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Gina Hartnett, **Michèle Daelemans**, Senior Associates, Mayer Brown International LLP

The mortgage pre-action protocol and UK RMBS

Perceptions of a flawed model

The mortgage funding and lending model in Anglo-Saxon jurisdictions is the focus of intense scrutiny. As the credit crisis advanced and words like "securitisation" and "subprime" became common parlance, so did political pressure mount to assist the consumer from what were perceived to be the excesses of the "originate to distribute" approach.

In the US, steps to enshrine anti-predatory lending practices in regulation culminated in the establishment of a Consumer Financial Protection Agency to protect consumers through its abilities to write and enforce consumer protection rules, and by imposing measures that ensure mortgage brokers' accountability. In the UK, the approach taken has been rather to provide direct assistance to consumers in order to stave off the effects of the "temporary economic shock". This has been done this by offering schemes that give liquidity support to homeowners who have lost their sources of income, by a mortgage rescue scheme run by participating local housing authorities to assist certain households by allowing for shared equity with housing associations, and by a repossession prevention fund for families at risk of homelessness through eviction or repossession. Late in 2008, six lenders which were recipients of government funding agreed to delay repossession until a borrower has at least six months of mortgage arrears.

Perhaps less widely publicised was the establishment of a mortgage pre-action protocol to be adopted by lenders and administrators of mortgage pools, following extensive consultation with stakeholders (including those representing the interests of wholesale residential mortgage funding, such as the European Securitisation Forum), regulators and other parties in the UK.

Mortgage Pre-Action Protocol

The Civil Justice Council's Housing and Land Committee published on 22 October 2008 the "Pre-action Protocol for possession claims based on mortgage or home purchase plan arrears in respect of residential property" (the "Protocol"). The Protocol became effective as from 19 November 2008 and was designed to encourage lenders and borrowers to exchange information at an early stage, to encourage early settlement of cases or, where that cannot be achieved, more efficient case management. It does not purport to alter parties existing rights and obligations. Further, it confirms the court's view that commencing repossession proceedings is the last resort and that alternative dispute resolution should first be explored between the parties.

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The main points of the Protocol can be summarised as follows:

- The Protocol applies to arrears on first and second ranking regulated residential mortgages as well as unregulated residential mortgages, including buy-to-let mortgages; it applies to both money claims and claims for possession after 19 November 2008.
- The Protocol requires discussion and information flow prior to the start of a possession claim and imposes a duty to consider proposals from borrowers, such as to change the date of regular payments or the method by which payment is made. Borrowers should be given reasonable time to consider payment proposals made by a lender; if a borrower breaches the terms of an agreement reached with a lender, the lender must warn the borrower of its intention to start possession claim by giving 15 business days' notice (unless the breach is remedied within that time period).
- The Protocol requires lenders to consider delaying repossession proceedings in certain circumstances (e.g. where a claim on mortgage payment insurance is submitted, when

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reasonable steps have been or will be taken by the borrower to market the property at an appropriate price or when a genuine complaint has been made to the Financial Ombudsman Service). If however, the lender decides not to postpone commencement of repossession proceedings, it must tell the borrower with reasons at least five business days before starting proceedings.

If requested by the court, parties must explain the actions that were taken to comply with the Protocol; the impact of this is that defaulting borrowers are able to seek to stall repossession proceedings by lodging with the court an objection on the grounds that the Protocol is not being complied with. The Protocol itself does not contain any specific sanction for non-compliance as the majority view during the consultation was that sanctions would not be appropriate for inclusion in such a protocol, and that courts already had adequate powers within their discretion to deal with non-compliance.

However, the absence of specific sanctions in the Protocol and some other shortcomings (e.g. the Protocol failed to close a loophole available to lenders intending to enforce their security over residential property without obtaining a court order (by appointing a receiver to sell the property)[1]), has been criticised by the Law Society.

Impacts on securitisation

While much has been said about the impact of the Protocol on different groups of consumers, what is there to say about the impact upon mortgages which form part of securitised pools in UK RMBS? And indeed on those securitisations?

- Servicing

The main issues surrounding the Protocol and its application where mortgages are part of securitised pools within the remit of the parties appointed to administer mortgage pools; the burden is on administrators to consider the Protocol and the heightened obligation to consider a wider range of arrears options that it brings.

The administrator is obliged to contemplate borrowers' interests at the same time as adhering to the "standard of a reasonably prudent lender of money secured by mortgages over residential property" (usually matched by a covenant to comply with applicable regulatory guidelines) on the one hand. On the other hand, parameters within which amendments and/or variations may be made are prescribed (for example, limitations on the extension of maturities) and disclosed to holders of securitised notes, posing a potential dilemma for the administrator.

The analysis becomes more complicated where a third-party administrator services the mortgages with existing contractual arrears procedures. The third-party administrator is exposed to the level of compliance with the Protocol by borrower-facing lenders, where it acts as a sub-servicer to a lender acting as master servicer. The administrator is appointed by the issuer in the securitisation, which in itself presents difficulties of reconciling the demands of the Protocol with the interests of the parties to the securitisation. Where it is master servicing a mortgage pool, the question hinges on whether it can demonstrate it has complied with the Protocol, requiring expenditure of systems and personnel resources.

Clearly, not only the Protocol but the other initiatives offered to support consumers will have an impact on how securitised mortgage pools are administered.

- Cashflow and other considerations

Fundamental assumptions for assessing mortgage pools regarding loss rates and expected times to repossession have been affected by the Protocol, which may result in increased cost of carry for some UK RMBS (even to such extent that the rating agencies' initial rating assumptions will no longer be met) and an increased premium demanded by investors for UK RMBS.

The way in which a borrower and lender agree an approach under the Protocol may have an impact on cashflow administration. If, for example, the agreed approach results in a capitalisation of interest, in the short term there may be revenue shortfalls which could then have an impact on the longer term principal receipts depending on the structure.

Ultimate recoveries of principal also appear to be affected as a result of the Protocol. The Protocol contains a delay in possession claims where the borrower is acting under "reasonable professional advice" to achieve a sale: the reconciliation of this process with payment obligations of the lender toward any wholesale funding source, including securitisation, is difficult.

Going forward

Given that the Protocol amounts to a statement of good practice (largely expected to be already in place), the impact of the Protocol on mortgage enforcements should be relatively small. Interestingly, however, according to the Ministry of Justice[2], the introduction of the Protocol coincided with a fall of close to 50% in the daily and weekly numbers of new mortgage possession claims being issued in the courts as evidenced from administrative records. As orders are typically made around eight weeks after claims are issued, the downward impact on the number of mortgage possession orders made was seen in Q1 2009. According to the Ministry of Justice, the extent to which the Protocol has resulted in the issue of claims being delayed rather than abandoned is as yet unclear.

The main concern about the Protocol in the context of the €455.8bn[3] residential mortgage backed securitisation market in the UK is to what extent it will stretch administrators and lenders where there are already a significant number of factors which are hampering lenders' ability to access the securitisation markets again, by potentially posing operational and legal complexities which are difficult to quantify or mitigate.

Suffice it to say, it is still too soon to assess the full impact of the Protocol on UK RMBS.

Footnotes

1) *Horsham Properties Group Ltd v Clark & Anor [2008] EWHC 2327 (Ch) (08 October 2008)* in which the High Court ruled that a mortgagee can instruct receivers to sell a Property if the mortgagor (the borrower) is in arrears without first obtaining a court order. Even though the case related to a buy-to-let mortgage, it diminishes the effectiveness of the Protocol which is only triggered if the mortgagee applies to court. The Home Repossession (Protection) Bill, introduced as a Private Member's Bill, seeks to amend the Law of Property 1925 to require lenders to first obtain a court order for possession before they can sell a defaulting borrower's home; the second reading of the bill is scheduled for late June 2009. The Council of Mortgage Lenders ("CML") issued a voluntary statement after the *Horsham* case, confirming that CML members will obtain a court order before seeking to sell, or appointing a receiver to sell, an occupied residential property when the borrower is in default.

2) The Ministry of Justice published the "Statistics on mortgage and landlord possession actions in the county courts – Q1 2009" on May 15 2009.

3) European Securitisation Forum, "European Securitisation Data Report – Q4: 2008", "2.6 Outstandings per Collateral and Country"