Mortgage regulation

Response by the Council of Mortgage Lenders to the HM Treasury consultation paper

Introduction

1. The Council of Mortgage Lenders (CML) is pleased to respond to the HM Treasury consultation paper on Mortgage regulation published in December 2009. The CML is the representative trade body for the residential mortgage lending industry. Our 110 members currently hold around 94% of the assets of the UK mortgage market and include commercial banks, mortgage banks, building societies and specialist lenders.

Background

2. In so far as the proposals on buy-to-let regulation are concerned, this consultation about new mortgage regulation needs to be read in conjunction with two subsequent government papers on the private rental sector published this month – Investment in the UK private rented sector by the Treasury and The private rented sector – professionalism and quality by the Communities and Local Government Department.

3. The latter two papers both highlight the importance of encouraging participation by good quality landlords, but the Treasury also explicitly recognises that increased regulation has deterred investment in the private rental in the past (and yet this paper suggests more mortgage regulation is necessary, which risks making the same mistake again).

4. It is not entirely clear whether these respective consultation papers – specifically the mortgage regulation proposals discussed below – paint a consistent and coherent picture of government’s policy to enhance the private rented sector as a means of delivering choice for consumers with a variety of housing needs.

5. This response should also be read in conjunction with our more detailed views on the Financial Services Authority’s (FSA) discussion paper 09/3 on the Mortgage Market Review (MMR). In this paper, we highlight that any regulation is only as good as the regulator which oversees the rules, and highlight a number of steps where we welcome the FSA’s reform agenda to enhance its supervision of firms.

6. However, decisions on broadening the scope of the regulator should, in our view, only follow proper assessment of whether intervention is the appropriate and proportionate response, and only if there is market confidence that the FSA will fulfil its regulatory role effectively in the future. Otherwise, there is no real benefit to consumers, but there are real costs of implementation of change for businesses.

7. We make the point that the “new” FSA is re-shaping the financial services market as a whole, and the MMR is only one important piece of the jigsaw. However, we believe that some of the regulatory approaches set out in the paper can only work if the FSA has a wider scope before the MMR proposals are implemented, and this influences our approach on arrears and possessions measures (where the existence of purchasers of mortgage books outside the regulatory framework creates real risks to borrowers in difficulties).

8. It also influences our views on the workability of affordability measures and income verification where it is seldom the decision on the mortgage alone which leads to economic distress, but rather borrowers use of multiple credit facilities, including debt consolidation and second and subsequent mortgages, or changes in borrowers’ circumstances after the loan is taken out.
9. On the FSA discussion paper, we concluded on proposed scope extensions that we support, in principle, measures to widen scope, other than in relation to buy-to-let lending where we suggested that a convincing case has not been put forward on why consumer-focused mortgage regulation should apply to what is essentially a commercial investment decision. For completeness, the annex to this response is a copy of the relevant extract from our response to the FSA.

10. The broad intention reflected in the consultation paper is to widen the FSA’s regulatory scope without making the changes retrospective in effect, so a key transitional issue not addressed in the HMT consultation paper or the FSA discussion paper will be how to manage parallel regulatory regimes with different consumer protection measures in place (particularly in relation to second and other secured mortgages). This should be a core element of the FSA’s plans to ensure consumer protection is maintained, and to avoid regulatory duplication or gaps between regulators.

Executive Summary

(a) Regulation of second-charge mortgages

11. The CML agrees with the analysis of the second-charge market and supports Option 2 in the paper to extend FSA regulation under the existing mortgage regime with a carve out from the scope of consumer credit regulation and oversight by the Office of Fair Trading. This has been the CML’s longstanding position since before MCOB, as it would ensure comparable and appropriate treatment of all secured borrowers without lowering the level of consumer protection.

12. The extension of scope to second-charge lending would create a coherent and comprehensive regulatory framework for all secured loans that is also more aligned with EU regulation. It would also help to reduce the opportunity for “gaming” between first and second-charge lending processes.

13. However, we are concerned about the impact on business lending secured on residential properties (particularly residential care homes and holiday rental homes) and low-cost home-ownership schemes, such as Homebuy Direct. Generally, local authorities and housing associations would be exempt thereby excluding purely government schemes but, as drafted, it is likely that private developers would be caught by the new provisions. The impact of the scope extension on Low-Cost Home-Ownership needs to be properly considered in the legislation, before the FSA develops the technical detail of regulation.

(b) Regulation of buy-to-let mortgages

14. We are unconvinced by the arguments that Treasury has put forward for regulating buy-to-let mortgage transactions through conduct of business rules. We do not believe that FSA regulation of the mortgage decision will mitigate the risks of market failure, nor address the concerns raised about information asymmetries between lender and borrower, nor the “negative externalities” set out in the evidence base for the proposal such as those stemming from fraud.

15. If the aim is to enhance consumer protection, when lenders in the buy-to-let market view it as a commercial business decision by the borrower, it is important to identify where the potential detriment arises. Arguably, it is the decision to invest in residential property which is the trigger, not the decision on how to finance the transaction by a mortgage.

16. Both the Treasury and FSA fail to set out how they would regulate the advice to consumers to invest in property, given by organisations such as property investment clubs, when it is poor advice which we believe has been at the centre of many of the causes of detriment arising in recent years (but these investment advisers are not even mentioned in the consultation paper as a key cause of past market failures).

17. The option of regulating the investment decision is not mentioned as an option in the paper, which we believe is an oversight. Moreover, the linking of the new scope to the definition of “regulated mortgage contract” seems to preclude FSA investment based regulation in the future.

18. As stated in paragraph 9.28 of the MMR discussion paper, a key consideration if the proposal is to proceed would also be defining the characteristics of investors that the government in fact want
to “protect” to ensure that regulation is not applied more widely to commercial businesses. However, based on the Treasury proposal, it is simple to avoid regulation by setting up a company, so we are not sure that even “consumers” who are investing will necessarily be protected if this scope extension proceeds as drafted.

19. There is a second regulatory purpose of buy-to-let regulation which is prudential, to ensure buy-to-let lenders do not represent any systemic risks. We believe that this is a relevant area to review further but it seems to have limited relevance as few firms operate outside of FSA regulation at present, and other financial stability measures may be more appropriate than seeking to regulate some buy-to-let businesses for some buy-to-let transactions as proposed.

20. Fundamentally, the CML still believes that buy-to-let loans are essentially commercial transactions with an investment dimension, and should not be subject to retail mortgage regulation. Inappropriate regulation could further damage buy-to-let lending, which has shrunk substantially in the last two years, at a time when the government is separately promoting investment opportunities in the private rental sector. Extending the FSA’s scope as proposed would undermine the government’s wider housing policy.

21. Moreover, despite all of the debate so far, we are yet to identify a viable definition of a “consumer” in a buy-to-let transaction who should be protected in the way proposed, without catching other commercial transactions inadvertently.

(c) Protecting borrowers when mortgages are sold on

22. The CML supports the Treasury’s proposal and definition of “managing” a regulated mortgage contract. We believe that the purchase of mortgage books by unregulated entities does have the potential to cause detriment to their borrowers, which requires a regulatory intervention and extension of FSA scope.

23. However, it should only apply where those purchasers of mortgage assets can have a material impact on the consumer through day-to-day decisions on the interest rate, other charges, service levels and arrears and possession management. Alternatively, where purchasers have waived or delegated to their servicer or administrator the power to exercise these rights they should not be subject to regulation where the servicer is regulated for these purposes instead.

24. The principle that only one firm should be regulated as “manager” is paramount.

25. Moreover, legal advice should be sought to seek reassurance that the regulatory change to the statutory definition does not adversely impact on existing funding structures that require mortgages to be sold to a separate legal entity such as a special purpose vehicle (SPV) in the case of securitisation and limited liability partnership (LLP) in the case of covered bond transactions.

Response to the consultation paper

26. We are committed like the government and the FSA to ensure that mortgage markets in the UK are fair, stable, efficient, flexible, sustainable and innovative. However, we have a different vision of what measures are needed to achieve these outcomes for consumers and the industry, as our response to the FSA discussion paper on the MMR articulated in detail.

27. We agree that the regulatory structure should be robust and responsive, and have welcomed a more intensive and intrusive FSA. Effective supervision would go a long way to address the perceived market failures identified in the consultation paper and the MMR.

28. As noted in our recent release on arrears and possession trends in 2009, we are working very closely with the government and advice agencies to help customers through short-term financial difficulties. And we share the goal to put in place a stable and sustainable framework, or safety net, for mortgage borrowers who get into difficulty.

29. As part of this shared commitment with government, we believe there is a compelling case for an extension of the FSA’s scope as we describe in this response below.
(a) Regulation of second-charge mortgages (Chapter 2)

30. We support the FSA regulating second-charge loans under MCOB (as amended) rather than Consumer Credit Act provisions (our policy position since 1999).

31. The HMT's own analysis of the second-charge mortgage market is that it is often used by debt-hungry consumers for consolidation purposes, in particular by borrowers with impaired credit records. This is an element of the market which rightly is a cause of concern if borrowers are acting irrationally, but by no means the whole picture. We continue to advocate that the FSA should regulate second charge mortgages because the serious impact of failing to pay the loan is the same as for first charge mortgages – the borrower's home is at risk. From an industry perspective, a single regulatory structure rather than multiple regulators also simplifies compliance processes.

32. The table below, compiled by White Horse Mortgage Services (who provide debt counselling services to customers in arrears on behalf of lenders) has been produced following interviews with 21,500 borrowers throughout 2009 and outlines the primary reasons for falling into arrears on their first-charge mortgage.

### The whole of the UK 2009

**Economic (Outside influence of borrower)** 59.71 %
- Unemployment Resolved 9.04 %
- Unemployment Unresolved 13.76 %
- Reduced Income Now Resolved 16.08 %
- Reduced Income Unresolved 20.83 %

**Lifestyle (Under direct control of borrower)** 23.12 %
- Over Indebtedness Now Resolved 2.11 %
- Over Indebtedness Unresolved 3.23 %
- Financial Mismangement 17.78 %

**Personal (Circumstances suffered by borrower)** 17.17 %
- Relationship Breakdown 7.96 %
- Ill Health - Recovered 4.02 %
- Ill Health - Long Term 5.15 %
- Other Reasons 0.04 %

Source: With kind permission of White Horse Mortgage Services Ltd, February 2010, Bulletin [pre-publication version]

33. The majority of borrowers fell into arrears for reasons beyond their control (either changes in economic or personal circumstances). However, some 23% of those interviewed cited that over indebtedness, or financial mismanagement as the primary reason.

34. In its MMR discussion paper, the FSA states that following analysis of number of repossession cases some 88% of participants had additional secured lending beyond their original first-charge mortgage. Therefore, it is likely that those individuals that cited over indebtedness as the primary reason for falling into arrears on their first-charge mortgage will be as a result of having further secured and/or unsecured debt.

35. In our response to the MMR, we state that the changes the FSA are proposing around the income verification and affordability assessment will be relatively meaningless unless second-charge mortgages are under the same regulatory regime as first-charge lending. A view that the FSA itself shares, as outlined by Jon Pain, Managing Director, Supervision in a speech last July, when he said:

"We know the reason some consumers fall into arrears is because of the overall level of debt secured against their home, including second charges. In order to truly keep sight of affordability, responsible
lending and overall indebtedness, we are asking whether we need to consider extending our regulation to these markets… So, as part of the review, we will consider whether FSA regulation should be extended to cover second charges. Because ensuring consumers are suitability protected – not over leveraged – might be better achieved if we had mortgage regulation covering first and second-charge mortgages on a consumer’s home.”

36. We agree with the FSA’s analysis, and therefore believe that for consumer protection purposes the FSA’s scope should be broadened to include second charge lending to individuals.

37. Looking beyond the primary aim of consumer protection, the CML believes that the are numerous advantages to FSA regulation of second-charge lending and these include:

- Simplification of training and application systems for lenders, resulting in cost savings over the longer term.
- More coherent lender practice across all secured lending, together with common regulatory parameters, lessening the potential for confusion amongst consumers, advisers and lenders themselves.
- The application of the MCOB rules to second-charge lending, which the CML believes would create a level of consistency and clarity that would be more cost effective approach to regulation and beneficial to consumers.
- Creation of a regulatory structure that more closely aligns with that in Europe. The EU Commission distinguishes between secured and unsecured lending for regulatory purposes, and this creates anomalies and uncertainty in translation of EU legislation into UK law. The implementation of the Consumer Credit Directive into UK law illustrates this problem well.

38. A number of our members provide second-charge business loans against residential property to directors or owners of companies, we are particularly concerned about the impact on business that are based in residential properties such as care homes and holiday parks. Whilst it is clear from the draft that the revised definition of a regulated mortgage contract (see below) is limited to those undertaken by an individual, it is essential that the government ensures that the drafting does not inadvertently capture commercial lending. We understand that the British Bankers’ Association response to this consultation paper will include more detail in this area.

39. Having said this, if an individual enters into a second charge mortgage, and in fact uses the loan for business purposes outside the knowledge of the lender, we believe that this is, and indeed should be, captured by the extension of the scope of mortgage regulation.

40. We are concerned about the impact on low-cost home-ownership schemes, particularly, shared equity, such as HomeBuy Direct. Generally, we believe that local authorities and housing associations are likely be exempt thereby excluding purely government HomeBuy schemes, but as drafted it is likely that private developers’ schemes would be caught by the new provisions. The impact of the scope extension on Low-Cost Home-Ownership needs to be properly considered in the legislation, before the FSA develops the technical detail of regulation.

41. Finally, there are a number of other reasons why second and subsequent charges may registered against a property that could be unintentionally captured in the expanded scope of FSA regulation, these include (but are not limited to) charges to:

(a) Secure repayment of legal aid;
(b) Repayment of right-to-buy discount; and
(c) Family members who have, for example, provided the deposit for purchase.

It may well be that the proposed revised definition of regulated mortgage contract would exclude these broader uses of second charges, but the Treasury should be mindful of such complexities.

**Question 1: Do you agree with the analysis of the second-charge mortgage market?**

42. We broadly agree with the analysis of the second-charge mortgage market linked to the FLA data in the consultation paper. We believe that the full picture of the second-charge market,
incorporating non FLA members, shows a higher level of possessions, and we note the anecdotal feedback to the Treasury Select Committee that arrears management process are worse among second-charge mortgage lenders. It is clear that the credit crunch has impacted disproportionately on the number of lenders and amount of lending done in this sector over the last two years, which is regrettable.

**Question 2:** Do you agree that extending the scope of FSA mortgage regulation to include the second-charge mortgage market would support the Government’s objective of ensuring a fair, stable and efficient market for second-charge mortgages?

43. Yes. The CML is advocating that the inclusion of second-charge mortgage regulation by the FSA should be under the MCOB regime. Clearly this will incur a cost to the industry, but we believe that the benefits outweigh any costs, and do not see the change damaging the long-term functionality of the market. It would be better than ongoing liaison between the FSA and OFT which has not demonstrably succeeded in delivering consumer protection in recent years.

**Question 3:** Do you consider that any further action would be necessary in order to ensure that any transfer of responsibility for regulating second-charge mortgages from the OFT to the FSA would not result in a loss of consumer protection?

44. We strongly believe that a single regulatory regime under MCOB would benefit consumer protection, and there is no need to import consumer credit measures in addition to the MCOB framework. We do not see the benefits of transferring the responsibility of mortgage regulation to a single regulator would be delivered if it operated two different regulatory structures (i.e. MCOB and CCA regulation).

45. The transitional arrangements under which some loans would continue to be CCA regulated until replaced by a new regulated second-charge mortgage would need careful consideration, but we are not convinced that it would be proportionate to require existing second-charges to be restructured as MCOB regulated loans. Similarly, this short-term risk of confusion does not persuade us that the change of scope is not appropriate for longer-term regulatory and business reasons.

**Question 4:** Do you believe there are any other ways to mitigate the potential future risks posed by second-charge mortgage markets?

46. We have no other points on this aspect.

**Question 5:** Do you agree with the costs and benefits of the options under consideration in relation to second-charge mortgages, as set out in the Impact Assessment?

47. We believe that the costs associated with expansion of the scope of the FSA’s mortgage regulation to include second-charge mortgages are offset by the benefits to both consumers and lenders.

**Question 6:** Do you agree that FSA regulation of second-charge mortgages should be limited to lending to individuals and trustees?

48. We believe that the proposals in the consultation paper should limit regulation to cover consumer and not commercial transactions. Small and medium-sized firms will sometimes use second-charge mortgages secured against the residential property of the individuals that own, or part own the business. Where these mortgages are applied for in the name of the business, they will be a commercial loan and will be underwritten based on an understanding of the business's ability to service the debt.

49. The revised wording of a regulated mortgage contract is targeted at individuals and we believe that the exclusion of business loans needs to be more clearly expressed. For example, the amended definition of a regulated mortgage contract could be revised to exclude second or subsequent charge mortgage secured against a residential property for business purposes.
Question 7: Do you agree that the proposed new definition of a regulated mortgage contract would include second-charge mortgages and continue to include first-charge residential mortgages in its scope?

50. As currently drafted, the definition of a regulated mortgage contract would seem to capture the first-charge mortgage as well as any second or subsequent mortgage charges.

Question 8: Do you agree that the regulated activities in relation to regulated mortgage contracts should apply to second-charge mortgages?

51. We agree that the regulated activities should also apply to second-charge mortgages, but would wish to await the FSA’s consultation paper before reaching a final conclusion on this aspect.

Question 9: Do you agree that the exemptions and exclusions that apply in relation to regulated mortgage contracts are appropriate for second-charge mortgages?

52. We agree in principle, but would wish to await the detailed FSA consultation paper before reaching a final conclusion on this.

Question 10: Do you agree with the proposed arrangements for dealing with second-charge mortgages entered into before the date specified in the draft order?

53. The consultation paper is relatively silent on the transitional arrangements from a CCA/OFT regime to the MCOB/FSA. However, we believe that this question highlights the key transitional issue, which is how firms and the regulators will manage two parallel regulatory regimes with different consumer protection measures in place.

54. Whilst we are not necessarily advocating that firms should be required to retrospectively apply new regulatory requirements onto existing books, some lenders may choose to migrate customers from one regime to another for ease of ongoing management. The transitional arrangements should allow for this level of flexibility.

(b) Regulation of buy-to-let mortgages (Chapter 3)

55. The decision to consider the extension of regulation to buy-to-let has been driven by perceived shortcomings in the buy-to-let market. In particular, the consultation paper characterises buy-to-let mortgages as high risk.

56. However, this is not supported by the evidence in our view. In fact, buy-to-let loans have out performed residential loans in respect of arrears and possessions for 10 of the last 12 years. Latest CML data for 2009 suggests that the performance of buy-to-let lending is again improving relative to the mainstream mortgage market.

Buy-to-let arrears vs. whole of market

![Graph showing buy-to-let arrears vs. whole of market]

Source: CML
The consultation paper suggests that an unregulated buy-to-let mortgage market poses risks both to consumers and to financial institutions. We do not believe that the Treasury has demonstrated that buy-to-let mortgages per se have created consumer detriment, but feel there is a much more convincing case for believing that poor investment decisions by some investors, often advised by unregulated property investment clubs, have been the source of much of the detriment in the market.

Equally, while the consultation paper highlights the risk to financial institutions from buy-to-let, it must be remembered that the overwhelming majority of lenders active in the buy-to-let market are already prudentially regulated and supervised by the FSA. If this supervision has failed to prevent a small minority of regulated firms taking unjustified risks, then the FSA is right to reconsider its supervisory approach rather than seek to extend the scope of conduct of business regulation.

We believe that the right way to address the risks that firms are running is through appropriate capital requirements, and more intensive supervision, rather than through new consumer-facing mortgage regulation, which tends to limit competition, curtail consumer choice, and increase the costs of borrowing (at a time when mortgage rationing has already had a number of these impacts and the objective should be to reverse the trend rather than accentuate the current market direction).

The CML continues to believe that buy-to-let loans are commercial transactions with an investment dimension, and that applying consumer regulation to the loan is therefore inappropriate. Landlords are engaging in a business activity with significant legal obligations (as reflected in the CLG paper promoting professionalism and quality in the private rented sector). Survey data shows that the majority of landlords have at least five years’ experience. This proportion is expected rise as the market matures.

Within the UK, the private rented sector (PRS) plays an increasingly important role in facilitating labour mobility, and in meeting the needs of those for who home ownership or social renting are inappropriate or inaccessible for some or all of their lives. Buy-to-let investment in the PRS sector has allowed the tenure to grow significantly over the past fifteen years, and buy-to-let funding is also believed to have contributed to a marked improvement in property condition (as the separate Treasury consultation paper on promoting investment in the private rental sector highlights).

Going forward, buy-to-let finance is likely to remain the predominant funding for future expansion. Institutional investment can make a useful contribution in certain niche sub-markets such as student accommodation, but commentators agree that the low returns on corporate investment will mean that it is unlikely to make a major investment contribution to the mainstream rental market.

Outstanding buy-to-let borrowing now stands at over £140 billion, and has facilitated a still larger investment in the PRS. This is over twice the £60 billion private finance supporting the social rented sector; itself rightly seen as a major success in terms of private investment in housing. Government needs to be concerned about the risk that interventions that raise costs to buy-to-let landlords may, at the margin, reduce the appetite for further investment in the PRS, and the availability of choice in housing tenure for consumers.

The increase in the cost of finance caused by the introduction of consumer regulation into this commercial market, and the additional bureaucracy associated with gaining access to finance, when taken alongside other proposed regulation of landlords, could be deterrents to further investment at a time when the PRS needs to grow steadily. History shows that such interventions deter ongoing investment, and this cannot be a risk worth taking when the government is so reliant on private sector support to help deliver its various housing policies.

Regulation always has a price in terms of costs, and some curtailing of innovation and product choice. In the case of buy-to-let, countervailing benefits in terms of consumer protection are not clear nor demonstrable.

Question 11: Do you agree with the analysis of the buy-to-let mortgage market and the risks of market failure?

The consultation highlights the risk that problems in mortgage markets can pose to financial institutions and the wider financial system, citing recent events in the US sub-prime mortgage market.
It also highlights the risk of “market failure” in the buy-to-let mortgage market that could stem from fraud, the sale of unsuitable mortgage products to buy-to-let borrowers, and the adverse impact of poor lending decisions on tenants.

68. Whilst we agree with the analysis that mortgage markets can have negative effects on other markets, we do not see strong evidence that the UK buy-to-let mortgage market has been the source of market failure. The arrears performance of the buy-to-let market has been superior to that of the mainstream market in 10 of the last 12 years of published data. Rising arrears and repossessions is to be expected in an economic downturn, and thus not necessarily an indication of market failure.

69. The consultation also raises the issue of gaming, with a concern that poor quality lending might migrate to segments where standards are lower because of an absence of regulation. We agree that gaming is a risk and would point out that it is a feature even of regulated markets where, for example, a borrower can achieve their objectives by borrowing through one market to circumvent rules in another.

70. The willingness of some consumers to engage in gaming is the reason that we believe regulation of specific lending markets should not be overly prescriptive.

71. The evidence base in Annex B for the case for regulation of buy-to-let needs careful consideration. It is suggested that there is evidence of information asymmetries and negative externalities in the market, but are these features of the buy-to-let mortgage decision, and can they demonstrably be addressed by the extension of conduct of business rules as suggested in the paper? We believe the answer is “No”.

**Question 12: Do you agree that FSA regulation will mitigate the risk of market failure in the buy-to-let mortgage market?**

72. The consultation does not make the case for how the proposed regulatory solution of bringing buy-to-let lending into the MCOB regime would address the market failures that are identified. Regulation under MCOB cannot be expected to address the market’s systemic implications, fraud or indeed necessarily the level of repossessions, which can result from a range of factors including poor choice of property purchased or tenant arrears.

73. The proposals for requiring all buy-to-let lenders to be prudentially regulated by the FSA are more relevant to the analysis of market failure. However, the overwhelming majority of buy-to-let lenders have been FSA regulated since 2004, and this did not prevent some poor outcomes at a small number of regulated firms.

74. The consultation paper states that evidence of market failure in the form of “imperfect information” can be inferred from higher arrears and repossessions. In the impact assessment it states “increased levels of arrears and repossessions in the buy-to-let mortgage market suggest that borrowers have not purchased suitable products”. It continues “a number of the drivers of increased arrears and repossessions highlighted in HM Treasury’s consultation (exaggerated effect of interest rate changes, non payment of rent, structure of property portfolios) suggest that borrowers have not understood the risks presented by buy-to-let mortgage borrowing.”

75. The evidence actually shows low level arrears in the BTL market for the last decade and a spike in a recession (now being reversed) cannot simply be laid at the door of the mortgage decision. This is overly simplistic, and ignores the fact that it is the decision to invest in residential property rather than the mortgage choice which may have been unsuitable for a small minority of investors.

76. Addressing “understanding of risk” about the investment or the assertion that some consumers had “imperfect information” cannot be addressed in the mortgage choice, as it is relevant to the investment advice and controls in place at this preliminary stage of the transaction.

77. We see no evidence that buy-to-let borrowers took on unsuitable mortgage products or that particular features of their mortgage contracts have been the source of any difficulties they have subsequently experienced. An unprecedented financial crisis and the deepest recession since the second world war would seem like far more plausible explanations for the increase in arrears and repossessions.
78. Indeed, the concerns that have been expressed about the buy-to-let market have focused on completely different issues; most prominently on property investment decisions made by inexperienced investors and saturation of supply in some inner city areas. Complaints about the mortgage products buy-to-let borrowers have taken out do not seem to figure in analyses of the shortcomings of the market over the past few years.

79. The consultation paper also identifies market failure in the form of three negative externalities; the impact of repossession on tenants; the costs of fraud and the systemic risks posed by buy-to-let lending.

80. The cost of fraud and systemic risk are prudential issues that we believe would not be addressed through the regulation of buy-to-let under MCOB. Thus we believe it appropriate that a review of prudential regulation is carried out. Prudential regulation should be focused on ensuring that individual lending institutions are not taking excessive risks or leaving themselves vulnerable to fraud and thereby wider posing systemic risk. However, conduct of business measures would not stop determined fraudsters, and there are a range of other measures being pursued by the FSA and firms to ensure systemic risks are avoided in the future.

81. Concern is raised about the position of tenants. In fact, tenants in BTL transactions are fully protected in the event of a default by landlords. It is the position of unauthorised tenants which needs to be addressed, and is to be enhanced by the legislation currently proceeding through Parliament. This negative externality is irrelevant to the case for BTL regulation.

82. So we fundamentally disagree with the conclusion that these factors, or alleged or possible market failures, justify the regulation of the buy-to-let mortgages as stated in Annex B.

83. **Question 13: Do you agree with the costs and benefits of the options under consideration in relation to buy-to-let mortgages, as set out in the Impact Assessment?**

84. We believe that the cost estimates outlined in the impact assessment are reasonable ranges for the likely cost of implementation, drawing on figures related to the implementation of FSA regulation in the owner-occupied mortgage market.

85. However, the estimate of benefits is entirely unrealistic. The impact assessment provides a range for the average annual benefit from zero to £414.8m. The upper boundary of this range is calculated by taking the number of buy-to-let repossession in 2008 multiplied by the average outstanding balance on a buy-to-let mortgage.

86. Firstly, based on information provided by our buy-to-let members, we estimate that the average cost to a lender of repossessing a buy-to-let property was more like £20,000 in 2009, compared to the figure of £122,000 used in the impact assessment. Second, by using the number of repossession for 2008 (3,400), the impact assessment is likely to exaggerate the typical level of repossession per annum as this number reflected the effect of the financial crisis and recession.

87. Third, there is no basis for the view that regulation could reduce repossession to zero. Using the impact of FSA regulation on the owner-occupied mortgage market as a benchmark, the number of repossession has risen every year since regulation was introduced in 2004. Although it is extremely difficult to estimate a counterfactual case without regulation, it is difficult to see how it could be argued that regulation would have more than a limited effect on the number of repossession, with say an upper estimate of 10%.

88. Using more realistic numbers for the upper boundary of benefits (10% of annual average repossession of 2,000 with an average loss of £20,000) would suggest total benefits of not more than £4m.

89. However, even this smaller benefit is questionable. The impact assessment assumes that each repossession prevented by regulation will provide a saving to the lender. In reality this is unlikely to be the case, since it is not the act of repossession that causes a loss, but borrower default coupled with a shortfall in the property value. If regulation delays repossession in some cases it could increase lender losses. But as many lenders already conduct their buy-to-let lending as if it were
regulated, the likely benefits of regulation under MCOB compared to maintaining the existing situation is likely to be smaller still.

90. For the reasons outlined above, we are also unconvinced of the key non-monetised benefits highlighted in the cost benefit analysis (reduced risk posed by the buy-to-let market to financial stability and improved outcomes for lenders and consumers).

91. **Question 14:** Do you agree that FSA regulation of buy-to-let mortgages should be limited to lending to individuals and trustees?

92. The proposed extension of mortgage regulation to include buy-to-let is designed to extend the protection of a regulated environment to buy-to-let borrowers. This would treat buy-to-let borrowers as consumers rather than individuals entering into commercial or business transactions.

93. We do not believe that it would be appropriate to extend such consumer protection to corporate bodies. Neither do we believe that experienced buy-to-let landlords or those with larger property portfolios require the same consumer protection. Therefore, if the Treasury decides to broaden the scope of regulation to buy-to-let, we believe that it should be limited to lending to individuals and trustees and exclude cases where the individual could be classed as a professional landlord, by for example deriving the majority of their income from rented property.

94. **Question 15:** Do you agree that the proposed new condition relating to the use of the property as a dwelling would include buy-to-let mortgages and continue to include residential mortgages?

95. We agree that the proposed new condition relating to the use of the property as a dwelling would capture buy-to-let mortgages and would continue to include residential mortgages.

96. **Question 16:** Do you agree that the regulated activities in relation to regulated mortgage contracts should apply to buy-to-let mortgages?

97. If buy-to-let mortgages become FSA regulated, we agree in principle that the corresponding regulated activities should apply to buy-to-let mortgages. But, we would wish to await the detailed FSA consultation paper before reaching a final conclusion on this.

98. **Question 17:** Do you agree that the exemptions and exclusions that apply in relation to regulated mortgage contracts are appropriate for buy-to-let mortgages?

99. As stated above, we believe that the exemption of corporate bodies is appropriate, but that professional landlords who chose to run their businesses in their own name are equally deserving of exemption as they are experienced commercial operators with no need for consumer protection.

(c) Protecting borrowers when mortgages are sold on (Chapter 4)

100. **Question 18:** Do you agree with the analysis of potential consumer detriment in the market for the onward sale of mortgage books?

101. We accept that a purchaser of a mortgage book which has the authority to alter interest rates or charges or to alter arrears management or the level of service standards will be in a position to create consumer detriment. Having said that, we are not aware of any cases where mortgage book purchasers have acted in a fashion that has altered the offering to the customer in a way that has caused consumer detriment.

102. While unregulated firms are not bound by the FSA's requirements which apply to authorised firms, they are subject to the unfair terms regulations and to common law principles related to fairness. Moreover, the pre-action protocol for mortgage repossession cases adopted in October 2008 (which overlaps in a number of respects with the FSA's standards as set out in MCOB 13) applies to repossession cases involving unregulated firms.

103. The suggestion is that the lack of regulation of mortgage purchasers in general may be a factor in the decision by unregulated firms to purchase mortgage books. The evidence for this
proposition is not set out and, as noted above, unregulated firms are subject to consumer fairness related standards and requirements which meaningfully restrict (amongst other things) interest rate setting and changes to charges. As such, it seems unlikely that unregulated firms would be motivated to purchase mortgage books on the basis suggested.

104. If mortgage book purchasers are to become subject to regulation, it is important that the regime they are subject to is proportionate and does not stifle the market for sales of mortgage portfolios. By enhancing liquidity in the mortgage market, and enabling lenders to exit the market if their circumstance change and they want or need to monetise their mortgage book, the sales market serves an important economic function. The sale of a mortgage book from a lender whose circumstances have adversely changed to a purchaser on a firmer financial footing will often protect consumer welfare by ensuring that the owner of the mortgage book remains financially secure.

105. **Question 19:** Do you agree that borrowers should continue to benefit from the protection of FSA regulation in the case that their mortgage is sold on by their lender?

106. We agree that consumers should continue to benefit from the protection of FSA regulation when their mortgage is sold. But the regulations need to be proportionate for the reasons given above. Administering a regulated mortgage contract is already an FSA regulated activity and regulatory duplication should be avoided, so a mortgage book purchaser that waives or delegates to the servicer or administrator the power to exercise or to control the exercise of all of the rights of a lender should not be subject to regulation.

107. The regulations also need to be careful not to capture legal owners such as special purpose vehicles (SPVs) which are required for lenders to access funding mechanisms such as securitisation or the covered bond market. The Treasury needs to ensure an effective carve out for such vehicles.

108. **Question 20:** Do you agree with the costs and benefits of the options under consideration in relation to protecting borrowers when mortgages are sold on, as set out in the Impact Assessment?

109. We believe that the cost estimates outlined in the impact assessment are reasonable ranges for the likely cost of implementation, drawing on figures related to the implementation of FSA regulation in the owner-occupied mortgage market.

110. However, the estimate of benefits is entirely unrealistic. The impact assessment provides a range for the average annual benefit from zero to £66m. The upper boundary of this range assumes that £66m of mortgages are sold annually and that, in the absence of regulation, all of the loans are repossessed with the lender losing the entire value of each loan.

111. Using the impact of FSA regulation on the owner-occupied mortgage market as a benchmark, it is possible to arrive at a more realistic upper boundary. The number of repossessions in the regulated mortgage market has risen every year since regulation was introduced in 2004. Although it is extremely difficult to estimate a counterfactual case without regulation, it is difficult to see how, against this experience, it could be argued that regulation would have more than a limited effect on the number of repossessions, with say an upper estimate of reducing them by 10%.

112. If it is assumed, as an upper boundary, that 30% of loans included in mortgage book sales are in serious arrears and face repossession and that 10% of these are saved from repossession by regulation and that losses would have been 50% of the loan amount, the upper boundary on financial benefits is c.£1m per annum (rather than £66m).

113. However, even this much smaller benefit is questionable. The impact assessment assumes that each repossession prevented by regulation will provide a saving to the lender. In reality this is unlikely to be the case, since it is not the act of repossession that causes a loss but borrower default coupled with a shortfall in the property value. If regulation delays repossession in some cases it could increase lender losses.

114. **Question 21:** Do you agree that the proposed definition of “managing a regulated mortgage contract” would include the activities that have the potential to cause harm to borrowers when mortgages are sold on?
115. We agree that the proposed definition of “managing a regulated mortgage contract” would include the activities that have the potential to cause harm to borrowers when mortgages are sold on but as stated above, the regulations must be carefully worded to avoid capturing legal owners such as SPVs.

116. Question 22: Do you agree that a mortgage owner’s ability to delegate this activity to a third party means that only those firms engaging in activity with the potential to cause harm to borrowers will be subject to regulation?

117. We agree with the proposal that only purchasers of mortgage books that have the power to cause detriment to consumers should be required to be regulated. Where those powers have been delegated to the servicer or administrator the owner should not be required to be regulated.

118. Careful consideration needs to be given to SPVs in securitisations, covered bond programmes and similar arrangements. Although they are the legal owner, SPVs typically carry out instructions which are laid down in the initial documentation or delegate powers to a mortgage administrator, either the originator or a third party.

119. Such vehicles are not set up to be decision making bodies but the regulations will have to be careful not to inadvertently capture them under certain circumstances, for example, in the event of the insolvency of the originator, when some decisions made need to be taken. Similarly, if bondholders in such a vehicle are asked to vote to change the transaction’s documentation, this should not trigger a requirement that either the vehicle or the bondholders should be regulated unless there is a clear detriment to the borrower.

120. Question 23: Do you consider that there will be further costs and benefits of the options under consideration when these options are combined, which are not reflected in the Impact Assessments?

121. We do not believe that the combining of these options would have a material impact on the costs and benefits.

Contact

This response has been prepared by the CML in consultation with its members. Comments and queries should be addressed in the first instance to Rob Thomas, Senior Policy Adviser:

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15 February 2010

Annex

Extract from CML response to FSA discussion paper 09/3 on the Mortgage Market Review

Chapter 9: Scope extensions

122. As the government is consulting on scope extensions, the FSA does not ask any questions in Chapter 9. The broad intention is to widen the FSA’s regulatory scope, but not to have retrospective effect, so a key transitional issue will be how to manage parallel regulatory regimes with different consumer protection measures in place.

123. It is right for us to put on record that we support the FSA regulating second charge loans under MCOB (as amended) rather than Consumer Credit Act provisions (our policy position since 1999).
124. We are concerned about the impact on low-cost home-ownership schemes, particularly, shared equity, such as HomeBuy direct. Generally, local authorities and housing associations would be exempt thereby excluding purely government homebuy schemes but as drafted it is likely that private developers would be caught. The impact on LCHO needs to be properly considered before the FSA work through the technical detail of regulation.

125. We are unconvinced and unclear about the Treasury’s arguments for regulating buy-to-let transactions. The aim is, first, consumer regulation. In which case, we would argue the decision to invest in property is the regulatory trigger, not the decision on how to finance the deal by a mortgage.

126. Both the Treasury and FSA fail to set out how they would regulate investment advice to consumers – property investment clubs – who arguably have been at the centre of many of the causes of detriment identified in recent years.

127. It should be noted that our comments throughout the paper are limited to the FSA’s current scope of mortgage regulation and do not apply to any potential or future regime that could include buy-to-let mortgages.

128. There is a second regulatory purpose which is prudential to ensure BTL lenders do not represent any systemic risks. We believe that this is a relevant area to review further, rather than MCOB-like regulation of some consumer-led BTL transactions as we believe the FSA already has sufficient powers in the vast majority of cases.

129. As stated in paragraph 9.28, a key consideration will be defining the characteristics of such investors to ensure that regulation is not applied more widely than necessary.

130. Despite all the debate so far, we are yet to identify a viable definition that would achieve the stated regulatory aims.

131. Finally, whilst we see benefits for requiring all purchasers of mortgage books to be regulated, we do have concerns about how this may impact on current and future securitisation deals. Therefore the wording of the proposed legislation needs to be carefully considered to ensure that it covers only those mortgage book owners that have a material impact on borrowers.