CML interest-only toolkit

April 2013

Council of Mortgage Lenders

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CML interest-only toolkit

Paper 1 - An overview of the options for lenders and borrowers

Council of Mortgage Lenders

Scope of the toolkit

1. In 2010 the CML started working with members to identify and mitigate repayment and conduct risks associated with existing interest-only mortgages, which may arise in particular circumstances. The CML's interest-only toolkit is intended to help and inform lenders to develop policies and actions related to existing interest-only mortgages.

2. The toolkit is not prescriptive – rather it sets out a framework which we believe will allow members to develop a strategy which is appropriate to their business model and, crucially, helps them to meet the needs of their current interest-only customers.

3. The options set out in the toolkit only apply to residential owner-occupied mortgages, where the property is the borrower's primary home. As such buy-to-let, second homes and equity release mortgages are excluded.

4. The content of this toolkit has been reviewed to reflect the rules which will come into force on 26 April 2014 as a result of the Mortgage Market Review (MMR) insofar as they impact the interest-only back book. The overall content will also be reviewed to reflect the outputs from the FCA's thematic work on the maturity of interest-only mortgages. The toolkit is a living document and will continue to be reviewed and updated when necessary.

Contact with borrowers

5. Contact with the borrower and awareness of their individual circumstances is an essential pre-requisite to any action being taken. In line with the MMR final rules for new lending, it is suggested that the lender should seek to make contact with the borrower to re-validate the existence of the repayment method at least once during the term of the mortgage and in good time to be able to identify if any remedial action is required.

6. Lenders should have a risk-based policy in place for contacting existing borrowers. Given the complexity of contact strategies the CML has not sought to determine the detail of what constitutes an appropriate contact strategy (either pro-active or reactive). It is for each lender to determine its own approach.

7. In deciding which customers should be contacted and with what priority it is suggested that lenders take the following issues into consideration:

- Time to maturity of the loan;
- The customer's age;
- The value of the outstanding loan;
- Levels of evidence (or lack of evidence) held on:
  - The customer's financial circumstances; and
  - The customer's proposed repayment vehicle.

8. To help lenders work through these issues and identify customers most at risk, we have prepared a suggested matrix for completion which is included as paper 4 of the toolkit.

Repayment shortfalls - options open to lenders and borrowers

9. There are a range of options open to lenders and borrowers to help mitigate repayment shortfalls towards the end of the term and to manage them where they do occur at the point of maturity. All actions are likely to have different benefits and risks for both lenders and borrowers and consequently they may not be appropriate in all circumstances. These are discussed below.

- **Keep things as they are**

10. 'Keeping things as they are' will be the pre-maturity option for the vast majority of borrowers who have a viable strategy in place that is on target to repay the capital by or at end of term. It is also a viable option in limited circumstances depending on the characteristics of the borrower and the mortgage (e.g. low loan-to-value (LTV), the time remaining prior to maturity and proximity to retirement age/ age generally when post–maturity and past retirement age).

11. Where the sale of the property is the acknowledged repayment method, or the lender has knowledge that the borrower has the necessary means to repay the capital by the end of the term, and the lender has evidenced this, then 'keeping things as they are' should be the default option.

Applicable pre-maturity

12. 'Keeping things as they are' is only applicable pre-maturity and in lower risk circumstances (to be determined by individual lenders). Once a mortgage has matured and the capital has not been fully repaid then action, of some sort, becomes necessary.

- **An additional reminder of the need to repay the capital and/or a signed declaration from the borrower**

13. This option could be used to contact borrowers and could also allow lenders to ask borrowers to 're-validate' the existence of their proposed repayment strategy and to agree, where appropriate, to remedial action.

14. There are four potential forms that additional reminders could take (in addition to the annual statement that lenders send). These are as follows:

- Firstly, reminders are sent to **all existing interest-only customers** as a means of prompting action by the borrower to either review their current repayment strategy and/or provide information regarding their strategy to the lender.

- Secondly, reminders are sent to **a targeted risk-based cross-section of interest-only customers**. The risk-based approach would be determined by the individual lender, but could be dictated by, for example, the amount of time before maturity, proximity to retirement age and/or an LTV basis as suggested in paragraph 7 above.

- Thirdly, the reminders could be used to **require a signed declaration from the borrower of their intent and responsibility to repay the capital**. Some lenders currently require borrowers to sign this declaration when they make proactive contact with them for a remortgage or contract variation and this could therefore form a standalone option for lenders. This would have to be used only where there is a likelihood of getting a response from the borrower, e.g. face to face contact or making it a term of the re-mortgage etc.

- Fourth, proactive contact with the borrower, **to assert that remedial action is necessary.** This is likely to be where the lender is aware that the borrower is unlikely to be able to repay the capital because they are in financial difficulty and struggling to make payments. There will often be triggers for this such as the customer contacting the lender to request, for example, a payment holiday.

Applicable pre- or post maturity

15. Reminders are most important during the term to either ensure that the borrower is aware of their responsibility to repay the capital by maturity, or to act as a prompt to contact the lender if they have concerns. Where the original mortgage has expired and the lender has agreed to extend the term on an interest-only basis, similar reminders could be used to prompt a response from the borrower.

16. Additionally, under the FCA's guidance on forbearance and impairment provisioning, the lender is likely to have to monitor the borrower's circumstances to determine if they can afford to make capital repayments.

17. There is further information on proactive and reactive contact strategies in papers 2 and 3 of the toolkit.

- **Extension of term**

18. Extension of the term is a viable option and one that could be used for a broad range of consumers. The main issues that need to be resolved are:

- whether the term extension would constitute advice;
- whether the term extension would constitute a potential impairment;
- whether any specific warnings regarding the impacts of the action are necessary (i.e. that the extension of term will increase the amount of interest payable over the life of the mortgage); and
- if the new term will take the borrower into retirement.

19. The CML's understanding is that such changes, when recommended by the lender, would constitute regulated advice. Lenders would have to be mindful of lending into retirement and would need to apply the appropriate controls as necessary. Once the MMR rules are in force (from 26 April 2014), an extension of term which it is reasonable to expect will extend into the borrower's retirement, will be deemed to have a 'material impact on affordability' and as such a full affordability assessment will need be carried out.[1]

20. Alternatively, instead of providing advice the lender could give the customer all of the options, and supporting information about each, appropriate to their circumstances and the customer is then able to decide for themselves. Once the MMR rules are in place, a customer may then undertake to proceed on an execution-only basis under specific circumstances.

21. The FCA's forbearance and impairment provisioning guidance states that a term extension, where it is to improve affordability, may be considered to be an impairment event. In this instance the term extension is not to improve affordability of monthly payments, but to allow the borrower more time to repay the capital. If there is no certainty that the capital will be repaid by the end of the extended term, it may not adequately repair the borrower's position and therefore may not prove viable.

Applicable pre- or post maturity

22. This option should be a central part of a lender's policy options. It is applicable both during the term and post maturity. It is likely to be essential post maturity, to ensure that the terms and conditions of the mortgage contract are extended, protecting both the borrower and lender's position and as a means of countering the impaired status following a breach of contract.

23. In most cases the lender may wish to consider moving the borrower to capital repayment terms at the same time as extending the term, depending on the circumstances of the borrower, the length of the term extension and, ultimately, if it is affordable. Obviously, a crucial factor will be the customer's age and whether the customer would be able to maintain payments should the extended term go into retirement.

- **Move to a presently accepted repayment method**

24. Any remedial action taken by lenders is without prejudice to the previous lending decisions, processes or policy. As a consequence it is very difficult to justify forcing a borrower to move to an alternative repayment method, simply because of a change in the lender's policy.

25. Therefore, it is likely that this option will only be applicable in very limited circumstances, for example where a borrower seeks to increase their borrowing – or internally remortgage – the lender may require the borrower to use an acceptable repayment method for the new/additional lending.

26. The approach of exploring alternative repayment strategies which may not be acceptable for new lending should actively be considered for existing borrowers. Such flexibility may be necessary to enable the borrower to repay the capital.

27. This may include discussing with the borrower the option of selling their current property to repay the capital and downsizing. This is likely to be most pertinent where the borrower faces a certain, or very likely shortfall, after it has crystallised at the end of the term, or where it is the borrower's repayment strategy.

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[1] Note that in cases where there is no additional borrowing and the lender judges that the term extension is in the customer's best interests, the lender can choose to apply the MMR transitional arrangements thereby disapplying the otherwise required affordability assessment. In practice lenders will need to assess affordability first to determine that the borrower cannot afford the change, before they can apply the transitional arrangements.

28. This process would need to be handled very carefully, as it bears similar reputational risks as assisted voluntary sales. Research by the University of York, published in September 2011 outlines how lenders could approach the difficult conversation with a borrower about the benefits of selling their home.

Applicable pre- or post maturity

29. This is likely to be used in very limited circumstances both pre- and post maturity. During the term it is likely to only be used when a borrower requests a further advance on an interest-only basis, with the lender requiring a different repayment method for the new lending. It may also apply where a borrower is in arrears.

30. Finally, where it becomes apparent (either during the term or at maturity) that the borrower does not have an adequate repayment method, the lender will want to discuss the range of options open to the borrower, and this may include other means of repaying the capital that are not currently accepted by the lender.

- **Voluntary move to capital repayment (full or part)**

31. Any voluntary move to capital repayment terms would require the lender to undertake an affordability assessment to ensure that the borrower can afford the new payments. If the repayments are unaffordable, the borrower may consider extending the term as well.

32. The key issues to consider are:

- that a lender recommending a move to capital repayment to the borrower constitutes regulated advice;
- that presenting the borrower with factual information about the choices available to them without making a recommendation does not constitute regulated advice (i.e. moving to capital repayment will increase monthly payments, but will ensure that the capital is fully repaid by the end of the term). Once the MMR rules are in place, a customer may then undertake to proceed on an execution-only basis under specific circumstances; and
- whether any move to capital repayment should have to pass either a full affordability assessment for new lending, or if a 'lighter version' would still be sufficient. Once the MMR rules are in force (from 26 April 2014), a change in repayment method will be deemed to have a 'material impact on affordability' and as such a full affordability assessment will need be carried out.[2]

33. A more flexible approach may be to encourage the borrower to make overpayments, but remain on interest-only terms. Many borrowers currently use interest-only in this way, particularly those with uneven income. The downside of this approach is that it does not provide either the lender or the borrower with certainty that the capital will be fully repaid, as the borrower is not contractually obliged to over pay.

Applicable pre- or post maturity

34. This option should form a core part of a lender's policy and is applicable during the term and post maturity. If there is likely to be a shortfall at the end of the term, the earlier the change to capital repayment can be agreed the better. This of course relies on contact with borrower, which may occur following proactive communication by the lender or as a result of borrower contact with the lender to discuss their current mortgage (e.g. payment difficulties, internal remortgage or further advance).

- **Compelled move to capital repayment (full or part)**

35. The lender may have the power under the terms and conditions of the mortgage contract to compel a move to capital repayment. However, this **should only be used in very limited circumstances and where all other voluntary options have been explored and discounted**. For example, where a borrower requests a further advance and, as part of an affordability assessment, the lender obtains clear evidence that the borrower can afford to pay more and cannot provide evidence of a credible repayment strategy.

[2] Note that in cases where there is no additional borrowing and the lender judges that the move to repayment is in the customer's best interests, the lender can choose to apply the MMR transitional arrangements thereby disapplying the otherwise required affordability assessment. In practice lenders will need to assess affordability first to determine that the borrower cannot afford the change, before they can apply the transitional arrangements.

36. The lender needs to be mindful of its obligations under the Unfair Terms in Consumer Contracts Regulations (UTCCR).[3] The need to clarify the conditions when a term is fair and how it should be disclosed to the borrower is **essential** for lenders to include in future mortgage contracts.

37. Generally the FCA's interpretation of the UTCCR is that the benefits of the power must be balanced between the firm and the consumer and critically the circumstances when the firm can use the terms must be controlled (preferably predictably) and should be clear to the consumer from the outset.

38. A borrower who is in arrears, or having payment difficulties, is unlikely to be able to afford to make payments into a repayment vehicle. Therefore, forcing a move to capital repayment terms in these circumstances will clearly worsen the borrower's situation and is likely to be seen as unfair treatment by the FCA.

Applicable pre- or post maturity

39. This option can be applied both during the term and after maturity but should only be used in limited circumstances as discussed above. The crystallisation of a repayment shortfall at the end of the term is unlikely to provide sufficient evidence to justify this action in itself.

- **Switch to lifetime**

40. As only a limited number of lenders offer a lifetime product, a switch to a formal lifetime mortgage will only be available and appropriate in a small number of cases.

41. Where this option is available there are a number of compliance issues that will need to be resolved, particularly around the advice process given the enhanced regulation of lifetime products. Equally, there is the consideration as to which type of lifetime product is most appropriate, if the borrower can afford to make interest payments or if the interest should be rolled up into the loan.

42. Lenders may consider options for moving customers to a lifetime mortgage where they do not offer the product. For example, this may be through a referral to specialist lifetime mortgage intermediaries.

43. Some lenders may offer continuing rolling term extensions to customers with regular reviews. In this situation the lender continues to agree to extend the term on an interest-only basis, to give the customer time to repay the capital. This option should only be used where all other options have been explored with the borrower and discounted. There will have to be tight internal procedures and communication with customers (or their representatives) around this to ensure that the lender's position is protected until either voluntary sale of the property or death of the borrower(s), whichever is first.

44. This approach creates a number of issues for consideration for lenders including:

- advice – should lifetime controls apply, as there will be similar risks for consumers, as the FCA's guidance on forbearance provisioning will apply;
- the need to ensure that the lender regularly checks if the borrower's circumstances have changed and can make additional payments;
- if extending the term on a rolling basis without a clear route for capital repayment adequately repairs the borrower's position so that it is no longer considered to have an impaired status; and
- the lender must then provision and report the loan appropriately (as the risk becomes both repayment and actuarial).

Applicable pre- or post-maturity

45. A switch to a lifetime mortgage is an option that could apply both during the term of the mortgage and after the term. Given the restrictions on age and LTV, in the majority of cases it will only be applicable towards the end of the term or after it has expired. Given the nature of continuing term extensions in perpetuity, it can only be applied after the original term has expired.

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[3] See The FCA's Finalised Guidance - http://www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg12-01

- **Commence possession procedures**

46. This would only be applicable in **limited circumstances** when the borrower is in arrears or where the borrower has breached their contract by not repaying the capital at the end of the term.

47. Possession may be the most appropriate option either during the term or after the term has expired. If the borrower is in arrears the lender would have to adhere to the regulation in MCOB 13 and the requirements of the pre-action protocol and litigate on the basis of arrears. **Consequently, as with any other arrears case, it should only be considered as a last resort.**

48. A referral to mortgage rescue may be applicable in a small sub-set of arrears cases where the borrower is facing repossession and the household is in a vulnerable group such as families with children or where the property has been specially adapted for their use because of disability.

49. Where a borrower does not repay the capital balance at the end of the term they are in breach of contract and the lender has the right to demand payment, including by taking possession of the property. To ensure that possession is the last resort the lender should seek to reach an agreement with the borrower before commencing action. The lender will be litigating on the basis of breach of contract rather than arrears – as such, neither the bulk of MCOB 13 nor the pre- action protocol will apply.

Applicable pre- or post-maturity

50. Where possession procedures are dependent on the borrower missing regular payments, this is applicable both pre- and post-maturity.

51. Clearly repossession as a consequence of a breach of contract following a capital repayment shortfall at the end of the term is only applicable post-maturity.

CML interest-only toolkit

Paper 2 - Reactive lender contact strategies

Introduction

1. The CML's interest-only working group has considered the best way to communicate with interest-only customers.

2. As part of developing contact strategies, the group has noted a number of differing customer contact points which could occur over the life of an interest-only mortgage term. The group has considered how these contact points could be used to engage with, and gain information about, interest-only customers and their intended repayment vehicles, on a reactive basis.

3. A further paper (Interest-only toolkit, paper 3) considers key issues that lenders may wish to cover in proactive contact letters to interest-only customers.

4. Lenders may wish to consider using the Money Advice Service leaflet *'Take action with your interest-only mortgage now'* as part of their reactive customer contact strategies.

Customer contact points – contract variations

5. Contract variation requests from interest-only customers could include requests for:

- Rate switches
- Payment holidays
- Overpayments
- Term extensions
- Equity transfers
- Permanent transfers to part interest-only
- Permanent transfers to full repayment basis

Customer contact points – new lending

6. New lending requests from interest-only customers could include, but are not limited to, requests for:

- Equity withdrawal – new lending or existing loans
- Porting – new lending or existing loans

Issues to consider

7. Issues that lenders may wish to consider when reacting to requests for contract variations and/or new lending from interest-only customers could include whether the transaction will be allowed:

- Under any circumstances, irrespective of whether the mortgage is interest-only or repayment;
- Without reference to the repayment method – this is only likely to be appropriate for low risk contract variations (such as requests to make overpayments). Lenders reacting to customer requests for new lending should always carry out checks on the proposed repayment vehicle;
- Following a reminder to the borrower of their responsibility to repay the capital lent at the end of the mortgage term;
- Following verbal confirmation that a repayment vehicle is in place;
- Following verbal confirmation that a currently acceptable repayment vehicle is in place;

- Following written confirmation from the customer that a repayment vehicle is in place;
- Following written confirmation from the customer that a currently acceptable repayment vehicle is in place;
- Following receipt of evidence that a repayment method is in place;
- Following receipt of evidence that a currently acceptable repayment method is in place.

8. Lenders will need to consider what level of evidence (eg, declaration of intent signed by the customer vs third party evidence of investment performance) they require regarding the customer's chosen repayment vehicle.

9. Lenders may wish to consider using greater controls if the borrower wishes to increase their lending. This could include additional requests for information about the borrower's circumstances and/or requests for evidence to support affordability.

10. Lenders should be aware of the potential for confusing customers when using reactive strategies to create opportunities to review the customer's circumstances with respect to their interest-only mortgage. Care should be taken to ensure that the customer understands that the lender is considering their contract variation request and that any further conversation relating to the status of their interest-only mortgage is in addition to the primary conversation regarding the variation. Lenders should make it clear that they will take into account any additional information that the customer can provide with respect to their interest-only mortgage where this has an impact on the variation request.

11. The lender's response will be dependent on the circumstances of each individual customer, the customer's request, and the lender's own risk profile.

CML interest-only toolkit

Paper 3 - Proactive lender contact strategies

Introduction

1. The CML's interest-only working group has considered the best way to communicate with interest-only customers.

2. As part of developing contact strategies, the group has considered the best way to engage with interest-only customers on a proactive basis.

3. This paper sets out a number of issues that lenders may wish to consider when developing proactive interest-only customer contact letters.

4. A further paper (Interest-only toolkit, paper 2) considers key issues that lenders may wish to cover in developing reactive contact strategies to engage with interest-only customers.

5. Lenders may wish to consider using the Money Advice Service leaflet *'Take action with your interest-only mortgage now'* as part of their proactive customer contact strategies.

Proactive customer engagement – general feedback from lenders

6. Feedback from lenders regarding customer engagement with interest-only borrowers has resulted in the emergence of some key themes:

- The most common method of proactive contact is via a contact letter. Lenders write to customers at set points pre-maturity and post-maturity and these contact points vary from lender to lender (see below);
- Customer response rates following proactive lender contact are low but improving. The CML will continue to engage with lenders regarding response rates from proactive contact strategies to try to understand what types of letters or messages encourage greater responses;
- Understanding response rates, segmenting customers, and data collection, is difficult for lenders without further engagement after initial contact;
- Specific teams have been put in place by some lenders to deal with interest-only customers/cases on a case-by-case basis;
- Lenders are keen to clarify the message that lenders can advise customers on the mortgage but not the repayment vehicle;
- Some lenders also send information flyers to interest-only customers with annual mortgage statements. These flyers highlight risks and available assistance. However, in general, they do not generate many specific customer queries or responses for lenders;
- Lenders are clear that customer engagement needs to be tailored to individual consumers and individual circumstances for best effect;
- Assistance for vulnerable customers is generally encompassed as part of the wider interest-only customer engagement strategy. While there is a need to deal sensitively with these cases there is also a clear need to balance conduct risk with prudential risk overall.

Proactive customer contact letters – points of engagement

7. Lenders proactively contact interest-only customers by letter at varying points throughout the term of the mortgage.

8. This varies from a periodic contact throughout the mortgage term, to an annual basis throughout the mortgage term with more specific letters close to term or after the end of term, to specific contact only being made close to term.

9. It is for each lender to determine the points at which customers are contacted.

10. Issues lenders may wish to consider when deciding on points of contact include:

- The value of the outstanding loan;
- Time to maturity of the loan;
- The customer's age;
- The results of previous engagement with the customer;
- Levels of evidence held on:
  - The customer's financial circumstances; and
  - The customer's proposed repayment vehicle.

Proactive customer contact letters – content

11. The content of proactive contact letters will vary dependent on each lender's risk profile and the circumstances of each individual customer (as far as they can be determined).

12. Lenders should consider tailoring proactive letters to reflect the customer's individual position (eg, setting out the amount outstanding, remaining term, maturity date and other personalised information). In particular, it may be helpful to use the letter to reflect whether the customer is pre– or post maturity, with options and warnings tailored appropriately

13. Issues which lenders may wish to consider when developing proactive customer contact letters could include:

- The lender's contact details for further advice/engagement if the customer is concerned about their ability to repay their mortgage;

- A reminder of the customer's contractual responsibility to repay the mortgage at the end of term, including a reminder to check the sufficiency of the proposed repayment vehicle;

- A note of the potential breach of contract if the mortgage is not repaid at term;

- A statement that lenders cannot provide specific advice on the performance or sufficiency of the customer's repayment vehicle and referring the customer to their investment provider;

- A request for evidence about the intended repayment vehicle – this could take the form of a customer declaration, or, a request for third party evidence;

- A summary of potential solutions available to the customer (this may need to be tailored to the customer's circumstances). Solutions that some lenders have offered in proactive letters include:

  - conversion of all or part of the loan to a repayment basis;
  - increasing monthly payments/making overpayments;
  - making a lump sum payment;
  - extending the mortgage term;
  - offering a savings review, where appropriate;
  - selling the property to pay the loan.

- A note of the potential for property repossession (this may not need to be highlighted as much for a customer a long way from term as for a customer close to term).

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Paper 4 – Spreadsheet matrix for lenders

Council of Mortgage Lenders

Potential Actions	**Circumstances when appropriate** (refer to triggers)	**Volume risk**	**Legal risk**	**Regulator risk**	**Credit risk**	**Reputational risk**	**Process issues**
Do nothing							
Additional reminder of need to repay capital							
Extend term							
Move to an acceptable repayment method							
Voluntary move to **part** capital repayment							
Voluntary move to **full** capital repayment							
Compulsory move to **part** capital repayment							
Compulsory move to **full** capital repayment							
Switch to lifetime							
Start possession procedures							
Other (please list)							

Notes

Risks are for existing interest-only borrowers where action is deemed to be necessary

Members should outline whether they perceive the action to have a high/medium/low or risk with a reason as to why.

LTV (indexed)			**LTV too high** (based on current policy)	**Outstanding balance too high** (based on current policy, excluding very high value loans > £1 million)	**No repayment method in place**	**Repayment method likely to result in shortfall** (not performing)	**Unacceptable repayment method** (based on current policy)	**Near retirement age** (55 +)	**Mortgage near maturity** (less than 7 years)
Negative equity	**Action required**	Yes							
		No							
75% - 100%		Yes							
		No							
50 - 75%		Yes							
		No							
Less then 50%		Yes							
		No							

Note:
When completing this tab, lenders should take a view as to whether they would take action depending on the indexed LTV of the mortgage (the first column) and the individual borrower's circumstances (first row).