Finalised guidance

Dealing fairly with interest-only mortgage customers who risk being unable to repay their loan

29 August 2013

Contents

1 Executive summary

1.1 We wanted to understand the risks to consumers when interest-only mortgages reach maturity and borrowers do not have the capital to repay the balance due. And we wanted to develop – with the industry – ways of tackling this issue. As the industry has been seeking a steer from us on this area, we are setting out this guidance to help residential mortgage lenders and third-party administrators.

1.2 We conducted a thematic review on the maturity of interest-only mortgages. We did this by:

- analysing the size, scale and time horizon of future maturities of interest-only mortgages
- understanding consumers' readiness for the repayment event and the management of any potential shortfall
- conducting a sample review of firms' strategies, policies and practices for interest-only mortgages
- reviewing how our rules and principles apply for post maturity interest-only mortgages

We have published the findings of the first two points on our website (Experian report and GfK report). This guidance contains the findings of our analysis of the last two areas.

1.3 Our review of firms' strategies, policies and practices covered eight lenders (23 mortgage brands), representing approximately 40% of the UK interest-only residential mortgage market (i.e. excluding buy-to-let mortgages). We found that the industry is engaged with the interest-only maturity risk and that firms are generally trying to treat customers fairly, but are at different stages of engagement with the maturity risk.

1.4 The guidance is based on the findings from the firm review, as well as other industry practice information we have received; it sets out what we expect firms to do to ensure the fair treatment of customers who are unable to repay the capital sum at the end of the term. For clarity and completeness, we have also included our views on applying our existing rules and guidance to this issue.

1.5 We recognise that customers remain responsible for repaying their mortgages, that repayment of the capital at the end of term is a contractual requirement, and that firms are not obliged to offer options at maturity.

1.6 This guidance relates to the 'back book' of existing residential interest-only mortgages. Separately, under our Mortgage Market Review (MMR)[1], new rules for new mortgage contracts will come into effect in April 2014. The enhanced lending standards included in the new rules are expected to reduce the risk of future maturity issues occurring.

[1] PS12/16 (*Mortgage Market Review: Feedback on CP11/31 and final rules*), published October 2012.

Information about the application of this guidance following implementation of the MMR can be found in section 5.

2 Guidance summary

2.1 This guidance sets out what we expect firms to do to ensure the fair treatment of customers who are unable to repay the capital sum at the end of the term, and to minimise the risk of non-repayment through early and effective engagement with customers over the mortgage term.

2.2 Customers are responsible for repaying their loans. However, to act in line with Principle 6[2], a firm 'must pay due regard to the interests of its customers and treat them fairly'. To demonstrate this in the context of existing residential interest-only mortgages[3], firms could do the following.

2.3 Governance

a Have a **written strategy** setting out the firm's policy and procedural framework for managing mortgage loans that may not be repaid in full at the end of the term.

b **Consider what options can be offered** to interest-only customers, either during the mortgage term or at maturity, demonstrating why the firm offers some options and not others.

c Provide procedural **guidance for front-line staff** on how to execute the firm's policy, with appropriate **monitoring** to ensure fair and consistent customer outcomes.

d Collate **enough management information** to enable the firm to monitor its interest-only back book and review the performance of mitigation actions taken during the mortgage term or after maturity.

2.4 Action to protect consumers

a **Communicate early and frequently** according to the potential risk of non-repayment within the firm's mortgage book, communicating more regularly as customers approach the end of the mortgage term.

b Give customers **enough time to consider maturity options**, especially if the firm's range of options is limited or if customers must meet specific criteria to be eligible; customers may wish to consider other options and should be given enough time to do so.

c Assess **affordability** if any variation to an existing mortgage materially increases the monthly payment or where the revised terms extend the loan into retirement.

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[2] Principle 6 of the FCA's Principles for Businesses states that 'a firm must pay due regard to the interests of its customers and treat them fairly.

[3] All existing mortgages on an interest-only basis including part interest-only/part repayment (capital and interest)mortgages.

d **Consider MCOB 11.8.1E.**[4] Some interest-only customers may be unable to change their mortgage or move to a different provider. Firms should be able to demonstrate how they have complied with Principle 6 (Customers' interests) in their treatment of such 'trapped' customers. For instance, they should not unfairly charge them a higher rate of interest than other customers to exploit the fact that they are unable to exit the mortgage.

Who does our guidance relate to and what do we expect firms to do?

2.5 This guidance is primarily aimed at residential mortgage lenders and third-party administrators of residential mortgages but will also be of interest to mortgage intermediaries.

2.6 We expect firms to act in line with Principle 6 when dealing with interest-only mortgage customers. This guidance sets out our views on how firms can act in accordance with Principle 6 to achieve a fair outcome for their customers. It is not intended as a prescribed course of action and is not the only way firms can act to abide by Principle 6.

2.7 To provide more detailed insight to firms on our expectations, we also give examples of some good and poor practices based on our findings from our thematic review.

2.8 In addition, it clarifies when the requirements of our Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) apply.

[4] MCOB 11.8.1E states 'where a customer is unable to:
(1) enter into a new regulated mortgage contract or home purchase plan or vary the terms of an existing regulated mortgage contract or home purchase plan with the existing mortgage lender or home purchase provider; or (2) enter into a new regulated mortgage contract or home purchase plan with a new mortgage lender or home purchase provider; the existing mortgage lender or home purchase provider should not (for example, by offering less favourable interest rates or other terms) take advantage of the customer's situation or treat the customer any less favourably than it would treat other customers with similar characteristics. To do so may be relied on as tending to show contravention of Principle 6 (Customers' interests).

3 Finalised guidance

3.1 This section sets out our expectations for firms in dealing with mortgage customers who may be unable to fully repay their loan at the end of the mortgage term, and provides examples of the good and poor practices we identified.

Governance

3.2 Firms must comply with SYSC 4.1.1R.[5] One way to do this would be to have a written strategy setting out the firm's policy and procedural framework for the management of mortgage loans that may not be repaid in full at the end of the term. The firm's policy approach and procedural framework should be clearly defined and approved by senior management.

3.3 As stated above, we recognise that customers are responsible for repaying their loans, repayment of the capital at the end of term is a contractual requirement and that firms are not obliged to offer options at maturity.

3.4 Under Principle 6, however, and in line with good industry practice, firms should consider what options they are able to offer customers who find themselves unable to repay the capital at the end of the term or express to the firm that they may be unable to do so. Firms should be able to demonstrate the options they have considered and why certain options are not being offered (if applicable).

3.5 Examples of potential options that firms could consider either before or after the mortgage matures are listed below, but this list is not exhaustive and firms can abide by Principle 6 in other ways:

a switching the mortgage to a full or part capital-repayment basis

b extending the mortgage term incorporating a switch to a full or part capital-repayment basis

c extending the mortgage term to provide more time to repay the capital outstanding or to sell the property

d accepting overpayments to reduce the end-of-term balance

e combining part redemption and any of the above

f extending the mortgage term on an interest-only basis

g combining any of the above

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[5] SYSC 4.1.1R states 'a firm must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems'.

3.6 We recognise that options offered to customers may not entirely resolve the repayment problem, but may improve the situation for the customer.

3.7 We expect firms to give customers enough time to consider the pre or post-maturity options available to them (including any specific eligibility criteria) or to make alternative arrangements. This also applies when no maturity options are offered to customers.

3.8 This means that firms will need to consider the following:

a Providing reasonable time for customers to respond to letters.

b How much time customers have to take action and how this may differ for customers who have not benefitted from early communications highlighting the need to take action. So, for example, lenders may wish to consider whether to offer more options to customers who have loans maturing in the near future (for example, 1-2 years) or give them more time to take action if no or limited options are available.

c For customers who have received early communications highlighting the need to take action (for example, ten years before maturity), lenders should make it clear what options are likely to be available at maturity. We recognise that certain options available to customers earlier in the process may not be available closer to maturity and, if so, clear early warnings should be provided.

3.9 Firms must comply with SYSC 9.1.1R.[6] One way to do this would be to ensure any options agreed with customers are followed up in writing.

Examples of good and poor practice - governance

Good practice	Poor practice
Governance	
A written strategy setting out the policy and procedural framework for the management of mortgage loans not repaid in full at the loan term end, with defined ownership and senior management sign-off. Where firms are not offering certain options to customers, the reasons for this are fully documented.	No written strategy in place. Inconsistent options applied for customers in similar situations. No designated ownership of the governance framework. Interest-only back book strategies that rely on attrition rates not aligned to the current mortgage market.
Interest-only strategy options	
Switching the mortgage to a full, or part, capital repayment basis after checking customer's affordability and with the customer's agreement.	Insufficient time given to customers to consider options or to make alternative arrangements. In particular, when no maturity options are offered to

[6] SYSC 9.1.1R states 'A firm must arrange for orderly records to be kept of its business and internal organisation, including all services and transactions undertaken by it, which must be sufficient to enable the appropriate regulator or any other relevant competent authority under MiFID or the UCITS Directive to monitor the firm's compliance with the requirements under the regulatory system, and in particular to ascertain that the firm has complied with all obligations with respect to clients.

Good practice	Poor practice
Overpayments are accepted to reduce the end-of-term balance. Extending the mortgage term to provide more time to repay the loan outstanding (where appropriate to the customer's circumstances). Facilitating switching to alternative products or repayment arrangements, where it is in the customer's best interest, by working with customers to overcome potential barriers such as fees/charges. Where options have been agreed with customers verbally, this is followed up in writing.	customers.

Documented guidance framework

3.10 Firms are expected to have in place written guidance for front-line staff (including third party administrators) which ensures a consistent approach but meets the individual needs of customers.

3.11 The policy should differentiate the options/communication strategy for customers in arrears or under forbearance arrangements.

3.12 It is important that front-line staff have enough knowledge and training to be able to deal with customers who have interest-only mortgages. This should include an awareness of the process and knowing where to direct customers if dealt with by a central point.

3.13 Firms should ensure that staff reviewing interest-only mortgages receive sufficient training with regular competency assessments. The staff should ensure any options they offer customers are plausible for the customer's individual circumstances, not only at maturity of the loan, but also if problems with the customer's repayment strategy are identified at any point during the mortgage term.

3.14 Firms must comply with SYSC 4.3.1R.[7] One way of doing this is to have in place sufficient monitoring to ensure that staff (and third parties, if applicable) are adhering to the firm's interest-only maturity policy and to ensure customers are being dealt with fairly and consistently.[8]

3.15 Sometimes varying the existing mortgage materially increases the monthly payment (for example, if all or part of the mortgage is changed to a repayment basis), or extends the loan period into retirement. When this happens, we expect a firm to reassess the customer's ability to afford the revised regulated mortgage contract in line with its written policy.

3.16 So if a firm has the right under the contractual terms of the mortgage to change it unilaterally from an interest-only to a capital repayment basis, we would not expect it to do that unless it has taken reasonable steps to first contact and agree this action with the customer. It should also have considered whether the customer can in fact afford the increased payments. (Further information on unfair terms considerations is in Annex 1).

3.17 Under Principle 6, we would expect to see firms proceed with repossession action as a last resort and only after the customer's circumstances have been assessed and all available options considered. As such, firms should be able to demonstrate they have tried to discuss and agree alternatives to repossession and have given customers enough time to make alternative arrangements.

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[7] SYSC 4.3.1R states 'a firm (with the exception of a sole trader who does not employ any person who is required to be approved under section 59 of the Act (Approval for particular arrangements)), when allocating functions internally, must ensure that senior personnel and, where appropriate, the supervisory function, are responsible for ensuring that the firm complies with its obligations under the regulatory system. In particular, senior personnel and, where appropriate, the supervisory function must assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the firm's obligations under the regulatory system and take appropriate measures to address any deficiencies.
[Note: article 9(1) of the MiFID implementing Directive and articles 9(1) and 9(3) of the UCITS implementing Directive]'.
[8] Where advice is given, firms will require permission to give advice on mortgages.

3.18 Firms should consider our prudential forbearance, reporting and provisioning requirements for non-repayment of the capital balance at the term end. (Further information is available in Annex 2).

Examples of good and poor practice – documented guidance framework

Good practice	Poor practice
Documented guidance framework	
Written policy and procedural guidance for front-line staff to ensure a consistent approach[9], including: ○ Giving customers options that are plausible and appropriate to the customer's individual circumstances, both before and after maturity. ○ An assessment of the customer's ability to repay when varying the existing mortgage term increases the monthly payment or extends the loan period into retirement. ○ Repossession action is taken only as a last resort following an assessment of the customer's circumstances and ability to repay the loan over a revised term acceptable to the firm. ○ The firm's defined criteria for a change in the customer's mortgage product and/or interest rate both pre and post-maturity. ○ The firm has a process for regular reviews of the customer's circumstances where forbearance has been provided, such as customers on temporary transfers to full or part interest-only. Appropriately trained staff to deal with these customers (both before and after maturity) to ensure customers in similar circumstances are treated consistently while recognising the individual circumstances of the customer.	Unilateral conversion to a repayment mortgage with no understanding of customers' circumstances and their likely ability to repay. Conversion to a repayment mortgage where there are existing signs of financial stress, such as monthly payment arrears or recent forbearance. Policy and practice guides that do not clearly define when a customer requires new mortgage contract terms and conditions, for example when the customer's circumstances necessitate a lifetime mortgage contract. Firms using collections staff only trained in mortgage arrears handling. No internal monitoring of staff to ensure they are adhering to the firm's interest-only maturity policy and that customers are being dealt with fairly and consistently. Insufficient due diligence and training in respect of outsourced field agents who may not appreciate the firm's requirements for customers with interest-only mortgages reaching maturity. Where field agents are instructed for customer home visits, the customers are not given enough time to be able to cancel the visit without being charged.

[9] Where advice is given, firms will require permission to give advice on mortgages.

Management information

3.19 We expect firms to have enough management information (MI) in place to monitor their interest-only back book.

3.20 The data recorded should be appropriate and sufficient so firms can:

a review the performance of options deployed during the mortgage term and after maturity

b monitor any communication strategies deployed within the term of the mortgage

c monitor and measure the interest-only back book to assess exposure

d capture the current repayment strategy for existing interest-only customers (where known)

e record and monitor prudential forbearance to meet reporting and provisioning requirements

3.21 It is good practice for a firm to use analysis of its current mortgage portfolio to provide a basis to develop its current and future maturity strategy.

Examples of good and poor practice – management information

Good practice	Poor practice
Management information includes: ○ Communication strategy responses. ○ Options deployed before and after term end (maturity), such as term extension, transfer to part interest-only/repayment. ○ Post-maturity rolling options, such as renewing term extensions. ○ Post-maturity arrears, litigation and repossession. ○ Predictive data, such as loan repayment probability, which might include customer payment behaviours, loan size, loan to value, age at term end and past regional performance indicators. ○ Collating information to capture current repayment strategy for existing interest-only customers (as part of a wider contact strategy via mail, phone and branch). This information is then used to develop the firm's interest-only strategy.	None or very limited management information being collated. No management information that reviews the performance of options deployed after maturity. No analysis of current mortgage portfolio to inform the firm's current and future maturity strategy.

Customer communications

3.22 It is important that firms have a communication strategy in place that gives customers enough time to take action where there is doubt about their ability to repay their interest-only mortgages.

3.23 If an existing arrears or forbearance arrangement is in place, firms may wish to consider how they adapt communications to those customers.

3.24 Firms provide annual statements to customers as required by MCOB 7.5.3, which include a prominent reminder to interest-only customers of their responsibility to repay their loan. It is also good practice for firms to engage early with interest-only customers by sending communications that set out the options available if a customer is concerned that they may be unable to repay their loan at the end of the mortgage term and detail, in a balanced way, any potential risks of not taking action in this situation. These communications may increase in frequency as the customer approaches the end of the mortgage term.[10]

3.25 Firms are required to comply with Principle 7[11] in their communications with clients. Firms should ensure that communications seeking to engage customers are clearly-worded (for example, using plain language), meaningful and encourage customers to respond. We recently published our papers on applying behavioural economics and encouraging customers to claim redress, which we encourage firms to consider when developing their communication strategies.

3.26 Firms may consider a risk-based approach when developing their communication strategy to ensure the highest-risk customers are prioritised. For example, firms might choose to contact those customers with loans due to mature within the next 10 years as a priority and may consider customers who chose a part interest-only/part repayment mortgage to be a lower risk.

Examples of good and poor practice – customer communications

Good practice	Poor practice
Before maturity	
A communication strategy where customers are contacted over the term of the mortgage and more regularly as they approach the end of the mortgage loan term. In addition to annual statements, communications that: ○ set out and facilitate the options available if a customer is concerned that they are unable to repay by their	Customer communications do not give the customer enough time to take action, such as letters that advise the loan has reached its end date and full repayment is required, issued either after, or very close to the end date. The same standard letters are issued throughout the life of the mortgage, and do not appropriately differentiate the message to the customer as

[10] Firms are reminded that the requirements for a mid-term review, set out in PS12/16 (*Mortgage Market Review: Feedback on CP11/31 and final rules*), will apply in respect of new mortgage contracts taken out after the rules come into effect in April 2014. The current guidance relates to the back book of existing interest-only mortgages.
[11] Principle 7 of the FCA's Principles for Business states that 'a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading'.

Good practice	Poor practice
loan-term end date ○ keep the process simple for customers ○ provide a helpline contact telephone number and times of availability ○ suggest customers seek independent financial advice ○ inform customers of free impartial or independent advice services, such as the Money Advice Service ○ provide a balanced position which includes any potential risks of not taking action Communications that are targeted to the specific circumstances of the customer, and take account of different stages in the mortgage lifetime to enhance levels of engagement. Communications that are piloted and reviewed to improve levels of customer engagement (for example using plain language, etc). Communication strategies that are supported by follow-up telephone campaigns. Communications that recognise customers may have a strategy for repayment, such as downsizing or selling a business, rather than a specific savings or investment plan. Requests for proof of repayment strategies are proportionate and balanced. Communications that are tailored for those customers with existing arrears or under forbearance arrangements. Online access that allows customers to self-check current disposable income (with an income and expenditure tool) and consider surplus funds available for mortgage overpayments or transfer to partial or full capital repayment. Tool indicates the benefit of these steps by demonstrating the potential mortgage balance reduction.	maturity approaches. No warnings on the impact of not having a suitable repayment strategy in place within communications to customers. Firms do not keep a central record of options discussed/agreed with customers, leading to inconsistent or poor customer outcomes. Insisting on original or certified copies of documentation to verify information where copies are sufficient.

Good practice	Poor practice
After maturity	
Communications that encourage customers to contact the firm to agree a resolution and set out options available, with warnings of the potential consequences of not taking action.	Communications issued at maturity that do not give customers clear details of the actions they can take or who they should contact. No warnings to the customers of the potential consequences if no action is taken. Firms do not keep a central record of options discussed/agreed with customers, leading to inconsistent or poor outcomes.

4 Application of existing rules and guidance

4.1 As set out in Section 3, we expect firms to act in line with Principle 6 when dealing with interest-only mortgage customers.

4.2 While we do not have detailed existing rules that specifically set out how firms must treat customers unable, or at risk of being unable, to repay their loan, some of our MCOB rules may still apply in particular situations. This section aims to clarify the application of the rules in some common situations that may arise when dealing with existing interest-only customers.

4.3 We also reiterate for firms previously issued guidance on unfair contract terms and prudential forbearance, reporting and provisioning which can be found in Annex 1 and Annex 2.

MCOB 13: Arrears and repossessions

4.4 Our review has shown that the approach taken by firms to interest-only customers reaching maturity has broadly been aligned with the requirements set out in MCOB 13 (arrears and repossessions), which amplifies Principle 6. We recognise the positive treatment of customers achieved by firms voluntarily aligning their approach with MCOB 13. But firms are not bound by this approach, as a failure to repay the capital at the end of the term does not fall within our Handbook definition of 'arrears'.[12]

4.5 So most of MCOB 13 does not apply. However, provisions relating to repossessions and sale shortfalls do apply where relevant, i.e. where there is a repossession or a sale shortfall, whether or not the customer has had payment difficulties during the term of the mortgage.

4.6 For any customers who are in arrears when they reach the end of the term, MCOB 13 continues to apply.

MCOB 8 and MCOB 9: Equity release: advising and selling standards and product disclosure

4.7 Where long-term extensions are offered as a solution to customers unable to repay the capital at term end, a firm should consider whether this constitutes a lifetime mortgage, where the requirements of MCOB 8 and 9 will apply.

[12] The FCA Handbook definition of *arrears* (in relation to a regulated mortgage contract or a home purchase plan) is either: (a) a shortfall (equivalent to two or more regular payments) in the accumulated total payments actually made by the customer measured against the accumulated total amount of payments due to be received from the customer; or (b) remaining in breach, for more than one month, of an agreed borrowing limit or of an obligation to pay or repay where the loan or home purchase plan does not have a regular payment or repayment plan.

4.8 In our view, however, it should be possible for a firm to approach extending the term of a mortgage contract in such a way that it does not fall within the definition of a lifetime mortgage.[13]

MCOB 4 and MCOB 7: Sales and disclosure requirements for contract variations

4.9 If a firm is arranging a variation to an existing regulated mortgage contract then MCOB 4.7 (advised sales) or MCOB 4.8 (non-advised sales) may apply, depending whether it is an advised or non-advised sale.

4.10 After the Mortgage Market Review is implemented in April 2014, the new rules for advised sales and execution-only sales will apply.

4.11 The disclosure requirements in MCOB 7.6 (event driven information) apply where certain changes are made to the mortgage, such as a rate switch, or a change to the amount of each payment due.

[13] The FCA handbook definition of lifetime mortgage is a regulated mortgage contract under which:
(a) entry into the mortgage is restricted to older customers above a specified age; and
(b) the mortgage lender may or may not specify a mortgage term, but will not seek full repayment of the loan (including interest, if any, outstanding) until the occurrence of one or more of the following: (i) the death of the customer; or (ii) the customer leaves the mortgaged land to live elsewhere and has no reasonable prospect of returning (for example, by moving into residential care); or (iii) the customer acquires another dwelling for use as his main residence; or (iv) the customer sells the mortgaged land; or (v) the mortgage lender exercises its legal right to take possession of the mortgaged land under the terms of the contract; and
(c) while the customer continues to occupy the mortgaged land as his main residence: (i) no instalment repayments of the capital and no payment of interest on the capital (other than interest charged when all or part of the capital is repaid voluntarily by the customer), are due or capable of becoming due; or (ii) although interest payments may become due, no full or partial repayment of the capital is due or capable of becoming due; or (iii) although interest payments and partial repayment of the capital may become due, no full repayment of the capital is due or capable of becoming due.

5 Application of this guidance following implementation of the Mortgage Market Review

5.1 Following implementation of the Mortgage Market Review on 26 April 2014, new mortgage conduct of business rules will apply. These new rules will particularly affect the following areas relevant to firms dealing with existing interest-only mortgage customers.

Sales

5.2 Most mortgage sales and variations will be advised. Execution-only sales are permitted in some circumstances, where the customer has positively elected to transact on an execution-only basis, such as contract variations with no additional borrowing.

Responsible lending

5.3 Responsible lending requirements will be strengthened. Lenders will be required to assess affordability where a contract variation has a material impact on affordability. This is likely to include a change of repayment method (e.g. interest-only to repayment). Where a customer is unable to demonstrate affordability, lenders will be able to use the assessment of affordability transitional arrangements (see MCOB 11.7), where it is in the customer's best interest to do so.

5.4 Our policy statement PS12/16[14] sets out the final MMR rules.

[14] PS12/16 (*Mortgage Market Review: Feedback on CP11/31 and final rules*)

6 Considerations regarding mortgage contracts

6.1 In general, where a mortgage has reached maturity without the capital being repaid, the Terms and Conditions (T&Cs) of the mortgage will continue until the loan is repaid. That means the borrower will still be a customer of the firm and must be treated fairly under Principle 6. Most contracts are likely to require monthly payments to be made until the loan is repaid.

6.2 Mortgage contract parties may agree a strategy for repayment of the debt and that may lead to an agreed change in the original terms and conditions. When firms implement facilities at maturity, such as a term extension, this may restrict a firm's right to foreclose unless a further breach of contract occurs. Where there is a change in the terms and conditions at maturity, we expect the new arrangements to be documented appropriately.

6.3 A failure by the party not in breach to act at maturity, could, in some circumstances, limit the way that party is able to behave thereafter.

Annex 1: Changing a contract – Unfair terms considerations

1. Our views on terms we consider may be unfair under the Unfair Terms in Consumer Contracts Regulations 1999, which include switching terms in mortgage contracts, were published in January 2012.[15]

2. We considered that a term may be unfair under the regulations if it provided a firm with too broad a discretion to determine if or when the term would apply. 'Improving Standards in Consumer Contracts' includes our views in relation to variation terms and terms that provide firms with too broad a discretion.

3. We expect firms to consider our previously published guidance and as such firms should not be relying on such (potentially unfair) terms in contracts to unilaterally convert mortgages.

4. We were disappointed to see during our thematic review, in some examples, terms in contracts provided firms with the right to unilaterally (in other words, independently of a customer's agreement to the change) convert mortgages from interest-only to a repayment basis with no understanding of customers' ability to repay. We consider such terms are likely to be unfair under the regulations.

[15] Guidance published in January 2012 about switching terms in mortgage contracts: www.fsa.gov.uk/static/pubs/guidance/fg12_01.pdf and also 'Improving Standards in Consumer Contracts': www.fsa.gov.uk/static/pubs/guidance/fg12_02.pdf which includes our views in relation to variation terms and terms that provide firms with too broad a discretion.

Annex 2:
Prudential forbearance, reporting and provisioning for non-repayment of the capital balance at the term end

1. We published guidance in October 2011, which set out our findings during our prudential review of firms' mortgage forbearance and impairment provisions processes and set out the actions we want firms to take www.fsa.gov.uk/pubs/guidance/fg11_15.pdf.

2. This existing guidance includes consideration for loans past maturity (p21) and identifies the full or partial non-repayment of the capital balance at the end of the term end as a potential impairment event (p37).

3. If a lender becomes aware, during the term, that a customer's repayment strategy is insufficient (or likely to be insufficient) to repay the loan balance at the end of the term this may indicate a loss event has occurred. Whether a loss event has in fact occurred will depend on an assessment of what other viable arrangements to repay the loan can be put in place and, if those arrangements are not sufficient to repay the loan in full at the end of the term, whether there will be an impact on the estimated future cash flows. The Prudential Regulation Authority has advised that "it is not appropriate to interpret the 'objective evidence of impairment'[16] test as meaning that there needs to be current cash arrears or that actual contractual payments are, for example, 90 days past due; the event that causes future shortfalls has already occurred".

[16] International Accounting Standard (IAS) 39 Financial Instruments: Recognition and Measurement

Annex 3:
Cost benefit analysis

1. As we are not making any new rules, our statutory cost-benefit analysis (CBA) requirements do not apply. However, we have committed to consider conducting and publishing an analysis of the costs and benefits of any guidance that is likely to result in firms or consumers incurring significant costs that were not formally considered when we consulted on the rule or the principle the guidance relates to.

2. The guidance on *Dealing fairly with interest-only mortgage customers who risk being unable to repay their loan* may impose some costs. This annex considers these costs and explains why we believe the benefits justify making this guidance.

Costs

3. **Costs to firms:** firms may incur some small administrative costs as a consequence of considering the guidance, by undertaking some of the following activities.

   a **Developing an interest-only maturity strategy:** firms may incur costs to develop an interest-only maturity strategy and implement a documented guidance framework for dealing with interest-only mortgages.

   b **Increased engagement with customers**: after considering our examples of good and poor practice, and implementing an interest-only maturity strategy, firms may decide to increase their level of engagement with customers. As a result, firms may incur increased administrative costs due to greater staffing levels required to discuss options with customers, introducing dedicated help lines or teams to undertake this work, or increased frequency of mailings to customers.

   c **Training and monitoring staff:** firms may incur additional costs to undertake appropriate training for front-line staff dealing with interest-only mortgage customers. Firms may also incur increased costs to monitor staff undertaking this work in order to ensure staff are adhering to the firm's interest-only policy and ensure customers are being dealt with consistently.

   d **Increased monitoring/management information:** firms may decide to review their internal reporting arrangements after considering our examples of good and poor practice, which may incur increased costs. Firms may decide to consider how they effectively collate appropriate data to provide meaningful management information (MI) to:

      (i) review the performance of options deployed during the mortgage term and after maturity

      (ii) monitor any communication strategies deployed within the term of mortgage

(iii) monitor and measure their interest-only back book to assess exposure

(iv) capture the current repayment strategy for existing interest-only customers (where known)

(v) record and monitor prudential forbearance to meet reporting and provisioning requirements

4. While these costs may be material, we do not expect the incremental costs to be large. This is because firms will have to deal with the maturity of interest-only mortgages, and treat their customers fairly, regardless of any guidance we make. Moreover, some firms already have a strategy for dealing with interest-only mortgages, or meet our principles in a different manner, so will likely incur only minimal costs in adapting this as a result of the guidance.

5. **Costs to the FCA:** while there could be an opportunity cost from supervisory time being spent assessing firms' interest-only maturity policies and associated governance and controls, we expect this to be subsumed into normal supervisory activities. Additionally the increased clarity on our Principle 6 requirements may lessen the time our supervisors need to spend assessing these policies and controls. As such we expect any incremental costs to the FCA to be very small.

Benefits

6. We expect firm actions following the guidance to result in customers having a greater opportunity to put in place a suitable solution for the repayment of interest-only mortgages. This will result in more options for customers at the end of the loan and lower the risk of repossession which in turn would lessen the impact on the UK housing market.

7. The guidance provides increased clarity on our expectations for firms and how we envisage interest-only customers should be treated. In particular this guidance provides clarification around: MCOB 13, mortgage contracts considerations, unfair contract terms, prudential forbearance and other MCOB requirements. Moreover firms agreeing early solutions with customers through active engagement are likely to secure improved asset values and reduce the potential for further 'impaired' loans on their books.