CML news & views

the fortnightly newsletter from the Council of Mortgage Lenders

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Making the price of new homes clearer

- How much is a brand new property really worth? In recent years, discounts and incentives have had the effect of making the real value of new homes less than transparent.
- This is bad news for genuine buyers and for lenders. Buyers may find themselves with a mortgage worth more than the property's value, while lenders may find themselves exposed to fraud and the risk of loss.
- To restore confidence in the new-build market for lenders, the CML is working on a solution that will make the disclosure of incentives and discounts compulsory. This will help to improve transparency and solve the potential problems caused by the current confusing and inconsistent disclosure.
- This will involve changes to the CML Lenders' Handbook (which sets out instructions to conveyancers acting on behalf of lenders), to the RICS Red Book (which sets out instructions to valuers), and to lenders' own mortgage application forms.
- These changes are likely to take effect from this summer.

FLA Treating Customers Fairly (TCF) Conference, 12 February 2007, London

Every company knows they should be treating their customers fairly and most companies are. But how do they do it, and how does this fit with the Financial Services Authority's TCF programme?

Keynote Speaker: Sarah Wilson, Director, Treating Customers Fairly, FSA

Question the FSA and learn from other financial services companies as they prepare to meet the March and December 2008 deadlines.

Full programme and booking details at: www.flaevents.org.uk or call +44 (0)20 7420 9626

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Making the price of new homes clearer

How much is a brand new property really worth? This riddle has been a growing concern to both valuers and lenders for a number of years. The crux of the problem is a lack of transparency on the detail of all incentives offered by the developer to the buyer. Although commonly perceived as a buy-to-let problem, this issue stretches right across the new-build market.

This has led to a disproportionate increase in the number of frauds perpetrated against new-build flats located in city-centres (highlighted in the FSA's *Financial Risk Outlook* in 2008) resulting in increased losses, further undermining lenders' confidence.

This article, by CML senior policy adviser Matt Smith, outlines the issues and the steps that the CML is taking to address them.

The importance of clarity

Valuation is an essential aspect of the lending decision. Lenders expect it to deliver an accurate, robust, transparent, and predictable calculation of a property's worth. The valuation process is guided by the Royal Institution of Chartered Surveyors (RICS) 'Red Book' of standard instructions to valuers.

By applying the Red Book and using comparable properties in the local market as benchmarks, valuers are unlikely to submit materially different valuations, but valuation is not a science and will always incorporate elements of opinion. Lenders understand these differences, and will allow for variations in their calculation of how much they will lend. But where a valuation is significantly out of sync with the true market value, it changes the risk profile of the loan.

New-build properties have proven particularly difficult to value, because of a combination of factors:

- the 'new-build premium';
- a lack of comparable properties in the market; and
- the lack of transparency around the incentives offered by the developer to the borrower.

The 'new-build premium'

New-build properties are traditionally seen as being worth more than comparable older properties. Buyers are usually prepared to pay more because they do not require any additional building or decoration cost upon moving in.

It is difficult to judge the exact level of the new-build premium (although a typical value might be 5%). When house prices are rising, the likelihood is that the second hand value will meet or exceed the new-build premium. When prices are static or falling, the second hand value will not keep pace; under such circumstances it is likely that the value given to the new-build premium will be reduced.

Where the deal is not fully transparent and the incentives inflate the price, and hence the mortgage that the borrower is offered, the difference between the new-build premium and the second hand value will be artificially enhanced.

Comparables

In order to corroborate a valuation, a valuer will look at the sale prices for comparable properties in the local area. This can prove difficult where a new development delivers a new type of property to an area. These properties may have asking prices that are significantly higher than the current stock sell for. This leaves the valuer in a difficult position. Where do they find enough comparables to back up their valuation?

A valuer may use the sales that have already taken place in the same development as comparables. This, however, brings its own problems. The sale prices of other properties in the development are unlikely to take into account any incentives that have been offered to reduce the price and achieve the sales.

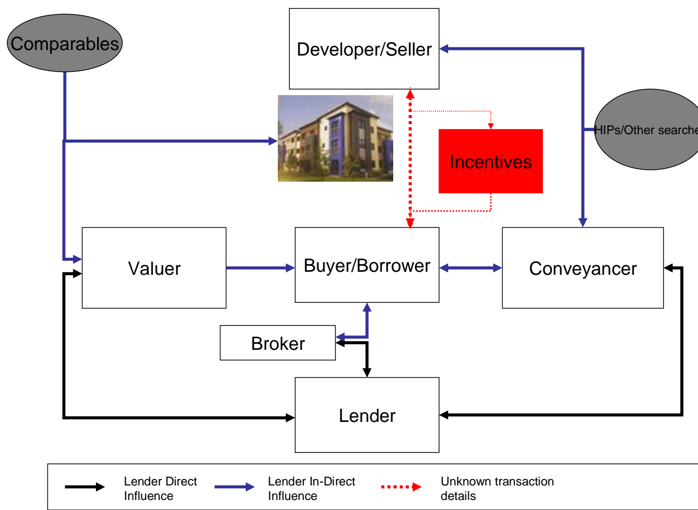
"How much is a brand new property really worth? This riddle has been a growing concern to both valuers and lenders for a number of years."

It is in the developer's interest to list the gross price of transactions as it provides an artificially high benchmark for valuers.

Incentives

It has become common practice for developers to offer a package of incentives which have a material effect on price and value. These may typically include: paying legal fees and stamp duty, cashbacks, reduced mortgage payments/guaranteed rent for a set period, 'white goods', and holidays.

The diagram below shows the current flow of information. The black lines represent those which the lender has direct contact with. The blue lines represent the indirect lines of contact (through other professionals). The red lines are the details that the lender cannot see – unknown transaction details.



If the lender and valuer are aware of these incentives then they are able to take them into account in the valuation, and the mortgage offered by the lender. If they are not aware of the discounts, then the gross price will be used to inform the lending decision and will skew the valuation higher, leaving the borrower paying either a significantly reduced deposit or no deposit at all. In some cases the borrower will even make a profit on the deal. Unknown to the lender, they will be facing a greater risk of loss than they had anticipated.

Example of the problem…

Gross sales price: £200,000
Mortgage: £180,000 (90% LTV)
Buyer actually pays: £170,000 to the developer

Mortgage fraud

Rising house prices, the lack of clarity around new-build transactions, the valuation difficulties and the consequent prospect of making quick profits are vulnerabilities that have attracted fraudsters.

We are aware that fraudsters are significantly inflating the values of properties through setting up an investment company as a shell to purchase new-build apartments in bulk. Buying in bulk enables them to negotiate significant discounts, greater than those offered to individual buyers. The fraudster will reserve the properties with a holding payment. They will then sell the properties at a much higher price. Upon selling the property the fraudster will pay the developer the agreed price, and will pocket the difference.

A) Price of £100,000 per unit agreed with developer
B) Sale of £150,000 agreed
C) Both transactions completed on same day.
D) Profit to fraudster of £50,000.

This type of transaction is not in itself fraudulent, but it becomes fraudulent where the initial transaction is hidden, and where the purchaser is either completely fictitious or is complicit - 'a mortgage mule'.

"Rising house prices, the lack of clarity around new-build transactions, the valuation difficulties and the consequent prospect of making quick profits are vulnerabilities that have attracted fraudsters."

To achieve this is fairly complex and is an indication that organised rings are involved including brokers and professionals. This heightens the need to increase the transparency of new build pricing, which is the root cause of the problem.

Awareness of the problem

Lenders, valuers and conveyancers have been aware of this problem for some time and have been working to find solutions.

The RICS, in conjunction with the CML, updated the Red Book in 2006 emphasising the need for valuers to consider the effect of any sales incentives which could have had a distorting effect on the agreed sale price. The amendment emphasised the need to look for comparable evidence beyond the immediate development.

The Lenders' Handbook provides comprehensive instructions for conveyancers acting on behalf of lenders in residential conveyancing transactions. Paragraph 6.3 of the Lenders' Handbook sets out what is expected of the conveyancer in respect of the purchase price. It provides that, unless specifically instructed by the lender, the purchase price for the property must be the same as set out in the instructions.

If it is not, the conveyancer must tell the lender. The conveyancer must also tell the lender if the contract provides for a cashback to the buyer or part of the price is being satisfied by a non-cash incentive to the buyer. If this is the case, this may lead to the mortgage offer being withdrawn or amended.

The conveyancer must also tell the lender if he will not have control over the payment of all the purchase money (for example, if it is proposed that the borrower pays money to the seller direct) other than a deposit held by an estate agent or reservation fee of not more than £500 paid to a builder or developer.

The Law Society has standing guidance for it members on mortgage fraud, which states that a solicitor is under a duty to inform the lender of the true price being paid for a property. This includes not only informing the lender of straightforward price reductions, but may include other allowances which amount to a price reduction. The examples given in the guidance include incentives offered by builders such as free holidays and part-subsidisation of mortgage payments.

But, these protections do not work if incentives are not disclosed to the lender's conveyancer.

In a slowing market, where developers are under pressure to meet sales targets, and where there is a saturation of certain types of property, there is a strong rationale for increasing the value of incentives offered to keep sales up. This underlines the need why transparency of new-build deals is increasingly important for lenders and more action is required.

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The market has reacted with some lenders reducing the LTVs they offer on new-build apartments, factoring in the unknown incentives, whilst other lenders have stopped lending on new-build apartments altogether.

Whilst this action is a sign of the market allowing for the additional risk of new-build property, pan-industry action is required to restore faith across the board.

Industry response

It is essential that developers recognise the problem and act to solve it. The CML has been discussing the issues involved with developers and their representative bodies.

Further action is required to improve confidence. The CML is working on a solution that will re-install confidence in the new-build market by:

- Requiring full disclosure of incentives offered
- Improving the flow of information to the valuer
- Identifying the existence of any third party interests in the property.

To make these changes a requirement of the conveyancing process, the Lenders' Handbook, the RICS Red Book and mortgage application forms will have to be amended and work is underway to make this happen. These changes are likely to take effect by the summer.

NEWS *in brief*

How we spent then…and how we spend now

Last week saw the publication by National Statistics of its 50th annual Family Expenditure Survey, giving a fascinating insight into how spending has changed between the first survey in 1957 and the most recent in 2006.

According to the report, mortgage or rent accounted for an average of only 8.7 per cent of the weekly household budget 50 years ago, compared with a fifth today (or a quarter, after taking insurance, maintenance and utilities into account).

For 2006, London, the South East, the East and East Midlands government office regions all showed a higher spending on mortgage than the UK average, with all other regions showing a lower spending than the UK average. On rent, there is a slightly different picture: London far exceeds the UK average in terms of the cost of rent, with the South East showing a slightly higher level than the average and all other regions showing a lower level.

Back in 1957, one of the biggest items of expenditure was cigarettes, accounting for an average 5.6% of the weekly budget! Food accounted for a third of expenditure in 1957, but less than half of that proportion in 2006.

As *The Times* headline of 29 January reporting on the survey findings observed, “Then we spent it on fags, booze and food. Now it all goes on the mortgage.”

Scotland moves ahead with single survey plans

Plans to introduce a single survey scheme for Scottish house sales were approved by MSPs this week.

From 1 December 2008 prospective house sellers will need to commission a Home Report with detailed information about the condition and value of the property before offers are made.

The three tiered Home Report will include a single survey, energy efficiency report and property questionnaire. The Scottish Government hopes the introduction of Home Reports will address three major issues within the house buying and selling process in Scotland:

- That by providing sellers and buyers with more information on the condition of the property, action may be taken to rectify the problems highlighted and therefore the quality of housing stock in Scotland will improve.
- It will lead to a reduction in multiple valuations.
- It will address the issue of low upset (asking) prices.

While the introduction of the single survey will not result in a major change to existing mortgage lender practices, the CML has continued to stress the need for individual lender valuations, transparency in the relationship between estate agents and surveyors, and the introduction at a quiet time in the housing market.

- The 2006 English House Condition Survey reported the number of non-decent homes across England was reduced by 3 million from 1996 to April 2006.
- HSBC recently announced an innovative “rate-matcher” offer to allow borrowers coming to the end of two-year, three-year, or five-year fixed rate mortgages to roll over onto a deal at exactly the same rate.
- Mervyn King has been re-appointed Governor of the Bank of England for a period of five years when his present term of office expires on 30 June 2008.
- IT and software provider Phoebus has joined the CML as an associate. There are now 94 CML associates.

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Time to reposition Repossession?

Last week turned into a feeding frenzy on the subject of mortgage repossessions, with Shelter, the Royal Institution of Chartered Surveyors and even the Financial Services Authority contributing - whether by accident or design - to the media melee.

First off the blocks was the FSA, with the publication of its *Financial Risk Outlook* on Tuesday. The FRO is always a scary document, designed as it is to present a warts-and-all view of the possible risks that the financial industry may face over the coming year. Although the FSA is always keen to emphasise that these are risks, not central forecasts, this has a tendency to get lost in translation.

This year, that was particularly true, as the FSA had included a diagram showing the number of borrowers who had taken out loans exhibiting one or more of three different risk factors (more than 90% loan-to-value; more than 3.5 times income; more than 25-year term), but had failed to realise how much media attention this one diagram would attract in the context of its 63-page document. As a result, the FSA was taken by surprise and inadvertently managed to end up with the following day's headlines focusing as a key message on its prognosis that a million borrowers were vulnerable to default and "at risk of repossession" – which would equate to more than 1 in 11 borrowers. The actual scale of repossession is, in fact, likely to equate to fewer than 1 in 250 borrowers.

Next up was the Royal Institution of Chartered Surveyors on Wednesday, whose press release trumpeting its new accessibility index, showing how easy or otherwise it is for first-time buyers to enter the market, also contained a throw-away line forecasting 123 repossessions a day (=45,000 for the year, the same as the CML forecast). Surprise surprise, the repossession forecast gained probably more media coverage than the main subject of the press release.

And finally, on Thursday, Shelter entered the arena with a policy briefing issued to the media on mortgages and repossessions, presumably deliberately timed to pre-trail the CML arrears and repossessions data this week. We agree with many of Shelter's recommendations – and have already worked with them to call jointly on the government to regulate sale-and-leaseback companies, for example – although we disagree with others, for example the "SHOP" proposal for compulsory payment protection (which would in effect be a tax on mortgages).

If we had to take a punt, we would guess that Shelter achieved its objectives in the publicity it received, that RICS got perhaps a little more focus on the repossessions number than it might have expected, and that the FSA got distinctly more than it bargained for.

Overall, we do not recognise the pervasive doom that seemed to characterise coverage of the housing and mortgage markets last week. Yes, we are concerned that mortgage funding channels remain limited, and that this will reduce the ability of the mortgage industry to fully meet consumer demand. Yes, we expect repossessions to rise, albeit from what has been a very low base in recent years. But with interest rates on a downward path, with the impact of payment shock likely to be more muted than we had previously feared, and with the vast majority of borrowers coping – albeit with less confidence than they might have felt a year ago – the real picture of the 2008 mortgage market is rather brighter than the dark canvas that so many seem determined to paint. Our data will be published on Friday.

news & views contacts

News & Views is the fortnightly newsletter of the **Council of Mortgage Lenders**

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