

<b>Title:</b> Renewing the sale and rent back 'by way of business' amendment <b>IA No:</b> <b>Lead department or agency:</b> HM Treasury <b>Other departments or agencies:</b>	<b>Impact Assessment (IA)</b>		
	<b>Date:</b> 18/07/2014		
	<b>Stage:</b> Final		
	<b>Source of intervention:</b> Domestic		
	<b>Type of measure:</b> Secondary legislation		
<b>Contact for enquiries:</b> Simon.smith@hmtreasury.gsi.gov.uk			
<b>Summary: Intervention and Options</b>			<b>RPC Opinion:</b> Awaiting Scrutiny

Cost of Preferred (or more likely) Option			
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Measure qualifies as One-Out?
£0	£0	£0	Yes
			Zero Net Cost

**What is the problem under consideration? Why is government intervention necessary?**

In 2008 the Office of Fair Trading (OFT) found evidence of significant consumer detriment in the Sale and Rent Back (SRB) market. Following this, the Government gave the Financial Services Authority (FSA) - as it then was- permission to regulate this market. However, many firms were avoiding regulation by claiming they were not operating 'by way of business' and were therefore exempt. Rather than the FSA having to undertake costly investigations and legal proceedings with such firms, the Government introduced the 'by way of business' amendment to clarify the scope of regulation and ensure the market was regulated as intended. The amendment is due to sunset on 1 January 2015.

**What are the policy objectives and the intended effects?**

The policy objective is to ensure the SRB market is regulated appropriately. The initial regulation intended to improve outcomes for consumers entering into SRB, increase the transparency of information provided by SRB providers, reduce the potential for consumers to enter into unsuitable arrangements, and increase product quality by driving providers to improve or exit the market. The 'by way of business' amendment is an important part of the effective functioning of these regulations and is due to sunset on 1 January 2015. The Government intends to renew this amendment as it ensures the FCA has the appropriate powers to effectively regulate the SRB market.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

The Government has considered two options:

- Option 1 - allow the 'by way of business' amendment to sunset; and
- Option 2 - renew the 'by way of business' amendment, maintaining the existing regulatory framework.

The Government will proceed with option 2. This is on the basis that there is no evidence to suggest that the detriment the regulation intended to prevent would not return if the 'by way of business' amendment was allowed to sunset.

**Will the policy be reviewed? It will not be reviewed. If applicable, set review date: N/a**

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	<b>Micro</b> Yes	<b>&lt; 20</b> Yes	<b>Small</b> Yes	<b>Medium</b> Yes	<b>Large</b> Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)			<b>Traded:</b> N/a	<b>Non-traded:</b> N/a	

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:

..... *Andrea Leadsom* ..... Date: 11/9/14

# Summary: Analysis & Evidence

# Policy Option 1

**Description:** Allow the 'by way of business' test for SRB providers in the Financial Services and Markets Act 2000 (Carrying on Regulated Activities By Way of Business) Order 2001 to sunset.

## FULL ECONOMIC ASSESSMENT

Price Base 2009	PV Base 2009	Time Period 10 years	Net Benefit (Present Value (PV)) (£m)		
			Low: £-97.6m	High: £25.9m	Best Estimate: £-35.8m

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	£0.8m	£-0.9m	£-7.5m
High	£2.3m	£13m	£113.9m
Best Estimate	£1.5m	£6m	£53.2m

### Description and scale of key monetised costs by 'main affected groups'

Consumers: cost of equity foregone by not receiving a 'fair' price for a property

FCA: costs from having to legally challenge SRB transactions wrongly using the 'by way of business' transaction.

### Other key non-monetised costs by 'main affected groups'

Consumers: there will be some additional costs to consumers which are difficult to monetise, including the cost of premature eviction and paying above the market rate in rent.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional	£1.9m	£16.2m
High	Optional	£2.1m	£18.4m
Best Estimate	£0	£2m	£17.3m

### Description and scale of key monetised benefits by 'main affected groups'

SRB businesses: There are benefits to firms of reduced costs of entering and operating in the SRB market, which would allow firms to undertake profitable business.

### Other key non-monetised benefits by 'main affected groups'

Consumers: There are some benefits associated with the additional choice that consumers will receive as a result of an increased number of firms doing SRB business.

### Key assumptions/sensitivities/risks

1288 SRB unregulated transactions would take place each year.  
Market conduct will closely replicate that seen in the market during the period 2009-2011.  
A 'fair' price received for a property in a SRB transaction is 85% of the market value.  
The average market value of properties in SRB transactions is £163,287.  
Previous estimate cost of regulation is equivalent to an upper bound for firm profits.

Discount rate (%)

3.5

## BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs:£0.1m	Benefits:£2m	Net: £1.8m	Yes	OUT

# Summary: Analysis & Evidence

# Policy Option 2

**Description:** Renew the 'by way of business' test for SRB providers in the Financial Services and Markets Act 2000 (Carrying on Regulated Activities By Way of Business) Order 2001.

## FULL ECONOMIC ASSESSMENT

Price Base 2009	PV Base 2009	Time Period 10 years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	High: Optional	Best Estimate: £0

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional	Optional	Optional
High	Optional	Optional	Optional
Best Estimate	£0	£0	£0

### Description and scale of key monetised costs by 'main affected groups'

This is the continuation of the status quo against which the cost of option 1 has been calculated. Therefore, the costs are zero.

### Other key non-monetised costs by 'main affected groups'

This is the continuation of the status quo against which the cost of option 1 has been calculated. Therefore, the costs are zero.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional	Optional	Optional
High	Optional	Optional	Optional
Best Estimate	£0	£0	£0

### Description and scale of key monetised benefits by 'main affected groups'

This is the continuation of the status quo against which the benefit of option 1 has been calculated. Therefore, the benefits are zero.

### Other key non-monetised benefits by 'main affected groups'

This is the continuation of the status quo against which the benefit of option 1 has been calculated. Therefore, the benefits are zero.

Key assumptions/sensitivities/risks N/a	Discount rate (%)	N/a
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## BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:	In scope of OIOO?	Measure qualifies as
Costs: £0	Yes	Zero net cost
Benefits: £0		
Net: £0		

# Evidence Base (for summary sheets)

## Introduction

The sale and rent back (SRB) market offers homeowners the option of selling properties at a discounted rate in exchange for tenancy rights. The Office of Fair Trading (OFT) published a formal market study into the SRB market in October 2008. This study found that the SRB market was not working well.

As a result, the Government introduced legislation to bring SRB transactions into regulation under the Financial Services Authority (FSA). An interim system of FSA regulation of SRB arrangements started in July 2009 and was replaced by full regulation in June 2010.

FSA regulation only captured providers that engaged in SRB 'by way of business'. The 'by way of business' test was intended to ensure that providers that carry out SRB transactions for commercial purposes were within scope of the regulator's jurisdiction, while ensuring those that do so for other purposes, such as arrangements with immediate family members, were not within scope.

As the FSA started to regulate these transactions, it became apparent that a large number of SRB transactions (estimated to be around 80%) were taking place outside of FSA regulation. This was because firms were using the 'by way of business' test to circumvent FSA regulations that were intended to cover them.

The FSA could have taken enforcement action against providers who were undertaking commercial SRB agreements without FSA authorisation. However, this would have required the FSA to demonstrate that each individual transaction had in fact been done 'by way of business', which would have been expensive and time consuming. As a result, in 2011 the Government made a technical amendment to the 'by way of business' test. The amendment made it absolutely clear that firms are acting 'by way of business' and are therefore captured by the regulations, unless they are closely related to the homeowner selling the property. This vastly reduced the scope of firms to circumvent regulation.

In line with the Government's commitment to reduce legislative burdens where possible, the amendment included a 'sunset' clause. This means the legislation used to make the amendment will sunset on 1 January 2015.

In April 2013, the Financial Conduct Authority (FCA) took over responsibility for the regulation of SRB transactions from the FSA.

## Problem under consideration

The 'by way of business' amendment is due to sunset on 1 January 2015. The Government has to make a decision as to whether to renew this legislation or allow it to sunset.

The market in SRB is known to have several structural features that lead to market failure and consumer detriment. The OFT market study published in October 2008 identified the following market failures:<sup>1</sup>

- SRB agreements suffer from an information asymmetry. Many consumers will not be aware of, or able to fully assess, the true costs and risks they face in entering into a SRB transaction.
- SRB agreements are extremely complex contracts. This complexity was often compounded by an intentional lack of transparency in relation to the agreement being offered.
- Consumers entering into SRB agreements are often vulnerable individuals with low levels of financial capability. They are likely to be in debt, with the perception that their financial situation is out of control, and are unlikely to seek financial advice.
- The majority of negotiations relating to SRB agreements were conducted by professional sales people, who in some cases may exploit the emotional or psychological aspects of a SRB agreement (for example, attachment to a family home). Transactions often take place in the consumer's home, where people are typically more vulnerable to persuasion and deals can take place very quickly.<sup>2</sup>
- For most consumers a SRB agreement will be a one-off transaction. Consumers are unlikely to have had previous experience of such transactions and may not know anyone else who has. This means that there is almost no scope for learning effects; that is, consumers cannot be expected

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<sup>1</sup> Sale and rent back – An OFT market study, Office of Fair Trading, October 2008, Chapter 3.

<sup>2</sup> Doorstep Selling – A report on the market study, Office of Fair Trading, May 2004, Annex F.

to learn from their mistakes and avoid making the same mistakes in the future. The absence of this potential feedback channel as an additional disciplinary mechanism further hampers competitive forces in this market.

Furthermore, consumers are likely to be myopic when considering a trade-off that involves outcomes with different time horizons – in this case between clearing debts in the short term and the long-term implications of the SRB agreement.

The impact of these market failures is demonstrated by two significant instances of consumer detriment. The first is financial loss to the consumer through a distressed sale. The OFT Study found evidence to suggest that most SRB providers pay between 70 and 90 per cent of the market value of the property.<sup>3</sup>

The second is a lack of security of tenure. SRB agreements make a virtue of the homeowner's ability to continue to live in their home. However, the OFT report showed that in many cases, consumers were relatively quickly evicted from their home, while they had been led to believe they would be able to stay there over the medium to long term.

The OFT report provided strong evidence that without proper regulatory oversight, the lack of (or provision of misleading) information on the part of the SRB provider may lead to poor outcomes for consumers, such as early eviction, which entails significant financial and psychological costs and therefore decreases consumer welfare.

Furthermore, even during periods of regulatory oversight, the firms operating in this market have attempted to avoid compliance and continue detrimental practices. The introduction of the 'by way of business' amendment in 2011 was a direct consequence of firms wrongly operating outside the scope of regulation and in 2012 the FSA temporarily closed the market following an investigation into 22 regulated firms, where evidence of poor practice was found<sup>4</sup>.

### **Policy objective and options**

The policy objective is to ensure the SRB market is regulated properly. This entails striking the correct balance between consumer protections and allowing markets to develop where they will provide consumers with *valuable* additional choice. While the Government is committed to reducing the regulatory burden, this must be balanced against the need to protect consumers.

In order to meet the policy objective stated above, HM Treasury has fully considered two options:

- **Option 1** - Allow the 'by way of business' test for SRB providers in the Financial Services and Markets Act 2000 (Carrying on Regulated Activities By Way of Business) Order 2001 to sunset.
- **Option 2** - Renew the 'by way of business' test for SRB providers in the Financial Services and Markets Act 2000 (Carrying on Regulated Activities By Way of Business) Order 2001.

### **Evidence Base**

Estimates of the market in 2007 suggest that around 20,000 transactions were taking place per year. However, the market contracted following the introduction of regulation; the FCA report there was just one SRB transaction in 2012/13.

Given the narrowing of the evidence base following the 'by way of business' amendment, this Government's impact assessment is mainly based on the findings of the 2008 OFT report and the evidence gathered for the 2009 Government consultation on SRB regulation. Where it is possible figures have been updated in line with known changes to the SRB market and the wider economy. The Government has seen no evidence to suggest that the structural aspects of the SRB market that led to the market failure that originally provoked the introduction of regulation have changed. The consumer detriment resulting from these structural problems are detailed further in the description of costs and benefits below.

### **Costs and benefits of SRB transactions**

Option 1- Allow the 'by way of business' test for SRB providers in the Financial Services and Markets Act 2000 (Carrying on Regulated Activities By Way of Business) Order 2001 to sunset.

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<sup>3</sup> Sale and rent back - An OFT market study, Office of Fair Trading, October 2008, Chapter 3.

<sup>4</sup> <http://www.fsa.gov.uk/library/communication/pr/2012/011.shtml>

The counterfactual against which the costs and benefits of option 1 have been calculated is the status quo.

### Market sizing

While there is evidence that changes to supply side (funding costs) and demand side (house prices) factors did affect the size of the market over the years for which we have available data, the changes to the regulatory architecture are more likely to have been the main cause of this change<sup>5</sup>. Our base assumption therefore, was that were the Government to choose option 1, allowing the 'by way of business' amendment to sunset, this would effectively be returning to the regulatory regime that was in place in between 2009 and 2011. As such, the size of the market would be the same as during this period. Information gathered by the FSA and previous Government analysis of this market gives us a market where 1250 transactions were taking place<sup>6</sup>, conducted by 150 firms or individuals<sup>7</sup>.

Following the establishment of a base assumption, we have adjusted our estimate of the market to make it more accurately reflect the size of the market following the expiration of the amendment. The first step here is to scale the size of the market in line with known changes to the cost of funding<sup>8</sup> and house prices<sup>9</sup>. These two factors represent the main supply side and demand side factors that determine the size of this market<sup>10</sup>. The imperfect data available meant we could not ascertain the precise relationship between the cost of funding, house prices and the size of the SRB market. As such, we made an assumption that a percentage increase in the cost of funding would translate one for one into a reduction in the size of the SRB market, with the converse occurring to positive demand side changes (house price increases). This allowed us to come to a final market size of 1288 transactions, conducted by 155 firms or individuals<sup>11</sup>.

### Adjusting for a transition period

While the above estimate is an accurate representation of the probable size of the market following the expiration of the Sale and Rent Back 'by way of business' amendment, it is unlikely that the market will instantly rebound to this point due to the time it takes firms to adapt to regulatory changes and correctly identify profit making opportunities. On this basis we have chosen to adjust our estimates to include a period in which the market adjusts to the new regulatory environment. Here we have considered two different scenarios; slow and quick adjustment. Under the 'slow adjustment' scenario, the market reaches the peak market size after four years. However, under the 'quick adjustment' scenario this peak is reached in just two years. This is one factor driving the range of cost and benefit estimates in this impact assessment.

### Market conduct

In order to assess the impact of this policy option we have to make a judgement about the likely behaviour of consumers, firms and other individuals involved in this market. The consumer detriment previously seen in this market was largely determined by the market failures identified by the OFT and described earlier in this impact assessment. HM Treasury analysed these factors again during our review period and concluded that the majority were structural factors unlikely to be specific to the circumstances under which the market previously operated, and as such would have a similar effect following the expiration of the 'by way of business' amendment<sup>12</sup>.

HM Treasury's role with regards to financial services regulation is to set the regulatory framework for financial services, within which the FCA create detailed rules according to their statutory remit. The FCA's remit includes a duty both to proportionality and competition, which must be met alongside their consumer

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<sup>5</sup> The evidence for this statement is primarily contained in the observation that changes in funding costs and house prices are gradual, whereas the change to regulation is sudden, with the timing coinciding with changes in the market.

<sup>6</sup> An estimated 80% of these transactions were thought to be taking place outside of regulation.

<sup>7</sup> These 150 firms were comprised of 30 larger firms and 120 small or micro firms.

<sup>8</sup> The data used to measure the cost of funding data is HM Treasury internal data which rates the cost of funding according to the prevailing interest rates and accessibility of funds for mortgage lenders.

<sup>9</sup> The data used here is Bank of England data on house price inflation.

<sup>10</sup> Funding costs are the main determinant of a Sale and Rent Back firm's ability to finance a transaction of this type, particularly since this tends to be done via using buy-to-let mortgages. House prices represent an important proxy for the desirability of operating in the Sale and Rent Back market, since flat or falling house prices lower the profitability of such transactions.

<sup>11</sup> With the same proportions of regulated/unregulated transactions and large/small firms as previously.

<sup>12</sup> For example, the complexity of contracts, information asymmetry and one-off nature of transactions are all structural factors that are features of a market of this type.

protection objective. This leads to the conclusion that Sale and Rent Back is a market where it is difficult to create a sustainable, profitable business without causing disproportionate consumer detriment. It is also important to note that even during periods of regulation, firms in this market have exploited loopholes to circumvent regulations, which have led to detriment (hence the original introduction of this amendment and the decision by the FSA to shut down this market in 2012). As such, it does not seem an unreasonable assumption to proceed on the basis that the expiration of the 'by way of business' will undermine the FCA's regulation of this market and allow detriment to return.

### Costs

A key consumer detriment highlighted by the OFT study was equity foregone due to a distressed sale. On this basis we have calculated the cost to consumers of equity foregone by not receiving a 'fair' price for their property. SRB agreements will necessarily involve a discount in value when the house is sold in exchange for a tenancy agreement. However, many unregulated SRB providers did not pay a 'fair' price. The OFT report<sup>13</sup>, 2009 Government impact assessment and 2011 impact assessment assume a 'fair' price as being 85% of the market value of a property. This value represents the average price received in the OFT survey of SRB transactions and is therefore a rough estimate of what a healthy market should lead to. It is important to note that this is a conservative estimate since the OFT report clearly shows that this market was not functioning well and so it could be argued that a fair price is higher in reality than this estimate<sup>14</sup>.

This impact assessment uses results from a survey published in the OFT report (Table A) to estimate the overall cost to consumers in terms of equity foregone. The survey is a sample of the distribution of discounts to market value paid to SRB customers. This analysis is not based on cases dealt with by advisory organisations such as Citizen's Advice (which may produce a skewed sample as these are more likely to be cases where consumers experienced poor outcomes), but on a sample of responses to an industry trade association. While the results of this survey only provide a range of the discounts offered, we have calculated the costs using both the upper and lower bounds of these ranges to deal with this issue. It is this that causes an upper and lower bound for our estimate of the costs from equity foregone.

The difference between the 85 per cent 'fair' value and the price paid is a cost to consumers in terms of equity foregone. If consumers on average are receiving more than the 'fair' price from a SRB transaction the overall impact will be positive. Conversely, if consumers receive on average less than the 'fair' price from a SRB transaction the overall impact will be negative.

The OFT estimated that most properties involved in SRB transactions are seldom valued at more than £200,000. An analysis of case studies submitted to the OFT by Citizen's Advice, Shelter and National Debtline was consistent with this assessment, with the average property value for the property being approximately £158,000. We have scaled this price up in line with increases in house price inflation. As such, this analysis uses a scaled up average of £163,287 to estimate the cost to consumers of equity foregone.

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<sup>13</sup> Sale and rent back - An OFT market study, Office of Fair Trading, October 2008.

<sup>14</sup> In particular, when considering what is a 'fair' price it is sensible to assume that this will depend on the security of tenure and subsequent rental rate charged by the SRB landlord. The OFT report and subsequent FSA thematic review elaborate on the significant consumer detriment caused by widespread poor practice in this area in terms of above market rate rents and premature evictions.

**Table A – Proportion of market value paid, SRB provider survey**

Proportion of market value paid (%)	Number of responses
0 - 49	1
50 - 59	0
60 – 69	2
70 – 79	59
80 – 89	93
90 - 100	11

Source: Sale and rent back – An OFT market study, Office of Fair Trading, October 2008, Chapter 3.

Using the above assumptions concerning market size, distribution of discounts to market value paid to SRB customers and the average price of a property involved in a SRB transaction we estimate that the overall loss to consumers in terms of equity foregone is £6.5 million per year. This is an average loss of £5,057 per consumer.

We have also able to monetise the cost to the FCA from enforcement. The key rationale behind the introduction of the ‘by way of business’ amendment was that it would reduce the significant costs the FCA would face by having to initiate legal proceedings for the large number of unauthorised SRB transactions.

The FCA would face a cost of £24,000 per transaction to get an interim injunction against an unauthorised SRB transaction. If this transaction then required full litigation this would then lead to external costs of in between £100,000 and £150,000. However, when considering these costs, we recognised that transactions where enforcement proceedings have been successful should mean that the consumer was compensated for any detriment arising as a result of the transaction. Therefore, the cost to the consumer from equity foregone cannot be counted towards the impact of this option for transactions where we have already counted the costs of enforcement, including both the cost of enforcement and the cost to the consumer from equity foregone would be effectively double-counting costs.

In principle the FCA could attempt to enact enforcement proceedings against all 1288 unauthorised transactions (with an expected 50% of these leading to full litigation), this was unlikely to occur as the cost to the FCA would be over £100 million. This would represent more than a 5th of the FCA’s overall budget of £435.4 million<sup>15</sup>. Discussion with the FCA revealed that they would be more likely to only take enforcement action against transactions where the detriment is particularly severe. We have assumed that this proportion (where enforcement action needed to be taken) would mirror the proportion of consumers facing exceptionally large losses in terms of equity foregone. This is represented by the 3 responses received in the OFT SRB provider survey shown above, where less than 69% of market value was received in the transaction. As such, our assumption is that 1.8%<sup>16</sup> of the 1000 transactions (i.e. 23 transactions) would see enforcement action taken against them, resulting in additional costs to the FCA of £1.58 million<sup>17</sup>.

Based on these findings, we also had to adapt our estimate of the loss from equity foregone, since there would now be 23 transactions that have been compensated for any consumer detriment. This means that our estimate of the loss to consumers from equity foregone falls from £6.5 million per year to £6.3 million<sup>18</sup>.

<sup>15</sup> This is the amount raised by the FCA in the 2013/14 financial year.

<sup>16</sup> This is calculated by simply dividing the number of responses (3) where the price received was below 69%, by the total number of responses (166).

<sup>17</sup> We have created a range in this figure by calculating this figure on the basis of external costs of £100,000 and £150,000. The best estimate represents the midpoint of this range.

<sup>18</sup> More detail on the calculations involved in reaching this figure is provided in Annex A. It differs from the average annual cost figure in the summary of this option due to the yearly variation created by adjusting for a transition period as set out in Annex B, and the required conversion to 2009 prices.



### Non-monetised costs

The OFT report also identified other costs arising as a result of the tenancy agreement. For example, this could include instances whereby the consumer is evicted from rented accommodation after the expiration of a tenancy agreement, when rent is suddenly and significantly increased, or consumers paying well above market rents. FCA rules address these scenarios through, for example, conduct rules on the tenancy term.

Case study analysis conducted by the OFT indicates that 31 per cent of consumers who had proceeded with an unregulated SRB transaction had been evicted or were threatened with eviction. This was the case even though the majority of these consumers were not reported as having payment difficulties. The OFT found examples of tenants losing their home due to landlords imposing significant rent increases after a only a short tenancy period or because the landlord had defaulted on the mortgage for the property, with the property subsequently being repossessed.

These costs are important since they represent an erosion of the gains that SRB consumers receive in return for the transfer of equity to the SRB provider.

We were not able to monetise these costs due to a lack of quantitative evidence in the original OFT report. Creating a robust estimate of these costs would require detailed data on average price paid above market rents by SRB customers, average length of SRB tenancy, costs arising from eviction and proportion of SRB customers evicted. It is however worth noting that prior evidence from the OFT report suggests this source of consumer detriment is (even under conservative assumptions) comparable to those arising from equity foregone.

It is also important to note the potential cost emanating from inappropriate SRB transactions in terms of distress caused to consumers, increased likelihood of medical difficulties and a required increase in the resources needed to fund organisations such as the Money Advice Service in order to deal with these transactions. These were all concerns raised by stakeholders in the original government consultation and there is no reason to believe they would not also be relevant now.

### Benefits

Prior to the introduction of the 'by way of business amendment' there were many more firms conducting SRB transactions. As mentioned previously, the market has now reduced in size significantly. However, the profit that these firms could make in a market without the 'by way of business' amendment is a benefit that needs to be considered. Assuming that SRB firms left the market following the 'by way of business' amendment because the cost of regulation absorbed their profit margins, the cost of FSA regulation will provide an upper bound for the profits firms would have been making. As we are assuming that the market will largely rebound to this level, the costs of FSA regulation can therefore be used as an estimate of the profits resulting from this option.

The 2009 FSA consultation paper on SRB estimated that the regulation of SRB agreements imposed one-off costs on providers of between £16,000 and £36,000, and ongoing costs of between £10,000 and £15,000 (depending on firm size). However, this impact assessment assumes that the 20% of firms that were regulated were all large firms. These firms would already be FCA authorised, so would not face the same one-off costs. Therefore, this impact assessment assumes that the ongoing annual costs alone were sufficient to erode their profits and cause them to exit the market.

For the small firms without FCA regulation, it would have been both the up-front costs and the ongoing costs of regulation that eroded their profits. We therefore derive our estimate of annual profit per small firm by adding the initial cost for small firms (averaged over the ten year evaluation period since 'initial profits' does not make sense in this context) to the annual cost for small firms. This gives us an estimate of annual profits per small firm of £11,600. The estimate of annual profit per large firm is then equal to the annual costs to large firms, £15,000.

To arrive at an estimate of the total benefits to firms, we continue with our initial assumption that the market will return to its pre 'by way of business' size. This means a market populated by 155 firms, undertaking 1288 transactions. As explained above the 20% of firms that are regulated are assumed to be larger firms. The other 80% are unregulated smaller firms. This leads to a market populated by 124 small firms and 31 large firms.

Using these estimates of the profits accruing to different sized firms and our assumption on the distribution of firm sizes in the SRB market, we therefore estimate that were the market to return, a reasonable estimate of the upper bound of firms' annual profits is £2.2m<sup>19</sup>.

### Non-monetised benefits

The introduction of the 'by way of business' amendment was followed by a fall in the number of SRB transactions conducted in the UK, with just one transaction taking place in 2012/13. While the evidence is extremely strong that there was significant consumer detriment in the SRB market, there may be some cases in which SRB could be appropriate. Therefore, by allowing the unregulated market to remerge, consumers will have a wider number of products to choose from.

We were not able to monetise the benefits to consumers of this additional choice. However, the benefit of added choice is expected to be negligible since the evidence seems to show that the choice provided by unregulated SRB providers is not one that is usually in the best interests of consumers, given the market failures involved typically lead to pressured sales, without a market feedback mechanism and under conditions of asymmetric information. While reducing entry costs may encourage firms to use enter the market, it is likely that they will be entering the market in such a way that exploits this loophole to circumvent regulation and compete not just on price and quality, but over the extent to which they can use exploitative business practices to extract wealth from consumers. Furthermore, it is worth noting that firms offering genuine valuable additional choice to consumers are not prevented from entering the market by the current regulatory framework and as such, this benefit is likely to be very small.

The expiration of this amendment may also lead to benefits for non-business organisations wishing to conduct SRB transactions, but previously prevented from doing so by the cost of regulations. In practice, we expect the size of this benefit to be negligible, if it exists at all, as neither the Department nor the FCA have any evidence of this type of organisation conducting SRB transactions. There isn't currently a specific exemption from this amendment for organisations that are not businesses. This is on the basis that there is no reason why the same regulatory standards intended to protect consumers should be different for this type of organisation. As such, if the amendment were to sunset, these organisations could in principle circumvent regulation, and enjoy the benefits as smaller firms have been assumed to do in our earlier analysis.

### Small and Micro Business Assessment (SaMBA)

Before the SRB was regulated, it was primarily served by SMEs. The OFT report<sup>20</sup> stated that "it is clear that the sector comprises a very large number of small firms, family businesses or individuals together with a few firms". The OFT estimated that there were 37,500 SRB landlords in the UK at the time of the report. Since regulation was introduced, these firms have largely exited the market.

Micro- businesses would not remain regulated under Option 1. This is since some SRB providers are micro-providers and are expected to be net-beneficiaries of allowing this amendment to sunset.

Were the Government to allow these regulations to sunset, the analysis undertaken by HM Treasury assumes that these firms will re-enter the market. This will allow these firms to make a combined profit of £1.66 million per year, with a total combined benefit of 13.1 million<sup>21</sup> npv over the 10 year renewal period.

### Competition Assessment

The Government would expect competition in the SRB market to increase under option 1. This is because the current market is limited with only 6 firms and 1 registered transaction in 2012/13, whereas the best estimates of this market prior to this amendment being introduced were of a market with over a hundred firms and around one thousand transactions. As such it seems reasonable to assume that competition would increase were option 1 pursued.

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<sup>19</sup> More detail on the method of calculating this figure is set out in Annex A. However, this figure has been scaled up from 1.84m to convert it to 2014 prices. It differs from the average annual benefit set out in the summary page for this option, due to the impact of the transitional adjustment set out in Annex B, and the required conversion to 2009 prices.

<sup>20</sup> Sale and rent back - An OFT market study, Office of Fair Trading, October 2008, page 15.

<sup>21</sup> This is the best estimate of the npv. It is estimated by taking the average of the slow and fast adjustment points for the benefits from small firm profits.

## Overall assessment

The net benefit of Option 1 is a loss of £35.8 million over the standard ten year reference period. Furthermore, it is worth noting that there are several elements where in reality we expect the costs to be higher and the benefits lower. In particular, a key loss identified from SRB transactions is from paying above market rents, receiving a tenancy agreement with no security and the distress caused to consumers by these transactions. We are not able to quantify these in our impact assessment, but we expect this impact to be large since they undermine the rationale behind a SRB transaction. Additionally, our method of estimating firm profits is only able to capture an upper bound for firm profits and the non-monetised benefits from additional choice for consumers is expected to be negligible relative to the status quo given that firms can already enter this market so long as they are willing to comply with regulations and therefore provide valuable additional choice.

### Option 2 - Renew the 'by way of business' test for SRB providers in the Financial Services and Markets Act 2000 (Carrying on Regulated Activities By Way of Business) Order 2001.

By choosing to proceed with Option 2, the Government would be effectively maintaining the status quo in terms of all aspects relevant to the SRB market. As such, relative to the counterfactual (which in this case, is the current legislative and regulatory framework) the impact of undertaking this course of action would be completely neutral.

However, in the interests of clarity, it is worth making it clear, that given that the Government is only able to take two decisions in this case, renew or sunset, the benefit of renewal can be seen as manifested in the avoidance of the costs associated with Option 1.

We are currently aware of 6 firms with FCA authorisation to operate in this market. Half of these are SRB providers, whereas the other half only offer advice on SRB transactions. Two of these firms also hold FCA authorisations to provide Home Reversion plans and another also holds a permission to advise on a wider range on mortgages and investments. The firms in this market range from micro businesses to medium sized business, supporting our previous assessment that smaller firms can still operate in this market. It is likely therefore that the increased costs brought about through compliance with regulation has put a limit the number of firms that can operate at a profit in this market, in a similar manner to the textbook case of natural monopoly.

A greater level of detail on these firms cannot be provided as it is commercially sensitive information.

### Small and Micro Business Assessment (SaMBA)

As with our assessment for the impact of Option 2 on the whole market, relative to the counterfactual (the current legislative and regulatory framework), the impact of Option 2 on Small and Micro businesses would be neutral.

However, as above, we can see from comparison with the SaMBA in Option 1 that Small and Micro Businesses would face a loss relative to the case where the Government allows this regulation to sunset. Based on this observation the Government considered whether it would be possible to provide an exemption from this amendment to Small and Micro businesses. However, it was made clear by our assessment of the market based on evidence from the OFT and the FSA's review of Sale and Rent Back firms, that the majority of the firms previously causing detriment in this market were Small or Micro businesses. As such, while an amendment would allow these Micro and Small businesses to continue doing business, it would also allow the emergence of detriment and as such would undermine the rationale for regulation. The impact of the inclusion of a Micro and Small businesses amendment would be identical to our assessment of the impact of Option 1. This is since we assume in Option 1 that the market would return to the pre-amendment situation, where the larger firms conduct regulated business, while smaller firms abuse the 'by way of business' test to operate outside of regulation. As such, providing an exemption would lead to a net loss of £35.8 million npv over ten years, entirely undermining the policy intention behind the renewal of this amendment.

In our assessment of the costs to Small and Micro Businesses we also considered a wider set of possible options, in line with the Government's Better Regulation guidance. Table B sets out the other options considered and the reasons why they do not meet the Department's objectives.

**Table B – Options for mitigating against the impact of regulation on Small and Micro Businesses**

Option	Reason for rejection
Partial exemption	<p>A partial exemption does not make sense in the case of this amendment as its only impact is to ensure the regulatory perimeter is correctly and clearly defined. As such, a partial exemption would be equivalent to a full exemption and is therefore rejected on the same grounds as the full exemption above.</p> <p>In the case of the specific regulations for SRB. The purpose of this IA is to consider this amendment only, but is also worth noting that responsibility for these rules sits with the FCA, who have a statutory duty for proportionality and competition and so can adjust their rules accordingly.</p>
Extended transition period	This does not make sense in the context of a decision on whether to renew the Sale and Rent Back amendment or not since Small and Micro Businesses already have to comply with this legislation.
Temporary exemption	Similarly to the reasoning for the extended transition period, this does not make sense in the context of this policy decision.
Varying requirements by type and/or size of business	<p>The specific costs of registering for this type of business are set by the FCA who already have a duty set out in their statutory remit to ensure their rules are proportionate and promote competition.</p> <p>Intervening in this manner would undermine the FCA's independence and therefore the Government's broad approach to financial services regulation.</p>
Specific information campaigns or user guides, training and dedicated support for smaller businesses	It would be for the FCA to decide independently whether such support was appropriate for this market, particularly with reference to their statutory objectives.
Direct financial aid for smaller business	Direct financial aid would be equivalent to the promotion of the entire SRB market given that it is largely made up of small and micro businesses. It is not clear what the policy rationale would be for promoting this market.

Overall assessment

Relative to the status quo option 2 is expected to deliver a net benefit of £0 npv over ten years. However, the benefit of this is primarily seen through the avoidance of the costs and risks associated with option 1. The specific nature of this market means that mitigation options for Small and Micro businesses undermine the policy aim that the Department is trying to achieve.

Self-regulation

During the review period of this policy the Department also considered whether self-regulation could deliver the Government's policy objectives. There are two cases to consider here:

1. the appropriateness of a self-regulatory solution to the decision of whether to renew the 'by way of business amendment'
2. the appropriateness of the removal of regulation entirely and replacement with a self-regulatory framework

In case 1 it is not clear both what a self-regulatory option constitutes or how it would help. If by a self-regulatory solution we mean that SRB firms ensure between themselves that they correctly interpret the regulatory perimeter, it is unclear this is a viable option. This option was open to

firms during the period 2009-2011, during which many firms actively tried to circumvent regulation. It therefore seems unlikely that this option would have had any success in fulfilling the Department's policy aims.

Case 2 is a different matter entirely. It is not the purpose of this Impact Assessment to consider the case for SRB regulation more widely. While the renewal of the 'by way of business' amendment has the effect of ensuring effective regulation, our discussion of this has been primarily to describe the impact of this legislation, rather than SRB regulation in the round. When SRB regulation was originally brought in the possibility of self-regulation was fully considered and consulted upon<sup>22</sup>. The Department made it clear at this point that self-regulation could not deliver the intended policy aims for several reasons, which still seem relevant to the market today.

Reputational effects are an important consideration in evaluating the likely efficacy of a self-regulatory solution. Where consumers are taking a planned decision (as happens when entering into a mortgage), reputational effects can be powerful and self-regulation may achieve a high rate of coverage and impose a strong discipline on the sector. However, where consumers are taking decisions in pressured circumstances (as with many sale and rent back agreements), reputational effects may be weaker. Given the lack of shopping around and the pressure under which decisions are taken, it is not likely that many prospective sale and rent back consumers will look for a badge of quality, such as membership of a reputable industry association. This means that sale and rent back providers are less likely to join such an association, and those that do may have a weaker incentive to abide by their rules, as both the cost of being expelled and the benefits from being a member are low. Incentives to abide by trade association rules will be further weakened as it is hard to police such rules in a fragmented industry, where many transactions are conducted face-to-face.

It seems unlikely therefore that self-regulation will have wide coverage and a strong disciplinary effect on the sector. This is particularly the case given that the industry will be re-emerging again from a low level of activity, with a small number of firms, making it difficult to see where the leadership will come from to develop and make such schemes work.

### **Equalities impact**

The Government does not believe that there are any equalities impacts presented by any of the options considered in this impact assessment. Religion, gender, pregnancy and maternity, race and sexual orientation are not thought to be affected by the 'by way of business' amendment or its expiration.

### **One-in-two-out regulatory costs**

The options covered in this impact assessment are within scope of the one-in-two-out calculation of new regulatory burdens. HM Treasury's preferred option has no net impact on business.

### **Rationale and evidence that justify the level of analysis used in the impact assessment**

The Department believes that the level of analysis used in the impact assessment is proportionate. As the SRB market is very limited in size at present, it is not possible to contact potential providers to understand their views on the regulatory changes.

As a result, the analysis carried out has been largely based on the information used when SRB firms were brought under regulation originally - the OFT report of the market<sup>23</sup>, the impact assessments by Government, and the thematic review of the market carried out by the FSA<sup>24</sup>.

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<sup>22</sup> See for example the 2009 Government consultation on SRB

<sup>23</sup> Sale and rent back - An OFT market study, Office of Fair Trading, October 2008.

<sup>24</sup> Sale and Rent Back Review, Financial Service Authority, March 2011.

The Department has decided against providing a full assessment of the impact of a self-regulatory regime for this market. As explained in the summary page, this is because this option ran counter to the Government's position on financial regulation and previous analysis of the market suggested self-regulation was unlikely to reduce consumer detriment in this market.

### **Implementation plan**

HM Treasury's preferred approach (Option 2) will be delivered by tabling secondary legislation to renew the existing legislation, as the amendment is due to sunset on 1 January 2015. Therefore this policy will enter in effect from 1 January 2015.

## Annex A- Summary Sheet

### Market sizing

No. of regulated transactions	No. of unregulated transactions	No. of transactions with enforcement proceedings	Total no. of transactions
258	1030	23	1288

### Yearly cost of equity foregone (2014 prices)

Average property price in SRB transaction	'Fair' price received in SRB transaction	Average loss per transaction (best estimate)	No. of transactions with consumer detriment	Overall cost (best estimate)
163287	138793	-6324	1007	-6369000

### One-off cost of FCA enforcement (2014 Prices)

No. of transactions with enforcement proceedings	Proportion of case requiring full litigation	Cost from initial enforcement	Average cost from full litigation	Overall cost (best estimate)
23	50%	24000	125000	1582000

### Yearly benefit from firm profits (2008 prices)

No. of small firms	No. of large firms	Profits per small firm	Profits per large firm	Overall profits
124	31	11600	15000	1903000

Annex B – Transition period weighting

**Adjusting for adaptation time**

Year	Original estimate	0	1	2	3	4	5	6	7	8	9
Weighting	1	0.5	1	1	1	1	1	1	1	1	1
<b><u>Scenario 1 (Quick adjustment)</u></b>											
<b>Low</b>											
Cost 1 (equity foregone)	-1030161	-515080	-1030161	-1030161	-1030161	-1030161	-1030161	-1030161	-1030161	-1030161	-1030161
Benefit 1 (Firm profits)											
<b>High</b>											
Cost 1 (equity foregone)	13768497	6884248.309	13768497	13768496.6	13768497	13768497	13768497	13768497	13768497	13768497	13768497
Benefit 1 (Firm profits)											
<b>Best Estimate</b>											
Cost 1 (equity foregone)	6369167	3184583	6369168	6369167	6369167	6369167	6369168	6369168	6369168	6369168	6369168
Benefit 1 (Firm profits)	2279779	1139889	2279779	2279779	2279779	2279779	2279779	2279779	2279779	2279779	2279779
Year	Original estimate	0	1	2	3	4	5	6	7	8	9
Weighting	1	0.25	0.5	0.75	1	1	1	1	1	1	1
<b><u>Scenario 2 (Slow adjustment)</u></b>											
<b>Low</b>											
Cost 1 (equity foregone)	-1030161	-257540	-515080	-772620	-1030161	-1030161	-1030161	-1030161	-1030161	-1030161	-1030161
Benefit 1 (Firm profits)											
<b>High</b>											
Cost 1 (equity foregone)	13768497	3442124	6884248	10326372	13768497	13768497	13768497	13768497	13768497	13768497	13768497
Benefit 1 (Firm profits)											
<b>Best estimate</b>											
Cost 1 (equity foregone)	6369168	1592291	3184584	4776875	6369168	6369168	6369168	6369168	6369168	6369168	6369168
Benefit 1 (Firm profits)	2279779	569944	1139889	1709833	2279779	2279779	2279779	2279779	2279779	2279779	2279779