C L I F F O R D

C H A N C E

FCA PAYMENT DEFERRALS FOR CONSUMERS AND THE SECURITISATION MARKET

Lenders of regulated credit in the UK have been required for many years to treat their customers fairly under the regulatory framework applicable to them, however COVID-19 has placed a renewed focus on these requirements and what they mean in practice. The FCA, as their regulator, was quick off the mark to set out its expectations as to how borrowers should be treated and over the past 6 months – releasing a string of guidance to firms on how they should interpret the existing requirements in light of COVID-19. In this briefing we look at what measures the FCA have put into place for consumer credit and the consequences for the UK securitisation market in particular.

The outbreak of COVID-19 has presented challenges for market participants on many fronts, but perhaps one of the greatest challenges for banks, building societies and non-bank financial institutions is the effect that the pandemic has had on consumers. Significant volumes of borrowers have struggled to meet scheduled payments under mortgages, home purchase plans, auto loans, consumer loans and credit card accounts, among many other types of consumer debt, which in turn has resulted in delinquency spikes in the secured and unsecured consumer credit space. The challenge for all market participants is balancing short term forbearance versus longer-term macro issues resulting in an increase in customers who may ultimately default under their debt obligations. The response from the [FCA] in the UK has been to balance these competing needs whilst offering breathing space for consumers during the immediate COVID-19 crisis.

In the United Kingdom, the FCA has sought to implement guidance for firms in how they should approach delinquent customers in light of COVID-19, building on the existing regulatory framework applicable to secured and unsecured consumer credit. This framework is set out in the Treating Customers Fairly principles, the Mortgage Conduct of Business ("**MCOB**") regime and the Consumer Credit ("**CONC**") regime. This guidance has predominantly centred around optional 3 month payment deferrals being afforded to consumers, extendable for a further 3 months, with options for partial payments during that period.

Key issues

- Regulated firms in the UK now have guidance on how to interpret their existing treating customers fairly obligations in light of COVID-19
- Separate guidance has been issued for different groups of products: (i) mortgages and home purchase plans, (ii) credit cards and consumer credit, and (iii) motor finance and high-cost credit
- 3 month payment deferrals have been made available to borrowers, with a further 3 month payment deferral available where needed

In this article we examine the steps that the FCA and market participants have taken to date and what is to come in terms of forbearance for customers who continue to find themselves in financial difficulty as a result of COVID-19.

Existing forbearance regime

Regulated firms which provide credit under regulated agreements in the United Kingdom already have regimes that apply to customers in financial difficulty. The principles of how firms should treat their customers are set out under the Treating Customers Fairly principles with additional more prescriptive guidance set out in the MCOB framework for mortgage and home purchase plan products and the CONC framework for unsecured credit such as credit cards, consumer loans, high-cost credit and motor finance. Throughout the COVID-19 crisis the FCA has made it clear that the guidance published is in light of the COVID-19 pandemic and sets out the FCA's expectations on how firms will interpret this existing framework. In certain limited circumstances, including in relation to some aspects of the persistent debt regime most applicable to credit card products, the FCA has disapplied select rules inconsistent with their guidance on a temporary basis.

Treating Customers Fairly

The Treating Customers Fairly principle is found in the Principles for Business Sourcebook ("**PRIN**") and principle 6 provides that a "*a firm must pay due regard to the interests of its customers and treat them fairly*". The FSA (as it then was) originally published the six customer outcomes that underpin this principle and sets out the baseline on how the FCA expects firms treat its customers. Most relevant of these customer outcomes in the context of customer hardship as a result of the COVID-19 pandemic is that products and services must meet customers' needs, consumers must receive clear and appropriate information, any advice is suitable and takes into account personal circumstances, and products perform as expected.

Supplementing the overarching Treating Customers Fairly principle is the CONC sourcebook for unsecured consumer products. CONC provides that firms must treat customers in default or in arrears difficulties with forbearance and due consideration. Forbearance, where relevant in the circumstances, is defined to be one or more of (1) considering suspending, reducing, waiving or cancelling any further interest or charges, (2) allowing deferment of payment of arrears: (a) where immediate payment of arrears may increase the customer's repayments to an unsustainable level; or (b) provided that doing so does not make the term for the repayments unreasonably excessive; and (3) accepting token payments for a reasonable period of time in order to allow a customer to recover from an unexpected income shock, where a customer demonstrates that meeting the customer's existing debts would mean not being able to meet the customer's priority debts or other essential living expenses (such as in relation to a mortgage, rent, council tax, food bills and utility bills).

For mortgage and home purchase plan products, the MCOB regime provides a slightly different approach that focusses less on modifications to payments, but rather on the term of the debt and product offered. A firm must consider whether, given the individual circumstances of the customer, it is appropriate to do one or more of the following in relation to the regulated mortgage contract or home purchase plan with the agreement of the customer: (a) extend its term; or (b) change its type; or (c) defer payment of interest due on the regulated mortgage contract or of sums due under the home purchase plan (including, in either case, on any sale shortfall); or (d) treat the payment shortfall as if it was part of the original amount provided (but a firm must not automatically capitalise a payment shortfall where the impact would be material); or (e) make use of any Government forbearance initiatives in which the firm chooses to participate.

Irrespective of product, a fundamental principle is that firms should allow customers reasonable time and opportunity to repay debts.

FCA's general approach

At the outset of the COVID-19 crisis the FCA launched various consultations with market participants on its proposed guidance to firms on how to interpret their existing obligations to their customers under the Treating Customers Fairly principle, CONC and MCOB. The approach taken has been specific to three identified product types, each with their own risk characteristics from a customer harm perspective: (1) mortgages and home purchase plans, (2) consumer loans and credit cards, and (3) motor finance (personal contract purchase, hire-purchase and conditional sale loans) and high cost credit and the FCA has sought to tailor the regulatory guidance to each sector. Additionally, as the COVID-19 crisis has developed, the FCA has launched further consultations and currently has revised and updated guidance in place for three product segments, taking the guidance through to 31 October 2020. The first phase of the guidance was designed as a reaction to the significant harm done by the COVID-19 crisis to the UK economy. It began with a one-size-fits-all approach affording 3 month payment deferrals to customers where requested, then progressed to a revised, more tailored cohort based approach to forbearance – and is now encouraging those who can pay to do so as the UK customer base is weaned off payment deferrals.

As noted above, the three product types have subtly different needs from a customer harm perspective: a further 3 month payment deferral at the beginning of a 25 year mortgage has a very different cost to a customer compared to a further 3-month payment deferral under a high-cost short term loan. As a result, guidance for products with higher interest rates has tended to suggest that affordability for the customer is more of a concern in granting further payment deferrals.

The Guidance

The FCA's guidance across the three product groupings set out above has been comprehensive and has been put into place in consultation with market participants. Broadly, the forbearance regime set out by the FCA has included the following:

- The overarching principle is that the FCA is asking that firms deliver certain broad outcomes, including provision of appropriate forbearance measures (and application of appropriate resources to do so), recognising vulnerable customers, and referring customers to appropriate debt advice as needed.
- Forbearance in the form of a 3 month payment deferral, which may be requested by a customer until 31 October 2020. Customers who have already been granted a 3 month deferral may, before 31 October, request a further 3 month payment deferral.
- The first set of guidance effectively gave customers blanket access to payment deferrals irrespective of need.
- The second set of guidance was published over the course of May and June 2020. Under this second set, the firm is entitled to determine it is not in the customers' interests (acting reasonably) to grant or extend a payment deferral. Firms are entitled to take into account the longer-term effects of a payment deferral on the customer's situation.

- For those customers coming to the end of a payment deferral, firms must distinguish between those no longer experiencing payment difficulties and those who are. For those who are, firms should seek to implement either a further deferral of up to 3 months (on a full or partial basis) to reduce payments to a level the customer can afford. For those can afford to pay, the firm may lengthen the period of time to repay such that the customer keeps the same contractual payments (customers must be made aware of the consequences e.g. for auto loan products, insurance, annual compliance checks, etc. will be relevant).
- Customers should be contacted in good time before their forbearance comes to an end; this may be through a digital or scripted process. To ensure customers are offered quick support, firms can consider whether the offering of a payment deferral period is in customers' interests at a book or cohort level. Though some may choose to do so, there is no expectation under the guidance that the firm makes enquiries with each customer to determine the circumstances surrounding a request for a payment deferral, or whether this is not in the customer's interests. This represents a change from the draft guidance, which proposed to set out an expectation that customers should be contacted individually. With lenders often having millions of customers, many market participants felt this was unworkable and made representations to the FCA accordingly. However, it should be noted that the FCA has flagged that a single solution for all customers is unlikely to be in the best interests of customers under TCF Principle 6.
- Repossessions of cars or goods are not permitted until 31 October 2020 where the customer is still facing temporary payment difficulties as a result of coronavirus and where they need their vehicles or goods for a particular purpose. No repossessions under mortgages are permitted until 31 October 2020.
- If a firm determines that a customer is no longer in financial difficulty, but the customer then says they are, the firm should reassess the situation and provide forbearance where appropriate. Where customers are still in financial difficulty at the end of the first or subsequent deferral, firms are expected to waive accrued interest, but are not expected to if the customer is no longer in financial difficulty.
- If a customer is treated as being able to pay and misses a payment, the firm must use reasonable efforts to contact the customer. If the customer fails to respond then the firm may treat the customer as being in arrears and proceed in accordance with the general CONC and MCOB principles.
- The FCA has flagged that it expects firms to be training staff, monitoring outcomes against TCF principles and have processes designed to comply with the principles.
- A key pillar in the FCA's guidance to date has been that customers should not have their credit record affected as a result of accessing COVID-19 related forbearance. This has been a change in process for many lenders who had historically reported forbearance to the credit rating agencies in the same way as arrears. However, although

this may come across as a reprieve for affected customers, the FCA has also flagged as a reminder that a customer's credit score is not the only means by which a lender can assess an application for credit (e.g. lenders may use bank statements that show no payments).

Certain product specific guidance has also been provided, including but not limited to:

- For credit cards only, where interests rates on products are high, firms should consider whether continuing to accrue interest is in the customers best interest.
- In relation to motor finance, guaranteed minimum future value and residual value calculations should not be amended in a way that takes advantage of the customers position and should not lead to unfair outcomes.

As this guidance is implemented and customers in need of temporary forbearance receive it, the FCA is looking to the next steps and the transition away from the COVID-19 forbearance regime. It has published transitional guidance for mortgages and home purchase plans and is expected to consult on the remainder of the product groups. The broad direction of travel from the FCA is that those customers who can resume payment should, and should pay as much as they can reasonably be expected to. For customers who continue to need forbearance into the longer term, the expectation is that they are treated according to their individual circumstances and the existing frameworks and processes will apply, including payment plans, repossessions and defaults where appropriate.

Complaints

In response to the FCA's guidance, the Financial Ombudsmen Service, which is tasked with resolving complaints in relation to the products discussed above, has released its own guidance on how it intends to assess complaints relating to the range of targeted temporary measures introduced by the FCA. Although its guidance is detailed, the running theme is that it expects firms to be able to demonstrate that they treated consumers in financial difficulty positively and sympathetically, fairly and with forbearance. In particular, firms should listen to consumers and proactively look for signs of financial difficulties. In this respect, the Financial Ombudsmen Service notes that consumers may not always know the best way to express their concerns - a reminder to firms to consider this. Finally, if a consumer is facing financial difficulty, the Financial Ombudsmen Service expects firms to consider forbearance measures such as token repayment plans, freezing interest and charges, reasonable arrears rescheduling and debt write-off where appropriate. This last aspect is perhaps the most interesting as it can be interpreted in a wider fashion than the underlying FCA guidance and perhaps suggests that the Financial Ombudsmen will take a more consumer-oriented approach when assessing which of the options available to lenders they should be selecting.

Credit impairments

On a prudential level, the EBA and the UK Prudential Regulation Authority have both confirmed that the effect that such payment deferrals should not be treated as creating a significant increase in credit risk because they were not based on the specific financial situation of the particular customer. One of the

Access to funding

Many consumer lenders have long accessed the securitisation markets as a means of funding, however central bank liquidity schemes, such as those offered by the Bank of England have long been important sources of alternative funding. At the height of the COVID-19 crisis, the public securitisation markets temporarily stalled and the Bank of England created the Term Funding Scheme with additional incentives for SMEs (small and medium-sized enterprises) (the "**TFSME**"). As a result of the COVID-19 crisis many consumer lenders faced a drop off in collections as a result of customer delinquencies combined with a lack of wholesale funding through the securitisation markets. While banks and building societies were generally able to access central bank liquidity from the Bank of England, that was not the case for non-bank financial institutions. This put the spotlight in a shortcoming in the support for all lenders to the real economy and a disparity in the treatment between banks and building societies on the one hand, and non-bank financial institutions on the other hand. While the merits of which institutions to support in a time of crisis can be debated at length, it is worth bearing in mind that non-bank financial institutions are now often the sole suppliers of credit products in certain markets that the large UK retail banks have retreated from since the 2008 financial crisis. These non-bank financial institutions are regulated at a product level in the same way as banks and building societies and their customers can be more vulnerable and more reliant on credit: supporting such institutions therefore supports those customers that they serve.

key drivers behind these statements was the motivation to keep firms lending at a time when credit is needed to create economic growth, rather than firms withdrawing from credit markets for prudential reasons. However, with the end of widespread deferral measures and the move to tailored forbearance arrangements would suggest significant increase in credit risk and the exposure level and accordingly banks should adjust their records and prudential treatment accordingly at that time by taking appropriate credit impairments and by implication appropriate capital charges.

The effect on securitisation

Data, data, data. Traditionally both private and public securitisation transactions had provided data on delinquency alongside defaults, but have made no distinction related to the causes of delinquency. As a result, in most cases delinquency due to non-payment (arrears) and the limited instances of forbearance granted under the MCOB and CONC regimes have not historically been distinguished. Historically, no data has been shown on the ageing of customer forbearance either. Before the COVID-19 crisis, defaults and delinquencies may have been sufficiently low that investors did not need to distinguish between the different types of delinquency. But with delinquency rates experienced on deals now often topping 20%, the investor community has sought more data to understand the forbearance picture in more detail. In particular, volumes of FCA forbearance have started to be reported, split out so as to provide month-by-month ageing of forbearance alongside the number of defaulted loans, value of defaulted loans and any repurchases. To assist with the development of market consistency in reporting AFME published best practice on data reporting in July 2020.

Many securitisation transactions, both public and private, have traditionally included triggers in the documentation for delinquency and default rates. The COVID-19 crisis has brought a significant amount of focus on the definitions of "delinquent". Most definitions regard a receivable as delinquent if one or more payments have been missed when due, and forbearance levels have historically tended to be low. However with the recent spike in delinquencies, many market participants have begun to examine this is more detail. Forbearance involves either the lender unilaterally waiving the requirement for a customer to make a payment or entering into a modifying agreement with the customer such that the payments under the credit agreement are amended. In either case, the payment is no longer due and therefore it cannot be said to have been missed when due. As a result, many transactions which would have breached delinquency triggers if forbearance had counted as delinquency under the documents have not. By contrast, many private transactions have triggers that treat forbearance as arrears or delinquency. Accordingly, these triggers have sometimes been breached resulting in discussions with lenders.

Next steps and the exit plan

Although the revised FCA guidance has been in place across the various product categorisations since the summer and firms are seeing strong increases in origination and falling delinquencies, the picture is still moving.

The FCA has published revised proposals for mortgages and home purchase plans setting out the transition away from the temporary guidance to the ordinary interpretation of existing principles (although the focus remains on ensuring adequate support is afforded to customers who remain in difficulty or who are experiencing higher levels of indebtedness following payment deferral schemes), industry groups such as AFME have published guidance on data for market participants in the securitisation space and structurers are busy re-evaluating liquidity and credit support features in securitisations to ensure they are fit for purpose.

On the financing side, the sense is that the industry is ensuring that if a second wave, or second virus, materialises, the lessons learned from the present COVID-19 crisis will have been learned and changes in place to ensure financings of consumer assets are robust to the prevailing macro-economic headwinds.

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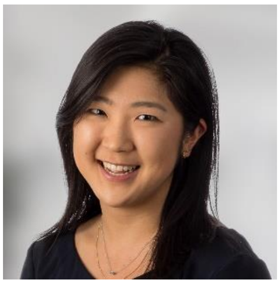

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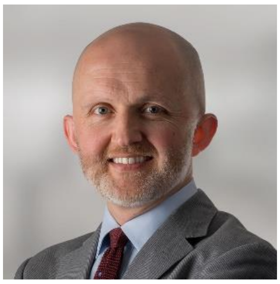

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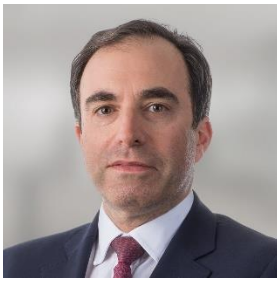

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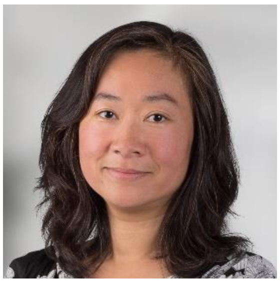

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