Financial Conduct Authority

Thematic Review TR14/3

Mortgage lenders' arrears management and forbearance

February 2014

Contents

1. Executive summary

Overview

This report summarises the key findings of our thematic review of mortgage lenders' arrears management and forbearance.

It considers whether firms have improved policies and practices since the Financial Services Authority (FSA), our predecessor organisation, last reviewed this.[1] It summarises areas where firms can strengthen their practices so they are well placed to consistently treat customers in financial difficulty fairly.

We found that:

- Arrears management in firms has improved since the last review.
- However, mortgage lenders and administrators need to place greater emphasis on delivering consistently fair outcomes for customers based on their individual circumstances.

We want firms to take steps to identify risks to borrowers posed by changes in the macro-economic environment and take proactive steps to reduce the impact on the most vulnerable.

Arrears management in firms has improved since our last review

Firms have addressed a number of the specific issues that we raised, improved policies and practices, and strengthened their control environments.

As a result, firms now:

- place greater emphasis on the need to treat customers in financial difficulty fairly rather than focusing primarily on their own interests
- offer a wider range of forbearance options, and
- take more time to engage with customers and place a greater focus on borrower affordability

1 FSA reviews of 'Mortgage Arrears and Repossessions Handling' 2008 and 2009: www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/mortgage_arrears_1/index.shtml

Mortgage lenders and administrators could do more to produce consistently good outcomes for customers

We found:

- cultures which focus on treating customers fairly and delivering good customer outcomes are not always fully embedded at firms
- firms did not always adopt proactive and forward-looking strategies to identify and effectively engage borrowers in financial difficulty
- collections agents often followed overly process-driven 'one size fits all' frameworks which failed to allow for sufficiently flexible, judgement-led solutions that consider borrowers' individual needs and circumstances, including specific customer vulnerabilities
- front-line staff sometimes lacked the experience, knowledge and skill to make informed judgements and decisions in customers' best interests, reflecting their individual financial and personal circumstances
- firms' governance arrangements are not always sufficiently focused on customer outcomes, and
- rigid systems and processes, due in part to lack of investment, sometimes prevented staff from delivering good customer outcomes and made it difficult for customers to engage

Actions for firms

We are concerned about the risks to borrowers from potential interest rate rises.

We want firms to build on the progress made to date by investing in their systems and people to:

- better support and empower front-line staff to make appropriate decisions at all stages of the arrears cycle, and
- provide greater flexibility to support fair treatment of individual customers, based on their specific personal and financial circumstances

We also want firms to take proactive steps to identify borrowers who could be susceptible to potential interest rate rises and have strategies to treat these customers fairly.

We are working with the industry to help them to improve their arrears-handling practices and taking firm-specific action where appropriate

We are working with firms and industry bodies to explain our concerns and help them strengthen their arrears management practices. We will take action where we observe customer detriment.

We have asked the firms that participated in our review to make specific improvements. Some firms were making positive changes to their approach at the time of our review and others are already acting on our findings.

We recognise that this is a challenging area for the industry and want to work with firms to get this right.

Key findings

Chapter 2 provides further details of our findings, including examples of practice within firms.

Embedding a customer-orientated culture in arrears management is key to achieving good outcomes for borrowers.

Identifying borrowers experiencing financial stress at an early stage, engaging appropriately with them and tailoring solutions to their individual personal and financial circumstances (including providing timely debt advice) is likely to result in better outcomes.

Factors that are more likely to result in poor customer outcomes include:

- lack of skill, knowledge and experience in collections agents
- governance and oversight focused on process failings rather than customer outcomes
- weaknesses in the oversight of outsourced activities
- inappropriate incentivisation of collections agents
- an overly process driven approach which fails to take account of individual borrowers' financial and personal circumstances
- inappropriate application of fees and charges

Economic context

Chapter 3 focuses on the risk posed by over-indebtedness and the impact of potential interest rate rises on borrowers.

Mortgage Market Review

Our Mortgage Market Review comes into force on 26 April 2014 and will strengthen our existing arrears and repossessions regime. Our rules are also being extended to include 'payment shortfalls' which will protect borrowers in financial difficulty at an earlier stage.[2]

Who will be interested in this report?

Our findings will primarily be of interest to mortgage lenders and administrators. This report does not constitute guidance but provides a factual summary of our observations.

2 Further information on the FCA's Mortgage Market Review can be found here: www.fca.org.uk/firms/firm-types/mortgage-brokers-and-home-finance-lenders/mortgage-market-review

2.
Our findings

This chapter provides further detail that explains how firms' cultures, strategies, arrears management infrastructure, assurance frameworks and staff capability can affect customer outcomes. It includes examples of practices seen to illustrate our findings.

Embedding a customer-oriented culture in arrears management is key to achieving good outcomes for customers

We expect senior management in firms to promote cultures in arrears management functions which focus on delivering outcomes aligned with the best interests of customers.

Management need to provide leadership and direction to create an environment that enables capable and competent collections agents to make informed judgements, and take decisions that reflect the specific personal and financial circumstances of individual borrowers.

In our review we found:

- Some firms' senior management and front-line staff could not demonstrate they understood the risks to customer outcomes that can arise from poor arrears management, and
- Collections frameworks which placed insufficient focus on the customer experience because:
  - process-driven approaches allowed little flexibility for collections agents to apply judgement or tailor actions to individual customer circumstances
  - firms focused on mitigating regulatory risk rather than on delivering good outcomes for customers, and
  - assurance functions did not assess the suitability of decisions or quality of outcomes for individual customers

Proactively and effectively engaging borrowers at an early stage is likely to result in better outcomes

We expect firms to have clear strategies for engaging with customers and proactively managing them through the full arrears cycle (from pre-arrears to post repossession). Customers and firms benefitted from better outcomes where the collections and litigation functions were seamlessly connected and the consequences of actions were transparent to customers, with 'no surprises'. This also promoted better customer engagement.

Some firms proactively reviewed their customer information to identify customers who were particularly susceptible to changes in economic conditions. These firms were taking action to engage their customers and provide support before they faced difficulties paying their mortgages.

Pre-arrears strategies which identified early financial stress

One lender had made changes in its processes to identify financial stress in performing borrowers. The firm 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 the loan would move from performing to being one or more payments in arrears in a defined period.

Both strategies allowed these 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.[3]

The role of money advice

Over-indebtedness is a significant driver of arrears. Many lenders encouraged customers to contact sources of free, independent money advice. Customers were often actively encouraged to examine the possibility of making insurance and/or state benefit claims.

Third-party agencies can help customers who are experiencing financial difficulties by providing debt and benefits advice, support and information. This is particularly important where lenders are reluctant to discuss wider debt issues with borrowers.

The earlier borrowers receive advice about their debts, the more likely they will be to agree affordable and sustainable arrangements to pay.

3 This data was not used to facilitate cross-selling or targeting of additional products or services which benefitted the firm but were not in the best interests of the customer.

Firms that made it easy for customers to obtain early money advice saw better outcomes

One lender had piloted a 'hot key' system which allowed agents to transfer borrowers directly to a third-party debt advice agency. The advice was independent and free of charge to the borrower.

As a result of these referrals, some borrowers prioritised their essential outgoings against non-essential expenditure. The lender experienced up to a 50% increase in payments received, resulting in reduced levels of arrears and improved outcomes for both borrowers and the firm.

Capability in front-line staff is key to achieving good customer outcomes

Firms that demonstrate good outcomes typically focus on building capability in collections agents so that they can have high quality conversations with borrowers at an early stage. Agents need to be able to deploy a full range of arrears management and forbearance solutions, taking account of the personal and financial circumstances of individual borrowers.

Our review highlighted that most collections agents wanted to 'do the right thing' but that some lacked the knowledge, skill and experience to deal with more complex cases.

These issues were compounded at some firms which had introduced overly process-focused 'one size fits all' approaches that failed to empower agents to tailor solutions to individual customer circumstances.

We found that some collections agents did not always:

- accurately identify the root cause of borrowers' inability to pay
- effectively probe and consider all factors which were relevant to individual borrowers' circumstances and their ability to repay
- undertake robust assessments of borrowers' income and expenditure to establish their ability to make mortgage payments
- consider the full range of forbearance options in the context of individual borrowers' circumstances or
- make well-informed decisions when assessing or establishing the suitability and sustainability of forbearance options, including arrangements to pay

Front-line staff don't always feel empowered to make judgements

One lender used a matrix which set out a range of arrangements to pay which were acceptable to the lender at different stages of the arrears cycle.

This allowed borrowers to negotiate very low-cost short-term arrangements to pay in early months (which were significantly lower than the contractual monthly payment). In later months the firm would insist on arrangements to pay equal to, or in excess of, the regular monthly commitment unless limited exceptions applied.

Some staff did not validate or challenge affordability for borrowers in early arrears. They agreed very low payment arrangements which did not necessarily reflect a borrower's ability to pay. The matrix also led staff to decline offers to pay for customers in more serious arrears because they did not meet the minimum criteria, even though proposals were informed by detailed affordability assessments undertaken by field agents and debt advisers.

Borrowers making very low initial arrangements to pay risked seeing their arrears escalate quickly and experienced sudden payment shocks which were not clear to them from early discussions.

Although this policy was intended to control risks and provided guidance for exceptions it did not promote or enable solutions focused on borrowers' individual personal and financial circumstances. Staff reflected that they followed the process and did not feel empowered or capable of making judgements to deliver effective and timely solutions tailored to the facts in individual cases.

Customers with circumstances which require particular care

Firms need to engage sensitively with borrowers who have specific needs or circumstances which are likely to limit their ability to engage effectively, for example, customers dealing with bereavement or terminal illness, or those with physical and mental health issues (this is not an exhaustive list).

These circumstances were not consistently identified or appropriately probed by front-line staff in some firms, even when they were explicitly referred to by borrowers. Referrals to specialist teams were also missed or made late in the process.

This resulted in firms failing to treat some customers sensitively and failing to provide the benefit of short term leniency set out in their policies.

The benefits of governance and oversight focused on customer outcomes

Senior management rely on front-line quality assurance and control functions to provide them with assurance that the firm is treating customers fairly. Some firms' quality assurance focused on reviewing compliance with only limited parts of the arrears process. For example, firms listened to calls in isolation or tested compliance with individual processes.

These firms did not have a holistic end-to-end view of the customer experience and were unable to assess the suitability of decisions and quality of outcomes for individual borrowers.

Quality assurance that is not focused on customer outcomes

One firm failed to take account of borrowers' individual personal and financial circumstances when assessing the quality of judgements made. The firm failed to assess the fairness of customer outcomes such as the suitability of arrangements to pay, and the appropriateness of a decision to instigate litigation proceedings.

Another firm's quality assurance team identified issues in the early stages of the arrears process but considered these 'out of scope' and took no steps to provide feedback to collections agents or remediate the issues noted.

These firms failed to identify weaknesses in the quality and fairness of judgements made by collections agents, or the root causes of poor decisions. Supporting management information also gave management false assurance of the overall customer experience. Senior management were not aware of poor customer experiences and there was no opportunity for staff to learn from mistakes.

Some firms appear to have concentrated on strengthening control environments rather than focusing on front-line activities. Others have introduced structured frameworks to promote consistency of approach but failed to identify where this could inadvertently drive poor outcomes.

Firms need to remain alert to the possibility of unintended consequences arising from their policies and arrears management practices to ensure they treat all customers fairly.

Impact of unintended consequences

Collections agents at one firm repeatedly asked customers to provide information which was already known to the firm, and in some cases, which had already been provided earlier the same day. This was because the firm's quality assurance placed inappropriate focus on mandatory requirements which required staff to verbally request specific pieces of information on each call. As a result, customers became disengaged and staff spent less time focused on delivering good customer outcomes.

Managing outsourced providers effectively reduces risks of poor customer outcomes

Where a firm outsources any part of the arrears-handling process it remains responsible for how that work is carried out.

Although standards in outsourced providers have improved since the FSA's last review, we identified weaknesses in some firms' oversight of outsourced arrears management, administration, litigation and recoveries.

Inadequate monitoring and oversight of outsourced providers

One firm relied extensively on service-level agreements and process monitoring to provide assurance. This resulted in a focus on compliance with stand-alone elements of the process and promoted a 'tick box' mentality amongst collections agents. The firm did not have sufficient access to the outsourced provider's systems or customer information to support risk-based sampling. The firm was not in a strong position to assess and monitor borrowers' experiences and was unable to demonstrate effective oversight or control of the risks inherent in an outsourced model.

A different firm outsourced litigation, recoveries and field agent visits to third party firms and identified regulatory breaches and deficiencies in service, e.g. failing to issue regulatory communications on time and failing to correctly identify complaints. Issues were dealt with on a piecemeal basis and no root cause analysis was undertaken. This meant that poor practices recurred and were not tackled effectively by the firm.

Some firms demonstrated better oversight of outsourced activities.

Managing outsourcing risks effectively

One firm applied a full QA and monitoring regime to the outsourced provider, mirroring the standards which were applied to in-house activity. The firm had full access to all customer and case material, allowing effective oversight and identification of risk. Outsourcing contracts also included clawback provisions which were triggered if QA thresholds were not met.

Lack of investment in back-office infrastructure: inflexible processes and systems

We identified fewer issues in processes and policies adopted by firms compared to the FSA's last review. Overall, staff had more flexible mandates and were typically able to spend more time discussing a customer's circumstances and agreeing solutions. However, we observed that lack of investment in infrastructure made it difficult for staff to carry out their jobs or made it difficult for customers to make arrangements that suited their circumstances.

We found that some firms:

- were unable to switch direct debit payment dates to suit borrowers' circumstances, for example to facilitate prioritising of secured versus unsecured payments or to reflect the timing of salary payments
- made errors in manual 'workarounds' resulting in incorrect information being recorded on case files, or unnecessary delays to case management, and
- had poor quality record-keeping and limited system performance, restricting staffs' access to full case details and requiring borrowers to constantly re-explain sensitive circumstances or provide information on multiple occasions

Poor systems and processes can make it difficult for staff to deliver good customer outcomes

One firm had no electronic system based functionality to capture information about income and expenditure. Each customer had to complete a manual budget planner and send this to the firm. The firm had not made sufficient allowance for the limitations in this process when validating and challenging affordability or updating income and expenditure information.

One firm only permitted borrowers to pay direct debits on one day in the month. Others provided only three or four options. This meant that customers were unable to make payments easily on a day of their choice and made it more likely that arrangements would break, for example, due to unsecured lenders' more flexible collection arrangements.

One firm would only confirm and put in place forbearance options such as arrangements to pay on receipt of certain customer documentation such as bank statements. The firm did not permit customers to submit this information electronically and did not prioritise its incoming post in an efficient or timely way.

The standard of customer records maintained in file and diary notes was insufficiently detailed in more than one firm. This often hampered subsequent call handlers' ability to deal with borrowers in a professional and consistent manner. In some cases this appeared to be due to pressure on agents to move on to the next call before they were able to complete notes of typically complicated and in-depth discussions.

Staff are likely to need additional support when dealing with complex, or non-standard cases such as shared ownership

Some firms had not considered the particular features of shared ownership loans when developing training and competence schemes and had not provided sufficient guidance to staff. Staff did not always understand the distinctive features of these arrangements, including the rights of the landlord or the risks to both borrowers and lenders if rental payments are not maintained. We found examples of staff:

- not including rent due to the landlord in income and expenditure assessments
- not taking rent arrears into account when assessing the customer's circumstances or determining the collections strategy
- failing to consider the impact of rent arrears and ongoing rent commitments paid by the lender (to protect their security) on the customer's longer term ability to repay their arrears, and
- failing to consider whether the customer could sell all or part of their owned share back to the landlord to reduce the overall mortgage balance or level of arrears ('downward staircasing')

This led to an increased risk that staff deployed strategies which were not appropriate for borrowers' circumstances, leading to a risk of poor customer outcomes.

Application of fees and charges

Many firms had improved their charging practices since our previous review. However, we found isolated examples of charging policies which inappropriately applied costs to borrowers' accounts, for example where the firm was not actively administering the account or proactively seeking resolution of residual arrears.

Unfair charging practices

One firm levied multiple arrears charges where more than one mortgage 'account' existed on the same property. These charges did not reflect the additional resources required to administer the cases, on which such charges should be based. This resulted in significant increases in overall charges and levels of arrears in some cases.

Another firm charged customers for failing to keep to their arrangement to pay despite the customer making the payment within days of the agreed date and within the month that the regular monthly commitment fell due.

One firm charged customers a fee where the firm elected to cancel a field agent visit, due to no fault of the customer. The relevant fee doubled when the customer cancelled the visit and exceeded the costs incurred by the firm.

Firms need to control risks when incentivising collections agents

We warned firms that incentive schemes could encourage inappropriate behaviours and lead to the unfair treatment of customers following our 2013 review of 'Risks to customers from financial incentives'.[4] We provided guidance on managing the risks and governance of incentive schemes and gave examples of what effective controls and governance may look like in practice.

Many firms had taken steps to remove inappropriate incentive schemes or had taken steps to make them more customer-focused. However, we identified one scheme which risked driving negative behaviours in front-line staff.

Incentive schemes can encourage inappropriate behaviour

In one firm, staff were incentivised by the amount of cash collected from borrowers. This created a risk that staff placed an overriding focus on agreeing short-term arrangements to pay, rather than considering other options that might be more suited to individual customer needs.

4 FSA finalised guidance: FG13/01: *Risks to customers from financial incentives* (page 23) www.fsa.gov.uk/static/pubs/guidance/fg13-01.pdf

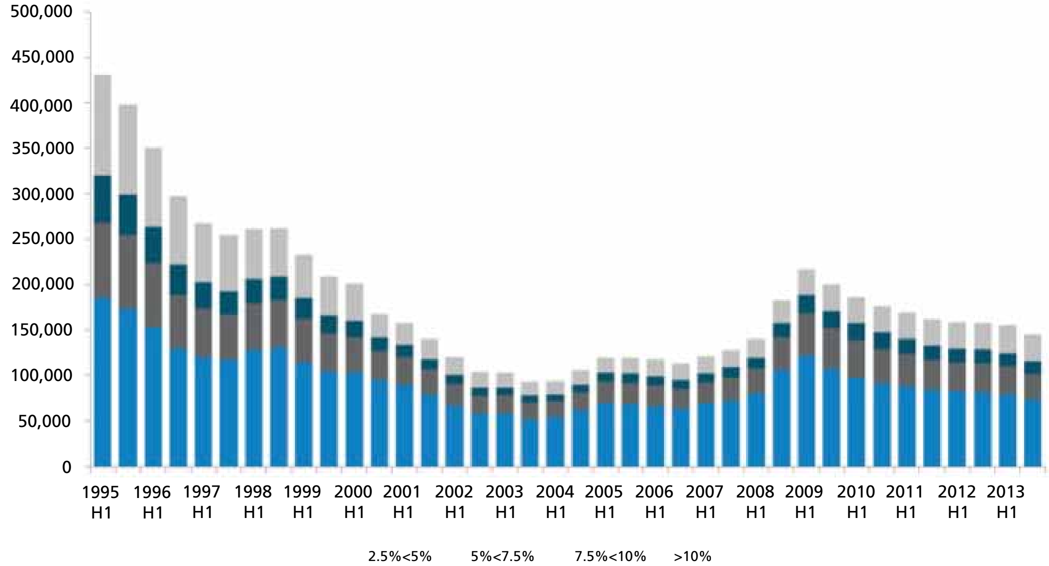
3.
Economic context

This chapter provides context to our thematic review and considers underlying factors that firms should consider when deploying their strategies for managing customers in financial difficulty.

There are 11.2 million mortgages in the UK, with loans worth more than £1.2 trillion. A total of 144,700 mortgages, representing 1.29% of all mortgages, had arrears equivalent to more than 2.5% of their mortgage balance at the end of 2013.[5]

The total number of first charge mortgages in arrears has trended downwards since the beginning of 2009. The downward trend has been evident across all arrears bands, with the exception of accounts more than 10% in arrears, which have remained broadly stable.

Arrears on mortgages by percentage of total balance in arrears



Source: Council of Mortgage Lenders Q4 2013: www.cml.org.uk/cml/media/press/3817

The economic outlook – forward-looking observations

Although all firms in our review support the principle of treating customers in financial difficulty fairly, we found that firms did not always have robust strategies which fully consider the impact of potential interest rate increases on existing borrowers in arrears, or those borrowers susceptible to arrears.

5 Source: Council of Mortgage Lenders Q4 2013: www.cml.org.uk/cml/media/press/3817

The impact of over-indebtedness

Despite an extended period of low bank base rates, household debt-to-income remains high and unsustainable levels of debt remain a key driver of financial distress for UK borrowers. This, and the possibility of further debt accumulation, leaves some households exposed to potential interest rate increases, income and expenditure shocks and changes to credit conditions. Lower income and 'credit-hungry' borrower groups are likely to be particularly exposed in a changing interest rate environment. These borrower groups have a higher than average concentration of negative equity and are at risk of falling into arrears on their mortgage regardless of changes in macro-economic conditions.

The impact of life events and the importance of considering borrowers' specific individual financial and personal circumstances

Other drivers of financial difficulty can be exacerbated by over-indebtedness.

Borrowers who fall into arrears as a result of life events can also be particularly sensitive to lender collection strategies. It is important that lenders understand a borrower's specific individual financial and personal circumstances before making decisions on the most appropriate action to take.

The impact of any future interest rate increases

The current low interest-rate environment is likely to have reduced debt servicing costs and supported indebted households through the post-crisis period - in part off-setting the impact of inflation on living costs and negative real wage growth. Low rates and improvements in funding conditions for lenders are likely to have supported firms' forbearance strategies, for example by reducing the financial costs of non-performing loans to firms.

The overall costs of forbearance to borrowers, where the ability to repay their arrears is absent, can be high once you include fees, charges and interest costs as well as any loss on sale. Lenders need to be alert to this risk.

Interest rates can be expected to increase as the economy improves. The impact of higher rates on both firms and borrowers, and their response to this, will to some extent be impacted by the environment against which rates start to rise (including house prices, wage inflation, employment and household expenses). These risks may impact both borrowers currently in arrears and those borrowers who are susceptible, for example, due to over-indebtedness.

Actions for firms

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.

Firms need to ensure their cultures, policies and practices are well placed to treat their customers fairly. Firms must ensure that decisions around forbearance or repossession are suitable given the specific personal and financial circumstances of borrowers - dealing sensitively with borrowers who may have particular vulnerabilities. Decisions should take account of a borrower's likely long-term ability to repay their arrears.

Lenders should take action now to identify customers susceptible to falling into arrears and have appropriate strategies to treat these customers fairly.

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