Unit 3
Mortgage law, policy practice and markets

After studying this unit, you will be able to demonstrate the following.

Knowledge of:

- ♦ the definition of a mortgage;
- ♦ the house-buying process, the key parties involved, and their roles;
- ♦ the principal types of property defect that surveys can identify and understand their implications when seeking a mortgage, including the options available to consumers;
- ♦ the process and implications of buying property at auction;
- ♦ the common types of borrower and how their main mortgage-related requirements may differ, and what factors may disqualify people from borrowing.

Understanding of:

- ♦ the main requirements of the Mortgage Conduct of Business rules and the legislation affecting mortgages;
- ♦ the economic and regulatory context for giving mortgage advice.

© The Chartered Institute of Bankers 2006

Section 1

Borrowers

Section 1 covers the key points relating to agency and contract law; and describes the different types of mortgage borrower and their needs, and those who cannot take out a mortgage.

Section 1 covers part 1 of the syllabus for Unit 3.

1.1 Types of borrower and capacity to borrow

Before looking at the types of borrower, it is important to establish that buying a house and taking out a mortgage are contracts.

This means that the principles of contract will apply. Similarly, before dealing in detail with buying a house and arranging a mortgage, it is important to understand the concept and principles of agency.

1.1.1 Principles of contract

The basics of a contract are:

- that it is an agreement between two or more people to enter into a legal arrangement;
- that one party will make an offer and the other will accept. Both *offer and acceptance* put legal obligations on both parties;
- that a *consideration* must be given – in property terms the buyer usually gives a consideration (money) and the seller gives a consideration (property);

© The Chartered Institute of Bankers 2006

- that all parties must have the capacity to enter a contract. This means they must be:
  - aged 18 or over,
  - legally able to sell or buy the property – acting either as principal or agent (with authority),
  - of sound mind;
- *utmost good faith* – which means that both parties should answer all questions honestly and, with property, this is particularly relevant to the seller. The buyer's solicitor will ask a number of questions about the property, the surroundings and any disputes. If the seller does not answer honestly, he may face legal action.

1.1.2 Principles of agency

An ***agent*** is a person who acts on behalf of another, referred to as the principal. In law, the acts of the agent are treated as being those of the principal.

It is vital to set out the conditions of the agency in writing before the agent begins to act on the principal's behalf because an agent should only act within the powers given to him by the principal. When dealing with property, it is vital that the seller and the estate agent have a written contract that sets out exactly what is expected from each party and the limits to the agent's remit.

In general, the *principle of agency* is that the principal is liable for the agent's actions. On occasions a statement or action by the principal might appear to give the agent wider authority. For example, where the agent carries out a number of actions that are outside his remit, with the full knowledge of the principal. Another example might be where the principal makes a statement that appears to allow or endorse actions outside the agent's remit. In these cases, the principal may be deemed responsible for the agent's actions, even though they are outside his remit, because he has given *apparent authority.* Where it is clear that the agent has acted outside his authority, the agent may be liable for any redress, unless the principal agrees after the event that his action was acceptable; this is known as *ratification*.

Estate agents act as agents for the seller (the principal). The terms of their agency will usually state that they pass on offers on the property to the seller, who makes the decision whether to accept. This is in contrast to many other types of agency, where the agent is given authority to act on the principal's

© The Chartered Institute of Bankers 2006

behalf. An example of this would be an independent financial adviser (IFA) with a discretionary investment agreement with a client.

1.1.3 The mortgage

The process of mortgage lending must focus on two key activities:

- determining who may borrow;
- determining whether, and to what extent, the property is suitable security on which to lend.

It may appear obvious to the observer that some people may be able to borrow while others may not. For example, if a person has no income, it is unlikely that a lender will allow them to borrow at all. If a person is in an excellent permanent and full time job, however, he will normally be able to borrow. There are several issues that all lenders must address in assessing types of borrower:

- who may and may not borrow according to the law;
- in respect of those who can legally borrow, to whom is the lender prepared to lend;
- should funds be allocated to, or earmarked for, particular groups or classes such as first-time buyers, professional introducers, and so on;
- how much should the lender lend to each applicant.

A sound lending policy considers these matters and others on an ongoing basis, taking into account:

- the lender's strategy and market positioning and its consequent required business levels in certain sectors;
- the risk profile of the applicant;
- the lender's desired levels of profit margin;
- arrears and recovery statistics and other circumstances.

© The Chartered Institute of Bankers 2006

1.1.4 Types of borrower

In this section, we will consider the following types of borrower:

- personal borrowers;
- business partnerships;
- corporate borrowers;
- commercial borrowers;
- personal representatives and attorneys;
- trustees;
- other types of borrower.

Finally, we will look at those who are unable to borrow.

1.1.4.1 Personal borrowers

Personal borrowers constitute the majority of property purchasers. They fall into two main categories:

- first-time buyers;
- second or subsequent buyers.

The rules for working out how much an applicant is able to borrow vary from lender to lender, but lenders generally use a multiple of gross income to determine the amount of loan.

If two or more people take out a loan or mortgage, the document they will have been asked to sign will make them jointly and severally liable for that loan. This means that they are both (or all, as the case may be) liable for the whole amount of the loan, not just each for a part of it.

The parties to the loan, however, can arrange between themselves to share responsibility for the loan (and other outgoings as well) in whatever proportions they wish. But it is important to remember that the lender is still able to pursue them individually for the loan (subject, of course, to recovering no more than is owed).

© The Chartered Institute of Bankers 2006

1.1.4.2 Business partnerships

A ***partnership***, also sometimes known as a firm, is an arrangement between people carrying on a business in common. Unlike a company, it is not a separate legal entity and the assets (and liabilities) of the partnership are jointly owned by the partners themselves. Therefore, a lender will not only need to look at the partnership business itself as a credit risk but will also look behind it to the financial standing of the partners themselves.

Because the partnership is no more than an arrangement between its partners, it may – unless specific provisions are made to the contrary in the partnership deed – terminate on the death or bankruptcy of any one partner. Therefore a lender will take particular care both in assessing a partnership proposition at the outset and in its dealings with the partnership on an ongoing basis.

Lenders may make mortgages available to partnerships (eg to a solicitor's practice for the purchase of office accommodation), subject to the satisfaction of appropriate lending criteria. Lenders must be satisfied that they are not at risk in lending to a partnership (as opposed to an individual or a limited company) because of the different legal rules applying to partnerships. Consequently the lender will protect itself by, for example, obtaining an up-to-date and valid copy of the partnership agreement to check that there is nothing in it that will prevent it from safely lending to the partnership. The lender will also ensure that the partnership is legally bound by, for example, requiring all partners to sign the appropriate documents or, if it is impractical to require all to sign, to agree to a lesser number doing so, but checking that they are authorised to sign on behalf of all.

1.1.4.3 Corporate borrowers

Corporate borrowing – ie where the money is lent to a company – may be for either residential or commercial purposes. In either event, the loan will be assessed as usual, in terms of the security being offered and the borrower's ability to pay. But because the borrower is a company and not an individual, and because it is a separate legal entity from its shareholders, there are some additional considerations.

- *The company's powers to borrow*: it is common for a company's *memorandum and articles of association* (the constitutional documents of a company setting out, inter alia, what it can and cannot do) to be drawn very widely. It may well therefore be that the company has automatic powers to borrow but in some cases and particularly with older

companies with more restrictive drafting, the memorandum may not include the power to borrow. It may place limits on the borrowings or state that borrowings may only be raised for specific purposes (eg where they are necessary for the trading or other activities of the company). It is important, therefore, that the memorandum is checked: if the company enters into unauthorised borrowings the agreement may be set aside as ultra vires (literally, 'outside the powers') and this may leave both lender and borrower in a difficult position.

- *The authority of its officers to borrow*: in addition to checking the memorandum for the company's power to borrow, the lender should check the company's articles of association to ensure that borrowing is not outside the power of the directors and that the amount is authorised. It is important to check:
  - that the individual(s) acting for the company are properly authorised to do so, for example by requesting a copy of the relevant board minutes;
  - that the form in which they do so is legally binding on the company.
- *The company's status as a credit risk:* as with an individual borrower, any prudent lender will assess the company's financial status. This will involve an assessment of the business carried on by the company, how long it has been carrying on this business, how it compares with other similar companies and what its trading record is. The investigation should include examination of the company's most recent audited accounts, those for a number of past years, and other available financial information.
- *The company's limited liability*: the vast majority of companies with which you will have dealings are limited companies. This means that the lender cannot normally pursue its shareholders for payment if the company cannot pay its debts. As a result, when considering lending to a company, it is sensible to look not only at the company's status as a credit risk but also to consider taking personal guarantees from the directors of the company. *Director guarantees* are sought because they exercise control over the company; in most smaller companies, they are also major shareholders. These directors may be encouraged to take a more prudent financial approach if their personal finances are bound up with those of the company. In the case of larger public companies, however, there are too many shareholders for shareholder guarantees to be either practical or desirable.

 © The Chartered Institute of Bankers 2006

Loans to corporate and semi-corporate businesses can represent potentially high margins for the lender and banks can, and do, lend considerable funds to limited companies. Building societies, however, are restricted under the provisions of the Building Societies Act 1986, (as amended by the Building Societies Act 1997), in respect of corporate lending. A maximum of 25% of a building society's commercial assets can be held in loans to limited companies secured on land.

The credit assessment process for corporate and semi-corporate borrowers is invariably more complex than that for personal borrowers, requiring an understanding of how to interpret formally prepared financial accounts, for example.

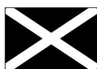
1.1.4.4 Commercial borrowers

A ***commercial borrower*** will seek a mortgage where the security for the loan is a commercial property (eg a shop or a factory) as opposed to a residential one. A commercial mortgage can be offered either to an individual or to a company.

When assessing a request for commercial lending, the lender will consider both the status of the borrower (often the company) and the viability of the lending proposition. The assessment will include the borrower's track record in running the business (or a similar business), the business plan and the expected impact of buying the property – increased capacity and so on. Where it is intended to rent the property, the assessment will include the type of tenant, the length of their lease, the type of the contract and the likelihood of getting a replacement tenant if necessary.

1.1.4.5 Personal representatives

Personal representatives (or *executors* in Scotland) act in managing the estates of deceased people. Lenders can lend to personal representatives of an estate if a loan is sought in pursuit of administering the estate. If the deceased person has left a will, the personal representative is called an executor. The executor is named by *grant of probate*. If the deceased has not left a will, the representative is an *administrator*, appointed by *letters of administration*.



In Scotland, if the deceased person has appointed an executor in a will, he is the *executor-nominate*. Otherwise the executor is appointed

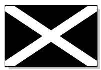
© The Chartered Institute of Bankers 2006

by the court (*executor-dative*). Both generally need to obtain confirmation from the court to deal with the estate.

While on the subject of death, a great many borrowers are prepared to address a wide range of financial needs when they take out a mortgage, including insurance, their pension and life assurance, yet many do not consider making a will. At a time when their fundamental financial circumstances are changing, it is nearly always in the best interest of the borrower to consider taking this important step.

1.1.4.6 Attorneys

An ***attorney*** is a person who is given the responsibility to act on behalf of another. There are many uses of attorneys (including by elderly people who can no longer manage their own finances or by people not living in the country for a long period). The person who creates the power of *attorney* is the *donor*, while the person acting for him is called a *donee*, or simply the *attorney*. Powers of attorney can differ in terms of the amount of responsibility that is given to the donee. Lenders can lend to donees but will wish to make sure the Power of Attorney document is current (not expired) and that the document does not exclude borrowing on behalf of the donor.



In Scotland, it is necessary for the Power of Attorney to confer specific authority to borrow.

Someone who does not have legal capacity to contract is not able to appoint someone else, who does have such capacity, to act as their attorney; for example, a twelve-year-old cannot appoint someone else as their attorney and enter into a contract that way. We will look at a specific type of Power of Attorney that applies to the mentally incapacitated later.

1.1.4.7 Trustees

Trustees are people appointed by a document called a *trust deed* to hold a specific asset on behalf of others, called the *beneficiaries* and to act for the beneficiaries according to the terms set out in the deed.

The property in the trust is called *trust property*. Generally the trustees of larger trusts are empowered by the terms of the deed to borrow money for certain purposes and within limits. Before lending to trustees, a lender will examine the deed to ensure the trustees have the power to borrow.

 © The Chartered Institute of Bankers 2006

1.1.4.8 Other types of borrower

There are other types of bodies who may enter into mortgages. These include the voluntary housing sector and clubs and associations.

1.1.4.8.1 Voluntary housing sector

The *voluntary housing* sector comprises housing associations and housing societies. The two types of body are different in law, but have the same objectives. They are non-profit-making organisations, often run by volunteer workers, which provide housing for rent, purchase or a combination of these.

Since 1980, when the government decided to withdraw from its prominent role in the provision of social housing, the role of housing associations has become much more important.

Housing associations are regulated by the Housing Corporation in England and Wales and by Scottish Homes in Scotland. If registered with these bodies, associations can qualify for *government grant aid* that may be used to develop housing. It is quite common for a three-way partnership or joint venture to be forged between local authorities, housing associations and mortgage lenders.

Most financial institutions are prepared to make long-term mortgage finance available for the development of housing for both rental and purchase, provided that the borrowing association (or body) is properly constituted and able to borrow, and has financial accounts that demonstrate that it is financially sound.

The borrower must also be satisfied that the association has been and is properly run.

Housing associations have had an important role to play in schemes such as:

- inner city regeneration projects;
- sheltered housing for the elderly;
- housing for social minority groups;
- housing for certain occupations – one large housing association operates exclusively for retired armed forces personnel, for example.

Mortgages for housing associations are usually granted taking security over the land that is being developed. For larger developments, it is common for there to be several lenders.

© The Chartered Institute of Bankers 2006

1.1.4.8.2 Clubs and associations

The powers of *clubs and associations* are often contained in a set of rules or other terms of reference under which they must be operated. These rules will normally show that the club can borrow and the extent to which it can do so.

Clubs and associations are usually managed by committees on behalf of their members. The committees are elected through procedures laid down in the rules. A chairman will be elected, as will a treasurer and secretary. In larger clubs, the post of secretary may be a full-time, salaried appointment.

Example

The Heathens Rugby Union Club has been established for 75 years. It draws its membership from the professional community. The Club now wishes to acquire a piece of land on which to build a club house with licensed bar, gymnasium and meeting facilities, as well as providing two rugby pitches and a training area.

- What document would you wish to see in order to help you consider this proposition?
- List the main underwriting considerations that should be taken into account.

Before making a loan available, lenders need to be satisfied that the club has been properly established, is properly constituted and is financially able to repay the loan. Prior to considering an application, the lender will require evidence that the committee has correctly resolved that the club requires a loan together with full details of its income and trading performance (if it trades), and plans and projections for repaying the debt.

1.1.5 Those unable to borrow

There are three groups of people who are not allowed, or who have restricted ability, to borrow by law:

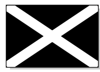
- minors;
- the mentally incapacitated;
- undischarged bankrupt.

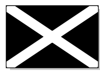
 © The Chartered Institute of Bankers 2006

1.1.5.1 Minors

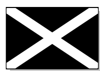
A person under the age of 18 years (a *minor*) cannot hold a legal estate in land. A minor normally cannot be made to account for contractual obligations entered into, except in the case of contracts for necessaries, which are things that, in law, are considered necessary for the welfare of the minor.

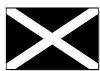
For these reasons mortgages are only made available to persons of 18 years of age and over. Lenders require evidence of age.

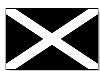

In Scotland, the law of minority is quite different, although the principle that lenders should take great care when considering loans to young people is essentially the same.


The Age of Legal Capacity (Scotland) Act 1991 states that children who are under 16 years of age are (with certain limited exceptions) unable to enter into transactions that have a legal effect. There are two main exceptions to this:

- those that are 'commonly entered into by persons of their age and circumstances';
- those that are entered into on 'terms which are reasonable'.


Both of these criteria are vague. It might be assumed that a minor buying sweets would be capable of contracting while the same person looking for a loan may not.


A lender considering a loan to a young person might have the proposed contract ratified by the court. Under the 1991 Act, a *guardian* may contract on behalf of someone who is under 16 years old.


Those 16 years old or over are, under Scots law, considered to have full contractual powers. The 1991 Act, however, introduced a statutory challenge procedure to *prejudicial transactions* concerning those over 16 years but under 18 years. The transaction can be set aside by the court if it is considered that the transaction was one into which a reasonably prudent adult would not have entered *and* that the young adult has suffered loss as a consequence.

© The Chartered Institute of Bankers 2006

Example

Martina and Matthew Rush enquire about a mortgage with your lending institution. Matthew is an apprentice engineer, aged 21 years. He has worked in the same job since leaving school. He is a keen motor mechanic and supplements his income with out-of-hours work. Martina is 17-years-old and has been a shop assistant for just two months. Up to now they have been living with Martina's parents.

They have some savings, including a small legacy from an aunt who recently died.

They approach you for advice about a mortgage.

- ♦ How would you deal with the fact that Martina is under 18 years of age?
- ♦ What other underwriting considerations would have to be considered?

1.1.5.2 The mentally incapacitated

A person who is *mentally incapacitated* cannot borrow in his own right. In practice another person will have to act for that person. In England and Wales, a person of unsound mind who requires housing to be funded by a mortgage is represented by an attorney appointed by the Court of Protection.

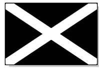
If the individual has anticipated the possibility of becoming mentally incapable, he may already have chosen the person who he would like to represent him. This is done under a special type of Power of Attorney known as an *enduring power of attorney (EPoA).* While an ordinary Power of Attorney ceases when the donor becomes mentally incapable, an EPoA is specifically designed to enable people to decide who will look after their affairs if and when they are mentally unable to do so themselves. EPoAs must be set out in a specific form and must be registered with the Public Guardianship Office. They can only be revoked with the consent of the Court of Protection.

While we noted earlier that a Power of Attorney cannot be made by someone of unsound mind, this is not inconsistent: an EPoA is arranged while the donor

 © The Chartered Institute of Bankers 2006

is still able to manage his affairs and comes into effect only when, and if, he can no longer do so.

The mental capacity Act 2005, when it come into force in 2007, will replace the EPoA with the lasting power of attorney.



In Scotland, the court appoints a *guardian* to act for the mentally incapacitated, including the purchase of property.

A person of sound mind can have another party act on his or her behalf by giving them power of attorney. This can be general, *specific, or enduring* (indefinite).

A person of unsound mind, however, cannot create a power of attorney. For another to act, it is necessary to have an order from the Court of Protection.

1.1.5.3 Undischarged bankrupts

Under the Insolvency Act 1986 or the Bankruptcy (Scotland) Act 1985, a bankrupt is any person who has been made subject to a petition for bankruptcy by the county (or Sheriff) court. Bankruptcy arises when:

- a person's liabilities exceed his assets; or
- a person cannot meet his financial obligations within a reasonable period of them falling due.

To most people, bankruptcy means financial ruin and the almost certain prospect of losing one's home if it is mortgaged to a financial institution.

Although it is true that bankruptcy is a drastic and often calamitous event, it does not always result in loss of the family home. In many cases, the bankrupt person has no equity in the property and so it serves no benefit to the creditors for the trustee in bankruptcy to force a sale.

In addition, there is often a situation where one partner is bankrupt and the other is not, which often results in any forced sale of the mortgaged property being delayed for at least a year.

Existing borrowers who are likely to be made bankrupt can be referred to the excellent free information pack on insolvency available from the Citizen's Advice Bureaux.

© The Chartered Institute of Bankers 2006

1.1.5.3.1 The Enterprise Act 2002

The Enterprise Act received Royal Assent on 7 November 2002. It was a wide-ranging act dealing with a number of issues, one of which was the approach to bankruptcy. From the individual's perspective, the Act reduced the amount of restrictions placed on an undischarged bankrupt at the discretion of the court.

The Act reduced the discharge period from three years to a maximum of 12 months for all individuals declared bankrupt after 1 April 2004. In some cases the period can be shorter. Those who have been declared bankrupt in the past may be subject to a longer discharge period.

Those who were made bankrupt on or before 1 April 2004 will be discharged:

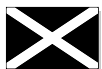
- at their original discharge date if that occurs within 12 months of the Act coming into force, or
- 12 months from the date of the Act if the original discharge date is longer than 12 months from that date.

During the discharge period, the person subject to the order is said to be an *undischarged bankrupt*. Such a person cannot borrow (other than very nominal amounts) during the period that the order is in force.

Once discharged from bankruptcy, the person is perfectly entitled to borrow. It is another matter, however, whether they will find a lender prepared to lend. A borrower must declare a previous bankruptcy by law – failure to do so can render the person guilty of fraud. Previous history of bankruptcy is invariably revealed by a credit search.

Many lenders will automatically decline applications from those with a history of bankruptcy. Some set down a minimum period of years after being discharged before a mortgage will be considered. Lenders take each case on its merits.

A person can be made bankrupt for owing just £750 and failing to pay this within a reasonable period.



The shortening of the discharge period introduced by the Enterprise Act 2002 did not apply in Scotland, where the period of discharge remains at three years. There is currently a Bill before the Scottish Parliament that proposes to reduce the period of automatic discharge to one year.

© The Chartered Institute of Bankers 2006

1.2 Policy and practice matters

Lending policy is concerned with the following areas:

- to whom loans will and will not be made;
- whether the loan security is acceptable;
- product prices, interest rates, fees and charges;
- special conditions attached to each category of loan.

It is necessary at the outset to determine the type of borrower and the purpose of the mortgage proposition. As we have seen, there are different legal considerations applicable to different types of borrower. In addition:

- the Consumer Credit Act 1974 regulates certain consumer credit agreements for loans not exceeding £25,000;
- if the lender is a building society, the precise nature of the proposition must be determined before the mortgage can be classified in accordance with sections 10–16 of the Building Societies Act 1986 (as amended by the Building Societies Act 1997). The major point is that at least 75% of the society's commercial assets must be secured on residential property. In due course, it is likely that these provisions will be repealed and replaced under powers given to the Financial Services Authority under the Financial Services and Markets Act 2000: however, for the time being they remain in force.

The Financial Services Authority, which is now the main regulatory body supervising financial institutions, expects lenders to have clear, written policies laid down in respect of each category of borrower, including decision-taking mandates at each level of management. Specific status and security considerations are discussed in Unit 4.

Broadly, however, the adviser must consider the following areas of policy and practice:

- geographical catchment area of lending;
- minimum and maximum advances for each category of borrower;
- precise types of security acceptable and maximum loan-to-value ratios applicable to each;
- interest rate structure for different borrowers – often, higher risk causes higher rates to be imposed;

© The Chartered Institute of Bankers 2006

- interest rate calculation basis (annual/monthly interest; daily interest; other);
- discounting policy;
- charging structure in relation to:
  - administration fees;
  - penalties and fines;
  - redemption and part-redemption fees on variable rate loans;
  - settlement fees on fixed-rate loans;
  - special deals such as cashbacks, free valuations and reimbursement of legal fees, etc;
  - clawback fees;
- methods of repayment – interest-only or capital and interest – and product variations within these categories;
- mortgage-related products, sold either on behalf of subsidiaries of the lending institution or in conjunction with other companies.

Mortgage products have become more complex. Only 15 years ago, the borrower had a simple choice between capital and interest or interest-only (endowment). Almost all products were offered at variable rates of interest with 'no frills'. Today, the customer can be genuinely confused by the vast array of offers and special deals.

© The Chartered Institute of Bankers 2006

Test your knowledge and understanding with these questions

Take a break before using these questions to assess your learning across Section 1. Review the text if necessary.

Answers can be found on page [3] 20.

Answer true or false for each of these statements.

1. Alan was declared bankrupt in England on 5 May 2006. He will be discharged on 4 May 2009.
2. In a contract to buy and sell property, both vendor and purchaser give a consideration.
3. A partnership business has a legal existence of its own, separate from that of the individual partners.
4. A company's power to borrow is normally established in its Articles of Association.
5. A person who makes a power of attorney is known as a donor.
6. A lender can lend to trustees provided that the trust deed does not prohibit borrowing.
7. The age of majority is lower in Scotland than in England.
8. A person of unsound mind cannot enter into a contract but can appoint an attorney to do so for him.
9. People who are declared bankrupt remain as undischarged bankrupts for one year.
10. Loans of £25,000 and above are not regulated by the Consumer Credit Act 1974.

© The Chartered Institute of Bankers 2006

Answers

1. ***False***: he will be discharged on 4 May 2007.
2. ***True***: money from the buyer; property from the seller.
3. ***False***: the partnership is not a separate legal existence. Assets/liabilities are jointly owned by the partners.
4. ***False***: it is found in its memorandum.
5. ***True***: attorneys themselves are sometimes known as donees.
6. ***False***: the trust deed must specifically give the power to borrow.
7. ***True***: the age of majority in Scotland is 16, rather than 18 – but there are special provisions between the ages of 16 and 18.
8. ***False***: the Court of Protection can appoint someone but the individual cannot.
9. ***True***: the period to discharge used to be three years but is now 12 months.
10. ***False***: loans of £25,000 are regulated (unless exempt). Loans above £25,000 are not regulated.

© The Chartered Institute of Bankers 2006