

9 Conclusions

Contents

	<i>Page</i>
The mortgage and valuation markets	134
The residential mortgage lending market	134
The valuation market	136
The monopoly situation	138
The public interest	141
The selection of valuer	141
The lender's interest in selection	141
The borrower's interest	142
The cost of valuations	143
Acceptance of earlier valuations	143
Reciprocal business	144
Use of in-house valuers	144
Conflicts of interest	145
Lenders' use of scale charges to borrowers	145
Lenders' scale fees to valuers	146
Assessment	146
General effects of selection on borrowers	146
Use of in-house valuers	147
Charges to borrowers	148
Effects of selection on individual borrowers	149
Conclusions on effects of selection on borrowers	151
Associated issues	151
Reciprocity	151
Conflicts of interest	152
Scotland	153
Administration charges to borrowers	153
Conclusions on administration charges	153
Recommendation	154

The mortgage and valuation markets

The residential mortgage lending market

9.1. Most residential mortgage lending is for the purchase of residential property, but the market also includes remortgages, ie the refinancing of existing mortgage loans, which may involve the borrower switching from one lender to another, and further advances secured on the borrower's existing property. We estimate that currently almost four-fifths of total advances are made in connection with the purchase of a property, with remortgages accounting for over half of the remainder and further advances for probably less than 10 per cent of the total.

9.2. There are more than 150 lenders currently providing residential mortgages. We estimate that in 1992 the gross value of new lending on residential property was £54 billion. The seven largest lenders account for about half of new residential mortgage lending and the 15 largest for almost three-quarters; other lenders

range from substantial lenders operating throughout the country to some small building societies operating regionally or even locally. There are three main types of lender: building societies, banks, and the centralized lenders. The greater part of lending, over 70 per cent of new lending in 1992, was provided by building societies,¹ the traditional suppliers of residential mortgages. Following the loosening of controls on their lending in 1980, the banks entered the market in the early 1980s and quickly took a substantial share of business, through both their branch networks and intermediaries. Within a short period the banks had 40 per cent of new lending, although this level was not maintained (see paragraph 3.13). Banks draw funds mainly from the wholesale money markets, and have been particularly successful in times of low interest rates. The centralized lenders, who entered the market during the mid to late 1980s, also draw their funds from the wholesale money markets and attract business primarily through intermediaries. Many have withdrawn from the market altogether or cut back operations in the more difficult conditions of the last few years.

9.3. The entry of these new lenders was accompanied by the relaxation of controls on building societies under the Building Societies Act 1986 (the 1986 Act) which allowed them to provide banking, life insurance and pension services, structural surveys (SSYs) and homebuyers reports (HBRs) for borrowers, and to establish and acquire estate agencies. Controls on their sources of funds, which had meant that most funds were raised from depositors and rationed to borrowers, were also relaxed. Currently building societies can obtain up to 40 per cent of funds from wholesale money markets.² The changes in the market were accompanied by a large number of mergers of building societies, totalling 170 in the last ten years or so; the Council of Mortgage Lenders (CML) told us that currently 84 remain as active lenders (see paragraph 3.19).

9.4. These changes have had major effects in the market. The range of mortgage products available has increased. The borrower now has a wide choice between different kinds of endowment and repayment mortgages, available at fixed or variable rates. The recent decline in the housing market, accompanied by continuing availability of funds for lending, has intensified competition between lenders. There has been some switching by borrowers between lenders in search of better terms and a number of lenders have been actively seeking this business.

9.5. Most lenders tend to quote the same or a very similar basic interest rate. There is, however, a range of differing packages available featuring the different types of mortgage and a variety of special inducements, for example interest rate discounts or a contribution to the borrower's costs, which will be offered for a limited period or to particular classes of borrower. The costs incurred by the borrower in securing the mortgage include not only the valuation fee but lenders' legal costs and, where the loan:value ratio is high, a substantial mortgage indemnity premium. Many building societies charge an administration fee as a contribution to their costs, and where a fixed-rate mortgage is negotiated, an arrangement fee may also be charged at the point when the funds are booked by the lender. While some of these costs can be included in the mortgage advance and thus in the monthly payment, and others settled on completion, the valuation fee is traditionally paid by the borrower when he submits his application form and before any mortgage offer is made. The more recently introduced administration charge is also usually levied at this point. We describe these fees and charges, which have to be incurred by the borrower before he knows whether the mortgage transaction will proceed, as up-front costs.

9.6. Buying a home and taking out a mortgage to finance it involve some of the most important financial decisions in the borrower's life. He needs not only to make appropriate financial arrangements but to satisfy himself that he has made a sound purchase; we discuss the role of the valuation in reassuring him on this aspect later (see paragraph 9.49). Until the market changes described above there was little choice of product and the chief hurdle for the borrower was to be accepted by a building society. Today, in choosing a mortgage a borrower is faced with a variety of lenders and a far wider range of products than in the past. He is provided with a great deal of information on terms and costs, including the up-front costs described above. These costs are included in the APR (Annual Percentage Rate) which all lenders are required to quote under Consumer Credit legislation (see paragraph 3.33). The APR, however, although it may be well-suited to shorter-term credit transactions, is less informative when applied to long-term mortgage transactions. Given the way in which the relevant legislation has been interpreted, for example on truncated rates and fixed-rate mortgages, the APR is now of even less use to borrowers. There was general agreement on these points among those who

¹For the purposes of this chapter we group Abbey National plc (Abbey National) with building societies rather than banks or other lenders (see paragraph 3.11).

²There are proposals in the Deregulation and Contracting Out Bill, published on 20 January 1994, for relaxing this limit.

gave evidence to us on the subject. Moreover, regulation under the Financial Services Act 1986 does not extend to mortgage lending as such; for example, there is no obligation, as there is on insurance or pensions, to offer best advice.

9.7. Given the range of products and the amount of information available about them, many consumers prefer to rely on intermediaries, who are now responsible for over half of the business coming to some major lenders. The evidence from a number of lenders, however, and observation of shop window, newspaper and other forms of advertising, including pamphlets, suggest that most of those borrowers who do go direct to a particular lender will nowadays obtain initial information from a number of others. Borrowers examine the packages offered by the individual lenders and are principally concerned with the monthly outgoings on the mortgage, the interest rate, whether it is fixed or variable, and the size of any up-front payments; the first of these is generally the most important. While lenders are required to state costs to borrowers, the extent to which they break these costs down and the way the information is presented will vary.

9.8. It is clear, therefore, that the recent changes in the residential mortgage market have promoted active competition between lenders offering mortgages. This does not mean, however, that this competition is always fully effective. The range of factors to be taken into account by the borrower is particularly complex and, as indicated above and referred to in more detail in paragraph 3.41, the information he receives is not always presented in the most useful way to help him.

The valuation market

9.9. We now consider the valuation market. The cost of the valuation-the arrangements for which are the main subject of our inquiry-is likely to be an element in a borrower's calculations but not a major one; it is only part of the costs which the borrower will have to meet before the transaction is completed. Some lenders, however, now see the valuation as an element in the mortgage offer on which it is worth offering rebates as an incentive to attract potential borrowers. The cost of, and the arrangements for, the valuation will also be a factor for those borrowers who have already decided on, or commissioned a survey of, the property and who hope to save money by having their selected surveyor accepted also to provide the valuation.

9.10. A valuation report is essentially a professional assessment of the open market value of the property, to provide reassurance to the lender that the advance is adequately secured. It will take account of information on values of comparable properties and will note any major observable defects in the property which may affect its value. The lender may require these to be put right as a condition of making the loan (and this may lead to a reinspection by the valuer). More detailed assessments of the condition of the property are available to the borrower through an SSY which should give him a full picture of the condition of the property, or an HBR, which is a less detailed and less expensive report in a form drawn up by the Royal Institution of Chartered Surveyors (RICS) to encourage more borrowers to opt for their own advice (see paragraph 4.10). In broad terms an HBR, including a valuation, can be expected to cost about twice as much as a valuation carried out on its own and an SSY (again including the valuation) twice as much again.

9.11. On the basis of information provided by the seven largest lenders we estimate the total cost to borrowers of valuations carried out for all lenders in 1992 at £160 million. Other information we collected through a survey (see paragraph 3.60) suggested that the total value of all valuations carried out for lenders and other clients, together with the value of HBRs and SSYs commissioned, whether carried out with a valuation or separately, may have been twice as much as this figure.

9.12. Virtually all lenders require a valuation when they are lending on residential property. It is one of the two key elements in the decision to grant a mortgage, the other being the applicant's status (ie income and creditworthiness). There is a statutory requirement on building societies that before making an advance they satisfy themselves on the security for the advance and for that purpose have in their possession a written valuation made by a competent valuer. The requirement, currently in section 13 of the 1986 Act, is long-standing. While there is no comparable statutory obligation on other lenders such as banks and centralized lenders, virtually all follow the same practice. The statutory obligation requires only that the person carrying out the assessment of the security of the advance be in possession of a valuation. Building societies, however, and other lenders regard it as essential that they establish a contractual relationship with the valuer by directly commissioning the valuation themselves and all retain the final say over the selection of the valuer. He will virtually always be either an in-house surveyor (or one employed by a subsidiary) or one drawn from a panel

of approved surveyors established by the lender. Lenders have been under pressure to maintain strict controls by outside bodies including the Building Societies Commission (BSC), The Law Society and police fraud squads, and by their indemnity insurers. The views of these bodies have been taken into account in the guidelines issued by the CML to its members.

9.13. In Scotland, in part as a result of the different housebuying system, most mortgage applications are packaged by intermediaries who make arrangements for the valuation, but the surveyor is almost always from the lender's panel. A contract is established between lender and surveyor before the final arrangements for the mortgage are made.

9.14. Until the early 1980s the valuation report was not shown to the borrower and he was not considered to have a legally recognizable interest in its contents. However, as a result of a series of cases from 1981 onwards,¹ the courts have established a duty of care by the valuer to the borrower in respect of his report in cases where it is foreseeable that the borrower will rely on it. In the first of these cases (the *Yianni* case) the court took into account that the house concerned was at the lower end of the market, purchased by a person of modest means who would be expected to rely on the building society's valuation, for which he had paid, and not to obtain independent advice. The extent to which purchasers of more expensive properties or in different circumstances might benefit from a duty of care on the part of the valuer remains untested.

9.15. Shortly after the *Yianni* case Abbey National decided to disclose valuation reports to borrowers. Other lenders followed suit. It has now become normal practice for them to pass copies of valuation reports to the borrower. Most lenders' reports now contain more information about the condition of the property than the earlier undisclosed ones.

9.16. While the lender commissions the valuation, it is for the borrower to negotiate the terms and conditions for any SSY or HBR he may require and commission it directly from the surveyor. (However, at least one lender requires a prospective borrower to commission an HBR on pre-1914 property.) As noted above, such a fuller report is usually combined with the valuation. In the majority of cases the borrower will be content to commission his more detailed report from the same surveyor as the lender has selected for the valuation. Where, however, he wishes to use a surveyor who is not included on that lender's panel and the lender will not accept his choice of surveyor, he will either have to abandon his choice or pay separately for the lender's valuation, thus incurring additional cost.

9.17. Lenders normally require that the person carrying out a valuation for them be a member of either the RICS or the Incorporated Society of Valuers and Auctioneers (ISVA), have a minimum of two years' experience, and possess local knowledge of the area where he is carrying out the valuation, which will cover both comparative prices and local planning or physical conditions which may affect the value of the properties. Where independent valuers are employed they must satisfy the lender that they have adequate professional indemnity cover.

9.18. As noted in paragraph 9.12, valuations are provided to lenders by three main groups:

- (a) in-house employees of the lender who provide valuations solely for it;
- (b) valuers in a subsidiary company who may work both for the controlling lender and for other lenders;
and
- (c) external surveyors, who are usually on the panel of the lender commissioning the valuation.

9.19. Until the mid-1980s almost all valuations were undertaken by external surveyors. Since 1986, when lenders were allowed to buy and run estate agencies and to provide SSYs and HBRs, they have made increasing use of valuers in subsidiary companies then acquired, which often provide a national chain of surveying and valuation offices. The use of surveyors directly employed in-house has also increased; these staff, however, do not usually provide SSYs. Apart from Barclays Bank plc (Barclays), which has no in-house or associated surveyors, and Cheltenham & Gloucester Building Society, the other five of the seven largest lenders from whom we sought information now carry out the great majority of their valuations through in-

¹*Yianni v Edwin Evans & Sons* [1981] 3WLR843; *Smith v Bush* and *Harris v Wyre District Commission* [1989] 2WLR790.

house or subsidiary company surveyors. It appears, however, that other lenders still continue to rely more on external valuers.

9.20. At the same time the number of surveyors grew rapidly through the 1980s and, although reliable statistics are not available, the RICS estimates that currently about 5,000 of the 30,000 members in its General Practice Division undertake mortgage valuations or associated work, of whom about 1,150 are employed directly or indirectly by the seven largest lenders.

9.21. These changes, combined with the fall in total valuations required, have led to a reduction in numbers on panels and a further continuing decline in the volume of business going to non-panel valuers.¹ In addition, lenders have been increasingly reluctant to use sole practitioners or small partnerships, because of the perceived additional risk on any claims arising, and this group of surveyors appear to have been hit particularly hard by the cut-backs (see the views of the ISVA, the ISA and individual surveyors in Chapter 8).

9.22. While lenders have always been aware of the possibility of fraud and negligence in relation to valuations, the boom in the late 1980s followed by the fall in prices and an increase in repossessions brought to light a number of cases, some of which might otherwise have remained undiscovered. Proven cases of fraud are few; however, it is often difficult to draw a clear line between fraud and negligence and it may be more effective to pursue a case as one of negligence. Evidence from the seven largest lenders suggested that in this recent period they had between 1,000 and 1,500 cases of suspected fraud and negligence. While the numbers are small in relation to the number of valuations carried out for these lenders each year they are large enough to explain the increased attention being given by lenders to precautions against both fraud and negligence.

9.23. Until 1982 an industry-wide national scale for payments to valuers, based on property values, was negotiated between the RICS, the ISVA and the Building Societies Association (BSA); the arrangements were abandoned in the face of possible action by the Office of Fair Trading (OFT). Since then the fees collected from borrowers and paid to independent valuers have been set by the individual lenders. While they are still set by reference to scales based on property values, as shown in paragraph 5.18 fee scales may now differ significantly between lenders. In many cases the fee charged to the borrower will include an administration charge which may or may not be separately specified. When allowance is made for these the range of charges made for the valuation itself can vary by 20 per cent or more around the average.

9.24. Information from the seven largest lenders suggests that over the last five years the level of fees to borrowers has risen faster than inflation or earnings (see paragraph 5.19) although the lenders suggested that this was in part the effect of court decisions, leading to higher standards and more detailed reports.

The monopoly situation

9.25. Under the terms of reference made by the Director General of Fair Trading and dated 6 May 1993 (see Appendix 1.1) we are required to investigate and report on whether a monopoly situation exists in relation to the supply in the UK of services consisting of the lending of money on the security of any residential property (residential mortgage lending). In so doing we are required to limit our consideration to agreements and practices relating to the making or procuring of mortgage valuations and the making of charges, including administration or other charges, to borrowers in connection with such valuations. We have first to consider whether a monopoly situation exists and, if so, by virtue of which provisions of sections 6 to 8 of the Fair Trading Act 1973 (the Act), and in favour of what person or persons the situation exists. If we identify such a situation we have to consider whether any steps (by way of uncompetitive practices or otherwise) are being taken by that person or persons to exploit or maintain the situation, whether any actions or omissions by them are attributable to the situation and, finally, whether any facts found in pursuance of our investigations operate, or may be expected to operate, against the public interest.

9.26. Under the provisions of sections 7(1)(c) and 7(2) of the Act a complex monopoly situation is taken to exist when at least one-quarter of all the services of a particular description in the UK are supplied by, or to members of, one and the same group, consisting of two or more persons (not being a group of interconnected

¹ An external valuer who is not on the panel of the lender commissioning the valuation. Such a valuer may well be a panel valuer for other lenders.

bodies corporate) who, whether voluntarily or not, and whether by agreement or not, so conduct their respective affairs as in any way to prevent, restrict or distort competition in connection with the supply of these services.

9.27. In September 1993 we notified 41 residential mortgage lenders, and subsequently notified almost a hundred further lenders, that we had provisionally concluded that a complex monopoly situation existed in relation to the supply of residential mortgage lending, in that these lenders were members of a group who appeared to conduct their affairs so as to prevent, restrict or distort competition in connection with the supply of residential mortgage lending, in that they engaged in one or more of the following practices:

- (a) limiting a prospective borrower's choice of valuer by refusing to accept valuations by any competent valuer;
- (b) discriminating in the allocation of valuation business in favour of valuers that are employed by the lender, or associated firms or companies;
- (c) requiring the prospective borrower to pay a set fee based on a national scale established by the lender;
- (d) paying external valuers a set fee based on a national scale established by the lender; and
- (e) requiring prospective borrowers to pay fees in connection with valuation services which also contain administrative charges for the valuation or for other services, and which are not separately identified.

9.28. We also informed these lenders of the provisional finding that this monopoly situation existed in their favour.

9.29. In commenting on the provisional finding, a number of lenders and the CML argued that the practices had no anti-competitive effects and that there was therefore no complex monopoly situation. They drew attention to the strength of competition in the mortgage lending market and to the fact that the valuation report was the property of the lender, secured by him for his own purpose, with, in their view, no recognizable borrower's interest in the selection of valuer.

9.30. In relation to practice (a), they argued that a statutory responsibility was placed on building societies to obtain a valuation and that it had never been contemplated that any choice should rest with the borrower. As the borrower had never enjoyed the right to a choice of valuer the lenders' behaviour could not be held to affect competition. Borrowers were free to choose and pay for a surveyor for their own purposes if they so wished.

9.31. On practice (b), it was argued that individual lenders were entitled to make their own judgment how most economically to obtain the services they required and, where appropriate, to use their own resources and again no adverse competitive effects would arise.

9.32. On practices (c) and (d), it was argued that the use by individual lenders of set national scales for charging borrowers and paying valuers brought convenience and certainty to borrowers and, provided lenders set individual scales and these were made known to borrowers, competition would not be affected. Price lists were established by buyers on a national basis for many products and generally accepted without challenge, and a pricing policy which discriminated on the basis of borrower or locality would obviously attract a finding that it prevented, restricted or distorted competition.

9.33. On practice (e), the CML argued that, while the level of up-front charges was a factor in the borrower's choice of lender, it was irrelevant to his choice of lender whether the components of up-front charges were separately specified.

9.34. A number of lenders pointed to the desirable effects of practices (a) to (d).

9.35. We reviewed our findings in the light of the various comments and further information submitted. As a result we simplified practice (a) to read 'refusing to accept valuations by any competent valuer'. We removed practice (b), although the use of in-house and subsidiary valuers remained, as an aspect of selection of valuers (practice (a)), a matter for examination as possibly raising public interest issues for the inquiry. We

also slightly reworded practice (e) to read 'requiring prospective borrowers to pay fees in connection with valuation services which do not separately identify any administration charges levied in connection with or incorporated in the fee' to make clear that the restriction or distortion of competition provisionally identified was based on lack of transparency, ie the withholding of information.

9.36. In relation to practice (a) as revised, lenders' refusal to accept any competent surveyor as a provider of valuations, means that competent surveyors who might otherwise receive business are deprived of the opportunity to compete. A lender's refusal to accept the borrower's nomination, where he wishes to use his own choice of surveyor to carry out an SSY or HBR and to provide at the same time a valuation, can lead the latter to incur extra expense. To avoid this cost the borrower may be influenced to agree to instruct a surveyor whose valuation will be acceptable to the lender. These constraints distort competition in the provision of valuations and thus in connection with the supply of the reference services of residential mortgage lending. Moreover, to the extent that the borrower attaches importance in selecting a lender to being able to nominate the valuer, the failure of lenders to offer such a choice also distorts competition directly in the supply of residential mortgage lending.

9.37. In considering practices (c) and (d), we interpret national scales as those applied by lenders to mortgage transactions within their normal area of operation. Smaller societies will only apply their scales within a limited area. The use of set fees to borrowers based on a national scale established by the individual lender (practice (c)) results in fees to the individual borrower that do not necessarily reflect the cost of the individual valuation or take account of variations in the cost of valuations, either between regions or between properties of the same value. In combination with practice (a) the practice deprives individual borrowers of any opportunity to benefit from lower costs and fees that might otherwise be available and thus distorts the basis on which lenders compete to supply valuations to the borrower in connection with the supply of the reference services.

9.38. The lenders' practice of using their individual national fee scales to pay valuers (practice (d)) deprives surveyors of the opportunity of competing on price for valuation business. In combination with practice (a) it deprives many qualified surveyors of any opportunity of competing for valuation business from a large number of individual lenders. It therefore distorts competition in the supply of valuation services and thus distorts competition in connection with the supply of the reference services.

9.39. Requiring a borrower to pay a fee for the valuation which contains an unidentified amount for administration fees (practice (e)) deprives the borrower of information on the composition of an important component of the mortgage offer. Competition is distorted or restricted if borrowers have access to unequal or misleading information about the different mortgage packages available to them. The borrower knows that a valuation fee is charged for a specific professional service and in many cases this fee will be passed to an independent professional. He is likely to examine more critically the size of, and the reasons for, any administration charge levied and to look at the alternatives offered by other lenders particularly since, if the information is made available, he will find that many lenders make no such charges. Without information on the existence and amount of the administrative charge, he will be unaware, or may gain a misleading impression, of the element of the up-front payment required of him that is a true valuation charge. He is thereby prevented from making an adequately informed assessment of the lender's package and the competitive process is thereby distorted.

9.40. As set out in paragraph 3.50, the seven largest suppliers of residential mortgage lending accounted in 1992 for over 50 per cent of the gross value of all new residential mortgage lending. On the basis of the evidence set out in Appendix 4.6 it appears that all these lenders conduct their affairs in one or more of the ways described above. On the basis of the evidence set out in Appendices 4.6 and 4.7 it appears that most other lenders also conduct their affairs in one or more of the ways described. We therefore conclude that a monopoly situation exists by virtue of sections 7(1)(c) and (2) of the Act (a complex monopoly) in that the 129 lenders listed in Appendix 9.1 (being members of one and the same group for the purpose of these provisions) supply at least one-quarter of the residential mortgage lending supplied in the UK and, as set out in that appendix, each engages in one or more of the following practices:

- refusing to accept valuations by any competent valuer (practice (a) as revised);
- requiring the prospective borrower to pay a set fee based on a national scale established by the lender (practice (c));

- paying external valuers a set fee based on a national scale established by the lender (practice *(d)*); and
- requiring prospective borrowers to pay fees in connection with valuation services which do not separately identify any administrative charges levied in connection with or incorporated in the fee (practice *(e)*, as revised).

9.41. We have also concluded that the monopoly situation exists in favour of the lenders listed in Appendix 9.1. The appendix lists all the major lenders, together with a large number of other lenders. We accept that, given the large number of lenders and their different channels of operation, there may be some other small lenders engaging in one or more of the practices whom we have not identified. If so, however, such lenders do not play any significant role in this market and we took account of this commercial reality in coming to our conclusion.

9.42. We stress that the finding that a practice restricts, distorts or prevents competition, in the terms of section 7 of the Act, carries no implication that the practice in itself has any adverse or beneficial effects. Considerations of this kind arise in the discussion of the public interest, which we now address.

The public interest

9.43. Having found that a complex monopoly situation exists we are now required by our terms of reference to consider whether any steps (by way of uncompetitive practices or otherwise) are being taken by any of the persons in whose favour the complex monopoly situation exists, for the purposes of exploiting or maintaining that situation, and whether any action or omission on the part of those persons is attributable to the existence of that situation. Finally, we are required to consider whether any facts found in pursuance of our investigation operate, or may be expected to operate, against the public interest. We first, in paragraphs 9.44 to 9.69, set out the issues in relation to the various practices identified above, and then in paragraphs 9.70 to 9.111 we address the above questions and assess the public interest.

The selection of valuer

9.44. Practice *(a)* relates to the selection of valuers by lenders. One of the main reasons for this inquiry was complaints to the OFT from valuers that lenders were refusing to give them valuation business, either by excluding them from the lender's panel, or by refusing to accept them on a borrower's nomination. Almost all lenders operate panels of approved valuers for specified geographic areas who they consider have adequate competence and local knowledge. The extent to which lenders restrict choice to the approved panel varies. Some of the larger building societies adhere rigidly to their rule that valuations from external surveyors are only acceptable if made by panel valuers. Others, including most of the banks and centralized lenders, are prepared to consider a valuation by a surveyor nominated by the borrower who is not on their panel, subject to satisfactory checks on competence, particularly in cases where the borrower may already have commissioned an SSY or HBR from that surveyor before making a firm offer or seeking a loan. Over the last few years the number of valuations has fallen sharply through the recession; lenders have made increasing use of in-house valuers and valuers in subsidiary companies and some panels have been cut back. At the same time pressure from surveyors seeking work has increased. Sole practitioners and small firms have found it particularly difficult to gain admission to or be retained by lenders on their panels and have expressed their concerns throughout the inquiry.

The lender's interest in selection

9.45. Lenders represented strongly to us, both through the CML and individually, that the valuation report belonged to them and not to the borrower. It was required for their purposes, to determine whether the property was adequate security for the proposed loan, and any borrower interest was incidental. The selection of the valuer and the standards of valuation required were therefore for the individual lender to determine.

9.46. Lenders told us that standards of valuation required had become more rigorous for two reasons. First, the establishment by the courts over the last decade of a valuer's duty of care to the borrower had led to more

detail being provided in reports. Secondly, the experience of rapidly falling house prices in the late 1980s, after a long period of price inflation which had masked problems, had brought to light a number of unsatisfactory valuations, due either to fraud or more often negligence. Although small as a proportion of total valuations, these had led to significant losses and increased insurance costs and had caused much concern to lenders. This experience had led lenders to improve their valuation procedures and devote more resources to vetting valuers' competence. To accept valuations from a wider range of valuers would increase lenders' costs in training and monitoring valuers, which would have to be passed on to borrowers through increased charges.

9.47. In addition, lenders said that experience of fraud and negligence had shown that valuers' professional indemnity insurance cover was sometimes inadequate. While the RICS required members to carry professional indemnity insurance cover, including 'run-off' insurance (to cover claims arising after the valuer has retired from practice), the RICS relied on self-certification to check that this was in place. Once a valuer had retired, or a firm had been wound up, there was no way of ensuring that 'run-off' cover was maintained for claims which could take some years to come to light. Lenders therefore saw some advantage in relying on established firms which might reasonably be seen as more likely to stay in business than sole practitioners. A further consideration was that fraud by a sole practitioner, unlike negligence, could not be covered by his insurance. Nor had the RICS established a compensation scheme of the kind run by, for example, The Law Society, to meet claims arising from fraud or negligence by its members in cases where individual firms or their insurers were unable to meet their obligations. Lenders therefore felt obliged to protect their interests and to keep down their own mortgage indemnity premiums by adopting a selective approach to valuer approval and thoroughly vetting those whom they accepted.

9.48. We accept that without lender controls there would be increased opportunities for both fraud and negligence. The removal of such opportunities benefits lenders, depositors and borrowers and the public interest generally. Equally, however, we think that such dangers should not be used as a justification for any or all restrictions lenders might choose to introduce, if adequate protection of their interests might reasonably be expected from less stringent restrictions on selection.

The borrower's interest

9.49. The borrower's interest in the valuation may at first sight appear the same as that of the lender since both have an interest in knowing the market value of the property. There are, however, important differences. The lender is interested only in satisfying himself that the property represents adequate security for the loan he contemplates making. The borrower may also reasonably expect a valuation to provide reassurance that the property is worth what he proposes to pay for it, should he wish to resell. But the borrower also appears in many cases effectively to rely on the valuation to give him a general reassurance on the condition of the property, eg that it is free from major defects. Evidence from lenders, and detailed figures from some of the largest lenders, suggested that only a small proportion, perhaps 10 to 15 per cent or so, of borrowers take out a further HBR or SSY on the property. It is at first sight surprising that this proportion is not larger, given the serious consequences of major defects in a property and an earlier survey suggesting that one in five more detailed inspections reveal significant defects (see paragraph 8.36). There may be a number of explanations. First, our own study (see paragraph 3.61) suggests that the proportion indicated by lenders above may be an underestimate of the numbers taking their own advice. Secondly, some borrowers switching lenders or taking out a further loan will already be familiar with the condition of the property and will not need a further survey, while those buying newly-built properties are usually protected at least against major structural defect for the first ten years by the National House Building Council or an equivalent guarantee. Finally, the proportion may be an indication of the extent to which borrowers still think their interests are fully covered by the lender's valuation report. Even allowing for these factors, however, it is clear that only a minority of those who could benefit from further advice commission it. In spite of the frequent warnings in lenders' literature that valuations are prepared for their own purposes and not for the borrower's, there may well still be some confusion in the borrower's mind, strengthened by the fact that he pays for the valuation, about the extent to which he is entitled to rely on it. Recent court decisions,¹ by recognizing a degree of borrower interest and a duty of care to him, together with lenders' policy of disclosing reports to borrowers, have probably strengthened the borrower's inclination to rely on the lender's report.

¹ See paragraph 2.17.

9.50. In practice therefore the majority of borrowers appear content to rely on the lender's valuation and on its choice of valuer. Many of the minority who do decide to commission an SSY or HBR will already be in discussion with the prospective lender and will make a choice from the lender's panel for a combined survey or report and valuation. However, a number of instances were drawn to our attention where the borrower had either already commissioned a survey or report before submitting a mortgage application or wished to use a surveyor already known to him by reputation or past experience. In such cases, if the lender refuses to accept a mortgage valuation from that surveyor the borrower finds he has to pay two separate fees and his costs are significantly increased.

The cost of valuations

9.51. It was also argued by many surveyors that the lenders' refusal to accept a wider range of valuers deprived consumers of the benefit of the lower prices that surveyors not on their panels were prepared to charge for composite reports. In the course of the inquiry we received complaints from surveyors about individual cases where they had quoted for composite reports and then lost the business, and where the charges of the lender's approved valuer were claimed to be substantially higher (see paragraph 5.30). We collected information through our own survey about the charges for independently commissioned valuations, and compared these with the seven largest lenders' charges (see paragraph 5.20). There was a wide dispersion of charges but the average of larger lenders' charges appeared higher at all levels of property prices than the median figure for valuers' quotations for independently commissioned work, by approximately £10 on average. For valuing a house in the £25,000 to £50,000 price bracket, one in five of the fees quoted by valuers were at least £20 less than the fee charged by the lender. Our information on levels of total charges, ie including administration charges, collected from a wider selection of lenders suggests that the charges of the seven largest lenders tend to be higher than those of smaller lenders (see paragraph 5.22). This may to some extent reflect their need as national lenders for more detailed and therefore costly checking procedures. We therefore think it unlikely that, on average, quotations by surveyors for independently commissioned work are significantly lower than lenders' charges.

9.52. We noted that valuation charges had risen over the last five years faster than either the retail price or earnings indices. Lenders, however, linked this to the fuller inspection and more detailed reports now being prepared; some produced evidence of the consequential decline in numbers of valuations carried out per day.

9.53. We looked at the profitability of valuation business to the seven largest lenders. As explained in paragraph 5.33, there are difficulties in trying to isolate the results of this comparatively small part of lenders' business, which they do not separately account for, and the different accounting treatment of lenders make aggregation difficult. There are also problems in trying to produce an overall measure of profitability for an activity where some fees are transferred directly to third parties and others set against work in-house. Subject to these reservations the information collected suggests that overall modest margins are being made, mainly due to returns on in-house valuations. Part of this, however, was due to the treatment for VAT purposes of lenders' valuation activities, a matter to which we return later, in paragraphs 9.59 and 9.80.

Acceptance of earlier valuations

9.54. We received complaints, mainly from valuers rather than borrowers themselves, that the latter are put to unnecessary expense because, where an earlier prospective transaction has been frustrated, lenders are unwilling to accept a valuation recently made on the property which may have been prepared either for the same borrower or for a different prospective borrower. We were given estimates (see paragraph 3.57) that about 20 per cent of applications fail to result in a completed mortgage and in most of these cases a valuation will have been carried out. Lenders' practice varies: some will only accept valuations already carried out for them; others will in certain circumstances accept valuations carried out for other lenders. In this respect banks appear more flexible than building societies. Because of past experience, however, all lenders tend to be wary of earlier valuations carried out for the seller or the prospective borrower rather than commissioned by a lender.

9.55. It was suggested by some surveyors that lenders should be prepared to accept any valuation carried out for another lender within a set preceding period, say one month or six weeks previously. Some lenders

told us that they were ready to consider such requests from borrowers. Where they had commissioned a valuation for a transaction that did not then take place and another borrower contacted them, or where two prospective borrowers were trying to buy the same house, they would normally offer a reduction to the unsuccessful purchaser. All lenders insisted, however, that they must retain the ultimate responsibility for deciding when an earlier valuation was acceptable. They would not be prepared automatically to accept a valuation acceptable to another lender whose standards or coverage of the valuation form might be different; some of the largest lenders would not necessarily accept valuations prepared for another equally large lender. Nor did lenders think it possible to lay down set time periods within which an earlier valuation should remain acceptable.

Reciprocal business

9.56. We received complaints from individual surveyors that valuers were appointed to lenders' panels, and valuation instructions were allocated, on the basis of the valuer's ability and willingness to provide reciprocal mortgage introductions. The RICS also expressed strong concern about the practice and submitted a dossier of evidence from members on its extent. Our own survey of surveyors (see paragraph 4.41) suggested that most were aware of the practice, and that a significant minority provided introductions or considered that they had lost business as a result of failure to do so. Some lenders told us that reciprocity played no part in their choice. Most, however, told us that, while this factor did not determine their selection of valuer, nonetheless if all the essential criteria of professional competence, local knowledge etc were satisfied, this was a factor which could be taken into account. While the RICS condemns the practice of choosing valuers purely on grounds of reciprocity, it has agreed a joint statement with the CML which accepts that, in considering appointments to its panel, reciprocity may be used by a lender as a determining factor in choosing between equally suitable valuers.

Use of in-house valuers

9.57. While some building societies have employed their own valuers for many years, until the 1986 Act most valuations were carried out by external surveyors. Since then the numbers of in-house valuers employed have grown and some major lenders now have subsidiary companies which carry out valuations both for them and for others. Information from the seven largest lenders suggested that (excluding Barclays which has no in-house valuers) about three-quarters of their valuations are now commissioned in-house or from associated valuers. A number of independent surveyors expressed concern that increasing use of in-house valuers was a major factor in the decline of business going to them, thus depriving borrowers of a source of well-qualified advice. It was claimed that in-house surveyors frequently had less local knowledge than the independent valuer and were less able to comment on structural matters. They therefore tended to call for additional technical advice, involving the borrower in further expense. Concern was also expressed by the professional bodies and individual surveyors about the potential for conflicts of interest arising and this is discussed further below.

9.58. Lenders argued that the extent to which in-house valuers were used was a matter of commercial judgment. They denied that their staff were less well-qualified and claimed that because they were trained specifically to meet the needs of the individual lender the quality of their reports was often higher. Given their wish to make full use of in-house valuers economically it was inevitable that the proportion of work carried out in-house rose when total numbers of valuations fell, as in the recent recession.

9.59. As indicated in paragraph 9.53, the financial information we collected from the seven largest lenders suggests, subject to the qualifications there indicated, that their returns on valuations, which vary widely between lenders, are earned on in-house valuations. A contributory factor here is the different treatment for VAT purposes of valuations carried out in-house or by subsidiary valuers as compared with those carried out for the lender by other valuers. External valuers liable for VAT have to charge and account for at the 17.5 per cent rate on the valuations they carry out for lenders, and this has to be allowed for in the level of fees set by lenders. The provision of loan finance and associated costs, however, including the provision of valuations in-house or by subsidiaries, are exempted from VAT. A standard fee is charged to borrowers, irrespective of whether the valuation is carried out by an independent valuer or not, and, even allowing for the fact that lenders, unlike independent valuers, cannot reclaim VAT paid on inputs, a financial benefit arises for the lender from using in-house or subsidiary valuers (see paragraph 5.42).

Conflicts of interest

9.60. The RICS, as well as individual valuers, drew our attention to the potential for conflicts of interest where lenders have a direct or indirect commercial interest in the sale of the property on which the mortgage is being sought, which might lead to pressure on the valuers to value to order, so that a property transaction might proceed. The potential scope for such pressures had grown with the increasing ownership by lenders of estate agents and the extension of their activities to other financial areas such as banking, life assurance and pensions which provided a wider range of profit opportunities from the transaction.

9.61. There are statutory constraints in the 1986 Act which prevent building societies using as a valuer 'any person having a financial interest in the disposition of the [property]'. These provisions, which were enacted before the great increase in the use of in-house or subsidiary valuers, preclude the use of in-house valuers or of valuers in associated companies to value for a mortgage advance properties repossessed by the lenders. Legal advice has been sought by the RICS on other circumstances in which lenders might be deemed to have an interest which precluded valuation by their employees, and there has been some difference of view. It is generally accepted, however, that in those other circumstances in-house valuers or those in other subsidiaries can legally value where an agent within the same corporate group is selling the property.

9.62. The RICS put to the CML in 1991 the proposal that the lenders should explain the types of valuer that might be used and their relationship with the lender, allowing the borrower, if concerned, to ask for another type of valuer. The CML rejected this proposal; it did, however, advise lenders to make clear to borrowers that in-house or associated valuers may be used without suggesting that borrowers had any choice in the matter.

9.63. Lenders told us that their overriding interest was in a good-quality valuation and that it would not be in their interests to allow pressures on valuers to adjust valuations to arise which would lead to unreliable valuations. They followed the CML guidance in one form or another and told borrowers that in-house or subsidiary valuers might be used but they had found that borrowers did not appear concerned by the problem.

Lenders' use of scale charges to borrowers

9.64. Virtually all lenders use a set scale of charges payable by the borrower for valuations, linked to the purchase price of the property. The level and spread of these charges is discussed in paragraph 5.22. The valuation fee charged may include an administration charge towards the general administration costs associated with granting the mortgage. While some lenders make clear the existence and size of the administration element, others do not and the effects of this practice are discussed further in paragraphs 9.109 and 9.110.

9.65. These scales, and the scales for payments to valuers discussed in the following section, stem from the original industry-wide scale for payments to valuers negotiated between the RICS and the BSA. All lenders now have their own individual scales but all still use a set scale linked to property prices although the actual amounts charged differ.

9.66. Lenders' scale fees clearly involve cross-subsidy between borrowers since the amount of work involved in a valuation may be largely unrelated to the price of the property. For example, an expensive new property on an estate may involve far less work for the valuer than an older city property or a character cottage in the country. Moreover, the large lenders' scales, which apply throughout the country, take no account of variations in valuation costs between different regions.

9.67. The lenders argued that the borrower above all required clear information on the up-front charge that he had to pay. To attempt to charge on the amount of work involved or by the hour would be administratively complex and the latter might lead to inefficiency. While larger lenders might be able to operate local or regional scales this would introduce complexity and would create difficulties in the marketing of mortgage offers, which was usually done on a national basis. Lenders argued, moreover, that cost differences between regions were not a major factor and since they tended to be reflected in house price levels, the linkage of the fee to the house purchase price provided a rough adjustment which accommodated such regional variations.

9.68. We also received a number of complaints from valuers that if given the opportunity they were prepared to offer borrowers lower fees than lenders' current scales for valuations, either for valuations on their own or provided with an HBR or SSY. The lenders argued that their bargaining strength *vis-à-vis* surveyors enabled them to keep fees below those which the average borrower would be able to negotiate. As indicated in paragraph 9.51, there is some evidence that lenders' charges to borrowers tend on average to be a little above those quoted by independent surveyors. However, the range of individual quotations can be large.

Lenders' scale fees to valuers

9.69. Most lenders establish set fee scales for payment to valuers which, like their valuation charges to borrowers, are linked to the selling price of the property; indeed many lenders simply pass on to the valuer the valuation fee received from the borrower. The level of fees is set by the lender without negotiation, although representations are received from valuers, and occasionally from the RICS, on the level of fees. Lenders told us that in setting fees they took into account the fees charged by other lenders and the need to set their own at the level necessary to secure the quality of valuations required; where in-house valuers were employed fees were set to cover costs, and in some cases to achieve targeted margins. We received no direct complaints from panel valuers about the level of fees offered and we heard of no work being refused on the grounds that fees were too low. Although independent valuers criticized lenders' fees as being too high, we were told of no offers by non-panel valuers to try to secure work or a place on the panel by offering to accept lower fees. However, they may have been influenced by the attitude of lenders, who told us that they would be wary of offers to work at cut rates in case standards were compromised; lenders considered that their bargaining power, accompanied by the need to compete with other lenders on fees to borrowers, enabled them to set competitive fee levels to the benefit of borrowers.

Assessment

General effects of selection on borrowers

9.70. The various features of the arrangements for valuations made by lenders discussed in the preceding paragraphs are all aspects of the arrangements made by lenders which involve the selection of valuers from the pool of those competent to carry out the work. We accept that the prudential responsibilities of lenders to their depositors, which for building societies are set out in section 45 of the 1986 Act (see paragraph 2.14), require them to retain the ultimate responsibility for selecting the valuer in any particular instance. In so doing they take into account their own circumstances and the balance of costs and benefits in deciding what principles of selection to follow. We have, however, to consider whether lenders' selection practices and charging arrangements operate in a way which has effects adverse to the public interest in respect of the consumer in his role as borrower.

9.71. There is clearly a borrower's interest to be taken into account, first at the general level and secondly in specific cases. First, the lender's practice of requiring the borrower to pay for the valuation, together with the valuer's duty of care to the borrower in many cases, established by the courts, gives the borrower a recognizable interest in the choice of valuer. Lenders' selection, combined with their practices in setting fee scales, also determines the prices paid by borrowers for valuations. There is thus a general borrower interest in the choice in so far as this affects the price and the quality of the valuation. Secondly, there is the interest of those borrowers who wish to commission their own survey advice by way of an HBR or SSY and hope to lessen the combined costs of valuation and survey by having their own personal choice of surveyor accepted to carry out both. We look first at the general aspects.

9.72. Lenders' prudential responsibility requires them first and foremost to be satisfied on the valuer's competence. It is generally accepted that to be regarded as competent and acceptable a valuer must have professional training, experience, local knowledge and adequate professional indemnity cover. There is at present no outside agency or professional body which checks whether surveyors meet all these tests, nor any power, apart from the ultimate sanction of expulsion from the professional body, to require valuers to carry adequate professional indemnity cover; nor is there any professional compensation scheme to provide run-off cover. The lender's responsibility can therefore only be met by satisfying itself by its own investigation that the individual surveyor whose valuation it accepts meets the necessary standards. In such circumstances we consider that it is not unreasonable for lenders to limit the costs of administering and checking such

procedures by operating a panel of approved valuers and for each lender to limit its panel to the number it considers appropriate to give it adequate coverage geographically and by type of property.

9.73. We have considered whether the restrictions on panel appointments operate in a way which leads to higher costs or poorer service to consumers, bearing in mind particularly the interests of those borrowers who wish to have a say in the choice of valuer. We have noted criticisms by independent surveyors that some in-house valuers and even panel valuers lack local knowledge of the areas they work in. The lenders explained to us their systems for controlling the areas in which their valuers work and for monitoring the quality of their reports. Given the large number of valuations commissioned there will inevitably be some individual cases of poor-quality reports and examples of these were given to us. We were satisfied, however, that the valuers used by lenders, whether employed in-house or in subsidiary companies or on panels, are generally competent, and that the arrangements result in reports that are satisfactory for the lenders' purposes.

9.74. While all lenders appear to use broadly the same tests of competence, they differ in their willingness to accept sole practitioners as valuers and to consider requests for use of a surveyor not on their own panel. On both of these aspects building societies tend to take a more restrictive approach than banks and centralized lenders.

9.75. The reluctance to accept sole practitioners arises from the lenders' concern over possibilities of fraud and negligence. There may be concerns that if a sole practitioner has to meet claims for negligence or gets into other difficulties he is less likely to be able to maintain cover than a larger firm. He may have problems in maintaining run-off cover to meet liabilities arising after he retires and his insurance cannot cover fraud by him. We think it reasonable, however, that lenders should take account of both factors in establishing a panel, and that it is for the individual lender to decide how much weight to put on these dangers.

9.76. In practice, there is a broad distinction between building societies¹ and banks, both in the way they draw up their panels and in their willingness to accept valuers who are not on their panels. The banks tend to leave greater discretion to local managers to select panel valuers and to vet requests for use of non-panel valuers, which they are usually prepared to entertain. Building societies usually insist on their own choice of surveyor where a valuation alone is required but will often be prepared to accept a borrower's choice, where he has selected a surveyor for an SSY or HBR, provided the choice is already on the lender's panel; a non-panel valuer is not usually acceptable. The more flexible attitude of some banks can be attributed to the wider local knowledge their managers usually possess, which puts them in a better position to exercise flexibility and, as some banks suggested, to their information about their account-holders' income and status.

9.77. We received few direct complaints from borrowers although there were numbers from surveyors who had lost business. Some borrowers may already have been aware of the lenders' attitudes and arranged their affairs accordingly; others may have been able to take advantage of the more flexible attitude of, for example, some banks. However, it seems reasonable to assume that most borrowers have no complaint about their inability to choose the valuer and thus do not find the different levels of restriction operated by lenders a practical constraint. As noted, we found no evidence that the quality of valuation was currently affected.

Use of in-house valuers

9.78. One aspect of selection of valuers by lenders is the use of in-house or subsidiary valuers. When the 1986 Act was passed most valuations were carried out by independent professionals and the increasing use of in-house valuers or valuers in a subsidiary company is one of the biggest changes in recent years in the arrangements for valuations. This use of in-house valuers was criticized primarily on grounds of potential conflicts of interest, particularly where the lender was involved in the sale of the property through an estate agent or other subsidiary. Conflicts of interest are considered in more detail in the following section (paragraphs 9.102 to 9.105). We note, however, the RICS view that it is difficult to draw a distinction between the potential conflicts of interest faced by in-house or associated valuers and those faced by panel valuers. We are not satisfied that potential conflicts of interest have in practice led to major problems in this area. Some external valuers also, however, criticized the quality of work of in-house valuers. As already stated in paragraph 9.73, we do not believe that their work is generally inadequate.

¹For the purposes of this chapter we group Abbey National with the building societies (see paragraphs 3.11 and 9.2).

9.79. We have therefore not found evidence that the extent to which such staff are used leads to lower standards of service to borrowers nor that their use significantly increases the risks of any potential conflicts of interest arising. Those lenders we questioned follow the CML advice to inform borrowers that in-house or subsidiary valuers may be used; we have not found any evidence that this is a matter which concerns any significant number of borrowers. We consider that a lender should be free to employ in-house valuers or valuers in subsidiary companies where this seems to it an efficient way of conducting business and likely to assist in the control of standards of valuation.

9.80. We have identified an anomaly whereby valuations done in-house or by subsidiaries are not subject to VAT (see paragraph 9.59). We asked lenders whether in this situation it was feasible for the benefit to be passed on to borrowers. Lenders responded that when the charge is collected from borrowers it will usually not be known whether the valuation will be carried out in-house. Lenders assured us that the VAT position was not a factor in allocating individual instructions and suggested that a two-tier structure of fees would itself tend to create a bias against using panel valuers.

9.81. On the evidence available to us this difference in VAT treatment of valuations does not result in excess profits to lenders (see paragraph 9.53). While it may not influence the allocation of individual instructions, it does provide a general incentive to the maintenance of in-house valuation teams. It arises, however, from the requirements of EC law and will apply equally to the provision of other services that the lender has a choice between buying-in or providing in-house, for example legal advice. We do not see it as an issue that can be tackled in isolation in the context of this inquiry.

Charges to borrowers

9.82. We considered whether, if borrowers had a greater say in the choice of valuer and were able to negotiate fees directly, they might secure lower prices. As stated earlier (see paragraph 9.51), the survey we carried out of fees quoted by independent valuers suggested that these varied widely but that the majority were slightly below the scale fees charged by the seven largest lenders and unlikely to be significantly below those set by lenders taken as a whole. The majority of the seven largest lenders' valuation work is at present carried out in-house and even if borrowers had greater influence on choice it is likely that most of these would continue to accept an in-house valuation, bearing in mind that were the valuation negligent the borrower would then have direct recourse against the lender. Of those prepared to shop around some probably would benefit from lower prices but the admittedly limited evidence before us does not suggest that the benefit would be significant. Any such benefits would probably be offset to some extent by lenders' charges for checking the valuations provided.

9.83. Lenders are likely also to have a stronger bargaining position on fees than borrowers, and in practice most lenders set their fees without discussion with valuers. The incentive to keep charges down may be weaker for a lender who has a high proportion of in-house work and may see this as an additional source of earnings but, provided competition is fully effective, sufficient incentives will exist to keep charges down. Although the largest lenders' profits on in-house valuations taken as a whole at present appear healthy, their returns overall on valuations are modest. We do not consider that these financial results could be relied on to support the view that charges for valuations are excessive.

9.84. We then considered the effect on prices to borrowers of the lenders' use of national fee scales. As discussed in paragraph 9.66, such fee scales cannot hope to mirror at all accurately either the resource cost of the individual valuation or variations in costs between different regions. There are, however, advantages to the borrower in knowing the fee he will have to pay at an early stage in the mortgage transaction. Regional scales could be established at some administrative cost to lenders; they would remove part, but not all, of existing cross-subsidy between borrowers and there is no reason to think the average fee would fall. The greater part of the largest lenders' valuation work is carried out in-house or through subsidiaries; to negotiate individual fees on a work or time basis would create considerable additional costs for these larger lending organizations. As long as lenders choose valuers it is not reasonable to expect them to abandon the negotiation of fees for panel valuers to the borrower. When account is taken of higher cost of administration for lenders it is difficult to be certain whether the general level of fees would fall except perhaps in depressed market conditions of the kind

recently experienced. On balance we do not think there is evidence that as a result of the present system of national fee scales prices generally are higher than they would otherwise be.

9.85. We also considered whether the lenders' use of national scales for paying panel valuers disadvantaged borrowers. The effects on price are a direct reflection of the effects of the parallel scales for borrowers which we have already considered. The main concern must be that the use of such scales, combined with restricted panels, increases the difficulty for a new valuer in gaining entry to the panel, even if competent in all respects. In a more competitive situation such a valuer would be able to seek business by offering his services for a lower fee. In itself the fee scale does not formally preclude this action but lenders told us that they had received no such approaches and a number made clear that they would be suspicious of the motives for such an approach. Awareness of this attitude may itself discourage valuers from attempting to compete on price. There may be some loss of opportunities for recently qualified surveyors to enter through this route but, given the alternative opportunities for entry through existing panel firms and lenders' own organizations, we do not think borrowers will be disadvantaged in this respect by the continuation of lenders' national scales.

Effects of selection on individual borrowers

9.86. We now consider the second more specific borrower interest identified in paragraph 9.71. The present situation disadvantages those borrowers who for good reasons wish their chosen surveyor to be instructed for the valuation, and in particular those who have already commissioned an SSY or HBR from a surveyor who would be prepared to quote for a combined report. As noted in paragraph 9.77, we received few direct complaints from borrowers but there were a number, purportedly on their behalf, from surveyors who had wished to act for them. It is difficult to estimate what proportion this reflects of the considerable numbers of borrowers who commission such reports, but who are themselves, as pointed out in paragraph 9.49, a minority of borrowers who might benefit from them.

9.87. We have set out above the benefits which arise from lenders' control of valuations, in fulfilling their prudential responsibilities, maintaining the quality of valuations and guarding against fraud and negligence. We consider that the benefits these provide for depositors, borrowers themselves and the public interest generally outweigh the disadvantages to particular borrowers outlined above that result from these controls. However, we recognize that for some of these borrowers the disadvantages may be serious. We therefore considered carefully whether some way could be found to introduce changes to lenders' present arrangements which would remove or lessen the disadvantages, while retaining the lenders' ultimate responsibility for selection. We had in mind that, were such changes feasible, we would need to consider whether the present arrangements were against the public interest to the extent that they did not incorporate these changes. We looked at a number of possibilities.

9.88. It was suggested to us at one stage that the RICS should co-operate with lenders in widening the numbers of acceptable valuers by drawing up a list of approved valuers selected by peer group review. It seems likely, however, that valuers could only reasonably be excluded from such a list on clear evidence of incompetence, and it would still be necessary for lenders in the light of their prudential responsibilities to approve the selection. The RICS itself acknowledged that in present circumstances it would be difficult for it to select valuers in this way to establish a wider but still restricted panel.

9.89. Moreover, even if large numbers of additional valuers were approved by lenders the total of valuations they commissioned would not thereby be increased; it would be spread more widely, with each valuer probably doing a smaller number of valuations for each lender, thus losing the advantages of a steady flow of instructions from the individual lender to the panellist. We noted in this context the RICS comment that it would normally expect a valuer to carry out sufficient volume of work to establish experience and meet the client's particular requirements. We did not therefore consider that this approach ought to be pursued.

9.90. Another possibility we examined was to require lenders to accept valuations from surveyors who were on the panels of other lenders. It may seem at first sight unreasonable for a major lender to refuse to accept a valuer acceptable to another reputable lender whose vetting procedures appear equally stringent. A lender may, however, have justifiable doubts about the vetting procedures of some other lenders and it is not easy to see how a line could be drawn between the acceptable and the unacceptable.

9.91. We next considered whether, in a case where a borrower has already selected a surveyor to carry out an HBR or SSY for him, the lender should be required to consider the suitability of that surveyor to provide the valuation required against its usual standards (ie professional qualifications, local knowledge, professional indemnity insurance). Such a procedure was recommended to its members in 1979 by the BSA in its Circular No 2274 (see paragraph 4.22) but does not now appear to be generally followed. While some lenders continue to do so others will only consider a valuer who is already on their panel. The BSC in its draft Prudential Note on Lending (currently under discussion) advises lenders to make thorough checks if a borrower asks a society to use a valuer not on the panel and to be especially wary if the borrower provides a completed valuation. Clearly these are safeguards all lenders should consider.

9.92. We recognize that vetting a borrower's chosen surveyor would involve some administrative costs to the lender. Building societies already operate a system in relation to property insurance, where the borrower may secure his own insurance cover but the society has to be satisfied that the terms of the cover are adequate and that the insurer is generally acceptable and may levy a charge to meet the costs of scrutinizing the insurance offered. The costs of verifying the standing of an individual surveyor might well be higher than those involved in assessing an insurance company. Moreover, while the lender might be required to consider the borrowers' nomination the ultimate responsibility for selection would still have to remain with the lender. It would be difficult to lay down guidance on when scrutiny should lead to acceptance without curtailing this responsibility and raising some issues of liability.

9.93. We also considered whether the problem might be dealt with by requiring lenders to cease charging borrowers for valuations and to meet the costs of valuations as part of their general overheads. This would leave the borrower free to make whatever arrangements he wished for his own survey or valuation advice. The current practice of lenders requiring borrowers to pay for the valuation commissioned by the lender arose from the situation where this was seen as a fee for professional services which the lender passed directly to an independent surveyor. If the borrower no longer pays, the costs of valuation will still have to be met, either as an administrative charge to the borrower or absorbed into the lender's general administrative costs and recouped as it thought fit. In the latter case new borrowers would be receiving a cross-subsidy at the expense of existing borrowers or depositors. A significant proportion, perhaps 20 per cent, of all valuations are not followed by a completed mortgage transaction and it would be unfair for these costs to be borne either by other borrowers, existing borrowers or depositors. We recognize that the costs have to be borne at some point in the business and that, as we discuss later, it would be unreasonable to prevent lenders charging administration fees to borrowers to cover the costs of an application. It seems unlikely therefore that the change would have any practical benefit.

9.94. The limitations which lenders place on acceptance of valuations carried out earlier on a property are a particular aspect of the selection of valuers which may disadvantage individual borrowers. Again it seems to us impossible to lay down general rules for the circumstances in which lenders should accept such valuations provided for other lenders, or the time within which they should be regarded as valid.

9.95. The best guarantee that lenders will take a reasonable approach to borrowers' requests lies in active competition in this aspect of the lending market. Lenders' approaches to valuation arrangements vary and some are prepared to be a good deal more flexible than others in accepting a borrower's nomination. Borrowers seriously concerned by the issue and not satisfied by the response from their initial choice of lender have the opportunity to seek a competitive mortgage package from another lender. Those who have already commissioned a survey and are concerned about additional costs or who wish an earlier valuation to be accepted may, for example, find some of the lending banks, who place more reliance on the judgment of their local managers, more willing to accommodate them.

Conclusions on effects of selection on borrowers

9.96. We have identified in paragraph 9.87 the clear advantages of the prudential and other controls exercised by lenders to ensure the quality of the valuation provided, which we recognize require that lenders retain ultimate control over the choice of valuer. We have not found that the present arrangements for selection, combined with the use of fee scales, result in higher prices for valuations for borrowers generally. They do, however, directly disadvantage the minority of borrowers who wish to exercise their own choice of surveyor to provide an HBR or SSY, by requiring them either to pay for a separate valuation as well, or to abandon their initial choice of surveyor. We consider that the benefits that lenders' controls provide for depositors, for borrowers themselves, and for the public interest generally, outweigh the disadvantages that may result for these borrowers. As explained in paragraph 9.87, we have examined various ways in which these disadvantages might be overcome but consider that it would be neither practicable nor desirable to attempt to remove the disadvantages we have identified by regulating lenders' arrangements. We have reached the view that it is in fact not feasible to combine such regulation with the principle of ultimate discretion for the lender.

9.97. We conclude therefore that the lenders' refusal to accept valuations from any competent valuer, the use of panels of selected valuers, and the use of set national scales for charging borrowers and paying valuers are all steps taken by lenders to maintain the complex monopoly situation. We further conclude, however, that for the reasons set out above they are not facts which operate or may be expected to operate against the public interest.

9.98. Our consideration of the issues set out above has, however, suggested specific ways in which lenders could themselves go some way to meet borrowers' interests without prejudicing their prudential control. We suggest that the CML should examine the BSA Circular No 2274 (see paragraph 9.91) and consider reissuing a revised version under its name, to take account of subsequent changes, including advice on prudential safeguards and the introduction of HBRs. It would also be helpful if those lenders which operate panels of valuers were to indicate, in their initial discussions with borrowers, that only certain valuers are acceptable to that individual lender to carry out its valuation and therefore able to provide a joint SSY or HBR and valuation. The borrower who wishes to commission an HBR or SSY can then take this information into account in selecting the surveyor to carry out the work.

Associated issues

9.99. We considered two related aspects of selection which were drawn to our attention but which did not arise directly in the preceding assessment: first, the importance of reciprocity in the selection of panel valuers and allocation of business to them, and secondly, the problem of conflicts of interest.

Reciprocity

9.100. The application of reciprocity by some lenders results in some well-qualified valuers failing to get business, but this would only be a matter of general concern if those who received the business were less well qualified and were providing a lower standard of service. The RICS has accepted in discussions with the CML that, other things being equal, the availability of reciprocal business may be used to direct business between equally qualified and competent valuers. There have been criticisms from other surveyors of the work of surveyors used by lenders and in particular that such surveyors have been valuing out of area and were thus ill-informed about the local housing market; these criticisms related primarily to in-house and subsidiary valuers. There is no firm evidence that lenders have been employing less competent or poorly-qualified valuers in order to acquire reciprocal business. Rather the situation appears to be one where the decline in total instructions has led some lenders to be more selective within the pool of qualified and competent valuers.

9.101. We conclude that the use of reciprocity by lenders as a factor in selecting panel valuers is a step taken to maintain the complex monopoly situation, but we further conclude that it is not a fact which operates or may be expected to operate against the public interest.

Conflicts of interest

9.102. The RICS drew our attention to its concerns over the conflicts of interest that arose from lenders' ability now to combine mortgage lending with other activities, in particular the ownership of estate agencies and numbers of surveyors, and in this context registered its concerns about the position of in-house valuers. There is clearly potential for conflicts of interest to arise. We take the lenders' argument about their overriding interest in a sound valuation. However, the most likely effect that might be expected from pressure on a valuer, from an estate agent wanting to make a sale or a branch manager hoping to make a loan, is a modest shading of a valuation within an acceptable range of opinion rather than a seriously defective estimate. Given the existence of mortgage indemnity insurance, this is unlikely to undermine the lender's interest. It may, however, involve significant extra expense for the borrower and may also harm the vendor's interest. We received evidence of a limited number of cases where valuations appeared to have been influenced. However, this is an extremely difficult area to test, given that valuations are ultimately a matter of judgment, and even significant variations between different valuations of the same property have been regarded in court cases as not necessarily open to challenge. We are not satisfied that this potential conflict of interest has in practice led to major problems which would affect our conclusions. Nor is it apparent that a valuer employed in-house or by a subsidiary is substantially more vulnerable to pressure arising from a conflict of interest within his organization than is a panel valuer to the pressure arising from his reliance on the lender for a steady flow of work.

9.103. The RICS was, however, concerned about pressures on all valuers, including independents, and thought that the potential adverse effects were exacerbated by borrowers' ignorance of the issues and their apparent confusion over the extent to which they could rely for their own purposes on the lenders' valuations. The RICS criticized the lenders' practice of requiring borrowers to pay for the valuation when the mortgage application is made as contributing to borrowers' confusion over the purpose of the valuation report and thus indirectly discouraging them from commissioning their own HBRs or SSYs, which it would be in their interest to obtain.

9.104. The RICS therefore urged two changes to achieve greater transparency and choice for borrowers. First, it suggested that the borrower should not only be informed whether an in-house or independent valuer was to be used by the lender but be given a say in the choice between them. On the suggestion that borrowers should be given a say in the decision on whether an in-house or independent valuer was to be used, we have already set out in paragraph 9.79 our view that lenders should be free to use in-house or subsidiary valuers where they wish to do so. We consider that they should be capable of identifying situations where these valuers might be thought open to such conflicts and taking steps to avoid them. Moreover to establish such a right for borrowers would not be consistent with the principle of lender control which we have earlier recognized.

9.105. Secondly, the RICS also urged that to increase his awareness the borrower should no longer be required to pay for the valuation. The lender should do so and to clarify the position further should no longer disclose the valuation report to the borrower, who would then be left under no misapprehension as to the ownership of the report and encouraged to seek his own professional advice. We have already discussed in paragraph 9.93 the proposal that borrowers should not pay for the valuation and the reasons that persuaded us not to adopt it. Moreover, even if the borrower were no longer to be required to pay for the valuation, we do not think that lenders would wish to 'turn back the clock' by withholding the valuation report from a borrower; or that, if they were to do so, this would in practice lessen the borrower's reliance on the report. Given the tenor of the court decisions referred to earlier (see paragraph 9.14), withholding the report would not appear likely to affect the duty of care thereby established. At the time when reports were not disclosed only a minority of borrowers took out independent advice and, even if the report were not disclosed, the borrower would normally infer that a valuation adequate for mortgage purposes guaranteed that the property was sound, since he would still have to be informed of major defects which affected the size of mortgage or retentions. We would not see merit in arrangements which would deprive borrowers of information they at present receive and influence them towards further expenditure, without clearer evidence that the majority who at present manage without independent advice are suffering harm. We therefore do not regard this as a practicable proposal, nor do we see that it would bring clear benefits for borrowers. However, we think that lenders should continue to make clear in their literature the distinction between their valuation and

independent advice and to encourage borrowers to consider the options available by offering a choice of acceptable professionals.

Scotland

9.106. We have borne in mind throughout our consideration of valuer selection the different legal framework for house purchase in Scotland from that in the rest of the UK and the different arrangements that have developed there for providing mortgages. In particular we noted the widespread use of intermediaries to handle the buying transaction, including the arranging of the mortgage and in the commissioning of the valuation. We concluded, however, that none of these differences affected our findings, which apply to the whole UK.

Administration charges to borrowers

9.107. In recent years many lenders have begun to levy, or have increased, administration charges to meet part at least of their costs in arranging mortgages. These are sometimes charged separately. The usual practice, however, among building societies is to collect the charge from the borrower with the valuation fee. Information given to borrowers about the composition of the sum collected from them at that stage varies widely. Some lenders, including the two largest, Halifax Building Society and Abbey National, make clear in their literature that an administration fee is charged and state the amount. Others, however, state that there is an administration fee levied but do not disclose its amount. There are a number of lenders who do not disclose the existence of the charge nor its amount. Finally, some lenders make a deduction from the valuation fee passed to external valuers to cover their administration costs. Both these last practices leave the borrower under the incorrect impression that the up-front charge he pays is solely for carrying out the valuation.

Conclusions on administration charges

9.108. We see no grounds for objecting in principle to administration charges. In a competitive situation it is for the lender to decide how to recoup his costs, and if he decides to do so at least in part by up-front charges, this is a factor that the borrower can take into account in selecting his preferred source of mortgage funds. Some lenders suggested that all that concerned the borrower and all that needs therefore to be disclosed to him is the total of up-front charges. We consider, however, that the borrower will attach importance to the nature of the charges. We were told, for example, by one of the largest lenders that while borrowers recognize the need to pay valuation charges, which many still see as a professional fee passed on by the lender, there is greater consumer resistance to paying administration charges; this severely limits the proportion of lenders' costs that can be recouped in this way. This indicates that the borrower should have this information as one of the elements which may affect his final choice of mortgage package. The borrower is more likely to examine critically the reasons for, and the size of, any administration charge levied and to look at the alternatives offered by other lenders particularly since, if the information is made available, he will find that many lenders make no such charge. If the information on the existence and amount of administration charges is not made available to him he is prevented from making these assessments. There is also a danger that a borrower who pays a substantial charge labelled as a valuation fee, of which only part is passed on to the surveyor, may assume that he is getting a fuller report than is in fact the case or may make distorted comparisons with other lenders' valuation fees. There is a further advantage in a separate identification of the level of valuation fee, since it is only through transparency of the fees actually being charged for those professional services that changes in their levels and those of administration charges can be monitored.

9.109. All borrowers need to have clear information on this, as on other aspects of the mortgage package, if they are to make fully informed choices in connection with what is probably the largest single financial commitment undertaken by most individuals. As we have pointed out earlier, we expect competition in the mortgage market to provide the best protection for consumers against any disadvantages of the present valuation arrangements. But if such competition is to work effectively, as we have already noted in paragraph 9.39, the consumer must have full information on the up-front charges he will have to meet and the

breakdown of these between valuation and administration charges. Not disclosing such information distorts competition and increases the likelihood that borrowers will not select the best mortgage offer for their needs.

9.110. We find, therefore, that the practice by some lenders (see Appendix 9.1 for the lenders involved) of not disclosing the existence and amount of administration charges levied with the valuation fee is a step taken to exploit the complex monopoly situation and a fact which operates and may be expected to operate against the public interest with the adverse effects set out above in paragraphs 9.108 and 9.109.

9.111. We have not identified any action or omission attributable to the existence of the complex monopoly situation.

Recommendation

9.112. We are required by section 54(3) of the Act to consider what action (if any) should be taken for the purpose of remedying or preventing the adverse effects we have identified and may, if we think fit, make recommendations as to such action.

9.113. We recommend that in order to remedy the adverse effects identified above all lenders should be required, where reference is made to a fee to be paid by the borrower in connection with the provision of a valuation in any promotional material, including that made available in response to initial enquiries from prospective borrowers and in their mortgage application forms, to specify separately and clearly the amount of any fee relating to the acquisition of the valuation and any other administration charge made in connection with this valuation fee. The amount of the valuation fee to be specified should be the fee that would be paid by the lender to an external valuer carrying out the valuation.

9.114. Our recommendation relates only to the need for greater information to be provided in relation to valuation and administration charges. In our discussion of the mortgage lending market in paragraph 9.8 we have drawn attention to some difficulties for borrowers arising from the presentation of some of the information they need. The main problem is that of shortcomings in the APR (see paragraph 9.6). While this rate should in principle provide a clear indication to the borrower of the cost of credit and of the relative competitiveness of different lenders, the way it is currently calculated, taking account of recent court rulings, means that it is no longer useful for that purpose. We suggest that the application to mortgage lending of the Regulations made under the Consumer Credit Act 1974, which set out the rules for calculating APRs, should be reviewed, in particular the arrangements for calculating APR on fixed-rate mortgages and for quoting truncated rates.

9.115. We have concluded above that, with the exception of some lenders' practice of failing to disclose administration charges levied with or within valuation fees, lenders' practices in commissioning and charging for valuations do not operate against the public interest. We have recognized that it is not possible to combine freedom for borrowers to select valuers with the lenders' ultimate responsibility for the valuation, which is in the interests of borrowers, lenders and depositors alike. Control must therefore remain with the lenders. We have, however, drawn attention to the position of borrowers for whom the lack of choice creates difficulties and can lead to extra expense, concerns about whose problems led to the present inquiry. We have made two suggestions in paragraph 9.98 designed to help these borrowers and we hope that lenders will give careful consideration to these.

9.116. We have also pointed out that some lenders are able, for various reasons, to be more flexible in their willingness to meet borrower wishes on selection, and we would expect in a competitive situation that such lenders would find it in their interests to make their attitude on valuations known to such borrowers. It is for the borrower who is concerned about the choice of valuer to shop around to find the lender who offers the best package to meet his needs, taking account of any special concerns he may have about the valuation. We would expect implementation of our recommendations for greater transparency of charges to help him to do so.

D G GOYDER (*Chairman*)

C M BLIGHT

R O DAVIES

D J MORRIS

A ROBINSON

A J NIEDUSZYNSKI (*Secretary*)

4 February 1994