Regulated Mortgages

March 2012
Introduction

Since 31 October 2004, Regulated Mortgage Contracts have been subject to statutory control, supervised by the Financial Services Authority ("FSA"). Under Section 19 of the Financial Services and Markets Act 2000 ("FSMA") no person may carry on a regulated activity by way of business in the UK unless he is an authorised person or an exempt person.

The regulated activities are set out in Part I of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (as amended) and include:

• advising in connection with;
• arranging;
• administering; or
• entering into as a lender,
• a Regulated Mortgage Contract.

These statutory controls also apply to variations of Regulated Mortgage Contracts which come into effect after 31 October 2004. Whether a course of action results in a variation of an existing Regulated Mortgage Contract or an entirely new Regulated Mortgage Contract will be a question of degree.

Upcoming changes to the regime

The Government has announced that the FSA will be split into the Prudential Regulatory Authority, as an arm of the Bank of England, and the Financial Conduct Authority (the "FCA") by early 2013. In June 2011, an FSA news release stated that enabling legislation is planned for the end of 2012. The FSA also confirmed the newly formed FCA will regulate the provision of financial services and will be tasked with the delivery and implementation of the Mortgage Market Review.

In December 2011 the FSA published a consultation paper on the Mortgage Market Review as a whole. It is expected that the feedback statement and the final form of rules in respect of the Mortgage Market Review are to be published in summer 2012. Implementation would be by the FCA in 2013. However, it is likely the substantial reorganisation of the FSA will impact on time to implementation. The FSA will have regard to market conditions and may defer implementation if that proves necessary. If there is wide support for particular proposals, for example, in relation to mortgage charges, some aspects may be implemented sooner.

In the interim, the current rules continue to apply.

What is a "Regulated Mortgage Contract"?

A Regulated Mortgage Contract is one where, at the time it is entered into:

• the lender provides credit to an individual or trustee;
• the lender takes a first legal charge over property in the UK;
• at least 40% of the property by area is used or intended to be used as or in connection with a dwelling by the borrower, or the beneficiary of the trust (where credit is provided to a trustee), or a member of the borrower's or beneficiary's immediate family (i.e. spouse, partner whether or not of the opposite sex, parent, brother, sister, child, grandparent or grandchild). In assessing whether the required area is used in connection with a dwelling, reference is made to all associated land area and the aggregate floor areas of each storey within a building. Where a single charge is being taken over a portfolio of properties, the assessment will be made with reference to the total area of the entire portfolio.

In addition to residential mortgages, the term "Regulated Mortgage Contract" can extend to cover a wide range of loans where security is taken over residential property such as loans for home improvements (including, for example, some in-store credit), lending for debt consolidation, business lending to sole traders and partnerships in England and Wales, secured overdrafts, secured credit cards and bridging loans.

However, the 40% requirement means that the statutory controls will not apply to mortgages secured on most buy-to-let property, timeshare accommodation or mixed used property where the borrower/beneficiary or his immediate family occupy less than 40% of a dwelling (e.g. a farm or a public house). The statutory controls will also not apply to second charges on residential property, mortgages on commercial property, mortgages granted by limited companies, mortgages secured on overseas property or equitable charges.

Why was statutory regulation introduced?

Prior to 2004, mortgage providers (but not mortgage intermediaries) were subject to the Mortgage Code, a system of self-regulation by the industry. Although a
highly competitive industry, consumer groups reported that the complexity of documentation and wide variations in the information given to consumers by lenders were leading to confusion among consumers and a lack of understanding about which products were most suited to their circumstances.

HM Treasury believed that statutory regulation would improve consumer protection by ensuring that borrowers receive better quality and clearer information about mortgages, enabling them to make informed choices about mortgage products. The regulations therefore apply to all stages of a mortgage product’s life, from first contact to enforcement or repayment.

Regulated activities

If a mortgage comprises a Regulated Mortgage Contract, FSMA will apply to the lender and all intermediaries who are advising, arranging, entering into or administering that Regulated Mortgage Contract by way of business in the UK. In assessing whether a regulated activity is being undertaken by way of business, the FSA will consider:

- whether the activity is continuous;
- the existence of any commercial element; and
- the scale of the activity and its proportion to non-regulated activities.

This caveat effectively excludes from the scope of the statutory regime bodies who are engaged in advising, arranging, entering into or administering Regulated Mortgage Contracts for non-commercial purposes, such as charities, citizens’ advice bureaux and community law centres.

If a mortgage comprises a Regulated Mortgage Contract, consumer credit legislation will not apply to that mortgage.

Entering into a Regulated Mortgage Contract

A lender or any person who provides credit under a Regulated Mortgage Contract (including an assignee) will be carrying on the regulated activity of entering into a Regulated Mortgage Contract.

Advising on a Regulated Mortgage Contract

A person will carry on the regulated activity of advising on a Regulated Mortgage Contract where:

- they provide advice (rather than, for example, just information on a mortgage product);
- the advice is provided to a person in his or her capacity as a borrower or potential borrower (rather than, for example, advice in a publication intended for a general audience);
- the advice concerns a particular Regulated Mortgage Contract (rather than, for example, generic advice on the characteristics of a type of mortgage product); and
- the advice is on the merits of entering into the Regulated Mortgage Contract or varying the terms of an existing Regulated Mortgage Contract (if that existing contract was entered into after the regulated mortgage contract regime came into force on 31 October 2004).

Arranging a Regulated Mortgage Contract

There are two regulated activities relating to arranging regulated mortgage contracts. These are:

- Arranging for a potential borrower to enter into a Regulated Mortgage Contract or for a borrower to vary the terms of an existing Regulated Mortgage Contract (if that existing contract was entered into after the regulated mortgage contract regime came into force on 31 October 2004),
  
  For this activity, it is not necessary for the potential borrower to be involved in making the arrangements. This activity will only be carried on if the arrangements bring about, or would bring about, the Regulated Mortgage Contract.

- Making arrangements with a view to a person who participates in the arrangements entering into a Regulated Mortgage Contract as a borrower.
  
  For this activity, the potential borrower must utilise the arrangements to enter into the Regulated Mortgage Contract. However, there is no requirement for the arrangements to bring about a Regulated Mortgage Contract, nor does it cover arrangements leading to contract variations.

The definition of arranging is broad enough to include, for example:

- certain introductions (for example arrangements under which a builder or estate agent introduces customers to a lender in return for a fee or commission for each customer introduced);
- helping the borrower to negotiate, or negotiating on
the borrower's behalf, the terms of a Regulated Mortgage Contract with the lender; and

- helping a borrower to complete an application form and/or forwarding completed application forms to lenders where there is direct contact with the borrower.

**Administering a regulated mortgage contract**

Administering a Regulated Mortgage Contract which was entered into by way of business after 1 September 2002 is a regulated activity. For these purposes, “administering” a Regulated Mortgage Contract will include:

- notifying a borrower of changes in the interest rates payable or payments due under the Regulated Mortgage Contract; and
- taking any necessary steps for the purposes of collecting or recovering payments due under the Regulated Mortgage Contract.

A person will not be administering a Regulated Mortgage Contract merely because they have, or exercise, a right to take action for the purpose of enforcing that Regulated Mortgage Contract. In addition, a person will not be administering a Regulated Mortgage Contract if one of the statutory exemptions apply, for example:

- where the person is arranging for an authorised person to administer the contract; or
- if the person administers the contract for no more than one month; or
- if the person administering the contract does so pursuant to an agreement with an authorised person with permission to carry on that regulated activity.

**Authorised persons and authorised firms**

In order to be an authorised person under FSMA, the person or firm generally needs either to:

- have applied for and been granted permission by the FSA to carry on one or more regulated activities (referred to as "Part IV Permission"); or
- be a firm with so-called passport rights under European legislation entitling it to establish a branch or provide services in states which are members of the European Economic Area ("EEA").

An application to the FSA for permission to carry on one or more regulated activities may generally be made by any person or body, whether an individual, a body corporate, a partnership or an unincorporated association. Authorised persons are able to carry on the regulated activities for which they have been granted permission, subject to any requirements, modifications or other constraints imposed on their authorisation.

In granting Part IV permission or varying an existing authorised person’s Part IV Permission, the FSA has to be satisfied that the applicant satisfies certain conditions. These conditions include assessing the person's suitability, resources, and links to other persons which may affect the FSA's ability to supervise that person. As part of the application process, an applicant is required to provide a variety of information about itself, including its business plan. It will also be necessary to provide information about individuals within the organisation performing particular functions, who will need to be approved by the FSA to perform that function.

The planning of an application and the devising of a business model which complies with the FSA’s rules is a substantial exercise which will require significant time. There will then follow a period of consideration by the FSA. FSMA allows the FSA six months from the date of receipt of a completed application to make its determination, although in a straightforward case it may take as little as three months. Where an incomplete application is sent to the FSA, the FSA has 12 months from the initial receipt of the application in which to make its decision.

Fees will vary from £1,500 for straightforward applications to £25,000 for complex applications.

**Exempt persons**

Certain persons are exempt under FSMA and so do not need to become authorised persons in order to carry on regulated activities in the UK. The categories or ‘exempt person’ are fairly narrow, and include:

- the Bank of England and central banks of other EEA states;
- supranational bodies of which the UK or another EEA state is a member, such as the IMF or the European Central Bank;
- recognised investment exchanges or recognised clearing houses;
- appointed representatives (meaning persons who contract with an ‘authorised person’ to carry out certain activities (including arranging and advising on Regulated Mortgage Contracts) and for whom the
authorised person has assumed regulatory responsibility; and

- in relation to Regulated Mortgage Contracts, various housing bodies who are involved in the provision of social housing.

FSMA enables the FSA to allow certain professional firms to carry on certain regulated activities in the course of providing their usual professional services to their clients where that professional firm is permitted to do so by its professional body (which must be a ‘designated professional body’ for the purposes of FSMA). In such instances, the firm does not need to be authorised by the FSA but can carry on the exempt regulated activity under the supervision of, and regulation by, the relevant professional body (such as the Solicitors Regulation Authority for solicitors or the Institute of Chartered Accountants in England and Wales for accountancy firms) provided it complies with the provisions or codes issued by that professional body.

Disclosure and continuing obligations

In addition to limiting who can undertake regulated activities relating to Regulated Mortgage Contracts, the FSA regulates the advertising of products and requires that the borrower is given various standard form documents, including:

- **Key Facts Illustration** – the KFI must be sent to the potential borrower before he or she makes an application and must set out in a standard format prescribed information about the product, fees and commissions. The intention is that a potential borrower will then be able to compare like for like information given about a range of different products before making his or her choice;

- **Mortgage Offer** – this must also follow a prescribed form so that it can be compared easily against the KFI. Once the Regulated Mortgage Contract is in place, lenders are required to supply prescribed information to the borrower throughout the life of that product. There are also rules governing how lenders treat borrowers who are in arrears and how lenders deal with repossessions.

Effects of breach

There are various penalties if an authorised person has not complied with FSMA or an unauthorised person has been carrying out regulated activities without the benefit of an exemption:

- **Criminal offence under FSMA** – any person who carries out a regulated activity without permission is liable to imprisonment of up to two years and/or a fine. Any agreement made by a person who has been carrying on a regulated activity without permission will be unenforceable against the borrower;

- **Civil sanctions** – private persons (including the borrower) have a right to bring an action for damages for losses arising as a result of a breach by an authorised person of the FSA’s Mortgage Conduct of Business rules;

- **FSA powers** – the FSA has powers to investigate and take enforcement action including by initiating criminal prosecution, levying fines and/or taking disciplinary action against firms and approved persons which may include restricting their activities or removing their licence to trade;

- **Financial Ombudsman Service** – the borrower can complain to the Financial Ombudsman Service. The Service’s decision will bind the lender/intermediary although the borrower can still take action in the courts; and

- **Financial Services Compensation Scheme** – this Scheme is funded by compulsory levies on authorised firms but is free for use by borrowers. The FSCS is a compensation scheme of last resort that may pay compensation if an authorised firm becomes insolvent or ceases trading after a claim has been made against it.

The FSA has successfully exercised these powers, levying fines and securing redress for borrowers who have been unfairly treated.

Is the current statutory regulation working?

The FSA has been monitoring the effectiveness of the regime almost since its inception. Back in 2005, a secret shopper survey conducted by the FSA indicated that the majority of mortgage disclosure documents (i.e. the Initial Disclosure Documents and Key Fact Illustrations) did not comply with the FSA’s content requirements and a number of firms were not supplying the documents at the correct time. The FSA’s subsequent secret shopper survey in early 2006 found many examples of good practice but also found “significant flaws” in the advice process in a “disappointing number” of the authorised firms it reviewed. The more recent reviews following the financial crisis in 2008 have reaffirmed the FSA’s view that it is necessary to put in place measures to prevent the re-emergence of poor lending practices.
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