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**Whose mortgage is it anyway?
Producers, consumers and the law in the UK mortgage market**

by

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A. Introduction

The collapse of the UK's housing and housing finance markets, following hard on and to a considerable extent contributed to by the subprime mortgage crisis in the US housing market and its knock-on effects on the US and UK banking and financial system, the unravelling of the securitisation of mortgages taken together with the two Crosby reports on Mortgage Finance² (which followed earlier reports on mortgage finance by Miles³) and the rapid rise in repossessions of homes of defaulting mortgagors should have placed the mortgage as a legal instrument at the centre of any analysis and discussion of the current financial and housing crises and the possible solutions thereto. So far however, there has been a deafening silence on the mortgage as a legal phenomenon and any consideration of whether alongside all other reforms being mooted to address the crises, the law relating to mortgages needs to be reviewed and reformed. Indeed, the government seems to have consciously shied away from any possible alterations in mortgage law, preferring a series of inadequate administrative initiatives to tackle the repossession issue. This article will attempt to redress what the author suggests is a gap in discussions on housing finance and the current crisis in the mortgage market by a discussion of some of the principal defects of current mortgage law in England and Wales and some suggestions for reforms. Hopefully this will stimulate a wider discussion of the subject and provide the basis for a thorough re-examination of the law on mortgages.

This article will not confine itself just to reviewing the law with a view to suggesting a few changes here and there or even a codified law on mortgages similar to that proposed by the Law Commission in 1991 (and rejected by successive governments and the mortgage industry) but will include the need to rethink mortgages on the lines of the innovative suggestions made by Professor Robert Shiller in his *The Subprime Solution*⁴ (but by no means fully worked out) and for the total rethinking of

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² Sir James Crosby, (2008) Interim Report on Mortgage Finance, July; Mortgage Finance: Final Report and Recommendations; November. Both on hm-treasury.gov.uk.

³ David Miles, (2003 and 2004) The UK Mortgage Market: Taking a Longer-Term View: Interim Report 2003; Final Report and Recommendations, 2004. Both on hm-treasury.gov.uk.

⁴ D Shiller (2008) *The Subprime Solution*, Princeton, Princeton UP.

residential mortgages. It will focus particularly on the securitisation of mortgages, the role of the Financial Services Authority in mortgage regulation, including the regulation of mortgage brokers and the problems of repossessions and arrears.

Such an approach to mortgages is long overdue. The fact is, extra-ordinary though it may seem, that there has not been a thorough overhaul of the law on mortgages since the 1925 Law of Property Act. Since that time, the real world of mortgages has been transformed. From a relatively minor part of the land law applicable to very few people (over 85% of the population lived in rented accommodation in 1925) mortgages and so mortgage law have become *the* central legal and economic instrument in the housing market and affect millions of people in their every day lives. It is difficult to think of any other branch of law so central to people's lives that has been left unexamined and unreformed for so long. These points were made by the Law Commission's sadly neglected report on mortgages published in 1986⁵ and the intervening 23 years has only added further support to their comments.

It might be argued that the law has not been examined or reformed because there is no need to examine it: it is working perfectly satisfactorily. Anyone who believes that in the light of the government's scrambling to head off the avalanche of repossessions with a series of administrative and political (but not, legal) initiatives is clearly not living in the real world. Nor can it be seriously argued that the 'public law' of mortgages – the regulation of mortgages and mortgage providers by the Financial Services Authority – is not in need of review and reform in the light of the FSA's own rather downbeat assessment of the effect of its regulation. In addition, the whole area of securitisation of mortgages is totally outside any regulatory framework; only the most complacent of commentators could argue that that position should be maintained. Finally, the recent Miles and Crosby reports on mortgage finance have been written with more or less complete disregard for the law on mortgages which renders some of their recommendations less than feasible or sensible.

It might also be noted that there is a paucity of writing about mortgages from economists and financial experts, apart from some writing about securitisation and official reports on mortgages⁶. Even now with books and articles pouring forth on the

⁵ The Law Commission (1986) *Land Mortgages* Working Paper No.99 London, HMSO

⁶ An exception is D.Leece (2004) *Economics of the Mortgage Market: Perspectives on Household Decision Making*, Oxford, Blackwells. There are useful chapters on mortgages in J.L. Suárez (2009) *European Real Estate Markets*, Basingstoke, Palgrave Macmillan, chaps. 5 and 6. See too M. Pryke and T. Freeman, (1994) Mortgage-Backed Securitization in the United Kingdom: The Background, 5 *Housing Policy Debate*, 307 – 342. This last article is a little dated but provides a good overview of the position in the early 1990s.

credit crunch, mortgages as such are not seen as a central part of the story⁷. In the USA that is not the case. Quite apart from Shiller, a good deal of writing is beginning to appear on mortgages with special reference to both securitisation and to default and the need for reforms on both aspects of mortgages⁸. Part of the latter literature is inspired by legislative reform, actual and proposed, on foreclosure and repossession in various states and in the US Congress – another difference to the somewhat supine reaction of UK legislators to our repossession crisis.

This paper will address the following issues:

- A survey of the public law of mortgages since this is largely absent from any current discussions and analysis of mortgage law;
- A survey of the financial and economic context of mortgages with particular reference to securitisation of mortgages and the Crosby and Miles Reports;
- A more detailed discussion of the problems in the current law and regulatory framework of mortgages with particular reference to defaults and repossessions
- Suggestions for changes.

B. A summary of the public law of mortgages

1. The historical background

The public law of mortgages is a very recent development. A decade ago it didn't exist. It still doesn't in most of the textbooks on land law or real property law.⁹ To explain why it has developed, a small amount of institutional history is in order.

⁷ G Turner (2008) *The Credit Crunch*, London, Pluto Press, has a few references to mortgages but the majority are dealing with subprime mortgages in the US.

⁸ C. R. Morris (2008) *The Trillion Dollar Meltdown*, London, Public Affairs Ltd is very useful on the mortgage market in the US. A. J. Levitin and J.S. Goodman (2008) *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, Business, Economics and Regulatory Policy Working Paper Series Research Paper No. 1071931, Washington DC, Georgetown University Law Center is an excellent discussion of mortgage default in the light of the US foreclosure crisis. It may be downloaded at <http://ssrn.com/abstract=1071931>. Another very useful paper is C. L. Peterson (2009) *Over-Indebtedness, Predatory Lending, and the International Political Economy of Residential Home Mortgage Securitization: Comparing the US Subprime Home Mortgage Lending Crisis to Home Finance in the United Kingdom, Germany and Japan*, (draft paper on file with the author). See too the 2008 Utah Law Review symposium: *Subprime Meltdown: The Law and Finance of the American Home Mortgage Foreclosure Crisis* and the 2008 South Carolina Law Review Symposium on *Issues and Problems Stemming from the Subprime Mortgage Crisis*.

⁹ To take four leading textbooks published in 2008 and 2009: C. Harpum, S. Bridge, and M Dixon (2008) *Megarry and Wade The Law of Real Property* 7th ed, London, Thomson Sweet and Maxwell; in immensely detailed and scholarly chapters on mortgages (pp. 1077 – 1206), only 4 pages are devoted to statutory regulation and they focus principally on the Consumer Credit Act 2006, a relatively minor part of the regulation of mortgages. K Gray and S.F. Gray (2008) *Elements of Land Law* 5th ed, Oxford, Oxford UP, in equally scholarly chapters on mortgages (pp. 694 – 813) has 1½ pages on statutory intervention focusing on the FSA. R. J Smith, (2009) *Property Law* 6th ed, Harlow, Longmans has 2 pages out of 45 (pp. 544 – 589) of his chapter on mortgages on statutory controls but these are

Until comparatively recently, the main institution providing mortgage loans was the building society. Building societies go back to the middle of the nineteenth century. In the words of Professor Miles:¹⁰

The essential characteristic of building societies is that they are mutuals that take funds from members and that make mortgage lending on residential properties their primary business. Building societies are set up and owned by members with the aim of providing lending to finance house purchase...The Building Societies Act 1986 sets funding and lending limits or “nature limits” on building societies. Following the amendment to the Act that took place in 1997, at least 50 per cent of funds raised by a building society must be in the form of members’ funds.

The history of building societies is a mixture of the staid and respectable and enormous scandals where promoters ran off with depositors’ cash – e.g. the Birkbeck Building Society featured in the leading case of *Sinclair v Brougham*.¹¹ The last similar scandal concerned the Grays Building Society and is recounted in *Halifax Building Society and another v Registry of Friendly Societies*¹². A brief summary is in order to show how much has changed since that scandal and the way it was resolved.

In mid March 1978, the chief executive of the Grays Building Society committed suicide and it was then discovered that as a result of defalcations on his part the building society had a deficit of £8 million. The building society movement as a whole considered that if the investors in the Grays were left to bear all the losses, there might be a run on the Grays Building Society and the reputation of the movement as a whole would suffer. So they put together a scheme whereby the big five societies would in effect take over Grays and bear the losses, paying out to the Grays investors their full amount. The Registry of Friendly Societies was at the time

overwhelmingly on the Consumer Credit Act. N Jackson, J Stevens, and R Pearce (2008) *Land Law* 4th ed, London, Thomson Sweet and Maxwell, in a chapter of 59 pages on mortgages (pp. 567 – 626) there is no mention of the FSA and only 1 page commenting on the Consumer Credit Act. What is so odd about this lack of discussion of the FSA and its rules is that Oldham had made it very clear in an excellent paper in 2002 that the new statutory regulation must be seen as an example alongside judicial developments associated with *Royal Bank of Scotland v Etridge (No.2)* [2002] 2 AC 773 “where the law continues to develop to protect vulnerable parties to mortgage transactions.” All of the above books contain considerable discussion of *RBS v Etridge (No.2)*. M. Oldham (2002) *Mortgages* in L. Tee (ed) *Land Law Issues, debates, policy*, Cullompton, Willan Publishing, chap.6.

¹⁰ Miles, op cit., footnote 2, pp.93, 92.

¹¹ [1914] AC 398.

¹² [1978] 3 All ER 403.

the regulatory body of building societies and had to agree to the scheme. The Chief Registrar was disinclined to as he considered it did not come within the powers of building societies under the Building Society Act 1962. The High Court disagreed with his interpretation of the law and permitted the arrangement to be made. The whole episode took from early March to late May to resolve.

The numbers of building societies have shrunk with the years. 50 years ago there were over 800 building societies. Now there are less than 50. Mergers, takeovers, transmogrification into banks and ignominious collapse have reduced their numbers. They used to be very much local financial institutions adopting policies and practices aimed at local communities and sensitive to local conditions. That is no longer the case. However as building societies have dwindled, other institutions have come to the fore. The Treasury in its response in 2007 to the EC's Green Paper on Mortgage Credit in the EU¹³ noted that there are 600 lenders and 12,000 intermediaries in the UK at present: banks, building societies, insurance companies, finance houses and credit unions. They offered some 7000 mortgage products. The number of products on offer at the beginning of 2009 was less than half that number.

Until the mid 1980s building societies were, generally, safe and unimaginative; they fixed interest rates so they all changed rates together, and there was very little variation in what they all offered. That changed with financial deregulation in the mid 1980s which in the case of the building societies took the form of the Building Society Act 1986, coming 150 years after the first such Act – the Benefit Building Societies Act 1836. The 1986 Act freed the building societies from much of their former legal restrictions; made it possible for building societies to convert themselves into banks, and for banks to take over building societies and so facilitated their much more aggressive and, ultimately for some, disastrous approach to borrowing money and lending. The Act was part of the philosophy that competition in the market in financial services would benefit consumers more than an over-regulated market. Some regulation remained however but not of the provision of mortgages. A Building Societies Commission replaced the Registry of Friendly Societies as the regulator but its role was of macro-regulation of the financial stability and probity of building societies and not of the provision of mortgages. In addition an Ombudsman made an appearance; tacked on to the Bill during its passage through Parliament. Formerly it was a voluntary arrangement and not all building societies had joined the scheme.

¹³ HM Treasury and FSA (2007) *UK Response to Commission Green Paper on Mortgage Credit in the EU*, London, HM Treasury.

This brief history of the development and regulation of building societies provides a better understanding of the whys and wherefores of mortgage regulation. Building societies are no longer safe local financial institutions where local businessmen could and often did have regard to local circumstances and conditions when determining how to handle difficult cases¹⁴. They have become part of an international financial market with respect to which minimalist administrative self-regulation has been replaced by national law-based regulation, still however minimalist, but with no local community safeguards. In the case of building societies and other mortgage providers, what is now regulated is an area which just a few years back, no-one thought merited any national regulation at all – the beginning of the relationship between mortgagor and mortgagee.

2. Mortgage regulation

There are two parallel and overlapping systems of public law regulation of mortgages; one operated by the Financial Services Authority (FSA) under the Financial Services and Markets Act 2000 (FSMA). Mortgages regulated by the FSA are known as regulated mortgage contracts (RMC). The second system is operated by the Office of Fair Trading (OFT) under the Consumer Credit Act 1974 – 2006 (CCA). Up until April 2008, the CCA only applied to consumer credit contracts of up to £25,000 but from April, that upper limit has been removed so bringing mortgages within the remit of the OFT. However, Sections 16, 16A and 16B of the CCA and the Consumer Credit (Exempt Agreement) Order 1989 (as amended) provide for certain consumer credit agreements to be exempt from the operation of the CCA and these include most mortgages offered by banks, building societies, insurance companies and friendly societies.

A memorandum of understanding (MoU) between the two agencies in July 2007 set out their respective areas of jurisdiction and how they would ensure complementarity between these roles. This was followed by a Joint FSA and OFT Action Plan in May 2008 which highlighted mortgage arrears as one area of joint action. The aim was to ensure that borrowers who experienced difficulty with repayments were treated fairly.

¹⁴ Two small examples from some work I did on building societies in the Midlands in the mid 1970s. The then Coventry Economic Building Society was prepared to lend to car-workers in the Midlands at a time when large national societies were not because it was considered that they did not have a regular steady income. The then Leamington Spa Building Society provided mortgages to purchase older houses, of which Leamington Spa has an abundance, when again large national societies preferred to lend on post World War I houses only. Both societies made plain to me that their policies on these matters were in large part derived from their understanding of and willingness to support local housing markets.

In parallel with these developments, the Government made an order – the Financial Services and Markets Act (Consequential Amendments) Order 2008 No. 733 which amended relevant sections of the CCA and earlier Orders to ensure that there would not be cases of mortgages already regulated by the FSA being subject to dual regulation. The broad effect of all these provisions is to distinguish between first mortgages which are regulated by the FSA and other consumer credit agreements which come within the CCA. This will include second mortgages and some agreements modifying first mortgages.

3. Regulation by the Financial Services Authority¹⁵

From 31 October 2004 mortgages have been regulated by the FSA. To quote Oldham:

Three key concepts in the new regulatory regime for mortgages are ‘the general prohibition’ regulated activity and authorisation.

Central to the new regulatory regime is ‘the general prohibition’, contained in s.19 of the FSMA [which] provides that no person may carry on, or purport to carry on a regulated activity unless he is an authorised person or an exempt person...

A regulated activity’ is an activity of a specified kind, carried out by way of business...As regards mortgages, there are two separate regulated activities – entering into a regulated mortgage contract as lender and administering a regulated mortgage contract.

A contract is a ‘regulated mortgage contract’ if, at the time it is entered into, the following conditions are met:

- (i) the contract is one under which a person (the lender) provides credit to an individual or to trustees (the borrower);
- (ii) the contract provides for the obligation of the borrower to repay to be secured by a first legal mortgage on land...in the UK;
- (iii) at least 40% of the land is used, or is intended to be used as or in connection with a dwelling by the borrower...¹⁶

From April 2006, ‘Islamic mortgages’ came under the FSA as well¹⁷. Regulation covers mortgage lending; mortgage administration; advising on mortgages; and

¹⁵ Oldham op. cit. footnote 7 gives a clear overview of the provisions of the Financial Services and Markets Act 2000 and associated regulations connected with the (then) proposed regulatory regime for mortgages. Those details are not repeated here. See too C. Cummings (2007) *A Practitioner’s Guide to Mortgage Regulation*, London, City and Financial.

¹⁶ Ibid., pp. 190 – 191.

arranging mortgages. The FSA has four statutory objectives which are as applicable to the mortgage market as to all other financial arrangements:

- *market confidence*
- *public awareness*
- *the protection of consumers*
- *the reduction of financial crime*

In determining how and what to regulate, the FSA stated that it would identify the types of current behaviour or market practices which might prevent it delivering its objectives. In the mortgage market, it identified the provision of poor, incomplete or unclear information about mortgages, leading to consumer confusion, particularly of the benefits and risks of the different products on the market. The overall aim of regulation was to reinforce the responsibilities of senior management within mortgage lenders; ensure that the costs in improving mortgage product transparency and providing clear information to consumers are justified in terms of a reduction in consumer detriment and enhanced effective competition. All lenders have to be authorised by the FSA; brokers only if they carry out investment business such as advising on endowment mortgages.

In October 2004, the FSA produced a set of rules in a Sourcebook called *Mortgages: Conduct of Business* (MCOB). When published it had 146 pages. By late 2008, it was up to 332 pages. The FSA recognise that different products need different degrees of regulation: lifetime mortgages – equity release mortgages targeted at older consumers – are more complex than standard mortgages and need more regulation. Short mortgages and mortgages below £10,000 are not regulated extensively. The Sourcebook concentrates on four matters:

- product disclosure via an Initial Disclosure Document (IDD) which will tell the consumer what the firm can and cannot offer and what it will charge for its services;
- suitable advice requirements; which will concentrate on ensuring that advice is given which is designed to match the mortgage to the consumer's needs;

¹⁷ Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2006. See generally on Islamic Mortgages, P. McAuslan (2008) *Islamic Mortgages and the English Law of Mortgages: A Preliminary Inquiry*, Biennial Conference on Property Law, Cambridge.

- fair treatment of consumers aimed at preventing high pressure selling – cold calling is out for instance – and excessive charges or fees for advice and mortgagors in arrears;
- complaints and compensation dealing with the Financial Services Ombudsman and the Financial Services Compensation Scheme.

In developing its own code, the FSA paid particular attention to the Mortgage Code of the Council of Mortgage Lenders (CML) which is the main self-regulatory and representative body of mortgagees.

The FSA regulate two types of selling of mortgage products:

- *advised sales* where advice is provided on the merits of a particular product;
- *non-advised sales* where the firm uses filtered questions to narrow down the selection of mortgages, but does not make a recommendation.

In advised sales, the adviser must conduct a suitability assessment which involves:

- an assessment of whether a mortgage is in itself suitable including whether it is affordable;
- an assessment of what types of mortgages are suitable
- an assessment of which mortgage of the mortgages the firm offers best meets the consumer's needs and circumstances

In non-advised sales, firms will “have to script in advance the questions they ask about consumers' needs and circumstances. Firms will need to supervise staff to ensure that they keep to the scripts and do not give advice.”

Mortgage regulation started on 31 October 2004. The FSA set out five consumer outcomes for the regime which they established which were:

- firstly, consumers shop around for mortgages;
- secondly, consumers understand whether they are being given advice or information by firms;
- third, consumers better understand the risks and features of the mortgages they take out, including the affordability risks;
- fourth, consumers take out suitable and good value mortgages; and finally

- consumers are treated fairly over the life of the mortgage, including when they go into arrears.

The FSA undertook a Mortgage Effectiveness Review 2006 – 08 in three stages to see the extent to which providers of mortgages complied with the MCOB and so contributed to meeting the five outcomes set out above. The focus of stage 1 was pre-sale disclosure and advice and selling standards and concentrated on prime mortgages. It came to the overall conclusion that

Overall, we believe that in the areas we have looked at, the mortgage regime is operating effectively *where* firms comply with the requirements set out in MCOB. There continues to be pockets of non-compliance and it is disappointing that the non-compliance relates to some of the basic requirements of the disclosure regime.

The second stage looked at subprime mortgages¹⁸ and came to a more worrying conclusion:

The finding from Stage 1 and Stage 2 suggest that our market intervention in relation to disclosure may not be working as intended. This suggests that we may need to look further at our approach to disclosure in general but in intermediated sales in particular. Moreover it seems clear that we need to do something more to ensure consumers understand the implications for them of choosing between an advised and non-advised service.

The evidence also suggests that sub-prime consumers are not able to effectively shop around for themselves having to rely on brokers to find them suitable deals and lenders willing to accept their business. This reliance on brokers is hardly surprising given the distribution channels for this market. However it may be that something more needs to be done to protect sub-prime consumers...

That is an understatement to put it mildly. It does however draw attention to the central role of mortgage brokers with respect to loans to sub-prime borrowers. This in turn requires a brief discussion of the role of mortgage brokers or advisers and their regulation.

¹⁸ On subprime mortgages generally, M. Munro, J. Ford, C. Leishman and N.K. Kartey (2005) *Lending to higher risk borrowers, Sub-prime credit and sustainable home ownership*, York, Joseph Rowntree Foundation, especially chaps. 3 and 4 where a wide variety of less than fair practices of lenders and brokers are discussed.

Too little is known about mortgage brokers and advisers and how they work. Mortgage broking and adviser firms come under the FSA but individual mortgage brokers do not. According to Iain Martin writing in CityWire in July 2008:

The Financial Services Authority says it will begin a review later this year on whether it needs to regulate every single mortgage broker instead of firms as a whole and their directors.

When mortgage regulation was introduced in 2002 the FSA decided mortgage brokers did not need to be on the list of approved persons unlike investment advisers.¹⁹

The FSA has prepared a Handbook for mortgage brokers and advisers (intermediaries) and has issued a Fact Sheet to such persons advising them how to improve the advice they give and what factors they should take into account when giving advice. It reviewed the operation of such persons in its Mortgage Effectiveness Review finding that at least in relation to prime mortgages, intermediaries were giving generally sound advice but it did not make any specific comments about the performance of intermediaries. Its findings can be interpreted as giving intermediaries at the prime level a clean bill of health.

Its comments about the role of intermediaries in relation to subprime mortgages which has already been quoted was less complimentary and its findings there may have been a factor in its decision to consider whether every single mortgage broker should be regulated. The FSA has conducted two reviews of the conduct of intermediaries in the subprime market in 2005 and 2007. In a press release on its 2005 review issued in September the FSA stated

that its review of compliance by small mortgage brokers with requirements on selling and advising in the sub-prime market had revealed both good and bad practices. But overall, there were too many cases where firms were unable to show that they had followed the required procedures relating to suitability when advising on these mortgage contracts²⁰.

Its 2007 survey showed that the performance of intermediaries had worsened. The headline of its findings was that

¹⁹ Iain Martin City Wire 24 July 2008. Mortgage regulation was brought in in 2004.

²⁰ FSA/PN/095/2005 6 September 2005

FSA finds poor practices by intermediaries and lenders within the sub-prime market

while the earlier survey had been headlined as

FSA finds mixed picture on sub-prime mortgage compliance

With respect to intermediaries, the FSA in its 2007 survey found that

- In a third of the files reviewed there was an inadequate assessment of consumers' ability to afford the mortgage.
- In almost half of the files there was an inadequate assessment of customers' suitability (e.g. needs and circumstances) for the mortgage.
- In over half of the files customers had self certified their income but it was not clear in many cases why they had been advised to do this.
- Significant numbers of consumers were advised to re-mortgage, thereby incurring early repayment charges, without the adviser being able to demonstrate that this was beneficial to the customer.

The FSA has now referred five firms to enforcement, including those whose failings were identified during the initial study of this market in 2005, and who failed to show adequate improvement.

Clive Briault, Managing Director of Retail Markets in the FSA, said:

We are very concerned about these findings. Consumers in the sub-prime market are vulnerable people who may have high debts or a bad credit history. It is therefore important that they are properly assessed and advised. We will not hesitate to take action where we find bad practice.

Poor sales practices in this market may lead to serious wider consequences. The high level of sub-prime arrears in a benign market raises some important questions about the consideration given to affordability by lenders and intermediaries when undertaking this business. All mortgage firms must ensure they are treating their customers fairly by undertaking robust assessments of affordability and ensuring they have sound, and consistently applied, lending policies²¹.

A critical (and contested report) on subprime lenders was published by the Citizens Advice Bureau at the end of 2007 and this report also singled out some subprime mortgage brokers for their dubious advice and failure to check whether would-be

²¹ FSA/PN/081/2007 04 July 2007

borrowers could afford monthly repayments. The CML publication *Housing Finance* in its report on adverse credit mortgages made the point that “Intermediaries play a predominant role in advising on and sourcing suitable products for non-prime borrowers in general, and for adverse credit mortgages the intermediary channel accounts for four fifths of business.”²²

Inadequate regulation by the FSA has been identified as a factor in the near collapse of the banking system in the UK but little attention has hitherto been paid to the inadequacy of regulation at the level of mortgages and mortgage intermediaries which, albeit at a humbler but not unimportant level, has been a contributory factor in the rapid rise of mortgage default and repossessions by lenders. The basic assumption of the approach to mortgage regulation has been that better information – better structured and more of it – will lead to better decision-making by borrowers. Its own surveys are very ambivalent about the success of that form of regulation.

More important, the Miles Report²³ showed that was a degree of cross-subsidisation of mortgages – by long-standing standard variable rate mortgagors of new mortgagors offered low fixed-term rates for a short introductory period which the FSA had nothing to say on and did not require lenders to make explicit to those borrowers who were providing the subsidy. The Miles Report suggested several areas where the FSA should require lenders to provide further and better information to would-be borrowers but the FSA’s Mortgage Effectiveness Review of March 2008 gave no indication that Miles’s suggestions had been taken on board. The FSA’s approach to mortgage regulation has mirrored its approach to banking regulation; the less there is the better. That might have served producers well; it has not served consumers or the wider society well.

4. Regulation under the Consumer Credit Act (CCA)²⁴

The CCA provides two forms of control with respect to consumer credit: control over business activity through a licensing system and control of individual agreements. The OFT issues licences. A licence is personal and non-assignable. An applicant must prove to the OFT that he is a fit person to engage in the activities covered by the

²² CML (2006) *Adverse Credit Mortgages Housing Finance* Issue 10, November, 6.

²³ Miles, *op. cit.*, see further below, pp.

²⁴ The summary of the law which follows is based on G Woodroffe and R. Lowe (2007) *Consumer Law and Practice* 7th ed, London, Thomson Sweet and Maxwell. The Consumer Credit Act 2006 extensively amended and added to the Consumer Credit Act 1974. The references to the CCA are to the 1974 Act as amended and added to by the 2006 Act.

licence. If the OFT is minded to refuse licence, it must invite the applicant to make written or oral representations. An appeal from a refusal or the variation, suspension or revocation of a licence lies to the Consumer Credit Appeals Tribunal and from there to the Court of Appeal. Under new provisions introduced by the CCA 2006, the OFT is empowered to impose “requirements” on licensees. Where the OFT is dissatisfied with the way a business is being carried on, it may notify the licensee and require him to do or not to do any thing. The OFT is empowered generally to monitor all businesses that it has licensed.

The OFT does not have direct regulatory powers over consumer credit agreements which are the agreements we are concerned with here: the regulation is statutory but is applied by the courts. Consumer credit agreements are either regulated agreements or exempt agreements. Exempt agreements include debtor-creditor-supplier and two debtor-creditor agreements. In the first case, the creditor is a local authority or a body named in regulations (insurance companies, friendly societies and charities) and the agreement finances the purchase of land or the provision of dwellings on land and in either case, the purchase is financed by a mortgage of that land. In the second case, the agreement is exempt if the lender is a local authority and the agreement is secured by a mortgage of land. In the third case, the lender is a body named in the regulations; the agreement is secured by a mortgage of land and the agreement is to finance the purchase of land or the provision, inter alia, of dwellings on land.

The regulated agreements with which we are concerned includes conditional and credit sale agreements and loans secured by a land mortgage. A conditional sale of land is an agreement for the sale of land, where the purchase price is paid in instalments and the property in the land remains vested in the seller until all the instalments (or a set proportion provided for in the sale agreement) are paid. In a credit sale, title to the land passes to the buyer at the outset of the transaction. Until the coming into operation of the relevant sections of the CCA 2006, there was an upper limit of £25,000 on the application of the Act but this has now been removed and it is this that has brought all mortgages potentially within the scope of the CCA and necessitated the legal and administrative arrangements referred to above to ensure that first mortgages (RMCs) are not subject to two sets of statutory regulation.

There are basically three aspects of CCA regulation which apply to a ‘regulated agreement’ which includes second mortgages and conditional sales of land. The first deals with a ‘cooling off’ period which, subject to two exceptions – restricted-use agreements and bridging loans – applies to all land mortgages. The cooling off period

is a period of seven days during which the potential borrower may, on the basis of a copy of the loan agreement that must be sent to him or her, reflect on whether to proceed with the loan and during which the lender must not contact the potential borrower. After the end of the seven day ‘purdah’, if a notice of withdrawal has not been sent by the potential borrower to the lender, the lender may send a copy of the loan agreement to the borrower for his or her signature.

The second aspect deals with the form of an agreement. An agreement which does not comply with the required form (which is set out in various provisions of the CCA and regulations) is an ‘improperly executed’ agreement which can only be enforced by order of a court. Once an agreement is before the court, the court has considerable powers to make:

- an enforcement order which can “reduce or discharge any sum payable by the debtor...”²⁵ if the debtor has suffered prejudice by the improper execution of the agreement;
- a ‘time order’ which can extend the time for the making of payments under an agreement; and
- a modification of the agreement and thereafter enforce the agreement as modified.

Outside an enforcement order, but in respect of all regulated agreements, a court has similar powers. We will come back to examples of the exercise of these powers when considering remedies of the mortgagee and protection of the mortgagor more generally.

The third aspect of CCA regulation deals with “unfair relationships” between a creditor and debtor which entitles a court to intervene and rewrite or cancel the agreement. This test introduced by the Act of 2006 replaces the “extortionate credit bargain” test of the 1974 CCA²⁶. Unfair relationships can result from one or more of the following:

²⁵ S. 127(2) CCA.

²⁶ As to which see the very full discussion of what an extortionate credit bargain might consist of with respect to a mortgage in *Nash v Paragon Finance plc*; *Staunton v Paragon Finance plc* [2002] 2 All ER 248 and *Paragon Finance plc v Pender* [2005] All ER (D) 307. In both cases, differently constituted Courts of Appeal, while holding that the power to set interest rates contained an implied term that rates should not be set dishonestly, for an improper purpose, capriciously or arbitrarily, rejected arguments that setting high rates for ‘old book’ borrowers in order to tempt new borrowers with lower interest rates and to help it recover from losses which it had sustained over a period of time fell foul of these criteria; it was, the judges considered, a perfectly legitimate commercial reason for setting the rates which Paragon plc did. Furthermore, both Courts accepted that a lender might for

- (a) any of the terms of the agreement or any related agreement;
- (b) the way in which the creditor has exercised or enforced any of his rights under the agreement or any related agreement;
- (c) any other thing done or not done by or on behalf of the creditor (whether occurring before or after the making of the agreement or any related agreement).

There have as yet been no reported cases on this new test so it remains to be seen how it will be interpreted in practice. What is significant is that it is dealing with a very different kind of ‘unfair relationship’ than those covered by cases such as *Royal Bank of Scotland v Etridge (No.2)*²⁷ – what is commercially rather than domestically unfair. In the light of the *Paragon* cases however, it seems highly unlikely that an interpretation will be given to these new provisions which would significantly interfere with the ability of mortgagees to “make a profit by lending money.”

C. Securitisation of mortgages

No proper consideration of the law of mortgages would be complete without some reference to the wider financial world of mortgages – what happens to the property interest called a mortgage after a loan has been granted to a mortgagor, the mortgagor has signed the relevant documents to create a mortgage over his or her property and that mortgage has been entered on the land register. The principal matter which must be considered is the securitisation of mortgages, both because of the impact it is having on mortgages generally and because of possible impacts on the public and private law of mortgages. This section too will consider the Miles and Crosby Reports.

One of the clearest explanations of securitisation was provided by Richard Rosen in the *Chicago Fed Letter* of November 2007²⁸:

Thirty years ago, if you got a mortgage from a bank, it was very likely that the bank would keep the loan on its balance sheet until the loan was repaid. That is no longer true. Today, the party that you deal with in

genuine commercial reasons adopt a policy of raising interests rates to levels at which its borrowers might be expected to consider refinancing their borrowings at more favourable rates of interest offered by other commercial lenders. The basic point was made succinctly by Dyson LJ in the first *Paragon* case (and repeated with approval by Jonathon Parker LJ in the second *Paragon* case): “The claimant is not a charitable institution. Its aim is to make a profit by lending money.”

²⁷ [2002] 2 A C 772.

²⁸ R.J. Rosen (2007) The role of securitization in mortgage lending, *Chicago Fed Letter* 1 – 4.

order to get the loan (the originator) is highly likely to sell the loan to a third party...a private sector financial institution [known in England as a special purpose vehicle or SPV] The third party often then packages your mortgage with others and sells the payment rights to investors. This may not be the final stop for your mortgage. Some of the investors may use their payment rights to your mortgage to back other securities they issue. This can continue for additional steps. In effect, the eventual buyers of the mortgage—the parties that provide the funding—can be many steps removed from the originator of the mortgage. The process by which most mortgage loans are sold to investors is referred to as securitization. In the mortgage market, securitization converts mortgages to mortgage-backed securities An MBS is a bond whose payments are based on the payments of a collection of individual mortgages.

Rosen was writing about the US mortgage market but the basics of securitisation are the same in the UK. The principal difference between the UK and the US mortgage market is that whereas securitisation is the predominant mode of financing mortgages in the US it has, although growing very quickly, not yet reached that position in the mortgage market in the UK. According to Crosby, “between 2000 and 2007 the total outstanding amount of UK RMBS (residential mortgage backed securities) and covered bonds rose from £13 billion to £257 billion.” A table in Crosby puts the figure of UK RMBS at € 406.9 in 2008, which was just under 10% of the US figure but amounted to half the total EU figure. Since the near collapse of the global financial system triggered *inter alia* by rising foreclosures in the US subprime mortgage market in 2007, there has been a rapid falling away of investor demand for RBMS.

The very rapid growth and even more rapid decline of the market for securitised mortgages has led to some interesting contrasts in UK commentators’ positions on this form of mortgage finance. The major LSE/Cambridge University study on securitisation undertaken for the Council of Mortgage Lenders and published in 2003 was undertaken when securitisation was still very much a minor way of raising funds; only about 5% of mortgages were securitised. The study put the position thus:

The residential mortgage-backed securities market in the UK is based around the main prime lenders²⁹...Unlike the US where many dealers buy loans from the secondary market for securitisation, most UK issuers

²⁹ “The term ‘prime lenders’...refers to mainstream lenders [banks and building societies] for whom mortgage-backed securities are only one source of funds for lending alongside ‘retail finance’ [deposit taking] and ‘wholesale’ finance from the money market...” A. Holmans, N. K. Karley and C. Whitehead (2003) *The mortgage backed securities market in the UK: overview and prospects*, London, Council of Mortgage Lenders, 50.

of MBS notes originate and pool residential mortgage assets in their own portfolio and manage them in the most cost effective way...

For the majority of the bigger players, securitisation is a funding tool which gives them more diversification of funding rather than using it as a mechanism to get additional funds...

In addition to the predominant prime lenders...there are the specialised mortgage lenders in the UK³⁰ who approach mortgage lending intending to securitise them. For most of these specialised institutions funding comes mainly from securitisation which is the only source of long-term funding for them. They securitise every mortgage that is originated...Securitisation actually takes place right at the point of origination...This model is typical of the United States market...³¹

Under English law, an issuer could securitise every mortgage on the book and securitisation would not adversely affect the borrower. However, most UK issuers have chosen not to securitise mortgages where the borrower had not specifically consented to a change...³²

The study's explanation of the position and role of SPVs in the UK is of considerable legal interest:

The special purpose vehicle (SPV) is created with the basic function of holding the security charge on behalf of investors...The whole basis of securitisation lies in the transference of the asset between the lender and the SPV. The right to the asset is moved from the originator to the SPV and the asset is distinctively separated and managed from the assets of the originator...Although it might appear to be the case, the SPVs are not subsidiaries of the originator because title ownership of the assets is with the SPVs and not the originator...

³⁰ "These are the so-called 'centralised lenders' which did not have the organisations to collect 'retail' deposits and so turned to securitisation to finance their lending." Holman et al, op cit., 50

³¹ The study summarised the US mortgage market thus: "...it is clear that a strong secondary mortgage market has been established in the US. The fluid mortgage market has attracted a number of private institutions that could be substitutes for the GSEs [Government Sponsored Enterprises like 'Fannie Mae' (Federal National Mortgage Association) and 'Freddie Mac' (Federal Home Loans Mortgage Corporation)], which may continue to enhance mortgage finance and expansion of home-ownership for Americans. Indeed, this approach to enhancing housing affordability is probably one of the best models in living memory that most like-sophisticated economies, such as the UK could emulate to achieve their home-ownership dream..." 43. For a rather different view of the US mortgage market, O. Bar-Gill (2008) *The Law, Economics and Psychology of Subprime Mortgage Contracts*, Law and Economics Research Paper Series Working Paper No. 08-59, New York, NYU Center for Law, Economics and Organisation, New York University School of Law.

³² Ibid., 51, 52, 53.

This summary of the legal framework of relationships between the lender and an SPV was amplified and confirmed by the (so far) only reported case in which the matter was litigated: *Paragon Finance plc v Pender*.³³ Paragon Finance, a specialised lending institution had granted a loan to the Plenders on the security of the Plender's house. One of the conditions in the loan agreement was that Paragon could without any notice to or consent from the Plenders and at its absolute discretion transfer or assign all its rights and benefits under the legal charge taken on the Plender's house and all associated securities and the Plenders would be bound to any assignee to the like extent that they were bound to Paragon. That agreement formed the legal basis for the securitisation of the charge.

Paragon sought a warrant for possession of the defendants' house having been granted a possession order some five years earlier. The defendants applied to have the order set aside on various grounds, one of which was that Paragon Finance had no title to sue for possession of the property as by its agreement with its SPV, "a Jersey company associated with Paragon called Homeloans (Jersey) Ltd (HLJ)" the right to take such action had been vested in the SPV.

The agreement was one made between Paragon Finance, (the Administrator) HLJ (the Issuer) and Citicorp Trustee Company (the Trustee). It recited that Paragon Finance carried on the business of managing and administering mortgage portfolios; that HLJ had agreed to sell certain mortgages granted by individual borrowers; and that Paragon Finance was willing to provide administration and management services to the Issuer and the Trustee. The Agreement provided that the Administrator should not be obliged and should not, except on demand by the Issuer, execute and deliver transfers of the mortgages to the Issuer and this would only occur on one of seven specified events. In the words of the court:

In essence therefore, the obligation of the Administrator (Paragon) to execute formal transfers of the mortgages to the Issuer (the SPV) – thereby enabling the Issuer to be registered as proprietor, and hence legal owner, of the mortgages – arises only in the event of actual or threatened default by the Issuer on its obligations to the Trustee...

³³ [2005] All ER (D) 307

The parties differed as to the legal effect of the provisions of the administration agreements on the transfer of the mortgages. The defendants claimed that the transfer was governed by section 114 Law of Property Act and sections 33 and 34 Registered Land Act 1925 (the agreement in question being concluded before the commencement of the Land Registration Act 2002) and that section 114 had the effect of transferring to the SPV all the powers and rights of the legal chargee i.e. Paragon Finance, so that the SPV and not Paragon Finance was the proper claimant in the action. The appellants argued that as the land was registered land, section 114 did not apply; the relevant sections of the Registered Land Act applied and these made it clear that an executed transfer of a registered charge operated only in equity until registered so that Paragon Finance remained the proper claimant. The court agreed with Paragon Finance:

It is common ground that Paragon, as registered proprietor of the Legal Charge, retains legal ownership of it. One incident of its legal ownership...is the right to possession of the mortgaged property. I can see no basis upon which it can be contended that an uncompleted agreement to transfer the Legal Charge to the SPV (that is to say an agreement under which, pending completion, the SPV has no more than an equitable interest in the mortgage) can operate in law to divest Paragon of an essential incident of its legal ownership...

On the assumption that the consideration for the transfer of the Legal Charge has been paid in full, Paragon has since retained its legal ownership of the Legal Charge as trustee for the SPV... But it does not follow that in that situation the SPV as the owner of the Legal Charge in equity is a necessary party to the claim...indeed the SPV has, by virtue of the administration agreements expressly authorised Paragon to exercise such [mortgagee's] rights on its behalf.³⁴

³⁴ paras 109, 111. Earlier in the judgement of the court, Jonathan Parker LJ had referred to E. Ferran (1992) *Mortgage Securitisation – Legal Aspects*, London, Butterworths where the author points out that “for reasons of administrative convenience and cost, transfers by way of securitisation are usually left uncompleted but with provision being made for completion in certain specified circumstances...Typically such obligations will be contained in an ‘administration agreement’.” para.14. This administration agreement then followed the usual pattern. For a detailed discussion of SPVs, C. R. Roy (2003) *An Analysis of the Law and Practice of Securitisation*, Wolverhampton, Institute of Finance Law, University of Wolverhampton, chap. 5. For a US take on who ‘really’ owns what in a securitisation situation, see *In re Foreclosure Cases*, Case 1:07-cv-02282-CAB in the United States District Court, Northern District of Ohio, Eastern Division where Judge C.A. Boyko refused Deutsche Bank’s motion to foreclose on 14 properties on the grounds that the plaintiff was not the holder and owner of the Note and Mortgage as there was no evidence of any formal assignment of same having been made to the plaintiff bank and this was required both by the State of Ohio and by federal court rules. “Neither the fluidity of the secondary mortgage market, nor monetary or economic considerations of the parties, nor the convenience of litigants supersede those obligations.”

The key to the outward and visible indication that despite securitisation of the mortgage, nothing had changed in terms of the administration and management of the mortgage was therefore the equitable principle that pending the formal completion of a property transaction, the buyer had only an equitable interest in the property while the seller retained the legal title albeit as a trustee for the buyer. This ancient principle had been bolstered but not in any way departed from by the terms of the administration agreements between Paragon, the SPV and the Trustee.

The Study's suggested way forward reflected the complacent mood of the time:

The housing finance market is working well, competitively and gives a relatively good margin for the business, given the risks involved. However it would be harmful to the market if government, or any regulation, limits existing or future securitisation...

Thus there is no suggestion for direct action by government at this stage. Benign neglect of the market, which is making its own way, remains the main message...One important caveat though is that securitisation is a complex process and it is possible that new legislation, either on purpose or inadvertently, could obstruct the process. This is where government intervention must be carefully applied.³⁵

The Study did not in the main body of the report allude specifically to any legislation, actual or pending, that it thought might 'obstruct' the process of securitisation but Chapter 1 summarising the findings of the Study made this interesting comment:

Other concerns relate more to the general development of the mortgage market rather than being specific to securitisation. These include legal questions about how the Consumer Credit Act may be applied to mortgages and, in particular, the potential for enabling consumers to renegotiate fixed rate prepayment penalties. The current environment is seen as creditor friendly – any shift towards increasing consumer power is seen as increasing risks and costs.

The Study clearly agreed with this concern. The issue of 'consumer power' is one to which we will return.

³⁵ Holmans et al, op. cit., 69 – 70.

Five years on the Crosby Report had a very different take on securitisation and a very different approach to government involvement. Sir James Crosby was asked to review what market-led initiatives might be necessary to improve the functioning of secondary and primary markets in UK mortgage-backed securities (RBMS and covered bonds) in the context of the recent and ongoing disruption in global financial markets. His report highlighted “a number of weaknesses in the operation of mortgage backed asset markets” which the earlier study had failed to notice or if noticed had not thought fit to comment on:

- a lack of certainty about the financial health of counterparties, which has contributed to a loss of confidence in the banking sector;
- a lack of transparency in securitised products, which has led to valuation difficulties and a loss of investor confidence in these markets;
- an absence of standardisation, which has contributed to the lack of depth in the market; and
- concerns about the integrity of securitisation models, and whether loan originators have clear incentives to monitor borrowers.³⁶

When one notes the use of words like ‘certainty’, ‘transparency’, ‘integrity’ coupled with the use of the words ‘lack’ and ‘concern’ one is bound to wonder whether the earlier study, despite the eminent provenance of its authors, had not perhaps had the wool pulled over its collective eyes in its eagerness to give securitisation and its practitioners a clean bill of health and play down any need for more effective consumer protection³⁷.

³⁶ Crosby Report op. cit. 39.

³⁷ There may be an element of *déjà vu* in the Crosby Report. Sir James Crosby was the Chief Executive of HBOS when it commenced its disastrous lending and financial management policies which led to the demise of two of the most respected and secure financial institutions in the country: the Bank of Scotland and the Halifax Building Society – the latter institution being synonymous with 100% safe lending and savings practices for people to get on the housing ladder. Some may think that, given his record, Sir James was an odd choice to head up a review of mortgage finance but on the principle of the poacher turned gamekeeper, there might be a perverse logic in it. Crosby’s personal credit crunch came as a result of certain evidence given to the House of Commons Treasury Select Committee on 12 February 2009. He promptly resigned his position as Vice-Chairman of the FSA (sic) while denying the substance of the evidence which was to the effect that he had rejected the advice of his senior risk manager at HBOS of the risks to the bank that his policies were creating. See generally, M. Hyde (2009) Who would credit the word of banking’s knights-errant, *The Guardian* 14 February; N. Mathiason, H. Connon, and R. Wachman (2009) Banking’s big question: why didn’t anyone stop them, *The Observer*, 15 February 2009.

Crosby supported efforts by the EC and by European trade associations to bring about a greater degree of transparency to enable investors to undertake due diligence and value assets more effectively; to promote the standardisation of information and products – he notes for instance that there are no common definitions in Europe of what constitutes sub-prime and non-conforming loans or when a loan may be considered to be in arrears – and that the UK industry should develop RMBS best practice. He notes with approval that “the UK Government has already introduced legislation that should help encourage the development of the UK covered bond market”³⁸

His main recommendation, now that the market had, with his help (amongst others), been destroyed was for massive direct government intervention in the securitisation markets by guaranteeing the interest and principal on residential mortgage backed securities and covered bonds. The guarantee should total around £100 billion over a two year period. Key elements of the suggested guarantee were as follows:

- the guarantee would be restricted to assets where the underlying collateral is sterling denominated loans to owners of residential property, secured by first charge, and originated after a specified date.
- the guarantee would be restricted to assets backed by mortgages used for the purchase of residential property and not for re-financing existing mortgages.
- the guarantee would be available to banks, building societies and specialist lenders.
- the guarantee would only be available for assets backed by ‘prime’ mortgages. This could exclude high loan to value lending, loans to borrowers with impaired credit histories...and second charge loans.

³⁸ Op. cit., p.43. “While also an asset-backed security, there are key differences from both a lender and an investor perspective between covered bonds and RBMS:

- in the case of covered bonds (but no RBMS) the lender or special purpose vehicle is obliged, when appropriate, to make changes in the pool of assets so as to maintain its credit quality. Unlike RMBS, which are secured assets, covered bonds, technically, are not secured assets but are guaranteed by the issuing special purpose vehicle;
- the investor in a covered bond has a dual credit claim on both the cover pool of assets and the lender, meaning that the lender bears the credit risk first, protecting the bondholder. The RBMS holder typically only has a claim on the special purpose vehicle that issued the bond and is remote from the lender.” J. Crosby (2008) op. cit footnote 1 para. 1.11, pp.12- 13. This is a slightly extended description from that produced in the Interim Analysis published in July 2008. para. 1.17, p.6

- participating institutions would have to abide by high standards of disclosure and reporting, consistent with the recent proposals of European trade associations.
- the originating firms would be liable to reimburse the Government for any and all claims under the guarantee.³⁹

Crosby's main concern as reflected in his terms of reference was to get the mortgage and securitisation markets working again. He was not invited to be directly concerned with the plight of consumers who may have been encouraged to take out mortgages they could not service or who, owing to loss of employment or similar reasons, could no longer meet their mortgage repayments⁴⁰. Consumers it was argued, would benefit from the revival of the market but the Crosby proposals were designed for only a limited section of consumers: those seeking a prime mortgage in connection with a new housing transaction. Oddly, Crosby stresses that reopening the market in this way "would be of particular benefit to those specialist lenders which, without a deposit base, are entirely reliant on wholesale market funding."⁴¹ But these specialist lenders (like Paragon Finance) specialise in the very types of mortgages which Crosby is suggesting should be excluded from the guarantee: re-mortgaging, borrowers with impaired credit histories, Individual Voluntary Agreements (IVAs) or bankruptcy orders and second charge loans. The proposals then might be of benefit to specialist lenders but not to 'specialist' borrowers who, precisely because their mortgages would not be covered by any government guarantee, are likely to have more onerous terms imposed upon them. It might also be suggested that, if Crosby's proposals are taken up in the terms set out in his report, they will also disadvantage women, especially deserted, divorced and dishonestly treated wives or female partners who are more likely to need to re-mortgage their home or take out a second mortgage in the process of sorting out the financial mess left by a departed male partner.⁴² Crosby's recommendations involve *all* taxpayers being put at risk by the government guarantee he is arguing for but only some – the better off taking out prime mortgages – being

³⁹ *op. cit.*, p.47

⁴⁰ The list of Crosby's consultees set out as "A: Consultation list" at the end of the final report included banks,(including some foreign banks) building societies, specialist lenders and all their associations, builders, the European Commission, the Spanish Ministry of Economy and Finance, the US Treasury. Only Oxford Economics was outside that network. No organisations representing consumers or home-owners feature on the list. Truly, the A list.

⁴¹ *ibid.*, p.48

⁴² A good example is *Mortgage Corporation v Shaire* [2001] 4 All ER 364 where the dishonest male partner had forged his wife's signature on a mortgage and then died, leaving his wife to sort out the mess and try and fend off The Mortgage Corporation, a well known specialist lender, who wanted the home sold so that it could get its money back. It is doubtful whether the mortgage arrangements suggested by the decision of Neuberger J (as he then was) which offered the wife a life-line would have qualified for a 'Crosby' guarantee.

covered by the guarantee. One might suggest that this is very much a banker's perspective.

Crosby was required to adopt a producer-focused approach to the mortgage market and this inevitably led to viewing mortgagors not as homeowners perhaps at risk from the economic downturn but solely as consumers whose continued inability to borrow money on the security of their houses would imperil banks, building societies and the wider financial system. Similarly, the mortgage itself was viewed not as a socio-economic phenomenon to assist homeownership but purely as a financial mechanism which must be re-activated to help the housing market (and the banking sector) as quickly as possible. Hence the emphasis on a government guarantee for prime mortgages only: the rest of the market, whatever its social significance, is unimportant in financial terms, so is to be left to fend for itself.

The Miles Reviews⁴³ which preceded the Crosby Reports was also produced at the behest of the Chancellor of the Exchequer. Miles was asked to undertake an analysis of the supply and demand factors limiting the development of the fixed-rate mortgage market in the UK; consult with key stakeholders; and examine whether there had been any market failure which had held back the market for such mortgages⁴⁴. These terms of reference necessarily involved some concentration on consumers and Miles's recommendations were in two broad categories: those aimed at improving the advice and information borrowers receive so as to create a fairer and more transparent pricing structure; and those aimed at helping lenders fund mortgages and handle risk in the most cost-effective way.

In his report, Miles showed that while the mortgage market was very competitive and loans were available to a high proportion of the population including, increasingly, households at the lower end of the market, few borrowers were taking out longer-term fixed rate mortgages and many of those who did not "were taking on substantial risk by borrowing a large amount relative to their incomes at interest rates that are variable or only fixed for a year or two." The report continued:

⁴³ Op. cit., footnote 2.

⁴⁴ As one would expect from at least a part-time academic, Miles had a much wider range of consultees. Besides the 'usual suspects' from the banking community, he talked to a variety of academic economists and practitioners in the mortgage market. But there were no voices of consumers: Shelter was not consulted nor anyone from the Centre for Housing Policy at the University of York which has done a considerable amount of work on aspects of mortgages over the years.

The structure of mortgage pricing generates cross-subsidisation from many existing borrowers, a significant proportion of whom are paying standard variable rates, (SVR) to new borrowers taking out discounted variable and short-term fixed-rate mortgages. This creates unfairness and makes the market less transparent than it could be⁴⁵. It plays to a tendency of many borrowers to focus on the initial monthly payments on a mortgage and it makes medium-term and longer-term fixed rates appear expensive...

Monetary policy will be easier to manage if households make well-informed decisions about mortgage products that are priced in a transparent and sustainable way...Risks of over-indebtedness, debt affordability and excess volatility in the housing market – problems that can make monetary policy more difficult to operate – would be reduced.

Once again, the key concern seems to be the financial system: reducing over-indebtedness will make monetary policy easier to manage. It is perhaps worth pointing out that it would also reduce defaults and repossessions which would presumably make social policy easier to manage.

Miles's recommendations with respect to improving information to would-be mortgagors relied heavily on the FSA taking action: either it was to require lenders to e.g. "make their full range of mortgage products available to all borrowers"⁴⁶ and to "include with Annual Statements, a leaflet setting out the current mortgage rates on all their products"; or it was to take certain action itself – principally revise or create more user friendly guides and information leaflets. None of these recommendations can be objected to but their overall thrust can be criticised as being unrealistic. They completely fail to take account of the problem that most individuals are imperfectly rational. Not all would-be mortgagors are Professors of Finance (or of Law) They already enter into mortgage contracts with an imperfect understanding of the full

⁴⁵ This is a very restrained comment given the evidence in the Report. "European Economics (1999) in a report for the FSA on the compliance cost of extending financial regulation to mortgage advice, found that 'one industry source estimated margins on new mortgage advances to be typically around 0.4 per cent too low to cover costs.' Margins below cost had been supported by 'a proliferation of upfront charges and redemption penalties' and a 'cross-subsidy from existing borrowers who may face rates one percentage point higher than new borrowers.'" Miles, op. cit., para. 5.5, p.46.

⁴⁶ Recommendation 7. This was in response to "Issue: Some mortgage lenders distinguish between customers on the basis of whether they are a first-time buyer, someone who is re-mortgaging from another lender or an existing customer. Where there are differences in mortgage rates offered these different groups they do not reflect differences in risk for the lender. They also create a barrier to some borrowers getting better mortgages and can mean that switching to another lender – which is costly – is the only way to get the best deals." Miles, op. cit., para. 8.8, p. 99

implications of doing so. Loading them down with yet more information will not result in their becoming better informed; indeed it may well result in more people becoming less well informed. This outcome is well spelt out by Bar-Gill:

The imperfectly rational borrower deals with complexity by ignoring it... Facing a complex mortgage contract, a rational borrower would have to spend time reading the contract and deciphering the meaning. If the cost of obtaining perfect information and perfect understanding of the contract is large, the rational borrower would stop short of this theoretical ideal. In fact imperfect rationality can be viewed as yet another cost of attaining more information and better understanding. When this cost component is added, the total cost of becoming better informed goes up and thus the borrower will end up with less information and a less complete understanding of the contract...⁴⁷

In addition to this defect the recommendations all seem rather tame given the finding, quoted above, that lenders were, without informing borrowers, requiring some existing borrowers to subsidise new borrowers by offering the latter what are known in the US as ‘teaser’ rates – short term cut price deals to get mortgagors on board before hitting them with higher rates once they are hooked. Astonishingly, that practice was neither condemned nor recommended to be outlawed by Miles: apparently loading consumers down with more information about mortgage rates will enable them to work out what is happening for themselves⁴⁸.

Although the Miles Review paid attention to the interests of consumers, it was very much an economist’s review which saw consumers as rational economic men and women capable of making sensible decisions in their own best interests provided they were supplied with accurate and complete information about the matter in hand – very

⁴⁷ Bar-Gill, op. cit., footnote 29, pp. 40, 44.

⁴⁸ “Discounts are not the problem; differential pricing between new and existing borrowers reflect switching costs of moving a mortgage and a shortfall in information on different prices across the mortgage market. Recommendations should address these issues directly. The Review does not recommend that the pricing structure of initial discounts followed by higher interest rates is banned.” Ibid., para. 5.49, p.58. But that statement avoids addressing the problem discussed in Chapter 5. It is one thing for a mortgagor to have to subsidise his or her own ‘teaser’ rate by paying a higher SVR once he or she is moved on to it. It is quite another thing for mortgagors A B and C to be subsidising mortgagors D E and F *without knowing or being given the opportunity to know of this*. In the first case, the mortgagor should be informed of the arrangement and can then make an informed decision on whether he or she wants to go down that route; in the latter case, information is irrelevant. Miles admits that in such a case, many existing borrowers are being treated unfairly. Why then carefully avoid this issue and back away from recommending that such action be banned? Not surprisingly, Miles did not recommend that would-be mortgagors be told of this practice in the information given to them at the outset of their quest for a mortgage.

much the FSA's approach as we have seen. Nowhere is this approach to consumers more evident than in the discussion on the 'obstacles' to managing pre-payment risk; i.e. paying a mortgage off before the end of its term. The flavour of the approach is best set out in the Review's own words:

The option to pre-pay a fixed-rate mortgage is valuable to the borrower but it is not free. Lenders need to be compensated for the risk that they will not be able to reinvest the pre-paid funds at the contractual rate...Most fixed rate mortgages offered in the UK now have some form of early redemption charge. This is set at a declining rate and is generally unrelated (or only weakly related) to the level of future interest rates (i.e. mark-to-market charges are very rare)...

Mark-to-market redemption charges are equal to the market cost of breaking the mortgage contract. This is the difference between the present value of the mortgage discounted at market interest rates (for the remaining maturity) at the time of pre-payment and the present value of the mortgage discounted at the original contractual fixed rate...

There is nothing intrinsically unfair about mark-to-market pre-payment charges. They are designed so that the gain to a borrower from repaying a fixed-rate mortgage early and replacing it with debt paying a lower rate is exactly matched by the charge for repayment...

Two obstacles – which are linked – may prevent the use of mark-to-market charges: (i) they are not well understood and are popularly considered to be intrinsically unfair; and (ii) there is uncertainty about their enforceability...

The cases brought to the Banking Ombudsman in the late 1990s indicate that borrowers did not grasp how charges worked. Understanding is not helped by the fact that they are often portrayed as a penalty that the lender levies on the borrower at a time when they are already overcharging them because the contractual interest rate remains high while the general level of rates have come down. This reveals a misunderstanding of how mortgages are funded...

[On the issue of the difficulties of enforceability, the Review commented on the Annual Report of the Banking Ombudsman for 1998-99 which had set out suggestions for good practices concerning early repayment charges]

No-one can argue against the need for mark-to-market penalties to be properly explained, and with representative examples that are prominent

in the accompanying literature. But the suggestion that lenders need to act sympathetically ‘where the borrower is not seeking to redeem in order to strike a better deal elsewhere, but is genuinely forced into early repayment by an unexpected change in personal circumstances’ may itself rule out mark-to-market redemption charges in practice... There is no obvious reason why this is a requirement of a fair contract...

Lenders’ fear of litigation costs that could be incurred when deciding whether in such cases borrowers were genuinely “forced into early repayment” or not is understandable. Nor is it clear why lenders should bear the financial loss of the change in the borrower’s personal circumstances, such as divorce, when no other commercial organisations make allowances for such changes...⁴⁹

Clearly, Miles did not understand and had not sought any legal advice on the legal characteristics of a mortgage and especially on the fundamental principle that there cannot be any clogs or fetters on the equity of redemption. For Miles a mortgage is just a commercial contract governed by ordinary commercial principles. He was clearly unaware of several hundred years of law and legal decisions stemming from laws against usury in the 12th and 13th century through the intervention of courts of equity starting in the 17th century and continuing to the present day which have shaped the development of the law of mortgages and therefore the mortgage as a financial instrument so that a mortgage cannot be seen as just a commercial contract like any other commercial contract. This applies particularly to mortgages of residential property although the prohibition on clogs and fetters applies to all mortgages⁵⁰.

It is by no means certain that a mark-to-market charge (or penalty as Miles himself referred to it as in the quotation above) on a fixed-term residential mortgage would be seen as fair and reasonable in the light of general mortgage law and so escape being unenforceable. A charge which is designed to ensure that the mortgagor gains no advantage from early redemption and may have to pay a considerable sum to the lender⁵¹ for such early redemption is a clear disincentive to redeem early. That would seem to be a classic clog or fetter on redemption. Nor is there any suggestion in the

⁴⁹ Miles, *op. cit.*, paras. 7.24, 7.25, 7.26, 7.35, 7.36, pp. 80, 82.

⁵⁰ *Jones v Morgan* [2001] EWCA Civ 995.

⁵¹ In Annex A to the Review: Guide to giving advice, an example is given of a ‘market forecast for interest rates with significant downward surprise’ to show that comparing a 10 year fixed-rate mortgage with a tracker mortgage over six years when interest rates declined from 4% to 1.5%, a tracker mortgage would be £6,526 cheaper. That would be the sum which a mortgagor would be required to pay to a lender as the charge or penalty for early redemption. Miles, *op. cit.* p.106.

Review that any account would need to be taken of what happens in practice; that is, that any mark-to-market charge could only be enforced to the extent that the lender had in practice suffered a loss through early redemption: that too would seem to offend against the equitable principle⁵². While it may be true that other commercial organisations are not obliged to take account of changed personal circumstances in determining whether to enforce repayment of a loan, the principle that mortgagees may be required to is implicit in the powers given to courts under the Administration of Justice Act 1970 to suspend an order for possession of a home to allow a mortgagor in default a reasonable period to clear off the arrears.⁵³

The Miles Report like the Crosby Review focused overwhelmingly on making the mortgage market work better. This was their specific remit from the Treasury. The key to better working for both reports was more government support for the market; in the case of Crosby, a guarantee of £100 billion on the interest and principal on residential mortgage backed securities and covered bonds. Miles was more modest. He proposed three government initiatives. First, the government should exempt symmetric compensation payments from taxation. Second, the government should develop and enact specific covered bond legislation to ensure that covered bonds issued by UK lenders to raise funds for long-term fixed-rate mortgages could be recognised by the UK authorities under the Co-ordination Directive on Undertakings for Collective Investments in Transferable Securities (UCITS). Failure to enact such legislation would affect the extent to which European funds could invest in UK issued covered bonds; and would prevent UK covered bonds from qualifying for favourable treatment under the UCITS Directive. Third, the Government should give

⁵² It might be argued that the Review meets the clogs and fetters principle by suggesting symmetric mark-to-market pre-payment charges. “If borrowers pre-paid their mortgages at a time of higher market rates (of the relevant maturity) than those in their contract, they would be compensated with a lump sum equal to the market gain to the lender of breaking the contract...” para. 7.37, p.82. If only the real world of lenders and borrowers were that simple. Lenders would quickly invent ‘administration’ charges which would reduce any compensation payable. If lenders underpaid, how many borrowers would sue for the difference if indeed they were aware that they had been underpaid? There might be symmetry in theory but not in practice: only borrowers with special personal circumstances would benefit, as without such, few borrowers would voluntarily give up a mortgage with a low rate of interest to take on a mortgage with a higher rate which is precisely why the reverse situation – borrowers paying lenders to redeem a mortgage early to take advantage of a lower rate of interest – would make a pre-payment charge to ensure borrowers obtained no gain from such a course of action a probable clog. It is arguable that Miles underestimated the problem of calculating the ‘correct’ pre-payment penalty. “The prepayment option may seem straightforward at first glance but it adds a substantial dose of complexity to the mortgage contract.” Bar-Gill, op. cit., footnote 29, p.26.

⁵³ *Cheltenham and Gloucester Building Society v Norgan* [1996] 1 All ER 449 for what may be reasonable period. One suspects that the argument of the Court of Appeal would appal Miles as a gross and unjustified interference with a commercial contract.

“consideration to the potential costs and benefits of Government issuing interest rate derivatives.”⁵⁴

These recommendations, if acted upon, would put the Government at the heart of the mortgage market. They would – indeed in the case of covered bonds, they have – involve legislation and considerable commitment of taxpayers’ funds, hopefully more potential than actual. They have too – clearly in the case of Miles, implicit in the case of Crosby – been made without any reference to or understanding of the basic law of mortgages and the impact their recommendations might have on the operation of that law. Equally, they have been made without any overt recognition of the mortgage as anything other than a financial instrument which must be rejigged to make the market work better. A better working market will be of benefit to consumers but the whole thrust of both reports is to view homeowners purely as rational consumers; consumers moreover with prime mortgages. They should be assisted to play the market more effectively by being supplied with more information but equally, they must expect to pay if they want to use the market to their own advantage.

This economic model of the mortgage is far removed from the reality of the mortgage as a socio-legal institution in 2009 where the key issue for many thousands of borrowers is not how to play the market more effectively but whether they can remain in the market at all or whether they may lose their homes through repossession. It is to this aspect of the market that this article now turns to examine its defects and the Government’s apparent unwillingness to review the problems and bring forward legislation to correct them.

D. The private law of mortgages: default and repossession⁵⁵.

In concentrating on the issues of default, repossession and sale, there is no suggestion that all other parts of the private law of mortgages are satisfactory and in no need of an overhaul. In particular, and especially in the light of the Miles Report views on prepayment of fixed-rate mortgages and mark-to-market charging, there is a clear case for a review of the rules governing the equitable right to redeem (although I am doubtful

⁵⁴ Miles, *op. cit.*, para. 7.60, p.87. For the discussion on this see paras. 7.41 – 7.60, pp. 83 – 87.

⁵⁵ I have derived a great deal of assistance in writing this part of the paper from L.M. Clements (1999) *Residential Mortgage Repossessions and The Administration of Justice Acts, 1970 and 1973 - A case for Reform*. First published in *Web Journal of Current Legal Issues* in association with Blackstone Press Ltd.

whether the rules should be altered to permit such a practice in relation to residential mortgages since it amounts to transferring in probably 90% of cases all the risks of pre-payment to the mortgagor). But the reality now is that the key issue in mortgage law and practice from the grass-roots perspective as opposed to the more rarefied perspective of bankers and economists is default and repossession.

A brief summary of the evolution of the law from 1970 is in order. Until that year, there was some confusion in the courts as to the existence and extent of the powers of the courts to grant relief to a mortgagor who was in default with his/her payments. Some judges tried to ameliorate the harshness of the common law rule by granting stays of execution of an order for possession where a mortgagor had failed to keep up with payments to allow mortgagors an opportunity to sort out their affairs. Other judges resolutely refused to countenance any departure from the common law. Matters came to a head with the decision in *Birmingham Citizens Permanent Building Society v Caunt*⁵⁶. That decision had put an end to the practice developed by the Chancery Masters, under what was then Order 55 of the Rules of the Supreme Court, of adjourning possession hearings in order to give the mortgagor the chance to pay by instalments. The decision was criticised by the Payne Committee⁵⁷. Clements takes up the story:

The Payne Committee noted the trend towards owner-occupation and that successive governments had encouraged the purchase, instead of renting, of houses by persons of modest means. It therefore recommended...that when possession was sought of a dwelling-house which was subject to a mortgage, the court should have the discretion to adjourn the application or suspend or stay the execution of a possession order in circumstances where “the defendant (mortgagor) ought to be given opportunity to pay off the arrears of instalments...or otherwise requires the protection of the court.”

The wording of the Report of the Payne Committee is unfortunate in that it presupposes that the mortgagee will take the trouble to seek a court order for possession in the first place. Nevertheless, the spirit of what was intended is, it is suggested, fairly clear, namely, that mortgagors should have the protection of the court when the mortgagee seeks to take possession, whether by court action or otherwise. However, the *wording* of section 36 of the Administration of Justice Act, 1970 [which

⁵⁶ [1962] 1 Ch 883

⁵⁷ *Payne Committee on the Enforcement of Judgment Debts* (1969) Cmnd 3909, London, HMSO

purported to enact this recommendation] is insufficient to enable this “spirit” to be carried forward. Subsection (1) provides that the court may exercise its discretion in a residential mortgage case “where the mortgagee ... *brings an action* in which he claims possession of the mortgaged property...”⁵⁸

The section was extremely badly drafted by persons who clearly did not understand the nature of an instalment mortgage and was interpreted by a judge who managed to give the section a meaning that was virtually the same as the position in the common law that it had been designed to alter⁵⁹. This led to an amendment of the section by sec. 8 of the Administration of Justice Act 1973 to make it clear that in the case of an instalment mortgage or of a mortgage which permits a deferred payment, the “sums due under the mortgage” are any instalment of payment in arrears and not the whole capital sum. The section remains badly drafted but at least now it can receive a sensible interpretation.

The fundamental deficiency of the section however is, as noted by Clements, that it only operates if a mortgagee brings an action in court claiming possession of the mortgaged property. If a mortgagee does not, then the old common law right of the mortgagee to possession of the property remains in operation and in pursuit of this right a mortgagee can take possession without the necessity of obtaining an order of a court. This was confirmed by the decision of *Ropaigelach v Barclays Bank*⁶⁰ where the bank took possession of a house owned but not occupied by the Ropaigelachs in respect of which a substantial mortgage was outstanding and in arrears and sold it, placing the proceeds of the sale in the Ropaigelachs’ account to reduce their indebtedness to the bank. The Ropaigelachs took action to try and get the sale set aside but failed. The case affirmed that s.36 had not altered the law. Mortgagees are not legally obliged to go to court even when the house they are seeking possession of is occupied.

This case was confirmed in very forthright terms, in *Horsham Properties Group Ltd v Clark*⁶¹ decided in early October 2008. Carol Beech and Paul Clark took out a loan with GMAC RFC Ltd – an American specialist lender, an offshoot of General Motors – to buy a house. Beech signed a mortgage deed which provided that all the money they had borrowed would become due to be repaid one month after the

⁵⁸ Clements, pp.

⁵⁹ *Halifax Building Society v Clark* [1973] Ch. 307

⁶⁰ [1999] 4 All ER 235

⁶¹ [2008] All ER (D) 58

commencement of the mortgage. However this repayment would not be enforced provided they paid monthly instalments of the loan on time. If they missed one or more monthly payments, GMAC could give them notice to leave their home and use its statutory power under the Law of Property Act 1925 to sell their home or to appoint a receiver who by the mortgage deed was given the same power to sell the home.

The mortgagors were unable to keep up with their payments and GMAC appointed a receiver who sold their home to a company that immediately sold it to Horsham Properties. The mortgagors were still in their home and Horsham Properties brought an action to obtain possession from them on the grounds that they were trespassers in Horsham's property. The defendants argued that they were being deprived of their property contrary to Article 1 of the First Protocol to the ECHR. The judge, Mr Justice Briggs gave short shrift to that argument, saying that the exercise of the statutory power of sale under s. 101 Law of Property Act implemented rather than overrode the contractual bargain between the parties and found for Horsham Properties. He said the law had been clear for 160 years: by the express terms of the mortgage, Beech's rights in the house were all subject to being overridden by a sale of the property by GMAC or receivers appointed by GMAC at any time after a default in paying sums due under the mortgage and she had agreed to those terms. There was no obligation by GMAC to seek an order from the court before taking action to evict householders in default of paying their mortgages out of their homes and selling them.

The decision highlights the present unsatisfactory state of the law on mortgage arrears where the power of the courts to grant relief to defaulting borrowers is in the case of first mortgages in effect left largely to the discretion of lenders to invoke rather than being a duty imposed on lenders since it only arises if lenders bring an action in court seeking possession of mortgaged property and as the case shows, lenders do not have to do that.

What makes the decision even less satisfactory or indeed defensible is that the position is very different under the CCA with respect to second mortgages and other secured loans which are regarded as a regulated agreement under the Act where the law has recently been amended by provisions of the CCA 2006 brought into force in April 2008. Where a debtor under a regulated agreement under the CAA falls behind with payments, the creditor must serve first an arrears notice informing the debtor of the arrears in the prescribed form and then a default notice also in the prescribed form.

If these notices are not served or are not in the prescribed form, then the creditor will not be able to enforce the agreement.

A creditor can only enforce a regulated agreement through the courts. As noted above, the courts have the power to make an enforcement order which can “reduce or discharge any sum payable by the debtor...”⁶²; a ‘time order’ which can extend the time for the making of payments under an agreement; and a modification of the agreement. Here the decision of *Southern and District Finance v Barnes*⁶³ is very instructive. This concerned a time order under s.136, CCA 1974 but the provisions remain unaltered under the CCA 2006. Three cases were in issue; in each case, the appellants homeowners had a mortgage and had then taken out a loan with a finance company. In the named case, the loan was £12,000 payable back over 10 years by 120 instalments of £260 or £ 31,200. In the third case, a firm named with a rather warped sense of humour *Equity Home Loans v Lewis*, the regulated loan was £4000 repayable over 15 years by 180 monthly instalments of £105.66 at an APR of 44.1%. As the Court of Appeal pointed out in that case, assuming that the capital was repayable by equal monthly instalments, the defendant would have been paying £1000 a month for 15 years to borrow an average sum of little over £2000. In each case, the defendants had fallen behind with their payments and the issue was the powers of the courts to reschedule payments under a time order on which the lower level judges had disagreed with each other to a marked extent.

The Court of Appeal set out the position:

- When a time order is applied for or a possession order sought of land to which a regulated agreement applies, the first step is to consider whether it is just to make a time order and this involves a consideration of all the circumstances of the case and the interests of both debtor and creditor.
- When a time order is made it should only be for a stipulated period. If despite the giving of time (and this must mean *extending* the time for the repayment) the debtor is unlikely to be able to resume the contractual repayments, then the court should not make a time order;
- When a time order is made relating to the non-payment of money,
 - the “sum owed” means every sum which is due under the agreement and where possession proceedings are brought this will comprise the total indebtedness;

⁶² S. 127(2) CCA.

⁶³ [1996] 1 FCR 679

- the court must consider what instalments would be reasonable both as to amount and timing having regard to the debtor's means;
- The court may include in a time order any amendment of the agreement, which it considers just to both parties, and which is a consequence of a term of the order. This could include an extended period of repayment (i.e. extended beyond the agreed term);
- If justice requires the making of a time order, the court should suspend any possession order that it also makes, so long as the terms of the time order are complied with.

Applying these principles to the cases, the CA allowed two appeals by defendants and rejected the appeal by Equity Home Loans. Their summary of the District Judge's decision which had extended the period of repayment from 15 to 18 years and reduced the rate of interest to nil which they supported are worth quoting:

Though the Judge's methods were robust and his reasoning economical, his instincts were sound and his order just.⁶⁴

Two very significant differences between the Administration of Justice Act and the CCA is that first, second mortgagees under the CCA can only seek possession of a borrower's house by commencing an action in court to recover their loan and second, time orders under the CCA can extend the period of payment beyond the originally agreed term of the loan; courts exercising powers under the AJA have no such powers. There seems to be no good reason for this difference other than the assumption that lenders who come under the aegis of the CCA are less meritorious than lenders coming under the aegis of the FSA but given the FSA's comments on the problems of sub-prime mortgagors whose mortgagees are clearly not of the best quality, this assumption is hard to accept.

Both Clements and Oldham argued for changes to be made to the law governing default by mortgagors under a RMC, with Oldham arguing

It is unfortunate that while devising the new FSA regime the opportunity was not taken to rationalise and unify mortgage regulation into a single, coherent and consolidated package⁶⁵.

⁶⁴ p.

⁶⁵ Oldham, *op. cit.*, p.210

He goes on to note that the CCA was under review by the then Department of Trade and Industry and that the FSA regime was to be extended to mortgage advice so that it was not too late to move towards such a consolidated system. Oldham was writing in 2002 when there appeared to be no immediate need to consider any reform to the Administration of Justice Act as there was no problem of arrears and no thought that there might be a problem any time in the future. That is certainly not the position now.

Before turning to the Government's response to the current crisis, and possible reforms, it will be helpful to provide some statistics on the situation.

On Ministry of Justice statistics, in the first three quarters of 2008,

- 116,277 possession claims were issued
- 85,704 possession orders were made
- approximately 47% of possession orders were suspended

The CML reported that 1.44% of mortgages were at least three months in arrears as at the end of September 2008. This was up from 1.33% at the end of June. The number of cases in arrears at the end of September was 168,000, 8% higher than the 155,600 at the end of June.

The FSA has calculated that, by the end of the third quarter of 2008, 340,000 mortgages were in arrears. This figure is considerably larger than the CML's 210,000 predicted arrears cases by the end of 2008, in part due to the FSA's differing definition: the FSA says a mortgage with 1.5 per cent arrears is equal to three months in arrears. It found there was a huge rise in arrears by the third quarter of 2008, with an extra 60,000 cases in that period.

There is as yet no clear indication as to how lenders are responding to the rapidly growing numbers of borrowers in arrears. However some indication of likely responses may be gleaned from the survey done by the Centre for Housing Policy for the CML in 2005 into how firms were at that time managing arrears and possession cases. The summary of that survey highlights the following:

- The vast majority of lenders manage their arrears fully or at least partly in-house.
- Lenders attach a very high importance to contacting borrowers who are falling into arrears quickly, with 90 % of them aiming to make first contact when one part or full payment has been missed.

- The survey found that in 2005 3.2 % of homeowner mortgages were in arrears, but that these were heavily concentrated in the short-term category with two-thirds of cases 1-3 months down.
- Lenders' forbearance strategies are influenced when mortgage interest payments are met, or are likely to be met, in full by mortgage payment protection insurance or income support. Partial coverage of interest payments makes some but much less of a difference.
- More than three-quarters of lenders have formal criteria in place for initiating court action. These tend to revolve around how long arrears have persisted, whether contact with the borrower has been made, and whether remedies have been exhausted or have failed.
- A key finding from the survey is that there are clear differences between the prime and non-prime sectors of the mortgage market (the latter being defined as including adverse credit and self-certificated mortgages). The rate of arrears in the non-prime sector was almost four times higher and possessions ten times higher. In 2005 about 1 in 200 properties subject to a non prime mortgage were subject to possession. A much larger proportion of such possessions resulted in a shortfall, 31% in non prime cases compared with 6% for prime ones.⁶⁶

Three years later, it seems that practice among lenders may have hardened. In December 2008, a press release from The Paymex Group, one the UK's largest commercial providers of financial solutions products, noted that it had seen a dramatic increase in the number of new customers who have mortgage arrears. Nick Pearson, External Affairs Director at Paymex was quoted as saying:

Looking at our statistics for the 3rd quarter of 2008 compared with the 3rd quarter of 2007, Paymex has seen a very significant increase in the number of new customers with mortgage arrears. The number of people we have advised who have mortgage arrears has increased by some 76% over the last year. The average level of mortgage arrears is now just under £2900.

Despite the recent Council of Mortgage Lenders, (CML), Guidance on arrears and possessions, too many mortgage lenders still appear to be initiating court action to repossess the property when there are only 3 months arrears on the mortgage account. All too often lenders ask our customers for repayment of any mortgage arrears over a very short time

⁶⁶ M. Stephens and D. Quilgars (2007) *Managing Arrears and Possessions*, CML *Housing Finance* No. 5, p.1

period, such as 6 months. For many borrowers this short term arrangement is simply unsustainable and leads to further default.

We think that mortgage lenders must adopt a more realistic and sensitive approach to their handling of arrears cases and allow repayment of arrears over a more reasonable time period. The CML has already suggested in their recent guidance to members this can be the remaining term of the mortgage. We find it hard to comprehend why lenders are still insisting on taking such a short term approach to the collection of mortgage arrears, given that increasing the number of repossessions only exacerbates the fall in house prices.

Lenders' short term approach can lead to some borrowers feeling their situation is hopeless and deciding to abandon their home, resulting in a so called voluntary repossession. We would urge lenders to take a longer term approach to the repayment of mortgage arrears. The present rush to repossession by some lenders, particularly those who specialise in sub prime mortgages, is leaving many repossessed homeowners with substantial mortgage shortfall debts which the lenders then have 12 years in law to recover. Based on information we have recently been made aware of, the average mortgage shortfall debt owed by former homeowners is currently around £45,000.⁶⁷

This view from the front line trenches puts the dry statistics into the Ministry of Justice, the CML and the FSA into a more human and disturbing context. It also suggests very forcibly that Guidance from the CML and equivalent guidance from the FSA's MCOB 13 on fair and reasonable treatment of mortgagors in arrears is not being complied with. But these comments do not highlight the social costs of repossession both for the borrowers and their families but in some respects more important, those social costs borne by third parties: the negative externalities that repossessions can have on neighbourhoods, driving down property prices of houses near to repossessed and often vacant homes.

It is instructive to consider the Government's response to the crisis in mortgage arrears and repossessions and contrast it with its response to the crisis in mortgage lending. The Government has responded with the following initiatives. First, government introduced in December 2008 a Homeowners Mortgage Support Scheme. In the words of the Treasury press release:

⁶⁷ N. Pearson, (2008) Press release, Paymex Group 17 December.

The scheme will allow lenders to reduce a borrower's current monthly mortgage payments, with the deferred payments rolled up, added to the principal, and paid at a later date when the borrower's financial circumstances have improved. The Government will guarantee the lender against a proportion of any loss incurred on the deferred interest payments in case the borrower defaults.

The scheme will be voluntary and subject to eligibility criteria to ensure that there is proper risk sharing between Government, lenders and borrowers and the scheme is sustainable for those that participate. To qualify, borrowers will:

- have suffered a loss of income from employment or self-employment of a scale which now makes full mortgage payments difficult, but which is not expected to be a permanent loss of income;
- have been in dialogue with their lender, including over the use of existing forbearance policies, and have been making some level of regular payment;
- have taken out a mortgage of up to £400k;
- have savings below £16,000, (which is the same as for the existing Support for Mortgage Interest scheme (SMI));
- apply for assistance as owner-occupier – the programme will not apply to people with second homes or buy-to-let properties;
- not be in receipt of SMI or mortgage rescue assistance;
- have been assessed as being able to pay a certain monthly amount on an ongoing basis;
- have received financial advice from a party other than their lender to determine their eligibility for the scheme, including testing the long-term sustainability of their financial position, and their ability to resume full payments once their income increases; and
- have fallen into arrears for a number of months during which the lender has exercised forbearance.

The scheme itself will be open for a window of two years, subject to review. The guarantee will last for a maximum time period and will expire once the customer is able to commence normal payments. If, during the period of guarantee, the customer defaults, the Government will pay the lender the equivalent sum of the total amount of the interest guaranteed that is not recoverable from equity in the property.

Not all lenders are on board on this initiative; not all details have been worked so its impact is uncertain.

Second, the Government has introduced changes to the Support for Mortgage Interest scheme by making the means-tested benefit available after thirteen weeks, rather than thirty-nine.

Third, the Government has launched a Mortgage Rescue Scheme which in the words of the press release from the Department of Communities and Local Government is

a new £200m package of measures designed to prevent some of the most vulnerable families losing their homes and experiencing the trauma of repossession. This scheme is aimed at those who would be eligible for homelessness assistance and is subject to a range of eligibility criteria. £200m will avoid up to 6,000 repossessions across England...

Mortgage Rescue will operate by bringing together local authorities, Registered Social Landlords (RSL), lenders and debt advice agencies. The two elements work in the following ways:

Shared equity - RSL provides an equity loan enabling the householders' mortgage repayments to be reduced.

Government Mortgage to Rent - RSL clears the secured debt completely and the applicant pays rent to the RSL at a level they can afford.

The level of grant to a RSL will be determined using the Homes and Communities Agency's value for money assessment criteria after a Money Adviser has advised on the most appropriate route after establishing a household's affordable housing costs.

Fourth, the Government has provided additional funding to increase the amount of debt counselling and legal aid that can be given to mortgagors facing possession actions in the courts.

These are all specific and direct government initiatives, designed to avoid or reduce the incidents of possession actions in the courts. They are clearly little more than palliatives. There were 45,000 repossessions in 2008; it is estimated that there may be 75,000 in 2009; the Mortgage Rescue Scheme might help some 8% of potential repossesseees in 2009. Providing more legal aid and assistance at the door of the court so

to speak will give the appearance of concern without any real substance to back it up: by then it is too late to stop the process of repossession. It is difficult to disagree with both Shelter⁶⁸ and the Centre for Policy Studies that much more needs to be done and in particular the role of the courts needs to be re-examined and further powers given to the courts to stem the tide of repossessions.

It is therefore to the courts that we must now return. We have noted the present unsatisfactory nature of the role and powers of the courts with respect to RMCs under the Administration of Justice Act; and the slightly better though very complex powers of the courts under the CCA with respect to consumer credit which embraces second mortgages and other consumer credit contracts secured on a home. The government's response to this inadequate legal framework is of the same order as its response generally to the crisis in arrears and repossessions: 'all noise and no nuts'.⁶⁹ It is the Mortgage Arrears Protocol.

The Civil Justice Council, a non-departmental public body sponsored by the Ministry of Justice acting under powers conferred upon it by the Civil Procedure Act 1997 has developed a Mortgage Arrears Protocol. In the words of the CJC Consultation Paper on the protocol published in May 2008:

The overall intention of pre-action protocols is to ensure that before proceedings are commenced all reasonable steps are taken to avoid the necessity for litigation and particularly

- to encourage the exchange of early and full information about the prospective legal claim;
- to enable parties to avoid litigation by agreeing a settlement of the claim before the commencement of proceedings...

The draft Pre-Action Protocol for mortgage arrears...adopts many of the provisions of and reflects guidance on good practice by lenders in dealing with borrowers in arrears as set out in the Mortgage Conduct of Business Rules within the Financial Services Authority Handbook...

The Practice Direction for Protocols provides that the Court may impose sanctions for a failure to comply with the terms of a pre-action protocol...

⁶⁸ Shelter (2008) *Mortgages and repossessions* A discussion of the issues raised by the changing landscape of mortgage lending

⁶⁹ *Ron Burgess article; Latin American saying find ref*

The Protocol is intended to provide a clear structure to be followed in residential possession claims on the basis of mortgage arrears, encouraging more pre-action contact between the parties and enabling court time to be used effectively. It recognises that it is in the interests of both lenders and their borrowers to ensure that mortgage payments are made promptly and to ensure that difficulties are resolved wherever possible without court proceedings.

The protocol is intended to ensure that lenders deal fairly with borrowers in arrears and to that end lenders must put in place and operate within a written policy (agreed by its respective governing body) and procedures for complying with the requirement to deal fairly with borrowers. Courts should take into account whether this protocol has been followed when considering what orders to make using case management powers in any possession proceedings brought against residential mortgage borrowers.

The Protocol which came into effect (if that is not too strong a word) in November 2008 is then a non-binding guidance document inviting lenders to deal fairly with borrowers (which they are already encouraged to do by both the CML and the FSA) and implying that if they do not, then...probably, nothing much will happen to them. If this is regarded as an unfair comment, consider the comments of the Judicial Studies Board made in January 2009⁷⁰:

The practical effect of the Protocol, therefore, should be that the court should enquire at the first hearing, whether the lender has complied with the Protocol. The lender can demonstrate this by referring in the Particulars of Claim, or in a witness statement filed and served for the hearing, and by updating the position orally at the hearing.

If the Lender has not complied with the Protocol the court will have to decide first whether s36 is engaged. If it is definitely not...the court must make a possession order.

But where there is apparently non-compliance by the lender with the Protocol and doubt about the borrower's prospects of payment, or a sale, for lack of information, or it seems likely that s36 might be engaged in the foreseeable future, the court seemingly has the power, under the Protocol, the Part 3 case management powers and/or paragraph 2.3 of the Pre-Action Practice Direction to:

⁷⁰ in its newly launched Civil e-letter for January 2009 *full ref*

- Adjourn to enable the lender to comply with the Protocol and/or establish the facts e.g. about whether and when DWP may pay the mortgage interest (which from January 2009 will be from 13 weeks after the application where the applicant is eligible – previously it was 39 weeks)
- Adjourn or suspend on terms (e.g. that the borrower pays current monthly instalments plus £20 per month off the arrears, possible with a review if the borrower may be likely to be able to pay more in the foreseeable future)
- Stay the proceedings to enable the parties to explore alternative dispute resolution (e.g. capitalising the arrears), and/or
- Disallow the costs of the adjourned hearing because the lender's non-compliance caused the adjournment

But the interaction between the lender's statutory and contractual rights, and the court's powers under the Protocol are not straightforward. Satellite litigation and appeals on the application of the Protocol seem likely, but perhaps not for a time, because some lenders may not want to take possession of properties in the current stagnant property market even when they are entitled to do so.

So the Protocol will have no effect where section 36 AJA is not applicable and only the creation of relatively small procedural hurdles when it is or may be applicable. But infinitely more important, the Protocol only applies where lenders are using the courts to obtain possession of a home; where as in *Horsham Properties*, lenders have so arranged matters via the mortgage contract that they do not have to go to court to obtain a possession order, then it has no operation at all. The lenders which are more likely to offer mortgages which avoid the troublesome business of having to get a court order to obtain possession of a home if default takes place are specialised lenders (as was the case in *Horsham Properties*) and the borrowers are more likely to be subprime borrowers.

Well before the process of developing and bringing into effect the Protocol, Shelter's report on mortgage repossessions, which was based on practices prevalent in 2007, had highlighted the particular problems of subprime borrowers:

The mortgage lender should be willing to enter into an arrangement with a borrower to repay the arrears by instalments over a reasonable period

of time. This is specified as required practice under the FSA's MCOB. However...there are variable practices among mortgage lenders in the way they deal with arrears. Research by the CML indicates that the rate of repossessions in the sub-prime sector is 10 times higher than that in the mainstream sector, while the rate of arrears is only five times higher. This implies that borrowers who fall into arrears in the sub-prime sector may be twice as likely as those borrowing from mainstream lenders to end up being repossessed. There is also anecdotal evidence that some sub-prime lenders are very quick to repossess. The Citizens Advice survey of mortgage possession actions taken in one county court in 2006, showed that some lenders in the sub-prime sector were applying for many more possession orders than would be accounted for by their share of the sub-prime mortgage market. While the FSA's requirements in the area of arrears management exist across all lenders (mainstream or sub-prime), there are questions over how well these requirements translate in practice into protection for customers in the sub-prime sector⁷¹.

Note too that the Citizens Advice survey was of subprime lenders that were using the courts to obtain repossession orders. All the effect the Protocol is likely to have on such lenders is to encourage them to resort to court even earlier than they do already or rewrite the mortgage so that they can avoid the courts altogether.

There can be little argument that the necessary information was in the public domain that the government could have made use of in developing something stronger than the Protocol. The Protocol was still in the process of being finalised when the *Horsham Properties* case was decided. Attempts to toughen it up in the light of that decision were strongly resisted within the Civil Justice Council⁷² and the Ministry of Justice produced an anodyne statement on the decision which made crystal clear that no action was contemplated to alter the law⁷³. Attempts by Labour backbenchers to

⁷¹ Shelter, op. cit. pp. 4 – 5.

⁷² Personal communication from a participant at the relevant meeting.

⁷³ “The Horsham case confirms the long-standing right of a mortgage lender to sell a property without a court order by virtue of the mortgage agreement where the borrower is in arrears.” The official claimed such cases were rare because a borrower cannot generally be required to leave the property without a court order. The CML issued an equally anodyne statement stating that all members of the CML had undertaken to refer cases of repossession to the courts and counselling against precipitous action on the decision. *Ref.* Not all mortgage lenders are members of the CML.

amend the Banking Bill to *require* all mortgagees to seek a court order for possession were resisted by the government⁷⁴.

What might be the reasons for this obduracy in the face of such obvious and growing hardship amongst borrowers; and considerable evidence that non-binding guidance to be nice to borrowers in arrears was being ignored by lenders. It certainly cannot be that amendments and or additions to section 36 AJA to require all lenders to seek a court order before repossession and empowering the courts to extend the time for repayment of a mortgage are thought to create a dangerous precedent and give rise to moral hazard. Such provisions are already part of the CCA.

An important factor in the reluctance to burden mortgagees offering first mortgages – overwhelmingly banks and building societies – with further legal obligations is that the government is unquestionably caught up in an unresolvable conflict of interest: as the whole or part-owner of some of the major mortgagees in the country, it has a definite financial interest in the repossession and sale of the properties of defaulting mortgagors; as a government, it has a definite political interest in trying to ensure that mortgagors in difficulties can stay put in their homes. Non-legal and non-binding protocols and guidance to mortgagees together with some very limited financial assistance to mortgagors in distress are an attempt to square this particular circle.

There is however a possible major legal complication to altering the law. This is the effect that any attempt to rewrite the law on mortgages, particularly that part of it focusing on protection of mortgagors in default by preventing repossession or extending the term of the mortgage might have on the securitisation of mortgages and so on the liabilities of lenders. This matter has been the subject of some discussion in the USA available on the web and what follows is based on that discussion.

There are basically three schools of thought on the matter. The first two are summarised by Joe Nozera⁷⁵:

...As regular readers know, I have quoted a number of experts and people in the securitization business who have told me repeatedly that it is nearly impossible to modify mortgages that are trapped in toxic

⁷⁴ House of Commons Public Bill Committee, 13 November 2008; Banking Bill.

⁷⁵ J. Nozera (2008) *What Securitization Problem? The F.D.I.C. Weighs In, Executive Suite*; Joe Nozera Talks Business 18 November

mortgage-backed securities. The contracts, they say, don't really have provisions for preventing foreclosures. And the servicers face terrible conflicts if they try to modify mortgages, because inevitable some of the bond investors will do better than others — depending on where they stand along the risk continuum — and under those same contracts, servicers are obliged to treat all investors alike. Finally, I've heard, servicers have been unwilling to lift a finger for homeowners because they have no financial incentive to do so — and they face the prospect of being sued by one of their investors if they do.

The Federal Deposit Insurance Corporation...begs to differ. [It] took over the California bank, IndyMac, which had, as Ms. Bair, [the chairman of FDIC] put it, “a pretty impaired portfolio.” It has since instituted a broad mortgage modification effort that also serves as a laboratory for what can and cannot be done. What the agency has discovered...is that the contracts are rarely as constricting as investors and servicers have been portraying them. They do not allow principal reduction...but they almost never disallow interest rate reduction — or delaying principal payments for a short time...The servicer agreement simply says that the servicer's job is to maximize the investment — which often means avoiding foreclosure.

So why aren't servicers modifying mortgages? Ms. Bair and Mr. Kriminger. [policy adviser to the chairman] could only speculate. It could be inertia, or lack of financial incentives — or, indeed, fear of being sued.

The American Securitization Forum would seem to support this second position⁷⁶:

Servicing of subprime residential mortgage loans included in a securitization is generally governed by either a pooling and servicing agreement or servicing agreement. These agreements typically employ a general servicing practice standard. Typical provisions require the related servicer to follow accepted servicing practices and procedures as it would employ “in its good faith business judgment” and which are “normal and usual in its general mortgage servicing activities” and/or

⁷⁶ American Securitization Forum (2007) *Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans*

certain procedures that such servicer would employ for loans held for its own account.

Most subprime transactions authorize the servicer to modify loans that are either in default, or for which default is either imminent or reasonably foreseeable. Generally, permitted modifications include changing the interest rate on a prospective basis, forgiving principal, capitalizing arrearages, and extending the maturity date. The “reasonably foreseeable” default standard derives from and is permitted by the restrictions imposed by the REMIC sections of the Internal Revenue Code of 1986 (the “REMIC Code”) on modifying loans included in a securitization for which a REMIC election is made. Most market participants interpret the two standards of future default – imminent and reasonably foreseeable – to be substantially the same.

The modification provisions that govern loans that are in default or reasonably foreseeable default typically also require that the modifications be in the best interests of the securityholders or not materially adverse to the interests of the securityholders, and that the modifications not result in a violation of the REMIC status of the securitization trust.

In addition to the authority to modify the loan terms, most subprime pooling and servicing agreements and servicing agreements permit other loss mitigation techniques, including forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owing but extend the time for payment. In addition, these agreements typically permit loss mitigation through non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs.

Beyond the general provisions described above, numerous variations exist with respect to loan modification provisions...

A third perspective is suggested by Brian Grow⁷⁷:

...According to an analysis by foreclosure research firm RealtyTrac, about half of all subprime loans that have entered foreclosure were securitized and sold to investors. In normal times, mortgage servicers, which include giant lenders such as Countrywide and specialty firms such as Litton Loan Servicing, a unit of Goldman Sachs...have a simple and lucrative job: collect payment from borrowers, administer escrow accounts, and forward funds to investors.

But as mortgage defaults have surged in the past two years, these caretakers are under pressure to do more to stop the bleeding by modifying loan terms. Many have balked or dragged their feet, say industry experts, hoping the housing market will rebound. One reason is that servicers earn more, under most current contracts, when they foreclose, compared with when they modify a loan. Adding staff and technology to manage modifications is costly...

“The cost-benefit calculation of the servicers has been very lopsided” in favor of foreclosures, says Alan S. Blinder, a professor of economics and public policy at Princeton University...

Which, if any, of these three positions might apply to which, if any, lenders in the United Kingdom? Official reports on securitisation in the UK have not raised this important issue. It has already been noted that most UK lenders which securitise their mortgages keep them in their books which is different to US lenders so that the first position is unlikely to arise in the UK. This however is not the case with specialist lenders which tend to sell on their securitised mortgages so that they may face

⁷⁷ B.Grow (2009) What's holding back mortgage modification, *BusinessWeek on line* February 13.

difficulties if they are minded to extend concessions to their borrowers, However as *Paragon Finance* showed, by not fully completing the process of transfer of mortgages, a specialist lender retains the legal title to a mortgage as trustee for an SPV and so can take action to repossess or to show forbearance.

Paragon Finance also however shows that the third position is the most likely one that applies to lenders in the UK. For specialist lenders, using mortgage contracts which avoid the necessity to go to court to obtain a repossession order, it is clearly much more cost-effective to repossess the home of a defaulting mortgagor than to engage in the kind of discussions, negotiations and general hand-holding with mortgagors in arrears which the Protocol, the FSA's MCOB 13 and the CML guidelines recommend: more staff would need to be hired; and more time would need to be spent in pre-repossession processes.

But it is not only specialist lenders which prefer law law to jaw jaw: Northern Rock, *after* it was nationalised by the government set about an aggressive programme of repossessions which is still continuing⁷⁸. Northern Rock has made plain that it aims to reduce its outstanding loans from government as quickly as possible: it may also be that its earlier irresponsible borrowing from the global money markets was in part fuelled by securitised mortgages sold to overseas, principally US, investors on terms which now make it difficult to extend any concessions to those of its borrowers in arrears.

The government's actions, including the appointment of Crosby to review the mortgage market, have made it clear that it is more concerned to get the mortgage market working again than to mount the kind of major national action plan to rescue those in arrears with their mortgages that President Obama is bringing forward in the USA. The sums involved there are in the order of \$75 billion and legislation will be needed to rewrite the bankruptcy laws to empower bankruptcy judges to provide relief to defaulting mortgagors of first mortgages. In the UK it would require very little legislation to provide, first, that *all* mortgagees must obtain a court order to permit them to repossess a house occupied by either a mortgagor in default, or the family or a tenant of such a mortgagor; and second, to extend to courts dealing with orders for repossession of first mortgages – the RMCs coming within the jurisdiction of the FSA – the powers that courts have had since April 2008 under the CCA 2006 with respect to second mortgages and other consumer credit loans of any size, to

⁷⁸ Northern Rock borrowers failing to repay loans, Moneywise your money, your life 27 Aug 2008; <http://www.moneywise.co.uk/news-views/2008/08/27/northern-rock-borrowers-failing-to-repay-loans>.

make time orders in respect of such mortgages. It is a sad commentary on the government's priorities that it is putting so much money into rescuing banks from their past improvidence yet appears unwilling to put even one tenth of such sums into funding the outcome of legal reforms designed to keep people in their homes by shifting the balance in the courts ever so slightly towards mortgagors in arrears and developing arrangements to pay lenders the difference between what defaulting borrowers can afford and the contractually stipulated amount.

E. The future of mortgages and mortgage law

Earlier on in this article I drew attention to Robert Shiller's new book *The Subprime Solution* in which he made some outline suggestions on mortgages. I want to take up these suggestions and discuss how mortgages and mortgage law in the UK could be refashioned to provide a more effective instrument for homeownership in a social and economic future which will be very different to the immediate past which has come to such an abrupt and traumatic end. Shiller's ideas are based on the structure and functioning of the US mortgage market and in particular, on what happens on default.

There are two key differences in US mortgage law from the position in the UK. First, in some states, a 'no-recourse law' permits a mortgagor in default to walk away from his/her home. Such persons lose their homes but the mortgagee bears the loss of any shortfall between the amount of the loan and what is realised by the sale of the home. That is not the position in the UK where mortgagors can be and are pursued for the shortfall by their creditors. Second, bankruptcy courts handle foreclosure actions which are the usual way for mortgagees to obtain possession of the mortgaged property of a defaulting mortgagor. While bankruptcy courts can modify and cancel all or parts of other types of debt, including credit cards, automobile loans and mortgages for second homes, they are not empowered to modify loans, a process known as cramdown⁷⁹, on the bankrupt's principal home. President Obama's proposals for reform would, inter alia, give bankruptcy courts power to work out cramdowns on the principal home so keeping many thousands of mortgagors in arrears in their homes. This is the context within which Shiller's suggestions have been made.

⁷⁹ "A late 20th century term now common in bankruptcy law, refers to a reorganisation plan that creditors are required to accept as long as the plan attains minimum standards established by the Bankruptcy Code...*In re D & F Construction Inc* 865 F.2d 6573, 675 (5th Cir.1989)" B.A. Garner (1995) *A Dictionary of Modern Legal Usage*, 2nd ed, New York, Oxford University Press, 235.

Shiller argues strongly for a bailout of the mortgage market in the US and makes proposals for institutions to be established to facilitate this, not wholly dissimilar to some of the developments slowly being put together in the UK⁸⁰. But he then goes on, in a way totally lacking in the UK, to suggest a new type of home mortgage which would or could obviate the need for emergency bailouts in the future. He calls these ‘continuous-workout mortgages’ and explains them as follows:

A continuous-workout mortgage would have terms that are adjusted continuously...in response to evidence about changing ability to pay and changing conditions in the housing market. The mortgage contract would schedule an automatic workout every month...

Continuous-workout mortgages are one way of providing for a “responsible” bailout. These financial devices, set up in advance, would do what bankruptcy courts do on an emergency basis after the fact: they would adjust the terms of the loan to the borrower’s ability to pay. But, unlike bankruptcy proceedings, continuous-workout mortgages operate on an ongoing basis, responding to fluctuations of income as they occur and not allowing problems to build up to crisis level...Indeed, continuous-workout mortgages continue to function under circumstances that otherwise would trigger a bankruptcy claim, allowing the lender to continue collecting a stream of payments that, while perhaps reduced, is at least uninterrupted...⁸¹

Shiller goes on to make suggestions for dealing with problems of moral hazard which such a proposal would be likely to give rise to but notes that mortgage workouts are being widely advocated across the political spectrum so that it would make sense to institutionalise, regularise and make them permanent which his proposals do.

Would such a proposal be feasible in the UK? Would it be desirable? On feasibility, there are two aspects to consider. First, most US mortgages are fixed-rate⁸² and the Miles review was concerned to suggest ways in which more fixed-rate mortgages could be developed in the UK market. But Shiller’s proposals are in reality for a much wider use of flexible mortgages and the UK market, as all commentators are

⁸⁰ Shiller, op. cit., chap.5.

⁸¹ Ibid., 157, 159.

⁸² But not all. O Bar-Gill op cit., footnote 29 draws attention to the position of subprime mortgages which tend to be flexible as regards payment terms usually to the great disadvantage of mortgagors. Interestingly, “Under a conventional adjustable-rate mortgages (ARMs) where the monthly payment is calculated by adding a fixed number of percentage points to a fluctuating index, the dollar amount paid varies from month to month but without systemic trajectory.” p.2.

agreed, is extremely flexible and offers many arrangements that go some way towards what Shiller is suggesting; balloon mortgages; payment ‘holidays’; extended terms; negotiated reduced payments during financial hardship. It would not therefore be too dramatic a step for lenders to formalise their practices to offer continuous-workout mortgages although a term such as ‘flexible payment’ mortgages might be preferable for the UK borrower. In this respect, Miles’s proposals to facilitate and educate UK mortgagors to move towards fixed-rate mortgages would seem the wrong way to go.

Second, there is the issue of the handling of arrears. The powers of the courts under the Administration of Justice Act with respect to first mortgages and under the CCA with respect to second mortgages and other consumer credit loans already go a considerable way down the Shiller route. The major difference is that in both UK arrangements, the courts must be satisfied that the borrower will be able to pay off the mortgage or loan – under the AJA after *Norgan*⁸³, at the latest, by the end of the mortgage term and under the CCA by the end of any time order that the court might make. Although Shiller does not clearly spell the matter out, the logic of his proposal is that a continuous-workout mortgage would not have a definite term: it could be a lifetime mortgage.

Is the possibility of a lifetime mortgage an insuperable barrier to moving towards Shilleresque type mortgages? Lifetime mortgages are now an established part of the UK mortgage market for those over 60 and are indeed now regulated by the FSA. The basic principle of the lifetime mortgage is that the borrower makes no monthly payment of interest and principal; the interest is added on to the principal and the lender sells the property on the death of the borrower to recoup its loan. But there is no principle and no practical reason why a lifetime mortgage should not start at an earlier point in life with interest and the repayment of capital being repayable monthly as with a mortgage with e.g. a 30 year term. There could be a term in any such mortgage that at any time after the mortgagor reaches the age of 60, subject to there being sufficient equity in the property the subject of the mortgage, interest could begin to be rolled up into the principal sum lent. Clearly, a mortgagor who had had during the currency of such a mortgage to reduce payments below the agreed level, i.e. had ‘gone into arrears’ in the current system, would have more difficulty in transferring to a rolled-up interest mortgage than one who had not gone into arrears or had made up all arrears but such details would not seem insuperable to overcome.

⁸³ *Cheltenham and Gloucester Building Society v Norgan* [1996] 1 All ER 449

Shiller has not considered another possibility which, it could be argued, is, if not implicit, then a possible corollary of a continuous workout mortgage; a portable mortgage. If one has a continuous workout or a flexible lifetime mortgage, then there seems no prima facie reason why when one wishes or is obliged to move or wishes to purchase alternative accommodation, one should have to end one mortgage and commence another one. Such a process allows both lenders and a variety of professional and sub-professional personnel to levy fees for work done or claimed to have been done in connection with ending one and commencing another mortgage but apart from that not very persuasive argument for such mortgage transactions, what value added is there for mortgagors? What disadvantages would there be for mortgagees? There is no suggestion that portable mortgages would become obligatory so that mortgagees would be stuck with unsatisfactory borrowers; only that portable mortgages should become a normal and usual part of the mortgage market. Portable mortgages would be of considerable benefit to borrowers; they would reduce financial costs associated with moving or buying a new home; they would reduce the time and anxiety associated with obtaining a mortgage; allied to a lifetime flexible payment mortgage, they would assist in the planning and payment of long-term financial commitments.

It seems that little thought has been given by the CML, its constituent members, the FSA or the government to seeing the collapse of the mortgage market and the rapid rise in arrears and repossessions as an opportunity and challenge to rethink the mortgage and adapt it to be an institution more specifically geared to the needs of borrowers in a very different economic financial and social climate than that which has been in existence for the last 50 odd years. The concern of all parties is to get the mortgage market working again; to help the producers with large amounts of money and various guarantees – as suggested by the producers. It may be suggested that equal attention should be paid to the product from the point of view of the consumers and whether, given the product's current configuration and operation, it needs a fundamental retooling for the future; and that the producers themselves cannot be left to determine whether and how this should be done.

F. Conclusion

The government has accepted that it is obligated to rescue the banking system from its near collapse brought about by irresponsible borrowing and other financial malpractices by bankers. It has belatedly recognised that bankers took advantage of light touch regulation which they were so eager to espouse and then abuse. The

effects of this near collapse of the financial system has been the collapse of the mortgage market, and the very sharp downturn in the economy.

No-one doubts that banks must be recapitalised and that the government is the only source of the necessary finance at present. The government however is not the real source of the necessary finance: that is the taxpayers who are also, as workers and homeowners, having to bear the brunt of the cost of bankers' hubris and incompetence. Compared to the government response to banks' fecklessness, there has been a very inadequate government response to the human costs of the economic and financial collapse they have brought about: the rapidly rising toll of repossessions amongst the consumers of mortgages: 45,000 in 2008; expected to be 75,000 in 2009. This inadequate response advertised by the government as "real help for homeowners now" may briefly be recapped⁸⁴:

- A Mortgage Rescue Scheme to assist local authorities buy up to 6,000 homes of those in default and relet them to the sellers will help a mere 5% of those losing or likely to lose their homes last year and this year.
- A Homeowner Mortgage Support Scheme announced in December 2008 to provide government support to lenders to enable them to offer those in financial hardship relief from mortgage payment for up to two years has yet to take off as the details are still being negotiated. It will in any event be voluntary for lenders to join the scheme.
- A Mortgage Arrears Protocol, a form of semi-official guidance to lenders to be nice to borrowers in default as they take them to court which is not worth the paper it is written on as there are no sanctions behind it.
- Free legal aid for those taken to court on repossession actions.
- An anodyne statement from the Ministry of Justice on the *Horsham Properties* case making plain that no alteration of the law in the light of that case is in prospect. Lenders so minded to will still be able to avoid the courts when seeking to take possession of a borrower's home.
- No indication from the FSA that it is going to assert greater supervision over the terms and conditions of mortgages to prevent cross-subsidisation or over mortgage brokers and other intermediaries to tackle unfair selling of mortgages to subprime borrowers.

⁸⁴ See direct.gov.uk/mortgagehelp advertised in The Guardian 2 March 2009.

Contrast this with ‘real help for bankers’. The government is to support the mortgage market by guaranteeing the interest and principal on residential mortgage backed securities and covered bonds – a recommendation of Crosby. Miles too recommended that the government provide certain guarantees to facilitate the development of fixed interest rate mortgages which would, inter alia, make monetary policy easier to manage. Compared to the billions of pounds being put into the banks and the billions of pounds of toxic debts being guaranteed by the government which will help keep bankers in their jobs, the amount of money the government is putting into rescuing mortgagors in difficulties to keep them and their families in their homes is tiny; yet the social dislocation caused by repossessions is huge and will only get worse as time goes on. Local governments and organisations like Shelter will be expected to pick up the pieces.

Yet, as suggested above, a relatively minor and immediate reform of the law on repossessions and arrears – all mortgagees required to seek court orders for possessions; courts empowered to make time orders with respect to all mortgages extending the length of the mortgage term with perhaps a presumption that that should take place on possessions actions subject to a limited number of exceptions – could bring immediate relief to thousands of homeowners and their families. A more extensive reform which could be considered is the cramdown approach proposed in the US where courts are to be given the power to modify first mortgages on homes, i.e. reduce the amount payable as part of a general reorganisation of a defaulting mortgagor’s finances. If it thought necessary to guarantee the ultimate repayment of the full mortgage, the government could step in and guarantee the difference between the full payment and the amount the court orders a mortgagor in arrears to pay.

For the longer term and as part of a general plan to revive the economy and the mortgage market, the government should commission the Law Commission or the FSA or preferably the two together to review the whole of the law of mortgages – both public and private law – in the light of the operation of the mortgage market over the last 10 years, recent reports on mortgage finance and suggested innovations in mortgage products and prepare a comprehensive report and draft Bill to provide the legal framework for a mortgage law for the 21st century which will hold a more even hand between producers and consumers than does the current law and practice.