

Responsible lending and borrowing: whereto low-cost home ownership?

Sarah Nield*
University of Southampton

The recent experience of the credit crunch has cast doubt on the prudence of regulation of the mortgage market based upon the concepts of responsible lending and borrowing. Both the Turner Review and the Financial Services Authority's follow-up Mortgage Market Review identified irresponsible lending as one of the principle causes of the credit crunch. Yet easy access to mortgage finance has underpinned the growth of owner occupation and the promotion of low-cost home ownership. This paper examines recent regulatory initiatives to articulate responsible lending and borrowing in more concrete terms, which suggests a shift towards greater lender responsibility through affordability checks, clearer product explanation and the possibility of product regulation. Whilst such proposals may assist in the pursuit of a more stable mortgage market, they cast serious doubt on the future sustainability of low-cost home ownership.

INTRODUCTION

Market regulation is founded on the premise of rational and self-interested players. It is assumed that in credit markets lenders will make responsible lending decisions that minimise the risk of bad debts and that borrowers, with the benefit of clear, accurate and comprehensive disclosure, will choose affordable credit terms best suited to their needs. Regulation of secured credit under the Financial Services and Markets Act 2000 (FSMA) and the regulation of unsecured and secured lending under the Consumer Credit Act 1974 (CCA) reflects this assumption of responsible lending and responsible borrowing. The recent experience of the credit crunch, and the resulting economic recession, has cast doubt on the prudence of relying on self-correcting credit markets. The Turner Review (Turner)¹ identified irresponsible lending as one of the causes of the recent turmoil, pointing to the rapid and unsustainable growth of credit to new and riskier markets. Yet, although widely promoted as fundamental concepts of market regulation, the content of responsible lending and responsible borrowing had received little scrutiny.

To some extent this omission is being addressed by a host of recent initiatives to articulate in more concrete terms what lending and borrowing is responsible. As

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1. See Lord Turner *The Turner Review: A Regulatory Response to the Global Banking Crisis* (London: Financial Services Authority, 2009), available at http://fsa.gov.uk/pubs/other/turner_review.pdf.

promised by Turner, the Financial Services Authority (FSA) has produced more detailed plans to curb irresponsible lending (the FSA Review).² The Office of Fair Trading (OFT), in pursuance of their consumer credit licensing powers under s 25 of the CCA, has also published their guidance to lenders and brokers on second charge lending³ and irresponsible lending (the OFT Guidance).⁴ In July 2009, the government issued its White Paper *A Better Deal for Consumers*,⁵ which includes proposals to help consumers in financial difficulties, primarily from unsecured debt, and HM Treasury also contributed to the debate in its paper *Reforming Financial Markets*.⁶ These proposals have been advanced with the Chancellor's Pre-Budget Report issued in December 2009. At a European level, the European Commission has been consulting on responsible lending and borrowing within the EU (the EU Consultation).⁷ Whilst the implementation of the revised Consumer Credit Directive (CCD)⁸ precipitated consultation by the Department of Business Enterprise and Regulatory Reform (now the Department for Business Innovation and Skills) on the changes required to the domestic unsecured consumer credit regime (the BERR Consultation),⁹ the Department of Business Innovation and Skills has responded to this consultation¹⁰ and the implementing regulations will be in force by June 2010.¹¹

This paper examines progress made to articulate responsibility in borrowing and lending in more concrete terms. It will concentrate on the impact upon mortgage credit, although reference will be made, where appropriate, to proposals with respect to the unsecured credit market. It will look initially at the proposed realignment of regulatory responsibilities for consumer credit, before going on to consider the emerging thinking on what constitutes, first, responsible borrowing and, secondly, responsible lending and the resulting shift in the accountability balance. It will argue that, although a more constructive articulation of the balance of responsibilities between

2. See FSA *Mortgage Market Review* (London: Financial Services Authority, 2009), available at http://www.fsa.gov.uk/pubs/discussion/dp09_03.pdf.

3. OFT *Second Charge Lending – OFT Guidance for Lenders and Brokers* (OFT 1105, 2009), available at http://www.offt.gov.uk/shared_offt/business_leaflets/general/offt1105.pdf.

4. OFT *Irresponsible Lending – OFT Guidance for Creditors* (OFT 1107, 2010), available at http://www.offt.gov.uk/shared_offt/business_leaflets/general/offt1107.pdf.

5. Department of Business Enterprises and Regulatory Reform *Better Deal for Consumers* (CM7669, 2009), available at <http://www.berr.gov.uk/files/file52072.pdf>.

6. HM Treasury *Reforming Financial Markets* (CM7667, 2009), available at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf. A summary of responses was issued in November 2009, available at http://www.hm-treasury.gov.uk/d/rfm_responses.pdf.

7. The consultation has closed and there was a public hearing in September 2009; see the website available at http://ec.europa.eu/internal_market/finservices-retail/credit/responsible_lending_en.htm. The Commission's Consultation on the integration of EU mortgage credit markets issued in 2007 has been overtaken by events, although follow-up proposals are expected sometime in 2010.

8. 2008/48/EC, [2008] OJ L133/66.

9. Department of Business Enterprises and Regulatory Reform *Consultation on Proposals for Implementing the Consumer Credit Directive* (London: Department of Business Enterprises and Regulatory Reform, 2009), available at <http://berr.gov.uk/files/file50962/pdf>.

10. Department of Business Innovation and Skills *Consultation on Proposals for Implementing the Consumer Credit Directive Government Response* (London: Department of Business Innovation and Skills, 2009), available at <http://www.bis.gov.uk/assets/biscore/corporate/docs/c/consumer-credit-directive-consultation-response.pdf>.

11. See the website available at <http://www.berr.gov.uk/files/file52326.doc>.

lender and mortgagor is being developed, there is a conspicuous absence from the debate of the consequences that more stringent assessments of affordability will have upon government housing policy, particularly as it relates to low-cost housing provision.

MORTGAGE REGULATION RESPONSIBILITY

It is clearly important to be able to identify the body with regulatory oversight of secured credit, for it is they who are charged with both setting guidance on responsible lending and for monitoring and ensuring lender compliance with those standards. Presently, mortgage regulation is split between the FSA and the OFT. The FSA is responsible for regulated mortgage contracts,¹² being first legal charges secured upon the borrower's home, or other dwelling, entered into after 31 October 2004;¹³ whilst the OFT regulates lending secured by a second or equitable charge as part of its supervision of consumer credit under the CCA. This regulatory split has been widely criticised for having no logical base, being a consequence of regulatory history rather than rational policy.¹⁴

The Council of Mortgage Lenders (CML) has advocated a transfer of regulatory responsibility to the FSA for a decade, citing the more coherent and cost-effective regulatory structure that it would provide its members.¹⁵ FSA regulation would also bring together the oversight of secured credit and the prudential regulation of the financial institutions that primarily provide that credit, in particular banks and building societies.¹⁶ For the mortgagor taking out a first and second mortgage over their home, it is also difficult to see anything but confusion with two different information disclosure and process regimes. Citizens Advice has been advocating unified regulation but has suggested that a new regulatory body be established to oversee lending secured upon the home.¹⁷ A distinct regulatory body would draw a link between housing policies and secured lending, which has been sadly missing, but inevitably would draw other divisions and may not wield the influence of a super regulator such as the FSA.

12. Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544, art 61 (as amended).

13. The FSA also regulates Home Purchase Plans, ie financing devices that comply with Islamic law, and Home Revision Plans, commonly known as equity release schemes. There are also plans in place to bring Sale and Leaseback Schemes under FSA regulation. There is thus a clustering of financing devices over the home under the FSA umbrella.

14. See, for instance, M Oldham 'Mortgages' in L Tee (ed) *Land Law: Issues, Debates, Policy* (Cullompton: Willan, 2002) p 207; E Lomnicka 'The reform of consumer credit in the UK' [2004] JBL 129; S Nield 'Borrowers as consumers: new notions of unconscionability for domestic borrowers' in M Kenny, J Deveney and L Mahony-Fox (eds) *Unconscionability in European Private Financial Transactions* (Cambridge: Cambridge University Press, forthcoming).

15. See Council of Mortgage Lenders *Response to HM Treasury Consultation Paper Reforming Financial Markets* (2009), available at <http://www.cml.org.uk/cml/policy/responses>.

16. The FSA's duties include both maintaining confidence in the financial markets and the protection of consumers; see ss 2, 3 and 5 of the FSMA.

17. See Citizens Advice *Set Up to Fail: CAB Clients' Experience and Secured Loan Arrears Problems* (2007), available at <http://www.citizensadvice.org.uk>.

It is thus not surprising that the FSA Review recommends the expansion of FSA regulation to second-charge lending¹⁸ and the government, following consultation, is pressing ahead with this recommendation.¹⁹

A split between secured and unsecured consumer lending has synergies with European consumer credit policy. The European Commission work has diverged along secured and unsecured lines. The Commission's 2007 White Paper on the integration of EU mortgage credit markets²⁰ advocated various measures to facilitate cross-border secured lending, although progress towards integration has been cast into the shadows as the credit crunch has taken hold.²¹ Meanwhile, the CCD is confined to unsecured lending and the regulations to implement the CCD anticipate the proposed alignment of regulatory responsibilities along secured and unsecured lines.²²

Consumer credit comes in all shapes and forms. Security is generally only taken where the sums advanced, and the risks associated with repayment, are sufficiently large to justify the higher transaction costs. A first legal mortgage on a mortgagor's home is most likely to secure the often large sums required to finance its acquisition, which, it is anticipated, will be repaid over a comparatively long period. Alternatively, a first legal mortgage may provide collateral security for business finance to support the mortgagor's commercial activities. Again the facilities made available are likely to be large and for the medium to long term. Second mortgages may also secure this type of funding but are also utilised to support the consolidation of unsecured consumer debts. Unsecured credit, by comparison, is usually repaid over a shorter term to support a wide variety of consumer spending. The division between secured and unsecured lending regulation, however, does overlook the recovery of unsecured debt by the use of charging orders. There has been a worrying rise in the number of charging orders granted even for relatively small debts, which can put considerable pressure upon borrowers in default.²³ More radical are suggestions that the FSA might take over responsibility for regulating the whole of the consumer credit market, thus avoiding any regulatory divisions.²⁴

Wherever the final regulatory responsibility falls, it will be necessary to ensure that mortgagors do not lose out. Secured lending places the mortgagor's home in jeopardy and thus warrants the highest safeguards against predatory lending and enforcement practices. The regulatory approach of the two regulators does differ.²⁵ The FSMA

18. See ch 9. The FSA Review also advocates regulating previously unregulated buy-to-let mortgages and the sale of a lender's mortgage books.

19. HM Treasury *Mortgage Regulation: A Consultation* (2009), available at http://www.hm-treasury.gov.uk/d/consult_mortgage_regulation.pdf. The government announced in its 2010 Budget that it intends to transfer regulation of second mortgages to the FSA.

20. European Commission, above n 7.

21. See, for instance, the CML's Response to EU Commission White Paper on Integration of Mortgage Credit Markets (2008), available at <http://www.cml.org.uk/cml/policy/responses>.

22. Above nn 9–12.

23. See Citizens Advice *Briefing for the Treasury Select Committee Inquiry on Mortgage and Secured Loan Arrears* (London: Citizen Advice, 2009) and Department of Business Innovation and Skills, above n 5.

24. Lomnicka, above n 15, and HM Treasury, above n 7, para 8.41. The Hampton Review in recommending wider regulatory reform had explored the consolidation of consumer protection within a single regulatory body; see HM Treasury *Reforming Administrative Burden: Effective Inspection and Enforcement* (2005), available at <http://www.berr.gov.uk/files/file22988.pdf>.

25. Lomnicka, above n 14 and Nield, above n 14.

adopts a rather more sophisticated three-tier approach through over-arching principles, explanatory codes and detailed rules guiding the FSA's licensing, monitoring and enforcement functions. The Conduct of Mortgage Business (MCOB) section of the FSA handbook sets out those rules which govern regulated mortgage contracts. The OFT's regulatory controls are exerted primarily through its licensing functions,²⁶ including its power to vary, impose conditions upon and revoke licences,²⁷ in respect of which it may issue regulatory guidance.²⁸ The reforms, introduced by the Consumer Credit Act 2006, have bolstered the OFT's licensing and enforcement powers to bring them more into line with the FSA's 'enforcement tool-kit'. Nevertheless, the OFT has been accused of failing to provide adequate, comprehensive and current guidance and putting in place an effective monitoring and compliance strategy.²⁹ There has been a flurry of paper going some way towards addressing this vacuum, with the updating of the OFT's General Guidance on Fitness of Licensed Lenders in January 2008,³⁰ its Guidance on Second Charge Lending³¹ and the OFT Guidance.³²

However, the real concern is over the different remedial responses available to mortgagors offered by the two regimes, in particular the scope for judicial intervention. There is no mechanism under the FSMA to challenge the enforceability of a regulated mortgage, whereas under the CCA the court enjoys a number of opportunities to do so. A court may decide that a second or equitable charge is unenforceable, in the light of the prejudice caused to the borrower and the culpability of the lender, where it fails to comply with the prescribed rules governing pre-contractual information or the form or execution of the loan agreement and charge itself.³³ Alternatively, the court may order a variation of loan terms, either where the loan agreement or second charge falls foul of the CCA prescribed processes, or upon the grant of an enforcement or time order if the lender seeks repossession.³⁴

There is also wide power for the court to intervene in any unfair credit relationship under ss 140A–D of the CCA which is not available where a mortgage is regulated under the FSMA.³⁵ These provisions are intended to promote greater lender responsibility and the OFT's guidance on unfair credit relationships encompasses irresponsible lending.³⁶ The statutory test of an unfair credit relationship was left intentionally

26. Sections 25 and 29.

27. Sections 31–33 and 33A–E.

28. Sections 25, 25A and 26.

29. Citizens Advice, above n 17.

30. OFT *Consumer Credit Licensing: General Guidance for Licensees and Applicants on Fitness and Requirements* (OFT 969, 2008), available at http://www.of.gov.uk/shared_of/business_leaflets/credit_licences/of969.pdf. The OFT has announced that they will take into account any breach of the FSA rules and principles, in particular irresponsible lending, when making licensing decisions or taking enforcement action.

31. OFT, above n 3.

32. OFT, above n 4.

33. Section 127.

34. See ss 135 and 136. A lender may only exercise their power to take possession by order of the court (s 126) when the court may give the mortgagor time to remedy a breach of the mortgage, including time to clear arrears by way of a time order (s 129).

35. CCA, ss 140A(5) and 16(6C). See S Brown 'The unfair relationship test, consumer credit transactions and the long arm of the law' [2009] LMCLQ 90.

36. OFT *Unfair Contract Terms Guidance* (OFT 854, 2008), available at http://www.of.gov.uk/shared_of/reports/unfair_contract_terms/of311.pdf.

vague to allow the courts to develop their own criteria³⁷ but, unfortunately, judicial guidance remains undeveloped, with relatively few decided cases.³⁸

An individual mortgagor's route to judicial redress under the FSMA is limited to an action for damages to recover loss for breach of statutory duty where a lender has breached the MCOB rules.³⁹ Principle 6 of the FSA Handbook requires lenders to 'pay due regard to the interests of its customers and treat them fairly'. This is a higher level principle which the FSA has made a central plank of its regulatory strategy.⁴⁰ However, although Principle 6 does pervade the MCOB rules, it does not provide a premise upon which an individual mortgagor can found a cause of action against his or her lender. Nor does the principle provide a justification for the court to intervene to alter the terms of a mortgagor's credit relationship with their lender.⁴¹ Court supervision is restricted to judicial review in the event of the FSA failing to meet the procedural or reasonableness standards expected of a public authority in its decision-making functions.

There are other possible routes to redress that are available to borrowing regulated by both the FSMA and CCA. In respect of smaller claims, the mortgagor may make a complaint to the Financial Services Ombudsman, although any award again will be limited to compensation.⁴² A challenge to the fairness of a particular mortgage term can be brought under the Unfair Terms in Consumer Contract Regulations 1999.⁴³ The Unfair Trade Practices Regulations 2008⁴⁴ is of more limited assistance because it confers no direct right upon an individual mortgagor to question unfair practices. Enforcement is possible only at the regulatory level, for instance by the OFT.

Given the time and costs involved, judicial redress may not be the first choice for the individual mortgagor but there are fundamental principles at stake. Court oversight, individual autonomy and discriminatory treatment between mortgagors within different statutory regimes are just three. The bottom line is that in an exercise which is intended to curb irresponsible lending, it is counterproductive to remove protective

37. Professor Goode has criticized ss 140A–D as providing just too wide a discretion to be of much utility, see his evidence to House of Lords on proposed Consumer Credit Harmonisation Directive (2005), available at <http://www.publications.parliament.uk/pa/ld200506/ldselect/ldcom/37/37we07.htm>, at para 22.

38. See, for instance, *Maple Leaf Macro Volatility Master Fund v Rouvroy* [2009] EWHC 257 (Comm), [2009] 2 All ER (Comm) 287, *Khodari v Tamini* [2009] EWCA Civ 1109, *Patel v Patel* [2009] EWHC 3264, *MBNA Europe Bank Ltd v Thorius* (unreported) 21 September 2009, *South Shield CC and Nine Regions (t/a Logbook Loans) v Sadeer* 14 November 2008, Bromley CC, available Lexis 8QT25415 (transcript). Only the latter alleged an irresponsible lending decision, which the court surprisingly rejected.

39. FSMA, s 71.

40. *FSA Treating Customers Fairly Progress and Next Steps* (FSA, 2004), available at http://www.fsa.gov.uk/pubs/other/tcf_27072004.pdf and the press release available at <http://www.fsa.gov.uk/Pages/Doing/Regulated/tcf/index.shtml>.

41. FSMA, s 64(8).

42. FSMA, s 229. There has been a report of a mortgagor recovering compensation for the sale of an 'unsuitable' mortgage; see the website available at <http://www.guardian.co.uk/money/2009/mar/22/repossessions-mortgages>.

43. Unfair Terms in Consumer Contracts Regulations 1999, SI 1999/2083.

44. Consumer Protection from Unfair Trading Regulations 2008, SI 2008/1277.

measures which could have real consequences for an abused mortgagor.⁴⁵ After all, ss 140A–D were introduced to replace the widely criticised and inadequate protection afforded by their predecessor provisions, which had largely failed mortgagors.⁴⁶

RESPONSIBLE BORROWING

The neo-classical model of market regulation sees the consumer as a rational actor able to make responsible borrowing decisions best suited to their needs assisted by the provision of relevant, accurate and timely comparative information. This is one of the fundamental principles that have underpinned the regulation of the home mortgage market, whether under the FSMA or the CCA, where lenders are required to provide prescribed information to the mortgagor before and during the course of the mortgage transaction.⁴⁷

The retreat from disclosure and the rational consumer

Under the FSMA, the pre-application key facts illustration, setting out the essential loan terms provided to the mortgagor under MCOB 5, has been described by the FSA as the ‘cornerstone’ of mortgage regulation.⁴⁸ However, even before the credit crunch, there was evidence from both the FSA and Citizens Advice that suggested weakness in disclosure.⁴⁹ Their research found that certain mortgagors, particularly within the sub-prime market, did not compare different mortgage products or even understand some of the fundamental features of mortgage borrowing and thus could not play their part as a rational consumer.⁵⁰ Subsequent research into the role of the key facts

45. Citizens Advice highlighted these distinctions in their briefing for the Treasury Select Committee Inquiry on Mortgage and Secured Loan Arrears (2009), available at http://www.citizensadvice.org.uk/citizens_advice_briefing_for_the_treasury_select_committee_inquiry_on_mortgage_and_secured_loan_arrears_june_2009.

46. CCA, ss 137–140. See, for instance, *Ketley v Scott* [1980] CCLR 37, *Davies v Direct Loans* [1986] 1 WLR 823, *Wills v Wood* (1984) 81 LSG 1211, *Paragon Finance plc v Nash* [2002] 1 WLR 685, *Broadwick Financial Services Ltd v Spencer* [2002] EWCA Civ 35, [2002] 1 All ER (Comm) 446, *London North Securities Ltd v Meadows* [2005] 1 P&CR DG16.

47. FSA Handbook, MCOB 5 (Pre-application Disclosure), MCOB 6 (Disclosure at Offer Stage), MCOB 7 (Disclosure at the Start and of Contract and After Sale).

48. FSA Review, above n 2, para 6.1.

49. Similar findings are evident in other jurisdictions; see, for instance, in Australia, P O’Shea ‘Consumer credit disclosure does it work?’ (2008) 16 *Journal of Banking and Finance Law and Practice* 5 and, in the USA, E Renuart and D Thompson ‘The truth, the whole truth and nothing but the truth’ (2008) 25 *Yale Journal of Regulation* 181 and S Block-Lieb et al ‘Disclosure as an imperfect means for addressing overindebtedness: an empirical assessment of comparative approaches’ in J Niemi, I Ramsay and W Whitford (eds) *Consumer Credit, Debt and Bankruptcy* (Oxford: Hart, 2009) ch 8.

50. FSA *Mortgage Effectiveness Review: Stage 1 Report* (2006), available at http://www.fsa.gov.uk/pubs/other/mortgage_review.pdf; FSA *Mortgage Effectiveness Review: Stage 2 Report* (2008), available at http://www.fsa.gov.uk/pubs/other/MER2_report.pdf; FSA *Mortgage Effectiveness Review: Sub-Prime and Lifetime Findings* (2009), available at http://www.fsa.gov.uk/pubs/other/MER2_Illuminas.pdf and Citizens Advice Bureau, above n 17.

illustration has reinforced these findings.⁵¹ This research found that the key facts illustration, although valued by mortgagors, was used as a 'post-purchase' support to check a mortgagor's understanding of the loan terms and as a record of his or her borrowing decision. Its role in helping mortgagors shop around and compare different mortgage products was limited. Mortgagors generally reached their decision to borrow following face-to-face meetings with the lender or mortgage broker at which product information was disclosed orally. The research revealed further confusion over how this disclosure was perceived, whether as information, explanation or advice, an issue which is considered further in the context of irresponsible lending.

The advance of behavioural economics and paternalism

There is growing recognition that a mortgagor's decision to borrow may not be made on solely rational grounds but is a more complex process that is also influenced by factors that have inspired the development of behavioural economics.⁵² For instance, individuals can tend to be over optimistic and even when warned, for instance, that they may lose their house if they do not keep up their mortgage payments, do not believe that they will default and face repossession.⁵³ Individuals' assessment of risk also may not be rational, with dramatic events which attract high media attention being overestimated as more likely to happen as against less vivid risks that excite only muted attention. Hyperbolic discounting suggests that a mortgagor's ability to value discounted mortgage rates, arrangements fees, pre-payment penalties and the like may not be rationally consistent over the time frames in which these charges operate. An initial discount rate is immediately attractive even though it is apparent that, once the discounted period expires, subsequent rates render the overall cost of borrowing more expensive. Indeed, these discounted rates are sometimes termed 'teaser rates'.

The FSA Review notes that mortgagors' (as opposed to other consumers') decisions are subject to particular behaviours which can reduce mortgagors' caution and entice them into borrowing decisions which are not best suited to their interests.⁵⁴ Mortgages can appear deceptively cheap products. Considerable sums are received for relatively small periodic repayments which, being repaid over an extended term, contribute to the apparent affordability of the borrowing.

Mortgagors are motivated to borrow by immediate want or need which will lead them to focus on the end result. In contrast to other financial products, the mortgage (like other credit) is not always seen as the product being bought and sold but as a means to an end. The focus is then on the asset purchased. In relation to first legal charges, this will often be the mortgagor's prospective home. Second-charge borrowing might fund a home improvement or other substantial expenditure or it might be utilised to avoid default when existing unsecured loans are consolidated.

51. Illuminas *Disclosure in the Prime Mortgage Market* (2008), available at <http://www.fsa.gov.uk/pubs/consumer-research/crpr81.pdf>.

52. See generally I Ramsay *Consumer Law and Policy* (Oxford: Hart, 2nd edn, 2007) pp 71–76. The FSA commissioned research on the impact of behavioural economics by D De Meza, B Irlenbusch and D Reniers *Financial Capability: A Behavioural Economic Perspective* (2008), available at <http://www.fsa.gov.uk/pubs/consumer-research/crpr69.pdf>.

53. C Jolls *Behavioral Law and Economics*, available at http://www.law.yale.edu/documents/pdf/Jolls_Behavioral_Law_and_Economics.pdf.

54. FSA Review, above n 2, paras 6.7–6.11.

Mortgage credit and the aspiration of home ownership

Here is the link with the housing policy of successive governments which has promoted home ownership as an aspiration, if not an obsession, for all.⁵⁵ Before the restriction of credit precipitated by the credit crunch, 70% of housing in the UK was owner occupied and the government had expressed a hope that this figure would reach 75%.⁵⁶ This growth in owner occupation was made possible by an explosion of mortgage debt. Total mortgage debt to gross domestic product in the decade running up to 2007 grew from 50% to over 80%, with roughly 11.7 million mortgages in the UK and loans totalling over half a trillion pounds.⁵⁷ During the credit crunch, the level of home ownership dipped slightly to 68% and may be expected to slide further if access to mortgage credit continues to be limited.⁵⁸

Lower income groups, who in previous decades could not aspire to home ownership, are part of this dramatic growth. The Thatcher government's 'Right to Buy' policy oversaw the most dramatic promotion of owner occupation, as large swathes of council accommodation were sold to their tenants at discount prices. It is estimated that by 2002 over 2 million public sector tenants gained access to home ownership through the Right to Buy Scheme.⁵⁹ Right to Buy has now largely run its course⁶⁰ but low-cost home ownership has not. The government's 'Homebuy' schemes provide 'affordable' home ownership options which are dependent on the availability of mortgage finance.⁶¹ Most prominent are shared ownership schemes, which enable would-be homeowners to purchase a share of their home from a housing association and to pay rent in respect of the remaining portion. The aspiration is to move to full ownership by purchasing further shares, again using mortgage finance secured by increasing income levels or property values, in a process known as stair-casing. Unfortunately, evidence suggests that, for many, shared ownership is not a transitional, but a permanent, hybrid tenure.⁶² The government is also promoting shared equity schemes, which provide equity loans, secured by a second charge, to part fund a home that is purchased on the open market with the assistance of traditional mortgage finance. The shared equity loan is secured as a proportion of the mortgagor's equity and thus, on sale, any increase in value of the property is shared proportionately between the lender and the mortgagor. Shared equity loans are available through the Homebuy schemes, with funds provided by government or a developer (in respect of Homebuy Direct) on advantageous terms. The government is also interested in

55. The strength and importance of individuals' conceptions of home have been explored by L Fox in *Conceptualising Home: Theories, Law and Policies* (Oxford: Hart, 2007).

56. HM Treasury *Government's Response to Kate Barker's Review of Housing Supply* (2005), available at http://www.hm-treasury.gov.uk/d/prb05_barker_553.pdf.

57. Turner, above n 1, para 1.2.

58. See *English Housing Survey*, available at <http://www.esds.ac.uk/Government/SEH/>.

59. Office for National Statistics *Sales and Transfers of Local Authority Dwellings: Social Trends 34* (London: ONS, 2004).

60. In 2008/9 the number of Right to Buy transactions fell to below 1000: FSA Review, above n 2, para 10.35. The Housing (Scotland) Bill 2010 proposes an end to a Right to Buy for new council house and housing association tenants.

61. See the website available at <http://www.homebuy.co.uk>.

62. A Wallace *Achieving Mobility in the Intermediate Housing Market: Moving Up and Moving On?* (London: Chartered Institute of Housing/JRF, 2008) p 74.

developing the private shared equity market.⁶³ Presently, shared equity schemes are targeted at first-time buyers and key workers who have found it increasingly difficult to fund entry into the housing market.⁶⁴

Whitehouse has noted the move away from the state provision of housing to individual responsibility for the provision of accommodation with the promotion of home ownership through the consumerisation of mortgage finance.⁶⁵ This theme is taken up by Fox, who describes lenders as the 'gate keepers' to home ownership based upon affordability rather than need.⁶⁶ She looks to research which questions the sustainability of home ownership to low income households, with half of the households living in poverty being home owners.⁶⁷ Low-income homeowners are more exposed to the risk of default which may not be attributed to individual failure alone but to wider economic factors, including the burdens of home ownership itself.⁶⁸ Unsurprisingly, this exposure to default has increased in the current recession.⁶⁹ The FSA Review acknowledges the vulnerability of low-income mortgagors both to aggressive sales techniques and to repossession.⁷⁰ In 2005/06, the FSA took action against five of the ten most active firms in the Right to Buy market and records that statistics reveal that buyers of 'affordable' housing are two to three times more likely to fall into arrears than a borrower with a standard mortgage.

Fox goes on to point out that, whilst home ownership is promoted, it has not attracted commensurate protection or support, particularly when compared with the protection and support afforded to home renters.⁷¹ Mortgage Interest Tax Relief at Source (MIRAS) originally provided real support for home buyers utilising mortgage finance but this tax incentive was totally withdrawn from April 2000. Its abolition contributed to a shift in the balance of support between homeowners and home renters,

63. See Department for Communities and Local Government, *Pomeroy Review of Prospects for Private Sector Equity: Summary Conclusions* (2008), available at <http://www.communities.gov.uk/documents/housing/pdf/pomeroyreviewconclusions>.

64. See, for instance, National Housing and Planning Advice Unit (NHPAU) *Affordability Still Matters* (London: NHPAU, 2008) and *Affordability – More Than Just a Housing Problem* (London: NHPAU, 2009) and A Wallace, A Jones and S Duffy *Rapid Evidence Assessment of the Economic and Social Consequences of Worsening Housing Affordability* (London: NHPAU, 2009).

65. L Whitehouse 'The homeowner: citizen or consumer?' in S Bright and J Dewar (eds) *Land Law: Themes and Perspectives* (Oxford: Oxford University Press, 1998) and 'Impact of consumerism on the home owner' in D Cowan (ed) *Housing Participation and Exclusion* (Aldershot: Ashgate, 1998).

66. L Fox *Conceptualising Home: Theories, Law and Policies* (Oxford: Hart, 2007) ch 5.

67. R Burrows and S Wilcox 'Half the poor: homeowners with low incomes' (2000) 7 *Housing Finance* 47. For more recent research, see above n 62.

68. Fox, above n 33, p 217. Fox highlights research which suggests that low income homeowners, in contrast to low income tenants, must bear increased maintenance and repair costs, suffer from lower economic mobility but increased financial vulnerability. See also B Lyndhurst *Social Mobility and Home-ownership: A Risk Assessment* (London: Department for Communities and Local Government, 2007).

69. See M Stephens et al (eds) *Housing Market Recessions and Sustainable Home-Ownership* (York: Joseph Rowntree Foundation, 2008) and J Ford and A Wallace *Uncharted Territory? Managing Mortgage Arrears and Possessions* (London: Shelter, 2009).

70. FSA Review, above n 2, paras 10.41–10.42.

71. Fox, above n 66, p 211.

with research revealing that home owners received only 8% of state support for housing, the remainder being paid to home renters.⁷²

Fox also suggests that lenders do not adequately share the risk of mortgage default.⁷³ The predominance of the market model, exemplified through contractual obligations and property rights, largely leaves losses where they fall – that is upon the mortgagor through repossession. In the light of higher rates of repossession from the current recession, there has been a shift towards greater homeowner protection, with lenders being called upon to fulfil their obligations under MCOB 13 to seek repossession only as last resort after attempts to reschedule repayment of the debt have failed. The FSA reported in 2008 that lender compliance with MCOB 13 was variable;⁷⁴ however, the FSA has since been more vigilant in trying to ensure that lenders' enforcement policies do comply.⁷⁵ The Pre-action Protocol relating to Possession Actions based upon Mortgage Arrears⁷⁶ reinforces this policy, and the well-worn jurisdiction of s 36 of the Administration of Justice Act 1970 provides a final opportunity for debt rescheduling and the postponement of repossession.⁷⁷ Main stream lenders appear to be showing forbearance in their handling of arrears and repossession, with Shelter reporting 'a move away from a "pay or possess" approach, to a more consumer-focussed approach of "managed forbearance"'.⁷⁸ Given the incidence of irresponsible lending in the lead up to the credit crunch, 'managed forbearance' is the least that could be expected.

There also has been restrained acknowledgment that struggling home owners can expect more government support at least in the short term. The main source is Support for Mortgage Interest (SMI), which provides help with the payment of mortgage interest for those in receipt of certain social security payments, in particular income support and job seekers' allowance. As a result of the current recession, the qualifying period for those on job seekers' allowance has been reduced to 13 weeks (it was previously 39 weeks), although a limit of 104 weeks has been imposed on the period for which the benefit may be claimed.⁷⁹ There are also new initiatives in the Mortgage Rescue Scheme and the Homeowners Mortgage Support Scheme. The former enables

72. See Burrows and Wilcox, above n 67.

73. Fox, above n 66, p 225.

74. Illuminas for FSA *Mortgage Effectiveness Review Arrears Findings* (2008), available at http://www.fsa.gov.uk/pubs/other/mer_report.pdf.

75. See, for instance, letter of 27 November 2009 issued to all chief executive officers of licensed lenders, available at http://www.fsa.gov.uk/pubs/ceo/arrears_repossessions.pdf. CML have also updated their industry guidance on handling arrears and repossession; see the website available at <http://www.cml.org.uk/cml/policy/issues/1629>.

76. Council for Civil Justice *Pre-action Protocol for Possession Claims based on Mortgage or Home Purchase Plan Arrears in respect of Residential Property* (2008), available at http://www.civiljustice.council.gov.uk/files/Mortgage_Pre-action_protocol_21_Oct.pdf. See L Whitehouse 'The Mortgage Arrears Pre-action Protocol: an opportunity missed' (2009) 72 MLR 793.

77. M Haley 'Mortgage default: possession, relief and judicial discretion' (1997) 17 LS 483 and L McMurtry 'Mortgage default and repossession: procedure and policy in the post-Norgan era' (2007) 58 NILQR 194.

78. Ford and Wallace, above n 69, although Citizen Advice reports some continuing evidence of poor arrears collection practices particularly amongst sub-prime and second-charge lenders; see above n 45.

79. Social Security (Housing Costs Special Arrangements) (Amendment and Modification) Regulations 2008, SI 2008/3195. The regulations also increase to £200,000 the mortgage limit on which the benefit may be claimed.

mortgagors in priority need to sell and rent back their home to a housing association, whilst the latter enables certain mortgagors (with the agreement of their lenders) to convert their mortgage to interest only for up to 2 years, with the government providing an 80% repayment guarantee to participating lenders. These latter measures are limited, both in extent and time. They have been met with some scepticism, with a poor take up of the Mortgage Rescue Scheme⁸⁰ and assertions that the Homeowners Mortgage Support Scheme merely mirrors existing lender initiatives.⁸¹ Low interest rates have been of greater assistance to more households than these government measures.

The FSA's reaction to evident vulnerability of certain mortgagors is a policy shift away from market regulation towards greater paternalism 'to protect consumers more from themselves'.⁸² The immediate recommendation is greater product regulation based upon affordability. Moves to support the rational consumer by promoting greater financial capability remain on the agenda as a longer-term aspiration.⁸³ In the shorter term, consumer education initiatives are refocused upon guidance to those facing arrears and mortgage repossession, in other words the consequences of irresponsibility, whether of mortgagors or lenders.⁸⁴ What is missing however is any real engagement with the wider policy of mortgage-funded low-cost housing provision.

RESPONSIBLE LENDING

An overall assessment of lender responsibility should encompass the whole course of their conduct during the mortgage transaction from advertisement through to possible enforcement, and, indeed, the regulatory regimes of both the CCA and the FSMA do just that.⁸⁵ However, the focus of this paper is upon the responsibility of the lender as a 'gate keeper' to mortgage finance when deciding to make a mortgage offer. It will concentrate on FSA regulation given the anticipated regulatory realignment to which reference has already been made.

The current standards are found in MCOB 11, which provides that '[Lenders] must be able to show that before deciding to enter into, or make further advances, upon a regulated mortgage contract . . . account was taken of the customer's ability to pay'.⁸⁶ This demonstration is made against the lender's written policy.⁸⁷ The guidance provides that this policy should assume that repayments are made from income and thus the lender should take account of the mortgagor's actual or reasonably anticipated income against initial and subsequent repayments, allowing for discounted periods, at current interest rates.⁸⁸ However, MCOB 11 also permits a lender to rely on

80. By August 2009 it was reported that only six households had been assisted; see the website available at [http://www.politics.co.uk/news/economy-and-finance/mortgage-rescue-scheme-helps-only-six-households-\\$1317276.htm](http://www.politics.co.uk/news/economy-and-finance/mortgage-rescue-scheme-helps-only-six-households-$1317276.htm).

81. Ford and Wallace, above n 69.

82. FSA Review, above n 2, para 6.12.

83. Cm 7669, above n 5; HM Treasury, above n 6.

84. Ford and Wallace, above n 69.

85. See, for instance, OFT *Scoping Paper on Irresponsible Lending* (OFT 1012con, 2008), available at http://www.ofst.gov.uk/shared_ofst/business_leafllets/consumer_credit/ofst1012.pdf.

86. MCOB 11.3.1.

87. MCOB 11.3.4.

88. MCOB 11.3.5. Special guidance relates to interest-only mortgages and circumstances where payments are to be made from sources other than income; see MCOB 11.3.5 and 11.3.6.

self-certification ‘where the [lender] considers it to be appropriate, having regard to the interests of the [mortgagor], and where the [lender] has no reasonable grounds for doubting the information provided’.⁸⁹

In the aftermath of the credit crunch and a rise in the number of mortgage defaults and repossessions,⁹⁰ Turner announced the need to tighten regulation to promote more responsible lending. It left the FSA Review to flesh out a wider concept of responsibility. The FSA’s work revolves around three main areas of inquiry: first, product regulation, to provide a more restrictive definition of what types of lending are responsible; secondly, lender responsibility for affordability and suitability; and, thirdly, a rebalancing of the lender/mortgagor’s decision-making responsibilities.

Product regulation

In the past, the FSA has eschewed product regulation as likely to inhibit innovation and competition within the market model.⁹¹ There was also the concern that the relatively blunt application of product regulation could exclude certain mortgagors from access to mortgage credit and, thus, jeopardise low-income home ownership. However, the evident limits of disclosure as an effective tool to promote responsible borrowing and the vulnerability of certain mortgagors already discussed has forced the FSA into rethinking the unthinkable.

Turner suggested that loan to value (LTV) and loan to income (LTI) ratios might form the basis for product regulation by imposing limits on the loaned amount as measured against the value of the security and the level of the mortgagor’s income.⁹² Both these ratios grew dramatically in the time leading up to the credit crisis in the expectation that the property market would continue its upward trajectory. Turner found that the number of mortgages available with LTV ratios of 100% or more almost doubled between 2005 and 2007 and, further, that LTI ratios exceeding 3.5% rose to 30% of lending by 2007. However, the FSA’s further work has not persuaded them that these ratios provide the answer. The FSA’s analysis of available data suggests that, whilst there is some evidence that high LTV and LTI ratios have contributed to the credit crisis and a higher risk of default, they may not have been the most significant drivers.⁹³ They also conclude that wider debt to income (DTI) ratios, which take into account unsecured as well as secured borrowing, do not assist in providing a sufficiently sophisticated measure of affordability. All in all, whilst the FSA has not ruled out the use of any or all of these ratios, their initial assessment is that a cap upon them, although relatively clear and convenient to administer, would provide only a crude guide to responsible lending. Instead, the FSA Review suggests a ban on

89. MCOB 11.3.2.

90. In the first 6 months of 2009 there were 24,100 repossessions, 205,6000 mortgages were in arrears of 2.5% or more of the mortgage balance and over 270,4000 mortgages were in arrears by 3 months or more; see CML statistics, available at <http://www.cml.org.uk/cml/statistics>.

91. There has been a similar general reluctance to consider caps on interest rates; see I Ramsay *Consumer Law and Policy* (Oxford: Hart, 2nd edn, 2007) pp 555–559.

92. Turner, above n 1, ch 3.

93. FSA Review, above n 2, ch 4. Their findings reveal that, although there is some evidence of a link between high LTV ratios and the risk of default, the average LTV ratios have been falling since 1997. They found no substantial evidence of a link between high LTI ratios and the risk of default.

high-risk mortgages and more stringent assessments of affordability for individual borrowers. In other words, the suitability of particular products to particular mortgagors is advocated over product regulation per se.

The high-risk mortgages that may be prohibited are non-income verified (NVI) mortgages and loans to borrowers that exhibit multiple high-risk characteristics. These high-risk characteristics could include high LTV, LTI and DTI ratios to mortgagors with impaired credit histories or low or unstable income. However, the FSA has yet to articulate fully how these 'toxic' elements are to define prohibited high-risk mortgages and, again, the effect on low-cost housing provision is conspicuously absent.

NVI mortgages are of two types: first, self-certified mortgages, where the lender relies upon the borrower's self-certification of their income; and, secondly, fast-tracked mortgages, where the lender chooses to omit checks on the mortgagor's income. Self-certified mortgages were developed to cater for the self-employed, whilst mortgage applications originally were only fast-tracked where the proposed mortgagor was perceived as a low credit risk. Both forms of NVI mortgage grew beyond these confines, with 45% of all mortgages being made on a non-verification basis during 2006/07.⁹⁴ Unsurprisingly, the FSA has found that the rate of default on NVI mortgages is high and could be as much as three to four times higher than where the lender has verified the mortgagor's income.

NVI mortgages are proving a bone of contention between the FSA and lenders. The FSA believes there is 'a clear and non-controversial case'⁹⁵ for product regulation of NVI mortgages and sees no reason why income checks should not be provided by the self-employed or contract workers.⁹⁶ CML reaction is that there is still a place for some NVI mortgages and that, rather than an outright ban, there should be a redefinition to exclude fast tracking and permit limited self-certification, for instance where income verification is impossible.⁹⁷

Affordability checks

It might seem obvious that a lender will be centrally concerned with a mortgagor's ability to repay the loan but the nature of the modern mortgage market displays a number of disincentives to rigorous scrutiny of affordability.⁹⁸

The very nature of a mortgage as a security interest enables the lender to look to the underlying security, namely the mortgagor's home, if the mortgagor defaults. It is thus tempting for lenders to overlook affordability checks, particularly where there is considerable equity in the security. Inevitably, such checks take time and increase costs in a competitive mortgage market. They can also be intrusive to mortgagors keen to secure mortgage finance and press ahead with their chosen house purchase.

Securitisation has enabled lenders to pass on the risk of default with the sale of their mortgage books, thus clearing their balance sheets from the impact of bad debts. The

94. The number of lenders offering such mortgages has since dropped dramatically – only two lenders were offering self-certified mortgages by August 2009 and the last lender announced their withdrawal in November 2009; see CML 'Is it an end to self cert?' (2009) News and Views Issue No 22.

95. FSA Review, above n 2, para 4.46.

96. Ibid, para 4.57.

97. Presentations at CML's Conference on the FSA's Mortgage Market Review (2009); see the website available at <http://www.cml.org.uk/cml/events/highlights/event80>.

98. See EU Consultation, above n 7, p 7.

attractive returns generated by securitisation also played their part in encouraging lenders to look to riskier sub-prime and buy-to-let markets and employ more aggressive marketing strategies to provide mortgage debts to feed the securitisation machine.⁹⁹ In 2007, 18% of mortgage credit in the UK was funded by securitisation.¹⁰⁰ Steps are being taken to bring securitisation under control; for instance the European Commission is requiring issuers to retain 5% of risk to be securitised.¹⁰¹

The bonus culture has not been confined to City traders. There was also an incentive for mortgage sales staff and brokers, under pressure to meet sales targets, which looked to lending volumes rather than the risk of default, to negotiate loans to mortgagors with weak credit profiles and to push riskier products where the rates of commission were often higher. FSA research found worrying levels of poor practice, particularly within the sub-prime market, including inadequate assessment of the mortgagor's ability to pay, or the suitability for, the mortgage arranged, unjustified reliance on self-certification and churning, whereby mortgagors incurred pre-payment charges having been inappropriately advised to re-mortgage.¹⁰²

Mortgagors are called upon to protect themselves from default by taking out mortgage payment protection insurance (MPPI) against the risk that sickness or unemployment will trigger a loss of income. It has been government policy to try and shift mortgagor protection from the consequences of default away from the state, in the form of SMI, and onto the individual mortgagor by promoting the privatised safety net of insurance.¹⁰³ Unfortunately, the mis-selling of payment protection insurance products has generally rather tarnished their appeal,¹⁰⁴ with fewer than one in five of the 12 million homeowners with mortgages protected by MPPI.¹⁰⁵ Nevertheless, the government continues to press the private assumption of risk. For instance, they have recommended for further inquiry the Canadian policy of compulsory insurance for certain mortgages that exhibit a high degree of risk.¹⁰⁶

Dovetailing with their proposed ban on NVI mortgages, the FSA Review calls for lenders to take ultimate responsibility for proper affordability checks regardless of whether or not the mortgage is negotiated directly or through brokers.¹⁰⁷ This

99. C Peterson 'The political economy of consumer credit securitization: comparing predatory lending in home finance in the US, UK, Germany and Japan' in J Niemi, I Ramsay and W Whitford (ed) *Consumer Credit, Debt and Bankruptcy* (Oxford: Hart, 2009) ch 2.

100. Turner, above n 1, para 1.2.

101. See also government promises to bring securitisation under control: HM Treasury *Pre-Budget Report* (London: HM Treasury, 2009) para 3.12.

102. FSA *Mortgage Effectiveness Review: Stage 1 Report*, above n 50, and *Mortgage Effectiveness Review: Stage 2 Report*, above n 50.

103. See J Ford et al *Homeowners Risk and Safety-Nets: Mortgage Payment Protection Insurance (MPPI) and Beyond* (London: Office of the Deputy Prime Minister, 2004).

104. Both the OFT and FSA have investigated payment protection insurance in 2005 and 2006. CML's report of these investigations summarises their findings; see the website available at <http://www.cml.org.uk/cml/policy/issues1552>. In October 2009, the FSA reached agreement with MPPI providers on a £60 million compensation package for mortgagors subject to unfair variation of their MPPI; see the website available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/135.shtml>.

105. Centre for Housing Research, University of York *Developing Safety Nets for Home-Owners* (York: Joseph Rowntree Foundation, 2008).

106. See HM Treasury, above n 6, paras 8.48–8.50.

107. FSA Review, above n 2, paras 4.61–4.93, although it is unclear how the respective duties of lenders and intermediaries would be divided; see CML, above n 94.

responsibility would be significant, with brokers accounting for approximately 55% of all mortgage sales in 2008/9 and for a staggering 80% of sales to credit-impaired mortgagors.¹⁰⁸ MCOB 11 already requires lenders to take into account the mortgagor's ability to pay but leaves it to lenders to develop their own policies against which affordability is determined. The FSA Review suggests the tightening of affordability criteria, with all lenders being required to measure affordability against the mortgagor's free disposable income and an assessment of their borrowing capacity. The current or expected value of the underlying security is not to feature in this assessment. Inevitably, more far-reaching and intrusive inquiries into the mortgagor's income, outgoings and spending habits will be necessary, which will increase the cost of credit and lead to longer approval periods. To guard against the danger that mortgagors may intentionally or unintentionally under-estimate their expenditure or inflate their income, the FSA Review calls for verification of both income and expenditure against independent data, including credit reference agencies and official national statistics.¹⁰⁹ The FSA review is short on detail on how these checks will be implemented in practice.

The MCOB 11 test of affordability does not consider future changes in interest rates. When credit was easily available, mortgagors relied on their ability to re-mortgage at competitive rates when initial discounted periods had run their course. The FSA Review suggests that affordability should incorporate a measure of stress testing for possible interest rate raises and should take greater account of future material changes, including predictable falls in income, for instance as a result of the mortgagor's retirement.¹¹⁰

Affordability is thus to be objectively tested but nevertheless will need to be sufficiently flexible to assess the affordability of a wide range of mortgage products for a diverse profile of mortgagors.

This focus on affordability is mirrored in other initiatives to promote responsible lending. In particular, Art 8 of the CCD calls upon lenders to assess a consumer's creditworthiness on the basis of information provided by consumers and verified, where necessary, by independent checks from relevant databases.¹¹¹ This assessment is not confined to the initial grant of the loan but is to be monitored through the duration of a long-standing credit relationship, although what measures are to be taken if these checks subsequently fall short is unclear. The BERR Consultation sought to put detail on how this assessment of creditworthiness might be undertaken in the domestic context by proposing an ascending range of checks according to the character of the borrower and the credit.¹¹² The investigations considered ranged from the minimum of credit reference agencies searches through to an assessment of a borrower's disposable income and, at the most intrusive level, reasonable steps to verify information and

108. Ibid. para 5.4.

109. There are concerns over the widespread use of credit references agencies; see I Ramsay *Consumer Law and Policy* (Oxford: Hart, 2007) p 246. In particular there is a lack of evidence that reliance on positive as well as negative information leads to lower levels of default; see A Padilla and M Pagano 'Sharing default information as a borrower discipline device (2000) 44 *European Economic Review* 1951.

110. FSA Review, above n 2, para 4.79.

111. Earlier drafts of the CCD called upon lenders to assess the suitability of credit offered to individual consumers; see S Franken 'The political economy of the EC Consumer Credit Directive' in J Niemi et al, above n 49, ch 7.

112. BERR Consultation, above n 9, paras 5.1–5.12.

to explore possible changes in circumstances. These recommendations have not found their way into the regulations but have been incorporated into the OFT Guidance.¹¹³

Evident in all these proposals is a lack of clarity of exactly what affordable means. The current MCOB measures tend to concentrate upon the risk of default on the particular mortgage but the debate is advocating a wider impact assessment of the consumer's financial well being. The OFT Guidance, for instance, draws a distinction between 'credit-worthiness', which is a lender-focused assessment of the risk of default, and 'affordability' as a borrower-focused assessment which considers whether the borrower is able to meet the repayments over the life of the loan in a sustainable manner taking into account the loan's impact upon the borrower's overall financial well being.¹¹⁴ Sustainable equates with an ability to make payments without undue difficulty within a reasonable time frame from income and savings, rather than resorting to any security or incurring further indebtedness. The borrower's financial situation calls for a consideration of their past credit history, their present disposable income and some consideration of future affordability in terms of predictable future commitments and reasonably foreseeable changes in circumstances.

Clearly, affordability or sustainability is not an exact science. It can only present a close to accurate picture of present affordability and even then must rely on evidence that may be difficult to extract and verify. Article 8 expects borrowers to provide relevant, complete and accurate information of their financial situation but the FSA Review recognises that mortgagors are inclined, even inadvertently, to underestimate their expenditure and provide over-optimistic assessments of their income.¹¹⁵ Future affordability is much more of a crystal-ball-gazing exercise. Lenders look to mathematical models¹¹⁶ but any model is only as accurate as the assumptions on which it is based and cannot be separated from macro-national and global economic conditions. The CML suggests that most arrears build up as a result of a change in the mortgagor's circumstances that was not foreseeable at the time the decision to lend was made.¹¹⁷

Information, explanation and advice

The question mark over consumers' ability to use information to make responsible borrowing decisions has thrown onto lenders greater responsibility to try and confirm a particular consumer's understanding of the obligations into which he or she will be entering. The implication is that mere pre-contractual disclosure is not enough. These checks may operate through explanation of the credit product(s) or by giving advice on the suitability of particular product(s) to a consumer's individual situation and needs.

The present situation in relation to FSA-regulated mortgages is found in MCOB 4, which draws a distinction between advised and non-advised sales. A third of sales are

113. OFT Guidance, above n 4, ch 4.

114. Ibid.

115. FSA Review, above n 2, para 4.84

116. See the website available at <http://www.cml.org.uk/cml/publications/newsandviews/36>.

117. CML, above n 97. Evidence from the recession of the early 1990s supports this view; see J Ford *Problematic Home Ownership: The Management and Experience of Arrears and Possessions in Depressed Housing Market* (York: Joseph Rowntree Foundation/Loughborough University, 1994).

made on a non-advised basis,¹¹⁸ where the lender or broker is only required to provide clear and accurate information of a fair and unbiased selection of mortgages and to tell the mortgagor to seek advice if they consider that the mortgagor is making an inappropriate decision.¹¹⁹ It is only when the sale is advised that a lender or broker is required to ensure that the mortgage is suitable for a particular mortgagor.¹²⁰ Suitability is to be measured primarily in terms of affordability of the mortgage.¹²¹ Guidance also suggests that cost is the foremost criterion (ie the cheapest is the most suitable), although other factors such as speed might also influence suitability.¹²² Special considerations apply where the mortgagor is taking out the mortgage to consolidate debts or the mortgagor is already in arrears.¹²³

The gulf between advised and non-advised sales is considerable. Yet, it is evident from FSA research that mortgagors do not always appreciate the difference between advised and non-advised sales and are mystified by the various types of service offered by mortgage providers and brokers.¹²⁴ These services range from information to advice on products that are drawn either from the whole market or are confined to mortgages provided by a limited number of lenders. Mortgagors tend to assume that a lender or broker will not put forward options that are unsuitable. The FSA Review also found that mortgagors look to mortgage brokers to discover available products rather than to seek advice. The FSA Review does not go so far as to suggest that all mortgage sales be advised but it does recommend greater clarity between advised sales and sales that are made on an information-only basis.

The narrow focus of information and advice under the current rules has also drawn criticism. Interest rate levels dominate advisers' and mortgagors' decision making, with inadequate regard being given to other cost considerations including arrangement fees, pre-payment charges or the impact of default charges.¹²⁵ The acknowledgement of Lord Phillips of Worth Matravers in *Office of Fair Trading v Abbey National plc*¹²⁶ that consumers often do not focus upon overdraft charges when opening a bank account, which they expect to maintain in credit, provides a relevant analogy and reflects the findings of behavioural economists referred to above. Citizens Advice's experience also reveals that amongst some mortgagors there is a worrying level of ignorance about the basics of how mortgages work.¹²⁷ It is thus not surprising to find the FSA Review calling for greater explanation of mortgages and their associated risks to the mortgagor.¹²⁸

118. FSA Review, above n 2, para 5.10.

119. MCOB 4.8. The information is carefully scripted to avoid giving advice.

120. MCOB 4.7.2.

121. MCOB 4.7.4.

122. MCOB 4.7.13–4.7.14.

123. MCOB 4.7.6.

124. FSA Review, above n 2, paras 5.9 and 5.55.

125. Only arrangements fees and pre-payment charges need to be disclosed in the Key Facts Illustration; see MCOB 5. MCOB 12 requires pre-payment charges and arrears charges to be a reasonable pre-estimate of the costs incurred by the lender and prohibits other excessive charges. Any charges, which are not core terms, fall within the Unfair Terms in Consumer Contract Regulations 1999, SI 1999/2083.

126. [2009] UKSC 6, [2009] 3 WLR 1215 at [79] per Lord Phillips.

127. Citizens Advice, above n 17.

128. FSA review, above n 2, ch 5. A similar call for secure tenants exercising a 'right to buy' to be given adequate explanation of the costs of home ownership is found in ss 121AA and 121B of the Housing Act 2004.

This cry is echoed in the EU Consultation, which suggests the development of risk guidelines.¹²⁹ The EU White Paper on the integration of mortgage credit markets also called for full information to be supplemented by adequate explanations but stopped short of a requirement for advice. Explanation is also a focus of the CCD.¹³⁰ Earlier drafts of the Directive advocated a wider concept of lender responsibility, including obligations to assess the affordability and to provide advice, but this wider concept of lender responsibility fell by the way side.¹³¹ The BERR Consultation put forward a range of options of what sort of explanations are adequate depending on the type of credit and the vulnerability of the borrower.¹³² Again these guidelines do not appear in the regulations but are found in the OFT Guidance, which calls for clear product information and explanations of the consequences of default or other features of the credit that may have an adverse impact on the borrower. The guidelines place some responsibility upon the lender to ensure that the borrower understands the explanation, in the light of the borrower's levels comprehension, for instance by providing for a degree of oral interactivity to clarify points of uncertainty.¹³³

THE WIDER PICTURE

A lender's ability to lend is dependent upon available sources of funds. Before the credit crunch, there was plentiful liquidity. Lenders looked beyond traditional sources, namely their customers' deposits, to new sources of funding, including the wholesale money markets and the proceeds of their securitised mortgages. The rise in the property market and the associated growth of the mortgage sector even attracted lenders who had no access to savers' deposits but were entirely dependent on the wholesale markets for their funding. By 2008, these 'non-bank' lenders claimed 15% of the residential lending.¹³⁴ When the credit crunch came, the over-reliance on these new sources of funds became apparent. Many 'non-bank' lenders made a quick exit from the market, whilst certain well-known, but particularly exposed, banks were only shored up by government intervention.¹³⁵ This rapid expansion and contraction of loan funding has led to various measures to stabilise lenders' exposure to risk and to reduce future cyclical instability.

Steps have already been taken to impose new quantitative liquidity standards, which reduce the attraction of wholesale funds.¹³⁶ The capital requirements of banks and building societies have also been strengthened and will undergo further review when a revised EU Capital Requirement Directive implements the renegotiated Basel II Accord. Higher quantitative and qualitative levels of capital are required which must

129. Above n 7.

130. See Article 5.6.

131. See Franken, above n 111. The UK government was amongst those rejecting the proposal; see Department of Trade and Industry *Consultation on the Consumer Credit Directive* (2005), available at <http://www.berr.gov.uk/files/file14388.pdf>.

132. BERR Consultation, above n 9, paras 4.1–4.17.

133. OFT Guidance, above n 3, ch 3.

134. FSA Review, above n 2, para 3.44.

135. For instance, Northern Rock, which had relied upon securitisation and the wholesale markets for its funding, and Bradford & Bingley, which also relied on the wholesale money markets for funding and was particularly exposed to the buy-to-let market.

136. These measures are described in HM Treasury, above n 6.

be stress tested against adverse economic conditions. Inevitably, these measures impact upon lenders' sources of funding and their consequent lending policy. They militate against riskier forms of lending which need to be supported by higher levels of capital.

Turner described past FSA supervision as 'a light touch'.¹³⁷ There was a belief that evaluation of risk was the proper province of the firms themselves and lenders were largely free to formulate their business models and attendant lending policies. Thus, there was a focus upon supervising systems and processes, rather than on business strategies. The FSA's supervision was targeted on key personnel within the sector and was limited to checking the probity of past conduct rather than suitable expertise and qualifications for the job in hand. Again, it was thought that the firms were better placed to evaluate the competence of their staff. The FSA have now fundamentally changed their approach with the advent of more rigorous supervision, which looks not just at processes but evaluates lending strategies and monitors the associated risk. There is also more attention paid to the competence of those employees responsible for implementing authorised lenders' lending policies, with the FSA Review proposing to extend its supervision to all those engaged in arranging, or advising upon, mortgages.¹³⁸

BALANCING RESPONSIBLE BORROWING AND LENDING

Balancing responsible borrowing and lending is no easy task but the measures described indicate a clear shift towards greater lender responsibility. In the calls for lenders to take a greater role in assessing affordability and to move beyond mere information disclosure, lenders would be required to look beyond their own interests and take the mortgagor's interests into account. No longer can lenders be self-interested players within the neo-liberal market model. They should play a greater role in promoting and maintaining responsible borrowing by mortgagors which, in limiting the risk of default, should also serve lenders' own interests. This shift finds echoes in the overarching Principle 6, which requires FSMA-regulated lenders to 'treat customers fairly', and in the unfair credit relationship controls found in ss 140A–D of the CCA, where current mortgage lending falls within this legislation. It also underpins the tone of both the Unfair Contract Terms in Consumer Contract Regulations 1999¹³⁹ and the Unfair Practices Regulations 2008,¹⁴⁰ which capture mortgage sales as a form of consumer transaction.¹⁴¹

The concept of responsible lending has been advocated for sometime. For instance, Howells writing a decade ago, in the wider context of consumer credit, sought:¹⁴²

'... fundamental changes to the ground rules of creditor–poor debtor relations . . . The proposal could perhaps be viewed as person related and need

137. Turner, above n 1, para 2.7.

138. FSA Review, above n 2, ch 5.

139. SI 1999/2083.

140. SI 2008/1277.

141. *Newham LBC v Khatun* [2004] EWCA Civ 55, [2005] QB 37.

142. G Howells 'Poor consumers in credit markets' in P Cartwright (ed) *Consumer Protection in Financial Services* (The Hague: Kluwer, 1999) p 257.

orientated. It seeks to place into the contract paradigm a concern to respect the needs of the poor consumer and the position she finds herself in. It also requires of creditors an ethical standard . . . and requires them to acknowledge their responsibilities towards clients whom they dominate economically socially and psychologically.’

However, the content of what lenders must do to lend responsibly has remained hazy. The FSA Review and the other initiatives discussed point to affordability, rather than product regulation, as the key guideline. A more detailed consideration of suitability is contemplated only where the mortgage sale is advised, although even where a mortgage is sold on an information-only basis checks should be made of the mortgagor’s understanding of that information.

The downside of this proposed shift in responsibility is greater paternalism. The breadth of mortgage-supported home ownership is such that it encompasses a wide variety of mortgagors from diverse socio-economic groups and financial capability. One size will not fit all, with many mortgagors well able to look after their own interests without the intrusive inquiries into their financial status. Much of the focus has rightly been upon the sub-prime market and mortgagors at the margins of affordability, where the risks associated with mortgage borrowing are higher. Nevertheless, greater flexibility for different types of mortgagors and borrowing could be explored. For instance, the CCA opt out for high net worth borrowers provides an example of the different treatment of borrowers,¹⁴³ whilst the MCOB already contains additional provisions to cater for different types of borrowing in its regulation of Home Purchase Plans (covering Islamic mortgages)¹⁴⁴ and Home Revisions Plans (covering equity release schemes).¹⁴⁵ Distinct measures will also be necessary when the FSA takes over responsibility for second-charge lending.

This paper has concentrated on the decision to lend but the whole course of the lender and mortgagor relationship should not be forgotten; the balance between lenders and mortgagors’ interests on default being of particular import. The current pro-creditor stance is generally justified by the need to ensure that lenders continue to maintain an adequate flow of credit.¹⁴⁶ This justification has particular resonance in the aftermath of the credit crunch, but Fox argues that an evaluation of the lender–mortgagor balance should put these costs to one side.¹⁴⁷ Whilst there is evidence to support the proposition that higher creditor protection promotes cheaper and higher levels of lending, it is not as overwhelming as is often presumed.¹⁴⁸ Recent experience suggests that the higher creditor protection, offered by security, encouraged lenders to undertake higher risk lending.¹⁴⁹ The Ministry of Justice is proposing that a lender’s power of sale should only be exercised with the agreement of the mortgagor or by

143. Section 16A.

144. Eg MCOB 4.10 and 5.8.

145. Eg MCOB 8 and 9.

146. As the House of Lords has acknowledged in trying to find a balance between the rights of lenders and mortgagors, sureties and occupiers; see, for instance, *William & Glynns Bank v Boland* [1981] AC 487, *City of London Building Society v Flegg* [1988] AC 54, *Abbey National Building Society v Cann* [1991] 1 AC 56, *Barclays Bank v O’Brien* [1994] 1 AC 180 and *Royal Bank of Scotland v Etridge (No 2)* [2002] 2 AC 773.

147. Above n 66, p 227.

148. *Ibid.*, pp 88–96.

149. As suggested in Posner’s *Economic Analysis of Law* (Boston, MA: Brown and Company, 1991) p 440.

order of the court, provided either by a possession order or a distinct order for sale.¹⁵⁰ In both instances, the court would have the opportunity to consider the feasibility of debt rescheduling. However, such proposals are not a radical departure from current practice in the majority of mortgage enforcement cases and would not significantly shift the lender–mortgagor balance.

AFFORDABILITY AND SUSTAINABLE HOUSING

The focus on stricter affordability verification could cut a swathe through aspirant homeowners, leaving those unable to satisfy the affordability criteria excluded from credit and the home-ownership dream. That may be no bad thing if mortgage-supported home ownership and intermediated tenures were not a major plank in the government's low-cost home-ownership policy. Just how are individuals, who cannot meet more stringent affordability checks, going to find a roof over their heads?

The government's attention to date has been on the immediate need to stabilise financial markets to encourage the return of a viable mortgage market and to provide an immediate safety net to homeowners facing the threat of repossession. The measures described have achieved a degree of success but there is now a need to formulate medium- to long-term strategies which consider not just access to affordable housing but its sustainability in a climate of restricted credit availability.¹⁵¹ The pressure on social housing is growing rapidly. Recent figures suggest that the number of people on social housing lists will top 5 million people this year, which, at current rates of attrition, would need 280 years to clear!¹⁵²

Longer-term solutions contemplate increases in housing stock,¹⁵³ some of which might even be in public ownership, but houses take time to build, particularly when the construction industry has suffered as much as any other in the recession.¹⁵⁴ In the meantime, the government clearly envisages a greater role for the private rental sector in assisting housing supply.¹⁵⁵

What will also be required is a careful consideration of the possible legal frameworks, namely home ownership, intermediate tenures, and both social and private rental accommodation. Much hope is placed on intermediated tenures, presently provided by shared ownership and shared equity schemes, but both schemes are

150. Ministry of Justice *Mortgages: Power of Sale and Residential Property Consultation Paper CP 55/09* (December 2009), available at <http://www.justice.gov.uk/consultations/docs/mortgages-power-sale.pdf>.

151. See, for instance, CML 'The coming debate: lending, consumer choice, aspirations and risk' *News and Views* (2008); Stephens et al, above n 69, and Ford and Wallace, above n 69.

152. R O'Connor 'Mortgage demand at new heights' *The Times* 5 January 2010 relying on figures provided by the National Housing Federation.

153. HM Treasury, above n 56.

154. Housing starts and completions in 2008–2009 were down by 42% and 20%, respectively, on 2007–2008; see HM Treasury *Investment in the Private Rental Sector* (February 2010) para 1.8, available at http://www.hm-treasury.gov.uk/d/consult_investment_ukprivaterentedsector.pdf.

155. Ibid and Communities and Local Government *The Private Rented Sector: Professionalism and Quality* (2009), available at <http://www.communities.gov.uk/documents/housing/pdf/1229922.pdf>, responding to J Rugg and D Rhodes *The Private Rented Sector: Its Contribution and Potential* (York: University of York, 2008).

complex in structure and bring their own risks.¹⁵⁶ Mortgage finance underpins home ownership and intermediate tenures and also influences rental housing stock through lending to social landlords and the private buy-to-let market. Its availability and sustainability will play a vital part in any debate.

Feasible and effective safety nets for mortgagors are also part of this picture. The current measures already described are short term and MPPI has fallen short of expectations. The Joseph Rowntree Foundation has put forward more radical proposals for a Sustainable Home Ownership Partnership, which would provide a fund, with contributions from lenders, mortgagors and government, from which support could be provided to those facing repossession as a result of designated risks such as unemployment, sickness or accident.¹⁵⁷

CONCLUSION

The fall out from the credit crunch has shaken the belief in the discipline of the market and its regulation founded upon principles of responsible lending and responsible borrowing. Certain lenders have failed to demonstrate responsible decision making, by not conducting adequate checks upon the borrower's ability to repay and by promoting high-risk mortgages, whilst the provision of standard information has proved woefully inadequate to assist certain mortgagors to borrow within their means.

Prudential measures to impose greater confidence in financial markets are being implemented and regulators have tightened their grip. With some tinkering at the edges, lenders plead that these measures should be sufficient.¹⁵⁸ The mortgage market is still weak. Some lenders have withdrawn altogether from the market and those who are still lending have withdrawn their higher risk products and are only willing to lend to borrowers who can offer strong credit profiles and solid security. The FSA is yet to be persuaded that prudential measures are adequate and are keen to articulate lender responsibility in more detailed terms through limited product regulation and more stringent affordability assessments. The aspiration of the responsible borrower has not been abandoned, with measures to try and improve borrowers' understanding of their obligations through more extensive product explanations from lenders and, in the longer term, improved financial literacy.

A vital consideration that still needs to be considered is the interface between mortgage finance and a housing policy founded upon the aspiration of home ownership for all. More stringent tests of affordability will necessitate a rethink, both of levels of sustainable home provision and the part that mortgage finance can play.

156. See, for instance, S Bright and N Hopkins 'Low cost home ownership – the legal issue of the shared ownership lease' [2009] Conv 337.

157. M Stephens, M Daily and S Wilcox *Developing Safety Nets for Home-owners* (York: Joseph Rowntree Foundation, 2008).

158. CML *Response to the Financial Services Authority: Mortgage Market Review* (CML 2009), available at <http://www.cml.org.uk/cml/policy/responses>.