Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Financially Vulnerable Customers Thematic Review

Lead regulator: FCA

Date of assessment: 9 December 2016

Commencement date: Thematic review commenced January 2016 with publication of our findings in September 2016.

Origin: Domestic: There is no specific Handbook rule requiring firms to develop strategies to mitigate the impact of a mortgage interest rate increase on borrowers. However Principle 6 requires firms to treat customers fairly and having such strategies in place could help firms to do that when/if a rate rise occurs. Our review and findings are not linked to any EU directives or rules.

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? Whole of UK

Brief outline of proposed new or amended regulatory activity

This work followed our previous thematic review on Mortgage Lenders' Arrears and Forbearance Management (Thematic Report TR14/3) in 2013/2014[1].

In TR14/3 we asked firms to:

- consider which borrowers are most likely to be affected by potential rate rises (for example, those who have experienced payment problems in the past or those with a high loan-to-income ratio);
- consider deploying proactive strategies to engage them early; and
- take action now to identify customers susceptible to falling into arrears and have appropriate strategies to treat these customers fairly.

We recognised that if we found that firms had not acted on the recommendations in TR14/3, this would not constitute a breach of our mortgage conduct rules. However, firms would be expected to treat customers fairly when interest rates rise.

Our review assessed firms' strategies to mitigate the impact of an interest rate rise on financially vulnerable customers (i.e. those less able to cope with an increase in their monthly payment, including those customers not currently in arrears).

The majority of firms in our review had developed strategies to treat customers fairly when interest rates rise, although firms were at different stages.

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[1] The TR14/3 review followed reviews of 'Mortgage Arrears and Repossessions Handling' in 2008 and 2009.

Our publication restated our recommendations (as set out in TR14/3) and provided examples of how some firms are preparing for a future interest rate risk, in order to assist other firms in their preparations. We also reminded consumers of the need to be prepared for an interest rate rise.

Which type of business will be affected? How many are estimated to be affected?

All mortgage lenders and third party administrators. Approximately 130 firms.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2016	2016	10	-1.20	0.1	0.5

Please set out the impact to business clearly with a breakdown of costs and benefits

Likely costs to firms

Familarisation

The document contains approximately 1,000 words.

The speed of reading technical text is 50-100 words per minute based on EFTEC (2013), 'Evaluating the cost savings to business revised EA guidance -method paper'. Based on an assumption of 100 words per minute, this implies that it would take a firm's employee 10 minutes to read this document.

The cost of this time is based on the assumption that an experienced compliance staff member would read the document and that their hourly wage rate is £48 per hour. The average annual salary estimate from Robert Half's salary guide (2016) for such staff is between £70,000 and £104,000. Our hourly estimate of £48 per hour sits within this range (based on an assumption of an 8 hour day and working 260 days a year).

The cost, therefore, of reading for 10 minutes would be £8 per staff member per firm. If we assume that: i) one staff member per firm would read this; and ii) there are 130 firms in the sector (see Annex 1), this implies one-off familarisation costs to the sector of £1,040.

Remediation

Our publication aimed to assist firms in the further development of their strategies to ensure the fair treatment of mortgage customers should mortgage interest rates increase and followed on from the previous thematic review. We fed back on the findings from our review of the work undertaken (in this area) by 9 firms since publication of TR14/3. We also included examples of strategies seen in these firms.

The costs that firms may incur in response to this latest thematic review will depend upon what work they have already undertaken following publication of TR14/3. The costs will be a mix of: i) incremental costs for those activities that go beyond what has already been said in TR14/3; and ii) new costs that we anticipate firms may incur following the latest review document.

It should also be noted that our publication may help save firms costs. For example, in understanding the potential impact on their resources if rates do rise (e.g. extra staff needed to deal with financially vulnerable customers) through developing their strategies.

The potential costs to firms can be broken down into the following categories:

1. Identifying financially vulnerable customers
2. Mitigation strategies
3. Lenders' communications

4. Monitoring the impact

5. Preparing for an interest rate rise.

Annex 1 provides more details and estimates for each of the potential costs. The basis for our estimates is that firms are meeting the recommendations set out previously by the FCA in TR14/3.

Likely benefits to firms

By understanding the numbers of customers likely to be impacted by a rate rise and developing strategies, firms could:

- Reduce the risk of customers entering arrears or arrears positions worsening.
- Understand the potential impact on their resources if rates do rise (e.g. extra staff needed to deal with financially vulnerable customers and considering the impact on customers currently in arrears). It is difficult to predict the impact pro-active mitigation strategies may have on reducing the number of customers entering arrears (and the resulting impact on resource requirements).

Annex 1: Direct business cost estimation methodology

Of the 9 firms (representative of the sector) we reviewed, only 1 firm had not carried out any work to mitigate the impact of an interest rate rise on financially vulnerable customers. Based on this, it seems likely that across the 130 mortgage lenders targeted by our publication, the majority of firms will have carried out some work and will not be starting from a 'zero' position.

Analysis of the mortgage lender population (based on product sales data to H1 2016):

Type of firm	Approx. number of firms in population	Approx. number of mortgage customers in population	% market share*
Retail banks*	6	6,296,000	76%
Challenger banks	10	828,400	10%
Larger Building Societies	5	566,000	7%
Smaller Building	40	155,000	2%
Other lenders**	69	438,900	5%
Totals	**130**	**8,284,300**	

*Includes a large Building Society
**Includes non-deposit lenders (approx.10 firms), with the balance made up of private banks (lending primarily to high net worth individuals) and Equity Release lenders.

The total firm population we expect may act on the findings from our publication is approximately 70-75. This estimate is based on our broader supervisory knowledge of how many firms may need to take some actions to our thematic report and also on supervisory conversations with firms about their procedures relating to this specific review.

<u>Summary of potential costs</u>

The table below summarises the cost estimates for the five areas above. For the purposes of reporting a BIT score, we have taken the mid-point of the cost estimates below.

Section	**Cost description**	**Cost Estimate**
Identifying financially vulnerable customers	N/A	N/A
Mitigation strategies	Time cost of employee (calculated from annual salary)	One off costs of £114k to £228k for industry. (£3k per firm). We use the mid-point (£171k) of the range for the BIT calculation. Development of on-line calculator - £60k salary (2.5 weeks for development / testing)
Lenders' communications	N/A	N/A
Monitoring the impact	Time cost of employee (calculated from annual salary)	Ongoing costs ranging of £80-£160k. We use the mid-point (£120k) of the range for the BIT calculation
Preparing for an interest rate rise.	N/A	N/A

Details of cost estimates

1. Identifying financially vulnerable customers

In TR14/3, we asked firms to consider which borrowers are most likely to be affected by potential rate rises (i.e. financially vulnerable customers).

Our publication on Financially Vulnerable Customers provided examples of the work firms had carried out to identify financially vulnerable customers. This restated messages we conveyed in TR14/3 (for example, we stated: *"Firms should consider which borrowers are most likely to be affected by potential rate rises, for example, those who have experienced payment problems in the past or those with a high loan to-income ratio, and consider deploying proactive strategies to engage them early."*)

In TR14/3, we provided examples of firms who were proactively identifying customers susceptible to changes in economic conditions by developing strategies to detect and act on early warning signs such as borrowers consolidating debt or failing to meet all of their financial commitments. We considered that these examples allowed firms *"to detect and act upon 'early warning signs' such as borrowers consolidating debt or failing to meet all of their financial commitments. This allowed them to develop effective early engagement strategies and offer proactive solutions or money advice which increased the chance of better outcomes for both customers and the firm."*

Example cited in TR14/3 included:

- One lender making changes in its processes to identify financial stress in performing borrowers. This firm had also developed an impairment information and performance tracking system to proactively segment their pre-arrears population. Scenario testing was undertaken to assess the impact that stressed conditions would have on those groups.
- Another firm was actively developing a proactive contact strategy which used the outputs of an analytics model. The firm contacted borrowers if there was a high risk that the loan would move from performing to being one or more payments in arrears in a defined period.

Firms could only reasonably comply with TR14/3 by using credit reference agency (CRA) data. As a result, we do not consider that the reference to CRAs in our latest publication goes beyond what was stated in TR14/3.

As such, we do not envisage our latest publication resulting in firms incurring additional costs.

2. Mitigation strategies

In TR14/3, we asked firms to take action such that they *"should take action now to identify customers susceptible to falling into arrears and have appropriate strategies to treat these customers fairly."*

Firms cannot reasonably comply with the above expectation without carrying out analysis. The suggestion that firms should develop an appropriate strategy to treat financially vulnerable customers fairly is clearly set out in TR14/3. However, the examples now given of actions some firms have taken *might* be interpreted by other firms as additional requirements. These may include:

- removing barriers on product transfer criteria;

- providing training to front-line staff; and
- developing on-line mortgage calculators to assist customers in assessing the impact of an interest rate rise.

Some firms (in our project population) had already incorporated these into their mitigation strategies. We have no information from firms regarding the cost of specific initiatives.

It is not proportionate to go back to firms to ask for costs for a retrospective assessment. However, we have tried to provide cost estimates based on our broader supervisory knowledge of how firms respond to our thematic reports and also on supervisory conversations with firms about their procedures relating to this specific issue. Taking each in turn:

- removing barriers on product transfer criteria – should firms decide to adopt this approach, we would expect firms' costs to be minimal (requiring a proposal / agreement via credit risk and implementation).
- providing training to front-line staff – we expect staff to be appropriately trained to carry out their role. Should firms act on this specific example, we consider that this could be incorporated into front-line staff's ongoing training with minimal effort and cost.
- developing on-line mortgage calculators to assist customers in assessing the impact of an interest rate rise - we do not know how many firms already operate on-line calculators nor do we have any industry estimates on how much development of such an on-line tool would cost. However, as most firms involved in new lending will have an on-line tool to calculate how much a customer can borrow / the monthly payment, the development time and cost to adapt this should not be material.
  As an example, should the one-off cost be £3,000 per firm (a rough estimate based on employee time to develop such a tool), then this would be in the range of £114k to £228k one-off cost across the industry, depending on whether 50% or 100% (of the 75 estimated 'active' firms) of firms would have to develop this from a 'zero' base (i.e. not having one at all). We have used the mid-point of the range (i.e. £171k) for the BIT score calculation.
  In practice, smaller or closed book lenders may opt to direct customers to readily available on-line tools (e.g. ThisisMoney website has a 'interest rate rise/fall calculator').

<u>3. Lenders communications</u>

In TR14/3, we asked firms to consider deploying proactive strategies to engage borrowers most likely to be affected by potential rate rises early.

In our recent publication, the examples we gave of more developed communications strategies included:

- writing to customers;
- developing outbound communication strategies based on risk;
- developing communications to raise awareness of the potential impact of a rate rise;
- piloting customer contact exercises; and
- working collaboratively with debt advice agencies to develop ways to communicate with those customers most likely to be impacted by a rate rise.

Only the final point from the list above potentially went beyond what was suggested in TR14/3 (e.g. the second example cited from TR14/3 in 1) above).

The cost of engaging with a debt advice agency will inevitably depend on the extent of that engagement. One possible approach might be to set up a referral scheme and include reference to this in customer communications – which would incur minimal cost to the firm (beyond setting up the initial agreement and follow-up meetings).

4. Monitoring the impact

Our publication stated that most firms (in our population) produced management information (MI) as part of their analysis in order to assess the impact of an interest rate rise on the overall mortgage book. However, only one firm reviewed this regularly.

The major cost is, therefore, likely to be associated with the ongoing refresh, review and learning from such an exercise.

We have no direct industry information on these costs. Our cost estimate, detailed in the table below, is based on our broader supervisory knowledge of how firms respond to our thematic reports and also on supervisory conversations with firms about their procedures relating to this specific issue. Our ongoing annual cost estimate ranges from £80k to £160k in total. We have used the mid-point of the range (i.e. £120k) for the BIT score calculation.

	Larger firms (i.e. retail banks, challenger banks, 5 larger building societies = 21 firms)	**Small firms (i.e. building societies and non-deposit lenders = c.50 firms)**
Analyst time to refresh data (1 week of time, £30k annual salary)	£600	£600
Refresh of credit reference agency data	£2,000	£0
Review by compliance risk manager (3 days, £60k annual salary)	£1,200	£0
Senior management review	£300	£800
Total per firm	**£4,100**	**£1,400**

5. Preparing for an interest rate rise

In our publication, we stated that firms can take steps now to be better prepared and do not have to wait for interest rates to rise in order to develop strategies. We highlighted that there could be benefits to them in doing so (in potentially reducing the risk of customers entering arrears).

This effectively restates the message in TR14/3, where we asked firms to *"take action now to identify customers susceptible to falling into arrears and have appropriate strategies to treat these customers fairly"*.

As such, our publication did not imply any additional actions above and beyond those stated in TR14/3.