
Other	-	-	-	-	120,000	120,000	120,000[49]	1

Benefits

The benefits of these regulations are outside the scope of this report. The FCA is undertaking a separate CBA for responsible lending which will include a consideration of the benefits associated with the proposed regulations.

7.5.2 Industry costs associated with affordability assessments and interest rate stress tests

Taking the costs for the FCA mortgage regime requirements relating to affordability assessments and interest rate stress tests outlined above, we have scaled these up to estimate the costs for the industry based on the responses provided. These are set out in the figure below. Whilst the compliance costs of these proposals are not as significant as those for some other proposed regulations (such as disclosure via the ESIS), those firms we interviewed generally felt that these proposed regulations would have the most significant impact on the dynamics of the market and in particular the volume of lending.

[49] This other cost was estimated by a broker who quoted the "cost of lower conversion rates to the business as a consequence of stress testing" as the reason for this cost. This cost was over 10 times larger than the second highest total, estimated by a lender, and over 100 times larger than the second highest estimate for a broker.

Figure 30: Summary of estimated industry costs associated with affordability assessments and interest rate stress tests

£ million	One-off: Lender: Active in the market (currently advancing new loans)	One-off: Intermediary: Broker/Packager	Ongoing: Lender: Active in the market (currently advancing new loans)	Ongoing: Intermediary: Broker/Packager
Affordability assessment	0.2	<0.1	0.1	-
Interest rate stress test	0.1	0.1	0.1	0.6[50]

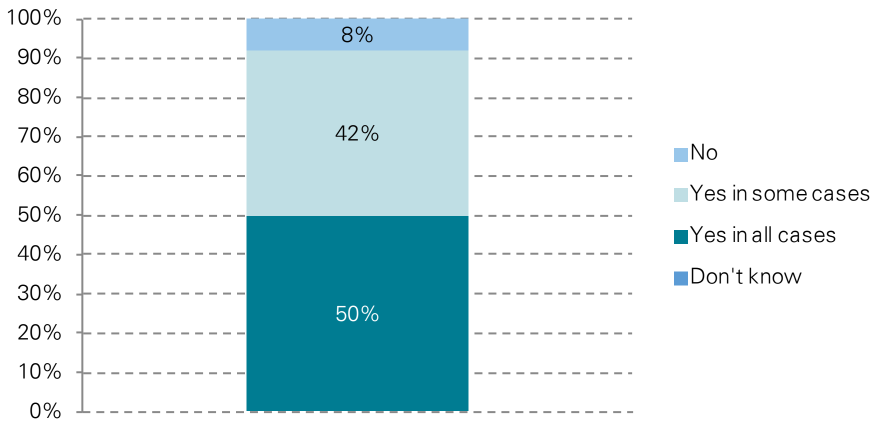
7.6 Other proposed regulations

7.6.1 Debt Consolidation

Where a borrower is consolidating its debts, the FCA is considering introducing a requirement for lenders to either take reasonable steps to ensure that these debts are repaid as expected or include these debts as part of an affordability assessment.

As shown in the figure below, almost all survey respondents told us that they already made payments directly to other creditors in either all or some cases when a borrower was taking out a second charge loan to consolidate existing debts. However, the FCA's proposal does not necessarily require that lenders make payments directly to creditors themselves. For example, providing the borrower with a cheque payable to their creditor would be one way of meeting this requirement.

Figure 31: Proportion of respondent currently making payments directly to the other creditors where a borrower is taking out a second charge loan to consolidate their debts



Costs

Lenders reported that secured loans are always paid off directly because they have to clear the charge before creating their new charge. However, where the borrower is consolidating unsecured credit, the processes followed by lenders differed. Whilst the large majority of firms indicated, in the

[50] This estimate is largely driven by an estimate of £120,000 from a broker to comply with this requirement. If this estimate was excluded this figure would fall to less than £0.1 million. We also not that the Oxera report for the FSA assessing the costs of complying with the MMR assumed the costs of a stress test would likely be low as most lenders' existing affordability models would already allow for some form of stress testing.

survey, that they paid creditors directly, in our interviews with them, only one lender reported that it paid the unsecured debts directly. Most paid by cheque to the customer made payable to the creditors. According to the lenders, this ensures that the funds can only go to the creditor, but the burden of administration in terms of naming the creditors lies with the borrower.

> *"Already done. For unsecured we issue the funds payable to the creditor - cheques to the customer. If you are consolidating 10 creditors how would we know we are sending it to the right place. But if we send it to the customer we know they are sending it to the right place."*
>
> **Lender**

A minority of lenders indicated that they left the consolidated unsecured debt payments for the borrower to arrange.

However, one major lender reported that it has already started paying directly by BACS to the borrowers' creditors, only sending cheques (again directly to the creditor) where it is not possible to do so. The lender stated that only one or two extra staff were required to make the shift to BACS. But given that under the proposed regulations payments would not need to be made direct to other creditors (e.g. a cheque could be written out to the creditor and sent to the client), other lenders might not have to incur the costs of moving to BACS system.

The majority of firms we interviewed and those who responded to the survey provided details of the impacts, and potential costs, on the basis of making payments directly to creditors (which the FCA is not proposing). If payments were to be made direct, one firm estimated an extra cost of £100,000 per year based on two to three extra staff members, not including any further overheads. One lender estimated an overall one-off cost of £250,000 to meet this requirement, however they did not break down the overall cost estimate in to the sub sections in Figure 32 below.

Additionally, if payments were to be made directly, it was highlighted that brokers would incur costs in having to collect more information during the sales process. Whilst one broker explained that it already collects information on creditors from the prospective borrower as part of its sales process and already issues a debt consolidation form that includes the majority of the information required, this appears to be a rare case and other brokers indicated that they do not have this system in place. One broker suggested that if payments had to be made directly it would lead to an increase in the sales process of 20 minutes per loan, whether the loan went on to be completed or not. Another broker suggested a 5-10% increase in case manager time per loan if it were to collect BACS account information.

The four responses to the quantitative survey questions in this area suggested that the one-off costs of arranging for direct debt consolidation payments are expected to be larger than the ongoing costs in totality. One lender expected costs of £20,000 for making changes to its IT system, developing new sales processes, HR/training costs, cots of appointing additional legal and compliance staff and costs of appointing additional sales staff. The same lender also expected a particularly high ongoing cost of spending additional time processing each loan. However, as noted above, the proposed regulations would not require direct payments, therefore lenders and brokers would not be required to incur these costs. Only the firms who do not currently provide borrowers with cheques payable to their creditors would have to change their practices and so incur costs. These would likely be considerably lower than those estimated below.

Figure 32: Response to quantitative questionnaire: Impact of arranging for direct debt consolidation payments to creditors

	One-off				Ongoing			
£s	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Cost to set up a new IT system	-	-	-	-	-	-	-	-
Cost of making changes to your existing IT system	20,000	20,000	20,000	1	-	-	-	-
Cost of developing new sales processes	2,000	20,000	11,000	2	1,000	1,000	1,000	1
HR/Training costs	2,000	20,000	11,000	2	1,000	1,000	1,000	1
Cost of spending additional time processing each loan	1,000	20,000	10,500	2	1,000	30,000	15,500	2
Cost of appointing additional legal and compliance staff	20,000	20,000	20,000	1	-	-	-	-
Cost of appointing additional sales staff	20,000	20,000	20,000	1	-	-	-	-
Other	30,000	30,000	30,000	1	-	-	-	-

Benefits

The proposed regulations would not require direct payments to creditors. Although most firms indicated that they already meet the FCA's proposed requirements by providing borrowers with cheques payable to their creditors, hardwiring current practice into rules would help ensure that benefits are realised consistently. Only those customers taking loans from lenders who do not already adopt these practices would benefit.

For these customers, the proposals would benefit them in that there will be an immediate payment of their other debts and it will decrease the burden on the borrower to organise his/her debt consolidation. Ensuring that the money is put towards debt repayments removes the risk that borrowers may use the money intended for debt consolidation for other (non-essential) expenditure, counteracting behavioural biases that might see customers making poor choices. Where a customer is in arrears on the debts being consolidated into the second charge loan, this could reduce any additional arrears charges faced.

Those limited number of consumers interviewed who had taken out loans for debt consolidation purposes indicated that they received the money directly into their account. Most were happy with this, stating that they preferred to have "control". They reported that they had paid the money off within a month - either making calls straight away or waiting until the next bill came in - and had therefore incurred minimal interest on their pre-existing debts. On this, albeit unrepresentative, sample of views, the benefits of the proposed regulations to require direct payment of creditors may be limited. However, there may be a case to suggest that those accruing large debts and unable to manage their finances would benefit from this policy.

7.6.2 Reflection Period

MCD regulations will require second charge lenders and brokers to give the consumer a reflection period before the conclusion of the credit agreement, or a period for exercising a right of withdrawal after the conclusion of the credit agreement, or a combination of the two. The FCA is proposing to rely on the first of these approaches.

Costs

Brokers had two immediate reactions to this policy in the qualitative interviews. The first was that the proposed reflection period is shorter than the current consideration period in place in the regulations (seven days compared to 16 days) and under the proposals there is also an opt-out where the prospective borrower can waive the right to a reflection period and continue the processing of the loan. More than one broker commented on the fact that for the vast majority of their customers, speed is the most important factor and that customers, therefore, would likely be happy to waive the reflection period.

> *"The vast majority of our clients would waive the reflection period."*
>
> *"From a broker perspective, it is more risky for us, because you have paid for everything and then lose contact with the client for however long the reflection period is."*
>
> **Broker**

However, more than one broker also explained how the consideration period in place at present, whilst longer, is towards the beginning of the sales process, therefore meaning fewer costs for the broker in incurring administration, processing and valuation costs. The proposed reflection period, on the other hand, is towards the end of the process, which means that the aforementioned costs will be incurred before a prospective borrower has committed to the loan process.

Non-bank lenders saw the regulation creating another problem with their funding costs. One medium-sized lender explained that a binding offer is required to start a reflection period of seven days. That requires the lender to put aside non-interest bearing funds for the length of time that the binding loan offer is in place. Under current arrangements, a release of funds is only initiated after the consideration period, when the prospective borrower has accepted the offer of a loan. Much of this will depend on the rate of customer drop-out at this point of the process.

One large broker explained that drop-out during the reflection period was likely to be low mainly because prospective borrowers tend to leave earlier on in the process. Therefore, by the time the process has moved onto the final binding offer when the reflection period is started, borrowers are likely to move towards accepting the offer given the amount of effort going into securing the loan in the first place. The same brokers explained that, because of the change in the timing of the process, there may actually be a cost saving from the regulation. During the initial consideration period, brokers tend to initiate costly processes such as valuations. These turn into abortive costs if a high rate of prospective borrowers pulls out at this point. Therefore a movement in the timing of the reflection period could allow brokers to incur fewer abortive costs.

Benefits

The regulation should decrease the number of borrowers entering costly loans that they cannot afford, purely because there was a need for funds in a very short period of time. However, the additional impact of this policy is limited as second charge loans are currently under a longer 16-day consideration period.

The option for the consumer to opt out of the reflection period drew a variety of responses from lenders and brokers. In general, most industry respondents warned of potential customer detriment resulting from a waiving of the reflection period and many suggested that customers should not be allowed to waive the reflection period. One large lender stated that there should be no return a 'one-minute mortgage' regardless of the timing needs of the consumer. One particular risk was a hypothetical case of a customer waiving the reflection period to accept the offer of a loan and then blaming the broker for 'forcing them' to waive the reflection period a few years later. Another lender disagreed, explaining that if a customer is borrowing for home improvement or debt consolidation, then it is in their interests to pay of the debts as soon as possible and initiate improvements to their house.

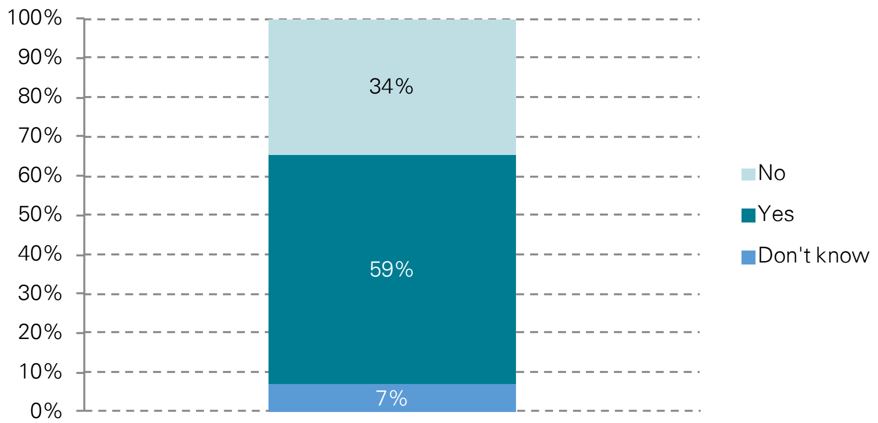
Overall, the expected benefits to consumers from these changes are likely to be dependent on the proportion of customers who chose to waive the reflection period (which anecdotal evidence suggests could be high). Waiving the reflection period could result in consumer detriment compared to the current situation by resulting in consumers not taking the time to consider the loan information provided, the risks involved and potential alternatives to the second charge loan. However, as the reflection period is at the end of the application process, dropout rates during the reflection period could be expected to be relatively low (resulting in limited consumer benefits) as drop out is more likely to have already occurred by the point in the process the reflection period is reached. Additionally, even with the consideration period that is currently in place, few customers we interviewed indicated that they has spent much time searching for alternatives to their second charge loan and 8 of the 12 indicated that they took out their loan because it was someone who would lend to them. This was the most commonly cited answer.

7.6.3 Advertising

The MCD will introduce a requirement that any promotional material containing the cost of credit to the consumer should include standard information on the identity of the creditor/intermediary; rate information; total amount of credit; annual percentage rate of cost (APRC); information on the duration of the agreement and the instalments payable by the consumer.

These requirements already apply to first charge mortgage lenders and to some second charge lending, as the FCA already regulates second charge advertising if it is for loans from a firm with an FCA 'entering into' or 'administering' mortgage permission and, if the product is being advertised by an intermediary, where that intermediary is FCA authorised. As shown in the figure below, 58% of respondents to the survey indicated that they were already subject to the advertising regulations under the mortgage regime. Therefore, it could be expected that these firms would not be impacted. However, around a third of firms thought that they were not subject to the requirements at present.

Figure 33: Proportion of respondents already subject to these advertising requirements under the mortgage market regime



Costs

Brokers, in responding to the qualitative interviews, did not believe that there would be a large impact on the costs of their business. A large number of brokers do not currently engage in large-scale advertising. This is partly because introducers (comparison websites) are now engaging in advertising to the consumer and brokers pay a fee for these introductions. On

> *"A few changes but nothing major".*
>
> **Broker**

the calculation of the APRC, one broker suggested that it is a burden that falls on the lender.

Benefits

Two respondents commented on how the nature of advertising may change. One explained that newspaper adverts would become more 'vanilla', as more terms, conditions and information would need to be inserted in the same advertising space. Another explained that this would be true of billboards as well.

Prospective borrowers could benefit from these more information-rich adverts, allowing more information up front to be gathered by the consumer. However, the market has changed in recent years and the role of aggregators/introducers has become more important in generating demand for second charge loans. One lender said as much as 70% of business now originates from price comparison websites. It is therefore unlikely that traditional advertising regulation will have a large impact on the majority of consumers. Our consumer interviews suggested that the respondents had used comparison websites and had also searched the internet for more general information. There was a high degree of recall of television advertising in the past though which in some case prompted the customers to search of loans secured against their homes when they needed credit years later.

7.6.4 Industry costs associated with debt consolidation and advertising

Taking the costs for the FCA mortgage regime requirements relating to debt consolidation and the advertising requirements outlined above, we have scaled these up to estimate the costs for the industry based on the responses provided. These are set out in the figure below.

	One-off		Ongoing	
£ million	Lender: Active in the market (currently advancing new loans)	Intermediary: Broker/Packager	Lender: Active in the market (currently advancing new loans)	Intermediary: Broker/Packager
Arranging for consolidated debt payments to be made directly to creditors	0.7	-	0.2	-
Advertising	0.1	-	-	-

7.7 Data Reporting

7.7.1 Data Reporting Requirements

The FCA proposes to introduce reporting requirements for the second charge lending market similar to those requirements in place for first charge lenders so that it can monitor and supervise second charge mortgage activity effectively.

If reporting requirements similar to those for first charge are introduced, lenders will need to report, using proven reporting methods, transaction level data on sales of regulated mortgage contracts (Product Sales Data, PSD) and submit the Mortgage Lenders and Administrators Return (MLAR).

PSD, will require:

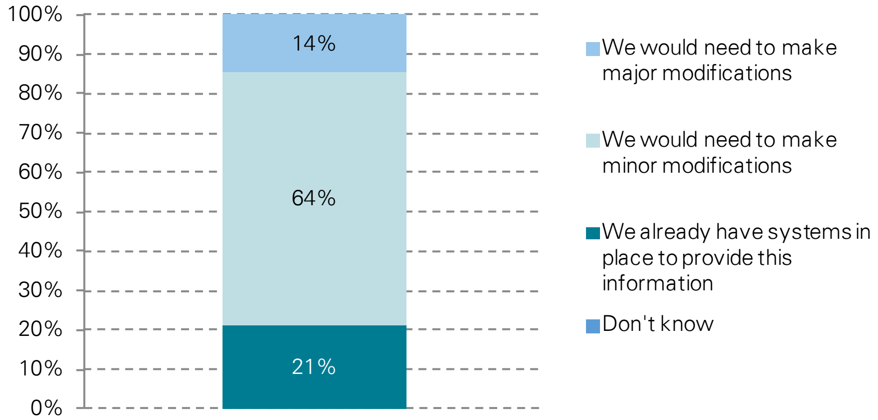
- sales data: information on the characteristics of the loan (size, type of interest rate, affordability, such as income and expenditure); and
- performance data: details of ongoing characteristics of the loan (outstanding balance, type of interest rate, info about payment difficulties/forbearance).

MLAR will require lenders to provide aggregated data on their lending activities on a quarterly basis.

Additionally, the FCA is proposing that second charge intermediaries submit Retail Mediation Activities Returns (RMAR). However, it should be noted that firms that will become authorised by the FCA to undertake consumer credit broking will be required to report data to the FCA in any case, some of which is not dissimilar to RMAR.

In response to our survey, a limited proportion of lenders (21%) indicated that they already have the systems in place to provide the information that would be required by the FCA. However, 64% would need to make minor modifications to their systems, whilst 14% would need to make major modifications.

Figure 34: Proportion of respondents with the management information systems in place to report data in the way that would be required by the FCA



Costs

Some of the firms already undertake first charge activity and submit data using these methods, dampening the cost implications for second charge activity. Only one of the major lenders interviewed suggested that it had not yet started a process to set up the IT requirements in order to adhere to any data reporting requirements

> *"We are already working on a data warehouse for this. You cannot do them manually – you need a data warehouse."*
>
> **Lender**

For example, one large lender already undertakes CoRep (common reporting) and FinRep (financial reporting) as good practice. Others indicated that they have sophisticated data warehouses already in place. One medium-sized lender suggested that its completed data warehouse would cost them £50,000 as a one-off cost, but with no further ongoing costs. Another medium-sized lender, already involved in first charge lending, said there might be the need for another compliance staff member, but all other costs are very small. However, this particular lender did state that MLAR was more expensive to implement than PSD.

There were seven respondents to the quantitative survey questions on data reporting requirements, all of whom expected costs of making changes to their existing IT system. These costs were expected to be both one-off and ongoing, and similar in magnitude. Respondents also expected significant ongoing costs of spending additional time appointing additional legal and compliance staff.

Figure 35: Response to quantitative questionnaire: Impact of data reporting requirements on costs

£	One-off				Ongoing			
	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Cost to set up a new IT system	-	-	-	-	-	-	-	-
Cost of making changes to your existing IT system	1,000	50,000	17,813	8	2,000	30,000	11,667	3
Cost of developing new sales processes	1,500	10,000	4,667	3	1,000	1,000	1,000	2
HR/Training costs	10,000	10,000	10,000	1	1,000	1,000	1,000	1
Cost of spending additional time processing each loan	1,000	10,000	5,500	2	1,500	30,000	11,500	3
Cost of appointing additional legal and compliance staff	10,000	10,000	10,000	1	1,000	30,000	15,500	2
Cost of appointing additional sales staff	10,000	10,000	10,000	1	-	-	-	-
Other	-	-	-	-	-	-	-	-

At the time of conducting the survey, the FCA proposals in relation to the reporting requirements for brokers were not clear, therefore, information on the potential costs of second charge intermediaries submitting RMAR was not collected. However, the FCA has requested that the analysis conducted for the reporting requirements for mortgage, insurance and investment firms, set out in FSA CP197 be used as a proxy. This suggests that the one-off costs per firm would be approximately £200 and the annual ongoing costs would be approximately £800[51]. As noted above, however, firms that will become authorised by the FCA to undertake consumer credit broking will be required to report data to the FCA in any case, some of which is not dissimilar to RMAR. Therefore, these costs estimates are an overestimate of the incremental costs of introducing RMAR.

Benefits

The reporting requirements proposed for lenders and intermediaries in the markets will enhance the benefits realised through the various individual proposed regulations for the second charge lending market. This is because the key benefit of the data reporting requirements will be the improvement in the ability of the FCA to monitor compliance in the market with the MCD and proposed mortgage regime regulations. Whilst the FCA could monitor compliance through other mechanisms (such as through its thematic work), the frequent and systematic collection and analysis of data will allow the FCA to monitor the second charge lending market in a more timely and efficient way. The use of data is a less resource intensive method of monitoring compliance and identifying trends than thematic reviews or one-off information requests to firms so it may enable the FCA to deploy its resources more effectively.

[51] This is calculated on the basis of CP197 RRAR costs divided by the number of firms estimated to apply for FSA authorisation at the time. The FSA estimated that one-off costs = £3.9m/25000 and ongoing costs = £15m/25000. Costs have also been adjusted to account for inflation.

Furthermore, not only will the reporting requirements allow the FCA to supervise firms' behaviour but this in itself should lead to greater compliance as firms will be aware that this is being actively monitored and assessed by the FCA. Indeed, some of the firms we interviewed indicated that since regulation of the market shifted from the OFT to the FCA in April 2014, they were increasingly aware of the likely scrutiny and monitoring of the market and that this has already influenced their activities. Once, the proposed data reporting requirements are enacted, this is also likely to result in a further change in behaviour as the regime that applies to second charge changes.

Given that there are benefits associated with each of the individual proposed regulations (as detailed throughout section 7), increased compliance and supervision aided by data would support the realisation of these benefits and ensure that they are higher than would otherwise be the case. To assess the scale of these benefits we would ideally analyse compliance rates with the proposed regulations among firms who also faced the data reporting requirements, compared to a group of firms who did not have data reporting requirements. However, given that the proposed regulations have not been implemented yet, it is not possible or practicable to assess what the likely level of compliance with the proposed regulations would be or to estimate the extent to which this would be enhanced through the data reporting requirements. It is feasible to assume that there would be an incremental increase in compliance as a result of them, however, and that the benefits would be enhanced as a result of the data reporting requirements.

A further benefit of the data reporting requirements is that it will support the FCA in developing its regulations going forward and ensuring that they are both effective and proportionate. At present, the data available on lending, sales and performance in the second charge market is very patchy and is inadequate for developing a detailed understanding of outcomes across the entire sector. Whilst the FCA has been able to collect data from some of the large lenders, this has been incomplete and unreliable in a number of cases. Furthermore, no data was available for the smaller lenders in the market or for the brokers.

By monitoring sales and performance data, and thus outcomes in the market, the FCA will be able to identify any emerging issues and the extent to which the regulations are addressing the negative outcomes currently observed in the market. This will allow it to take corrective measures where needed.

7.7.2 Industry costs associated with data reporting requirements

Taking the costs for the FCA mortgage regime requirements relating to data reporting outlined above, we have scaled these up to the costs for the industry based on the responses provided. These are set out in the figure below. The analysis suggests that this proposed data reporting requirement would make up a relatively large component of the increase in overall costs for lenders on both a one-off and on-going basis.

Figure 36: Summary of estimated industry costs associated with data reporting requirements

	One-off		Ongoing	
£ million	**Lender: Active in the market (currently advancing new loans)**	**Intermediary: Broker/Packager**	**Lender: Active in the market (currently advancing new loans)**	**Intermediary: Broker/Packager**
Data reporting requirements	0.5	See footnote 52	0.3	See footnote 52

[52] The FCA is also proposing that second charge intermediaries submit Retail Mediation Activities Returns (RMAR). 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.

8 Total costs and benefits of the proposed regulatory package

As noted previously, the FCA intends to implement the MCD for both first and second charge by copying out relevant MCD Articles into the Handbook and/or relying on existing MCOB rules where appropriate. In addition, the FCA also proposes to apply some additional MCOB rules to the second charge market. Having considered the individual costs and benefits associated with each of the proposed regulations to be tested in the CBA, in this section of the report we summarise the total costs and benefits, scaling up the results for the industry as a whole. This analysis assesses the costs and benefits of the proposed regulatory changes against the current regulatory framework. As noted in Section 6.2, this means that the analysis overestimates some of the *actual* costs to firms of FCA discretionary proposals, given that the true counterfactual is not the current regulatory framework, but rather the MCD framework that would otherwise apply.

Additionally, in this section we analyse how different firms in the second charge lending market may be affected and also consider the total costs and benefits to industry in 2016 under scenarios of market growth between the present 2014 situation and then.

8.1 Overall cost impact for industry

Having scaled up the reported costs for each individual proposed regulatory area considered on a per-loan basis and reflecting whether the costs would apply to new or back book (depending on the proposed regulatory policy)[53], our analysis suggests that the **combined measures are estimated to cost the industry in the region of £9.9 million in one-off costs, and £5.4 million in on-going costs per year**.

We note that the scale of costs estimated by second charge firms in relation to the proposed regulatory changes are high relative to the size of the industry in comparison to the estimated mortgage industry cost of implementing the MMR (£40-65 million one-off and £47-170 million on-going). Although there would be higher incremental costs on second charge firms due to the scale of changes that would be required to make their operations compliant with the MCD requirements and the mortgage regime more generally, the scale of the estimated costs in relation to the size of the market suggests that they could be overestimated. In some areas, providers have already made changes and therefore the proposed rules present only a marginal change from current practice.

It should be noted that due to incomplete data for the industry as a whole and for certain sub-sections of the market in particular (specifically dormant lenders and brokers), these total industry costs should be viewed as indicative only. Indeed, dormant lenders, who would incur costs as a result of some of the proposed regulatory requirements applying to their back book of loans, are not included in this analysis due to incomplete data. Attempting to scale up the few quantified costs for a very small number of dormant lenders would be highly unreliable.

These quantified total industry costs do not include estimates for all areas of potential costs of the proposed regulatory package. Some costs were identified in the qualitative interviews but not through the survey, but the majority of respondents believed these would be negligible.

Potential additional costs from the MCD requirements include:

- Disclosure of charges – all but one large lender interviewed agreed that these costs would be negligible. The large lender indicated that it would have to change its internal system and this will be a one-off cost "in the tens of thousands".

[53] The approach taken to do this is set out in the technical assumptions in section 10.1.

- Advertising – all of the respondents indicated there would be a few minor costs as a result of the proposed regulations but these would not be significant.
- Sales performance targets - the MCD's requirement that brokers are no longer permitted to base their targets at all on sales could have large cost implications for firms. It could also negatively impact volumes.
- Reflection period - most of the firms interviewed indicated there would be no associated costs with the proposed regulatory changes. One broker suggested costs could be as high as £20,000 of IT system programming time. One of the lenders indicated that if this is linked to the offer, then it could be an expensive change but did not provide an estimate of cost.

Potential additional costs of the FCA proposals include:

- Broker remuneration – All brokers interviewed said the costs would be negligible, apart from one master broker who said there would be a significant technology change cost. Also, there would need to be a change to the call-recording system to delete credit card details. It suggested that it would probably reflect these extra costs in their fees.
- Post-contractual fees - one large lender said the proposed regulations might be a bigger change than might be anticipated, depending on the exact requirements the FCA imposes but it did not provide a cost estimate.

The table below shows that the greatest share of the quantified costs (both one-off and ongoing) relates to the costs for disclosure via the ESIS. This is true both for active lenders and brokers. The other costs are much less significant in comparison. The costs are much lower for brokers than for lenders: total one-off costs for brokers are approximately 21% of the costs to lenders, while total ongoing costs for brokers are approximately 43% of the costs to lenders.

In the table:

- the grey highlighted in purple denotes the MCD's key maximum harmonising requirement;
- rows highlighted in orange denote MCD requirements where FCA proposes to implement the Directive using a combination of existing MCOB requirements and Directive copy-out; and
- rows highlighted in purple denote discretionary aspects of the mortgage regime, separate to MCD requirements.

Figure 37: Total costs incurred (scaled to industry size)[54], one-off and ongoing

£ million	One-off		Ongoing	
	Lender[55]	Inter-mediary[56]	Lender	Inter-mediary
Disclosure via ESIS	5.3	1.0	1.9	1.0
Disclosure of remuneration	0.1	-	0.4	-
Arrears charges	<0.1	-	<0.1	-
Affordability assessment	0.2	<0.1	0.2	-
Interest rate stress test	0.1	0.1	0.1	0.6[57]
Arranging for consolidated debt payments to be made directly to creditors[58]	0.7	-	0.2	-
Data reporting requirements[59]	0.5		0.3	
Advertising	0.1	-	-	-
Arrears management	0.6	-	0.7	-
Arrears management – information sharing	0.1	-	-	-
Knowledge and Competency and sales standards[60]	0.4	0.7	-	-
Total costs	**8.1**	**1.8**	**3.7**	**1.7**

In order to put the estimated industry costs of the proposed regulations in context, we have estimated costs as a proportion of industry profits. This provides a high level, indicative view of the potential scale of impact:

- According to FLA estimates provided to the FCA for a sample of its members, we have estimated that there were approximately 14,650 new loans written by FLA members in 2013. FLA members are estimated to cover 85% of the market so total number of new loans is estimated at 17,240. Based on lenders' survey responses scaled up to the industry level, the annual cost in 2013 of providing these loans was approximately £30 million. Estimated annual ongoing costs of the proposed regulations for the industry are approximately £3.7 million, representing around a 12% increase in annual costs.

[54] The assumptions used to scale up the costs to reflect the industry are contained in the appendix.

[55] Active in the market (currently advancing new loans)

[56] Broker/Packager

[57] This estimate is largely driven by an estimate of £120,000 from a broker to comply with this requirement. This is discussed further in section 7.5.1. If this particular estimate was excluded this figure would fall to £36,005. We also note that the Oxera report for the FSA assessing the costs of complying with the MMR assumed the costs of a stress test would likely be low as most lenders' existing affordability models would already allow for some form of stress testing.

[58] We note that the FCA proposals will not require lenders to make payments direct to creditors but the current practice adopted by most lenders to provide the borrower with cheques payable to their other creditors will suffice. Therefore, these estimated costs are an overestimate of the actual impact of the proposed regulations.

[59] The FCA is also proposing that second charge intermediaries submit Retail Mediation Activities Returns (RMAR). 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.

[60] We note that an Oxera report prepared for the FSA in 2010 (http://www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf) estimates an incremental cost of £35 per loan for both affordability and suitability tests in its analysis for the MMR. We estimate on-going costs for affordability but acknowledge there would be further smaller incremental costs for the advice part.

- Based on lenders' survey responses, on average they achieved an approximate 11% profit margin, which suggests that for the industry lenders' profits in 2013 were in the region of £3.6 million.
- The increased annual ongoing costs represent around 103% of lenders industry profits[61]. However, these costs are only indicative and are presented at the industry level based on the responses to our surveys. Respondents were only able to given their initial estimates of the potential costs of the proposed regulations. A number of firms we interviewed highlighted that they had not considered the proposals in detail or undertaken a full assessment of the likely compliance costs.
- There is evidence to suggest that the cost burden of the regulations may fall disproportionately on smaller lenders in the market, thus having a greater impact on their profit levels and a lesser impact on large lenders' profit margins. This is assessed further in Section 8.2.
- It is important to note that these larger lenders account for the majority of the second charge lending market. The six largest lenders accounted for approximately 84%[62] of new lending in 2013, as was the case in 2012. Therefore, even if smaller firms were to exit the market it may not have a significant effect on competition in the market. Furthermore, although there was concern about the effect the regulation would have on the volume of new lending in the market, no respondents to the qualitative survey indicated that there was likely to be large scale market exit as a result of the planned regulation. It is likely that there would be some degree of cost pass-through to consumers, through increased prices, thus allowing some of the existing profit margin to be maintained.
- In addition to being asked in the survey for estimates of cost for the individual components of the proposed regulatory package, firms were also asked about the impact of package in total. The majority of lenders and brokers agreed that there will be some cost to the industry as a result of the regulatory policy proposals for the second charge lending market. The table below summarises the views of lenders and brokers when asked their views about the potential changes in costs, headcount and new loan volumes as a result of the proposed new regulations in total.

The majority of lenders expected costs to increase by 11% to 20% as a result of the regulations. The expected change in costs was less consistent across brokers' responses, 21% of whom expected costs to stay the same, 21% of whom expected costs to increase by less than 10% and 36% of whom expected costs to increase by 11% to 20%.

Half of the lenders responding to the question on the impact of the overall proposed regulatory package on employment reported an expected increase in headcount of less than 10%. The expected impact on headcount was smaller for brokers, 50% of whom reported it would stay the same.

In relation to the expected impact on the total volume of loans, most lenders and brokers expected volumes to either stay the same or fall as a result of the regulations.

[61] We note that intermediaries active in the market also make profits from second charge lending. Very limited data on the profit level of intermediaries associated with second charge lending was provided by firms. Therefore, it was not possible to accurately estimate total industry profits (i.e. lenders' and brokers' profits).

[62] The FLA estimates that of its members, the largest six accounted for approximately 99% of new lending in 2013 (and also 2012). It also estimates that its members account for approximately 85% of the second charge lending.

Figure 38: Overall impacts

£		Fall by more than 20%	Fall by 11%-20%	Fall by less than 10%	Stay the same	Increase by less than 10%	Increase by 11%-20%	Increase by more than 20%	Total
Lenders									
Change in costs	Number of respondents	0	0	0	0	4	7	3	14
	Proportion of respondents	*0%*	*0%*	*0%*	*0%*	*29%*	*50%*	*21%*	*100%*
Change in headcount	Number of respondents	0	0	0	2	7	4	1	14
	Proportion of respondents	*0%*	*0%*	*0%*	*14%*	*50%*	*29%*	*7%*	*100%*
Change in volumes	Number of respondents	3	3	2	5	1	0	0	14
	Proportion of respondents	*21%*	*21%*	*14%*	*36%*	*7%*	*0%*	*0%*	*100%*
Brokers									
Change in costs	Number of respondents	0	2	0	3	3	5	1	14
	Proportion of respondents	*0%*	*14%*	*0%*	*21%*	*21%*	*36%*	*7%*	*100%*
Change in headcount	Number of respondents	0	0	0	7	4	2	1	14
	Proportion of respondents	*0%*	*0%*	*0%*	*50%*	*29%*	*14%*	*7%*	*100%*
Change in volumes	Number of respondents	2	1	1	4	4	0	1	13
	Proportion of respondents	*15%*	*8%*	*8%*	*31%*	*31%*	*0%*	*8%*	*100%*

It was difficult to find a consensus view from the qualitative interviews on the overall potential effect on costs. Some respondents did agree however that the most important factor in the imposition of the new regulations was that they were given adequate time to implement the changes. There was some concern that the changes were going too far in a short space of time and there should be some flexibility shown in the implementation of these regulations.

Large lenders believed the effect on overall costs would probably be negligible. This was particularly the case for current mortgage lenders.

There was concern that the burden may fall disproportionally on small brokers whereas it could offer an opportunity for larger more established brokers to enter the first charge market once they have overcome the initial costs of the regulation for a long term gain.

"It depends on how long we have to implement and whether we have a transition time. We have a very short timeframe to get these changes in."

Lender

The majority of respondents indicated that they thought it unlikely costs would be passed on to customers as they believed the market is a competitive one and any pass on would lead to a loss of customers.

8.2 Overall cost impact by size of firm

As noted above, in the interviews with firms, it was suggested that there may be a differential impact of the proposed regulations on firms depending on their size. Therefore, we have sought to analyse the total costs by size of firm to assess this and what it may mean for the market going forward.

The tables below split the lenders into the six largest active lenders (by Value of loans outstanding at 31 December 2013) and all other active lenders, depicting one-off and ongoing costs respectively.[63] The six largest lenders accounted for approximately 84%[64] of new lending in 2013, as was the case in 2012.

As shown in the table below, the analysis indicates that the costs of disclosure via the ESIS are scalable in absolute terms (likely linked to the differing needs for IT systems and levels of amendments required). However, whilst for the large lenders, the other costs are small in comparison to those of disclosure via the ESIS, this is not the case for small lenders. This appears to suggest that large lenders may benefit from economies of scale in these other costs. For the smaller active lenders, costs of disclosure via ESIS are not the largest estimated costs. It is important to bear in mind however, that the number of non-zero responses (firms that provided a cost estimate) is low and so the results may not be informative. Furthermore, the results depend to some extent on the way in which the respondents interpreted the proposed regulations.

[63] The top six are the six largest active FLA members currently advancing loans. We have identified these lenders through the sales and performance data collected by the FCA from lenders. The assumption that FLA members cover roughly 85% of the market is used to scale up costs separately for FLA members and non-FLA members. This is explained further in the appendix.

[64] The FLA estimates that of its members, the largest six accounted for approximately 99% of new lending in 2013 (and also 2012). It also estimates that its members account for approximately 85% of the second charge lending. However, at the time of receiving the FLA data, some of their members had not submitted their results for the last quarter of 2013. It is estimated that the data we have for 2013 covers closer to 70% of new loans advanced in 2013.

Figure 39: One-off costs to lenders, small and large (per firm)

	Six largest active lenders				Other active lenders			
£s	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Disclosure via ESIS	600,000	2,000,000	1,100,000	3	1,205	250,000	49,530	7
Disclosure of remuneration	-	-	-	0	490	29,000	11,163	3
Arrears charges	-	-	-	0	500	5,000	2,750	2
Affordability assessment	140,000	140,000	140,000	1	898	6,000	3,466	3
Interest stress test	10,000	25,000	17,500	2	421	14,000	5,384	5
Arranging for consolidated debt payments to be made directly to creditors[65]	250,000	250,000	250,000	1	5,000	120,000	62,500	2
Data reporting requirements	50,000	50,000	50,000	1	2,000	100,000	29,417	6
Advertising	-	-	-	0	50,000	50,000	50,000	1
Arrears management	30,000	30,000	30,000	1	2,000	100,000	36,000	4
Arrears management - information sharing	-	-	-	0	3	16,880	7,622	3
Knowledge and Competency requirements	5,636	85,091	45,149	4	4,817	31,600	14,972	3

The table below depicts the same story for ongoing costs. The second largest cost for large lenders is only 16% of the cost of disclosure via the ESIS. This is in contrast to other active lenders, who face several other ongoing costs that are almost equally as large in magnitude as those relating to the ESIS requirements. These are namely costs of disclosure of remuneration and arrears management. Again however, it must be noted that the number of non-zero responses is low and some of the costs may not be reflective of each group.

[65] We note that the FCA proposals will not require lenders to make payments direct to creditors but the current practice adopted by most lenders to provide the borrower with cheques payable to their other creditors will suffice. Therefore, these estimated costs are an overestimate of the actual impact of the proposed regulations.

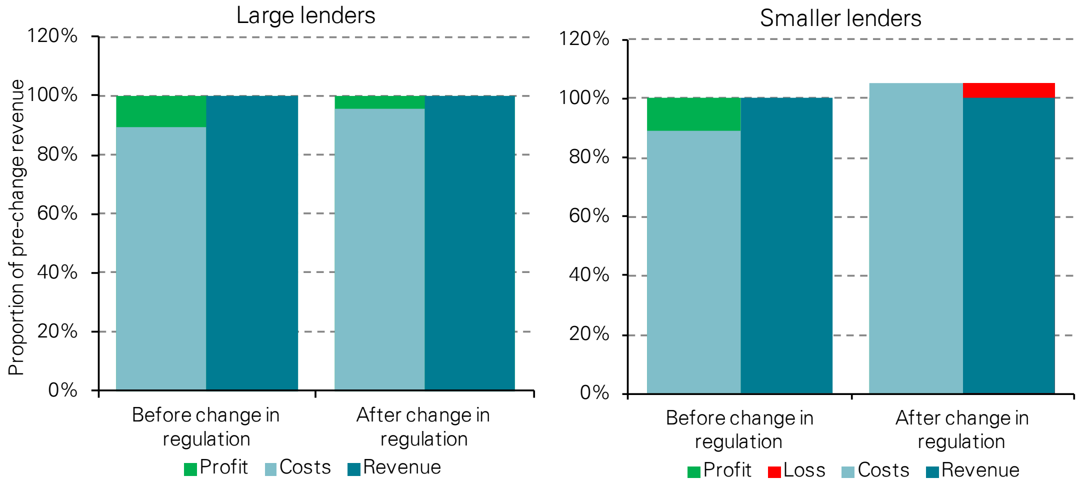
Figure 40: Total ongoing costs to lenders, small and large

£s	Top six lenders				Other (active) lenders			
	Min	Max	Average	Non-zero answer	Min	Max	Average	Non-zero answer
Disclosure via ESIS	250,000	500,000	375,000	2	499	180,000	50,534	7
Disclosure of remuneration	-	-	-	0	499	134,000	46,500	3
Arrears charges	-	-	-	0	1,000	3,000	2,000	2
Affordability assessment	50,000	60,000	55,000	2	499	6,000	2,833	3
Interest stress test	194	194	194	1	200	12,000	5,425	4
Arranging for consolidated debt payments to be made directly to creditors	60,000	60,000	60,000	1	3,000	30,000	12,000	3
Data reporting requirements	-	-	-	0	2,000	90,000	25,700	5
Advertising	-	-	-	0	-	-	-	0
Arrears management	1,714	1,714	1,714	1	3,000	130,000	44,500	4

In Section 8.1 we analysed the potential impact on industry profits of the costs of the proposed regulations. We have extended that analysis by looking at the profit/loss margins pre- and post- the proposed regulatory changes based on the size of firm. This suggests that the large lenders (who account for the vast majority of the market) are able to absorb the increase in costs of regulation whilst maintaining a profit.

In contrast, however, the analysis suggests that the smaller lenders (who it is estimated accounted for only 16% of new lending in 2013) are not able to do so, and would incur losses as a result of the incremental costs of the proposed regulatory package if they did not pass any of the cost increase on to consumers. However, it should be recognised that implementing the maximum harmonising nature of the ESIS, which is part of the MCD, is the biggest component of aggregate compliance costs.

Figure 41: Effect of regulations on profit margins of small and large lenders[66]



> *"The amount of time and efforts to meet FCA requirements outweighs the profitability if you are smaller."*
>
> **Lender**

This analysis assumes revenues remain the same (indexed at 100) before and after the introduction of the proposed package of regulations. When we lift this assumption, the conclusion that the smaller lender may no longer be viable is likely to be even stronger. This is because of the potential decrease in volumes that may be brought about due to the regulations (potentially the affordability assessment and interest stress test regulations in particular). As noted above, firms generally reported that they considered there would be a fall in the volume of loans after the introduction of the proposed regulations.

In the interviews, firms indicated they had concerns about the cost of regulation falling more heavily on smaller lenders and the impact on the dynamics of the market going forward. Some respondents suggested that they expect smaller lenders to exit once they fully comprehend the regulatory requirements of operating under a fully authorised FCA regime.

> *"We would be concerned about anything from a regulatory point of view that puts greater relative burden on us than larger firms."*
>
> **Lender**

8.3 Summary of overall benefits

In terms of the benefits of the proposed regulatory package, for the purposes of the CBA we took a largely qualitative approach due to inherent difficulties in estimating the potential scale and exact value of benefits. The impacts of the responsible lending proposals are covered in the FCA's CBA.

Our analysis, based on the information we obtained from lenders, brokers and customers, as well as based on economic insights in to the market suggests that, for the ESIS:

- as a result of the proposed regulations relating to disclosure of information via the ESIS, there may be benefits from the improved provision of information to consumers, enabling them to make better-informed decisions about borrowing. This could also drive greater competition in the market if consumers use the information to seek out and compare products. However, there were some reservations as to how much this would benefit consumers due to behavioural biases in the market, the currently level of availability of information and the fact

[66] FLA estimates that approximately 84% of the second charge lending market is covered by 'large lenders' as defined in this analysis.

that the limited customers we interviewed suggested that they had already received helpful and understandable information.

For other areas, our analysis suggests that:

- there could be a potential lowering of costs to consumers if they enter arrears as a result of cost reflective arrears charges. Although the majority of respondents indicated that they already have systems in place to demonstrate that charges are cost reflective, the more prescriptive proposed regulations than those already in place should help to ensure that the benefits are realised for all customers;
- arrears management processes under the FCA's proposed regulations would also benefit the large proportion of customers going in to arrears by ensuring that greater forbearance measures are taken than observed in the market at present. The proposed regulations should benefit customers by ensuring that those in arrears are supported and helped to manage this effectively before any potential repossession action is taken and/or high arrears charges incurred. Further benefits will also arise from cost savings to borrowers from reduced direct debit reprocessing changes and proposed requirements to improve the sharing of information between first and second charge lenders at the point of commencing litigation action. Our quantification suggests that these may be small: in the region of £30 per loan[67]. This is low given the existing practices of lenders in relation to direct debit payments and the very small proportion of repossessions compared to total loans;
- charges disclosure may improve not only the provision of information to borrowers, but also competition in charges;
- there may be improved transparency on post contractual fees resulting in customers being able to make better informed decisions. However, the balance between those customers that may pay higher and lower Early Redemption Charges (ERCs) when they are calculated based on costs is unclear and will depend on the extent to which lenders choose to levy ERCs going forward;
- the knowledge and competency proposal for sales staff, specifically the Level 3 qualification requirements, coupled with the proposed move to advised (and execution only) sales for second charge firms may improve the quality of information and advice given to potential borrowers to help them better understand the product being offered, its risks and the potential alternatives. This, along with the suitability tests and responsible lending regulations are likely to help mitigate the risk of customers suffering detriment from taking out second charge loans where this is not appropriate for them;
- the proposed requirement for lenders to take reasonable steps to ensure payments are made directly to previous creditors (e.g. by making cheques payable to them) where debts are being consolidated may yield some benefits by ensuring that the money is used for the intended purpose, counteracting behavioural biases that may result in borrowers making poor choices, and helping to facilitate payments being made promptly without further costs being incurred. However, evidence suggests that the majority of lenders already adopt this practice;
- more information-rich advertisements as a result of the proposed advertising requirements may allow more information up front to be gathered by the consumer to improve their decision making. However, much of the evidence suggests that much of the business now originates from price comparison websites. It is therefore unlikely that traditional advertising regulation will have a large impact on the majority of consumers; and
- the data reporting requirements should help to support the realisation of benefits from the other proposed regulations by increasing compliance and ensuring that the FCA is able to effectively monitor firms' behaviour and market outcomes to ensure that the regulation is fit for purpose.

[67] This is calculated as an average across all loans for which we received data in the quantitative survey, not just those loans going in to arrears and then leading to repossession action being taken.

8.4 Potential impacts on competition of the proposed regulatory package

As explained in Section 3.4, respondents were generally upbeat about the second charge market, and most expected modest growth over the next three to five years as more lenders enter the market and existing lenders slowly expand their funding lines. Lenders felt that the market was currently constrained, largely due to a lack of supply rather than a lack of demand from customers for second charge loans. That said, none thought that the market would return to anything like its pre-crisis peak. It could be expected that the ongoing demand for second charge loans from customers and improved funding lines may make competitive entry more likely. Indeed, there is already planned new entry to the market.

Despite this, one of the reasons cited for considering that lending levels in the market would not return to those seen in the pre-financial crisis period was the introduction of the proposed regulatory requirements. Although there are reportedly new lenders considering entering the market in the near future, those firms we interviewed generally felt that the smaller lenders may exit the market once they fully comprehend the regulatory requirements of implementing the MCD and operating under a fully authorised FCA regime. Our analysis of the impact of the proposed regulations on small lenders, set out in Section 8.2, indicates that the additional ongoing costs they would face may make them no longer profitable and so they may exit the market.

The market is relatively concentrated at present with only a limited number of active lenders. The largest of these dominate the market and account for the vast majority of new lending. The exit of small firms from the market as a result of the regulatory burden may decrease competitive pressures in the market. However, as noted above, there is evidence of planned new entry and the positive signs of growth and ongoing consumer demand in the market may also make this more likely in future. If the entrants are of a sufficient scale to enter profitably, this may counterbalance some of the risks of consolidation that arise from the compliance costs associated with the proposed regulations. Also, the barriers to entry for first charge lenders may be reduced, as they already face similar regulations in the first charge market to those proposed for the second charge market. Indeed, some of the firms we interviewed expect the market to open up if second charge lending is regulated in the same manner as first charge lending.

The impact on the overall volumes of new lending in the market is also likely to impact on the comparative dynamics of the market. As shown in Figure 38, the majority of respondents to our survey considered that the overall impact of the proposed regulations would be a decline in the volumes of lending. 21% thought that it would fall by more than 20% and a further 21% thought that it would fall by between 11% and 20%. Based on our interviews with firms, most thought that the decline in volumes would be driven by the proposed responsible lending regulations. This view appears to be confirmed by the FCA's own CBA of these requirements which suggests that 10-17% of borrowers might be excluded from the market and 22-30% lent less. However, these estimates are calculated using data which ends in 2011. Given improvements in the market since then, the FCA considers the immediate impact of its responsible lending proposals will be materially smaller than these estimates.

A smaller pool of customers may affect the competitive dynamics in the second charge lending market in two ways:

- With fewer potential customers there may be more vigorous competition between lenders to attract these customers, leading to increased innovation in the market in terms of the products available and better prices and quality of service.
- Conversely, with fewer potential customers this may force lenders out of the market as it would no longer be profitable to service a significantly reduced volume of loans, particularly when facing the incremental one-off and on-going costs of the proposed regulatory requirements.

It is not possible to assess the balance of these two effects, although our analysis does suggest that the smaller lenders in the market would incur losses as a result of the higher ongoing costs they would face following the introduction of the proposed regulations, and so there may be market exit. However, as noted above, some of the firms we interviewed expect the market to open up if second charge lending is regulated in the same manner as first charge lending. From a lending perspective, some firms could envisage mainstream mortgage lenders offering second charge loans alongside mortgages, remortgages and future advances. From a broking perspective, existing second charge credit brokers could be forced to expand their offering to first charge lending in order to offer a full range of products to consumers, while mortgage brokers and mortgage networks may take the opportunity to expand their offering to cover second charge loans as they will no longer have to comply with the Consumer Credit Act and instead operate under a regulatory regime they are familiar with. Overall, we may see new business models enter the second charge market which would have positive effects on competition.

> *"It [regulatory change] will bring in mortgage brokers, and a number of secured loan brokers will start to do first charge business."*
>
> **Lender**

Whilst the overall impact of the proposed regulation on the number of players in the market is uncertain, a number of the proposed regulations may have a positive impact on competition between firms that remain in the market after their introduction. For example, the disclosure requirements, coupled with the advised sales process, will mean that customers are better informed about the loan offered to them and the range of alternative products that may be available. With more information about the level of charges for the loan offered and lower search costs due to the disclosure of additional information, customers may be in a better position to assess the value for money and seek out alternative offers. This would increase competitive pressures on firms in the market. As noted in relation to the benefits of disclosure, however, it may be the case that the consumers do not fully understand, or use, the information made available to them so it would not affect their decision making process and so the potential competition benefits would also not be fully realised. At the same time we note that the market is moving towards the more prime consumer segment. This, in combination with the above rules, could put consumers in a better position to drive competition in this market. In addition to the above, we would expect revised regulations on fees and charges to lead to greater product variation and potentially to greater competition.

9 Industry costs and benefits based on alternative scenarios

Our baseline CBA, set out above, assumed total industry costs on the basis of the current volume of loans in the market.

However, if there is growth in the market between now and 2016 (when the regulations are implemented) this assessment would change.

Additionally, there are other potential factors in the market that may change between now and 2016 when the regulations are implemented which would affect the market dynamics and the incremental costs and benefits of the regulations. As the market has already changed over recent years, for example in terms of the tightening of lending criteria and arrears rates, it could be expected that there may be further changes in the market ahead of the implementation of any regulatory changes in 2016.

Whilst we have not run scenarios based on all the potential changes in the market between now and 2016, we agreed with the FCA to run a scenario based on market growth to understand how the total costs and benefits of the proposed regulatory package may be affected.

9.1 Potential changes to industry costs associated with a growth in the market for second charge lending

There is uncertainty about the size of the second charge lending market by the time the proposed regulations would be introduced in 2016. Respondents in the quantitative interviews were generally upbeat about the second charge market, and most expected modest growth over the next three to five years as more lenders enter the market and existing lenders slowly expand their funding lines.

Lenders felt that the market was currently constrained, largely due to a lack of supply rather than a lack of demand from customers for second charge loans. That said, none thought that the market would return to anything like its pre-crisis peak due to improved lender business practices, more stringent regulatory control and a lack of appetite for wholesale funding.

> *"I don't think we will get back to 2007-8, but growing back towards where that market is. New lenders are coming in."*
>
> **Lender**

With growth in the market between now and 2016, costs are not likely to increase at the same rate. This is because not all the costs of regulation compliance are incurred on a per-loan basis. For example, costs relating to making changes to existing IT systems are likely to be independent of market development. On the other hand, costs of developing new sales processes and the cost of spending additional time processing loans are both likely to depend on the number of new loans arranged/advanced, and will thus be affected by market development.

9.2 Possible changes to the benefits resulting from changing market conditions

The potential benefits would also be expected to change depending on the development of the second charge lending market before 2016. Growth in the market would be expected to lead to a proportional increase in the total expected benefits given that the benefits identified are likely to be linked to an increase in the volume of loans (and number of customers) in the market.

10 Appendix

10.1 Technical assumptions

10.1.1 Allocating staff costs

In order to allocate the staff costs, the staff functions had to be categorised by the costs of complying with the new regulation. The table below shows the mapping that was assumed for the CBA.

Figure 42: Assumptions of staff functions for different costs of regulation

Costs of regulation	Staff function
Cost to set up a new IT system	IT/Systems
Cost of making changes to your existing IT system	IT/Systems
Cost of developing new sales processes	Front line staff (sales)
HR/Training costs	Human Resources/Training
Cost of spending additional time processing each loan	Front line staff (sales)
Cost of appointing additional legal and compliance staff	Legal, Compliance & Risk
Cost of appointing additional sales staff	Front line staff (sales)
Other (please specify)	Other (please specify)

Where firms reported their cost in terms of hours, we calculated the cost by multiplying by the salary of the FTE that mapped to that cost. For example, if a firm reported that for disclosure via ESIS, 50 hours would be required to develop new sales processes, the cost would be calculated by multiplying the hourly wage of a front line sales employee at that firm by the number of hours.

10.1.2 Calculation of hourly wage

Firms were asked only to report their employees' annual wages. The hourly wage was calculated from this by dividing by 1650 hours worked per year as defined by the Joint Costing and Pricing Steering Group. This is based on an assumption of 220 working days in a year, at 37.5 hours a week for 44 weeks of the year.

10.1.3 Cost of Level 3 qualification

The Level 3 qualification has been estimated to cost £1,000 per head based on lender responses to the qualitative interviews as well as information on the website of the Institute of Financial Services.

The number of hours of study leave is estimated to be 120 hours based on a response by a mid-sized lender in the qualitative interview.

10.1.4 Percentage of loans in arrears

This was calculated using FCA data for large lenders.

10.1.5 Scaling factor

In order to scale the costs to the industry as a whole, we applied a number of separate scaling factors calculated using data from the FLA and the quantitative survey.

For the back book, date from the FLA indicates that their members had a total of 260,825 outstanding loans as of April 2014 and the FLA estimate that their members represent roughly 85% of the market. Using this, we calculated the estimated total number of loans in the back book. To determine the scaling factor for the back book for FLA members we divided the total FLA back book number by the total number of loans in the back book for those FLA members who responded to the quantitative survey. For other lenders we divided 15% of the total number of loans in the market back book by the total number of loans in the back book for those other lenders who responded to the quantitative survey. Any cost that will be applicable to both the back book and new loans will be scaled using this back book scaling factor which is larger than the factor calculated below for new loans.

For 2013, the FLA data only covers roughly 83% of the total loans advanced by their members. This is a FLA estimate as some members have not submitted data for the last quarter of 2013. The FLA estimates that their members represent roughly 85% of the total market. We analysed the FCA transaction data for FLA members and found that, in 2013, 90% of loans were organised by brokers – we have assumed this trend is consistent with that in the rest of the market. Using these figures, we calculated (for FLA and non FLA lenders as well as brokers) the estimated total number of new loans advanced (in 2013) in the whole market. We used these market estimates and the number of loans advanced by those who responded to our quantitative survey to determine the relevant scaling factors for FLA and non FLA members as well as brokers.

10.1.6 Proportion of the back book that is covered by now dormant lenders

To determine the appropriate costs that would fall on active lenders in the market it was necessary to make an assumption on the number of outstanding loans in the market back book that were originated by now dormant lenders. The FCA provided us with data from the FLA outlining the number of loans originated by their largest members, assumed to cover roughly 85% of the market in 2012, since 2005.[68] Four of these lenders are no longer advancing new loans i.e. they are dormant. FLA data indicates a total back book outstanding for their members of 260,825 loans.

To work out the proportion of the FLA back book that is from dormant lenders we assumed 100% of the loans taken out in 2013 were still active in the market (and thus were part of the 260,825 loans in the outstanding back book) and applied a linear decline in the proportion of loans from each year that were still outstanding in the market back to 2005. To get to a total of 260,825 loans in the back book a linear decline of 7.84% per annum was assumed. This means that we assume 92.2% of second charge loans taken out in 2012 are still outstanding, 84.3% from 2011 and so on so that 37.2% of loans taken out in 2005 are still active in the market.

Using this linear decline rate, we calculate that 65.1% of the FLA back book for which we have data is made up of loans from now dormant lenders. We assume this proportion is the same for the total market.

10.1.7 Application of proposed regulations to the back book

Some of the regulations apply to the back book as well as to new loans. The table below sets out the mapping used in our CBA.

[68] Mintel data between 2005 and 2007, FLA since 2008.

Figure 43: Back book versus new loans only

Regulatory Policy	Applies to new loans or back book and new loans
Pre-contractual disclosure via ESIS	New
Disclosure of remuneration	New
Arrears charges	Back Book and new
Affordability assessment	New
Interest stress test	New
Arranging for consolidated debt payments to be made directly to creditors	New
Data reporting requirements	New
Advertising	New
Arrears management	Back Book and new
Staff training	New

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