THE COMPLIANCE COSTS OF EXTENDING FINANCIAL REGULATION TO MORTGAGE ADVICE

EXECUTIVE SUMMARY

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Introduction

1. The Financial Services and Markets Bill will, if passed in its present form, give the Treasury the power to introduce statutory regulation of the provision of information and advice on mortgages. Europe Economics was asked to help the Financial Services Authority form a view on whether the benefits of statutory regulation are likely to exceed the cost.

2. In particular, Europe Economics was asked to provide:

   - estimates of the likely compliance costs of statutory regulation of those providing information and advice on mortgages; and

   - an analysis of the likely impacts of statutory regulation on market entry, exit and competition.

3. The study examined the effects of introducing, from 1 January 2002, each of four different options for statutory regulation of advice and information on loans secured on residential property.

4. Information and advice on mortgages is provided both by the lenders themselves, largely banks and building societies, and by intermediaries such as independent financial advisers and life assurance companies. Both kinds of business currently provide advice under the Mortgage Code, a form of self-regulation. Almost all lenders subscribe to the Code. Intermediaries that wish to arrange mortgages are effectively required to subscribe.

5. The four options for statutory regulation, developed for the purpose of this study, would seek to strengthen the protection for consumers currently provided by the Mortgage Code. The Counterfactual, against which the costs of possible statutory regulation were assessed, was a version of the Mortgage Code agreed with the Council of Mortgage Lenders as a reasonable model of how the Code might be expected to operate by 1 January 2002 in the absence of statutory regulation.

6. The Standard Case of statutory regulation incorporated the Counterfactual treated as statutory rather than voluntary, with statutory authorisation and monitoring, and requirements for league tables and for independent advisers to give “best advice”.

7. The Enhanced Coverage Case of statutory regulation would cover all mortgages sold to retail customers. The Lighter Regulation Case would have the same coverage but there would be no “best advice” requirement for intermediaries and no training and competence requirement.

8. The Minimal Coverage Case would cover equity release mortgages (mortgages sold to an existing owner-occupier with no outstanding mortgages), foreign currency mortgages, and mortgages qualifying for cover under the Consumer Credit Act 1974.

Approach

9. Samples of lenders and intermediaries were first asked to estimate the once-off and annual recurring costs of the systems and processes that they introduced as a result of the Mortgage Code, which was introduced in 1997 for lenders and in 1998 for intermediaries. The lenders and intermediaries were then asked about the once-off and recurring costs of any new systems and processes that they thought would be required to comply with the different options for statutory regulation. These estimates were scaled up using the current distributions of firm size to produce estimates for the total cost and cost per mortgage.

10. Different scenarios for market development by 1 January 2002 were used to assess the sensitivity of the estimates to changes in industry structure.

Cost Estimates

11. Table E1 shows the total expected costs of statutory regulation for lenders and intermediaries together. The estimates are the averages for the different scenarios, and reflect a slightly higher degree of market concentration than the current market structure.

Table E1 :Summary of Estimates of Compliance Costs

	Industry			
	Once-off		**Recurring*** **	
	Total	Per mortgage advanced	Total	Per mortgage advanced
In £'s 1999	£m	£	£m	£
Statutory Regulation, Standard Case				
(Costs over and above those of the Mortgage Code 2002 Counterfactual)				
Supervision*	3.8	2.2	19.1	10.7
Training and disclosure	19.9	11.1	9.4	5.3
Other	12.3	6.9	3.8	2.1
Total**	36.0	20.2	32.4	18.1

Note:
* Supervision consists of documentation checks, monitoring visits and management time.
** Individual components might not add up to totals due to rounding.

*** These estimates would be raised or reduced according to whether the annual cost of registration, monitoring and enforcement under statutory regulation exceeds that under Mortgage Code 2002, expected to be about £5m.

12. For ***lenders and intermediaries together***, the once-off costs of the Standard Case of statutory regulation, over and above those of Counterfactual (ie "Mortgage Code 2002"), are expected to be about £36m, or £20 per mortgage advanced. The annual costs thereafter are expected to be about £32m, or £18 per mortgage advanced.

13. Of this total, the once-off costs to ***lenders*** are expected to be about £14m, or £8 per mortgage advanced, and the recurring annual costs to lenders also to be about £14m, or £8 per mortgage advanced. For lenders, new disclosure requirements are the largest single source of expected once-off costs from statutory regulation, and the costs of additional documentation checking the largest continuing costs.

14. The once-off costs to ***intermediaries*** are expected to be about £22m, or £31 per mortgage arranged by intermediaries, and the recurring annual costs to intermediaries about £18m, or £26 per mortgage arranged. For intermediaries, initial training requirements are the largest single source of additional once-off costs expected from statutory regulation, and the costs of additional documentation checking the largest recurring cost.

15. For both lenders and intermediaries, the Counterfactual was expected to generate large additional once-off training costs: about £35m each for lenders and intermediaries. Most of these expected costs were generated by the requirement for a Certificate in Mortgage Advice and Practice (CeMAP) qualification for individuals giving information or advice on mortgages. For intermediaries, the cost of employees' own study time outside work may, at the outside, double this estimate if costed at the same rates.

16. These cost estimates implicitly reflected judgements from most lenders and intermediaries that their customer interviews and internal procedures would not be greatly affected by the model of statutory regulation used for this study. More rigorous disclosure requirements could generate much higher costs, and the once-off costs of statutory regulation would be also higher if statutory regulation were introduced earlier.

17. The once-off compliance costs to lenders of the Enhanced Coverage Case of statutory regulation would be slightly greater (perhaps 10 per cent higher) than the compliance costs of the Standard Case, but the continuing costs were not expected to be significantly different. Similarly, the costs to intermediaries may be little different. Many interviewees would welcome a common regulatory framework being applied to all residential mortgages.

18. The Minimal Coverage Case was not regarded as viable by interviewees, and it was not possible to produce consistent cost estimates from companies' returns for this Case or for the Lighter Regulation Case. Under the Minimal Coverage Case, many lenders and intermediaries would withdraw from providing advice on the forms of mortgage subject to regulation. Some interviewees did not believe that statutory regulation of mortgage advice could sensibly be introduced without a requirement for a qualification to demonstrate competence, as in the Lighter Regulation Case.

19. Large lenders expected lower compliance costs per adviser than smaller lenders, and large intermediaries expected lower compliance costs per adviser than smaller intermediaries. Further increases in concentration amongst lenders or intermediaries in the period before any statutory regulation was introduced would therefore reduce compliance costs.

Market Impacts

20. The magnitude of the estimates of compliance costs are not so large that instituting statutory regulation is likely to have a significant effect on the volume of mortgage transactions or the amount of advice provided. But the compliance costs are sufficiently large to potentially lead to less advice being provided by mortgage intermediaries.

21. Because larger lenders and intermediaries typically expected lower compliance costs per adviser than smaller lenders and intermediaries, statutory regulation would probably give them an additional advantage and tend to accelerate the trend to concentration in the lending market.

22. Significant exit would also be likely amongst intermediaries on the introduction of statutory regulation, with many intermediaries for which mortgage advice is only a marginal activity leaving the market. On the other hand, the costs created by a requirement for the CeMAP qualification, taken for this study to be part of the Counterfactual, may lead many of those “marginal” firms to exit the market even in the absence of statutory regulation.

23. The qualification requirement; the expected exit of marginal intermediaries; greater specialisation amongst lenders’ staff; and tighter controls on registration, would be likely to lead to some improvement in the quality of advice but would not reduce the ability of an adviser to exploit an information advantage.

24. Both lenders and intermediaries considered that league tables of mortgage products were impractical and that “best advice” could not be introduced in a way that was significantly different from the “most suitable” advice specified in the current Mortgage Code. The criteria developed to establish what was *not* best advice could have a major impact on the market for mortgage advice.

25. The effects of introducing a CAT Standard for mortgages along the lines outlined in the questionnaire would depend on the margin specified and on the requirements on availability. If the new standard were successful, it would tend to increase the pressure on tie-ins, redemption penalties and arrangement charges.

26. Most, but not all, of the lenders and intermediaries in the sample said they would welcome statutory regulation of mortgage advice as a natural development from the Code. There was some preference for any statutory regulation to apply to all mortgage lending on residential property.