

Consumer Protection and Regulation

by Michael Coogan

INTRODUCTION

As experts in housing finance in your respective countries, you know the importance of having happy consumers. Their willingness to borrow provides a firm basis for a stable housing finance market. A mortgage is a long-term commitment likely to be the most significant financial transaction for most consumers. Therefore, it is vital that the regulatory regime delivers adequate consumer protection and reinforces consumer confidence.

I will mention some of the key outcomes which regulation should seek to deliver. I will also describe the United Kingdom's recent experience as a result of the Council of Mortgage Lenders (CML) introducing a voluntary Mortgage Code. The theme throughout is the need to strike the right balance between consumer protection and providing scope for innovation by lenders in their national and international operations.

THE IMPACT OF REGULATION

The interplay between consumer and lender advocacy groups is an educational experience. First, I think it is a fallacy to suggest

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that simply because you regulate a market that it will operate efficiently. I could point to a number of examples in the U.K. where legislation has simply failed consumers. The most stark example is the operation of the regulations for calculating the annual percentage rate of charge.

Theoretically, the APR should be the single most important piece of information for borrowers to use in comparing and contrasting different offers of credit. In the U.K., the APR for mortgages is misleading and meaningless, because lenders are forced to assume the initial discounted or fixed rate will apply for the whole term of the loan. This ignores the reality in the U.K. that most loans will be fixed for up to five years and will be variable for the rest of the typically 25-year term. With a mortgage product with no payments in the initial period, the regulations require the lender to quote an APR of 0%, a statutory regulation which delivers no consumer benefit. Indeed, the reverse is true.

Second, even if regulation delivers sufficient consumer protection, the impact may be unwarranted costs for the industry, bureaucracy in the sales process and significant barriers to market innovation. Consumers may be protected, but they are actually disadvantaged by the cost of the product being higher than it needs to be; the sales process is more complicated and unintelligible; and the choice of products is more limited.

For example, in the U.K. we have legislation covering consumer credit loans. It prescribes the form of documentation that must be used. I am sure most consumers do not read it. It requires a cooling off period that most consumers would not want, as it delays access to the funds. The prescriptive nature of the legislation has created a barrier for some lenders who wish to offer "flexible" mortgages in the U.K., with facilities for borrowers to overpay, underpay, take payment holidays and draw down funds which have been paid back previously.

At a time when consumers' credit needs are changing, no one has a guaranteed job for life, more people are on short-term contracts and may face periods of unemployment or lower income, they want loans that match their lifestyle. Legislation in the U.K. has fallen behind the pace.

Having said this, I am also firmly of the view that regulation must provide a vital underpinning for the sales process for any long-term, high-value product or service such as a mortgage. Competition without any constraints would be a recipe for disaster for consumers. What is needed is a regulatory framework which is understandable to consumers, easy to work within for the industry and which delivers effective redress where consumer detriment arises due to noncompliance. Easy to say, less easy to do.

Consumer Risk Remains

What regulation should not seek to do is remove any "risk" from the consumer. The principle of caveat emptor—let the buyer beware—is key. Consumers do have a personal responsibility to look after their own financial interests. But, they need to be given the tools to make informed buying decisions.

Consumers cannot expect that taking out a loan will be risk free. At the same time, there should not be any hidden pitfalls. In regulatory terms, it is not possible to protect consumers from all potential damage in the mortgage market. So, although there is undoubtedly real damage as a result of events such as unforeseen changes in household circumstances, divorce, unemployment, etc., regulation cannot be expected to prevent financial damage that results. However, it should be possible to prevent damage arising from poor quality or misleading information leading consumers to buy an inappropriate mortgage product.

This issue of consumer detriment is perhaps more relevant in the U.K. than many other countries because of the open nature of the mortgage market. We have a huge variety of mortgage products on a fixed and variable basis. Lenders provide discounts, give cash-backs, apply different charging arrangements, sell conditional insurances with the loan, and offer discounted products which are only profitable if customers agree to be locked in on a variable rate for a period after the discount ends. It is all too easy for consumers to make the "wrong" decision. With such a range of choice, there is seldom only one "right" product to fit the borrower's circumstances.

There is a debate within the U.K. at present as to whether the market is too open. Consumer choice is seen by some to be too wide, making it impossible for consumers to make suitable mortgage decisions. Some

suggest that to simplify the market, certain types of mortgage product need to be banned or the price of variable-rate products fixed to external indices to remove any discretion for the lender to widen or narrow their margins.

CML Position

The CML does not support these suggestions, although I recognize they have been adopted in a number of countries around the world. Instead, the CML believes that the best way to avoid consumer detriment is through effective disclosure of information, better advice by well-trained staff, and access to free and independent redress arrangements if problems arise.

In the U.K., we have a task force which was set up by the government to promote "better regulation." As a lawyer, I support the concept but doubt it is achievable in practice. The task force has put forward five key principles by which any proposed regulatory measures can be assessed: Is it transparent, accountable, targeted, proportionate and consistent? All these measures are designed to ensure that regulation is effective and cost effective, and the potential success or otherwise of a regulatory framework can be analyzed in terms of the balance of perceived benefits to consumers as against the cost to the industry.

Regulation can and should:

- Ensure that consumers receive sufficient information to make rational mortgage purchasing decisions.
- Make provision for those consumers who do not wish to research the market themselves but instead rely on advice from a third party.
- Ensure that a system of free and fair redress exists for legitimate complaints.

- Provide a framework which encourages good lending and sales practice and penalizes poor practice.

MORTGAGE REGULATION IN THE U.K.

It may surprise many of you that in a highly developed housing finance market such as the U.K. there are few statutory controls on the mortgage sales process. There have been requirements in relation to mortgage advertising and the calculation of the APR, as I have mentioned already. However, there have been no controls over the types of documentation used for mortgage loans, nor successful attempts to regulate the ways in which lenders and mortgage intermediaries conduct their business at the point of sale.

There have on occasions been government proposals to intervene in the market, for example to control the selling of insurance with loans. However, the CML has largely been able to defend the industry against potentially costly intervention through its representational work. This position is now under threat.

Conversely, other financial services in the U.K. are already heavily regulated. Whether this regulation has been effective is questionable when you consider that in the U.K. there has had to be an industry-wide review of the past improper selling of pensions. The compensation costs which the pension industry faces are estimated to be in the region of £20 billion and rising.

Voluntary Mortgage Code

In 1996, the CML decided that the absence of any regulatory structure dealing with the mortgage sales process was unhelpful both to the industry and consumers. At the time, the then Conservative government was on its last legs and had no appetite to legislate. The new Labor government in waiting had

UNITED KINGDOM

an appetite to intervene but had higher priorities after 18 years out of office.

The CML, therefore, decided to "bite the bullet" by introducing a voluntary Mortgage Code to plug the regulatory gaps. This decision has led to some interesting challenges for the CML and the industry in the last few years. However, I believe that the code has delivered tangible consumer benefits already. The evolutionary process of regulation in the U.K. mortgage market needs to continue to deliver more benefits in the future.

The code has been introduced in two stages, in 1997 for lenders and in 1998 for mortgage intermediaries. This approach was taken because, until we decided to find out, no one knew the size and scope of the mortgage intermediary market in the U.K. We had estimates from members ranging between 15,000 and 100,000 individuals introducing loans to lenders in the U.K., an intermediary sector significantly larger than most countries around the world covering, among others, insurance salesmen, independent financial advisers, estate agents, solicitors, accountants and credit brokers.

In fact, we now know that there are around 43,000 individuals in some 15,000 firms. We know who the firms are and where they are located, which is always a good start if you want to monitor their activity!

The original objectives we set ourselves in writing the Mortgage Code were to:

- Provide minimum benchmark standards of service for lenders to seek to exceed and for consumers to measure actual performance against;
- Cover the whole of the relationship between the borrower and the lender, i.e., the code is not limited simply to advice on the type of mortgage;

- Be principles-based, rather than setting out detailed rules or a prescribed format, thus promoting competition and innovation in the market; and
- Underpin the key principle of transparency on the implications (particularly financial) of a long-term commitment such as a mortgage.

What has the impact of the Mortgage Code been so far? It has:

- Introduced a comprehensive set of standards into the mortgage market adopted by virtually the entire lending and intermediary market;
- Structured the mortgage sales process more clearly, bringing in for the first time an option for providing advice and written recommendations about particular products based on customers' personal circumstances;
- Clarified the relationships between lenders and intermediaries to make it clear to customers who is accountable when problems arise;
- Implemented a compulsory system of independent, free redress for all consumers with mortgage complaints against subscribers to the code, whether a lender or intermediary; and
- Introduced a new, comprehensive independent qualification for mortgage advisers.

One of the key challenges we set ourselves was to ensure better awareness of the code principles. There is little point to regulation if consumers do not know it protects them. Without awareness, consumer confidence cannot be instilled and reinforced.

A few statistics might illustrate whether we are making progress. In 1998, there were

around 1.35 million transactions in the U.K. market. This is expected to rise to a figure nearer 1.5 million in 1999. Overall, there are nearly 11 million borrowers. Since 1997 when the code was launched, 6.45 million copies of the code, and 20.9 million copies of a short consumer leaflet describing the key principles, have been printed and distributed by the CML to lenders and intermediaries in the market, and on to consumers themselves.

On a voluntary basis, over 4,000 sales staff have already obtained the new mortgage qualification, which involves three separate examination papers, and 12,000 registrations have been made to sit for the qualification in the coming months. Some lenders are making it compulsory for all of their mortgage sales staff to pass the course to keep their jobs.

In addition to advice about the products available in the market from intermediaries (and around 50% of new loans are introduced to lenders), consumers receive a written recommendation about the product which most suits their circumstances in around 40% of cases arranged through lenders' branches. The availability and reception of advice by consumers is seen as a key indicator by the U.K. government. On this measure, we think there has been considerable progress in a very short time since the code came in.

Mortgage Code Register of Intermediaries

As I have said, we have also identified for the first time the full scope and shape of the mortgage intermediary sector. To do this, we set up a separate independent company called the Mortgage Code Register for Intermediaries Ltd., which has been in operation since 1998. In addition, there has been an Independent Review Body, which has monitored code compliance by around 130 lenders since 1997. Some £4.5 million will

be spent this year by these bodies registering subscribers and monitoring compliance with the Mortgage Code.

The bulk of these costs arise from monitoring activity. This year, there has been a major new initiative with a "mystery shopper" exercise of 5,000 outlets—3,000 intermediary offices and 2,000 lender offices—to assess compliance with the code. The results of that mystery shopper exercise are expected later this month.

All of this activity shows significant commitment by the industry to the voluntary code framework. But is it working in delivering sufficient consumer protection? Despite all of this progress, I would be the first to recognize that the code is not perfect. A key omission which we have been working on is the need for a more explicit disclosure regime for mortgage products at the point of sale, describing the key features of mortgage products, the financial costs of the loan and related insurance, and any potential pitfalls which the consumer should be aware of.

Such a disclosure regime is needed because of the complex nature of the U.K. market combined with the inadequacies of the APR regime. We are currently consulting the industry about a disclosure document that could be introduced across the industry on a standardized basis to enable customers to compare and contrast different offers of credit available. If acceptable, we would hope to introduce a new disclosure regime in the second half of 2000.

Government Position

What has been the government's position? It has been happy to let the code evolve,

because there has been a wide range of other policy priorities to progress. However, now we have reached the point where a decision needs to be taken about the long-term framework of regulation of the mortgage market. A bill is going through the U.K. Parliament which is creating a new single regulator, the Financial Services Authority, which will replace nine different regulators covering banks, building societies, insurance companies, investment firms, etc.

There is considerable pressure on the U.K. government to include mortgage regulation within the scope of this new body. A number of lenders who have supported the Mortgage Code would also now favor statutory regulation, because it would ensure a level playing field and reinforce consumer confidence in the market place. Despite the tangible progress made over a very short time frame, there are some consumer bodies which believe that the self-regulatory approach will, at some point, fall into the trap of perpetuating self interest. They are also concerned that voluntary arrangements do not have sufficient "teeth." Nothing the CML will do will satisfy these audiences other than expelling one of our members, a course of action that I would like to avoid!

Will the U.K. government decide to impose statutory regulation? I suspect that it will be impossible to resist the political pressure. The vast majority of CML members now believe statutory regulation is inevitable in the U.K. They do not fear it, but they do not yet know what form it will take. There is universal support among our members that it should be based on the code framework put in place.

SUMMARY

It is important to get regulation right. It must deliver sufficient consumer protection—not too much because it could constrain market development, not too little because it could leave customers exposed.

So far as I am aware, the U.K. has done more to have a comprehensive, effective and cost-effective regime on a voluntary basis than most other countries around the world. I think the voluntary code has succeeded up to a point. However, the U.K. market is very complex and diverse, and we have now reached the stage where statutory regulation is needed to ensure consistency of regulation across the whole of the market.

In the U.K., we now have the task of debating with government how best to introduce that regulation to ensure that it meets the principles of transparency, accountability, targeting, proportionality and consistency. The code framework is the right way forward. The challenge for industry is to demonstrate this fact to the government, consumer bodies and other interested organizations that might prefer, instead, to go down the route of product or price restrictions. This might deliver "protection" but at too high a cost in stifling innovation. Getting the balance right remains the challenge that faces governments, regulators and the industry. At the CML, we will continue to play our part in informing these debates on behalf of U.K. mortgage lenders.