

## Chapter 2

# The Role of the Financial Services Authority in the Mortgage Market

## Chris Cummings

Director General, AMI

## Vanessa Moore

Policy Officer, AMI

### 2.1 Introduction

The mortgage market was shaken up by the announcement that from 31 October 2004, it would fall under the remit of the Financial Services Authority ("FSA"). The FSA is a statutory regulator, created by the Financial Services and Markets Act 2000 ("FSMA").

The FSA is a company limited by guarantee, but financed by the financial services industry. The Treasury appoints the FSA Board, which consists of a chairman (Sir Callum McCarthy), a chief executive (John Tiner, who has announced his resignation and will leave the organisation in early 2008), three managing directors (currently Clive Briault, Retail markets, Hector Sants, Wholesale markets, and David Kenmir, Operations) and nine non-executive directors (including a lead non-executive member, the deputy chairman, currently Dame Deirdre Hutton). These individuals were in post as at July 2007. This Board sets the overall policy, but day-to-day decisions and management of the staff are the responsibility of the Executive.

The FSA has four statutory objectives:

- (a) market confidence: maintaining confidence in the financial system;
- (b) public awareness: promoting public understanding of the financial system;
- (c) consumer protection: securing the appropriate degree of protection for consumers; and
- (d) the reduction of financial crime: reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

These are supported by a set of *principles of good regulation* to which the regulator must have regard when discharging its functions.

In pursuing its functions under the Act, the regulator is required to have regard to additional matters referred to as “principles of good regulation”. These are:

### **2.1.1 Efficiency and economy**

The non-executive committee of the FSA Board is required, among other things, to oversee the allocation of resources and to report to the Treasury every year. The Treasury is able to commission value-for-money reviews of the FSA's operations and these are important controls over the efficiency and economy of the operation. Indeed, a National Audit Office review of the FSA was conducted in early 2007, with a report produced in May of that year. Many commentators have suggested such a review should be a two-yearly scheduled event.

### **2.1.2 The role of management within regulated firms**

A firm's senior management is responsible for its activities and for ensuring that its business complies with regulatory requirements. This principle is designed to guard against unnecessary intrusion by the regulator into firms' business and requires the FSA to hold senior management responsible for risk management and controls within firms. Accordingly, firms must take reasonable care to make clear how responsibilities are divided within the firm, and to ensure that the business can be adequately monitored and controlled.

### **2.1.3 Proportionality**

In making its judgments, the regulator must take into account the costs to firms and consumers of any proposed regulatory changes. One of the main techniques used is a “cost benefit analysis” of any proposed regulatory intervention. This approach is shown, in particular, in the different regulatory requirements applied to wholesale and retail markets.

### **2.1.4 Innovation**

This involves, for example allowing scope for different means of compliance, so as not unduly to restrict market participants from launching new financial products and services.

### **2.1.5 International character**

The FSA must take into account the international aspects of much financial business and the competitive position of the UK. This involves cooperating with overseas regulators, both to agree international standards and to monitor global firms and markets effectively.

### **2.1.6 Competition**

The regulator should look to minimise the adverse effects on competition that may arise from regulatory activities. The FSA is neither an economic nor a competition regulator and so must be mindful of competition between the firms regulated. There has been some speculation of late that “competition” could be elevated to be added to the regulator’s four objectives in order to ensure that they pay due regard to any new regulatory proposals.

### **2.1.7 The impact of regulation on the mortgage market**

The FSA is a regulator in transition. It has clearly signposted its view that it will achieve more and have a better regulated market if it moves towards a more principles-based regulatory regime.

Key tenets of this are the FSA’s belief in a principles framework, more focused on outputs than in the (tick-box) process of regulation. This is supported by a risk-based approach, the desirability of regulation working with the grain of the market rather than against it, the restriction of regulation to those circumstances where the market does not provide adequate answers and where regulation has the prospect of doing so at reasonable cost, and an acceptance that a regulatory system neither can nor should aim at avoiding all failures.

In December 2005, the FSA published its Better Regulation Action Plan to move the balance of financial services regulation further towards high-level principles rather than detailed rules and guidance. It has since followed this up with a progress report, published in June 2006. April 2007 saw the publication of a further paper on principles-based regulation, designed to give more detail on what the impact will be on the FSA, the Financial Ombudsman Service, firms and, indeed, on consumers. These proposals clearly signposted the move towards principles-based regulation, a cull of the Handbook and a desire to see the industry solve more of its own problems – rather than looking to the regulator.

This approach is underpinned by the principle that it is neither possible nor desirable to write a rule to cover every specific situation, or need for a decision that a regulated firm might encounter. Instead, the regulator will focus on the Principles set out in FSMA. These set out in more general terms the types of behaviour that they expect of firms and individuals.

Many in the financial services industry, particularly at senior level, support this approach. However, the regulator’s experience is that many of those operating in compliance or legal departments within regulated firms have yet to become comfortable with this approach and consistently seek detailed guidance on how to interpret principles in specific situations. They expect that understanding of how to operate in a more flexible, principles-based regime will evolve over time. In the meantime, the regulator accepts that, as an inevitable result of amalgamating

the rulebooks of all the predecessor regulators, the FSA Handbook is a large document.

## **2.2 The regulator**

Around 90 per cent of all the firms now regulated by the FSA are classed as “small” – and this is especially true of the mortgage intermediary community. To help cater for the particular relationship between an intermediary firm and the regulator, the FSA established the “Retail Intermediaries” team, headed by Stephen Bland (in-post at time of going to press).

In setting out the role of the Retail Intermediaries team, Stephen Bland commented that it will bring about the delivery of the FSA’s three strategic priorities in the sector. These objectives are: to promote efficient, orderly and fair markets; to help retail consumers achieve a fair deal; and to improve the regulator’s capability and effectiveness.

In line with these priorities, over the next five years, the team will focus on harnessing the efforts of the FSA to achieve a sector:

- consisting of responsible firms who treat their customers fairly and are soundly managed and adequately capitalised;
- that provides clear, simple and understandable information to consumers.

## **2.3 Key issues**

Later sections of this book take a look at some of the key regulatory issues for mortgage intermediaries in running compliant and profitable businesses. However, firms should realise that the FSA is not a reactive regulator and takes its objectives seriously.

The mortgage market has already seen some work undertaken by the FSA and this will grow as the regulator becomes more familiar with the market’s issues. Whilst much of this work will be done through desk-based supervision, firms should also be prepared for thematic studies (as discussed separately) and also to be “mystery shopped” by individuals posing as potential borrowers. The FSA believes this approach gives it useful information on how firms actually behave as opposed to behaviours seen when the firm knows it is being scrutinised.

The FSA’s approach to supervision at a firm level is determined by the impact the firm has on its statutory objectives. Currently, around 90 per cent of regulated firms are categorised as “low impact” by the regulator. These are known as “small firms” and most mortgage intermediaries will fall into the small firms division.

## **2.4 Building a good relationship with the regulator**

The FSA's risk-based approach to supervising regulated firms means that most small firms will not be in close contact with the FSA on a regular basis.

Under normal circumstances, the most common interactions between small mortgage intermediary firms and the FSA are through three events:

- (a) the firm submitting its Retail Mediation Activities Report ("RMAR") and complaints returns;
- (b) the FSA selecting the firm to be included in thematic work;
- (c) the firm contacting the FSA, either through its website or through the Firm Contact Centre ("FCC").

## **2.5 Regulatory reporting**

In supervising small firms, the FSA will rely largely on the data collected through regulatory returns – the Retail Mediation Activities Report ("RMAR") for mortgage intermediaries, and the Product Sales Data ("PSD") submitted to the FSA by insurers and lenders. The data collected through these returns provides the FSA with a full picture of the mortgage market; it should be able easily to identify those firms that carry out certain types of business, and those firms that display unusual characteristics for firms of their size or type, which could indicate that the firm poses a higher level of risk to FSA's objectives.

The RMAR and complaints return are submitted through the FSA's "Firms Online" system. The system requires the firm to set password-protected access. The firm is able to set different levels of access within the system for each person the firm registers on the site. Firms Online allows the data to be saved and viewed by the firm throughout the reporting process. It also creates a bespoke reporting timetable for each firm based on their accounting reference dates. When the returns are complete, they can be securely submitted to the FSA and an acknowledgment is issued to the firm.

The FSA's reliance on RMAR and PSD data means that the quality of the data is of utmost importance to the success of the risk-based approach to supervision. Firms who do not submit returns on time are subject to an automatic fine, of £250 for late RMAR returns. The collation of data from both intermediaries and product providers provides the FSA with a source from which to cross-reference the data: those firms who submit inaccurate or incomplete data are at the very least likely to draw attention to themselves, at most they could find themselves subject to enforcement action where the error is considered to be serious enough. In the year ending 31 March 2007, FSA cancelled the permissions of 151 firms – 98 of these were due to firms failing to submit their RMAR.

To avoid these difficulties, mortgage intermediaries should familiarise themselves with the reporting requirements and create systems to collect the data needed for the RMAR and complaints returns – most of the data can be recorded on a day-to-day or transactional basis, reducing the time needed to complete the return.

## **2.6 Thematic work**

Small firms are not usually subject to specific assessments by the FSA; however, they will be involved in thematic work triggered by the FSA's market knowledge and the monitoring of the data received through the reporting requirements. The FSA uses a variety of sources to identify emerging retail risks including:

- market data;
- current trends and developments in the markets;
- financial promotions;
- issues identified through discussions with firms, including information which firms give in the course of retail intelligence visits; and
- risks identified by FSA sector teams, supervisors, contact centres, and other stakeholders such as industry and consumer bodies.

The FSA will look for indicators of new or unexpected developments and try to identify risks, so that action can be taken to mitigate them at an early stage. For example, an unusual surge in sales of a product might prompt the FSA to make further enquiries about the market conditions and sales processes in that area.

The decision to select a firm for thematic work takes into account a number of factors including how many and what type of firms are active in the market or sector the FSA is interested in. Most thematic work will look to include firms of varying sizes and business volumes in order that the FSA can try to gain a more accurate picture of how the market is working in practice. Thematic work can help the FSA to identify the scale and nature of risks presented in the area focused on, and whether or not regulatory intervention is necessary or appropriate.

When carrying out thematic work, the FSA uses a range of methods to assess and monitor the risks being addressed. The regulator may decide to use one or more of these methods in any piece of thematic work. For example, a desk-based review of firms' product literature, mystery shopping and programmes of firm visits are just some of the tools the FSA may use when undertaking thematic work.

The FSA's thematic work programme in the mortgage market has been extensive since mortgage regulation began. So far, the work includes:

- the quality of mortgage advice;
- self-certification mortgages;
- equity release (lifetime mortgages);
- payment protection insurance;

- treating customers fairly;
- mortgage lead generation companies;
- Islamic finance products; and
- early repayment charges.

The FSA communicates the results of its thematic work to the industry on a regular basis. Some key themes have emerged:

### **2.6.1 Training and competence (“T&C”)**

A robust T&C scheme is essential to ensure that all staff have the necessary skills and knowledge to carry out their role effectively. In the quality of advice work on mortgages, almost three-quarters of firms either did not have a T&C scheme in place, or were not following the scheme properly. The main areas of concern were lack of adequate monitoring procedures and failure to assess competency of advisers on a regular basis.

### **2.6.2 Record keeping**

Firms have much to gain from implementing good record-keeping procedures. Without adequate records, firms will find it difficult to justify their advice when called upon to do so by the FSA, or to put up a robust defence in the event that complaints are made – especially if the case goes to the Financial Ombudsman Service (“FOS”). In particular, recording the reasons for suitability of recommendations and demonstrating affordability through recording income and outgoings.

Mortgage intermediary firms who have put in place robust compliance procedures and carry out adequate monitoring are best placed to avoid regulatory scrutiny and should experience higher customer satisfaction and low complaints levels.

## **2.7 Handling thematic visits**

The principal purpose of any visit is to establish that the firm has the systems, controls and records in place to evidence compliance with the requirements of the FSA rules. Remember, though, that compliance with the specific rules is only the start – the FSA’s 11 “Principles for Businesses” need to be embedded in the actions of the firm at all times. The visit is also likely to assess whether the firm demonstrates that it has considered, and acts in accordance with these wider principles and treats its customers fairly.

Firms included in thematic visits will normally be asked to supply certain information in advance of the visit, such as the company organisation chart. This will help the supervisor leading the visit to identify which members of staff they would like to talk to. Those holding the controlled function of CF8 (Apportionment and Oversight) will nearly always need to be available during the visit, as will any

additional staff members who are responsible for compliance within the firm. If the visit is about a certain product, the firm may be asked to supply information about the sales it has conducted recently, and may then be asked to supply certain client files for review during the visit.

In addition to information provided before the visit, it may also be useful to have the following information to hand during the visit:

- latest accounts and management information on business performance;
- structure chart showing who in the firm is responsible for what;
- copies of any supplier agreements used for external support services;
- information on how the firm obtains new business and, if this is through referrals, exactly how new customers are approached;
- the firm's documented sales process and an example client file;
- copies of the firm's IDD/CIDD and "fact-finding" documents;
- the firm's T&C scheme, including the process for evidencing ongoing competency of staff;
- records of advice and recommendations, for example, suitability letters;
- TCF management information.

Remember that the topic of the visit will influence what documents are needed.

The FSA will normally arrange to see some or all of the firm's senior management during a visit. The attitude of senior management matters, and is an aspect which could affect the visit. The FSA's "Principles for Businesses" mean that firms have undertaken to be open and honest with the regulator. Visits are also an opportunity for the firm to receive useful feedback from the regulator to confirm that the firm is correctly applying the rules, and to highlight areas where improvements could be made. Visits are also a chance for small firms to meet the FSA "in person" and have the opportunity to ask questions or raise concerns they may have directly with the FSA supervisor.

More information on how to handle an FSA visit can be found in Chapter 17, "Preparing for an FSA visit".

## **2.8 Contacting the FSA**

Those firms who are part of the small firms division will not have a dedicated relationship manager or supervisor within the FSA. Instead, firms can contact the FSA directly through its Firm Contact Centre ("FCC"). The FCC aims to answer most queries at the first point of contact by the firm. Some more complicated queries will need to be passed to other areas of the FSA for a response. The FCC's service standards are published on the FSA website, as is its performance against these standards.

## **2.9 The FSA website**

The FSA website can be a good source of information for small firms who want to understand more about the regulator's requirements. The site now has a dedicated small firms area which is then split into business categories, including mortgage and other home finance advisers, general insurance firms and financial advisers.

## **2.10 Conclusion**

FSA regulation is markedly different to that most firms will have encountered in the past – especially those who were only familiar with the MCCB. This is not to say that smaller firms will not be able to cope with the rigours of statutory regulation – just that due regard must be taken of its requirements.

The regulator takes its duty of care to consumers exceptionally seriously and expects firms to be able to demonstrate that they are of similar mind. The Treating Customers Fairly agenda must be part of the firm's DNA and, as the regulator will be checking on firms' progress implementing and embedding TCF, good firms will clearly be able to demonstrate that they place the customer at the heart of their business. This is discussed in Chapter 18, "Treating Customers Fairly in the Mortgage Market".

FSA regulation sets a high bar. This level of regulatory scrutiny brings some benefits in terms of consumer protection, but also brings potentially harsh penalties. Individuals, as well as firms, can be fined and prevented from working in the industry again. All this means that those in responsible positions in organisations must understand their regulatory responsibilities and seek to satisfy them completely.

<http://www.pbookshop.com>