Financial Conduct Authority

Guidance consultation

GC 16/7 - Revised proposed guidance on guarantor loans

October 2016

1 Introduction

1.1 Under section 139A of the Financial Services and Markets Act 2000 (FSMA), the Financial Conduct Authority (FCA) may give guidance that consists of any information and advice we consider appropriate to matters relating to our functions.

1.2 In this publication we propose guidance on the requirement in section 87 of the Consumer Credit Act 1974 (CCA) to serve a default notice before enforcing a guarantee or indemnity following breach of a regulated agreement.

1.3 The guidance relates to regulated credit agreements and regulated consumer hire agreements under which an individual[1] other than the borrower or hirer provides a guarantee or indemnity (or both). For convenience, we refer to these agreements as 'guarantor loans' and the person providing the guarantee or indemnity as the 'guarantor'.

1.4 In this document, references to 'credit agreement' include a consumer hire agreement where relevant, and references to 'lender' and 'borrower' include owners and hirers. We use the word 'guarantee' to cover both guarantees and indemnities.

[1] As set out in section 189 of the CCA, 'individual' includes a partnership consisting of two or three persons (not all of whom are bodies corporate) and an unincorporated body of persons (which does not consist entirely of bodies corporate and is not a partnership).

1.5 We consulted on draft guidance in February 2016 in GC16/2[2], and are now consulting on revised draft guidance that takes into account the comments we received.[3]

1.6 We would welcome any further comments, by 25 November, before we finalise the guidance.

1.7 You can send them in writing to the following address:

Consumer Credit Policy

Strategy & Competition Division

Financial Conduct Authority

25 The North Colonnade

Canary Wharf

London E14 5HS

Email: toby.watkinson@fca.org.uk

1.8 We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

1.9 Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commission and the Information Rights Tribunal.

1.10 All our publications are available to download from www.fca.org.uk. If you would like to receive this paper in an alternative format, please call 020 706 0790 or email: publications_graphics@fca.org.uk or write to Editorial and Digital Team, Financial Conduct Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS.

[2] GC16/2: *Proposal to issue guidance on the FCA's view of enforcing security under the Consumer Credit Act 1974: Guarantor loans – default notices* (February 2016).
[3] The guidance we propose here is concerned only with enforcing a guarantee or indemnity under a guarantor loan, and not enforcement against a borrower.

2 Background

The CCA requirements

2.1 Section 189 of the CCA defines 'security' as including a guarantee or indemnity, and 'surety' means the person by whom security is provided or to whom that person's rights and duties in relation to the security have passed.

2.2 Under section 105, any security provided in relation to a regulated agreement must be expressed in writing. Regulations under section 105[4] define the form and content of that document, including information that must be provided and a prescribed statement of the surety's rights. The document must be signed by or on behalf of the surety.

2.3 Following a breach of the agreement, under section 87 a default notice must be served on the borrower before the lender can enforce the security. Section 111 requires a copy of the default notice to be served on any guarantor.

2.4 The notice must meet the requirements of section 88 and relevant regulations[5], and must contain specified information, including:

- The nature of the alleged breach of the agreement.
- If the breach can be remedied, what action is required to do so and the date before which that action is to be taken. (The date must not be less than 14 days after the date on which the notice is served).
- A clear and unambiguous statement of the action the lender intends to take if the breach is not remedied.

The February consultation

2.5 We consulted on draft guidance on 19 February 2016. In GC16/2 we set out our view that a default notice is required if a lender wishes to request or take payment from a guarantor following non-payment by the borrower. This includes where payment is taken using a continuous payment authority (CPA) or direct debit mandate previously provided.

2.6 We invited comments by 18 March and received 17 responses. These were provided by four trade associations, eight lenders and five consumer organisations.

[4] The Consumer Credit (Guarantees and Indemnities) Regulations 1983, SI 1983/1556.
[5] The Consumer Credit (Enforcement, Default and Termination Notices) Regulations 1983, SI 1983/1561.

2.7 The consumer organisations supported our interpretation and argued that the CCA provisions provide important consumer protections. Some suggested that we should go further and require additional post-contractual transparency.

2.8 Trade bodies and firms were largely opposed to our proposed guidance. Most considered that our view was not in line with relevant case law, or with a proper interpretation of the CCA. There were also concerns (including by respondents who accepted our view) about the potential implications for consumers (both guarantors and borrowers) and for the future availability of guarantor loans. For example, it was suggested that our approach could lead firms to serve a default notice sooner than they do currently, with poor consequences for an individual's credit record. Alternatively, it could extend the period of the arrears and so increase interest and default fees, potentially adding to a borrower's financial difficulties. It could also increase costs for firms, and hence prices to consumers, and could lead some firms to exit the market or scale down their lending.

2.9 Most industry respondents felt that we should withdraw the proposed guidance and either issue alternative guidance or leave the matter to the courts to decide.

2.10 We have considered these issues carefully, and do not agree that 'enforcement of security' is limited to obtaining a court judgment. In our view it is clear from the structure of the CCA, and relevant case law, that enforcement can include exercising some forms of 'self-help' remedy relating to security if the remedy is sufficiently coercive.

2.11 In particular, sections 111 and 126 expressly contemplate that security is, in principle, capable of being enforced without a court order. Sections 76 and 86 also illustrate that 'enforcement' includes various self-help remedies (including exercising certain contractual rights). Further, a number of other CCA provisions could lead to anomalous results if the concept of 'enforcement' were narrowly interpreted (for example, section 40 (now repealed) and sections 105(7), 106, 113 and 126).

2.12 We also do not agree that our interpretation should necessarily have the adverse consequences suggested. However, we recognise that aspects of the draft guidance could have been worded more precisely, and that it did not cover all possible scenarios.

2.13 We are proposing revised draft guidance to clarify our position, and to address some of the points raised in the consultation.

3 Guarantor loans – default notices

Purpose

3.1 Once finalised, this document will constitute general guidance to consumer credit firms regarding our interpretation of relevant CCA provisions.

Enforcement of guarantees

3.2 A guarantee is enforced in the FCA's view if, following breach of the agreement by the borrower:

- the lender *demands* payment by the guarantor, or
- the lender *takes* payment from the guarantor by using a CPA or direct debit mandate that was previously provided and without at least appropriate prior notification to the guarantor

3.3 This is consistent in our view with a proper interpretation of section 87, having regard to the purpose of the relevant CCA provisions and case law.

3.4 On the other hand, a guarantee is *not* enforced in our view if:

- payment is made *voluntarily* by the guarantor, following notification of the borrower's default, and without any element of compulsion, or
- the lender *requests* payment by the guarantor, but making clear that this is not a demand for payment

3.5 While a guarantor may have consented upfront to a facility enabling payments to be taken from his or her account, unlike the borrower, the guarantor does not know when payment may be taken, or for what amount, given that the guarantee will not be used unless the borrower fails to make one or more payments. Exercise of the CPA or direct debit, without appropriate prior notification, would in the FCA's view be sufficiently coercive as to constitute enforcement of the security within the meaning of section 87.

3.6 On the other hand, we accept that taking payment via CPA or direct debit may not constitute enforcement of the guarantee where the guarantor is pre-notified before the payment is taken. It would not be sufficiently coercive in our view as the guarantor would have an opportunity to object or cancel the payment authority.

3.7 However, it is important that the notification gives the guarantor a reasonable opportunity to act if he or she wishes to avoid payment being taken. Specifically, we would expect the lender to inform the guarantor clearly of the following before any payment is taken:[6]

- that the borrower has defaulted on his or her obligations under the agreement, and the nature and extent of the default
- the amount of the overdue payment or payments[7] and the lender's intention to take payment from the guarantor using the CPA or direct debit
- the likely timing of the payment or payments[8] to be taken, and
- the guarantor's right to cancel the authority (but making clear that cancellation will not extinguish the guarantor's obligations under the terms of the guarantee)

3.8 We would expect the lender to allow a reasonable period before taking payment to enable the guarantor to respond (or to cancel the CPA or direct debit). What is reasonable is likely to depend upon the circumstances, but in general we would expect a lender to allow at least 5 working days following notification.

3.9 Where the guarantor is pre-notified in line with the above, and does not object or cancel the payment authority, we would not regard the subsequent use of the CPA or direct debit facility as 'enforcement' of security, requiring a default notice.

3.10 In effect, therefore, in our opinion a lender has three options:

- issue a default notice in accordance with section 87 and wait 14 days
- obtain the guarantor's express consent to payment being taken, or
- pre-notify the guarantor (in writing and with sufficient detail to enable an informed decision) and wait a reasonable period (at least 5 working days), during which the guarantor can cancel the authority

3.11 The first of these would remove any legal uncertainty about whether an alternative course of action may amount to enforcement of the security, but it is in our view not the only option.

[6] We would expect such notification to be in writing, but not necessarily on paper (unlike a default notice).
[7] Assuming the borrower makes no partial payment.
[8] If the borrower has missed more than one repayment, a firm may choose to take payments separately from the guarantor (over a period) rather than as a single payment.

Other relevant matters

3.12 Questions of interpretation of legislation are ultimately for a court to determine and we can only express a view.

3.13 Where a default notice is required under the CCA, failure to serve a valid notice (or to wait the required period before taking action) would be a breach of the CCA. If payment is taken, contrary to section 87, the borrower or guarantor may have a cause of action against the lender.

3.14 In addition, in such cases we may consider taking regulatory or disciplinary action against the firm, subject to evidence of actual or potential harm to consumers, the proportionality of opening an investigation and issues of relative prioritisation.

3.15 As noted above, a default notice must comply with sections 87 and 88, and lenders must allow a period of at least 14 days before taking action. However, there is no minimum period *before* a lender may issue a default notice. In particular, there is no requirement to serve an arrears notice before issuing a default notice, or to wait until two payments have been missed.

3.16 For example, the CCA would not prevent a lender issuing a default notice on (say) day 5 after the borrower's default. Allowing for postal delivery, the notice might expire on day 21, with the lender taking payment from the guarantor on day 22. In this way, the default could be remedied within the same month. The FCA would not object in principle to this, provided that the firm can demonstrate compliance with our rules and principles.

3.17 There also appears to have been some confusion regarding the requirements for reporting defaults to credit reference agencies (CRAs).

3.18 Industry guidelines on reporting to CRAs are set out in the Principles for the Reporting of Arrears, Arrangements and Defaults which were published in January 2014 by the Standing Committee on Reciprocity (SCOR).[9] These explain that a missed payment may lead to a consumer's account being reported as 'in arrears', whereas a 'default' is limited to a situation where the relationship between the parties has broken down. The guidelines state that, as a general guide, this may occur when the consumer is three months in arrears, and normally by the time he or she is six months in arrears. The guidelines also specify other circumstances when a default may be recorded, such as where there is evidence of fraud, or the account has been included in a bankruptcy or county court judgment.

3.19 It follows therefore that a 'default' on a credit file would not normally be recorded before the account is at least three months in arrears. In contrast, a default notice under the CCA has to be served before the lender can take certain actions, but can be served at any time following breach of the agreement, subject to this following our rules and principles. Issuing a default notice is not itself an event that has to be reported to a CRA

[9] http://www.scoronline.co.uk/principles

(and indeed, it would be contrary to the SCOR principles to do so if there is no 'default' for CRA purposes). Equally, a lender can register a default with a CRA without having previously served a default notice.

3.20 The SCOR principles state that the lender must generally notify the consumer of its intention to register a default at least 28 days before doing so, to give the consumer time to make an acceptable payment or to reach an arrangement. However, this is an entirely separate and distinct matter from the CCA default notice provisions.

3.21 In the above example, if payment is taken on day 22, the default would be remedied for CCA purposes. The account would have been in arrears for that period, and may have been reported as such to a CRA, but the arrears would be rectified before the next monthly instalment is due and no 'default' has arisen for CRA reporting purposes.

3.22 We are aware that this issue has given rise to some misunderstandings, given the different meanings of 'default'. We are taking this opportunity to clarify the position.

4 Next steps

4.1 We are publishing this proposed revised guidance on our website, and taking steps to bring it to the attention of guarantor lenders and other interested stakeholders.

4.2 We would welcome any comments or observations by 25 November 2016. Following that, we will take into account any responses we receive and issue a final statement of our guidance.