

MORTGAGE CREDIT DIRECTIVE: UK IMPLEMENTATION

Financial Regulation

Introduction

HM Treasury and the Financial Conduct Authority (FCA) have published consultation papers on implementation of the EU Mortgage Credit Directive (MCD) which needs to be transposed into UK law by 21 March 2016.¹ The MCD seeks to:

- ▶ prevent the repetition of irresponsible lending and borrowing practices;
- ▶ create a more efficient and competitive single market for mortgages;
- ▶ foster consumer confidence and customer mobility; and
- ▶ establish a level playing field and promote cross-border activity.

In contrast to HM Treasury's paper, which focuses on the Government's policy towards implementation and proposed legislative changes, the FCA seeks comments on its authorisation process and detailed changes to its rules, in particular, the Mortgage Conduct of Business Rules (MCOB).

As the UK's residential mortgage market has been largely regulated for a decade and the FCA has recently implemented new rules following its Mortgage Market Review (MMR), the UK has been openly sceptical about the MCD's value and will minimise its impact on the market as far as possible. MMR took effect from 26 April 2014 and concerns matters ranging from responsible lending, product distribution and disclosure, to arrears management and non-bank mortgage lending. In consequence, measures in the directive on, for example, affordability of lending and forbearance (when a borrower is experiencing financial difficulty) will have less impact on UK firms than in other Member States.

Nonetheless, areas such as second charge lending, consumer *buy-to-let* and disclosure requirements are subject to significant change that will require mortgage businesses to adapt processes and amend their documentation. Moreover, in contrast to the MCD, the FCA (through the MMR) has sought to reduce information overload for customers by replacing the Initial Disclosure Document (IDD) with a requirement for firms to disclose 'key messages' to the customer and reducing the trigger points for presentation of the key facts illustration (KFI). To avoid any regression in this regard, the FCA is proposing to retain the same timing triggers in respect of disclosure for the European Standardised Information Sheet (ESIS) as far as possible and retain the requirement to provide key messages verbally where there is spoken interaction.

¹HM Treasury, Implementation of the EU Mortgage Credit Directive, Consultation, September 2014; FCA, Implementing the Mortgage Credit Directive and the New Regime for Second Charge Mortgages, Consultation Paper CP14/20, September 2014.

Existing UK mortgage regulation

The UK chose to regulate first legal charge residential mortgage business from October 2004, independent of any EU treaty obligations.² This was achieved by a mixture of primary and secondary legislation together with regulatory rules, principally those in MCOB. Buy-to-let lending was excluded as the definition of a *regulated mortgage contract* requires that at least 40 percent of land is used by a borrower or their relative as their home. This was on basis that there is no social protection objective for these borrowers, some of whom may be engaged in business. In this way, a mortgage to acquire a shop with accompanying residential accommodation above could fall outside the scope of regulation, even though the borrower might reside there.

Second legal charges also fall outside current UK mortgage regulation, but are regulated under the Consumer Credit Act 1974 (CCA). As a result, this lending is subject to a number of exemptions but also consumer protections which will complicate MCD implementation. Unlike other measures in the MCD, HM Treasury has chosen to move second legal charges from consumer credit to mortgage regulation for reasons of consistency; the FCA became responsible for consumer credit on 1 April 2014 in succession to the Office of Fair Trading. This step will require amendments to the CCA to exclude second charges from the definition of a *consumer credit agreement*.

Approach to transposition into UK law

Unusually, but reflecting the Government's sceptical approach, the UK will not in general use "copy out" to transpose the provisions of the directive into law. Instead, it will make such changes as are necessary to UK legislation, including the Financial Services and Markets Act 2000 (draft legislation accompanies the consultation), and to MCOB. An exception concerns the introduction of an *appropriate framework* for buy-to-let mortgage lending to consumers where the minimum MCD requirements will be put into law through copy out. A similar approach is also used in parts of the FCA Handbook, as referred to below.

Transposition of the MCD into UK law will also see the extension of mortgage regulation to cover not just legal charges but equitable mortgages. Moreover, it will not matter where the security is located (i.e. the property over which security is granted could be in another Member State). In practice, these changes are unlikely to affect many mortgage businesses, who provide only legal mortgages secured over property in the UK.

² While equity release is regulated in the UK it is excluded from the scope of the MCD.

Second charge mortgage lending

The transfer of second charge loans to mortgage regulation from the CCA will mean the loss of certain bespoke consumer credit protections. Although the Government does not plan to have transitional provisions generally, there will be provisions in respect of certain protections for back book loans. Historic lender activity will be assessed against the rules in force at the time (e.g. information disclosure requirements when the loan was agreed) and where MCOB cannot provide equivalents (e.g. the ability to challenge unfair relationships and the rules over early settlement). Currently, certain second charge mortgage lending benefits from exemptions. Examples include bridging loans with four or fewer repayments or second charge business loans in excess of £25,000. These will be preserved, where permitted, under the MCD. Precise details and how the regulation of first and second charge mortgage lending will be distinguished are contained in the draft FCA rules under consultation.

Firms which offer second charge mortgages will need to apply to the FCA for authorisation and can do so early from April 2015. This will have both initial and ongoing cost implications for these businesses as they will need to comply with regulatory requirements, including meeting the *threshold conditions* (or minimum standards). Nonetheless, these firms would likely have had to apply for authorisation in any event, as the regulation of consumer credit has transferred over to the FCA. HM Treasury asks to hear from firms that may incur additional costs from regulation by the FCA as a mortgage business in contrast to a consumer credit business.

Buy-to-let mortgage lending

Buy-to-let made up 12 percent of the UK mortgage market in 2013. While this part of the market is dominated by a few lenders, there are many participants including buy-to-let specialists. A distinctive feature is that, compared to owner-occupier lending, most business comes from mortgage brokers. Due to the requirement that at least 40 percent of land is used by a borrower or their relative as their home, currently most buy-to-let mortgages fall outside regulation.

From a UK perspective, this is the most contentious part of the MCD and, until recently, HM Treasury had intended to maintain the regulatory status quo but this has not proved possible. The UK will, however, adopt a minimalist strategy to comply with its EU Treaty obligations.

The existing UK exemption based on less than 40 percent occupancy is incompatible with the MCD. Under the directive, only mortgages whose terms stipulate that a property cannot be occupied at any time by the borrower or a family member and which is to be occupied as a place of residence on the basis of a rental agreement may be excluded from regulation. On the other hand, because the MCD does not apply to mortgage lending where the purpose is wholly or predominantly for business purposes, most buy-to-let lending will continue to remain out of scope. In this regard, most borrowers who purchase a property to let will be seen as choosing to engage in a business activity. Helpfully, firms will be able to rely on a borrower's declaration unless they have reasonable grounds to believe otherwise.

Appropriate framework

To comply with the directive for “consumer buy-to-let,” HM Treasury proposes to introduce an *appropriate framework*. This framework is set out in the schedule to the draft Mortgage Credit Directive Order accompanying the consultation. Buy-to-let borrowers likely to be subject to the appropriate framework include ‘reluctant landlords’, i.e. those who have inherited properties or have lived in them and are unable to sell for the time being.

Those consumer buy-to-lets falling within the regulation will find that the appropriate framework does not apply the full force of the MCD. It consists of the copy out of relevant provisions in a proportionate manner from the directive, adapted so far as possible to align them with existing market practice. In this regard, rather than requiring lenders and brokers to be authorised (if they are not already), the burden of full authorisation will be removed and, instead, there will be a requirement to meet certain minimum standards (being less onerous than the *threshold conditions*) and to “register” with the FCA.

Replacement of KFI with ESIS

The MCD will require significant changes to initial document disclosure. The KFI will be replaced by the ESIS found at Annex II to the Directive and the FCA has included examples at Appendix 2 of its consultation paper. The format of the ESIS is very similar to the SECCI which is used by firms providing consumer credit. Transitional arrangements will apply for first (but not second) charge firms to rely on a “topped up” KFI in order to meet the disclosure requirements until 21 March 2019 (e.g. giving risk warnings for foreign currency loans and informing borrowers of the new 7 day period of reflection).

Other changes

In addition, mortgage firms should be aware of other changes including:

- ▶ UK practice is for lenders to make conditional offers subject to further checks. As the MCD requires lenders to make a binding offer, MCOB will be amended to introduce a new step prior to acceptance by borrowers;
- ▶ the methodology for calculating the annual percentage rate of charge (APRC), although not dissimilar from MCOB 10, will be copied out from the MCD definition which is closely aligned to the approach under the Consumer Credit Directive and the FCA consumer credit rules, (CONC). In a further change, a second APRC will be needed where interest or charges are variable;
- ▶ secured lending on timeshare property is to be brought within mortgage regulation – given the limited amount of such lending in the UK this is unlikely to have much impact on the market;
- ▶ clarification of the definition of the regulated activity of “arranging regulated mortgage contracts”;
- ▶ there will be a legal right to early repayment and the basis on which compensation or an early repayment charge is calculated will change from a reasonable pre-estimate of the costs to a “fair and objectively justified compensation for potential costs directly linked to early repayment.” This must not exceed the lenders’ financial loss;
- ▶ foreign currency mortgages – firms will face new obligations where either the currency of the loan is different to their income or different to the place of the borrower’s residence. These will include providing illustrations on the impact of currency fluctuations and more significantly taking steps to protect customers if there are adverse movements, for example, changing the loan to another currency; and
- ▶ unsecured lending where a loan is used to acquire or retain property rights (e.g. a loan advance used to pay off mortgage arrears) will also fall under the MCD, but such lending will remain in the consumer credit regime rather than the FCA mortgages regime for legislative purposes.

The MCD seeks to increase the cross-border provision of mortgages and intermediation services. While firms may wish to explore these opportunities, it is likely to be challenging to operate in foreign markets where borrowers prefer local lenders and the differences in legal and judicial systems will add further uncertainty to business models.

Next Steps

HM Treasury plans to finalise the draft secondary legislation by March 2015. Feedback is due to this consultation by 30 October 2014. Meanwhile, the FCA will publish its final rules in a policy statement in the first quarter of next year; feedback to its consultation is due by 29 December 2014. The Government’s objective is to allow firms a year in which to prepare for the coming into force of the amended regime on 21 March 2016. This is seen as particularly important because, with the exception of the new ESIS and competency arrangements, there are no transitional provisions. To facilitate this objective, the FCA proposes to allow firms to choose to use the new rules early from December 2015.

What should firms do?

Firms should, in the meantime, review their business models and ensure that their processes and procedures align with the proposed changes to consumer credit and mortgage regulation. There is likely to be needed much “re-papering” of documentation with some buy-to-let lenders and brokers having to register with the FCA under the appropriate framework regime.

Work will also be needed to put in place knowledge and competency arrangements for staff. A further year will be allowed (after March 2016) for staff to comply with MCD requirements (although the FCA considers these are already met in the UK, except for product design and for those granting credit), and a three year period to March 2019 for firms to move from using only professional experience to assess knowledge and competency.

The question of how to deal with pipeline business remains. HM Treasury and the FCA are considering the best approach to minimise disruption. There also remains the problem of second charge back book loans transferring over from the consumer credit regime while retaining some, but not all consumer protections and how lenders are to manage this business in the future in the context of their overall lending book.

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