The UK's model of effective non-statutory regulation provides a valuable framework for other mortgage markets

By Luke March, Sue Scott and Brad Baker –
The Mortgage Code Compliance Board (UK)

Introduction

This paper presents the rationale behind and an overview of the significant regulatory changes happening now in the UK. It goes on to speculate on how these changes might affect the shape and structure of the UK mortgage industry.

The paper will provide an overview of the current shape and structure of the UK mortgage market. The successes of non-statutory industry regulation of the UK mortgage market over the last four years will be reviewed – in particular the significant progress in raising industry standards in advice and information provision and in enhanced consumer protection.

Within the paper the potential value to other markets of the knowledge gained through the UK experience of effective non-statutory regulation will be explored, with particular reference to the keen interest in the model expressed by professional mortgage bodies in Canada and Australia, and of course elsewhere in Europe.

The paper will look at the potential impact of the introduction of statutory regulation on the UK market including some comments on the remaining transition period leading to the implementation of statutory regulation.

The Mortgage Code and the Mortgage Code Compliance Board (MCCB)

The Mortgage Code sets out standards of good practice in lending and in the selling of mortgages. It was introduced by the Council of Mortgage Lenders (CML), the UK trade association for mortgage lenders, for lenders in 1997 and was extended to mortgage intermediaries in 1998.

Having a consumer protection focus, with key commitments that firms must subscribe to in terms of fair dealing with customers and minimum standards for information disclosure and provision of advice, the Code and MCCB have become acknowledged models for non-statutory regulation in the UK. Lenders who are members of the CML must agree to comply with the Mortgage Code and register with MCCB. All lenders authorised by MCCB also agree to accept business only from registered intermediary firms. This means that almost all firms in the residential mortgage market – in excess of 98% - are covered by the Code and MCCB. This level of coverage is unique in UK non-statutory regulation in any field of business.

Established only since 1999, MCCB maintains a register of all lender and intermediary firms who have agreed to abide by the Mortgage Code and develops policies to promote cost-effective compliance. MCCB is funded by annual registration fees from registered firms but is, however, independent of the industry and constitutionally is principally a consumer focused regulatory body with a majority of public-interest directors. MCCB has wide power to warn, reprimand, direct future conduct, fine, suspend or de-register a registered firm.

Market Scope

The UK mortgage market is acknowledged as one of the principal drivers of the British economy, where 70% of households are owner occupied and home ownership is very much the tenure of choice.

MCCB has 156 active mortgage lenders registered. These range in size from building societies with a single branch office and mortgage assets of less than £50m to quoted companies with mortgage assets of over £100 billion. Additionally, the MCCB has more than 11,000 broker firms registered.

In 2003, new mortgage lending exceeded £250 billion for the first time and over two million completions took place - this being the fourth successive year of record lending levels within an unparalleled bull market period for the mortgage and wider housing industries.

Research published by the CML shows that over 45% of all advances are for remortgages or refinancing of existing loans – often to secure better short term rates –

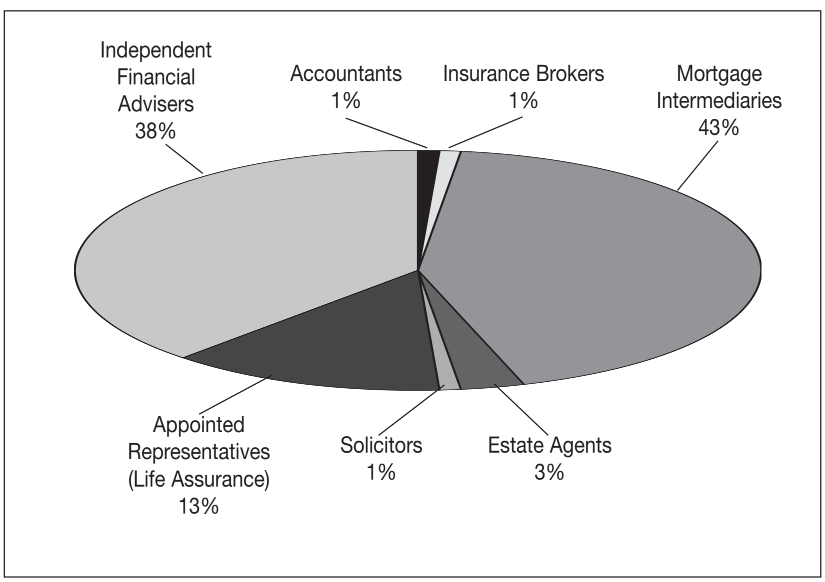
but many also tap into the unprecedented equity growth fuelled by the recent house price boom which represents a principal source of funds for consumer spending on 'big ticket' items such as home improvements, cars, holidays and consumer durables.

Mortgage intermediaries or brokers are very important to the UK mortgage industry – with over half of all mortgages originated through brokers. Typical broker margins are small, with intermediaries making a living from small introduction fees (typically around 0.5% of the mortgage advance for a standard case) paid by lenders and from commission from related product sales such as buildings and contents insurance, mortgage payment protection policies and life assurance sales. In the growing UK sub-prime sector there is more scope for intermediaries to charge a fee to the client – also usually a percentage of the loan – and to receive a larger fee from the lender for the introduction.

Type of Intermediary Firms

The Chart 1 below illustrates the make up of UK intermediary firms in terms of the nature of their business.

Chart 1



Registered Intermediary firms

43% of firms trade solely as mortgage brokers; 38% act as independent financial advisers – including providing mortgage advice and/or information; 13% of firms are attached to a life assurance office as a tied or appointed representative and smaller segments have a professional connection, being, for example, accountants or solicitors.

Size of Intermediary Firms

The huge majority of firms registered with MCCB are in the single or 2-5 sales staff category, (as seen on the left hand side of Chart 2) although the small number of larger registered firms also employ a large number of sales staff.

Some concerns have been expressed as to how statutory regulation might affect the structure of this sector of the mortgage market – where standards, as measured through MCCB's extensive compliance monitoring programme, are generally very high - and in particular the number of small intermediary firms now trading.

Recent consumer research, conducted by MCCB, shows the value of easy access to high quality and independent mortgage advice – especially for first time buyers of whom only 6% believed they have an adequate understanding of mortgages. With around 8,000 different mortgage product variations currently available, the scope for confusion and inappropriate choice for the ordinary consumer is significant.

Lenders

All 156 lenders registered with MCCB have agreed to meet the same minimum standards laid down in the Mortgage Code. Recently the number of specialist firms and subsidiaries has grown, reflecting growth in sectors such as sub-prime lending and equity release lending (known as 'lifetime mortgages') to older borrowers seeking to enhance their retirement income by drawing on the capital built up in their home. The latter area is expected to expand significantly in the next few years principally as a result of inadequate pension provision arrangements in place and the poor performance of pension funds.

The Achievements of Non-Statutory Regulation

In the last four years, MCCB has consistently and systematically raised industry standards through a range of measures, implemented in consultation and co-operation with the industry.

MCCB rules require all firms to hold a compulsory Government issued consumer credit licence and a minimum level of Professional Indemnity Insurance. Additionally, authorisation requirements (in the form of Fitness and Propriety checks) have been introduced as entry standards for the industry, which include credit checks and other reference requirements. Prior to introducing these requirements anyone could enter the industry. Over 1,000 firms which have failed to meet the minimum requirements have been deregistered since the introduction of the more onerous standards, thereby greatly reducing the risk of consumer detriment from high-risk practitioners. Interestingly, almost 50% of

Chart 2

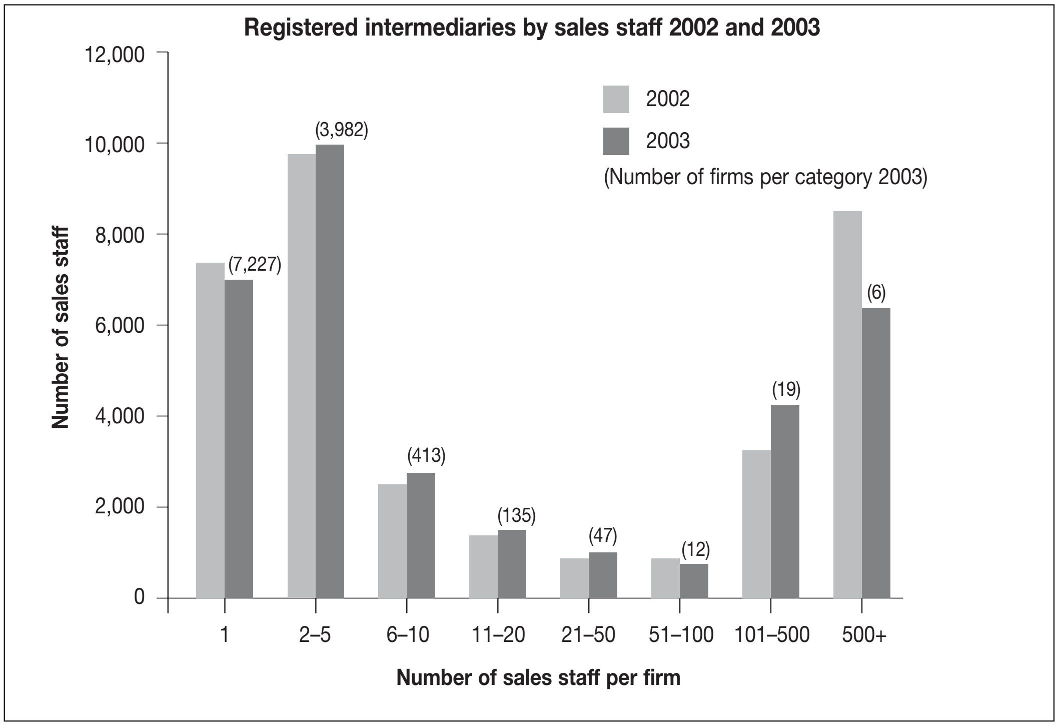


Chart 3

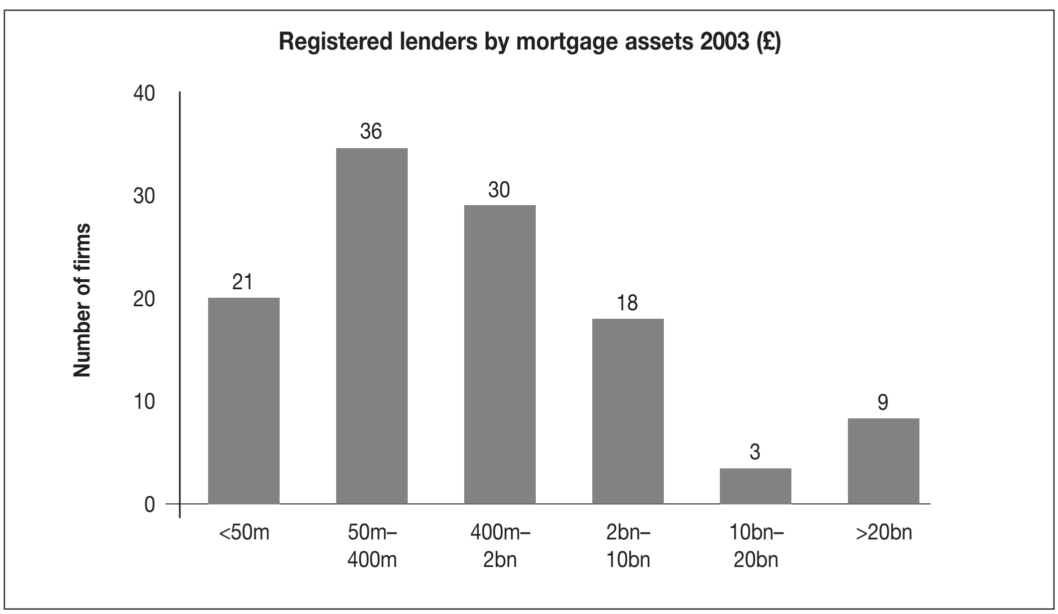
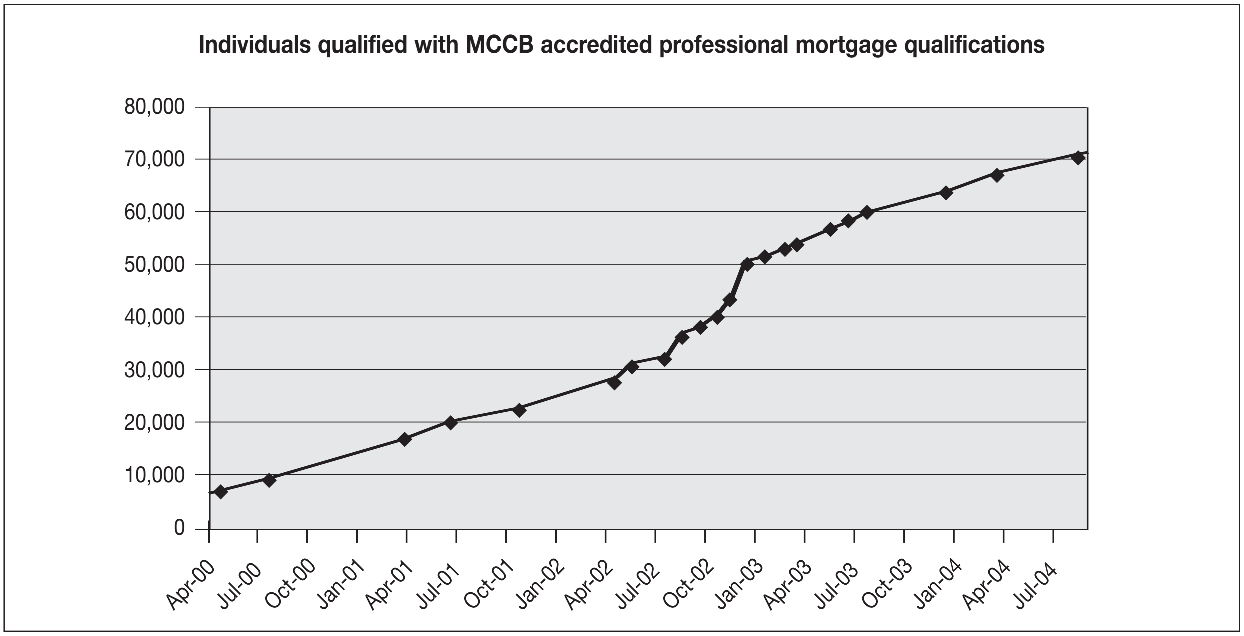


Chart 4



those expressing an interest in being authorised never submit an application after they have become aware of the authorisation requirements.

Perhaps most significantly, MCCB has fully implemented its Fitness and Competence Requirements for all mortgage advisers. In just over three years over 71,000 individuals have now passed one of the accredited examinations that are compulsory for mortgage advisers. Whilst the total number of individuals qualified will include some back office staff, managers and a number who may have since left the industry under normal employment cycles, it is certain that the vast majority of practising advisers are now qualified, with unqualified trainee advisers under robust supervision. The successful implementation of the qualification and MCCB training and competence requirements in this manner represents a significant uplift in standards, of which the industry can be justly proud. Indeed this will be one of the significant and lasting legacies of non-statutory regulation and now appears completely 'bedded in' as part of the ongoing entry criteria to the industry.

Furthermore, the Financial Services Authority (FSA) has confirmed that individuals who already meet MCCB's Fitness and Competence Requirements, and who have gained a professional mortgage qualification, will not need to pass a new examination in order to advise on standard mortgages after statutory regulation is introduced. Mortgage advisers will, of course, need to be 'competent' in relation to the new regime under the FSA's Training and Competence Requirements, but will not have to take a new examination. This process, known as 'grandfathering', acknowledges the impact of MCCB's Requirements in raising industry standards, and means that the effort of practitioners in meeting the MCCB's Fitness and Competence Requirements has been recognised in the new regime.

Chart 4 illustrates the increase in qualified individuals over the last few years.

Other significant achievements include the introduction of minimum standards in complaint resolution, including requiring firms to compulsorily refer unresolved complaints to an independent arbitration scheme - with decisions binding on the firm – where firms are not members of the UK's Financial Ombudsman Service. Customers of intermediary firms and lenders that are not banks or building societies have particularly benefited from these rule requirements.

A comprehensive disciplinary process is also in place if significant breaches are identified from over 2,000 compliance monitoring inspections every year. And MCCB has continued to educate firms about their other Code compliance obligations by holding over 250 workshops and publishing good practice and guidance notes in its monthly industry bulletin.

The rationale behind the progression towards statutory regulation

Following the enactment of the Insurance Mediation Directive under which general insurance intermediaries would require statutory authorisation and notwithstanding the acknowledged value of non-statutory regulation in the UK mortgage market, in December 2001 the Government announced that at a future date – now confirmed as 31 October 2004 – mortgages (specifically mortgage advice and arranging, and the authorisation and regulation of mortgage intermediaries) would come within the remit of statutory regulation under the UK's financial watchdog, the FSA. The Government had earlier announced that mortgage lending and administration would be subject to statutory regulation.

In 2001, the Treasury had also commissioned a review of banking services consumer codes under Dr DeAnne Julius, whose report, whilst recognising the robustness of the Mortgage Code and the consumer protection arrangements in place, highlighted the wider protection benefits available to the consumer through the introduction of statutory regulation in the longer term.

Despite acknowledging the successes of the non-statutory model, the Government's hand was forced in terms of timing for statutory regulation by the need to implement the Insurance Mediation Directive, requiring general insurance sales to be subject to statutory regulation in all European Union states. The Government decided that it would be anomalous if mortgages remained outside statutory control, when all other financial services in the UK were regulated by the FSA – hence the decision to include mortgages.

Despite signalling the end of the Code **and** MCCB's role, MCCB supports this logical decision and has been working hard to ensure there is a smooth and seamless path to statutory regulation, with no gap in coverage or consumer protection in the transition. As can be seen many pressures emerged leading towards the strategic shift towards statutory regulation. However, the non-statutory regime has successfully created a regulatory culture in the industry, where none existed before; standards have been raised and consumer protection measures introduced and enforced, allowing the potential for a successful progression to new statutory arrangements.

MCCB's annual revenue is approximately £5 million. With this it conducts all its registration and compliance monitoring and enforcement activities - including over 2,000 compliance visits and formal contacts with firms per year. This is remarkable value for money, especially when compared with the likely costs of statutory regulation. The likely start-up and first year costs of implementing statutory regulation of mortgages and general insurance have been estimated by the FSA at £15 million and £30 million respectively. Ultimately these will be passed on to the consumer.

Statutory regulation will encompass a move from a principles based Code focusing on the customer sales process to a rulebook-based regime encompassing some 15,000 pages in total, covering all aspects of business activity. There is a growing concern that smaller firms may feel overwhelmed by these new requirements and sink under the new bureaucratic burden, and it will be fascinating to consider, in a few years time, whether, and if so, how consumers have benefited from the shift from voluntary to statutory regulation in the mortgage market.

Impact of Statutory Regulation - choices for mortgage firms

Intermediaries face a number of choices as regards the future of their businesses in the coming months.

- Firms can choose to become directly authorised by the FSA;
- Firms can choose to become Appointed Representatives under the control and responsibility of a principal firm (intermediary network, principal lender or other principal firms) that itself is directly authorised by the FSA; or
- Firms can withdraw from direct sales and become an introducer to another firm directly authorised by the FSA; or
- Firms can withdraw from the mortgage industry

Some firms may also consider another option: to move into non-regulated areas such as buy-to-let mortgages or home reversionary schemes.

The latter options are likely to lead to less choice in the residential mortgage market for the consumer. Market consolidation is inevitable and it is likely that there will be only around 7,000 directly authorised mortgage firms when statutory regulation begins, compared to the 11,000 plus active today. The introduction of statutory regulation was not intended to bring about a restructuring of the UK mortgage industry. Early indications are that there will be fewer distinct firms operating in the market, although the number of individuals employed will not fall significantly – with many firms likely to choose the appointed representative route for their future business.

The Transition to Statutory Regulation

Building on the work of the MCCB, the FSA will assume responsibility for regulation of the mortgage industry on 31st October 2004 – a date known as 'Mortgage Day' or 'NM', with general insurance regulation to follow on 14 January 2005. It will have been a long path that finally reaches its end with the introduction of regulation. The transition period of almost three years since the Government's announcement in December 2001 has enabled the FSA to consult with the industry and other stakeholders on the detailed components of the new regulatory regime and has given firms time to adapt their processes and systems to meet the new requirements.

MCCB has worked closely with the FSA in this period – for example in responding to the various consultation documents – to help create a proportionate new regulatory structure.

At times this has not been easy, but the regime we now have is much fairer than where we started off. Time will tell how the new regulations are implemented and the long term effect they will have on our industry.

MCCB is tasked with the unique management challenge of maintaining its effective operations and consumer protection arrangements while knowing the organisation will cease to exist later this year. To date the effectiveness of the non-statutory regime has been maintained and MCCB has in place a range of measures to retain and retrain its staff to equip them for future opportunities.

This successful transition has been achieved through the strong support of both lender and intermediary sectors – for example, lenders agreed to maintain the Code requirement of accepting business only from registered intermediaries. Additionally, the FSA has declared that only firms which maintain their MCCB registration will benefit from due credit in the FSA authorisation process. We are confident that industry support will continue, as it is vital for the industry's reputation that robust consumer protection arrangements remain in place and no regulatory gaps allowed to arise prior to 'Mortgage Day'.

Wider Interest in the UK Non-Statutory Model

In late 2003 MCCB was the guest of the Canadian Institute of Mortgage Brokers and Lenders (CIMBL, the acronym being pronounced as 'cymbal') and presented a session at their 8th annual conference in Toronto.

There is great interest in Canada, and also in Australia (which has a very similar mortgage market to Canada's), in the successful application of non-statutory mortgage regulation in the UK and the Mortgage Code and MCCB, widely acknowledged for raising standards, consumer protection and the UK industry's reputation, are viewed as models for implementing self-regulation in these markets.

The Canadian Mortgage Industry

Canada has a population of 30 million. There is around 70% home ownership in Canada – similar to UK levels – and mortgage balances of around $524 billion CDN (about £240 billion). The industry is set to achieve record lending levels in 2003/4 of $250 billion with around 600,000 completions. There is a similar property price boom to the UK's in Canada, centred on the major urban areas. Over 200,000 new homes will be built this year. The Canadian base rate is now around 2.75% and mortgage margins are small.

Lenders dominate the Canadian market, with just 26% of all mortgages being originated by brokers, compared to over 50% in the UK, although this share is expected to grow rapidly in the next few years. Mortgages are funded through retail savings and the wholesale bond market in a very similar manner to the UK. Short term fixed rate and discounted rate products predominate – the five year fixed rate mortgage being the most popular single variation – and there are very high rates of renewal or loyalty to existing lenders at the end of these periods.

New entrants, particularly from America, are becoming active and some, particularly in the small sub-prime sector, use brokers as their primary and ready-made distribution channel. This, together with increasing consumer awareness, access to information and greater competition, could well mean it is an attractive and profitable time to be a broker in Canada.

CIMBL

CIMBL is the trade body for the entire Canadian mortgage industry. Founded in 1994, with input from regulators and representing lenders, brokers and insurers, its membership of 5,000 individuals covers 90% of all mortgage originations. CIMBL aims to enhance professionalism through enforcing a Code of Ethics – very similar in scope to the Mortgage Code's own key commitments – and through enhanced programmes for customer service and consumer protection, promoted via effective public relations campaigns. CIMBL is an organisation promoting honesty, integrity and professionalism in its industry.

Moves towards Self-Regulation

CIMBL aims to add value for its members and the overall industry, with the ultimate goal of becoming an effective self-regulatory body. It aims to evolve from a trade to a professional organisation, to harmonise national educational standards, to develop partnerships with regulators, and to avoid a regulatory solution being enforced in the future. It has implemented a variety of initiatives including designating individuals with 'Accredited Mortgage Professional' status, subject to strict requirements and standards.

Interest in the Mortgage Code and its value in Australia

Additionally, strong interest has been expressed by the Mortgage Industry Association of Australia (MIAA). The Australian market is strikingly similar to Canada's and the MIAA has similar goals to CIMBL for self-regulation and the raising of professional standards. It has similarly researched MCCB's experiences in the UK with a view to implementing a 'self-regulatory' framework in Australia.

Conclusions

The potential value of the non-statutory UK model of the Mortgage Code and independent regulator to other markets can clearly be seen. This especially is the case where the push for raising standards is industry or consumer driven (as was initially the case in the mid-1990s through the work of the CML and lender community) and in countries where there is no culture or appetite for centralised Government-led regulatory intervention – perhaps due to a federal structure (as is the case in Canada and Australia) or to environmental factors such as a less mature economic system (as may be the case in some emerging Eastern European markets).

Ruth Kelly MP, the Financial Secretary to the UK Treasury and the minister responsible for financial services market regulation, has