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Forbearance and Impairment Provisions
FSA Guidance Consultation

Response by the Building Societies Association

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 48 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for about 36% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

2. The BSA welcomes the publication of the guidance consultation and its intention to provide assistance to firms, in relation to dealing with forbearance and ensuring adequate reporting and provisioning of impaired accounts.

3. However, we have a number of concerns with the guidance, primarily with the overlap with conduct rules and the wider economic circumstances and influences on the use of forbearance by firms.

Executive Summary

4. We are concerned that the guidance focuses on one forbearance solution being offered, when in reality a number of solutions may be applied to assist the customer during a period of financial stress. In addition, some customers will not migrate back to their original terms as the change to their circumstances is long term or permanent. The guidance fails to recognise this and infers that firms should seek to migrate all customers back to the original loan terms, once the payment difficulties are overcome. As such the guidance does not take account of the individual and varying nature of customer circumstances and does not provide sufficient flexibility.

5. We are concerned with the guidance on standards such as IAS39, that are currently under review and widely recognised as imperfect and would question what value the guidance is providing to firms in this respect.

6. We are also concerned that the guidance fails to take account of smaller firms, particularly in relation to the reporting guidance and accounting standards, where much of the guidance in our view, would be inappropriate. We recommend the FSA undertakes further analysis to ensure the guidance assists smaller firms and mutuals more generally.

7. Whilst we recognise the need for the FSA to publish greater clarity where they have found areas of concern, the intent and the timing of issuing guidance must result in providing assistance to firms. We do not agree that this guidance achieves this in its current state.

8. The BSA recommends that the FSA works to ensure the guidance works from a conduct and consumer protection perspective as well from a prudential view. As currently drafted the guidance does not achieve this and has the potential to cause consumer detriment, with firms not offering the options they have done in the past, as well as causing considerable confusion to firms.

Context & Scope

9. We are concerned that the guidance fails to recognise the wider influences on lenders in relation to forbearance, such as Government policy and the wider economic environment.

10. Over the last two years, considerable pressure was placed upon lenders to offer forbearance to avoid repossession. We had two Government schemes (Mortgage Rescue and Homeowner Mortgage Support), criteria changes to Support for Mortgage Interest, and the Prime Minister at the time calling for lenders to offer a moratorium of three to six months on possession action.

11. The Homeowner Mortgage Support Scheme in particular focussed on the lender offering assistance to customers with temporary changes to income for up to two years. Lenders who did not offer the official Government scheme, were encouraged to offer similar options under their own forbearance policy, which many did.

12. We have also seen the introduction of the Civil Justice Council's Pre-Action Protocol, which scrutinises every repossession case, along with changes to MCOB 13, which strengthened existing requirements into rules. Both of which require lenders to consider appropriate forbearance before commencing action for possession.

13. Lenders have therefore been encouraged to do all they could to avoid repossession, by the Government, the FSA and the Courts.

14. The difficulty in all of this is determining what is right for the customer now to help them avoid repossession in conjunction with what may be in their best interests long term. We do not see how this is possible to determine without the benefit of hindsight. We do not disagree that forbearance should work in the long term interests of the customer, but we do not believe that in the majority of instances this will be evident until the options have been tried and failed to work.

15. That said, we also believe that it is important to recognise that mutual lenders constantly work with their customers during periods of financial difficultly. This includes customers who are on long terms arrangements, or in longer term arrears to assess whether remaining in home ownership is right for them going forward. This is often done in conjunction with money advice to ensure the customer’s overall circumstances are considered.

16. However, we do not believe that this guidance will lead to ‘better’ forbearance, but rather it will lead to less forbearance as firms have yet more considerations to factor into account when dealing with customers, along with an increased reporting burden and provisioning requirements.

Potential Impairment Indicators

17. We do not believe that 'potential impairment indicators' have been adequately defined in the guidance and therefore provides little assistance to firms. Whilst firms can usually identify customers who may be having financial difficulties, they may not identify all the indicators the FSA expects. We do not agree it is good practice for this guidance to be issued without a detailed definition of the indicators the FSA is referring to.

18. Furthermore the suggested good practice of identifying potential impairment across all contact points in the business may appear sensible in theory, in practice this is difficult to achieve, particularly across larger firms, who have numerous contact points.

19. Whilst firms may be able to implement the suggested good practice, this will take time and may also require a significant amount of training, to ensure all staff are able to identify relevant cases. This has not been taken into account in the cost benefit analysis. We

strongly suggest further analysis is undertaken to ensure the impact on firms is fully considered.

20. Furthermore, firms need to be given adequate time to implement the good practice examples and receive adequate support and assistance from their supervisor when doing so.

Forbearance Practice Guidance

The overall provision of forbearance to customers

21. We agree that forbearance should work in the longer term interests of the customer and that where a customer is identified as potentially having payment difficulties, the forbearance offered should be based upon their individual circumstances and is regularly reviewed.

22. However, the guidance fails to recognise that the ability for the lender to do this is often restricted, as customers are not always forthcoming with the required information. In our view the guidance appears to assume the consumer is always fully engaged with the lender. This is rarely the case therefore this limitation must be recognised, as it can hinder the lender in achieving the aims of the guidance.

23. We are also concerned with the interpretation of the wording of the poor practice guidance which uses the phrase ‘a forbearance solution’, as per the extract below:

> The firm has established a forbearance solution that does not seek either:
> - To fully recover the mortgage (where there is feasible)
> - To minimise the build up if a contractual shortfall and thus minimise future capital & interest repayment to burden the customer and potential future loss risks to the firm

24. In reality, a firm will look to offer a variety of options and as the customer starts to rehabilitate, is likely to make further changes to the mortgage with the intention of moving them onto a longer term sustainable position or full recovery.

25. For example, a firm may offer a payment concession of 50% of the monthly payment for a period of time to assist the customer during a period of income loss, then perhaps capitalisation and a term extension, which results in the customer being able to maintain the mortgage long term. The lender has therefore worked with the customer offering a variety of solutions.

26. The wording of the guidance does not result in this outcome and as currently worded, the interpretation is that if the payment concession in the example above does not move the customer back to sustainable terms, that is viewed as poor practice. We do not believe that this is the intention of the guidance therefore we would recommend that it is redrafted to reflect how forbearance is used in practice.

27. We are also concerned with the interpretation of ‘expected period of financial stress’ as per the extract below:

> Medium or long-term arrears arrangements are being agreed which do not fully rectify the contractual shortfall position of the mortgage without an assessment of the circumstances of the customer (including the duration of their expected period of financial stress), or their affordability to the customer.
>
> A forbearance solution is provided (e.g. a payment holiday or a drawdown) which tides the customer over for a limited period but is not sustainable for the whole period of financial stress and therefore places the customer in a worse position than they would have been otherwise.

28. In reality it is often very difficult to determine how long the period of financial stress will last. A customer who loses their job may expect to find new employment in a matter of weeks, but the reality may be very different and they may not find new employment for months. It may also be that the customer's situation worsens. For example the financial stress may initially be caused by a reduction in income (losing overtime), but the customer may then be made redundant. As such any forbearance solution offered initially is unlikely to see the customer through their financial stress.

29. Again we believe the wording of the guidance needs to take account of the varying nature of customer circumstances and reflect the fact that the reality is not as straight forward as the guidance perhaps assumes. This is imperative otherwise the guidance provides little use to firms and sets a benchmark which is not achievable.

30. On a minor note, the guidance refers to the 'Department of Social Security (DSS)'. This is incorrect, the department is Work & Pensions (DWP) therefore the guidance should be amended to reflect the correct terminology.

Capitalisation

31. We welcome the definitions provided for capitalisation. The BSA has called for consistent definitions of capitalisation in the past. However, we are concerned that these definitions will not be formally used within MCOB and the Handbook more generally and will form part of this guidance only. This therefore does not overcome the issues with existing regulatory reporting where different definitions will continue to be used. Nor does it ensure that any future rule changes relating to capitalisation are based on a standard set of definitions. As such we believe the FSA needs to consider how these new clear definitions should be integrated into other regulatory requirements.

32. It is also unclear how these definitions work within the existing MCOB requirements, which refer to capitalisation in terms of treating the payment shortfall as if it were part of the original loan amount (MCOB 13.3.4A 1(d)). The use of capitalisation in MCOB 13 is more akin to 'standard capitalisation', therefore this creates confusion as to how 'repayment capitalisation' works within the requirements of MCOB 13. This creates further confusion for firms and therefore provides little to no assistance.

33. We are also concerned with the requirement to seek formal confirmation from the customer before capitalising arrears, as per the extract below:

> The firm has formally sought confirmation that the customer understands and accepts the capitalisation event.

34. The guidance is unclear on the definition of 'formal' confirmation and whether this needs to be in writing, or if verbal confirmation is acceptable. It is also unclear as to whether all borrowers party to the mortgage need to provide formal consent, or if confirmation from one borrower is sufficient.

35. Furthermore, the requirement to ensure capitalisation is a last resort would, in our view, only apply to 'standard' capitalisation. The nature of repayment capitalisation under the guidance definitions would mean that this requirement would not apply, however; capitalisation is used as a general term, which we believe is confusing.

Interest Only

36. We are concerned that the guidance goes over and above what is currently required under MCOB 11 and that the guidance is not in line with the good and poor practice examples issued following the Responsible Lending Project in 2008.

37. We are aware that the FSA is intending to strengthen the requirements on firms as part of the Mortgage Market Review (MMR). This guidance therefore appears to pre-empt what firms should expect as part of the MMR. The following good practices examples demonstrate this:

An acceptable capital repayment strategy is in place that the firm has assessed as plausible. An affordability assessment, using a stressed interest rate consistent with new business, is carried out on the basis of a C&I repayment mortgage

38. We have serious issues with this for a number of reasons. Firstly firms have been repeatedly told by the FSA not to pre-empt the outcome of the MMR in their lending policies as the final conduct rules are not yet agreed. Secondly, the final rules are still to be consulted on, which we expect over the summer and therefore may be subject to change.

39. As a result, not only does this guidance contradict this position, the timing of the final publication must be in line with the publication and implementation of the MMR. Failure to do this will undermine the entire consultation process and ultimately will result in firms having additional detailed guidance for interest only switches on their existing book, compared to the existing rules and guidance for new loan origination.

40. Furthermore, the guidance fails to recognise the impact on customers who are not able to afford a repayment vehicle or move back onto capital and interest terms, within a 'reasonable period'. For example a customer who loses their job, is back in paid employment, but on a lower salary could have sufficient income to maintain interest only mortgage payments.

41. However, they cannot afford a long terms savings plan and despite their best attempts or future intent, they are unable to switch back to capital and interest payments. In this situation, the lender is likely to be content with this situation, rather than take repossession action. In addition, under the pre-action protocol the Courts are also likely to accept this position and would not grant a possession order.

42. However, the guidance infers that this would not be an acceptable alternative to repossession. This therefore places the lender in a conflicting position. The FSA needs to be much clearer in this respect and revisit the drafting of the guidance to ensure it takes account of the varying and individual circumstances of customers following payment difficulties.

Term extension

43. We again have concerns with wording of the good practice, which requires firms to stress test the interest rate, as this in or view also pre-empts the MMR and we would therefore refer back to our previous comments, in relation to interest only.

44. We are also concerned that the FSA has taken retirement as the Government's state pension age, when in fact the customer's actual retirement age could be much further away.

45. We agree that there needs to be a bench mark and we also agree that the customer's anticipated retirement age needs to be reasonable. However, firms also need to have flexibility and where they are aware that the retirement age exceeds the Government's state pension age and this can be reasonably evidenced, then there is no reason for the firm to use the state pension age as the benchmark. We believe the guidance should take account of this.

Calculating overpayments on a drawdown facility

46. We have concerns that the wording of the good practice in relation to overpayments, will be impractical to implement. In particular, the examples in the extract below:

The firm is fully aware of:
- where one or more repayment vehicles are paid out prior to the term end
- where additional payments are or have been made to support a capital repayment vehicle which is unlikely to repay the loan

47. In our view, firms would be unable to fulfil these requirements unless the repayment vehicle is assigned to the lender. This is rarely the case and would only be applicable to vehicles such as endowment policies which are no longer used as repayment vehicles.

48. Furthermore, this could lead to the lender being required to make an assessment of the performance of the repayment vehicle. In our response to CP 10/16 we argued against such an approach from a conduct perspective, primarily as it could require the lender to provide investment advice or make a judgement on an investment which they have little to no expertise.

49. We strongly suggest that the guidance is redrafted to take account of current practice, where repayment vehicles are not assigned to the lender and to ensure the guidance is brought into line with the MMR in terms of assessing the performance of the vehicle.

Internal Reporting Requirements

50. We understand the intention of the guidance, to ensure firms have a thorough understanding of the potential for loans to fall into arrears, as well as analysing those loans already in arrears.

51. However, we are concerned that the suggested segmentation and detailed reporting for the Board is disproportionate for smaller firms and there will be cost implications for larger firms, which we believe have been underestimated in the cost benefit analysis.

The impact on smaller firms

52. Small building societies[1] with total assets under £500 million have average arrears[2] of 1.07%. Very small societies[3] with total assets under £200 million have average arrears of 0.68%[4]. As such we do not believe it is proportionate for these firms to implement the suggested detailed reporting and we fail to see the benefits such reporting would provide.

53. These firms are unlikely to determine trends in loan characteristics as the number of loans are too few to draw any significant conclusions.

54. It is the BSA's view that the guidance reflects the expected practices in much larger firms. We note in the guidance the use of 'banks' on page 10, paragraph 17, rather than firms which is used throughout, which perhaps indicates the intended audience of the guidance. However, as the guidance applies to all firms we believe that further consideration needs to be given to smaller firms to take account of the scale of operations. Without this, the guidance provides little additional assistance to small firms and only serves to increase the reporting burden for very little benefit.

The impact on larger firms

55. Whilst many larger firms will already undertake some the recommended reporting, for some, system developments will be needed to extract the required data. The cost benefit

[1] Asset size taken from the BSA Yearbook 2011.
[2] Arrears based on 13 societies with total assets under £500 million, as at Q1 2011 from statistics collected from the BSA
[3] Asset size taken from the BSA Yearbook 2011.
[4] Arrears based on 5 societies with total assets under £200 million, as at Q1 2011 from statistics collected from the BSA

analysis states that the FSA expects firms to be able to extract information from existing data sources and therefore development costs would be material.

56. We do not agree and for some firms these costs could be significant, particularly in terms of the size of the arrears book. For mutual lenders these costs are ultimately borne by the customers. We strongly suggest that further analysis is undertaken to fully understand the impact on various types and sizes of firms to ensure the CBA is robust and fully supports the intent of the guidance.

Impact on all firms

57. We have concerns with the timing of the publication and implementation of the guidance, as all firms will require time to undertake a gap analysis and implement the necessary changes to policies and procedures. It is not clear what timescales are being given by the FSA for firms to move into line with the good practice examples. Further clarification would be welcomed by firms and would provide reassurance that the FSA recognises that enhancements may need to be made, which will not be immediate.

External Reporting Requirements

58. We recognise the intention of the guidance, to provide assistance to firms when considering more closely the credit risk characteristics of loans which have been the subject of forbearance actions, particularly when assessing loan portfolios for impairment. We are not convinced that the guidance provides assistance to smaller firms with small numbers of 'delinquent' accounts. The guidance has the potential to create additional reporting burdens for smaller firms, for little benefit.

Overlay of accounting regulations

59. We are concerned that the apparent overlay of accounting regulations by the FSA, will only complicate the reporting for firms and may result in the understanding of the reporting by third parties (such as Building society members) being obscured.

60. We recognise the FSA's position that the guidance is not intended to be an interpretation of accounting standards, nor mandatory reporting guidance. However, the wording of the guidance in our view, does just that.

61. If the FSA is concerned that firms are not complying with IFRS, then it should engage in the first instance with the UK’s Accounting Standards Board, rather than provide additional guidance to firms themselves.

Historic Data

62. We welcome the FSA's acknowledgment that some firms will have difficulties using historic data to calculate impairments. Smaller mutuals in particular are unlikely to have the required depth of data to estimate the expected life of their mortgage book. Low volumes of lending, which are then sub divided into smaller pools will result inaccurate or misleading conclusions.

63. However, despite this acknowledgement the FSA has still sought to issue guidance that some firms cannot easily apply, if at all. The BSA recommends that further work is undertaken to understand the impact on smaller firms and for the guidance to take account of the limitations that smaller firms have in terms of historical data.

IAS 39

64. The BSA does not agree that additional guidance should be issued on standards such as IAS 39, that are currently under review and widely recognised an imperfect.

65. For example, the FSA acknowledges in the guidance that when estimating the future stream of case flows from impaired assets, firms will encounter a high level of uncertainty, which makes estimating the impaired amount correctly, very difficult, if not impossible.

66. Furthermore, IAS 39 is based upon incurred loss rather than expected loss and the guidance appears to be based on the latter, which is likely to cause further confusion rather than assistance to firms.

67. Whilst we recognise that IAS 39 is still in force, it is in our view, inappropriate to issues guidance when it is known that the standards are subject to change in the short term.

Definitions

68. In addition to our comments on the definition of impairment indicators and capitalisation, we are also concerned with the definitions of contract shortfall and the assumptions made regarding he accounting standards adopted by firms.

Contract shortfall

69. The guidance defines a contract shortfall, as the difference between the value of cumulative repayments made by customers and the value of cumulative contractual monthly payments due.

70. Within MCOB 13 we already have definitions of arrears and payment shortfall. We therefore fail to see why another definition is needed for this guidance. We therefore recommend that the existing definitions in MCOB are used within this guidance. This will not only result in consistency, it will also reduce the confusion amongst firms who will have another definition for customers in payment difficulties.

Accounting Standards

71. We note that the FSA recognises that not all firms prepare accounts under IFRS. However, we are concerned that the guidance refers to FRS 26 being used by all 'significant UK financial institutions'. Smaller mutuals are less likely to have adopted FRS 26, therefore this guidance would not be applicable to these firms.

72. If this is the intention of the FSA, the guidance needs to clearly state this. If not, then further consideration needs to be given as to how the guidance assists smaller firms, as it fails to achieve this outcome in its current form.

Contact

73. This response has been prepared by the BSA in consultation with its members. Comments and queries in the first instance should be addressed to Victoria Barnard, Mortgage Policy Adviser (victoria.barnard@bsa.org.uk).