Finalised guidance

Forbearance and Impairment Provisions – Mortgages

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FSA®
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Contents

INTRODUCTION

This document sets out our findings during our prudential review of firms' mortgage forbearance and impairment provisions processes and sets out the actions we want firms to take. We have included good and poor practice guidance to help your firm comply with its responsibilities under the rules set out in our Handbook[1] (SYSC Chapter 4, SYSC Chapter 7 (Risk Control) and Principle 8 (Conflict of Interest)). The principles outlined in the Guidance are also applicable to other loan facilities and should be considered within this wider context.

Arrears and forbearance support provided with due care by firms has a beneficial impact both for the firm and the customer, in that it can reduce the number of repossessions and lower realised losses. However, where it is provided without due care or any knowledge or understanding of the impacts, it can have adverse implications for the customer, the firm's understanding of the risks inherent within its lending book and, in turn, for the regulators and the market.

This review considers forbearance processes across firms, whether in customer services, operations, debt management, credit risk or finance functions. It includes consideration of internal reporting of forbearance activities, impairments and provisions to management committees and boards and external disclosures of credit risk exposure and impairment provisions.

Our interest in this subject is not new. Our rules have long sought to ensure the fair treatment of borrowers in payment difficulties. Our thematic review findings subsequently highlighted a number of aspects of concern (especially among specialist lenders), leading us to publish good and poor practice examples, take enforcement action and enhance our conduct rules. This document confirms our thinking on the prudential considerations of this subject. (For next steps please refer to FURTHER RELATED WORK)

We believe forbearance based on sound conduct principles provides for sound prudential management, and that forbearance provided should be based on an individual assessment of the customer. Where this principle is applied we do not believe there is any conflict between Prudential and Conduct regulatory requirements for firms.

Who needs to read this?

This review is primarily aimed at residential mortgage lenders or mortgage administrators. This review should be considered by the management responsible for any aspect of forbearance activities, credit-risk reporting, finance, audit and the compliance functions of firms.

Since, under the International Financial Reporting Standards (IFRS) financial reporting framework, quantitative data provided in annual reports about a firm's exposure to risk (including credit risk) should be

[1] http://fsahandbook.info/FSA/html/handbook/

based on information provided internally to a firm's key management personnel, it is also relevant to financial reporting disclosure, and to external auditors of firms who are active in providing forbearance facilities for customers.

Context and scope

This prudential review looked at forbearance practices in firms which impact on the loss risks and loss-risk recognition of first charge residential mortgages. It followed earlier work considering the conduct implications of arrears-handling standards in mortgage firms. In particular, this review considers mortgage book *impairment* across firms' mortgage-servicing operations, rather than being specific to specialist debt management following the crystallisation of mortgage arrears.

The main aims of the review were:

- to understand the extent and variation of forbearance practices in firms and to identify good (and poor) practice;
- to assess whether there is clear and transparent reporting of forbearance, *impairment* and loss risks of a portfolio; and
- to understand whether lenders have sustainable business models where loss risks are fully recognised and embedded within the loss models of the firm, including impairment provisions; and, whether the executives of the business are aware of these loss risks.

This review is focused on the prudential risk responsibilities of firms and so on practices that impact on the loss risks of accounts (forbearance provided to support financial stress), the effective management of these risks and the mechanisms for their recognition and reporting. We are supportive of forbearance facilities that benefit both lenders (firms) and customers. We recognise that the provision of support and forbearance has, generally, been good for consumers and can enable customers in temporary financial difficulties to stay in their property. This review is very much aligned with the provision of forbearance and support which takes into consideration, the individual circumstances of customers undergoing financial stress. We believe forbearance based on sound conduct principles provides for sound prudential management.

However, we observed and are concerned that where support or forbearance is provided without careful consideration of the customer's individual circumstances it can place them in an even worse position. In some cases this can lead to the mortgage moving permanently onto non-*sustainable terms*. Clearly, this outcome is neither in the interest of the customer or the firm. From a prudential perspective, these kinds of accounts have a higher long-term loss risk which should be accounted for within reporting by firms.

The guidance provided in this document covers the following:

- the provision of forbearance support for customers undergoing financial stress;
- the recognition of *impairment* within the book through management committees and board reporting; and
- the disclosure of *impairment* and its recognition through loss provisions in external reporting.

Annex 1 provides a glossary of terms used throughout this document.

Conduct risk

This guidance should be considered with the relevant existing Handbook material such as Principle 6,[2] chapter 13 of the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB).[3]

Our Mortgage Arrears Handling thematic review, completed between 2007 and 2010, specifically focused on the fair treatment of customers in arrears. This programme reviewed a selection of mainstream lenders, specialist impaired-credit lenders and third-party administrators (TPAs) contracted to handle mortgage arrears and repossessions work on behalf of lenders.

It looked at:

- firms' arrears management policies and practices;
- assessment of customers' individual circumstances;
- the forbearance options considered before court action was taken;
- fees and charges and how they are applied;
- the fairness of securitised mortgage contracts; and
- the conduct and oversight of third-party outsourced services.

The conduct review observed several mortgage sector weaknesses, in particular, the way in which specialist impaired credit lenders and TPAs were handling mortgage arrears and repossessions. It identified good and poor practice across the sector and guidance examples were published in 2008 with further updates in 2009.[4] This publication neither replaces nor revises our previously published good and poor practice or the guidance examples. It does, however, highlight the interconnectedness of prudential and conduct considerations where there are potential or realised payment problems on mortgage accounts.

As a result of our Mortgage Arrears Handling thematic work, a number of firms were referred to enforcement, leading to five firms to date being issued a Final Notice with the imposition of financial fines and customer redress programmes. Enforcement action continues, supporting our intensive supervision and credible deterrence strategies. The thematic work also informed the strengthening of our existing arrears rules and guidance, confirmed in the June 2010 publication of our Policy Statement: *Mortgage Market Review: Arrears and Approved Persons.*[5]

We remain committed to securing lasting improvements in firms' arrears handling, enabling arrears customers to receive fair outcomes.

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[2] A *firm* must pay due regard to the interests of its *customers* and treat them fairly.

[3] http://www.fsa.gov.uk/pubs/hb-releases/rel61/rel61mcob.pdf

[4] http://www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/mortgage_arrears_1/index.shtml

[5] http://www.fsa.gov.uk/pages/Library/Policy/Policy/2010/10_09.shtml

What we want firms to do

After reading this Guidance we want firms to review their policies and processes for the following:

- **Policies and controls** – for the purposes of our Handbook[6] Systems and Controls (SYSC),[7] firms should develop a firm-wide strategy and policy regarding the provision of forbearance facilities to customers. Firms should review this policy and the associated controls annually.
- **Current practices** – for the purposes of SYSC 4.1.10, firms must review practices in the provision of forbearance provided to assist customers and be mindful of the provisions of Principle 8 (Conflicts of Interest). This Guidance is looking to firms to ensure that:
  - customers are not placed in an even worse position than they would have been otherwise; and
  - the firm either avoids the mortgage moving into a non-sustainable position or, once the period of financial stress has ended, continues to work with the customer to bring the mortgage back onto *sustainable terms* within a timeframe appropriate to their circumstances.
- **Ensure internal control, committee and board reporting** – for the purposes of SYSC 4.1.1 firms must ensure that effective processes are in place in the identification, reporting, monitoring and loss-risk assessment of forbearance and customer *impairment*.
- **Consistent reporting of impairment by firms** – we believe that there is scope for considerable improvement in firms' disclosures under IFRS 7 in this area (firms to be additionally mindful of the provisions of SYSC 4.1.9 in this regard).

We are also looking to accounting and auditing firms to become more aware of forbearance practices in the firms they audit and the requirement for consideration of their effect in the recognition and disclosure of accounting *impairment*.

[6] http://fsahandbook.info/FSA/html/handbook/SYSC/4/1
[7] SYSC4.1.1, SYSC 4.1.2/2A, SYSC 4.1.4/4A, SYSC 4.1.10/10A, SYSC 7.1.2/2A and SYSC 7.1.5 &.1.7/7A

A SUMMARY OF OUR FINDINGS

Extent and variation of forbearance practices – first charge residential mortgages

1. We observed a range of different forbearance facilities provided by firms to customers who experience a period of financial stress. The customer's financial stress may or may not have been identified by the firm, but where a forbearance facility has been requested or provided, this trigger is defined in this guidance document as a *potential impairment indicator*. The degree to which customers who use these facilities are actually impaired varies but we have observed that *impairment* losses relating to these customers are much higher than the norm.

2. *Potential impairment indicators* were evident at every customer contact point (in branches, call centres and by mail). They could be identified from:

   - a customer request to change *contractual terms* (eg transfer to interest only (IO), extension of term, payment holiday, drawdown, further advance);
   - the customer notifying the firm of current or likely financial stress; or
   - through pro-active contact by debt management functions following a trigger event (eg a missed payment on the mortgage, behavioural-scoring referral or a missed payment on another account).

3. Some firms were pro-active in looking for customer financial stress as a result of a *potential impairment indicator*. They then referred the customer to debt management where the personal circumstances of the customer and levels of affordability were assessed to identify an appropriate forbearance approach for that customer.

4. Forbearance has benefits for the customer in supporting them through periods of difficulty and enabling them to remain in their property. However, forbearance provided without careful consideration of the individual circumstances of the customer, the potential for future recovery; can place them in an even worse position and lead to increased difficulty in achieving recovery. This may lead to the mortgage moving permanently onto non-*sustainable terms* or to higher losses for both the customer and the firm if repossession takes place. From a prudential perspective, these kinds of accounts have a higher long-term loss-risk which should be accounted for within reporting by firms. *Sustainable terms* are defined as revised *contractual terms* where the mortgage can be fully serviced over its full life.

5. Each firm we reviewed provided a slightly different mix, but the primary facilities observed supporting a period of financial stress were as follows (see Annex 2 for a more complete list):

Primary facilities observed supporting a period of financial stress
1. Temporary reduction in monthly repayment amount (this may include zero or nil payment concessions and deferral of payment pending sale of property)
2. *Capitalisation* • Standard capitalisation • Repayment capitalisation

3.	Temporary or permanent transfer of all or part of mortgage on to IO terms
4.	Extension of the mortgage term
5.	Use of flexible facilities or other equity withdrawal: • payment holidays; • drawdown against previous *overpayments* or perceived overpayments; • use of linked pre-approved reserve/credit/overdraft limits on mortgage or a linked account; and • further advance or second loan.

6. It was observed that some firms have recently introduced effective controls and checks to identify a customer's circumstances and affordability details at the point of a *potential impairment indicator*. Where these checks have been implemented, material levels of *impairment* have been found for some facilities. For example, one firm's experience was that more than 95% of customers requesting a conversion to permanent IO terms were found to be in financial stress. As a result, firms who have implemented sound checks to identify financial stress, and in such circumstances provide forbearance support with lower long-term adverse impacts, may see their volume of permanent conversions drop significantly.

7. The volume of mortgages where *potential impairment indicators* were observed varied by firm and depended on each firm's policies and available facilities. In many firms these volumes were found to be material and to warrant a much higher level of executive scrutiny in respect of their role in account management and forbearance, and a much greater consideration of their associated loss risks by the credit and finance teams than we saw in operation.

8. We want firms to:

- **Policies and controls – for the purposes of SYSC,[8] develop a firm-wide strategy and policy regarding the provision of forbearance facilities to customers. This policy and the associated controls should be subject to annual review.**
- **Current practices – for the purposes of SYSC 4.1.10, review practices in the provision of forbearance provided to assist customers and be mindful of the provisions of Principle 8 (Conflicts of Interest). This Guidance is looking to firms to ensure that:**
    - **customers are not placed in an even worse position than they would have been otherwise; and**
    - **they either avoid the mortgage moving into a non-sustainable position or, once the period of financial stress has ended, they continue to work with customers to bring the mortgage back onto *sustainable terms* within a timeframe appropriate to the customers' individual circumstances.**

[8] **SYSC 4.1.1/4.1.2/2A, SYSC 4.1.4/4A, SYSC 4.1.10/10A, SYSC 7.1.2/2A and SYSC 7.1.5/&.1.7/7A**

Reporting, monitoring and disclosure of impairment and loss risk

Internal reporting and monitoring

9. Given the significant incidence of *potential impairment indicators* and forbearance and their role in supporting customers during periods of financial stress, we would expect to see full and effective reporting, performance monitoring and loss risk assessment in place in firms. We require firms to report accurately and transparently the impairment of their mortgage book.

10. We did not generally observe this, and reporting by firms of facilities provided, impairment, forbearance and the loss risk associated with these was found to be lacking across firms. It is our observation that there is room for considerable improvement in firms' understanding, control and reporting of forbearance.

11. Where reporting was in place this was generally found to be incomplete and either aimed at facilities where regulatory reporting was required such as standard *capitalisation* or purely local to the operational team. Usually, the credit risk team and executives did not see this reporting nor were they in a position to assess the implications, impacts or loss risks.

12. We require firms to ensure that loss risks are fully assessed, monitored and accurately and transparently reported within the business and that executives are informed of the true nature of these risks in making business decisions and accounting for the loss risks of the book through provisions.

13. One firm has, however, recently developed a forbearance database, monitoring a range of *potential impairment indicators* with the aim of developing its reporting, performance monitoring and loss risk understanding. This firm is now benefiting from some early results that provide significant insight.

14. We want firms to:

- **ensure internal control, committee and board reporting – for the purposes of SYSC 4.1.1 ensure that effective processes are in place in the identification, reporting, monitoring and loss risk assessment of forbearance and customer impairment.**

External reporting

15. Given that we consider there is scope for considerable improvement in firms' understanding, control and reporting of forbearance, it follows that we also found that firms' disclosure in this area shows scope for considerable improvement, since IFRS 7 *Financial Instruments: Disclosures* stipulates that quantitative risk disclosures made by firms should be based on information provided internally to key management personnel (IFRS 7.34(a)). We believe that this principle, and the other references to IFRS 7 given in this section, are directly relevant in the context of portfolios where forbearance is material. The risk exists that firms may not reflect the additional credit risk attached to accounts in forbearance and therefore may not provide a complete picture of the credit risk profile within portfolios. In addition, to the extent that loans subject to forbearance arrangements have not been separated from the general up-to-date pool for the purposes of *impairment* assessment, the impact of this additional credit risk may not be fully reflected in a firm's *impairment* calculation.

16. IFRS 7 is clear that firms should provide information about the credit quality of financial assets even if these are neither past due nor impaired (IFRS 7.36(c)). In addition, the Standard prescribes that, if the quantitative data disclosed as at the end of the reporting period are unrepresentative of a firm's exposure to risk during that period, a firm should provide further information that is representative (IFRS 7.35). In the case of retail loan portfolios, we consider that the use of forbearance procedures, that may have the effect of masking the true credit risk of the underlying portfolio, warrants separate disclosure.

17. We want firms to:

- **review their current practices to move towards better disclosure which reflects appropriate recognition of *impairment* and a position where there is consistent reporting of impairment by firms. We believe that there is scope for considerable improvement in firms' disclosures under IFRS 7 as noted in paragraphs 15 and 16 in this area. Firms should additionally be mindful of the provisions of SYSC 4.1.9; and**
- **we want accounting and auditing firms to become more aware of forbearance practices in the firms they audit and the requirement for consideration of their effect on the recognition and disclosure of accounting impairment.**

FORBEARANCE PRACTICE GUIDANCE

The following sections contain a summary of what, in our view, represents good and poor practice in the overall provision of forbearance to customers and our conclusions on the adequacy of controls, oversight, reporting and disclosure which we suggest may be of assistance to firms in complying with their responsibilities in our Handbook.[9]

This prudential review focuses on practices which impact on the loss risks of accounts and the effective management of these risks. Given this, there is significant emphasis on early recognition of the financial circumstances of the customer and understanding and managing forbearance to achieve fair consumer outcomes and long-term sustainability of mortgages where impairment exists.

We believe forbearance provided based on fair conduct principles provides for sound prudential management. We have highlighted Mortgages and Finance: Conduct of Business sourcebook (MCOB) references, where relevant, to draw attention to existing conduct requirements, but this guidance note does not purport to represent additional guidance under these rules.

Good and poor practice – when providing forbearance

18. The primary aim of providing a forbearance facility to a customer should be to enable the complete recovery of the mortgage through the full repayment of arrears. In this case the long-term impact on both the customer and the firm is minimised. Where the circumstances of the customer mean this primary aim cannot be achieved, the secondary aim would be to recover the customer into a *sustainable terms* position on their mortgage. In all events, the provision of forbearance should aim to minimise the risk of the customer ultimately losing their home.

19. This guidance should be considered in the light of relevant existing Handbook material such as Principle 6,[10] Chapter 13 of MCOB[11] and the good and poor practice in Mortgage arrears and repossessions handling published in 2009.[12]

    Firms should be mindful of these obligations and treat customers in arrears fairly. In relation to mortgage accounts in arrears:

    - the determination of a reasonable repayment period will depend upon the individual circumstances. In appropriate cases this will mean that repayments are arranged over the remaining term (see MCOB 13.3.4A R (1));
    - firms should not agree to capitalise a payment shortfall except where no other option is realistically available to assist the customer (see MCOB 13.3.4A R (1)(d)).

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[9] SYSC Chapter 4, SYSC Chapter 7 (Risk Control), Principle 8 (Conflict of Interest)
[10] A *firm* must pay due regard to the interests of its *customers* and treat them fairly.
[11] http://fsahandbook.info/FSA/html/handbook/MCOB
[12] http://www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/mortgage_arrears_1/index.shtml

20. It is recognised that a firm and a customer may enter into an arrangement which, at the time, looks practical in terms of the current circumstances of the customer. This may later prove sub-optimal either as a direct result of changes in customer circumstances or because the period of financial stress extends for a longer period than originally foreseen. Adequate records should be kept about these circumstances, the proposed forbearance, the rationale for the approach, the options provided to the customer and details of what was agreed (see MCOB 13.3.9).

21. Depending on the individual circumstances of the customer, it may be appropriate to use one or more forbearance approaches during the lifecycle of a period of financial stress. The same Guidance and Principals apply – that forbearance is provided based on an assessment of the individual circumstances of the customer, and that firms should 'not repossess the property unless all other reasonable attempts to resolve the position have failed (see MCOB 13.3.2 A R (6)).'

22. The level of forbearance provided by firms varied considerably, and firms generally did not take note of the role of *Potential impairment indicators* in the provision of forbearance. We would welcome greater consideration by firms of their role in the provision of forbearance and of the value of forbearance which is guided and informed by an assessment of the customers' individual circumstances.

Good practice

Potential impairment indicators are proactively identified at all customer contact points across the firm such as:

- a customer request to change *contractual terms* (eg transfer to IO, extension of term, payment holiday, drawdown, other equity withdrawal within or outside flexible terms, further advance);
- the customer notifying the firm of current or likely financial stress;
- pro-active contact by debt management following a trigger event (eg missed payment on the mortgage, behavioural-scoring referral, missed payment on another account, change of payment source); and
- another trigger event (eg change of payment source (the direct debit account, to cash or from/to Department of Work and Pensions (DWP)), a request to move to weekly repayment, exceptional lump sum payments (insurance, redundancy or pension payout, backdated DWP claim) or a change in activity or arrears on other accounts held by the customer (identifiable from firm data or credit bureau data).

Any temporary or permanent forbearance facility provided by the firm (whether directly within debt management or indirectly within other functions of the firm or its agents) is made with full awareness of the customer's individual, circumstances and intent and is affordable and sustainable for the customer.

Affordable repayments, practical to the customer's circumstances, are sought that minimise the build up of a *contract shortfall* (repayments made which fall short of those required under their *contractual terms*) and therefore the future capital repayment burden.

All concessionary arrangements are made for periods relevant to a customer's individual circumstances with set regular reviews (eg every three or six months) with the aim of recovering the loan as soon as is reasonably possible.

Aligned to their individual circumstances, customers are made aware of the forbearance choices or arrangements available to them, with the firm providing the customer with clear, timely and adequate information to understand the implications of any proposed arrangement or change in terms.

Also, the firm is aware that any permanent changes in terms are *sustainable*.

Information on free advice agencies that specialise in money problems[13], or telephone call referral support, is provided to customers where unaffordable, unsecured debt, or other priority debts exist or where a customer needs support to budget their finances. Care is then taken to liaise, if the customer makes arrangements for this, with these agencies eg to adopt the agency-completed financial statement or assessment information collected with the customer.

Engagement with debt-counselling services may help avoid forbearance on the mortgage being used to prioritise the repayment of unsecured debts, placing the home at greater risk.

Once the period of financial stress has ended and where affordability allows, the customer is encouraged to make greater than *contractual monthly payments* (the full repayment amount due under the mortgage contract) to repay the arrears, or consider contractual term changes to enable the full recovery of their account to minimise the long-term impact of the period of financial stress.

The firm has made and kept adequate records of conversations, correspondence and individual assessment information considered in reaching an appropriate forbearance approach to help the customer during the period of financial stress, which also seeks to minimise the long-term impact and risk of loss of their home. This includes reasonable efforts made to engage with customers in order to agree arrangements and options and justification for the forbearance option(s) proposed.

The firm considers, with the customer, whether staying in home ownership is appropriate only when all reasonable attempts to resolve the position of financial stress have been exhausted. Customers should be made aware of the current government mortgage rescue scheme or any future government support schemes available. Good practice would be to make an assessment in conjunction with free debt advice support to ensure the customer's overall circumstances are considered and that customers have access to advice on all their options.

Where moving out of home ownership or downsizing has been agreed with the customer and this is their preferred way forward, a customer-focused assisted voluntary sale (AVS) scheme is provided to help the customer manage expenses and processes associated with this key life change. Consideration should also be given to allow the customer to remain in possession for a reasonable period to effect a sale (see MCOB 13.3.2 A R (5)).

Poor practice

Failure to identify *potential impairment indicators* and customer financial stress.

Where the customer approaches the firm in a pre-arrears situation advising of financial stress, the firm fails to review the customer's individual circumstances and consider forbearance support where appropriate.

The firm has established a forbearance approach that does not seek either:

- to fully recover the mortgage (where this is feasible); or
- to minimise the build up of a contractual shortfall and so minimise the future capital and interest repayment burden to the customer and potential future loss risks to the firm (eg lower payments than the customer could afford are accepted).

A 'one size' fits all approach to forbearance is applied, with poor consideration of the customer's individual circumstances and impacts of the forbearance facility being provided.

A firm's approach to forbearance is restricted to focusing on the repayments owed to them, without taking proper account of other unsecured and priority debts owed by the customer to other creditors and their individual circumstances.

Medium or long-term arrears arrangements are agreed which do not fully rectify the contractual shortfall position of the mortgage and are not informed by an assessment of the individual circumstances and amount the customer can afford.

[13] http://www.moneyadviceservice.org.uk/_assets/downloads/pdfs/your_money/a5_guides/problems_paying_your_mortgage.pdf

A concession is set for a long period with no interim review or effective triggers to identify when circumstances may have changed and an additional review might be required eg DWP payment is replaced by alternative payment method or changes to repayments start being made. Consecutive extensions are applied to an arrangement period without a review of the customer's circumstances to consider whether it remains the most appropriate forbearance strategy, or whether alternative support or debt management strategies should be considered; and without ensuring the customer is fully informed on the impact of any extension or changes.

Good and poor practice – capitalisation

23. *Capitalisation* has continued to be one of the core forbearance tools used by firms. We have seen two methods of capitalisation taking place in firms:

- standard capitalisation (defined as a singular capitalisation event); and
- repayment capitalisation (defined as the non-accrual of arrears when short payments are received).

These are defined in more detail in *Annex 1*.

24. This section provides additional good and poor practice where *capitalisation* is taking place.

Good practice
Capitalisation is provided selectively to those cases where the recovery of historical arrears or monies due under the contract is not possible and *capitalisation* is the only option realistically available to assist the customer. *Capitalisation* is provided where the customer has demonstrated a sustained ability, intent and track record to repay and regulatory requirements are observed. The firm has formally sought confirmation that the customer understands and accepts the *capitalisation* event. For larger value *capitalisation* events or re-defaulters, the firm applies more stringent intent and track record criteria, to recognise the increased risks and the increased long-term impact on the customer. For standard *capitalisation* the revised monthly repayments are assessed as affordable now and sustainable over the term of the mortgage: • where the mortgage is paid on a capital and interest (C&I) basis and the revised repayments will fully repay the mortgage over the remaining term of the mortgage; or • where the mortgage is paid on a IO basis and the repayment vehicle will realistically repay both the original mortgage plus the increase in capital balance on the mortgage; or • where part of the mortgage is on C&I and part on IO terms, that each part satisfies the appropriate conditions above. Where repayment *capitalisation* is taking place: • the firm recognises short payment arrangements not accruing arrears based on the full *contractual terms* and temporary transfers to IO as repayment capitalisation events; • the customer is provided with notification of any break clauses in place, in the event that they fail to adhere to the requirements of the temporary arrangement; • if the repayment *capitalisation* period is extended, revised information and consents are provided and sought;

- the revised monthly repayment required to repay the loan over the remaining term of the mortgage is recalculated and the customer is notified immediately following the *capitalisation* period and not unduly delayed in order to minimise the repayment shock and minimise the long-term impact of the *capitalisation* event; and
- in cases where a customer's mortgage is placed in a *non-sustainable* position through *capitalisation* and where there is currently insufficient affordability to return the mortgage onto *sustainable terms*, the firm has in place an effective regular review and contact process to actively manage and support customers back on to *sustainable terms* over a timeframe that is appropriate to their individual circumstances.

The firm recognises that customers who have previously been given a *capitalisation* but then miss a repayment have higher loss risks than other accounts going into early arrears, so the firm prioritises them within the debt management process. The aim is to achieve early direct contact with the customer to reassess their circumstances and minimise the compounded impact of further financial stress or *capitalisation* events.

Poor practice

The firm fails to establish whether a *capitalisation* event is the most appropriate option for the borrower and whether there are other options realistically available to the customer.

Standard *capitalisation* or repayment *capitalisation* events take place in cases where:

- the customer has not demonstrated sustained ability, intent or track record to meet future repayments;
- the customer has not met the qualifying criteria for *capitalisation*;
- the firm has not provided the customer with clear, timely and adequate information to understand the implications of the proposed changes in their terms;
- the firm has not given sufficient time to the customer to understand these changes, the *capitalisation* event, and the impact it will have currently and ultimately on their repayments and interest payable;
- the firm has not formally sought confirmation that the customer understands and accepts the *capitalisation* event;
- the customer has an effective repayment arrangement in place, and is paying more than the contractual monthly repayment which will fully repay the outstanding arrears within a reasonable timeframe;
- the customer has been provided with misleading and biased information to encourage *capitalisation* which may not always be in the most appropriate option for them.

The firm operates a repayment *capitalisation* process whereby the difference between the *contractual monthly payment* and a reduced payment arrangement does not accrue as arrears; but the firm has failed to treat this as a *capitalisation* event and failed to apply all customer and firm good practice controls.

Good and poor practice – interest-only terms

25. We have observed that firms may offer their customers the ability to convert to IO terms, either permanently or temporarily during periods of financial stress. Some firms have tightened their processes to identify where a customer request to transfer permanently is driven by financial stress and so they are able to provide the customer with a lower impact approach to supporting their circumstances.

26. This section provides additional good and poor practice guidance to firms which provide permanent or temporary transfers to IO.

Good practice

Where the customer is requesting a **permanent** conversion to IO terms (where this is allowable within the firm's policy).

- The firm has assessed that the customer has a realistic capital repayment strategy in place.
- An affordability assessment, using their current or the firm's standard reversionary rate applicable to that mortgage, whichever is the higher, is carried out on the basis of a C&I repayment mortgage. Where these C&I repayments are unaffordable, a reasonable assumption is that the primary trigger for the customer conversion request is financial stress. The customer circumstances, therefore, need to be assessed to determine appropriate use of forbearance to avoid the mortgage moving into a long-term non-*sustainable terms* position.
- In all cases, an assessment of the customer's circumstances is carried out to identify any potential financial stress or expected difficulties. A sense check is conducted to confirm that the customer's intent is to adhere to the repayment strategy.
- In general, those customers with current or recent mortgage arrears or where another *potential impairment indicator* has taken place are considered as unlikely to be able to demonstrate both ability and intent to fully sustain the mortgage and repayment strategy.
- Where a customer is converted following the affordability assessment, this should show that the customer can afford to repay the IO repayments plus the cost of the repayment strategy, taking account of any known future changes to the customer's personal financial circumstances (such as retirement).

Where a transfer on to **temporary** IO terms is being considered to support a period of financial stress.

- If affordability allows for repayment above the IO element, a different forbearance approach is considered to maximise repayments and minimise the longer-term impact on the customer. This may include customers in receipt of Support for Mortgage Interest or Department of Work and Pensions (DWP) payments in some circumstances.
- The account converts back to C&I repayments after the expiry of the agreed temporary IO period unless an extension has been considered and agreed with the customer.
- There is an active review process in place to work with the customer to transfer the mortgage back on to C&I *sustainable terms* within a timeframe that is appropriate to their individual circumstances.
- In those instances where a repayment *capitalisation* is operating, that *capitalisation* controls and regulatory requirements are applied for each agreed repayment *capitalisation* period and each agreed extension.
- Where long-term financial stress is apparent, the process of review and extension of forbearance facilities is provided appropriately to ensure that the customer is fully supported. At the same time, returning to a *sustainable terms* position always remains a key goal to minimise long-term risks of home loss.

Poor practice

The debt management procedures of the firm default to transferring some segments of impaired borrowers on to IO repayment terms when affordability would allow for some capital repayment.

Borrowers are converted to IO terms on a permanent basis without consideration of the customer's individual circumstances, affordability assessment or a review of their capital repayment strategy.

There is information available which indicates potential financial stress that may impede the customer's ability to sustain or adhere to an agreed repayment strategy. A standard *capitalisation* takes place at the point of transfer to IO without satisfying the *capitalisation* performance requirements criteria and without applying normal *capitalisation* controls and notifications.

Good and poor practice – mortgage term extensions

27. We observed that term extensions were being used to support a period of financial stress. Most worryingly, in a significant proportion of cases the term had been extended beyond the *retirement income age* (for the purpose of this guidance defined as the government state pension age (SPA) or customer declared retirement age, whichever is sooner). This was often without a process in place to reduce the term once the period of financial stress had ended or an assessment of the income available to service the mortgage in retirement.

28. This section provides additional good and poor practice guidance to firms regarding term extensions.

Good practice
Where a mortgage term is being extended, an affordability assessment is carried out based on both the current payment rate and a stressed interest rate consistent with new business criteria, which allows for any future known or expected changes (eg a fixed or discounted rate period ending) to ensure, as far as possible, that the repayments are sustainable over the life of the mortgage. If the loan term goes beyond the *retirement income age*, retirement income is similarly assessed. Where mortgage terms have been extended during a period of temporary financial stress, a review and follow-up process is in place to support the recovery of the mortgage back on to shorter terms, subject to the individual circumstances of the customer, once the period of financial stress has ended. Where a mortgage term has been extended into retirement, and the retirement income to service the debt has not been assessed, there is an active review process in place to work with the customer to reduce the term to within working age limits and a fully sustainable position within a timeframe that is appropriate to their individual circumstances.

Poor practice
Failure to understand the customer's reasons for a request for a term extension and, where this is due to financial stress, exploring whether alternative shorter-term forbearance might better serve the customer's circumstances to minimise the long-term impact of this change. Where temporary financial stress exists and a term extension has been provided, the firm has failed to implement an effective review process to enable the recovery of the mortgage back on to shorter terms once the period of financial stress ends. A mortgage term has been extended permanently beyond the *retirement income age*, without an affordability assessment of the retirement income.

Good and poor practice – flexible terms facilities

29. Customers are able to utilise the flexible terms of certain mortgage contracts to support various lifestyle choices and as a means of providing relief during periods of financial stress. Often these features are used

without the lender considering whether there may be potential impairment and lenders do not sufficiently reflect the use of these flexible terms within their impairment calculations and loss risks, nor in pro-actively supporting the customer during that stress period. This could leave the customer in a *non-*sustainable position with their mortgage.

30. Flexible facilities, while providing the customer with additional features such as repayment flexibility or drawdown flexibility, should be used in a manner consistent with the customer repaying their loan in line with their original term. Firms need to be aware where flexible facilities are being used materially to support financial stress, to minimise the risk and propensity of mortgages moving into a non-sustainable terms position. Where this has happened, firms need to pro-actively work with the customer to bring the mortgage back into a *sustainable* position within a time-frame that is appropriate to their individual circumstances.

31. The terms of a flexible mortgage should be written to provide protection for both the customer and the firm at times of financial stress.

32. The following details additional good and poor practice regarding the provision and use of flexible terms.

Good practice

Where material use is being made of flexible terms (considered as cumulative drawdown value equivalent to greater than three contractual monthly repayments by value, or which has the impact of reducing the repayment amount affecting cumulatively more than three monthly repayments), then this is treated as a *potential impairment indicator*. Further triggers are in place for earlier identification of potential financial stress in customers using flexible terms (eg capturing information on customer circumstances as part of an application for a payment holiday, risk triggers from other accounts held or behavioural scoring).

Where a *potential impairment indicator* has been identified, the firm assesses the sustainability of the mortgage and whether financial stress exists and, in those circumstances, identifies the best forbearance facilities that support these circumstances.

Where a drawdown, payment holiday or other process resulting in a drawdown of equity is being taken, processes are in place to identify where a mortgage may be at risk of moving into a non-sustainable position and, in this event, the customer circumstances and facilities are reviewed with the aim of recovering the mortgage back on to *sustainable terms*. This should include an assessment as to whether the mortgage is at risk of not being fully repaid within the agreed mortgage term.

Where the mortgage is on a capital and interest repayment basis, credit limits are reviewed yearly to reduce the limit in line with their repayment plan or, warning triggers are in place to highlight where the repayments made are insufficient and thus place the repayment of the mortgage within agreed term at risk.

Full reporting is in place to monitor flexible terms usage, *potential impairment indicators*, impairment, materiality and potential loss risks. Additional consideration is given to the assessment of *impairment* and loss risk attaching to mortgages where the flexible terms enable an impaired customer to avoid moving into arrears for a sustained period of time (eg using drawdown facilities to meet regular contractual monthly repayments).

The firm provides the customer with clear, timely and adequate information so that the customer is fully informed about the impact of their flexible terms utilisation (e.g. repayments due to repay the loan within the original term, revised estimate of interest payable)

Appropriate limits are set for the account eg maximum use limits and review controls, loan to value (LTV), term of loan, repayment levels and valid/invalid uses of reserve/credit/secured overdraft limits, payment holidays and drawdowns.

Facilities are provided in line with the terms of the flexible mortgage, and where these limit the implementation of sound-lending controls in an *impairment* situation, then the affected mortgages are individually assessed for loss risk.

Applications for extensions of flexible terms or other equity withdrawal are fully underwritten and terms defined to protect both the customer and the firm.

Poor practice

Flexible facilities are not reviewed on accounts with a *contract shortfall* or where a *potential impairment indicator* has taken place or other forbearance is being or has been provided.

A long payment holiday (cumulatively equivalent to greater than three months), a drawdown or subsequent holiday/drawdown is provided without giving due consideration to the customer circumstances and affordability to restart payments at a higher level at the end of the payment holiday or after the drawdown. Holidays of significant length (eg 12 months) are provided with no additional interim update of the customer's circumstances.

Flexible mortgage buffers/limits/facilities are used to manage a financial stress situation by the firm without being clearly identified and separately reported.

A linked current account is allowed to go overdrawn, to make a mortgage repayment, but the mortgage is not identified as being potentially impaired.

Not monitoring accounts where the use of facilities is leading, or may lead to the mortgage not complying with contractual repayment terms eg repayment of the mortgage on a capital and interest basis or at risk of moving into a non-*sustainable* position.

Good and poor practice – overpayments where a drawdown facility is available

33. We observed a lack of effective controls in some firms regarding the allocation of payments into an 'over-payment' balance and the subsequent drawdown against these over-payments. There was insufficient scrutiny as to how the balance had accrued, the source of funds and whether drawing on this balance was appropriate.

34. The following additional good and poor practice seeks to ensure that effective controls are put in place and operated over the allocation of additional payment monies into an 'over-payment' balance and the subsequent drawdown of these funds.

Good practice

Where there is a *contract shortfall* as a result of *standard* *capitalisation* or *repayment* *capitalisation*, any additional repayment amount received above contractual monthly repayment or the agreed payment arrangement is not automatically allocated as an over-payment. Consideration is given to reducing the *contract shortfall* balance.

The firm has effective controls in place to identify capital repayments supporting the final repayment of the mortgage on an IO account. The firm is fully aware of situations where:

- one or more repayment vehicles are paid out prior to the term end;
- additional payments or increased repayments are being made to a mortgage whose stated repayment strategy would expect this eg 'additional repayments';
- additional repayments are or have been made to support a capital repayment vehicle which is unlikely to fully repay the loan; and

- a loan was previously on C&I terms and was transferred without effective validation of affordability and repayment strategy.

Where a mortgage is currently subject to a forbearance concession or has previously been subject to forbearance that included a *capitalisation* event, care has been taken to identify whether additional repayments are linked to the recovery of the mortgage back towards its original *contractual terms* or, where different, *sustainable terms* (eg. DWP payments above the IO amount).

Where the potential *overpayment* is to be drawn down, adequate checks are made to ensure the mortgage is not placed in a non-*sustainable* position.

Poor practice

A firm has processed a *capitalisation* event but then marks an account as overpaid in the event that the borrower or DWP makes additional or backdated payments to the mortgage account.

The firm refunds to the customer monies paid by the DWP or from a payment protection plan, supporting the mortgage in the event of sickness or unemployment, when the account is placed in an over-payment situation as a result of being on temporary IO forbearance.

The firm fails to consider if an additional payment made should be allocated as a capital repayment, rather than an over-payment.

RECOGNITION OF IMPAIRMENT IN INTERNAL REPORTING

35. We saw potential for considerable improvement when it came to firms' reporting on *potential impairment indicators*, impairment and individual assessment of loss risk. Firms should review their reporting to ensure that they move to a position where impairment within the book and its associated loss risks are fully assessed and accurately and transparently reported through committee and board reporting; and, that executives are informed when making business decisions. Additionally, firms should ensure that these loss risks are fully accounted for through provisions.

36. The *potential impairment indicators* identified during the thematic review will not be an exhaustive list, and firms may identify other facilities, processes or combinations which may also be indicative of financial stress. It is understood that where potential impairment exists, not all customers may be impaired, but there is an increased loss risk due to the increased levels of impairment risk.

37. Our handbook requires that firms maintain effective controls. Where firms do not yet have effective processes in place to identify, report, monitor and assess the loss risk of forbearance, we recognise they may require interim processes to report this information internally. In this case, interim management overlays may be the only practical means of factoring certain conditions into impairment calculations until such time as models can be improved.

38. Whilst we recognise that there may be a delay while firms develop their analysis in this area, given that assessment of forbearance performance may be best measured after completion process (eg a return from IO back to full capital and interest repayment), we believe that an approach which considers the loss risk of forbearance segments of a portfolio is more transparent.

39. Proxies may be needed where performance is difficult to measure, particularly in the short term. For example, take a flexible mortgage where access to a drawdown facility or long-term payment holiday could lead to a delay in performance monitoring and loss risk assessment. Here, a proxy for material use accounts may be needed eg the roll rates of material use customers who have reached the maximum usage limits of their flexible mortgages may be indicative of loss risks of material use customers that have not yet reached their maximum limits.

40. It may also be the case that firms, upon monitoring of a particular customer segment or potential impairment indicator pool, are able to demonstrate that performance is similar to the rest of the 'up to date' pool of customers and thus may be considered in the same pool. Care would need to be taken to ensure that separate pools are considered where loss risks might differ.

41. The same principles apply to behavioural scoring systems which are deployed to predict future default. The 'accounts defined as good' during the build stage of the scorecards should represent the pool of mortgages which have similar default risk. Impaired and potentially impaired mortgages are likely to display increased levels of default risk, re-offender risk and roll rates and thus should have separate consideration within the build. This may include, for example, additional behavioural scoring segmentation, characteristics, outcome windows, population samples and measurement of performance of mortgages once the account has moved off forbearance. This will help measure the true default, re-offender and loss risks.

Good practice

All *potential impairment indicators* are identified, reported and monitored at all customer contact points across the firm.

All *potential impairment indicators*, forbearance provided, volumes of live accounts and their associated loss risks are monitored, fully reported through management and board committee structures, and incorporated into all decision-making processes of the firm where loss risk is evaluated or used (eg provisions, capital, credit decisions, product pricing, strategy and forecasting, and planning).This assessment considers the forbearance actions taken and the type and level of customer difficulty.

This reporting and loss risk assessment is segmented by type of *potential impairment indicator*, whether *impairment* exists and the severity of customer *impairment*, type of forbearance provided, time since last *potential impairment indicator* and key loss characteristics eg LTV. Additionally, further segmentation is considered where a difference in the performance or loss risks is evident. For example:

- re-defaulters;
- multiple forbearance applied;
- duration of potential financial stress period or severity;
- period since account recovery or last *potential impairment indicator*;
- *non-sustainable* account;
- use of limits activity, accounts at risk of moving into a *non-sustainable* position due to activity;
- another account held by the customer shows potential impairment; and
- loans past maturity.

The performance and loss risks of a customer where a *potential impairment indicator* has taken place are considered within the whole up-to-date book only from the point when the loss risks and performance of this mortgage can be shown to be the same as the whole.

The firm's reporting, provisions and capital assessment are undertaken in full awareness of the *contract shortfall* of customers and thus the level of severity where financial stress exists or a *potential impairment indicator* has taken place.

Poor practice

The firm does not comprehensively report on the incidence of *potential impairment indicators* and customer *impairment*. These loss risks are not assessed or reported to executives who are not aware of the overall loss risks of the business.

Business decisions are made with incomplete *impairment* and loss risk information.

Incentive schemes for debt management staff which ignore the impact of forbearance facilities being provided, leading to a conflict in interests.

Management Information (MI) systems are not able to effectively monitor the performance of customers currently on, or previously on, a forbearance facility or post a *potential impairment indicator* to enable the firm to measure and understand the effectiveness and impact on the customer and longer-term outcomes.

Interest or fee income forbearance is not recognised in reporting, forecasts and loss risk assessment.

Customer decision systems do not incorporate *potential impairment indicator* and forbearance provision risks and these are not fully considered when making customer decisions (eg as part of a further lending scorecard development and monitoring process for customers).

RECOGNITION OF IMPAIRMENT IN EXTERNAL REPORTING

42. Transparency in accounting practice and disclosure is vital in achieving our goal of market confidence, particularly in judgemental and complex areas where the use of financial models may be required. So, we established new accounting functions following the recommendations of the Turner Review to survey and scrutinise in more detail firms' accounting judgements, noting any significant divergences in practice and their implications for market confidence.

43. While the observations and considerations provided around accounting in this document are driven by our wish to maintain market discipline and comparability between firms, and stem from prudential and conduct considerations, we recognise that there is some degree of overlap with considerations of accounting and auditing judgements.

44. This document is not intended as an interpretation of accounting standards, nor as mandatory accounting guidance; rather, it is a listing of accounting considerations which firms may find helpful in assessing their approach in the area of forbearance, and in which we will show an interest going forward.

45. The accounting considerations in this document are all made within the context of materiality. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report (IFRS Conceptual Framework, QC11). Where levels of forbearance are significant, and where the long-term financial effect of

forbearance might be uncertain, firms should consider whether their existence has an impact on users of the financial statements that is material by nature as well as size.

46. At the time of issue of this document, deliberations were ongoing at the International Accounting Standards Board (IASB) to replace the impairment model in IAS 39 with an approach to impairment that is based on expected loss. This is part of a comprehensive project to introduce a new standard, IFRS 9, for accounting for financial instruments. As of the date of issue, IFRS 9 had not yet been endorsed for use in the European Union (EU). While the considerations in this document relate to the current impairment rules, we consider that better management information systems and considerations of forbearance in calculating impairment are as valid under any future expected loss approach as under the current standard; however the mechanics of calculation may change significantly. If a new impairment model is endorsed for use in the EU, the accounting material within this document will be re-issued in due course.

47. We recognise that, in many cases, there may be limited actual experience of loss history data around which to provide accurate forecasts of cash-flow profiles for loans subject to forbearance practices, since the forbearance actions in question may have taken place recently and the true credit risk inherent in these accounts may only become apparent in the future (such as in a scenario where interest rates increase). However, firms should consider monitoring these accounts separately in order to meet the IAS 39 criteria, whether around loss events for individually assessed impairment or around realistic default probabilities on a portfolio basis for collective impairment. As noted in paragraphs 35-41 of this document, improved internal reporting can assist firms in making accounting judgements in this area.

48. With regard to *impairment events* and forbearance, our observations on accounting practices fall into the following main categories:

- application of the impairment event;
- collective impairment and appropriate segmentation;
- use of historic data;
- realism in estimates; and
- disclosure.

49. In all of the above areas, we have concerns that certain accounting practices can have the effect of concealing the full effect of *impairment* and forbearance and thus may not present the true nature of credit risk within retail portfolios.

50. In assessing market practice in this area, we note that there is some divergence in the terms used between firms. For example, the definition of 'default', and therefore of 'probability of default' may be interpreted differently. Other interpretations such as 'non-performing' or 'provision coverage' may similarly differ. While not the subject of this review, we nevertheless encourage firms to provide as accurate a description as possible of each term used in the area of *impairment* reporting within the firm's glossary of terms.

Application of impairment event per IAS[14] 39.59

51. IAS 39 ascribes the recognition of *impairment* losses to two factors: that one or more objective events have occurred after initial recognition of an asset (an *impairment event*) and that event has an impact on the estimated future cash flow of an asset or group of assets, which can be reliably estimated. The Standard is clear that an event for which there is objective evidence can give rise to an impairment charge if it can be demonstrated that the event has an impact on future cash flows. The existence of present cash losses is therefore not a pre-requisite for recognising *impairment* losses (see *impairment event*).

52. IAS 39.64 states that an entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.

53. In practice, retail mortgages may often be deemed not to be individually significant by firms, and included in a collective assessment of impairment. However some firms may initially opt to assess loans individually, and we recognise the existence of an accounting policy choice in this area. We also note that IAS 39.AG88 is clear that impairment losses recognised on a group basis represent an interim step, pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

54. Where there has been no cash loss to date, firms usually take account of the above factors by recognising a collective impairment on the 'good book' of assets where an individual *impairment event* has been observed. The collective impairment is intended to measure losses on those accounts where an *impairment event* may exist, even though the firm is unaware of its precise nature.

55. Our concern is that, in some cases where individual monitoring of accounts takes place, certain loans that have been subject to forbearance procedures may give rise to future cash losses (when assessed against the original terms and discounted using the original effective interest rate as required by the Standard), whether due to lower overall cash receipts or to later payment. Therefore, an objective assessment of future cash flows may give rise to a loss when compared with the original terms of the loan.

56. Factors such as (a), (c) and (f) detailed within the *impairment event* definition appear to have particular relevance in the context of forbearance practices, for example:

- an impairment event (such as unemployment of the borrower) could indicate significant financial difficulty, even when payments are up-to-date, resulting in reduced anticipated cash flows and hence an impairment charge;
- a forbearance action undertaken due to the financial difficulty of a borrower more generally may similarly result in reduced cash flow estimates; and

[14] International Accounting Standards

- the adverse status of borrowers in a collective assessment of impairment may give rise to an *impairment event* for a certain pool.

57. IAS 39.64 is clear that assets that are individually assessed for *impairment*, and for which an impairment loss is recognised, are not included in a collective assessment of *impairment*. As such, if loans are individually found to be impaired (even if up-to-date in accordance with modified terms following a forbearance action), these loans should not be included in the 'good book' for collective impairment assessment.

58. In practice, for retail portfolios, the main indicator usually used by firms to separate out pools of loans from the overall pool of retail loans is delinquency (item (b) within the *impairment event* definition). Market practice varies considerably in terms of how many missed payments are required to trigger an *impairment event* and hence the transfer of a loan into individual assessment, or a separate pool, for the purposes of impairment calculation. Firms may wish to ensure that, where loans might be individually assessed, full account is taken of all factors that may trigger an *impairment* loss. Some examples of good and poor practice in this area are as follows:

Good practice

Accounts that have been subject to an *impairment event* or forbearance procedure that has an impact on future cash flows are separately monitored as impaired loans. Loans subject to forbearance procedures as a result of financial stress are also considered to have different risk characteristics from the rest of the group, and therefore included in a separate pool where collective impairment assessment takes place.

Loans that are behind their payment schedule are assessed to consider whether these loans have different risk characteristics from loans that are not behind their payment schedule; if there is evidence of this, these loans are not included in the general pool for collective *impairment* purposes.

The firm uses a 'cure rate' to estimate those accounts which can objectively be expected to return to payment patterns as per the original contractual schedule. This cure rate can be verified by means of a demonstrable roll rate based on actual experience, specifically for these loan types. Thus no cure is assumed unless objectively verifiable.

For mortgage customers who also have unsecured personal loans (UPLs) with the firm that are in arrears, this is regarded as an *event* as a result of the significant financial difficulty displayed by the borrower, even if the mortgage product is up-to-date.

Customers who have material unsecured debt (relative to the customer circumstances), to the point where mortgage repayment appears dependent on further borrowing, are regarded as showing significant financial difficulty and assessed separately for *impairment*.

If arrears on an account have previously been capitalised, and the borrower has since relapsed into delinquency, the borrower is treated as individually impaired even if the firm otherwise has a longer period of delinquency as an indicator of *impairment*.

Poor practice

Loans without arrears or in early arrears are not deemed to be impaired even if they have been subject to forbearance practices and remain in the 'good book' for the purposes of *impairment* calculation or, when granting customers more favourable terms under a forbearance arrangement, the firm also changes the contractual monthly repayment for the customer. This has the effect of not showing the customer to be in arrears, and these arrears are effectively capitalised.

The firm presents an ageing analysis of these loans either as 'neither past due nor impaired' or 'past due but not impaired' for the purposes of IFRS 7 disclosure, potentially masking the separate risk characteristics of these loans.

Collective impairment and appropriate segmentation

59. In cases where accounts subject to an *impairment event* or forbearance are either individually assessed and found not to be impaired, or not individually assessed, a 'collective impairment assessment.' is possible. However, pooling of loans for collective *impairment* assessment is nevertheless dependent on certain criteria. Highlights of IAS 39 on collective *impairment* assessment are provided in *Annex 1*, which explains some of the restrictions. Given these restrictions around the use of collective impairment pools, it is unlikely that an entire retail portfolio of a large firm could be included in the same pool for the calculation in many cases. For example, it would be difficult to argue that loans that are subject to forbearance arrangements due to financial hardship have the same risk characteristics as those that are not. As such, even if it is determined that there is no individual *impairment* in these loans on the basis that they are not individually significant, they should not be included in a 'performing' pool together with other loans that have different risk characteristics.

Good practice

Impairment events and forbearance are considered in the loan portfolio when assessing *impairment*. Therefore, for example, where significant levels of loan assets have been changed to an interest only basis from capital repayment, these assets are not viewed as having similar risk characteristics to the remaining portfolio.

Collective *impairment* for each pool is calculated using metrics (eg probability of default (PD), loss given default (LGD), emergence periods, etc.) that are representative of that pool. This takes into account, for example, significantly different LTVs, debt on other accounts, or external bureau scores.

For buy-to-let properties, subject to an *impairment event* or forbearance, where possible those properties with tenants are separated from those without tenants.

The calculation for recovery discriminates by region.

For accounts that are in arrears after a certain period of time (eg six months), the PD is adjusted to 1.

Firms identify fraud rings and log up-to-date cases that were handled by third parties involved in fraud (eg packager, valuer etc.). A more realistic approach is taken towards *impairment* in these cases.

Accounts which are up-to-date, but have previously been in arrears or impaired, are separated out into a separate pool for loss assessment until such time as the loss risk is shown to match the rest of the up-to-date book (eg two years after the last *impairment* event).

Portfolios are segmented by LTV ratios. Where a 'cure rate' is used, this is also subject to LTV bands so that cures seen in customers with low LTVs do not affect expectations for those with higher LTVs.

Poor practice

In their collective impairment methodology, firms have only one pool for the entire book, with the exception of those loans significantly in arrears.

Loans subject to an *impairment event* or forbearance are included in the same pool for *impairment* calculation purposes as all other unimpaired retail loans, on the basis that there have been no cash arrears.

Use of overlays in impairment calculations

60. We note that, in many instances, firms employ certain overlays in *impairment* calculations in order to take account of some of the portfolio characteristics mentioned above. However, in viewing the calculations prepared to date, it appears that many of the good practice points noted above are not included in such overlays. In addition, overlays have the major disadvantage that they are seldom straightforward and it is often impossible to assess the amount of overlay against the potential problem. We do, however, recognise that timing constraints can result in overlays as the only practical means of factoring certain conditions into impairment calculations until models can be recalibrated. Therefore, while we recognise and support the recognition of uncertainty by firms in applying overlays on a temporary basis, we believe that an approach which segments aspects of portfolios as in the examples above is more transparent in assessing a firm's risk assessment.

Use of historic data in calculating impairments

61. In calculating collective *impairment* for retail portfolios, certain metrics in assessing probabilities are based on historic roll rates. For example, rates of customers going into significant arrears, or roll rates to possession may be based on a firm's experience to date over a set period of months.

62. The use of historic experience usually represents a reasonable starting-point for assessing potential 'latent' impairment within a collective provisioning calculation. However, historic experience alone may not take certain current conditions into account. Particularly in times of economic stress, retail portfolios may be subject to significant pressures which are not picked up by historic behaviour. In addition, historic information may mask the effect of forbearance and other activities designed to assist borrowers.

63. In some cases, the observable data required to estimate the amount of an *impairment* loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, a firm uses its experienced judgement to estimate the amount of any impairment loss. Similarly, a firm uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

64. When using historical loss rates to estimate future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions (IAS 39.AG91).

65. Use of historic loss rates that take into account losses suffered on assets with different risk characteristics, or those based on losses in a different market environment, should be amended with relevant observable data that take into account the specific risk characteristics of the portfolio. An argument for the use of a single roll rate for an entire retail portfolio therefore appears unlikely to be appropriate.

66. A number of factors, whether individually or in combination, may mean a need for significant adjustments to historic expectations. For example, where firms use historic roll rates to possession, these

rates may be lower in current conditions due to the unattractiveness of possession given the current property market. Therefore, current non-possession is not necessarily representative of a cure for an impaired customer. Similarly, the use of forbearance activities may result in accounts being up-to-date according to the new terms. So, roll rates to default may appear lower than the actual risk profile of a portfolio would suggest.

67. In addition, for customers who are already impaired on a portfolio basis, certain macroeconomic factors may be relevant in assessing future recoverable cash flows from the customer for the impairment calculation in accordance with IAS 39.63. Consider, for example, the low level of current UK bank base rates, which have a direct effect on most mortgage repayments. For accounts which are already impaired (due, for example, to a forbearance action), the level of arrears in some cases may be low or zero. However, these low levels of delinquency may be due in part or in full to the fact that current rates are low and the borrower may have no means of servicing a mortgage when bank rates rise. Therefore, the levels of arrears may not be representative of the true credit risk inherent in the portfolio. Firms may need to adjust probabilities of default to assess the true credit risk in the portfolio.

Good practice

Appropriate outcome periods are used as a model input to calculate accounting impairments. Although IAS 39 is a model based on incurred loss, once an asset is identified (individually or collectively) as impaired, expected cash flows (resulting from past events) are assessed on a forward-looking basis for those assets. Outcome periods may be significantly different for accounts which have been subject to certain forbearance arrangements. However, it is likely that there would be limited data available on these accounts since the forbearance arrangements were made relatively recently. Therefore, outcome periods for assessing defaults for loans subject to forbearance actions are set in a way which takes into account the period of forbearance and acknowledges potential increased loss risk once this period has ended.

In addition, the effect of the arrangement itself on the outcome period is considered. For example, if a customer is moved to interest only for a period of six months, it is possible that losses only become visible after this point. Thus an outcome period of 12 months is unlikely to be appropriate, taking into account the cash loss incurred for these accounts. Therefore, performance assessment may be best measured after completion of the forbearance process where this is feasible (eg a return from interest only back to full capital and interest repayment).

A realistic approach is taken in assessing probabilities of default by taking the current benign interest rate environment into account. Hence, for loans where there are signs of financial stress but which may not yet display cash arrears due to the current low interest rate environment, proper consideration is given to the true credit risk when assessing probability of default.

Accounts for which forbearance actions have been pursued are not shown as up-to-date when assessing the propensity of that pool to default. For example, the value of ‘cumulative *capitalisation*’ plus new arrears may be used for roll rate determination.

The up-to-date (UTD) book might include a number of accounts where the borrower is unemployed, and may be subject to forbearance. The firm separates out those accounts in arrears that are due to ‘unemployment’ and the average provision for those accounts. This is then used to extrapolate provision for the UTD accounts, that is, they assume all those who are unemployed in the UTD book will fall into arrears and roll in line with the unemployed accounts currently in arrears.

Poor practice

Cure rates are not used and firms incorporate an estimated roll to possession when accounts are in arrears. Thus, in the current market environment where possession is often unattractive due to property market considerations, some accounts are not captured.

Realism in accounting estimates

68. In calculating an impaired amount, firms are required by IAS 39 to estimate future cash flows arising from the impaired asset or group of assets. In estimating the future stream of cash flows, firms inevitably encounter a high level of uncertainty and this creates challenges in measuring the impaired amount appropriately.

69. For example, when a loan has moved to an IO basis as a result of a forbearance arrangement, or arrears are capitalised, a firm may need to assess whether all of the original cash flows will be recovered and any delay compensated for, using a degree of realism. In many cases, such as where there is no repayment vehicle in place in such arrangements, there may be a strong argument for assessing that all cash flows may not be recovered. IAS 39.86 is clear that, where a range of possible amounts is estimated, the firm recognises an impairment loss equal to the best estimate within the range. The footnote to this paragraph makes reference to the guidance in IAS 37.39 to estimate an obligation in these circumstances by weighing all possible outcomes by their associated probabilities. In the case of forbearance activities, it is important for firms to consider carefully whether an appropriate degree of neutrality has been used in applying these criteria, so that cash flows are estimated that reflect the level of underlying credit risk.

70. We have noted an element of divergence for firms in their choice of accounting policy with regard to the values ascribed to collateral. Some firms calculate a period to possession, and then use retail price indices to estimate the value of collateral at the point of potential possession. This may result in a positive fair value movement of the collateral, hence a lower provision, if the index anticipates appreciation in house prices. In contrast, some firms take a pessimistic view of future house prices and build in a discount to the value as at the balance sheet date. Still others use the value at the balance sheet date without modification, on the basis that future movements are not within the spirit of the IAS 39 impairment model; so, to recognise future gains in this way would not be appropriate.

71. We believe that there may be some lack of clarity in the accounting rules (IAS 39) regarding this question, which has led to divergent practice among firms. Whilst the *impairment* model is based on incurred loss, and should depend on past trigger events, disregarding future events, the cash flow stream estimated as a result of those past events necessarily extend into the future. Some argue that future rises in collateral values are future events and should not be included in an *impairment* calculation based on past events; others argue that they are only a factor that affects cash flow estimates (which necessarily extend into the future), and therefore can be used.

72. If a firm uses future house price indices to predict collateral values at possession, we believe an appropriate degree of realism needs to be factored into this estimate to ensure that any impairment charge properly reflects the credit quality of the relevant assets and inherent uncertainty involved in predicting future house prices. Therefore, if firms incorporate a significant appreciation of future house prices into cash flow models, careful consideration is required as to how realistic these estimates are likely to be, given the inherent uncertainty of future prices.

73. We are conscious that to judge whether an appropriate level of realism has been applied poses significant challenges to firms and their auditors. Unless management is able to support its estimates (including any overlays), it will be difficult for the auditor to obtain sufficient, appropriate audit evidence.

74. Within International Standards on Auditing, we note that paragraphs A16-A20 of ISA (UK and Ireland) 540 provide application material for auditors in assessing how management identifies the need for accounting estimates, including considerations where the auditor identifies transactions, events or conditions that give rise to the need for accounting estimates that management failed to identify. We also note the requirement of paragraph 164 of Practice Note 19 (Revised), issued by the UK Auditing Practices Board in March 2011, to review what is constituted as a loss event and what events will result in an impairment loss being recognised. If the auditor considers that levels of forbearance are material and that management information may not fully capture their effect, this may have an impact both on the impairment calculation and on audit conclusions regarding the robustness of internal control in this area.

75. In May 2011, the FSA issued the Guidance document *Code of Practice for the Relationship between the External Auditor and the Supervisor*. In this document, we note the importance of 'an open, cooperative and constructive relationship between the supervisor and the auditor so they can both provide effective input to the regulatory process'. We believe that this necessarily involves discussion and mutual understanding on key areas of judgement areas in the audit, and that assessment of firms' treatment of forbearance in impairment provisioning provides an example of such a judgement area. Therefore, where levels of forbearance are material, we will look to understand both the systems used by firms in the context of this document, and the approach taken by auditors in assessing and concluding upon firms' methodologies.

Good practice

It is assumed that a significant proportion of accounts where arrears have been capitalised will fall back into arrears and this fallback rate is quantified on each pool segment.

In assessing recovery amounts, the collateral values used (before forced sale discounts) reflect an appropriate degree of realism which reflects the inherent uncertainty with regard to any potential future movements in the index.

Probabilities of default within the up-to-date book are revised to be more pessimistic if behavioural scorecards suggest this is appropriate.

Credit quality of loans factors in the current low interest rate environment.

Poor practice

Conversions to IO assume full repayment of the principal at the end of the loan term, even though there is no repayment vehicle in place.

Term extensions are granted and these extend the life of a loan to the point where the borrower is likely to enter retirement without an assessment of the retirement income. All cash flows are assumed to be received and the loan is not considered impaired.

Lack of appropriate caution in estimates of forced sale discounts when computing possession values. In most cases, a forced sale discount of 10% is unlikely to be sufficiently realistic in the current environment.

Shortfall values are revised in line with quarterly revisions to the indexed property valuations eg update to the quarterly house price index.

No arrears are recognised as the customer's contractual monthly repayment is changed, resulting in repayment *capitalisation* following a forbearance action; and the severity of their true arrears based on their 'cumulative *capitalisation'* is not assessed.

Accounts subject to a mortgage rescue scheme are not considered problematic and are not shown as impaired.

Disclosure

76. IFRS 7 stipulates that quantitative risk disclosures made by firms should be based on information provided internally to key management personnel (IFRS 7.34(a)). We believe that this principle, and the other references to IFRS 7 given in this section, are directly relevant in the context of portfolios where forbearance is material. The risk exists that firms may not reflect the additional credit risk attached to accounts in forbearance and therefore may not provide a complete picture of the credit risk profile within portfolios.

77. IFRS 7 is clear that firms should provide information about the credit quality of financial assets even if these are neither past due nor impaired (IFRS 7.36(c)). In addition, the Standard prescribes that, if the quantitative data disclosed as at the end of the reporting period are unrepresentative of a firm's exposure to risk during that period, a firm should provide further information that is representative (IFRS 7.35). In the case of retail loan portfolios, we consider the use of forbearance procedures that may have the effect of masking the true credit risk of the underlying portfolio, warrant separate disclosure.

78. A firm's choice of accounting policies is important in addressing some of the measurement criteria used in impairment. Disclosure of significant accounting policies is a requirement of IFRS 7.21. We encourage firms to consider carefully which policies need to be disclosed in order to provide a fuller picture of how impairment is measured.

79. In September 2010, the British Bankers' Association (BBA) published a new Code for financial reporting disclosure. The signatories to the Code were the seven largest lending institutions in the UK. The Code commits these firms to high-quality, meaningful and decision-useful disclosures, and acknowledges the importance of good practice recommendations issued from time to time by relevant regulators and standard setters. The Code encourages disclosure at an appropriate level of granularity and also makes the point that topical issues, even where not material to a firm's overall business, may be material to the sector and hence relevant to stakeholders. In light of the continuing interest in the subject of forbearance from the UK FPC and other regulatory bodies, we believe that this subject warrants consideration under the Code as an area of interest in providing disclosure.

80. The Accounting Standards Board (ASB) of the UK Financial Reporting Council issued its report *Cutting Clutter: combating clutter in annual reports* in April 2011. The ASB makes the observation that unnecessary clutter in financial statements can make it harder for users to find the salient points about a firm's performance and position. In the area of financial instruments, the tentative view is given that firms should address 'only the risks that are material to the entity – many companies only have significant exposure to some financial risks, but still provide detailed disclosure about others'. We support disclosure that is targeted to reflect the true credit risk inherent in loan portfolios, and that is not obscured by more generic but less important disclosure.

81. In order to provide targeted disclosure in the area of forbearance within credit risk, and in the context of combating unnecessary detail and focusing directly on risk areas within portfolios, we encourage careful consideration of the type and levels of forbearance used by firms, and also of firms' policies and processes for managing credit risk in this context.

82. Appropriate disclosure in this area might include descriptions and quantification of types of forbearance where material, including an assessment of sustainability of forbearance arrangements. Accounting considerations might include disclosure of accounting policies relating to how the loss event criteria of IAS 39.59 are interpreted in the context of forbearance, how loans are separated into pools reflecting similar risk characteristics under IAS 39.AG87, and how impairment models are calibrated to take account of forbearance activities and other current market conditions.

Good practice

Firms disaggregate portfolios appropriately for *impairment* assessment to take account of the different types of forbearance action detailed in this document. This is mirrored in the disclosures provided on retail *impairment*.

Firms consider carefully the factors listed in paragraph 82 in providing disclosures in the credit quality of loan assets.

Poor practice

Firms disclose loans that are subject to forbearance arrangements due to customer *impairment* in the 'neither past due nor impaired' bucket without further disclosure, giving the user of the financial statements the impression that these loans are of good credit quality and masking the portfolio's true credit profile.

Within the analysis of credit quality of neither past due nor impaired loans as required by IFRS 7.36(c), no mention is made of forbearance arrangements.

Loans where arrears have been subject to standard or repayment *capitalisation* are treated as not past due for the purposes of IFRS 7.36-37 and no mention is made of the special status of these loans.

FURTHER RELATED WORK

83. As we apply our intrusive and intensive approach to firm supervision, we will be looking to see how firms have acted on this guidance. We will consider, for example, whether firms have robust procedures for the consideration of customer forbearance, that there is clear and transparent reporting of forbearance, impairment and loss risks of the portfolio including provision assessment, and that these loss risks are known by the executives of the business.

84. The Bank of England's interim Financial Policy Committee (FPC) on June 16 2011 said: "We advise the FSA to extend its review of forbearance and associated provisioning practices across UK Banks' household and corporate sector exposures, on a global basis." Work is underway to progress this.

85. Capital implications were not assessed as part of this review. We will consider the implications for firms in respect of capital requirements where impairment and loss risks have not been comprehensively considered by the firm.

86. Regulatory reporting requirements were not considered as part of this review. We will be considering whether additional reporting to the FSA in relation to forbearance activities would assist in the regulatory process.

APPENDICES

Annex 1: Glossary of terms used

Accounting standards

Under International Financial Reporting Standards (IFRS), specific accounting rules around impairments (also referred to as ‘provisions’) are governed by the accounting standard IAS 39 Financial Instruments: Recognition and Measurement, in particular by IAS 39.58-70 and IAS 39.AG84-AG93, supported by the relevant Bases for Conclusions and Implementation Guidance. In addition to these specific rules, more general guidance in accounting estimates is provided by the Framework and the Standard IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

All references to accounting standards within this section are to IFRS. We note that certain institutions may not prepare accounts under IFRS. However, with regard to impairment methodology, the UK standard FRS 26 Financial Instruments: Recognition and Measurement, used widely within the UK financial services industry, is identical to IAS 39. FRS 26 is applied by almost all significant UK financial institutions who report under UK GAAP rather than IFRS. For those firms where neither IFRS nor FRS 26 is used, we recognise that the specific accounting standards noted within this document are not mandatory under UK GAAP. However, we believe that the principles around loan provisioning and disclosure covered in this document are also relevant to measurement of accounting provisions in these cases, and recommend careful consideration of the effect of forbearance practices in loan provisioning and related disclosure. We consider the conclusions and recommendations around good and poor practice contained in this section to apply to UK institutions as a whole where forbearance strategies have been adopted. As well as IAS 39, this document refers to the IASB Framework as well as other international Standards.

Capitalisation or capitalisation event

Where a customer has made repayments that are less than is due under the *contractual terms* of the mortgage, but where this difference has not been retained as an arrears value, the mortgage is considered to have been subject to a capitalisation event. In these instances the interest repayable over the life of the mortgage and/or the future repayment amount and/or the term of the mortgage will have been affected.

It is recognised that a firm may capitalise small amounts of arrears where there is no resulting impact on interest payable, repayment amount or term of the mortgage, which have arisen from timing issues and interest rate rounding during rate change months etc. Where the long-term interest payable impact is less than £50 or less than £1 on the contractual monthly repayment amount and less than one month on the term, the capitalisation is deemed as immaterial and ignored for reporting and treatment purposes. Under this clause, where cumulative immaterial capitalisations become material, a *capitalisation* event is deemed to have occurred.

a) Standard capitalisation: a single capitalisation event to capitalise a pre-existing *contract shortfall*.

b) Repayment capitalisation: defined as any process which allows for a lower than contractual repayment to be made without this contract shortfall accruing as arrears (eg the account is temporarily transferred to IO, given a payment holiday or other payment arrangement where arrears are not accruing).

MCOB 13 requirements should be considered in both cases (reference to MCOB 13.3.4A R (1)(d))[15].

Collective impairment assessment.

IAS 39 states the following with regard to assessment of impairment on a collective basis (IAS 39.AG87-88)

a) For the purpose of a collective evaluation of *impairment*, financial assets are grouped on the basis of similar credit risk characteristics that indicate the debtors' ability to pay all amounts due according to the *contractual terms* (eg on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by indicating the debtors' ability to pay all amounts due according to the *contractual terms* of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for *impairment* and found not to be impaired and (b) assets that have not been individually evaluated for *impairment*, with the result that a different amount of *impairment* may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.

b) *Impairment* losses recognised on a group basis represent an interim step pending the identification of *impairment* losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

Contractual monthly payment

The contractual monthly repayment is defined as the monthly payment due, based on the *contractual terms* of the mortgage. To avoid doubt, a payment holiday taken or a drawdown against a flexible credit line during the life of the mortgage is deemed to be a change to the *contractual terms* where the interest repayable over the life of the mortgage, and/or the future monthly repayments due and/or the term of the mortgage will be varied as a direct result of the payment holiday or drawdown.

Contract shortfall

This is the difference between the value of cumulative repayments made by the customers and the value of cumulative contractual monthly repayments due.

[15] http://fsahandbook.info/FSA/html/handbook/MCOB

Contractual terms

This is defined as the original terms and conditions of the mortgage as agreed at the time of mortgage completion. *Contractual terms* are deemed to have changed to new terms where the new terms are a *sustainable* alternative to the original terms and the customer has been provided with clear, timely and adequate information to understand the implications of those changes in terms and has provided their consent to the changes based on that understanding.

Firms, when changing *contractual terms*, must remain compliant with the wider constraints of contractual legislation, for example the FSA-published Undertakings and Unfair Contract Terms regulation.

Impairment

A financial asset is impaired if there is objective evidence that an impairment event has occurred, and that the *impairment event* has an impact on the estimated future cash flows of the asset or group of assets which can be reliably estimated. An impairment may be caused by a single event, or a combination of events. If an asset is impaired, its new carrying amount is the present value of estimated future cash flows, discounted at the asset's original effective interest rate. The difference between this amount and the asset's previous carrying amount is taken to the income statement as an impairment loss.

Impairment event – Application of impairment event per IAS 39.59

a) IAS 39 ascribes the recognition of impairment losses to two factors: that one or more objective events have occurred after initial recognition of an asset (an *impairment event*); and, that the event has an impact on the estimated future cash flow of an asset or group of assets, which can be reliably estimated. As such the Standard is clear that an event for which there is objective evidence can give rise to an impairment charge if it can be demonstrated that the event has an impact on future cash flows. The existence of present cash losses is therefore not a pre-requisite for recognising impairment losses.

b) The type of objectively observable *impairment* events are listed in the Standard as follows (IAS 39.59):

   a) significant financial difficulty of the issuer or obligor;

   b) a breach of contract, such as a default or delinquency in interest or principal payments;

   c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

   d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

   e) the disappearance of an active market for that financial asset because of financial difficulties; or

   f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

i. adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or

ii. national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

Overpayments

This is where the firm has a facility to accumulate repayments made above *contractual terms* as an overpayment.

Potential impairment indicator

This is defined as an event which may be indicative of *impairment*. For example, the customer is provided with or requests a temporary or permanent reduction to their mortgage repayments or an increase in capital outstanding. This may take the form of a request to extend the term of the mortgage, the transfer of all or part of the mortgage on to IO terms, to take a payment holiday, or take an equity drawdown (against the mortgage or a linked credit line). For the avoidance of doubt, if a firm does not have a robust mechanism for identifying impairment from a potential impairment indicator, they should not assume that *impairment* does not exist. This may also include all or part of a mortgage which has passed its maturity without full repayment.

A *potential impairment indicator* is also considered to have occurred when the lender has provided the customer with a concession that it would not normally have provided had the impairment position of the customer not existed. Examples may include paying costs to support a voluntary sale of the property, payment of ground rent or maintenance bills on a leasehold property, waiving of Early Redemption Charges (ERCs), transfer to a reduced concessionary interest rate or support provided by smoothing of interest payments pre/post a rate change.

Retirement income age

The Office of National Statistics (ONS) states: “The transition from work to retirement involves a move towards part-time employment. The majority of those who are employed after State Pension Age (SPA) work part-time.” Historically, a higher proportion of women than men have continued to work beyond SPA (in April to June 2010, 13.4% of women aged 60 and over were in employment, compared with 11.0% of men aged 65 and over). This is largely because women’s SPA has been – and remains for the time being – lower than men’s. It may also reflect the different types of work done by men and women and the fact that many couples make joint retirement decisions.

Economic activity by age: men[1], April to June 2010[2]

Great Britain — Percentages

Age	Employed: full-time	Employed: part-time	Unemployed	Inactive: Retired	Inactive: Sick or disabled	Inactive: Others
25 - 49	80.1	5.5	6.3	0.0	4.7	3.2
50 - 54	77.3	5.2	5.3	0.7	8.3	3.2
55 - 59	66.6	9.3	4.9	4.1	11.3	3.8
60 - 64	41.9	12.2	3.7	19.6	16.5	5.9
65 - 69	11.0	13.0	0.7	63.3	8.2	3.7
70+	1.4	3.5	0.1	94.9	0.0	0.0

1 The ‘Inactive: others’ category includes those seeking and not seeking work. This includes students and people looking after family home.

2 Data not seasonally adjusted.

Source: Labour Force Survey, Office for National Statistics

Economic activity by age: women[1], April to June 2010[2]

Great Britain — Percentages

Age	Employed: full-time	Employed: part-time	Unemployed	Inactive: Retired	Inactive: Sick or disabled	Inactive: Others
25 - 49	44.7	29.5	4.5	0.0	4.5	16.7
50 - 54	43.9	31.3	2.9	1.0	11.2	9.7
55 - 59	35.6	29.5	2.6	6.0	13.7	12.5
60 - 64	12.9	20.6	0.6	47.7	8.0	10.2
65 - 69	3.7	12.4	0.2	72.4	5.8	5.6
70+	0.3	2.3	0.0	97.4	0.0	0.0

1 The ‘Inactive: others’ category includes those seeking and not seeking work. This includes students and people looking after family home.

2 Data not seasonally adjusted.

Source: Labour Force Survey, Office for National Statistics

Given the low rate of full-time employment after SPA, it is reasonable to assume that retirement income will be required to support the repayment of a mortgage after the SPA, or the customer’s expected retirement age, whichever comes first. It may be reasonable to extend this age where a customer, close to the government SPA, is intending to continue to work full-time or part-time past the government SPA and the firm has considered whether this is plausible for the customer’s circumstances, employment type and assessed that their employment income plus retirement income shows full affordability. ONS statistics identifies that the expected continued working life of a person working beyond the government SPA is less than three additional years for women and less than two for men.

Changes to SPA: currently the SPA for men is 65. The SPA for women was 60 until 5 April 2010, but under the Pensions Act 1995 the SPA for women increased on 6 April 2010. This increase is staged, with the exact age at which women become entitled to a state pension depending on their date of birth. Under the Pensions Act 1995, women’s SPA would reach 65 (in line with men’s) by 2020. Under the Pensions Act 2007, the SPA for both men and women would increase from 65 to 68 by 2046 (with increases to 66 from 2026, to 67 from 2036 and 68 from 2046). However, in January 2011, the government presented to Parliament a Pensions’ Bill which proposes faster increases to SPA. The proposed changes would bring women's SPA into line with men's at age 65 by 2018 and bring forward the increase in SPA for both men and women to 66 by 2020.

Sustainable terms

Contractual terms, which are considered to be a sustainable alternative, have met the following criteria:

a) In the event of a permanent transfer from capital and interest (C&I) repayment to interest only (IO), on all or part of the mortgage, that an acceptable repayment strategy is in place, which the firm has assessed is plausible. An affordability assessment has been conducted which confirms that the customer is able to fully service the mortgage loan commitments and the repayment strategy, and it would be reasonable to assume that this can be sustained over the full mortgage term.

b) In the event that a mortgage term is extended, then the term remains within the reasonable employment period of each income earner (see *retirement income age*). Where the term does extend beyond this, then affordability based on retirement income is assessed to ensure that the mortgage can be sustained over the full mortgage term.

c) In the event that a material drawdown, further advance, payment holiday or *capitalisation* is provided on an account (cumulatively equivalent to more than three months' payments) or there is an indication of potential customer impairment, an affordability assessment is conducted on the customer(s) to assess whether the customer is able to fully service the revised mortgage loan over its full life on a C&I repayment basis. If the mortgage is on IO terms, that a repayment strategy to repay the full revised exposure is in place which the firm has assessed as plausible; and the affordability is assessed to ensure both the mortgage and the repayment strategy is affordable. In the event that the term goes beyond the *retirement income age*, then retirement income is validated and affordability assessed to ensure that the mortgage can be sustained over the full mortgage term.

Where the *sustainable terms* above have not been met, the mortgage is considered to be on non-sustainable terms. Mortgages on non-sustainable terms should be separately considered and judged on the basis of their previously agreed *contractual terms* for the purpose of monitoring, reporting, provisions and capital assessment until such time as the mortgage has been brought into a sustainable terms position (eg the customer's affordability has increased due to a return to work or other changes in circumstances, enabling the mortgage to be brought back on to shorter terms, a return to C&I or a return on to full contractual monthly repayment). It is recognised that while forbearance is operating that the mortgage may be in a non-sustainable position and therefore a return to a sustainable terms position on a mortgage would, in these cases, generally follow after the period of financial stress.

Annex 2: Forbearance facilities observed

Ref	Options available to assist customers in financial difficulty	Description of the option
1	Temporary 'rehabilitation' tools for customers both in arrears and pre-delinquency	
1.1.	Change in payment date	A temporary (or on occasions permanent) change of the payment due date, typically to align payments to a customer's changed income/salary date.
1.2.	Change in payment method/or schedule of payments	A temporary change from monthly direct debit payments to a method more aligned to a customer's needs. Examples include: monthly or weekly bank giro credit; debit card; standing orders and cheque payments.
1.3.	Arrangement or promise to pay	A short-term monthly or lump sum payment plan agreed with the customer, which is affordable and practical in terms of the customer's circumstances. This tool may be used to stabilise the arrears position or used to collect a sum above the contractual monthly repayment to reduce the *contract shortfall*.
1.4.	Payment of fees or charges on behalf of the customer	Payment of outstanding fees and charges to protect security of property eg ground rent, maintenance.
2.	Temporary 'reduced repayment' tools for customers both in arrears and pre-delinquency	
2.1.	Reduced payment concession	A temporary reduced repayment concession is agreed where the repayment is lower than the actual contractual monthly repayment.
2.2.	Payment holidays for flexible mortgages	The customer has taken a payment holiday. This may be against previous *overpayments* on the mortgage, against a pre-approved credit limit or agreed with a maximum payment length boundary.
2.3.	Zero or nil payment concession	The lender has given the customer a zero or nil payment concession for a short period.
2.4.	Deferral of payment	The customer has deferred payments for a short period eg with the aim of selling the property where appropriate evidence is supplied to the lender.
2.5.	Use of linked pre-approved reserve/credit/overdraft limits	The customers' pre-approved reserve/credit/overdraft limit account is debited with the contractual monthly repayment, the customer uses monies from the linked current account to pay the contractual monthly repayment or the customer makes a drawdown to support the repayment of other debts or living expenses.

2.6.	Temporary transfer to interest only (IO)	The main loan account is transferred to IO payments for a temporary period.
2.7.	Transfer to a lower interest rate	The main loan account is transferred to a lower preferential interest rate for a temporary period.
3.	Permanent forbearance tools resulting in contractual changes	
3.1.	Extension of the mortgage term	The customer extends the contractual mortgage term. This entails a formal contract variation.
3.2.	Permanent transfer to interest only (IO)	The main loan account is transferred to IO payments on a permanent basis.
3.3.	Transfer to an alternate (usually lower interest rate) product	This is a contractual change on to another product. Standard product fees/charges (eg product fees, ERCs, penalties etc) may be waived as a concession.
3.4.	Capitalisation of arrears	The arrears (full or part) are capitalised into the principal debt. For standard capitalisation, this is typically after the customer has met six contractual monthly repayment payments. Repayment capitalisation may take place as part of a payment arrangement, such as a temporary transfer to IO terms.
4.	Hardship/possession tools (for customers typically in late arrears but also observed in pre- and early arrears)	
4.1.	Transfer to a special hardship product or reduced interest rate	This is a contractual change on to a special hardship product. Standard product fees/charges (eg product fees, ERCs, penalties etc) may be waived as a concession.
4.2.	Deferral of interest	Customer has applied and been accepted into the Government Homeowner Mortgage Support Scheme (HMSS) or similar in-house scheme.
4.3.	Partial debt write off (discounted pay off)	Lender writes off a substantial part of the debt, typically used where the mortgage book has been bought at a discount.
4.4.	Assisted property sales or assisted voluntary repossession	Lender financially assists customer with the sale of the property. For example, free property sales advice, the waiver of interest or fees during the sale period − typically six months, waived ERCs and penalties or support with upfront agent or solicitor fees etc.
4.5.	Short sales/full & final settlements	Lender has agreed a waiver or partial waiver of the shortfall debt.
4.6.	Government Mortgage Rescue Scheme	Customer has applied and been accepted in any Government Mortgage Rescue Scheme or similar in-house schemes.