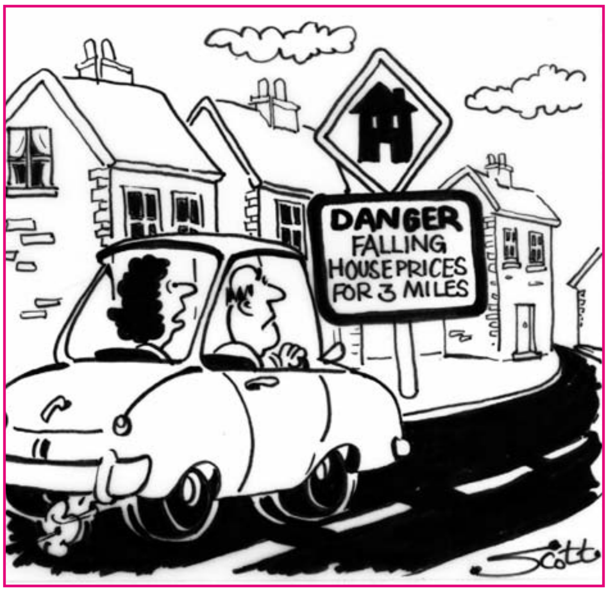
THE LOOK OUT

JULY 2008

Property Matters

Familiar Landscapes and New Challenges

After a flourishing decade or so, the UK property market is experiencing a severe downturn. Property prices and sales are falling as the mortgage market continues to shrink in the face of the ongoing credit squeeze in the world's money markets. As the tide of easy credit recedes, a familiar landscape emerges: cases of mortgage fraud on the increase (a report by the Association of Chief Police Officers delivered earlier this year found confirmed mortgage fraud of around £700 million) and rising numbers of claims against professional advisers as people seek to recover their losses. For those who experienced the last property recession, there is a sense of déjà vu.



Then there has been the challenge of the new - the introduction of the controversial Home Information Packs (HIPs). Earlier this year the Law Society warned home sellers and buyers to be careful about HIPs after it had been found that a number of HIP providers had been including the wrong documents in the packs (in particular in relation to evidence of title). To avoid this, the Law Society urged sellers to use solicitors to compile HIPs.

So what lies ahead? Will one continue to see rising levels of mortgage fraud as the economic downturn continues and what steps can one take to guard against it? How are HIPs bedding in and what liability issues do they raise? We asked our contributors – to whom our grateful thanks – for their views: Mark Wiggin, Director, Strutt & Parker; David Worrall, Senior Partner and Head of Property, Pickering & Butters Solicitors; Judy Gibson, Senior Solicitor, Robin Simon LLP and Deputy District Judge, Midland Circuit; Steven Pollock, Practice Leader Technical and Risk Management, Travelers Professional Risks Limited; Henry Pryor, The HiP Exchange.

Mortgage fraud – action replay?

Mark Wiggin, Strutt & Parker

Mark Wiggin has been buying and selling houses and farms for more than 20 years. During the last recession, he personally handled some 200 repossessions of which around 90% involved mortgage fraud. He has not yet come across mortgage fraud in the current market (this may be due to a tougher anti-money laundering regime), but, regrettably, sees a lot more repossession work coming with the middle market likely to be badly affected.

As a result of the downturn, banks are definitely being more cautious and asking more questions. Valuation questionnaires have become much lengthier and the whole valuation process is taking much longer. Banks are also challenging valuations, particularly the more complex ones.

David Worrall, Pickering & Butters

David Worrall has over 30 years' experience as a property lawyer. In his view, this downturn in the property market is more significant than the last because the credit crisis is at the institutional, rather than the consumer, level. Where it is individuals who have difficulties accessing funds, this can be remedied by their getting a better job. However, where it is the banks which are in borrowing difficulties, the situation is more difficult to resolve.

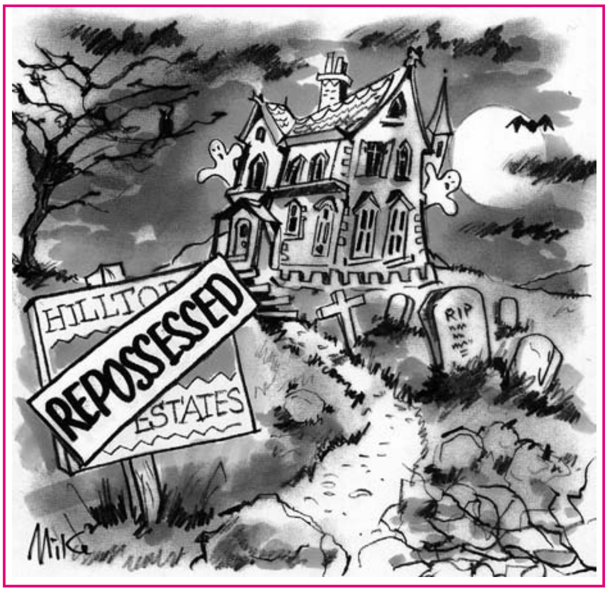
His firm has encountered mortgage fraud in the past. A series of copycat frauds came to light locally some seven to eight years ago, and it became clear that a deal in which the firm was involved was being done at a substantial undervalue – the firm told the client it could no longer act. However, like Mark Wiggin, David Worrall has yet to see any evidence of mortgage fraud during this downturn. This could be due to the usual time lag between a market downturn and mortgage fraud surfacing. However, it could also be because the firm's checks and controls are working well (insurers now require a greater awareness of risk management, although they have not as yet introduced questions specifically relating to mortgage fraud). The firm knows its clients and is always on the lookout for unusual transactions or requests from third parties.

Judy Gibson, Robin Simon LLP

Judy Gibson specialises in the defence of professional indemnity claims, including against solicitors and surveyors. She sees mortgage fraud as the almost inevitable consequence of a buoyant property market combined with keen lenders. A couple of significant changes in the market since the last recession may also have increased the scope for fraud: firstly, the use of mortgage brokers (many of the smaller scale mortgage frauds will have been facilitated by brokers) and, secondly, the decline in the concept of the 'family solicitor' with his or her long-term knowledge of a family's affairs. These days loans tend to be packaged with applicants signing up to the services of a solicitor and valuer, neither of whom knows the applicant, as part of the mortgage deal. This can achieve cost savings for the lenders, but the solicitor's and valuer's lack of personal knowledge of the borrower can leave open the possibility for fraudulent activity by the borrower.

"...This downturn in the property market is more significant because the credit crisis is institutional, rather than consumer"

Judy Gibson is already receiving growing numbers of lender claims and expects mortgage repossessions to rise: mortgage repossessions for 2007 were 27,100 and 45,000 repossessions are forecast for 2008. From discussions with her colleagues, it seems that it is surveyors who are currently bearing the brunt of the claims. Having worked on the lender litigation coming out of the last recession, she has a very real sense of déjà vu and anticipates a similar pattern this time round with rectification claims followed by mortgage fraud claims (framed as negligence because of the difficulty of substantiating fraud). However, the emphasis this time is likely to be on large-scale, organised mortgage fraud, particularly in the buy-to-let market which fraudsters have seen as fertile ground.



Steven Pollock, Travelers Professional Risks Limited

At Travelers, Steven Pollock deals principally with solicitors, mortgage brokers and surveyors. Given the time lag between the onset of a credit squeeze and claims being made, he expects to see repossession claims from this economic downturn peak over the next 12 to 24 months. The downturn seems to be occurring at a much faster rate than in the early 1990s which could compress the timescales through which losses are suffered by lenders and claims are made.

Amongst the general claims arising from repossessions, Travelers has already seen numerous cases of mortgage fraud. This a market wide problem – one the ABI, the SRA, the RICS and the FSA are actively engaged in tackling – but the true extent is difficult to report as the claims are often framed as negligence given the difficulty of proving fraud. The difference with this property boom seems to be that fraud is more organised. Steven Pollock puts this down to a number of factors: the willingness of lenders to lend to marginal risks (often ignoring their own underwriting criteria and having business models that emphasised sales over fraud controls), the use of mortgage brokers and volume mortgage packagers (which meant many mortgage transactions could be processed remotely and safeguards on the appointment of solicitors and valuers circumvented), and the introduction of buy-to-let mortgages which has increased the number of mortgages on the market. All of these have made a buoyant property market ripe for exploitation.

Identifying factors and claims trends which present an increased risk of fraud is an important part of Travelers' approach. For example, when reviewing its existing solicitors' professional indemnity book, it will look for potential dishonesty triggers such as an under-declaration of fees. It also applies stringent acceptance criteria to new applications, which include checking where people have worked previously - fraudsters often target people lower down in a firm who know how to circumvent the checks and controls and who may then move between firms. To address this, Travelers has introduced a number of mortgage fraud-related questions identifying firms working with property investment clubs and mortgage packagers and firms who have been removed from lenders' panels. Travelers also looks closely at the degree of supervision within both the firm as a whole and its individual offices. In this context, having Lexcel can be helpful, but for Travelers obtaining satisfactory responses to its own specific questions is much more important.

After several years of softening rates, premium increases are likely for conveyancing solicitors and surveyors undertaking valuation work. Commercial conveyancing while less prone to systemic fraud has had its share of problems – as shown by the recent Cheshire Building Society litigation against Dunlop Heywards and others which could reach £100M in claimed damages – and rate increases will soon follow. In the last six months, the value of commercial properties has fallen at an even faster rate than that of residential properties and losses increase significantly when properties have no buyers.

HIPs – the new kids on the block

Henry Pryor, The HiP Exchange

Appalled at the mess the government was making of introducing HIPs, Henry Pryor decided to set up The HiP Exchange to make the HIP process transparent and to avoid wasted costs. The HIP Exchange, which is entirely web-based, went live in August 2007

"...The difference this time is that fraud is organised rather than speculative"

as HIPs came in. Sellers, estate agents and solicitors can sign up, but their subscriptions have to be approved by The HIP Exchange. The HIP Exchange also checks out Domestic Energy Assessors and Home Inspectors who wish to register as well as the HIP providers (although here the HIP Exchange also relies on customer feedback as only limited checks are available).

"...The only good thing about HIPs is that their cost has deterred people from flirting with putting their homes on the market"

Subscription is free, but in the future a HIP provider, Domestic Energy Assessor or Home Inspector registered with the HIP Exchange will pay a brokerage fee when he or she accepts an instruction received through it.
Business has been slow since the outset due to a number of factors. The first day marketing day debate rumbles on – from June of this year, a seller was to have been required to have a HIP before marketing a property, but this deadline has now been put back until January 2009. Then there is the ongoing downturn in the property market: at the moment, roughly two of every three HIPs turn out to be unnecessary because no buyer can be found for the property which, with HIPs costing some £400, means substantial wasted costs. There are also the debates about the length of time for which searches are valid – of particular concern in a slow market – and which have resulted in some 10% of HIP water searches being redone.

'I expect to see a full home information pack before I decide to buy it'

It is too early for claims, but, in Henry Pryor's view, it is difficult to see how one squares our culture of caveat emptor with making the seller responsible for anticipating a buyer's needs.

Mark Wiggin, Strutt & Parker

For Mark Wiggin, the only good thing about HIPs is that their cost has deterred people who are not serious about selling from flirting with putting their house on the market. Apart from that, HIPs have slowed down rather than speeded up the conveyancing process and purchasers seem little interested - since August 2007, only one purchaser out of some 300 properties which he has sold has asked to see the HIP. HIPs delay the process of getting a property to market, result in duplicated work (the buyer's solicitors still do their own searches), and where a property has been on the market for some time, as can happen in the current climate, they may need to be redone.

HIPs are supposed to alert a potential buyer as to any problems with the property, but this was something which good estate agents made sure they knew anyway. For Strutt & Parker, it was standard practice to check with the vendor's solicitors at the outset if there was anything they should know about the property they were about to market, for example, concerning rights of way or covenants.

Strutt & Parker do not themselves provide HIPs; they use a HIP provider whom they are satisfied has appropriate professional indemnity cover. Not being HIP providers, they do not anticipate receiving HIPs-related claims However, they have altered their internal procedures to ensure that a property is not put on the market before the requisite Energy Performance Certificate has been obtained.

David Worrall, Pickering & Butters

David Worrall agreed with the original concept of the HIP, but is not sure about the watered-down version now in place which, worryingly, the estate agents say nobody looks at. He also has concerns about some of the information provided in HIPs. It can be threadbare - there may be evidence of title, but no details of any covenants – and may include search information carried out by inexperienced third parties instead of searches done by the local authority. In his view, this broadbrush approach is unlikely to assist a potential buyer in making an informed offer.

His firm's solution is to provide their own copper-bottomed HIPs which include searches stamped by the local authority which they know will satisfy a buyer's solicitors. Pickering & Butters has also introduced a case management system for HIPs as part of the firm's Lexcel framework.

As to potential HIP liability issues, Pickering & Butters have been proactive in asking insurers whether they would be willing to underwrite third party personal searches. Insurers are currently scratching their head about this and have asked the firm to provide information about the personal search market.

Judy Gibson, Robin Simon LLP

Robin Simon LLP has not received any HIPs-related claims as yet, but this could be because of the usual time lag between a purchase default and the crystallisation of any loss. It is also difficult to know at this stage, without any claims' experience, if the claims will be big or small (they could be substantial if they involve large-scale developments in the buy-to-let market), and whether there will ever be a sufficient number of claims to make major litigation

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worthwhile. However, HIPs raise a lot of interesting liability issues both for in-house HIP providers (who will need to ensure that any staff, especially junior staff, are properly trained) and buyers' solicitors who, when reviewing the seller's HIP, will need to decide what the search criteria should be and if these have in fact been applied (this will be particularly important with rural properties where different search criteria can elicit different responses).

For in-house HIP providers, the main issue will be controlling risk, for example, ensuring there are robust management procedures in place for what may be perceived as administrative tasks carried out by junior members of staff. The constantly changing HIP requirements present another source of risk and HIP providers will need to ensure that they are always up-to-date with any changes and that any alterations in insurers' requirements are fed down to those putting the HIPs together. For HIP providers who sub-contract, it will be important for the contractual arrangements to make clear where the responsibility lies for the accuracy of the information, compliance with the regulations, and whose professional indemnity cover will respond in the event of a claim.

Solicitors and surveyors involved in the provision of HIPs should be up-front with their professional indemnity brokers about the fact they are doing HIP work and have this noted on their policy so that insurers cannot avoid the policy in the event of a claim by alleging it falls outside the 'private practice' definition. It is also worth considering paying an additional premium to cap one's excess to avoid the risk of becoming self-insured where every claim falls within the excess.

The potential liability issues for solicitors are complex. At present, a solicitor who acts for a seller does not owe a duty of care to the buyer, save in exceptional circumstances in relation to pre-contract enquiries. However, there could be a shift here. It is likely that the courts will consider potential buyers who make an offer to be a defined class of people, and accordingly will wish to create a remedy where this class has relied on a HIP, suffered a loss and has no remedy against his own solicitor (for example, because on reasonable inspection it had not been reasonable to anticipate that there might be an adoption issue with a road). However, this is a difficult area of law as it would involve extending solicitors' duties to a class of people whose interests conflicted with those of their client.

Steven Pollock, Travelers Professional Risks Limited

Steven Pollock is not aware of any HIPS-related claims and the general view in his area of business is that HIPs have been rather a non-event. He thinks that claims against surveyors and estate agents will be extremely rare - although there could be some exposure for estate agents who discuss the contents of a HIP with a client and are then considered to have been giving advice – and he has heard that solicitors are not relying on them.

Last year, Travelers included quite detailed questions on HIPs in its proposal form, but this year it is simply asking insureds if they produce HIPs and how many. In short, Travelers does not currently consider HIPS to be a high-risk area.

CONCLUSION

In terms of repossessions and mortgage fraud, the unfolding landscape is familiar to those who experienced the last property recession. However, this time round, the fraud is likely to be on a larger scale and to affect the buy-to-let market in particular.

As regards HIPs, there are still a number of teething problems, which are being exacerbated by a slow property market. It is too early to predict the value, number and type of HIPs-related claims which might arise. However, one thing is certain: they raise a number of difficult liability issues to which there is no easy answer.

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