

Financial Services Authority

Mortgage effectiveness review

Stage 1 Report

September 2006



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Executive Summary

Overview

We began a review of the effectiveness of the mortgage regime at the end of 2005, in line with the commitment we made in 2004.¹

The review is looking at the effectiveness of the Mortgages: Conduct of Business (MCOB) sourcebook, against five consumer outcomes.

1. Consumers shop around for mortgages.
2. Consumers understand whether they are being given advice or information by firms.
3. Consumers better understand the risks and features of the mortgages they take out, including the affordability risks.
4. Consumers take out suitable and good value mortgages.
5. Consumers are treated fairly over the life of the mortgage, including when they go into arrears.

We have planned the review in stages, and we will look at different aspects of the regime at different points. We intend to identify trends and measure progress against the outcomes over time. The results of our research should be seen against a backdrop of relatively low financial capability across the general population – although there is some evidence to suggest greater financial capability in the mortgage market than in other financial markets. So any changes in consumer behaviour are likely to happen only gradually.

Scope of Stage 1

We began the first stage of the review in December 2005, and the findings and conclusions from this stage are detailed in this report. The focus of stage 1 was pre-sale disclosure and advice and selling standards. We felt it was too early in the regime to look at outcome 5 (above) in the first stage; we will cover this in the next stage of the review. We also plan to include work on suitability (part of outcome 4) in the next stage.

¹ Clive Briault: 'The lending landscape post October 31: the Financial Services Authority's view.' (7 Dec 04) www.fsa.gov.uk/Pages/Library/Communication/Speeches/2004/SP217.shtml

The effectiveness of the rules in achieving the intended outcomes relies, in the first instance, on compliance with the rules. We have therefore taken account of levels of compliance when drawing our conclusions. We do not have complete baseline data from before regulation, although we have drawn on industry surveys and other sources from this time where possible to aid comparisons. We intend to use our work in stage 1 as a baseline for the future – particularly to track changes in consumer behaviour.

Methodology

We targeted our questions from different angles, using different pieces of research to ensure our findings are robust (research triangulation). We commissioned three separate pieces of research: qualitative consumer research on mortgage disclosure; quantitative consumer research on the mortgage purchasing process and mystery shopping looking at both the advice process and information only (or non-advised) sales. We also carried out an in-house market analysis study looking at price dispersion and the efficiency of consumer purchasing decisions.

Key Findings

Outcome 1 – Consumers shop around for mortgages

Our quantitative consumer research has identified that the number of people obtaining product information from more than one firm has increased slightly from 75% in 2004 (Council for Mortgage Lenders: CML), to 77% in 2006. We have also recorded increasing numbers of consumers visiting the comparative mortgage tables section of our website². The average number of hits each month was 3000 in 2003 and rose to 7000 during 2006, after a successful consumer campaign (Mortgages Laid Bare) was launched in October 2005. This indicates that consumers are actively engaging in shopping around for mortgages.

The findings from our qualitative consumer research indicated that consumers are able to identify the key risks and features of mortgage products, and compare mortgages, using the Key Facts Illustration (KFI). Again, this should aid consumers' ability to shop around.

Our mystery shopping work found the average interview length was 47 minutes for a face-to-face interview, and 28 minutes over the telephone. Feedback from the mystery shoppers was that 61% felt the interview length was 'about right' and 21% of the shoppers felt it was slightly short, supporting the view that interview length does not act as a barrier to shopping around.

Additionally, remortgaging levels have remained high at around 38% in 2006 (CML), and remortgaging with the same lender has increased from 16% in 2003 to 23% in 2006 (GfK Financial Research Survey: GfK FRS³).

2 www.fsa.gov.uk/tables.

3 Formerly the NOP FRS survey.

Outcome 2 – Consumers understand whether they are being given advice or information by firms

Our mystery shopping work found that shoppers could understand whether they have received advice or information only, where they received an Initial Disclosure Document (IDD), or oral disclosure. However, firms failed to issue IDD in 26% of face-to-face interviews, and only 57% of telephone mystery shoppers recalled being told the level of service in interviews.

Our qualitative research showed that consumers find the IDD a useful and accessible document, and can identify and discuss key messages about the level⁴ and scope⁵ of service. This supports our belief that when an IDD is issued consumers are likely to understand whether they have received advice or information only.

Our mystery shopping work identified some instances where firms were unsure whether they were able to issue KFIs during advised sales when they were not recommending the product illustrated. However, we found no substantive evidence of advice being given in information only sales.

Outcome 3 – Consumers better understand the risks and features of the mortgages they take out, including affordability risks

Our qualitative research found that consumers can use the KFI to identify and discuss the risks associated with taking out a mortgage; the consumers reported that they felt the KFI was a useful prompt for further questions. Additionally, we received positive feedback on our affordability leaflet, which sets out the issues related to interest rate risk. Consumers in the qualitative research reported that they found the leaflet engaging and accessible.

26% of consumers in our quantitative research who definitely recalled receiving a KFI confirmed it had made them consider the risks of taking out the product, and 37% used it to decide if it was the right mortgage for them.

The KFI is intended to help consumers understand the full range of features associated with their mortgage, and although price remains a key factor (41% of consumers made their final decision based on price), it is encouraging that we found many consumers are also considering the risks and other features of mortgages.

Outcome 4 – Consumers take out suitable and good value mortgages

This is a longer-term outcome, and we will draw on thematic work looking at the Quality of the Mortgage Advice Process to provide evidence against this outcome in the next stage of the review. Our analysis of market data suggests that consumers have continued to make efficient purchasing decisions since regulation, although there is no evidence so far of an increase in efficiency. We have found that price dispersion remains fairly constant and there is evidence of an increase in prices.

4 The level of service includes whether the firm is providing advice or information only.

5 The scope of service includes whether the firm is selecting products from the whole market, a limited number of lenders, or one lender/their own products only.

One of several possible explanations for this is a competitive market before and after MCOB, whereby firms have passed on additional costs of regulation to borrowers.

There has also been an increase in the range of features in mortgage products, which may have led to more suitable mortgage products being available for some consumers. We will look more closely at suitability in the next stage of the review.

Next Steps

We have not identified any areas where we feel rule changes would be appropriate in stage 1 of the review. This accords with feedback we have received from the industry which has made clear that there is no appetite for piecemeal changes to MCOB.

We are also mindful that any future changes to MCOB will need to take account of any proposals in the European Commission's White Paper on mortgages due in 2007. Any future proposals on disclosure or advice would need to take account of any proposed European intervention.

However, we will scope the next phase of the mortgage effectiveness review with a clear focus on the Better Regulation agenda. We will look to actively engage stakeholders in helping us to identify where there are any areas of MCOB that we could look to simplify or move further towards a Principles based regime.

The next phase of the review will focus on the sub-sectors of the mortgage market where we believe there is more likely to be consumer detriment – this will include lifetime mortgages and the sub prime market.

In the next stage of the review we also plan to consider the fifth consumer outcome – 'consumers are treated fairly over the life of the mortgage, including when they go into arrears'. As part of this we will look at post sale disclosure, and arrears handling.

We will set out our detailed plans for stage 2 of the review in early 2007.

Introduction

Background to the review

We began regulating mortgage lending, sales and administration on 31 October 2004.

We announced in December 2004⁶ that we would begin an effectiveness review of the mortgage regime at the end of 2005. Effectiveness reviews are part of our approach to Better Regulation, seeking to ensure that major policy interventions in the market are making a real difference in practice.

In November 2005, we set out the scope of the first stage of the review, and the approach we were proposing to take⁷. We discussed these plans with our stakeholders from the industry and consumer groups, who provided valuable feedback on what we were proposing, and how we might best go about this.

What type of post-implementation review?

The benefits the regime seeks to achieve depend on firms complying with the rules, but our supervisory and thematic work during the first year of regulation showed that compliance was taking time to bed down. In addition, some of the objectives of the regime, in particular changes in consumer behaviour, are necessarily longer term. So we concluded that carrying out a cost benefit analysis (CBA)⁸ after just a year of regulation was unlikely to give us a true picture of the benefits of the regime.

Therefore, the review will seek to measure the impact of the policy over time, in a way that takes account of the unevenness of compliance across the whole market and the longer-term nature of some of our objectives. We will do this in stages, looking at different aspects of the regime at different points. This report summarises the findings and conclusions of the first of these stages.

6 Clive Briault: 'The lending landscape post October 31: the Financial Services Authority's view.' (7 Dec 04) www.fsa.gov.uk/Pages/Library/Communication/Speeches/2004/SP217.shtml.

7 www.fsa.gov.uk/Pages/Library/Communication/PR/2005/116.shtml.

8 Looking at the actual costs incurred and the benefits that had been realised as a result of the policy intervention.

The intended consumer outcomes of mortgage regulation

The review will measure progress against the consumer outcomes established for the mortgage regime. The key rules seeking to achieve these outcomes are in the Mortgages: Conduct of Business (MCOB) sourcebook, which was ‘designed to address the potential causes of consumer detriment FSA identified in the mortgage market’⁹. The review’s focus is therefore on measuring the impact and effectiveness of MCOB. In stage 1 we looked at disclosure and our ‘advice and selling’ standards.

We are looking at the effectiveness of the regime, against five consumer outcomes within the review¹⁰.

1. Consumers shop around for mortgages.
2. Consumers understand whether they are being given advice or information by firms.
3. Consumers better understand the risks and features of the mortgages they take out, including the affordability risks.
4. Consumers take out suitable and good value mortgages.
5. Consumers are treated fairly over the life of the mortgage, including when they go into arrears.

Scope of stage 1

We felt it was too soon to consider the fifth consumer outcome (looking at the life of regulated mortgage contracts) in stage 1 of the review. In addition, the limited number of regulated mortgage contracts¹¹ to have gone into arrears or have reached the stage of repossession would make it difficult to assess the impact of these rules in the first stage. However, we intend to look at this outcome in the next stage of the review, if there is sufficient data available.

We have focused on the overall mortgage market in the first phase of the review. While we have gathered some information on sub-prime mortgage lending¹² and lifetime mortgages, we did not anticipate looking at these areas in detail in the first stage. In the next stage we will focus our attention on some of the different market sectors, where the risks, consumer, or product characteristics may differ significantly.

We also committed to consider the recommendations of the Miles Report ‘on measures relating to the provision of advice and to the disclosures provided by firms to consumers’¹³, particularly in relation to interest rate risk. We discuss this further under Outcome 3 within the Stage 1 Findings section of this report.

9 From CP186.

10 See note 7.

11 Those taken out on or after 31 October 2004

12 Lending to consumers with impaired credit histories.

13 See footnote 1.

Performance Indicators

We developed a series of performance indicators against each of the outcomes, and have included these in full at **Annex 1**. We also refer to these indicators within the Stage 1 Findings section of this report.

Establishing a baseline

We do not have a complete baseline before mortgage regulation with which to draw comparisons, but where appropriate we have used data produced by other organisations to compare our results against. In some cases, regulation has introduced something new to the mortgage process (for example standardised disclosure documentation). Rather than making a comparison with the situation before regulation, we have looked to establish a baseline that we can repeat in the future as part of a longer-term trend analysis.

Financial capability

Our baseline study of financial capability¹⁴ revealed that mortgage holders were generally more capable when choosing financial products than non-mortgage holders. Those who had taken out a mortgage within the last five years had higher financial capability scores for choosing products than mortgage holders who had not.

Respondents who had recently bought a mortgage scored considerably higher on the financial capability rating when choosing products than people who had purchased less complex products (with the exception of investment products, which scored similar to mortgages).

14 Financial Services Authority/PFRC University of Bristol/BMRB (2005). Survey conducted June to September 2005, total sample size 5,328 respondents aged 18+.

Methodology

We used a methodology that would allow ‘research triangulation’. This involved targeting questions from several different angles, through different pieces of research, to try to ensure the validity and robustness of our results. We commissioned three consultancy firms to conduct the following specific pieces of research¹⁵:

- qualitative consumer research on mortgage disclosure (CR1);
- quantitative consumer research on the mortgage purchasing process (CR2); and
- mystery shopping looking at both the advice process and information only (or non-advised) sales (MS 2006).

We also carried out an in-house study, which analysed market data, looking at price dispersion and the efficiency of consumer purchasing decisions, to identify any changes since regulation (MAS).

Qualitative consumer research (CR1)

We commissioned the British Market Research Bureau (BMRB) to carry out this research. It looked at 70 consumers in the market for a mortgage, or who had taken out a mortgage within the last three months¹⁶. We asked consumers to look at either the Initial Disclosure Document (IDD) and the FSA’s affordability leaflet, or two Key Facts Illustrations (KFIs). We used anonymised documents from four prime lenders and one sourcing system¹⁷ (all identifying logos and text were removed).

We asked respondents to provide details of the mortgage they were looking for, including: amount of loan required; value of property; term of mortgage; and interest only or repayment mortgage. We then asked the lenders and sourcing system to provide us with KFIs matched to these requirements. Each respondent was given a KFI to read and discuss with the interviewer, and then a second KFI from a different lender was introduced. The KFIs illustrated similar products with some key differences – for example on rate and/or features.

15 These are available on our website www.fsa.gov.uk

16 A further 30 consumers who had an interest in a lifetime mortgage were recruited to look at understanding and use of the lifetime mortgage KFI (taking the overall sample to 100). However, this element of the research will be included within the next phase of the review when we carry out further work on the lifetime mortgage market.

17 We used a sourcing system as well as KFIs directly issued by lenders because many brokers get their KFIs this way.

Respondents in the group looking at the IDD were asked to bring the IDD they had received during their mortgage sale with them. Where they did not have their own IDD (either because they had not received one or had not kept it) a sample version from a lender was used¹⁸.

The key issues were:

- can consumers understand and use the IDD;
- can consumers understand and use the KFI;
- can consumers compare more than one KFI; and
- can consumers use the KFI to identify the risks and features of mortgage products.

Quantitative consumer research (CR2)

This research was carried out jointly by the Henley Centre Headlight Vision and BMRB, as part of a wider piece of FSA research on consumer purchasing behaviour in the retail financial market. We extended the mortgage element of this survey to recruit a sample of around 500 respondents (we recruited 481 in total). This was a sufficiently large sample for it to be statistically valid to report the findings as percentages. The key issues were:

- the extent to which consumers shop around for a mortgage;
- the number of consumers obtaining more than one KFI before taking out a mortgage;
- the number of consumers who read the KFI(s) they received;
- the extent to which consumers used KFIs to compare mortgage products; and
- the number of consumers who sought advice when looking for a mortgage.

Mystery shopping (MS 2006)

GfK carried out 348 mystery shops across both the prime and sub-prime mortgage market, via telephone and face-to-face, to both lenders and intermediaries.

	All	Telephone	Visits
Lenders	90	46	44
Intermediaries	258	81	177
Total	348	127	221

We were interested in looking at the regulated sales process, and gathering information on consumer perception and understanding. The agency forwarded all the documentation received by the shoppers so we could crosscheck their recollections. We also received the audio recordings from the face-to-face assessments¹⁹. The key issues were:

18 Since there is very little difference between an IDD from a lender and one from an intermediary, we used just one example from a lender where consumers did not have their own IDD.

19 We do not covertly record the telephone interviews for legal reasons.

- do consumers understand whether they have received advice or information-only;
- are firms who provide information-only sales ensuring they do not cross the line into advice;
- does interview length act as a barrier to shopping around; and
- are consumers who receive advice asked for sufficient information about their needs and circumstances to enable the adviser to recommend the most suitable product.²⁰

Market Analysis Study (MAS)

To provide some market context for the work we were undertaking, we carried out an in-house study looking at consumer consumption efficiency and price dispersion in the mortgage market. A summary of the methodology used for this work is included in **Annex 5**, and the main findings are summarised under outcome 4.

20 We are looking at this issue in a Thematic review of the Quality of the Mortgage Advice Process, using the mystery shopping data (MS 2006). We will draw on findings from this project in the next stage of our review.

Stage 1 Findings

Outcome 1: Consumers shop around for mortgages

Consumers gather information from more than one source (ind. 1)

Consumers who want to get a good mortgage deal generally need to shop around, or go to an intermediary who will search the market for them. To judge the extent of shopping around we surveyed consumers who had recently taken out a mortgage²¹. We found that 77% had received product information from more than one firm

A similar survey by the Council for Mortgage Lenders (CML) in 2004 found that 75% of consumers had received information from more than one firm. This suggests that consumers are actively engaged in shopping around.

We asked consumers in our survey which information and advice sources they found helpful when considering which mortgage to take out. Of greatest importance were independent financial advisers/mortgage brokers; other professionals (e.g. solicitors, accountants) and friends/relatives (only 26% of the consumers surveyed did not refer to any of these sources).

In addition, 44% of the consumers in the survey²³ had obtained generic leaflets or brochures from lenders, and 18% had looked at best-buy tables – although only a small proportion felt that these were the most important sources of information they consulted.

21 CR2.

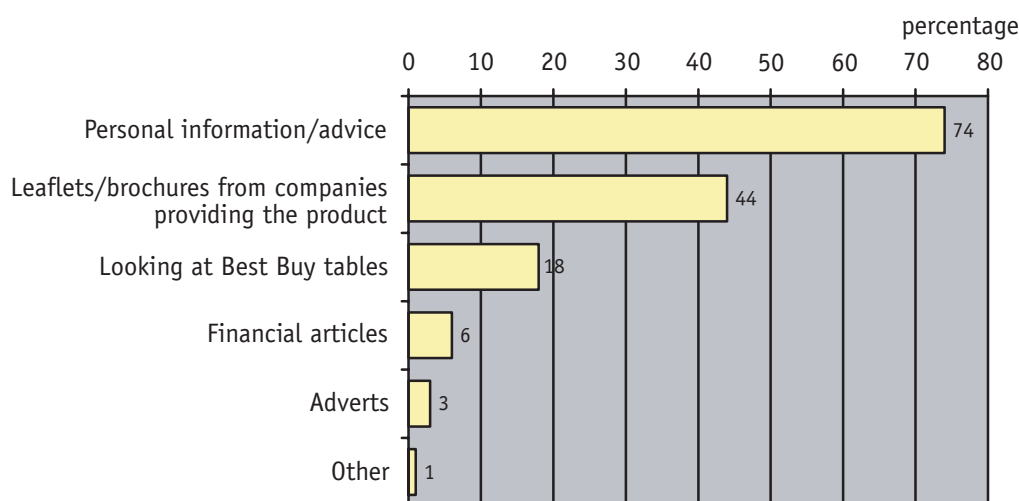
22 CR2.

23 CR2.

Figure I

Information/advice obtained in connection with the mortgage purchase (CR2)

(Note: respondents could choose more than one category)

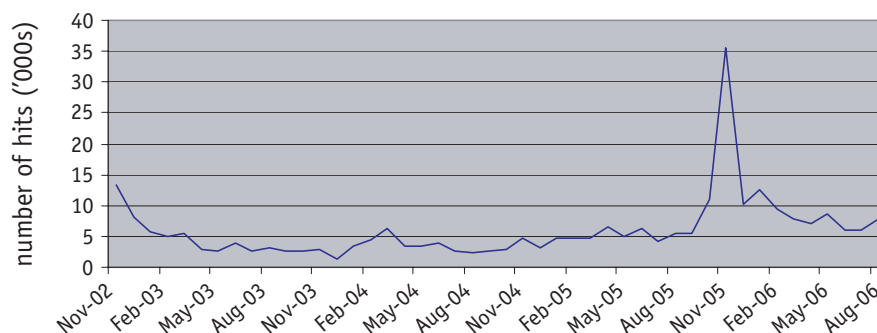


Base: All who have taken out a mortgage in the last 12 months (481)

Our website has a mortgage ‘comparative tables’ section²⁴ where consumers can search mortgage rates from a range of lenders, to help them shop around. We monitor web traffic to these tables, and found they averaged 3,000 hits per month in 2003, peaking at the end of 2005 while our Mortgages Laid Bare Campaign²⁵ was running. During 2006, the figure (to August) has been approximately 7,000 hits per month.

Figure II

Hits on FSA mortgage comparative tables



We also asked questions to establish consumer perception of the mortgage information available, and the impact of this on their ability to compare products²⁶. The results were encouraging, with 74% of consumers stating it was easy to compare information about mortgages from different firms, and 82% reporting it was easy to work out which information is really important. However, 31% felt they received too much unnecessary information, and 42% felt there was too much choice available – see Figure III.

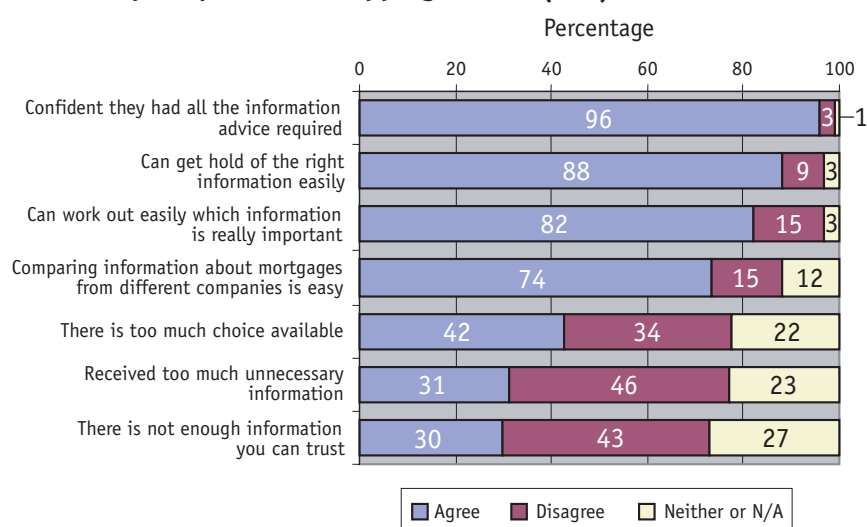
24 www.fsa.gov.uk/tables.

25 www.mortgageslaidbare.info/.

26 CR2.

Figure III

Consumer perceptions of shopping around (CR2)



Base: All who have taken out a mortgage in the last 12 months (481)

Using a mortgage intermediary who can search a number of different lenders and products is another way consumers can shop around for mortgages, so an increase in intermediated sales may be a proxy for shopping around.

Our quantitative survey²⁷ found that 57% of consumers used a mortgage intermediary, which represents an increase since 2003, where the figure from a similar survey (GfK FRS) was 42%.

Product Sales Data (PSD) submitted to us by mortgage lenders also shows that intermediated sales now represent approximately 58% of the market. In 2003, intermediaries accounted for just fewer than 40% of sales (Datamonitor)²⁸.

Feedback from our mystery shoppers²⁹ found satisfaction levels for both direct and intermediated mortgage interviews was high:

- 94% (242) of the 258 shoppers who saw an intermediary thought the firm was professional; this was 97% (87) of the 90 shoppers who saw a lender.
- 78% (201) would recommend the intermediary they saw; this figure was 84% (76) for lenders.

It is of course important to note that rapport building and ‘soft skills’ are likely to significantly influence consumer satisfaction. In terms of consumer perception, this may be as influential as the mortgage interview being – in regulatory terms – fully compliant and leading to a suitable recommendation (if applicable). We do not have a comparable measure of consumer satisfaction from before regulation. However, as a general indication of how consumers view the mortgage process post-regulation, this is encouraging.

27 CR2.

28 UK Mortgage Intermediary Distribution 2004 (Report January 2005).

29 MS 2006.

Consumers receive compliant KFIs (ind. 2)

One of the aims of mortgage regulation was to help consumers compare mortgage products between firms through a requirement for a standardised Key Facts Illustration (KFI) – see **Annex 2** for an example.

We prescribe the format and much of the content of the KFI. This means that a consumer who wishes to compare two products from different lenders can do so because the illustrations will follow the same structure. The KFI also uses our ‘Key Facts’ logo to help consumers recognise it is an important document to read.

The KFI is a short³⁰, straightforward document that sets out the key facts about a specific mortgage product in enough detail to allow comparisons to be made with other products. It is personalised to the consumer, so to produce a KFI the firm needs to have certain pieces of information, including: the loan amount required; the value of the property; and the term required. The KFI also confirms whether the firm is recommending the product.

The MCOB rules state that firms should issue a KFI when certain trigger events occur. These are:

- where a firm makes a personal recommendation to the consumer to take out a particular mortgage;
- where a firm provides written information specific to the amount that a consumer wants to borrow on a particular mortgage; or
- where the consumer requests written information specific to the amount they want to borrow on a particular mortgage.

The effectiveness of the KFI clearly relies in the first instance on compliance with these rules. However, mystery shopping in 2005 showed that many firms were not providing the KFI documents at the right time or in the correct format. Our follow-up desk-based review in 2006 found that the quality of mortgage disclosure documentation had improved over the past year. Large mortgage lenders are now on course to meet required standards by autumn 2006. However, this follow-up work found that more than 25% of the KFIs issued by small- and medium-sized intermediaries and small lenders still contain material errors relating to fees and charges.

Our recent mystery shopping work (MS 2006) found that KFIs were issued in 66% (121) of 183 face-to-face interviews, and 40% (44) of 109 telephone interviews³¹.

Consumers can use KFIs to compare different mortgage products (ind. 3)

Before mortgage regulation, we consumer-tested mocked-up KFIs³², and findings from this research shaped the final template, which forms part of the MCOB rules. As part of the review, we wanted to test the extent to which consumers were able to understand

30 We have suggested no more than five pages for a standard mortgage product.

31 We have excluded from these figures any mystery shops where we would not have expected a KFI to be issued, using the ‘trigger’ criteria described earlier.

32 Published in CP78 and CR14 (Reflexions Communication Research: 2002).

and use ‘real’ KFIs, using examples from lenders. This was particularly important because we do not prescribe the text for all sections in the KFI (lenders use their own descriptions in several sections) and we were interested to see how consumers found these. We conducted qualitative, in-depth consumer interviews³³ with a cross section of 50 consumers who were in the market for a mortgage to assess whether they could:

- identify the risks and features of a mortgage product using a KFI; and
- compare two mortgage products using KFIs.

Consumers reading the first KFI commonly identified three messages that they considered to be most important to them (often to the exclusion of information within the other sections):

- the amount of the loan;
- monthly repayments; and
- the risks.

Generally, consumers did not identify that the KFI was intended to assist comparisons between mortgages, despite this being stated at section 1.³⁴ However, in a ‘real’ mortgage interview, the firm would be more likely to introduce KFIs as they discussed the features of different mortgages, which would lead more naturally into a comparison of one against another. We found that once the second KFI was introduced many of the consumers in this research made spontaneous comparisons between the two; and when asked to pick out any differences they felt were important, they highlighted at least some of the following:

- the interest rate;
- the monthly payments;
- the total amount payable;
- the fees payable; and
- the loan term.

There were some areas where the consumers had difficulty understanding sections of the KFI, and these were mainly where the lender or sourcing system had used technical/legal language or jargon in their descriptions. This was particularly noticeable in the sections on fees and charges. While, overall, the ‘real’ KFIs tested well, it is clear that firms should take care to ensure they are using plain English descriptions, as this can otherwise undermine consumer understanding.

33 CR1.

34 ‘Ensure that you obtain other illustrations if you want to compare this mortgage with mortgages from other lenders’

Consumers read KFIs (ind. 4)

Consumers obtain more than one KFI before choosing a mortgage (ind. 5)

The findings above showed that consumers are broadly able to understand and use 'real' KFIs in a research situation, so the next step was to establish how consumers in the actual mortgage process were using them. Consumers who had taken out a mortgage in the last 12 months³⁵ were asked whether they recalled receiving a copy of the KFI. We found:

- 79% remembered receiving one (60% 'definitely'; 19% 'probably'); and
- 54% of those who said they had definitely received a KFI received more than one.

A CML survey carried out in 2005³⁶ found that 66% of consumers remembered receiving the KFI, which seems to support our finding that since regulation came in there has been a gradual increase in compliance in issuing KFIs.

The 79% figure³⁷ is higher than our latest mystery shopping (MS 2006) figure, where KFIs were issued in 66% of face-to-face interviews, and after 40% of telephone interviews. There is more than one possible explanation for this – firms not providing KFIs at the first interview but doing so at the second meeting; or general recall issues by consumers. If the issue is recall/recognition, then comparing the CML consumer survey with our quantitative survey should mitigate this in part, as both are subject to this limitation.

46% consumers of the consumers who had definitely received a KFI had read it in great detail and 35% had read it in a fair amount of detail .

Consumers who definitely recalled receiving a KFI used it in three main ways (see **Figure IV**)³⁹:

- 37% of consumers used it to decide whether it was the right mortgage for them;
- 32% used it to compare mortgages; and
- 26% said it made them consider the risks of the mortgage.

35 CR2.

36 CML (2006) – *Mortgage regulation – spot the difference?* British Market Research Bureau.

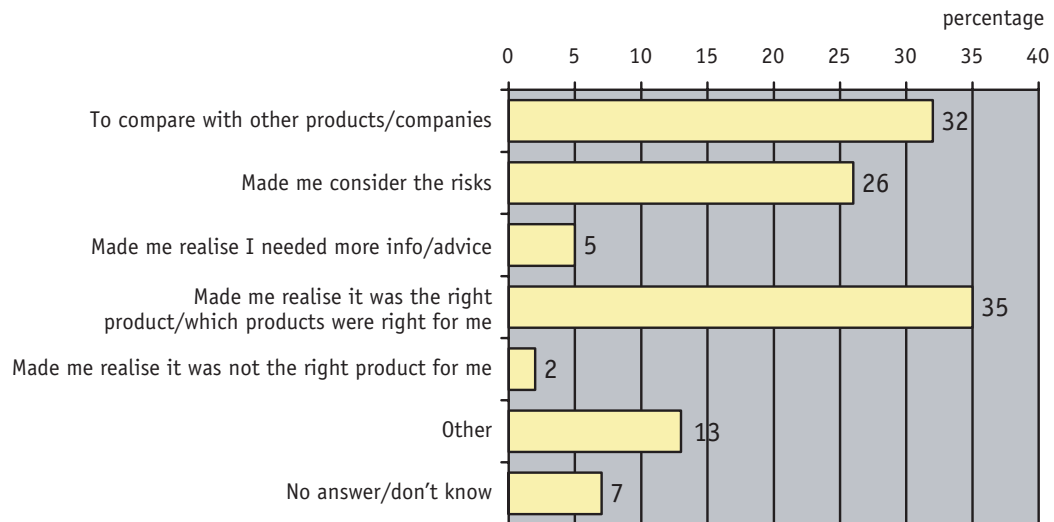
37 CR2.

38 CR2.

39 CR2.

Figure IV

Consumers using the KFI (CR2)

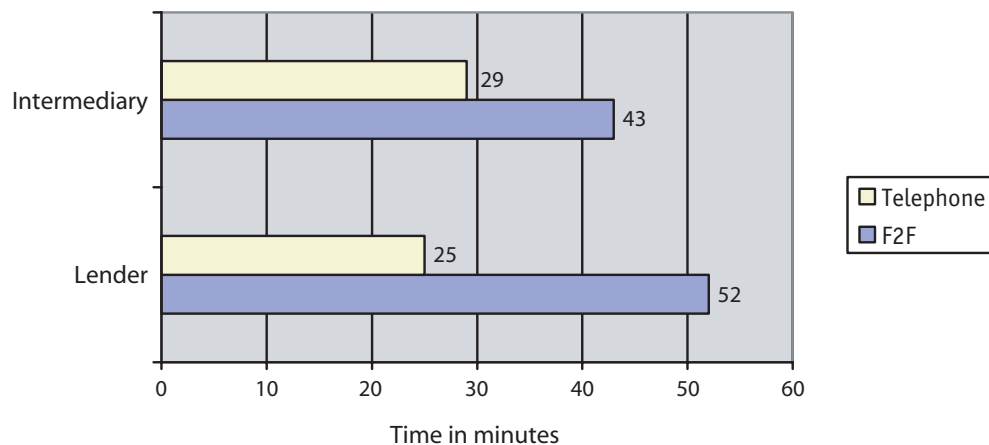


Base: All who have definitely received a KFI document (281) – consumers could pick more than one answer

Interview length does not act as a barrier to shopping around (ind. 6)

Feedback from our meetings with trade bodies was that interview lengths had increased since regulation was introduced, creating a potential barrier for consumers shopping around. We were able to collect detailed information about the length of mortgage interviews⁴⁰ from our 348 mystery shopping assessments (MS 2006). The average interview length was 47 minutes for a face-to-face interview and 28 minutes for telephone interviews.

Figure V



Base: 348 mystery shopping assessments

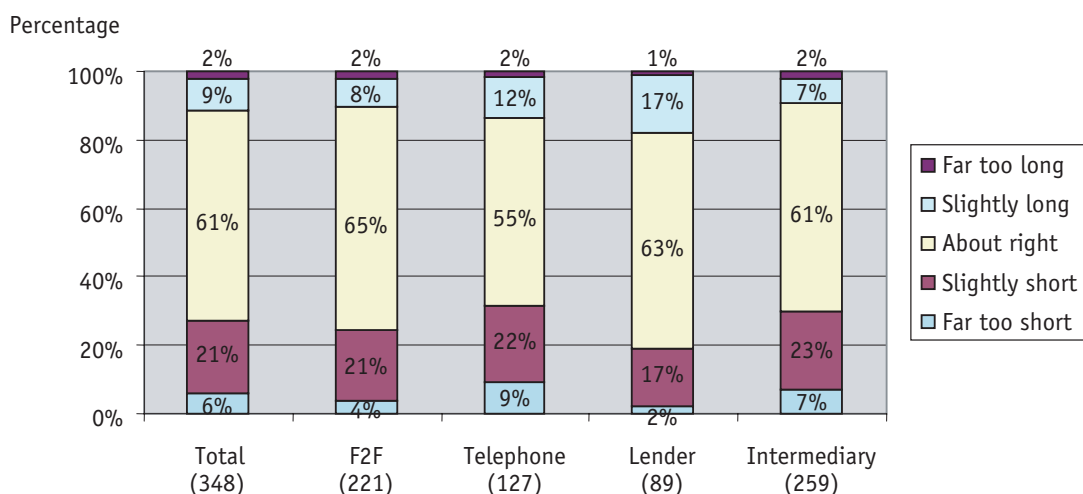
40 Obviously, as these were mystery shops they did not include the application stage of an interview – but for the purposes of shopping around a consumer does not need to go beyond receiving a KFI, so the initial interview was sufficient for our purposes.

We do not have comparable baseline data from pre-regulation to measure whether there has been an increase in the length of mortgage interviews. However, we conducted qualitative assessments of the longest 10% of interviews to determine why these interviews were longer than the others in our sample. From this it was clear that the main factors were lengthy periods of rapport building, and/or technical problems such as with printers/PCs (and not related to regulatory requirements).

Regardless of whether interviews have increased in length, consumers' perception is an important factor in assessing the impact of interview length on shopping around. We found that 61% of the mystery shoppers (MS 2006) felt that the length of the mortgage interview was about right, and a further 21% felt it was slightly short. This, along with an increase in the number of consumers seeking information from a number of firms, lends support to the view that interview length does not act as a barrier to shopping around.

Figure VI

Mystery shopper perceptions of mortgage interview length (MS 2006)



Consumer switching is efficient (ind. 7)

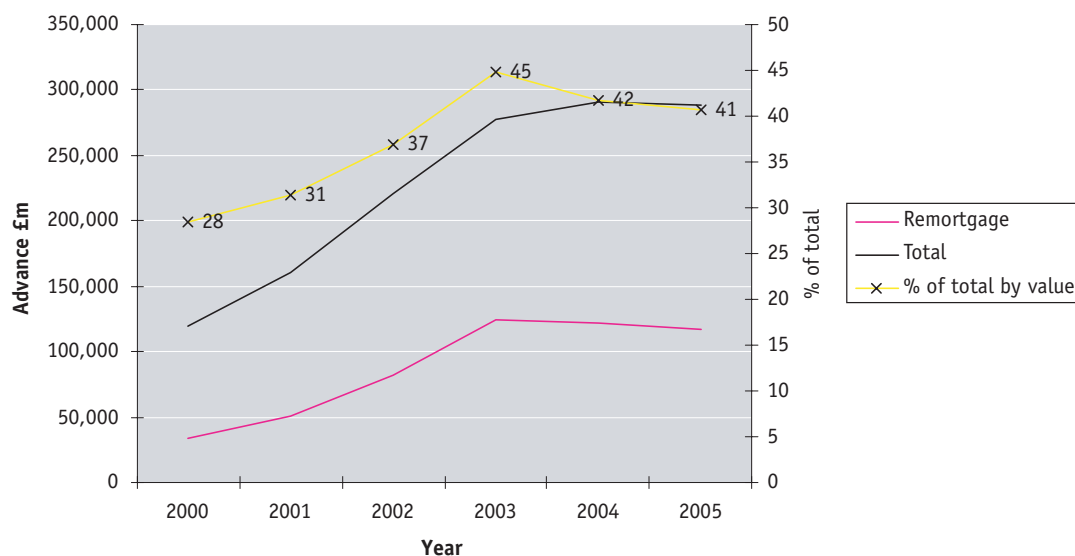
Consumer switching or remortgaging may be a useful proxy for consumers shopping around as it indicates whether people reconsider their mortgage after the initial purchase. This represents an opportunity for the consumer to look for a better deal, and may indicate they are being proactive and engaging in the market.

However, it should be noted that remortgaging can be an ambiguous indicator, as looking for a better deal is not always the primary driver in consumer remortgaging. For example, another objective of remortgaging can be to release equity.

Levels of remortgaging have increased substantially over the last five years. Figure VII shows this increase peaked before the introduction of regulation at 45% of total sales in 2003 (CML). Latest CML figures, from the first two quarters of 2006, show that remortgaging levels remain high at around 38% of total sales.

Figure VII

Remortgaging Levels (CML data on gross mortgage lending)



These remortgaging figures do not capture those borrowers who have switched products but have stayed with the same lender. The GfK FRS consumer omnibus survey has recorded an increase in the number of consumers who have remortgaged with their existing lender in this way. 23% of consumers surveyed in the first half of 2006 have remortgaged with the same lender; an increase from 16% of consumers surveyed in 2003⁴¹.

While the strong rise in remortgaging pre-dates mortgage regulation, there is no evidence to suggest that introducing regulation has discouraged people from remortgaging or reversed this trend.

Fees

The transactional costs of switching mortgage products in the prime market have increased since the introduction of regulation (MAS). We have identified an increase in set up fees and exit administration charges between 2003 and 2005. **Figure VIII** shows that set up fees have increased on average from £281 in 2003 to £430 in 2005. **Figure IX** shows that exit administration charges have increased on average from £98 in 2003 to £184 in 2005. We discuss this in more detail under Outcome 4.

Although it now costs more to switch from one mortgage to another, data on remortgaging shows this has not deterred consumers from switching.

41 Data from omnibus survey GfK FRS (2003 and 2006).

Figure VIII

Average Set up Fees (FSA Comparative Tables)

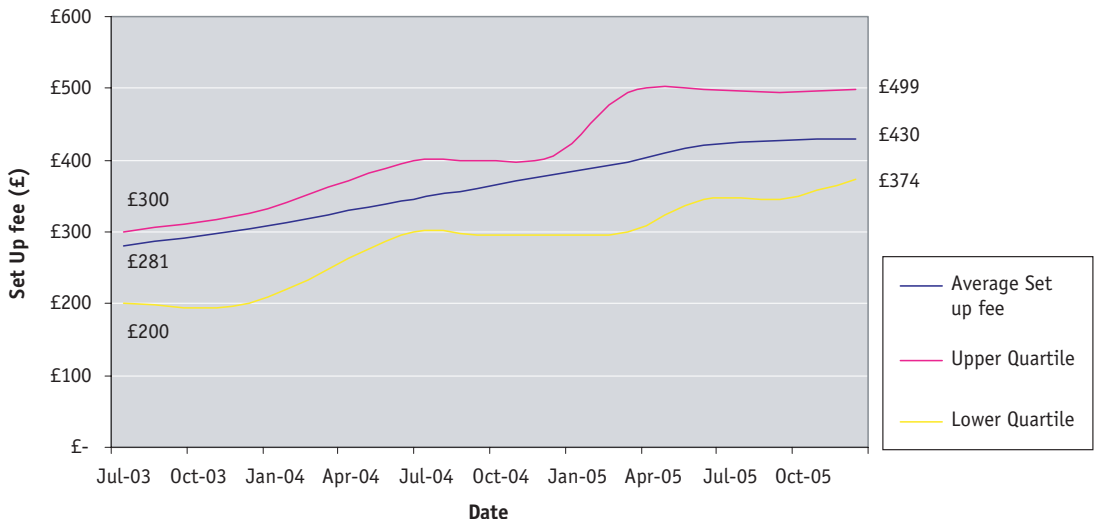
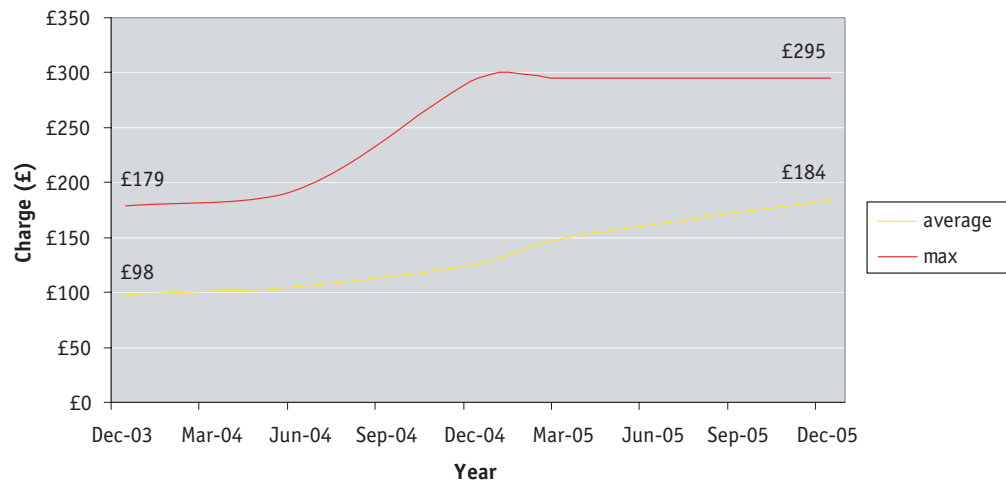


Figure IX

Exit Charges (Sample of charges from top 20 lenders by volume; source: MoneyFacts)



Outcome 2: Consumers understand whether they are being given advice or information by firms

When a firm anticipates giving personalised information or advice on a regulated mortgage contract, MCOB requires that consumers are given (on initial contact) a document that sets out the service they will receive. This Initial Disclosure Document (IDD) sets out:

- the scope of service - whether a firm will select products from the whole market, a limited number of lenders, or a single lender/their own products only;
- the level of service - whether the consumer will receive advice or information;
- whether a fee will be charged for the service; and
- under what circumstances the fee is refundable.

The layout of the IDD is mandatory, and we prescribe most of the text so the document is comparable between firms. (To view a sample IDD, see Annex 3).

One of the key reasons for providing consumers with the IDD is so they are aware from the outset (particularly before any fees are charged) what level of service they will receive.

Consumers receive compliant IDDs (ind. 8)

Mystery shopping in 2005 found that 80% of the firms sampled had five or more errors in their IDDs. Supervisors worked with firms over the following months to improve compliance⁴². Follow-up work in 2006 found that large lenders are on course to meet the required standards by autumn 2006, and smaller lenders produced IDDs of an adequate standard. However, more than half of the intermediary IDDs reviewed contained five or more errors.⁴³

Consumers understand and can use the IDD (ind. 9)

We also carried out qualitative research⁴⁴ to test consumer understanding of 'real' IDDs with consumers who had recently taken out a mortgage. This research found that consumers could identify and discuss the key messages of the IDD, finding it a generally useful and accessible document.

Consumers were able to identify the level and scope of service being provided by the firm, although they did not usually identify that one of the purposes of the IDD was so they could compare the services offered by different firms. The discussion tended to focus on the scope of service, with consumers interested in the distinction between whole-of-market advisers and those selecting products from a limited range of lenders. There was much less discussion of the implications of receiving advice.

42 By giving individual feedback, and providing templates and example documents on our website - see www.fsa.gov.uk/Pages/Doing/small_firms/mortgage/disclosure/index.shtml

43 www.fsa.gov.uk/pages/Library/Communication/PR/2006/064.shtml.

44 CR1.

Although a small number of consumers said they would always want to get advice, there was little engagement with the idea that not all firms would give advice, or what it would mean to receive information only.

The consumers generally saw the IDD as a useful prompt for asking questions about the service, and as a reference document, in case they had a complaint about the service received.

Consumers are informed about the level of service at the right time/upon initial contact. This is orally in a telephone interview and via IDD in a face-to-face interview (ind. 10)

MCOB also requires all firms who conduct face-to-face interviews to provide an IDD on initial contact. In telephone interviews they are required to disclose key pieces of the IDD information orally (e.g. about the scope and level of service), and send out an IDD afterwards⁴⁵.

Mystery shopping in 2005 found that an IDD was not provided in more than half of assessments (26 out of 45 shops), and where it was given out this was not always at the right time.

Our mystery shopping in 2006⁴⁶ found that IDDs were issued in 74% of face-to-face interviews, and shoppers recalled being told the level of service in 57% of telephone interviews. Firms failed to send out IDDs after telephone interviews in 64% of cases.

There were some differences between firms, but both lenders and intermediaries failed to issue IDDs in a number of cases. Lenders did not issue IDDs in 23% of face-to-face interviews and 50% of telephone interviews; intermediaries did not issue IDDs in 27% of face-to-face interviews and 72% of telephone interviews.

CML research in 2005 found that 45% of consumers recalled receiving an IDD. Our quantitative survey in 2006⁴⁷ put the figure at 62%, which may reflect an increase in compliance across mortgage firms.

Consumers understand whether they have received advice or information only (ind. 11)

We cross-referenced mystery shopper⁴⁸ recollections of the level of service with the disclosure documentation they received. Most shoppers who received an IDD recalled correctly the level of service they had received. For the interviews missing both an IDD and a Key Facts Illustration (KFI),⁴⁹ we were unable to verify the level of service, but where only a KFI was present we used this to assess whether the interview was advised. Our key findings are below.

45 MCOB 4.4.7R.

46 MS 2006.

47 CR2.

48 MS 2006.

49 KFIs are discussed under 'outcome one – consumers shop around for mortgages'.

Face-to-face interviews

Of the 221 face-to-face interviews:

- 59% (130) were given an IDD and also told the level of service they would get;
- 15% (33) were given an IDD but the level of service was not mentioned;
- 14% (30) were not given an IDD but the level of service was mentioned; and
- **13% (28) were not given an IDD and the level of service was not mentioned.**

Shoppers in the last category were most likely to be confused about the level of service, unless they received a KFI, which gave them an indication of whether or not they had received advice. This number is too small to break down further using percentages, but of the 13% (28) who were not given an IDD and the level of service was not mentioned:

- 17 did not feel that a specific product was recommended;
- **7 felt a specific product was recommended and did not receive a KFI;**
- 4 felt a specific product was recommended and received a KFI confirming the level of service as advice; and
- none felt a specific product was recommended and received a KFI confirming the level of service as information only.

One of the possible risks identified earlier was consumers believing that they received advice when they had received information only, so it is reassuring that we did not find evidence of this (last category). However, we cannot rule out that the firms in the second category may have intended the sale to be information only, although this cannot be verified in the absence of the disclosure documents.

Telephone interviews

MCOB requires firms conducting telephone interviews to tell consumers the level of service they will receive, and to send out an IDD afterwards.

Of the 127 telephone interviews:

- 28% (35) were told the level of service, and received an IDD;
- 29% (37) were told the level of service but did not receive an IDD;
- 9% (11) were not told the level of service, but received an IDD; and
- **35% (44) were not told the level of service and did not receive an IDD.**

Consumers in this last category would not know the level of service unless or until the firm provided them with a KFI.

Of the 35% (44) who were not told the level of service and did not receive an IDD:

- **26 felt a specific product was recommended but did not receive a KFI;**

- 16 did not feel that a product was recommended;
- 2 felt a specific product was recommended and received a KFI confirming a recommendation was made; and
- none felt a specific product was recommended but received a KFI ticked information only.

Consumers in the first category were told something that led them to understand the firm was recommending a product. If , the firm should have provided a KFI to confirm this. In the absence of both an IDD and a KFI, the consumer could not be sure of the service they had received. Again, it is encouraging that there were no consumers whose perception of the level of service differed from that stated in the KFI (last category). But we cannot rule out there being consumers within the first category whose interviews were actually information only.

Firms providing information only sales do not make recommendations or cross the line into giving advice (ind. 12)

Qualitative reviewing of our mystery shopping recordings (MS 2006) revealed a lack of clarity among some intermediaries about providing KFIs to illustrate products that they were not recommending. This mainly seemed to arise when a consumer wanted an illustration of a product – or the firm wanted to give details of a product to the consumer – but they had not yet decided to recommend a particular product. Their concern was that their systems only printed pre-ticked KFIs, stating that the product was being recommended. There is a need for clarification of this issue. Overall, we found no substantial evidence that firms carrying out non-advised sales are providing recommendations.

Outcome 3: Consumers better understand the risks and features of the mortgages they take out, including affordability risks

Consumers understand and can identify information on the key risks and features of mortgage products using the KFI (ind. 13)

This outcome is important in helping to reduce potential consumer detriment by enabling consumers to make more informed decisions; whether they decide to seek advice or select a product themselves. Mandatory disclosure about the risks of mortgages (section 7 of the KFI) came in with regulation in 2004.

Although the outcome refers to ‘better’ understanding, we do not have a baseline measure of consumer understanding. In the first stage of the review we were therefore seeking to establish a baseline of consumer understanding of the risks of mortgages. As compliance by firms increases, and as the work on consumer financial capability continues, we would expect consumer understanding of the risks involved in their mortgage to increase.

A second reason for focusing on consumer understanding of risk, particularly in relation to affordability and interest rate rises, is our commitment to look at the recommendations of Professor Miles in his report on the UK mortgage market⁵⁰. Stage 1 of the review tested consumer understanding of the sections on risk in the KFI, and our affordability leaflet (‘You can afford your mortgage now but what if...?’).

The KFI

Overall, we found that consumers were able to identify and discuss the risks associated with taking out a mortgage in qualitative interviews⁵¹. The key risks that the consumers in this research commonly identified were:

- whether they would be able to afford the repayments for the duration of the mortgage;
- the impact of an increase in interest rates on their monthly repayments; and
- the fact that payments have to be maintained even in the event of unemployment, a fall in income, or illness; and
- that failure to maintain payments could result in the loss of the property.

Consumers also saw the KFI as a prompt to ask questions to clarify their understanding, and some indicated they would want to seek advice or talk to someone about the product in more detail.

50 ‘The UK Mortgage Market: Taking a longer term view’ (David Miles; March 04).

51 CR1.

We asked consumers who had taken out a mortgage recently (and who definitely recalled receiving a KFI) whether they had needed additional explanation of the product information in the KFI. 52% of respondents said they had needed further explanation of the product after reading the KFI; and almost all of these confirmed they had gone on to seek advice or get additional explanation of the product⁵².

Of this group, 26% confirmed the KFI had made them consider the risks of taking out the product and 37% used it to decide whether it was the right mortgage for them⁵³ (see **Figure IV**).

The KFI is intended to help consumers understand the full range of features associated with their mortgage, and although price remains a key factor (41% of consumers made their final decision based on price), it is encouraging that we found many consumers are also considering the risks and other features of mortgages.

The quantitative survey did not incorporate a specific quota of consumers within the sub-prime market (although they were not specifically excluded). As we suspect that there is less understanding and awareness of risk in this area, we plan to undertake analysis of the sub-prime market in the next stage of the review.

The Affordability Leaflet

Our qualitative research⁵⁴ also tested our affordability leaflet, which covers what might happen if interest rates rise or if personal circumstances change (e.g. job loss). For a copy of this leaflet see Annex 4. Consumers found the material in the affordability leaflet engaging and accessible. While some felt the leaflet was mainly aimed at inexperienced or first-time buyers; other more experienced consumers (who had held mortgages for a number of years, or had remortgaged several times), saw it as a useful refresher on the risks associated with mortgages. Although providing the leaflet is optional for firms, consumer feedback from this piece of research suggested it might be helpful to make it a mandatory document.

Firms providing advice explain that their recommendation is based upon the consumer's current circumstances, which may change (ind. 14)

Consumers receive compliant KFIs (ind. 2)

As mentioned above, the affordability leaflet is not a mandatory document, and we do not propose to make it one, but it is one possible way of helping to make consumers aware of the risks.

52 CR2.

53 Consumers could pick more than one answer for this question.

54 CR1.

Other methods are through our ongoing consumer information and awareness raising work; through financial capability initiatives; and through firms training their staff as a matter of good practice to highlight affordability and the risks section in the KFI when discussing products.

It is also worth noting that of the mystery shoppers (MS 2006) who felt a specific product was recommended, only 42% (91 out of 219) recalled being advised that the recommendation was based upon their current circumstances, and that their ability to meet the monthly mortgage payments may change⁵⁵. While this does not necessarily mean that 58% were not given this warning, it certainly highlights that these consumers did not fully absorb this information.

55 This is a requirement in MCOB 4.7.5 where a recommendation is made.

Outcome 4: Consumers take out suitable and good value mortgages

This is a longer-term outcome, which we expect will be influenced by the extent to which some of the other outcomes are being achieved. This is because we anticipate that consumers who shop around for mortgages and who understand the risks and features of the mortgage they take out, will be more likely to take out a suitable and good value mortgage.

We plan to look in more detail at the suitability of recommendations in the next stage of the review, drawing on thematic work currently underway in this area.

Consumers shop around for mortgages (outcome 1)

We have found that consumers are seeking information from multiple sources, including a significant proportion who are using intermediaries to shop around for mortgages⁵⁶. Additionally, approximately a third of consumers who received a KFI used it to shop around, and 37% used it to decide whether it was the right mortgage for them. These are positive findings considering the relatively short period of mortgage regulation, and suggest that consumers are actively engaged in shopping around for the best deal.

Consumers understand the risks and features of the mortgages they take out (outcome 3)

There are positive signs that mortgage purchasers in the prime market understand the key risks and features of mortgage products, and will ask questions to clarify their understanding⁵⁷. Compliance is therefore important in achieving this outcome. Where consumers do not receive a KFI they will not have access to all the details of the product they are considering, or the risk warnings, and will therefore be less able to make an informed choice.

We will look at the level of consumer understanding within the sub prime market in the next stage of the review.

Consumers seek advice in appropriate circumstances (ind. 15)

As discussed under outcome 1, the Product Sales Data mortgage lenders have submitted to us shows that intermediated sales now represent approximately 58% of the market, which represents an increase since 2004. Since the majority of the intermediated market provides advice, we expect the rise in intermediated sales to result in an increase in advised sales.

56 CR2.

57 CR1.

An increase in the range and complexity of products on offer may also lead consumers to seek advice. We have noted an increase in the range of mortgage features since regulation was introduced (MAS). And results from both our quantitative (CR2) and qualitative (CR1) research suggest that consumers are using disclosure documents as a prompt to ask further questions and seek advice about the number and variety of different features on offer.

We began collecting Product Sales Data on the number of advised sales from the second quarter of 2005, but it was not a mandatory requirement until the second quarter of 2006. Subject to this caveat, PSD shows that across the market advised sales comprise approximately 62% of total sales. This figure differs between types of consumer - see Figure XI below. We will be in a better position to note trends in advised sales once we have further quarterly returns.

Figure XI

Advised sales (source: July 2006 Product Sales Data)

Type of buyer	Advised sales as a % of total
First-time buyers	74
Home movers (second or subsequent buyers)	67
Remortgagers	58

Consumers make efficient purchasing decisions (ind. 16)

To assess whether the products taken out by consumers constitute good value, we carried out two pieces of market analysis⁵⁸ (the methodology for this work is provided in Annex 5):

- Firstly, we looked at whether the mortgage market has become more competitive following the introduction of MCOB by examining movements in prices paid for mortgages in the market. Given data constraints, the hypothesis we tested was that enhanced competition would be reflected in tighter mark up of fees and lending rates over lenders' cost of funds; and/or reduced price dispersion.
- Secondly, since mortgages vary in quality as well as price, we used Data Envelope Analysis (DEA) as an indicator of 'consumption efficiency' – in broad terms, whether consumers are buying good value mortgage products. It is important to note that this technique does not address the suitability aspect of Outcome 4, so does not capture any changes that might be expected in this area.

Competition

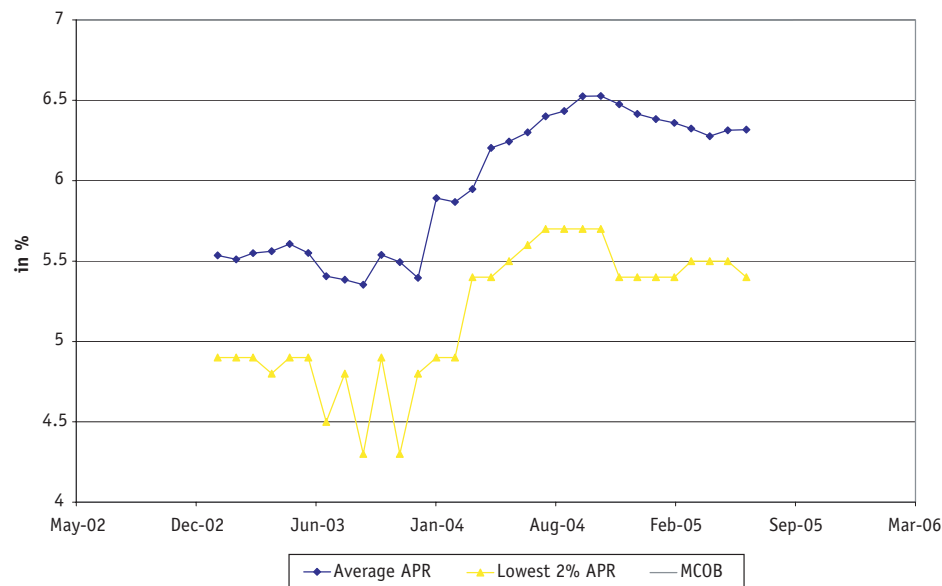
We looked at mortgage sales data from January 2003 to August 2005. Our preliminary conclusions are that there has been no change in price dispersion (see Figure XII) and the mark up of mortgage prices (including lending rates and fees) over cost of funds has not reduced (see Figure XIV).

58 MAS.

Figures XIII to XV show that APRs⁵⁹ and initial rates have increased since MCOB was introduced, after controlling for increases in the base rate. It was outside of the scope of this piece of work to attempt to establish a cause for this increase (and as we explained in the introduction, we were not seeking to carry out a CBA of mortgage regulation after the event). However, one possible explanation for these findings, amongst several, is a competitive market before and after MCOB whereby firms have passed on additional costs of regulation to borrowers. The increase in prices appears to be consistent across all prime lenders and across all mortgage types in the standard mortgage market (the study did not include analysis of the sub-prime market).

Figure XII

Price Dispersion (average and lowest 2% APR - Discounted Variable Mortgages)



59 The APR includes important factors such as the interest rate; how the loan is repaid (length of loan agreement (or term), frequency and timing of instalment payments and amounts of each payment); certain fees associated with the loan; and certain compulsory insurance premiums (for example payment protection insurance). See: www.fsa.gov.uk/consumer/07_MORTGAGES/KFI_diagram/APR.html

Figure XIII

Graph of average APR for different mortgage types over time

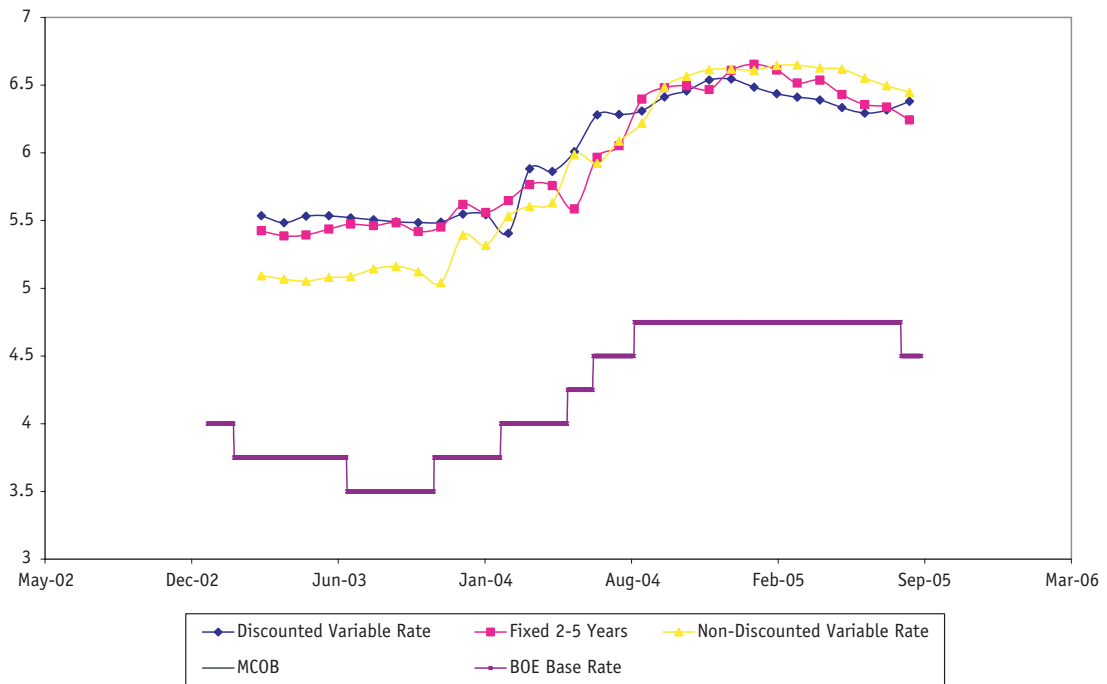


Figure XIV

Graph of average APR margin for different mortgage types over time

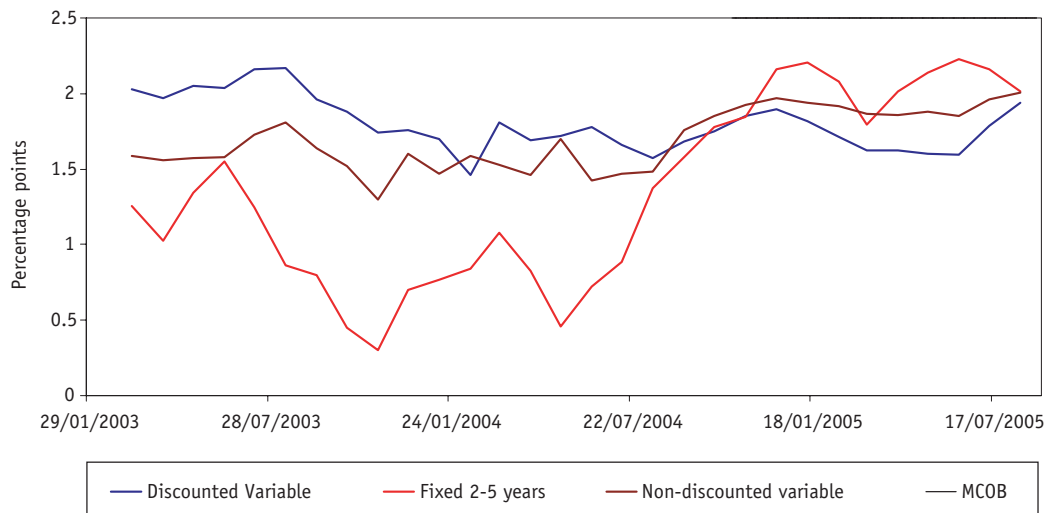
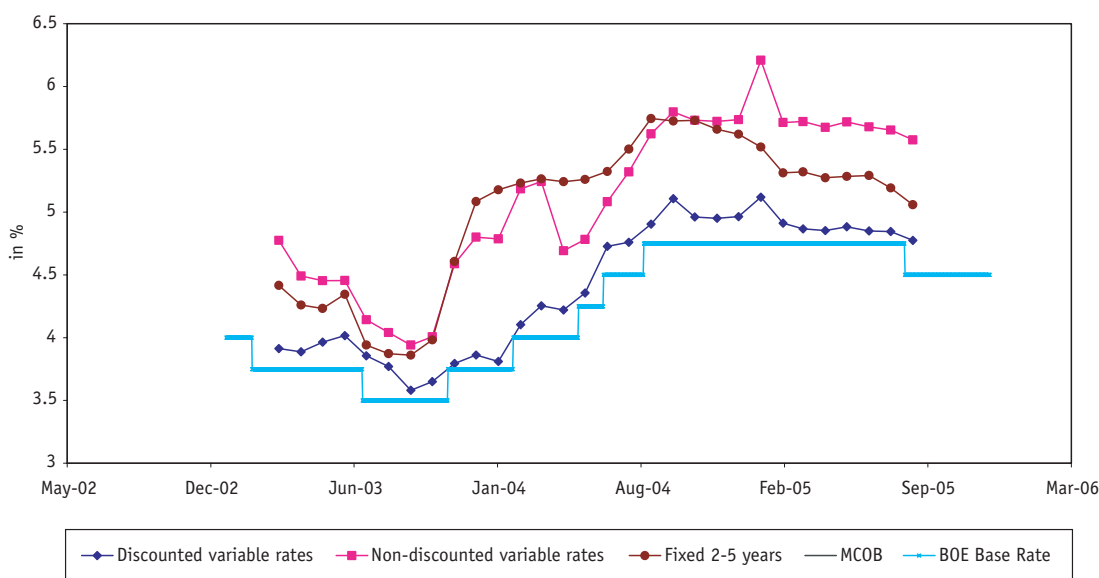


Figure XV

Graph of average initial rates for different mortgage types over time



We also found that the major lenders increased the variety of their offerings after MCOB was introduced. This is consistent with an increase in competition on product characteristics. However, there are other possible interpretations, such as increased price discrimination⁶⁰ by firms, and no definite conclusion can be drawn without undertaking further work.

Data Envelope Analysis (DEA)

Additionally we tested for the impacts of MCOB through Data Envelope Analysis (DEA). This is an experimental technique that compares the efficiency of individual purchases against the best purchase available in the market. It does this by using data on price as well as other characteristics of mortgages (e.g. cash-back, tie-in period). The difference between the choice of an individual consumer and the choice of the most efficient mortgage available in the market provided a measure of ‘efficiency’. We used DEA to look at the efficiency of the average consumer before and after MCOB to assess changes in average ‘efficiency’ scores between different points in time.

Our preliminary results indicate that, before and after MCOB, consumers tend to be efficient in their choice of mortgages. That is, consumers take out competitive mortgage products. However, we have not been able to establish that consumers have been choosing mortgages more efficiently since the introduction of MCOB. Even though we observed that a greater range of mortgage features were available after nine months of regulation (see below), consumers were not, in terms of the DEA, making more efficient purchases. This may change over time and with increased compliance so we would need to test again in the future to look for changes in efficiency.

These results do not tell us whether consumers are buying more suitable mortgages for their needs and circumstances, which would be an important benefit. However, if it is

⁶⁰ Price discrimination is where a firm charges different prices to different groups of consumers for an identical good or service for reasons not associated with the cost of production.

true that the market remained fairly competitive after the introduction of MCOB, then the increased range in mortgage features observed since MCOB may have resulted in an increase in suitability. This is because, in a competitive market, consumers have sufficient information to make decisions that reflect their preferences⁶¹. So the availability of additional products should enable some consumers (whose situations are diverse) to purchase products that suit them better than those previously available.

It is reasonable to expect that any increased product quality associated with regulation will increase consumers' willingness to pay for mortgages (this is a well-known benefit of the regulation of markets). It is also possible that increased consumer information and simply the presence of regulation may have increased consumer confidence in the mortgage market and further altered the willingness of consumers to pay. In economic terms, this indicates an increase in 'consumer surplus'⁶², even if their ultimate purchase of the mortgage is unchanged. However, such effects are difficult to measure reliably, and have not been assessed in this first stage of the review.

Summary of market study

Our preliminary results from the market analysis (MAS) indicate that competition has not been unduly affected by MCOB. The cost of MCOB may have led to an increase in the price of mortgage products, since we have not found evidence of an improvement in the package of product features purchased to account for this price rise. However, the introduction of regulation is likely to be associated with an increase in other dimensions of product quality. The increased range in mortgage features observed since MCOB may have led to an increase in suitability (although it may also have helped firms to price-discriminate against consumers).

61 Something that one can reasonably expect where there is well-designed product disclosure (mandated by regulation) that consumers fundamentally understand.

62 **Consumer surplus** is the amount that consumers benefit by being able to purchase a product for a price that is less than they would be willing to pay.

Analysis, conclusions and next steps

Summary

This report sets out the findings from the first phase of the mortgage effectiveness review, covering the two areas we have looked at: disclosure and the advice and selling process. We have concentrated on gathering information on the mortgage market as a whole in this stage, and have not looked in detail at particular sub-sectors, such as the sub-prime or lifetime mortgage markets.

In light of this, the conclusions we have drawn apply to the prime mortgage market. We are not yet in a position to comment on whether there are any significant differences in the way various sub-sectors operate, or on consumer understanding in these areas.

Overall, we believe that in the areas we have looked at the mortgage regime is operating effectively *where* firms comply with the requirements set out in MCOB. There continues to be pockets of non-compliance and it is disappointing that the non-compliance relates to some of the basic requirements of the disclosure regime.

Key conclusions from stage 1

We have set out our conclusions in line with the four consumer outcomes we have focused on in this first stage of the review. Clearly, these will only be achieved over time; however, we expect to see a move towards achieving the outcomes and delivering benefits for consumers.

Consumers shop around for mortgages – overall, we believe that good progress has been made towards achieving this outcome. Our consumer research (CR2) indicates that consumers are shopping around for mortgages. In addition, the majority of our mystery shoppers (MS 2006) did not find mortgage interviews too long – in fact a number found them slightly too short. This supports the view that interview length is not a barrier to shopping around.

Consumers understand whether they are being given advice or information – from our mystery shopping work (MS 2006) there is a clear link between firms providing the IDD and/or oral disclosure, and consumers understanding the level of service received. We anticipate that an improvement in compliance in this area will result in an improvement in the number of consumers who understand whether they have been given advice or information.

Consumers better understand the risks and features of the mortgages they take out including the affordability risks – the results of our consumer research (CR1) indicate that consumers are able to use the KFI to identify some of the risks and features of mortgage products. Given the background of a generally low level of financial capability, it is encouraging that of the 47% of consumers who said they had queries about some of the information included in the KFI, nearly all sought clarification (CR2).

Although price remains a key factor, it is encouraging that many consumers are also considering the risks and other features of their mortgages.

The qualitative consumer research (CR1) indicated that consumers were very positive about our affordability factsheet ('You can afford your mortgage now, but what if...?').

Consumers take out suitable and good value mortgages – we did not carry out work to assess the suitability of mortgage recommendations made by advisers as part of this stage of the effectiveness review. We plan to look at this in the next stage. We are carrying out a separate programme of work to look at the Quality of the Mortgage Advice Process. We will draw on the findings of this work as part of stage 2.

Our initial research indicates that in macro terms, consumers were taking out reasonably good value mortgages before the introduction of MCOB and this has continued to be the case (MAS). An active remortgage market may also indicate that consumers are engaged in trying to ensure that their mortgage remains good value and suitable for their circumstances.

Overall, we find it encouraging that there is evidence of progress towards achieving the four consumer outcomes we considered. As we do not have reliable baseline data from before mortgage regulation, we propose to use the information we have gathered in this phase of the review as a baseline for the next phases.

In relation to the specific areas of disclosure and advice and selling practices, we have drawn the following conclusions:

Product disclosure: overall, we believe that the KFI is working relatively well.

Consumers find the KFI useful in helping them to decide whether a mortgage is right for them, compare mortgages and consider the risks of a mortgage product (CR1&2). Given the backdrop of a low level of financial capability in the population as a whole, we think it is encouraging that our quantitative research indicated that consumers are using the KFI in their decision-making process (CR2).

Advice and selling process: some firms appeared to be unclear about the rules around issuing KFIs. Despite this, we found no substantial evidence that advisers in information-only sales are providing recommendations (MS 2006). As we stated above, we will undertake further work to look at the suitability of recommendations made.

Next stage of review

We have not identified any areas where we feel rule changes would be appropriate in stage 1 of the review. This accords with feedback we have received from the industry which has made clear that there is no appetite for piecemeal changes to MCOB.

We are also mindful that any future changes to MCOB will need to take account of any proposals in the European Commission's White Paper on mortgages due in 2007. Any future proposals on disclosure or advice would need to take account of any proposed European intervention.

However, we will scope the next phase of the mortgage effectiveness review with a clear focus on the Better Regulation agenda. We will look to actively engage stakeholders in helping us to identify where there are any areas of MCOB that we could look to simplify or move further towards a Principles based regime.

The next phase of the review will focus on the sub-sectors of the mortgage market where we believe there is more likely to be consumer detriment. In this stage, we plan to consider the fifth consumer outcome – 'consumers are treated fairly over the life of the mortgage, including when they go into arrears'.

We will undertake work on the following areas:

- lifetime mortgages;
- sub-prime mortgages;
- arrears handling; and
- post-sale disclosure.

We will be scoping the next phase of the review shortly and propose to set out our detailed plans in early 2007.

Mortgage Effectiveness

Review consumer outcomes and related indicators

Definitions

Outcome: A long-term, ultimate measure of success or strategic effectiveness.

Indicator: A measurable approximation of the outcomes we are attempting to achieve.

1. Consumers shop around for mortgages

Indicator 1	Consumers gather information from more than one source
Indicator 2	Consumers receive compliant KFIs
Indicator 3	Consumers can use KFIs to compare different mortgage products
Indicator 4	Consumers read KFIs
Indicator 5	Consumers obtain more than one KFI before choosing a mortgage
Indicator 6	Interview length does not act as a barrier to shopping around
Indicator 7	Consumer switching is efficient

2. Consumers understand whether they are being given advice or information by firms

Indicator 8	Consumers receive compliant IDD
Indicator 9	Consumers understand and can use the IDD
Indicator 10	Consumers are informed about the level of service at the right time/upon initial contact. This is orally in a telephone interview and via an IDD in a face-to-face interview.
Indicator 11	Consumers understand whether they have received advice or information only
Indicator 12	Firms providing information-only sales do not cross the line into giving advice

3. Consumers better understand the risks and features of the mortgages they take out, including the affordability risks

Indicator 13	Consumers understand and can identify information on the key risks and features of mortgage products using the KFI
Indicator 14	Firms providing advice explain that their recommendation is based upon the consumer's current circumstances, which may change.
Indicator 2	Consumers receive compliant KFIs

4. Consumers take out suitable and good value mortgages

(Outcome 1)	Consumers shop around for mortgages
(Outcome 3)	Consumers understand the risks and features of the mortgages they take out
Indicator 15	Consumers seek advice in appropriate circumstances
Indicator 16	Consumers make efficient purchasing decisions

5. Consumers are treated fairly over the life of the mortgage, including when they go into arrears

(This outcome will form part of the next stage of the review.)

Example Key Facts Illustration (KFI)

key facts about this mortgage	
Personalised illustration for: Mr & Mrs Yogi-Bare	
Date produced: 10 November 2004	
This illustration is valid for 7 days and the mortgage must be completed by 31/1/2005	
This is not a legally binding mortgage offer and it does not oblige Intellectual Flounder to provide you with the mortgage described in this illustration.	
1. About this illustration	
<ul style="list-style-type: none"> ➤ We are required by the Financial Services Authority (FSA) - the independent watchdog that regulates financial services - to provide you with this illustration. ➤ All firms selling mortgages are required to give you illustrations like this one, that contain similar information presented in the same way. ➤ Ensure that you obtain other illustrations if you want to compare this mortgage with mortgages from other lenders. 	
2. Which service are we providing you with?	
✓	We recommend, having assessed your needs, that you take out this mortgage.
	We are not recommending a particular mortgage for you. However, based on your answers to some questions, we are giving you information about this mortgage so that you can make your own choice.
3. What you have told us	
You require a mortgage of £90,000 plus £300 for fees that will be added to the loan. These and the additional fees that you need to pay are shown in Section 8.	
You require the mortgage over a term of 25 years on an interest-only basis secured against a property with an estimated value of £120,000 (This assumes you will be borrowing 75% of the property's estimated value).	
The property structure is currently insured for £105,000.	
Changes to any of the information you have given us, including the value of your property, could alter the information in this illustration. Please ask for a revised illustration if this is the case.	
4. Description of this mortgage	
<ul style="list-style-type: none"> • Five year discounted mortgage with Intellectual Flounder, a division of Cartilaginous Group Plc. • A variable rate currently 5.49% with a discount of 1.50% for 5 years, giving a current rate payable of 3.99%. • After 5 years, the rate that will apply is Intellectual Flounder's standard variable rate, currently 5.49%, for the remaining term of the mortgage. • Restrictions: This mortgage is only available for loans up to 95% of the purchase price or valuation. • Tied products: You are obliged to take out payment protection insurance through Intellectual Flounder as a condition of this mortgage. Please refer to Section 9 of this illustration for further details. 	
Dogfish Brokers	

5. Overall cost of this mortgage	
The overall cost takes into account the payments in Sections 6 and 8 below. It also takes into account the cost of the compulsory payment protection insurance in Section 9. However, it excludes any payments that you may need to make into a separate savings plan, to build up a lump sum to repay the amount borrowed, but assumes that you pay off the amount borrowed as a lump sum at the end of the mortgage.	
The total amount you must pay back, including the amount borrowed is	£208,950.60
This means you pay back	£2.31 for every £1 borrowed
The overall cost for comparison is	6.9% APR
The figures in this section will vary following interest rate changes and if you do not keep the mortgage for 25 years.	
Only use the figures in this section to compare the cost with another interest-only mortgage.	

6. What you will need to pay each month	Monthly payments
This illustration is based on a loan amount of £90,300, and includes the fees that are shown in Section 8 as being added to your mortgage, and assumes that the mortgage will start on 31 st January 2005.	
60 payments at a variable rate currently 3.99%	£300.25
followed by:	
240 payments at a variable rate currently 5.49%	£413.12
Cost of repaying the capital	
You will still owe £90,300 at the end of the mortgage term. You will need to make separate arrangements to repay this. When comparing the payments on this mortgage with a repayment mortgage, remember to add any money that you may need to pay into a separate savings plan to build up a lump sum to repay this amount.	
Savings plan that you do not have to take out through Intellectual Flounder or Dogfish Brokers	Monthly payments
Dromedary Plan (see separate key features document)	£120.00
What you will need to pay each month including the cost of a savings plan to repay the capital	
60 payments at a variable rate currently 3.99%	£420.25
Followed by:	
240 payments at a variable rate currently 5.49%	£533.12

7. Are you comfortable with the risks?
What if interest rates go up?
The monthly payments shown in this illustration could be considerably different if interest rates change.
<ul style="list-style-type: none"> For example, for one percentage point increase in Intellectual Flounder's standard variable rate, your monthly payment will increase by around £75.25.
RATES MAY INCREASE BY MUCH MORE THAN THIS SO MAKE SURE YOU CAN AFFORD THE MONTHLY PAYMENT



7. Are you comfortable with the risks?

What if your income goes down?

- You will still have to pay your mortgage if you lose your job or if illness prevents you from working. Think about whether you could do this.

MAKE SURE YOU CAN AFFORD YOUR MORTGAGE IF YOUR INCOME FALLS

The FSA's information sheet 'You can afford your mortgage now, but what if...?' will help you consider the risks. You can get a free copy from www.fsa.gov.uk/consumer, or by calling 0845 456 1555.

8. What fees must you pay?

Fee amount

Fees payable to Intellectual Flounder (not refundable)

Application fee (you have asked to add this to the mortgage)

£300.00

Valuation fee payable on application

£102.00

Fee payable on final repayment. Please note that this is the current fee and may change.

£95.00

Other fees

Fee to Dogfish Brokers for arranging the mortgage (payable on application and refundable if the mortgage does not proceed)

£250.00

You may have to pay other taxes or costs in addition to any fees shown here.

9. Insurance

Monthly Payments

Insurance you must take out through Intellectual Flounder

Mortgage Repayment Protector (See separate Policy Summary)

£17.33

You must take out and maintain this insurance policy through Intellectual Flounder for the discounted mortgage product period of 5 years.

The premium quoted is for Accident, Sickness & Unemployment cover of £300 per month. Premiums for this policy are reviewed each year.

Insurance you must take out as a condition of this mortgage but that you do not have to take out through Intellectual Flounder or Dogfish Brokers

No further insurance is required as a condition of the mortgage.

Optional insurance that you do not have to take out through Intellectual Flounder or Dogfish Brokers

Buildings & Contents (See separate Policy Summary)

£25.79

10. What happens if you do not want this mortgage any more?

Early repayment charges

An early repayment charge is payable on this mortgage during the first 5 years, calculated as 3% of the original loan plus the repayment of the cashback. An administration fee, currently £95 is also payable if you repay this mortgage early.

Cash example: £3,054 during the first 5 years.

The maximum charge you could pay is £2,959 plus a fee, which is currently £95.

Dogfish Brokers

10. What happens if you do not want this mortgage any more?

What happens if you move house?

If you move house you can transfer this product at any time to another property, as long as you borrow the same amount or more and the property is acceptable security to Intellectual Flounder. Please refer to Intellectual Flounder's product leaflet for further details of these terms and conditions.

11. What happens if you want to make overpayments?

- You can make overpayments or lump sum payments of up to 10% of the original loan amount in the first 5 years and for any amount after this without having to pay an early repayment charge. Otherwise an early repayment charge will apply on the basis set out in Section 10.
- The amount you owe and the interest you pay is not recalculated immediately following any regular or lump sum overpayment, but is recalculated annually on 31st December.

12. Additional features

Underpayments

- Underpayments can be made if sufficient overpayments have previously been made.

Payment holidays

- Payment holidays are available if sufficient overpayments have previously been made.

Incentives

- You will receive a Cashback of £250 within 7 days of the start of your mortgage.
- We will pay your standard legal fees.

Additional secured borrowing

- You can apply for additional borrowing at any time. Approval will be subject to your circumstances and our lending criteria.

13. Using a mortgage intermediary

Intellectual Flounder will pay Dogfish Brokers £300 and Catfish Network £50 in cash and/or benefits if you take out this mortgage.

14. Where can you get more information about mortgages?

The FSA publishes useful guides on choosing a mortgage. These are available free through its website: www.fsa.gov.uk/consumer, or by calling 0845 456 1555. The website also provides Comparative Tables to help you shop around.

Contact details

If you wish to discuss this mortgage illustration please contact:

Rock Salmon – Mortgage Adviser
Dogfish Brokers
4 Foot Square
Fishtank-on-the-Sideboard
F1 5HY

Tel: 0800 555 5555


Quote ref: DOG/8/DECAT

YOUR HOME MAY BE REPOSSESSED IF YOU DO NOT KEEP UP REPAYMENTS ON YOUR MORTGAGE

Dogfish Brokers

Example Initial Disclosure Document (IDD)

key facts about our mortgage services



LAMBS
Independent Mortgage Professionals

Flock House
Losttheir Way
Shepherds Bush
W0 0LY

1. The Financial Services Authority (FSA)
The FSA is the independent watchdog that regulates financial services. It requires us to give you this document. Use this information to decide if our services are right for you.

2. Whose mortgages do we offer?

- We offer mortgages from the whole market.
- We only offer mortgages from a limited number of lenders.
- We only offer mortgages from a single lender.

3. Which service will we provide you with?

- We will advise and make a recommendation for you after we have assessed your needs.
- You will not receive advice or a recommendation from us. We may ask some questions to narrow down the selection of products that we will provide details on. You will then need to make your own choice about how to proceed.

4. What will you have to pay us for this service?

- No fee.
- An upfront fee of £200 - and we will refund to you any commission that we get paid by the mortgage lender.

You will receive a key facts illustration when considering a particular mortgage which will tell you about any fees relating to it.

5. Refund of fees

If we charge you a fee, and your mortgage does not go ahead, you will receive:

- A full refund.
- A refund of £100 if the lender rejects your application.
- No refund in all other circumstances.

6. Who regulates us?

Lambs - Independent Mortgage Professionals is an appointed representative of Sheep Mortgage Solutions, 3 Bagsful Lane, Baa-th, SH3 3P which is authorised and regulated by the Financial Services Authority. Sheep Mortgage Solutions' FSA Register number is 222444.

Sheep Mortgage Solutions' permitted business is advising on and arranging mortgages.

You can check this on the FSA's Register by visiting the FSA's website www.fsa.gov.uk/register/ or by contacting the FSA on 0845 606 1234.

7. What to do if you have a complaint

If you wish to register a complaint, please contact us:

...in writing Write to: LIMP Complaints, Flock House,
Losttheir Way, Shepherds Bush W0 0LY.

... by phone Telephone: 0333 555 777.

If you cannot settle your complaint with us, you may be entitled to refer it to the Financial Ombudsman Service.

8. Are we covered by the Financial Services Compensation Scheme (FSCS)?

We are covered by the FSCS. You may be entitled to compensation from the scheme if we cannot meet our obligations. This depends on the type of business and the circumstances of the claim.

Mortgage advising and arranging is covered for 100% of the first £30,000 and 90% of the next £20,000 so the maximum compensation is £48,000.

Further information about compensation scheme arrangements is available from the FSCS.

'You can afford your mortgage now, but what if...?' leaflet



FSA.
Financial Services Authority

You can afford your mortgage now, but what if...?

This factsheet is from the Financial Services Authority (FSA), the independent watchdog set up by the government to regulate financial services in the UK and protect the rights of consumers

Taking out a mortgage is one of the biggest financial commitments you can make, both in terms of the amount you borrow, and the time you may take to repay it.

Are you sure you can afford it?

You may be able to afford the repayments now, but if you borrow a large amount over a long period of time think what could happen if, for example, your income falls or you lose your job. Or what if interest rates rise and your monthly repayments go up?

How could your income fall?

Your income could fall if:

- you lost your job, or had to take a drop in income;
- you or your partner stopped work to have a child or to look after a dependant; or
- you became ill and couldn't work.

Could you keep up your mortgage payments if your income falls?

How could your mortgage payments go up?

- Your mortgage payments to your lender could go up (or down) if interest rates change. Mortgage interest rates are related to the interest rate set by the Bank of England and your lender will usually apply some or all of any change to your mortgage.
- Unless your mortgage rate is fixed for the full term of your mortgage, this will affect you.

■ Often, special rates are for a set period only, so when this comes to an end your payment will change – it could be much higher.

Although interest rates have been stable over the past few years, this could change. In the past, interest rates have risen from 7.5% to 15% in just a few years. Interest rate rises could increase your monthly payments considerably, making it difficult for you to afford them.

The following examples show how different interest rates can affect your payments.

Example 1: repayment mortgage

You borrow £100,000 over 25 years on a repayment mortgage, initially at a rate of 4%:

Interest rate	Monthly repayment	Increase from 4%
4%	£528	-
6%	£644	+ £116
8%	£772	+ £244
10%	£909	+ £381

Source: UK Bank of Mortgages

Example 2: interest-only mortgage

You borrow £100,000 over 25 years on an interest-only mortgage, initially at a rate of 4%:

Interest rate	Monthly repayment	Increase from 4%
4%	£333	-
6%	£500	+ £167
8%	£667	+ £334
10%	£833	+ £500

Source: UK Bank of Mortgages

Don't forget that rates could be higher than those shown here.

The Financial Services Authority – regulating financial services and protecting your rights

With an interest-only mortgage you only pay the interest on your loan – but you will also need to have a way of paying off the loan at the end of the term (borrowing period). This will usually mean having a savings plan or investment to build a lump sum to pay off the mortgage.

Use our mortgage calculator on the Mortgages section of our website (see below) to work out the increase on your own loan.

Could you afford your mortgage if interest rates went up significantly?

What can you do now to help protect yourself against the risks of changes in your circumstances and interest rate rises?

- Plan your budget based on what you might have to pay in future as well as the initial cost – don't forget to include all your household expenses, such as buildings and contents insurance premiums and council tax.
- Try not to take the maximum mortgage on offer – just because you can afford it now, doesn't mean you can afford it in the future.
- Think about whether you need a fixed rate so that you know your mortgage payment will stay the same for a given period – but don't forget that if rates fall, your payment won't.
- Build up your savings so that in an emergency (for example, if you lose your job) you can still afford to pay your mortgage and bills for a short time. Compare rates on savings accounts on FSA's comparative tables, newspapers or websites.
- Work out how long you could live on your savings if you lost your job.
- Check what benefits your employer will provide if you became ill.

A mortgage is a long-term loan secured on your home. 'Secured' means that, if you don't keep up the loan repayments, the lender can repossess your home and sell it to get their money back.

November 2004

- **Insurance** – various products can insure you in the event of redundancy, critical illness, or accident. You should consider these but make sure they meet your needs: there are restrictions on when and how much they will pay out. Make sure you understand the limitations of any policy and how it protects you. For information on all types of insurance, see the Association of British Insurers (ABI) Information Zone at www.abi.org.uk.

If you do get into difficulties

Talk to your lender if you cannot meet your mortgage payments – they will have a set procedure for dealing with your case.

State benefits – may be available but may cover you only after an initial waiting period; for example:

- you won't qualify if you have a joint mortgage and only one of you loses your income;
- you won't qualify if you have savings of more than £8,000;
- you may only qualify for help nine months after you become unemployed (unless you took your mortgage out before October 1995);
- payments will only cover the 'interest' part of the mortgage; and
- there is a limit on the amount of mortgage that qualifies.

For more information contact your local Job Centre Plus (details in the Phone Book).

Other publications

Choosing a mortgage – Taking the right steps – Pack

What to do when you can't meet your mortgage payments – Factsheet

Available from our Consumer website or Leafletline – see below.



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FSA Leafletline: 0845 456 1555 FSA Consumer website: www.fsa.gov.uk/consumer

Methodology for the market impact study

1. Data

We primarily used Council of Mortgage Lenders' (CML) data because it provided us with information about each mortgage sold in the market. However, these data do not contain information about APR, initial rates or fees. Instead, we obtained that information from our Comparative Tables, which we combined with the CML data. The combined dataset gave us information about mortgages bought and sold during 2003-2005, which is 20 months before MCOB and ten months post-MCOB. It gave us data about more than 800,000 mortgages sold by 43 lenders, including the largest lenders in the market. We also weighted the data to ensure that they were representative of the overall market. However, the dataset data excludes buy-to-let transactions, which are not regulated, as well as sub-prime and lifetime mortgages.

2. Methodology for Price Analysis

Our methodology is based on comparing mortgage prices before and after the introduction of MCOB and testing whether any movements are statistically significant.

It is difficult to define a single price variable for a heterogeneous product such as a mortgage. Consequently, we used two different measures: APR and initial rate.

- Annual Percentage Rate (APR) has the advantage that it incorporates all fees and repayments for the life of the mortgage. However, it is calculated for a 25-year period when evidence suggests that the average mortgage is held for five years or less. One implication of the time period is that changes in individual components of the APR, such as charges, initial rate and other fees, have a minimal impact.
- Initial Rate (which is the headline rate offered on a mortgage) is frequently used as a marketing tool by mortgage lenders. However, it can be a volatile measure and unrepresentative of total payments made by the borrower.

Therefore, given that there is no ideal measure of price, we looked at both measures to provide a comprehensive picture. In addition, we controlled for lenders' cost of funds by using mortgage margins, which is the interest rate of the mortgage less the lenders' cost of funds, and is described further in the Miles Review. We also looked

at all mortgages together as well as the main mortgage types separately: discounted variable, non-discounted variable and fixed-rate mortgages of different fixity periods.

We examined mortgage prices in two separate analyses: graphical and econometric. Graphs provide a visual guide of whether there has been a change in mortgage rates and associated charges after MCOB compared to beforehand. Econometric analysis (a generalised linear pricing) allowed us to isolate the impact of MCOB from other factors that may influenced the mortgage price at the some time, such as changes in the yield curve affecting providers' cost of funds, the mortgage mix and buyer characteristics.

3. Methodology for Data Envelopment Analysis (DEA)

We used DEA to analyse how well consumers choose their mortgages, which is the same method used by Ward (2005). Other academics have also used this method to analyse different products, for example, Fernandez and Castro (2002) for cars and Lee et al (2004) for mobile phones.

DEA compares the efficiency of individual purchases against the best purchase available in the market by looking at price as well as other characteristics of the mortgage described in the comparative tables (e.g., cash-back, tie-in period). The difference between the choice of an individual consumer and the choice of the most efficient mortgage available in the market provides a measure of 'efficiency'. DEA allows us to look at the efficiency of the average consumer before and after MCOB and to assess changes in average 'efficiency' scores between different points in time. We carried out this analysis for all mortgages as well as sub-samples that exclude first time buyers and non-advised sales.

As in the price analysis above, difficulties in defining a single price variable mean that we use two models for input and output choices. They are described as the APR model and initial rate model in the table below.

Variable list	DEA formulation			
	APR model		Initial rate model	
	Input	Output	Input	Output
APR	✓			
Initial rate			✓	
Set up fees		✓	✓	
Higher lending charge		✓	✓	
Amount of discount		✓		
Loan to value ratio		✓		✓
Initial rate period		✓		✓
Self certifying mortgage		✓		✓
Incentives		✓		✓
Flexible features		✓		✓
Tie-in period		✓		✓
CAT standard		✓		✓
Cashback rate		✓		✓
Fixed rate dummy				✓

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Product sales data (PSD) - Product providers submit PSD to the FSA every three months. PSD details the sales of investment, mortgage and a limited range of pure protection products. For more information, see www.fsa.gov.uk/Pages/Doing/Regulated>Returns/psd/index.shtml

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