The Future Regulation of Secured Loans – A White Paper

Introduction

This White Paper sets out some of the key regulatory challenges and decisions faced by second charge secured loan brokers in the UK. The paper has been written by the Association of Finance Brokers to help secured loan brokers – whether AFB members or not – to understand the effect of European regulation on our sector, and to canvass opinion of the possible future regulatory routes.

AFB invites comments on the paper, and has attached a list of questions (Appendix One). We welcome feedback by intermediaries by 30th September 2008.

European Regulation

Increasingly, UK regulation stems from Europe. Already in existence and affecting UK financial services firms are many directives, including the Markets in Financial Instruments Directive, the Insurance Mediation Directive, Distance Marketing Directive and the Unfair Contract Terms Directive. For this reason, the industry must look to Europe for future regulatory direction.

Whilst politically European integration remains divisive, the reality is that the UK has historically demonstrated extremely prompt compliance when enacting Directives into UK regulation. MiFID was enacted on the 1st November 2007, with only Romania also enacting the directive into their national law. We must therefore assume that the UK will continue to enact legislation and should prepare for new Directives.

When the Commission adopts a Directive, the home-state has to enact it into their own legislation within two years. If this requires amendments to existing legislation – such as changes to the Conduct of Business (COBS) rules as was the case with MiFID – then the consultation and subsequent transitional arrangements can themselves require rapid debate and change to UK rules. Early engagement is therefore critical to successful outcomes.

UK Regulation of Credit

In the UK, regulation of the provision of debt and credit advice is divided between the Office of Fair Trading (OFT) and the Financial Services Authority (FSA).

The segregation between regulatory bodies has typically been characterised by ranking of legal charge over land, and purpose of loan. First charge residential lending falls under the statutory regulation of the FSA under the Financial Services and Markets Act, whilst subsequent charge, non-residential and unsecured lending falls to the OFT under the Consumer Credit Act.

European Regulation of Credit

In Europe, unsecured lending is regulated under the Consumer Credit Directive, in much the same way that the CCA regulates unsecured lending in the UK.

At the other extreme, first-charge residential mortgages are regulated under the Financial Services and Markets Act (FSMA) in the UK. In Europe, there is much work as a result of the Mortgage White Paper and Credit Intermediary Study, and it is widely expected that Europe will produce a Directive which will impact on Mortgage Intermediaries shortly.

However, whilst many aspects of European legislation are complementary in nature to the UK, there are some notable differences. A key difference is the segregation of credit offerings, with credit typically being split into ‘secured by land’ or unsecured. Whilst this complements UK legislation at either extreme – unsecured and first charge residential lending – there are contradictions in-between – namely for secured loans.

Because the UK regulates secured loans through the CCA, yet as ‘secured lending’ they would potentially fall into a Mortgage Credit Directive, there are a number of unintended consequences for second charge secured lending regulation in UK:

<table>
<tr><td>Sector</td><td>Unsecured</td><td>Second Charge Loans</td><td>First Charge Mortgages</td></tr>
<tr><td>UK</td><td colspan="2">CCA</td><td>Financial Services & Markets Act</td></tr>
<tr><td>Europe</td><td>CCD</td><td colspan="2">Possible Mortgage Credit Directive</td></tr>
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Consumer Credit Directive

The Consumer Credit Directive (CCD) has been adopted by the European Commission on 22nd May 2008. This means that the UK must have enacted the Directive by 11th June 2010.

The Directive only relates to unsecured lending. As demonstrated above, because second-charge lending falls under the CCA in the UK, whilst the Directive should have no impact on second-charge loans the unintended

consequence is that it will. We therefore now have a short window of opportunity to consider the future regulatory landscape of our industry.

Need for Change

Because the Directive affects all unsecured lending, the UK is required to make significant revisions to the existing CCA. Whilst second-charge lending is affected by the CCA, the CCD revisions do not directly affect them. This has three potential consequences:

1. The UK 'gold-plates' all CCD requirements across the whole CCA, thus inadvertently capturing secured loans with CCD requirements.
2. The UK creates a two-tier CCA, adopting new CCD requirements for unsecured borrowing, but leaving existing CCA regulations for second-charge loans.
3. The UK incorporates the CCD into the CCA for unsecured lending, and provides alternative regulation for second-charge lending.

The reality is that the CCA will have to change as a result of the CCD. In light of this, it is incredibly important that the secured loans industry considers where it wishes to position itself and quickly and strongly makes a case for their desired outcome.

Option One: Gold Plating the CCD

The government could apply all CCD requirements to the entire CCA. This would inadvertently capture second-charge secured loans, and could potentially require additional regulatory burdens in the areas of information provision, early repayment, APR assumptions and rights of withdrawal.

In the event that further secured lending regulation subsequently emerges from Europe (such as a Mortgage Credit Directive), second-charge lending would also be captured by these regulations. This could mean that the industry has to adopt CCD requirements today, and then subsequently adopt further, possibly contradictory, regulations within a short time frame.

The CCD requirements also pose specific challenges. For example, one of the requirements of the Directive is that a maximum limit of €75,000 is set for qualifying credit. If the Directive was applied across the entire scope of the CCA, this would re-instate a ceiling for credit covered by the requirements at €75,000. Given that one of the policy intentions of the 2006 CCA was to remove the £25,000 upper limit, this would re-impose a €75,000 limit, in direct contradiction to the recently achieved policy intentions.

Initial indications from BERR indicate a desire to exempt secured loans from any CCA changes, thus implying that full-scale gold plating is not, as yet, their desired outcome.

Option Two: Two Tier Consumer Credit Act

Given the Government's desire not to 'gold-plate' regulation where possible, it is conceivable that the CCD changes could be made to just unsecured credit within the CCA. If this happens, it could be that the UK ends up with a two-tier CCA, with the CCD amended terms relating to unsecured lending, and existing CCA regulations for secured loans.

This method clearly avoids extra change, and thus cost, for the industry. However, it is important for the sector to consider the reputational issues that accompany the sector.

The OFT has recently instigated the use of Credit Risk Profiles (CRPs) for perceived high-risk sectors, including brokers operating in the second charge arena. The implication of this is that they believe the secured-loan industry to be worthy of closer scrutiny. It is also likely that if the economy continues to struggle a greater public-policy emphasis will be placed on secured debts – linked to homes – in terms of consumer detriment.

This raises the question of whether politically the OFT would be able to maintain a two-tier CCA, with secured-loans, a perceived high-risk area, untouched by new European legislation. The pressure for further reform of the CCA for firms unaffected by the CCD could be significant, and fundamentally this could be nothing more than an awkward delaying action prior to inevitable first-charge comparable regulation created by a potential secured-lending Directive.

Further to this are current market conditions. Any significant variation in property prices and possession data are likely to encourage notable press interest, and variations in regulatory requirements for first and subsequent charge loans, when fundamentally both have the potential to put a consumer's home at risk, could add to the weight of consumerist opinion that secured loans should be regulated in parallel with first-charge mortgages.

Option Three: Alternative Regulation for Second Charge Lending

The final realistic option for the industry is an alterative regulatory regime altogether. Given that the CCD affects all unsecured lending, by removing second charge secured lending from the scope of the CCA would allow the CCD requirements to be simply applied to the whole CCA for all remaining sectors (with the exception of some small areas such as Credit Unions).

The question of where alternative regulation could reside could be answered by the Financial Services Authority (FSA). In the face of possible secured-lending directives from Europe, it could be the simplest option to pre-empt future changes and to pass regulation to the FSA.

One method for achieving this could be to alter the definition of a FSMA 'Regulated Mortgage Contract' (RMC). At present the definition requires a first legal charge. If this definition was altered to 'legal charge' without specification of legal ranking, second and subsequent charge lending would fall into the definition of RMCs. By statute, RMCs are exempt from the CCA, and thus would be exempt from any of the CCD requirements in an amended CCA. Existing requirements relating to 40% occupancy and borrowers as individuals could simply remain. The definition of qualifying credit could also be amended to allow financial promotions to remain within the FSA regime.

Whilst superficially extra FSA regulation could appear unattractive, there are potential benefits to AFB members, the wider industry and to consumers. It should also be noted that FSA are at present considering the implications of a possible NewMCOB sourcebook, following on from revisions to both COBS and ICOBS regulation, and therefore this could be a good time to influence.

Consumer Protection

Allowing FSA to regulate second-charge loans would potentially provide significant benefits to consumers. Whilst at present FOS's CCJ does cover second-charge loans, consumers do not benefit from access to the Financial Services Compensation Scheme (FSCS) in the event of a firm passing into default. Under FSMA it is likely that FSA regulated second-charge loans would benefit from this. Consumers could also benefit from improved complaint handling procedures, as set out in the FSA handbook.

There could also be significant benefits to consumers who indirectly benefit from industry development – from examinations to flexibility in product design.

Change of Rules – Business and Commercial Opportunities

One significant potential benefit to changing regulators would be the opportunity to lobby for better regulation. It is unlikely that FSA would simply adopt the OFT

rules, and equally unlikely that they would merely change MCOB to include secured loans.

In an environment where much of MCOB is principle based, some elements can be consistent. However, it is also possible to secure opt-outs and alternative wording for certain sections. An example of this is Lifetime Mortgages and Home Reversion plans which have benefited from inclusion in MCOB but have specific rules relating to just this sector. They fit within the overall rules, but still have individual requirements where appropriate.

- Examples of changes that could be lobbied for include the ability to charge a client a fee if they do not proceed with a case. In an increasingly professional sector, it seems only logical that a professional broker should be able to charge a fee – as per a mortgage broker or accountant – for work completed even if it does not reach completion.

- It would also potentially allow flexibility with product design. Some consumers may like products with up-front fees and no Early Repayment Charges (ERCs), but others may prefer ERCs but no up front fees. MCOB currently has few prescriptive rules relating to product design – transparency and Treating Customers Fairly being priorities – so a new regulator could open up new product design options.

- It is also possible that with careful lobbying it would be possible to change rules relating to consideration periods, bringing secured loans more inline with mortgages. This could potentially allow speedier transactions for those that desire them.

- Many firms struggle with the conflicts between the advertising rules in CCA and the financial promotion rules from FSA. A single regulator would simplify promotional rules.

An unforeseen consequence of all of the above is that lenders might benefit form loans staying on their books for longer as they will be more closely aligned to customer requirements.

Supervisory Style

OFT at present remains comparatively under-resourced compared to the FSA, in particular with regard to enforcement teams. However, with the perceived high-risk status of secured loans and the extra powers available to OFT since April, it is likely that OFT will focus greater resource on the sector in coming months and years. We have already witnessed the new 37-page CRP forms for renewal or application for Consumer Credit Licences. Supervision by an organisation with significant resource can allow for a more transparent and manageable regulatory burden.

Regulatory Style

The regulatory style of the FSA and OFT clearly differ also. OFT remains focused on rules, which FSA tends to operate, where possible, on a basis of high level principles and accompanying guidance.

Many small firms prefer the certainty of rules, and can benefit less from the potential flexibility that guidance and principles, and the interpretation thereof can provide. However, this may benefit some larger firms who can challenge and interpret guidance.

Treating Customers Fairly

TCF remains a priority for FSA. The reality is that in excess of 90% of existing and all new AFB members are already FSA registered – for either insurance and/or regulated mortgage advice. Given that they therefore already have to adhere to a TCF regime the increased obligations would be minimal, although should be considered.

Industry Reputation

There are wider benefits to the industry reputation from FSA regulation. Consumers and consumer groups are likely to see a move to FSA – and alignment with first charge lending – as a positive, for the public policy reasons already discussed.

There are possibly wider benefits to the industry, as an improved perception of second-charge lending could lead to increased interest in products, and of increased acknowledgement of the sector. This could lead to other regulated parties – mortgage advisers and IFAs – becoming more aware of second-charge solutions.

Dual Regulation

Whilst for some firms – notably those involved in first charge mortgage advice – the transition to FSA could effectively sever links with OFT, we should be aware that AFB membership covers a wide range of firms.

There are advantages to dealing with only one regulator for first charge, second charge and insurance business and for some firms the transition to FSA will be beneficial. However, for firms perhaps not active in first charge broking but with involvement in debt management there is still the potential for some aspects of their business to be under the jurisdiction of OFT, whilst others to be governed by FSA.

Qualification Requirements

One area that requires careful consideration is that of qualifications. Mortgage advisers have professional qualification standards that must be met, and it may be undesirable if regulation forced second-charge brokers to hold CeMAP for example. However, as a developing sector this could be an opportunity for the industry to work with the Financial Services Skills Council (FSSC) or awarding bodies to develop formal examinations relevant to the sector. This could again add to the professional image of the sector.

Costs

There are also clearly cost considerations for firms. It is unlikely that firms would be able avoid CCL registration and it is possible that firms not-active in first-charge mortgages may find marginally increased FSA fees. However, for those that are it is possible that the inclusion of secured-loans could have little impact on existing minimum MCOB fees.

It is also possible that firms would experience changes in costs for Professional Indemnity Insurance (PII) – though again whether these increase or decrease with FSA regulation is still unclear. An enhanced professional image could actually be beneficial. Other costs such as standards bodies may be reduced with formal FSA regulation.

One final area of cost that should be considered is capital adequacy. FSA regulated firms are required under prudential rules to hold set levels of capital. These rules could have a detrimental effect on some firms, although it could also see the emergence of secured-loan networks, similar to those in existence in the mortgage and investment sectors. Conversely, firms already directly holding FSA authorisation may not need to hold further funds.

Conclusion

This White Paper is written as an educative document to provoke discussion amongst both AFB members and the wider industry.

Whilst the document outlines three possible implications of the Consumer Credit Directive, it is clear that the third option – FSA regulation – could be an extremely logical conclusion for the industry. It also potentially offers clarity to consumers, which must be at the heart of the decision on the future direction of the industry.

Whilst there are clearly pros and cons to each option, the closer we get to enactment of CCD requirements, fewer options may be available to firms. Indeed, BERR's own work so far appears to indicate that 'gold-plating' CCD requirements through the whole CCA is not preferable; with the increasing volatility of the housing-market, the public policy agenda also places increased scrutiny on any lending which fundamentally puts people's homes at risk. It is therefore increasingly unlikely that a two-tier CCA will be politically acceptable.

Whilst this document therefore concludes that FSA regulation may be a positive next step for the industry, it also raises many questions. The role of examinations, the format of rule-books and the requirements for fundamental changes to definitions within FSMA all encourage open debate and discussion.

The AFB Executive request feedback from member firms on the thoughts raised in this paper, and welcome an industry-wide open dialogue on the subject.

The priority for the industry must be to consider the future of the sector, and then to make a quick and decisive decision for the route forward. A united desire to produce the best outcomes for the sector and for consumers will allow representative groups maximum time to work with stakeholders and regulators to achieve these outcomes. Procrastination and disagreements could potentially weaken our industry.

To feedback to this White Paper please complete the questionnaire below and email comments to whitepaper@theafb.net by 30th September 2008.

Your Name:	
Firm Name (if applicable):	
Role:	
Email:	
Telephone:	
Number of advisers in firm:	
FSA authorised:	
AFB member:	
Do you support Option 1, 2 or 3?	
Do you consider there are elements of the FSA style of approach which could be incorporated into the CCA to assist the industry?	
Are there issues not covered, which you consider important?	