

Research: report

Uncharted territory?

Managing mortgage arrears and possessions



Shelter

Foreword



We are all aware of the impact that the recession is having on homeowners. The soaring levels of mortgage arrears and possessions have been well documented by the media, putting the struggle to maintain home ownership at the heart of the public perception of the current economic crisis. Shelter sees at first hand, the individual trauma that affects every household in arrears or facing repossession. We have seen a significant increase in the numbers of homeowners coming to us for help.

There is an immediate need to help those households currently in crisis, but there are also bigger issues that need addressing. Arrears and possessions have received much attention since the credit crunch hit in 2007, but the level of mortgage arrears had started rising before then, in 2004, a symptom of more systemic problems in the housing market. Evidence suggests that most lenders are now operating more generous forbearance policies, but there is concern that they will revert to their more bullish approach when the market picks up. While attending to the current crisis, we must also do more to tackle longer-term issues and to establish a more sustainable housing market in the future.

This research takes a step back from the immediate situation to look at the measures that have been put in place to mitigate the effects of the economic downturn on vulnerable homeowners. Critically, it provides a timely reminder of how far we still have to go to establish a genuinely sustainable approach to responsible lending, regulation, and mortgage safety nets.

This report articulates the clear need for further action; this is no time for complacency. We urge all players – the Government, lenders, regulators and advice agencies – to work together to ensure that we meet the needs of all homeowners who are facing difficulties with their mortgage, now and in the coming months, and that we put in place appropriate safeguards to protect homeowners in the future.

A handwritten signature in black ink, which appears to read 'Sam Younger'. The signature is stylized and cursive.

Sam Younger
Chief Executive, Shelter

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Although the research was commissioned by Shelter, the views expressed in the report are those of the researchers.

Please note that all the names in the case studies have been changed.

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Key findings

Rising arrears and possessions

- Mortgage arrears have been rising since 2004. Lenders report that the rate of increase in arrears is slowing, but because borrowers are taking longer to pay off their arrears, the number of households in arrears is still increasing. The recent financial turmoil and its impact on the housing market, in particular the fall in house prices and transactions, along with the lack of available credit, are making the management of arrears more complex and increasing the likelihood of losses for lenders and borrowers.
- Most lenders and many borrowers entered the downturn more exposed to risk than previously. There are now more mortgagor households on low incomes or in insecure employment; the use of tailored financial products aimed at marginal borrowers is more widespread; and there is limited public or private safety-net support. There has been an increase in mortgages with high loan-to-value ratios or loan-to-income multiples. Lenders who had been more risk averse before the downturn have seen correspondingly lower levels of arrears.
- Commercial considerations are driving a cultural shift in lenders' management of mortgage arrears, prompting a move away from a 'pay or possess' approach to a more consumer-focused approach employing processes of 'managed forbearance'. The change is not universal, however; practice varies within and between lenders, so some borrowers remain unsupported if arrears arise.
- Lenders have been making earlier contact with borrowers in arrears and have improved the nature and flexibility of their forbearance arrangements – to varying degrees. The starting point is generally an expectation of regular monthly payments plus a contribution towards the arrears, but other options include payment holidays, extending the duration of the mortgage, and reductions to monthly payments. More innovative approaches include the waiver of early redemption fees to facilitate cheaper loans, direct access to advice services, assisted voluntary sales, and pro-active credit risk assessment of borrowers not in arrears.

Rethinking the management of arrears

- Mortgage lenders are currently offering greater forbearance to households in arrears. Their policy and practices have changed considerably in this respect since the 1990s. These changes were informed by statutory regulation (requiring lenders to treat borrowers fairly), but also by market conditions that would currently lead to significant losses for lenders on many possessed properties. It is uncertain whether current regulation will be adequate to prevent lenders from reverting to their former, less favourable practices, when market conditions improve.
- In general, borrowers had tried to resolve their arrears without seeking professional advice, believing that they would be able to conduct negotiations with lenders themselves. Most borrowers sought advice late in the arrears process, often in relation to court hearings or even after possession orders have been obtained.
- Borrowers welcomed earlier contact with lenders to address arrears, but suggested that some lenders needed to listen more, be more willing to negotiate, have better trained staff, and improve their records to avoid borrowers being asked to repeat their story on every contact.
- Self-employed borrowers experienced difficulties claiming Support for Mortgage Interest (SMI). They sometimes found that the advice available was not tailored to assist them and that lenders did not appreciate their specific circumstances.

The borrowers' perspective

Preventing possessions

- The Government has sought to mitigate the adverse impacts of increasing levels of mortgage arrears through a package of measures. It has introduced a pre-action protocol in relation to possession claims by mortgage lenders, a Homeowners Mortgage Support (HMS) scheme, a Mortgage Rescue Scheme (MRS), and modified Support for Mortgage Interest (SMI), with the aim of ensuring that possession is the last resort when arrears arise.
- The Government estimates that a total of 58,000 households may be assisted by HMS, MRS and SMI, a figure considered unlikely by lenders. Some lenders argued that they already offered measures comparable to HMS, but others noted that the measures would add to the range of 'tools' available to support borrowers. All lenders welcomed the changes to SMI.
- HMS was launched in late April 2009 and as yet few borrowers have heard of the scheme. There was limited interest in MRS, which was rolled out nationwide in January 2009. Borrowers who realised their mortgage was unsustainable were more interested in the scheme, but had experienced difficulty in obtaining information about it.
- Advice services are now recognised as a crucial contributor to the management of arrears and additional government funding has been made available to them. Some lenders and borrowers had concerns about the access to, and the quality of, the advice available, especially where complex debt management advice was required.

Uncharted territory

- There are various medium-term issues to consider in relation to the current level of forbearance offered by lenders and the Government's initiatives. Lenders may not maintain their more favourable forbearance arrangements when the market improves, which could result in a surge in possessions. The time-limited nature of some of the Government's rescue schemes means they may also merely be delaying possessions rather than preventing them. There is a need to develop and assess options for a comprehensive safety net to allow borrowers to remain as homeowners when they experience a temporary loss of income.
- The substantial reductions in bank base rates have played a major part in preventing possessions to date. A return to rising interest rates in the future may therefore lead to an increase in arrears.

Introduction

This chapter sets the context for the research, and indicates the ways in which home ownership has changed since the early 1990s. It notes the increase in arrears and possessions since 2004 and the associated social and economic consequences. It also outlines the research questions and the methodology.

The mortgage market has changed since the last housing market downturn in the late 1990s. One million additional households have taken out mortgage loans, the market has become more competitive for lenders, and a series of tailored financial products have been introduced to help increasingly marginal borrowers to access home ownership or to serve other specialist markets such as buy to let.

The housing market was buoyant for much of the last decade. Employment levels have been high and interest rates low, which, along with rising house prices, led to a sense of security among borrowers, lenders and the Government and to a view that the housing market as it was developing was demonstrably sustainable. However, there is longstanding commentary to the contrary, suggesting that this sense of security was false and that in reality the housing market was unsustainable and characterised by significant risks. Key issues raised included worsening affordability¹; the inadequate supply of housing²; the reduction in the state safety net³; the impact of less secure employment on sustaining mortgage commitments⁴; and the potential impact of the sub-prime sector.⁵ The contributors to an inquiry by the Joseph Rowntree Foundation

(JRF) into the risks to home ownership up to 2010 confirmed these risks.⁶ The turmoil in the financial markets since 2007, which continues to have serious repercussions for the mortgage and housing markets, reinforces the concerns about the sustainability of home ownership.

After the housing market downturn of the 1990s (when the number of loans in arrears of three or more months peaked at 627,000 in 1992 and possessions peaked in 1991 at 75,540)⁷, arrears and possessions gradually reduced.⁸ By 2004, there were only 101,400 households in arrears of three or more months and there were only 8,200 possessions that year.⁹ However, towards the end of 2004 arrears started slowly to rise again, initially as a response to increased interest rates in the context of high levels of debt among borrowers. By the end of 2007, 129,800 loans were three or more months in arrears and 27,100 properties had been taken into possession that year.¹⁰ These figures rose significantly over 2008: by the end of the year, arrears had reached 219,000 and 40,000 properties had been possessed.¹¹ The impacts of the credit crunch and financial turmoil – such as the lack of credit for refinancing – had reached lenders and borrowers, contributing to the levels

1 Wilcox, S, *Can work, can't buy*, Joseph Rowntree Foundation (JRF), 2003.

2 Barker, K, *Review of housing supply – Delivering stability: Securing our future housing needs – Final report*, HM Treasury, 2004.

3 Kempson, E, Ford, J, and Quilgars, D, *Unsafe safety nets*, Centre for Housing Policy, 1999.

4 Ford, J, Burrows, R, and Nettleton, S, *Home ownership in a risk society: A social analysis of mortgage arrears and possessions*, Policy Press, 2001.

5 Munro, M et al, *Lending to higher risk borrowers: Sub-prime credit and sustainable home ownership*, JRF, 2005.

6 Wilcox, S, *Home-ownership risks and sustainability in the medium term*, JRF, 2005.

7 Wilcox, S, *UK housing review 2008/09*, Chartered Institute of Housing (CIH), 2008.

8 Mortgage arrears can be measured in several different ways, for example by the number of missed monthly payments or as a percentage of the mortgage balance. This report uses the number of missed monthly payments. Figures for possessions include lenders taking possession of a property through the judicial process and properties voluntarily surrendered by borrowers. See Council of Mortgage Lenders (CML) and Financial Services Authority (FSA) notes on the measurement of mortgage arrears for further information: <http://tinyurl.com/cmlnote> and <http://tinyurl.com/fsanote>

9 Wilcox, S, *UK housing review 2008/09*, CIH, 2008.

10 Ibid.

11 CML statistics: www.cml.org.uk/cml/statistics

of arrears and possessions. However, as this report will show, the current economic situation has also influenced the ways in which lenders and borrowers can manage arrears and mitigate possession, with many contradictory processes at work. The industry estimates that arrears and possessions will continue to rise into 2010.

Research undertaken during the previous housing market recession identified the very detrimental social and economic consequences of arrears and possessions.¹² For borrowers these included:

- the risk of homelessness and family disruption
- the loss of the home as a major factor in a fall into poverty
- the stress of experiencing arrears and possession as a contributor to relationship breakdown, mental and physical health problems, and unemployment
- educational disadvantage and social exclusion and isolation among children whose homes had been possessed causing them to move to a new home and area.

Lenders incurred significant financial losses and the possession of houses contributed to the overall fall in house prices at that time. At the wider level, the last recession made it abundantly clear that changes in the housing market amplified changes in the wider economy, both on the downturn and the upturn.¹³

As the current housing market recession has deepened, there has been a concerted attempt to mitigate the detrimental consequences outlined above. The Government has implemented a series of initiatives designed to reduce possessions and since 2004, lenders have been governed by statutory regulation that requires them to treat borrowers fairly. It is also in lenders' interests to help borrowers manage arrears and avoid possessions that could lead to losses in the current falling market. However, borrowers and lenders face significant constraints on their management of arrears, including the lack of credit, the presence of multiple creditors, and falling house prices. As a result of all these factors, lenders and borrowers are trying to manage their arrears in a frequently changing context.

Research questions

Despite all this activity, there is no clear overview about how arrears and possessions are at present being experienced and managed by borrowers and lenders. This lack of a systematic evidence base hampers understanding of the likely impact of the current initiatives and discussion about what else might be done, both in the short and longer term, to ensure home ownership is sustainable. The research informing this report aimed to fill this gap.

The report presents a range of evidence in relation to four main areas:

- What are the key drivers of the current rise in arrears and possessions? How do the various drivers interact and with what impact?
- What strategies do lenders have for managing arrears and possessions? What is shaping these strategies and what are their likely short- and medium-term consequences?
- How are borrowers managing their arrears? What key constraints do they face, how do they interact with lenders and with what consequences?
- What policy initiatives have been taken? Who is likely to benefit and with what potential impact? Do gaps remain that further policy initiatives should and could fill?

Methodology

A range of methods and data sources were used in this research.

Interviews with lenders

Interviews were undertaken with 10 mortgage lenders between February and April 2009. They included four of the largest national lenders with significant prime lending, but different degrees of other specialist products; two regional lenders; a major sub-prime lender and three smaller lenders specialising in sub-prime and/or buy-to let mortgages; and one company specialising in arrears recovery for a range of lenders. The sample included independent lenders and those in which the Government has an equity share.

12 Ford, J, Burrows, R, and Nettleton, S, *Home ownership in a risk society: A social analysis of mortgage arrears and possessions*, Policy Press, 2001; Wilcox, S, and Burrows, R, *Half the poor: Homeowners with low incomes*, CML, 2001; Stephens, M, 'Institutional responses to the housing market recession', *Urban Studies*, Vol. 33, No. 2, pp.337–351, 1996.

13 Maclennan, D, Meen, G, Gibb, K, and Stephens, M, *Fixed commitments, uncertain incomes: Sustainable owner-occupation and the economy*, JRF, 1997.

Interviews with key players

Interviews were held with seven key players: four from the mortgage and finance industry, one from a regulatory agency, and two from the advice sector. Interviews were conducted between February and April 2009.

Interviews with borrowers in arrears

Telephone interviews were held with 17 borrowers: nine with loans from sub-prime lenders and eight with loans from prime or near-prime lenders but sometimes with riskier, niche products. Borrowers were accessed via a national survey of sub-prime borrowers and through two lenders using an 'opt-in' procedure. Interviews were conducted between March and June 2009.

Analysis of advice service case files

Information was drawn from 90 cases files from Shelter's advice services, providing information on borrowers at different stages of arrears who had recently sought advice. Cases that concerned clients with mortgage arrears, mortgage possession and priority debt problems, who had approached Shelter between September 2008 and February 2009, were selected for review.

A note about the sample

The information from borrowers and lenders is not drawn from a representative sample and the findings cannot be generalised in any statistical sense. With respect to borrowers, it should be noted that those who seek advice are likely to be in more extreme circumstances.

These caveats are important, but the lenders we interviewed do represent 80 per cent of the full range of the market and the pool of borrowers covers a wide spectrum of financial circumstances and socioeconomic situations, loans from a wide range of lenders, and a variety of forbearance arrangements. Therefore we have some confidence that the findings from the study provide a valid guide to the variety and complexity of the current management of arrears and possessions. We have also referred extensively to other studies and statistical sources to provide a context and/or support for the findings of this study.

Rising arrears and possessions

The growth in arrears and possessions from 2004 onwards has been driven by both structural and cyclical factors. Some of these factors have had a slow, steady impact, such as rising interest rates, and others have been more immediate shocks, such as the loss of credit availability for refinancing in 2007 and the rise in unemployment. This chapter discusses these drivers and the interaction between them.

Lenders and key players interviewed as part of the research (see Methodology on page 9) offered various explanations for the growth in arrears and possessions, and highlighted the key factors that were involved. We explore these here. The drivers behind arrears have a considerable impact on the ways in which lenders and borrowers can manage arrears. This is discussed in the following two chapters of the report (see pages 16 and 25 respectively).

Three phases of arrears

The growth in arrears since 2004 falls into three distinct phases, identifiable in terms of the changing factors driving arrears over time.

The growth of over-indebtedness

Lenders and key players shared a view that the rise in arrears in 2004 was driven by consumer credit expansion, in association with rising costs (including interest rates). This led to over-indebtedness. Lenders noted that, in addition to a mortgage, borrowers often had further second charge secured debts and several unsecured debts. One respondent described borrowers at that time as coming out of 'credit heaven'; while another noted that any stigma that used to be attached to being in debt had now disappeared. For borrowers who were heavily indebted, payment problems often emerged when interest rates began to rise. Although borrowers may no longer be taking on additional debt, their over-indebtedness continues to contribute to arrears and possessions today.¹⁴

The withdrawal of credit

Lenders noted that by mid-2007, another factor had entered the picture: the paucity of credit following the sub-prime crisis in the United States (US) was also driving arrears. It is estimated that the UK mortgage market will contract to only £145 billion in mortgage loans during 2009, compared to £360 billion in 2007.¹⁵ Borrowers facing payment problems were denied the option to refinance their way out of their difficulties and consolidate their debts. One lender reflected the comments of many by noting that whereas previously borrowers had moved between lenders, particularly those who were risky and perhaps 'scruffy payers', now the problem remained with the original lender.

The lack of credit availability was also a problem for borrowers coming to the end of fixed-term arrangements and looking to remortgage with another lender. The lack of credit now precluded this and the only option for many borrowers was to remain with their existing lender. Their situation was made worse by the upward progression of interest rates through 2007 and much of 2008 causing the variable interest rates offered by lenders to rise. The resulting hike in borrowers' payments had become a trigger for payment problems in a number of cases.

Rising unemployment

By mid-2008, interest rates were falling, but unemployment was rising, and an increasing number of people were experiencing reduced working hours and pay, as the wider economy felt the impact of the banking collapse and the credit crunch. Lenders reported that these wider economic factors were increasingly driving new cases of arrears.

¹⁴ Bank of England, 'The financial position of British households: Evidence from the 2008 NMG survey', *Quarterly Bulletin*, Q4, pp.384–392, 2008.

¹⁵ CML [online], Press release: 'April gross mortgage lending', 21 May 2009: <http://tinyurl.com/cmlpressrelease>

The majority of lenders interviewed reported that arrears among their clients were still rising, but that the rate of increase was generally slowing. Few expected to see any significant downturn in arrears until 2010. One lender summed up these changes by saying that it was a shift from arrears being '[un]affordability led to unemployment led'. One major lender noted that although the number of new cases of arrears was no longer growing, cases already in arrears were not 'curing', or recovering, so the overall pool of arrears was continuing to accumulate.

The impact of the mortgage market on arrears and possessions

In the context of the largely external drivers of arrears discussed above, lenders and key players identified a range of contributing factors that stemmed directly from the structures, processes and practices within the mortgage market. Over the last decade, these have been increasingly shaped by the sector's growing appetite for risk and the predominant belief that house prices would continue to increase. Against this background, the highly competitive and lightly regulated¹⁶ UK mortgage market interacted with individuals' predisposition to own their homes and government policy to extend home ownership, offering specialist products, lending to more marginal borrowers, and extending lending at higher multiples of income and value. All of these factors increased the risk of borrowers defaulting on their loans.

Although these drivers affected all lenders, they did so to varying degrees, with the result that lenders have experienced different absolute levels of arrears and rates of growth in arrears. Lenders and key players indicated that a major factor accounting for this differentiation in the incidence of arrears and possessions was the positioning of lenders in the mortgage market, in particular:

- the extent to which lenders had relaxed their lending criteria
- the extent to which they offered 'niche' products and lent to marginal borrowers

- the balance of variable and fixed-rate loans among their products
- the proportion of recent borrowers within their portfolio of loans.

Thus there is clear evidence that, in addition to the external drivers highlighted, factors directly related to the structures, processes and practices within the mortgage market play a central role in driving the growth in arrears. We look at some of the main factors in this cocktail in more detail below, as well as the interaction between the drivers and the impact this has on a borrower's predisposition to arrears.

Changing lending practices

Between 2003 and 2007, many lenders increased the amount that they would lend against a property and/or in relation to a borrower's income. Loan-to-value ratios of 90 per cent or more peaked in 2007, accounting for up to 15 per cent of new loans.¹⁷ The even riskier combination of high loan-to-value ratios and high income multiples accounted for nine per cent of new lending in 2007. Some lenders offered innovative products such as a 100 per cent mortgage and a further unsecured loan for up to 25 per cent of the value of the property, or loans where the borrower self-certified their income. These arrangements increase the risk of default if borrowers experience a loss of income and limit the potential for recovering the arrears should house prices fall. In the current economic climate, the combination of these two events is a common occurrence.

Until the downturn, many lenders had also been offering attractive remortgaging deals (often including equity withdrawal). As a result, some lenders saw the profile of their borrowers swing towards recent borrowers with little equity in their property. As house prices fell, the risk that borrowers and lenders would not be able to manage any default increased. One lender commented that the position in the US, where lenders had believed that it was not possible to lose money on mortgage lending, was replicated in many instances in the UK.

¹⁶ The regulation of mortgage lenders remained voluntary until 2004.

¹⁷ FSA, *FSA statistics on mortgage lending: August 2008 edition*, 2008.

Niche markets

The last five to 10 years have seen a range of specialist, niche products and markets characterised by riskier lending become established. These include self-certified mortgages and loans for borrowers who are defined as 'credit impaired' (typically by having a civil court judgment against them). The term 'sub-prime' is often used to refer to these markets collectively, but this is too simplistic, overlooking the fact that the mortgage market is in fact made up of a full spectrum of loans of varying degrees of risk. Increasingly, a further distinction is made between the sub-prime and near-prime markets. Another important niche market is buy-to-let borrowers, providing funding to borrowers for investment properties. We look at some of these markets in more detail below.

Sub-prime

The sub-prime sector peaked in mid-2007, at which time it provided more than seven per cent of mortgages.¹⁸ Fifty per cent of sub-prime lending was accounted for by remortgaging.

The sector drew in borrowers who could not meet the criteria of mainstream lenders because they had an impaired credit record or irregular income. It also played a role in enabling over-indebted borrowers (often with mainstream lenders), in or at risk of default, to remortgage and thereby consolidate their debts. As the extent of over-indebtedness grew, so too did the sub-prime sector.¹⁹

Although there were a number of sizable companies (for example, GE Money and Kensington) involved in sub-prime lending, some of which remain today, the market was dominated by small companies, with intermediaries (brokers and packagers) involved in almost all cases. Most sub-prime lending is securitised²⁰, which breaks the link between the original lender and borrower via a subsequent chain of 'owners' of the debt (because it was often repackaged several times via the 'new' financial instruments that were developed). This means that borrowers may not know to whom they owe their debt. Many sub-prime lenders were new entrants to the market, but a number of mainstream lenders also established or acquired organisations that allowed them to access the sub-prime market (for example, Halifax bought Birmingham Midshires as its near-prime/sub-prime arm) or bought bundles of loans originated by sub-prime lenders.

Sub-prime and near-prime mortgages are, by definition, riskier than prime mortgages. One respondent from the advice sector noted that up to one-third of the borrowers they advised could no longer sustain the loans on their homes and many had never been able to afford them. Another respondent concurred, noting that in the case of some sub-prime mortgages sold through brokers, borrowers had not even been able to make the first payment. The problems in the US sub-prime sector, relating in particular to the spread of risk as a result of securitisation, and the lack of wholesale market lending have led to a rapid reduction in the UK sub-prime sector. As noted previously, this has removed one of the recovery options available to over-indebted borrowers, leaving the problem with the mainstream lenders. Thus it is apparent that the structure and processes within the sub-prime sector globally have themselves contributed to the emergence of default.

Buy to let

In the UK, there were 1,156,000 buy-to-let loans at the end of 2008, accounting for 10 per cent of overall mortgage lending.²¹ These loans have enabled the private rented sector to grow and have also been portrayed as a form of investment that can help fund pensions. The question for the purposes of this research is whether buy-to-let lending can act as a driver of arrears.

The risks associated with the buy-to-let market are increasingly being acknowledged. Respondents in this study noted a number of risks predisposing arrears within this market:

- faced with income pressures, borrowers would give priority to their domestic residence
- fraudulent property valuations to obtain a loan in excess of the 'likely' market value of the property, thereby providing finance for other expenditure
- an unrealistic business plan underpinning the loan in terms of likely rental income and voids
- a 'knock-on' risk, whereby tenants become unable to meet the rent payments, which were in turn funding the landlord's mortgage payments.

18 Datamonitor, *UK subprime mortgages 2008*, 2008.

19 Munro, M, et al, *Lending to higher risk borrowers: Sub-prime credit and sustainable home ownership*, JRF, 2005.

20 Securitisation is the process whereby a number of mortgages are combined to make a financial product (security) that can be traded. Banks that buy these securities receive income when the original homebuyers make their mortgage payments.

21 CML [online], Press release: 'Buy-to-let lending in the fourth quarter 2008', 20 February 2009: <http://tinyurl.com/pressreleasefeb>

Statistics from the Council of Mortgage Lenders (CML) show a sharp increase in arrears among buy-to-let loans, from 7,500 loans (0.7 per cent of all buy-to-let loans) at the end of 2007, to 26,800 loans (more than two per cent) 12 months later.²² CML data also indicates that arrears on buy-to-let mortgages are at a higher level than on residential mortgages.²³

Second charge lending

The growth in second charge lending has already been noted. Second charge loans can relate to large consumer goods (for example, a car or home improvements), but until recently were also taken by borrowers to consolidate both unsecured and secured debts and sometimes arrears. Many second charge lenders have now left the market, reducing the availability of this option.

Second charge lending can also drive mortgage possession if such lenders choose to act quickly and independently of the first charge lender when arrears arise. Furthermore, second charge lenders are not subject to the same regulation as first charge lenders: they are not governed by the Mortgage Conduct of Business (MCOB). They are, however, regulated by the Consumer Credit Act and the Office of Fair Trading, and are bound by the Pre-action Protocol for Mortgage Possession Claims (see page 18).

There was little consensus among the key players and lenders interviewed about the extent to which mortgage possessions were being driven by second charge lenders. Interviewees from the advice sector noted that their own internal survey in 2008 had shown that while about half of all cases going to possession had second charge loans against them, in only around one in eight cases had the action been initiated by the second charge lender. This view was echoed by a representative of second charge

lenders who noted that in 2008 such lenders were only granted 1,500 possessions, compared to 40,000 first charge possessions in that year. However, representatives from the main mortgage industry claimed that the proportion of possessions initiated by second charge lenders was closer to 30 per cent of possessions, although they could not substantiate these suggestions. Where precise figures were reported by first charge lenders, these varied between 'two to three per cent' or 'five to seven per cent'.

An analysis of the case files of the 90 borrowers who had sought advice from Shelter about their mortgage arrears revealed that two-thirds of them had court cases pending or possession orders already granted against them by first charge lenders. In eight cases the possession action had been taken by a second charge lender, and in a further nine cases both the first and second charge lenders were taking action.

House prices

Falling house prices could also contribute towards arrears, depending on the extent to which borrowers respond to the value of their mortgage falling below the value of their property by ceasing to make mortgage payments. No concrete information exists on this; however, although lenders and advice sector respondents noted that the majority of cases they took possession action against or saw in their advice work were in negative equity, only one respondent explicitly stated that in some cases borrowers had made a positive decision not to pay. Many more respondents noted that they were experiencing a higher level of voluntary possessions than expected, which could potentially be seen as an expression of a decision to stop adhering to a repayment agreement.

22 These figures refer to the number of loans granted, not the number of properties (a single loan may cover a portfolio of properties). The statistics also only cover members of CML, rather than the whole market. The statistics may therefore understate the number of properties affected.

23 CML [online], Press release: 'Buy to let lending in the fourth quarter 2008', 20 February 2009: <http://tinyurl.com/pressreleasefeb> and 'Arrears and possessions in 2008', 20 February 2009: <http://tinyurl.com/pressreleasefeb2>

Changes to the safety net

A further potential contributor to the growth in arrears, which a number of lenders and key players cited, was the reduction in safety-net provision for borrowers. A number of independent studies have indicated how such cuts result in increased levels of arrears.²⁴ The private sector 'replacement' safety net – mortgage payment protection insurance – has experienced falling take up, in addition to the documented limitations of the protection it provides.²⁵

Only one respondent thought that the changes to safety-net provision had been a driver of arrears throughout the period since 2004. Most respondents disagreed, noting instead that in the early part of the period, the safety net was generally irrelevant because of low unemployment, which is one of the main risks covered by both the state safety net and private insurances. They noted that the reforms to SMI at the end of 2008 had mitigated some of the risks associated with the reduced safety-net support that would have materialised in 2009 as a result of growing unemployment (see page 32).

Conclusions

The range of factors driving the rise in arrears and possessions is wide and complex. Lenders and key players interviewed indicated that the mortgage market itself is implicated in the growth in arrears. Developments in the market contributed in terms of the introduction of new sectors and products and a relaxation in the terms and conditions of lending. These developments reflected an increasing appetite for risk among lenders, although in some cases neither lenders nor regulators had perceived the risks because of the false securities of house price inflation and risk-offsetting via innovative financial products. Arrears are lower among lenders that, for whatever reason, had made fewer relaxations in their lending criteria and had eschewed niche products.

Risk also emanated from outside the market. This began with the unsustainable growth of consumer credit, then the rise in interest rates and the cost of living generally, and finally the impact of the global financial crisis, which is currently feeding through to borrowers via effects on the labour market and the lack of credit. The impact of the latter on the mortgage market has also meant that borrowers who have become over-indebted no longer have the option of refinancing products to help them manage and consolidate their debt.

The complexity of the current mortgage market is likely to mean that the ability of both lenders and borrowers to manage the rise in arrears and possessions will vary. Some will be very tightly constrained in the actions they take, particularly where borrowers have little equity or ability to trade out and where both lenders and borrowers would face losses. In other cases borrowers may be longer standing and/or have greater equity and hence a wider range of options may be open to them and lenders.

24 Ford, J, Kempson, E and England, J, *Into work? The impact of housing costs and the benefit system on people's decisions to work*, JRF, 1996; Kempson, E, Ford, J, and Quilgars, D, *Unsafe safety nets*, Centre for Housing Policy, 1999.

25 Ford, J et al, *Homeowners risk and safety-nets: Mortgage Payment Protection Insurance (MPPI) and beyond*, Office of the Deputy Prime Minister (ODPM), 2004.

Rethinking the management of arrears

This chapter examines evidence from interviews with lenders about their current responses to arrears and possessions. It discusses the factors that influence lenders' ability and willingness to forbear and lenders' strategies towards arrears and possessions. Finally we consider the forbearance practices of the lenders who participated in the study.

Forbearance practices by mortgage lenders have changed over the past three decades. In the 1980s lenders had limited forbearance policies.²⁶ During the recession in the early 1990s, lenders started to implement changes to these policies and practices²⁷, but difficult market conditions and corporate inertia slowed the rate and extent of change. By the mid-1990s, more had been achieved and lenders' policies and practices typically emphasised contact with the borrower, earlier intervention, and stronger management and control of the situation. However, there was often a gap between policy and practice, as experienced by borrowers in arrears, and lenders' approaches to the management of arrears varied greatly.

Statutory regulation of the mortgage market (in the form of MCOB), introduced in 2004, requires that all borrowers are treated fairly across the lifetime of the mortgage, including those in arrears. The extent to which lenders have complied with regulation is unclear. A survey of lenders conducted in 2006 revealed that very few lenders thought that statutory regulation had made any difference to their arrears management practices.²⁸ In 2008 the Financial Services Authority (FSA) reported that non-compliance with the aspects of MCOB that relate to arrears recovery was commonplace.²⁹ The situation at the start of the current housing market recession was mixed. On the one hand, there was some good practice and innovative solutions among some lenders, but others still did not take into account borrowers' personal circumstances and used court action to trigger payment.

Influences on forbearance

The evidence from the interviews with lenders (see Methodology on page 9) indicates that lenders' responses to the rise in mortgage arrears are shaped by the rapidly deteriorating housing market, the characteristics of their mortgage book, regulation, and the Government's interventions. Overarching these factors are individual, political and corporate memories of the last housing market recession and the fallout from the current sub-prime mortgage crisis in the US. The confluence of these factors, illustrated in Figure 1 (opposite), has produced a change in the way lenders manage arrears, which has largely occurred within the last 12 months.

Housing and mortgage market influences

Falling house prices, falling transactions, the costs of possession and the extent of exposure to risk, are central factors influencing how lenders respond to arrears. Lenders reported that a large proportion of their mortgage accounts in arrears are currently secured upon properties that are in negative equity. As a result, as one lender reported, while a year ago it was typical for the sale of repossessed homes to generate surpluses, now possession sales often failed to cover loans secured on the property and the associated possession costs. Another lender provided more detail and Figure 2 (opposite) outlines their estimated costs of possession; these are incurred initially by the lender, but many are passed onto the borrower in due course.

Lenders with significant exposure to borrowers with above-average risks (because of high loan-to-value mortgages) and/or with significant loans in sectors

26 Doling, J, Karn, V, and Stafford, B, *Behind with the mortgage: lenders, borrowers and home loan debt, a consumer view*, National Consumer Council, 1984; Ford, J, *The indebted society*, Routledge, 1988.

27 Ford, J, Kempson, E, and Wilson, M, *Mortgage arrears and possessions; perspectives from borrowers, lenders and the courts*, Department of the Environment, 1995.

28 Stephens, M, and Quilgars, D, 'Managing arrears and possessions', *Housing Finance Online* (5), 2007.

29 FSA, *Mortgages effectiveness review: Stage 2 report*, 2008; Illuminas, *Mortgage effectiveness review: Arrears findings*, FSA, 2008.

Figure 1: Factors influencing lenders' arrears recovery practices



Source: Lender interviews

* Mortgage Insurance Guarantee was more widely used during the 1990s and indemnified lenders against losses as a consequence of possession.

experiencing above-average falls in prices (for example, the buy-to let sector in certain locations) face greater risks of losses than lenders with a more limited pattern of exposure. Possession action on these loans serves only to crystallise the steep falls in property prices into actual losses for the lenders. The pressure to modify forbearance arrangements to limit losses is correspondingly greater among lenders with the highest risks. One lender highlighted how the prospect of recording such losses in the year-end

accounts was an important prompt for them to stem possessions and suggested that had they not been faced with these losses they would have been under much less pressure to change.

The terms and conditions of securitised loans may also constrain the form of forbearance by permitting only a certain proportion of loans in arrears across the bundle of securitised loans, or by having to request consent from the holders of securitised contracts to make changes to current practices.

Figure 2: Estimated costs of mortgage possession

Litigation	£500–700
Eviction day costs (drain down heating system, lock changes etc)	£500–1,000
Estate agent fees	Two per cent of property value (£3,000 on £150,000 home)
Conveyancing	£400–500
House insurance	£200–300 depending on type/value of property
Maintenance (vandalism, making wind- and watertight)	Varies (assume £1,000)
Possible loss per home	£5,600–6,500

Source: Lender interview

Government and regulatory scrutiny

Another major factor that has influenced lenders' arrears management policies is closer regulatory scrutiny and government intervention. Lenders were reluctant to acknowledge that the actions of public bodies had directly prompted strategic reviews, but it was clear from the discussions that regulatory attention and the Government's focus on preventing possessions added to the climate in which the lenders felt compelled to review their policies.

The main regulatory tools are the general guidance issued by the FSA – the Mortgage Code of Business (MCOB) and Treating Customers Fairly (TCF) – and the Pre-Action Protocol for Possession Claims Based on Mortgage Arrears provided by the Civil Justice Council. The impact of MCOB has been discussed earlier, but the impact of the pre-action protocol is also important. The protocol was introduced into the county court system in England and Wales, as a permanent feature, in November 2008, earlier than originally planned.³⁰ Figure 3 provides an overview of its main provisions.

The protocol was not specifically related to the current concern around the housing market downturn and had been the subject of longstanding consultation. It forms part of the civil court's endeavour to make efficient use of court time and encourage alternative dispute resolution. However, the protocol formed part of the context in which lenders considered the pressures they faced during this market downturn and it is likely that the protocol has had more influence on lenders' actions than they care to admit. Some lenders readily discussed the protocol as a contributory factor to their strategic changes, while others reported that extensive analysis of their systems and processes was undertaken to ensure compliance. Many lenders were quick to suggest that their arrears management processes had required little revision as a direct result of the protocol, although among almost all the lenders rising arrears had already prompted strategic reviews.

Lenders held mixed views on the protocol. One lender commented that there might be a degree of 'over-compliance' with the protocol among lenders,

³⁰ A similar protocol is being considered in Northern Ireland and Scotland. Lenders operating across the UK are all required to comply with MCOB.

Figure 3: Provisions of the pre-action protocol

Aims
<ul style="list-style-type: none"> ▪ To ensure that the lender and borrower act fairly and reasonably with each other in resolving arrears. ▪ To encourage more pre-action contact between the lender and borrower in an effort to seek agreement to ensure court time is used effectively.
Scope
<ul style="list-style-type: none"> ▪ It applies to first charge mortgages, second charge mortgages and unregulated residential mortgages. It does not apply to buy-to-let mortgages.
Operation
<ul style="list-style-type: none"> ▪ Borrowers must be provided with an advice leaflet and clear information on arrears and whether charges have been incurred. ▪ Lenders must ensure that they have the full information on the borrower's financial circumstances and proposals for repaying arrears. ▪ Lenders have to consider any reasonable request from the borrower to change the date or method of payments and respond promptly to any offers of repayment. ▪ If agreement is not kept, lenders must give borrowers 15 days' written notice that they plan to start court action. ▪ Lenders must give reasons in writing within 10 days if they refuse an offer of repayment from the borrower. ▪ The court expects lenders to pursue alternative dispute resolution by considering extending the mortgage term, changing the type of mortgage, deferring interest due on payments, or capitalising the arrears.
Situations in which lenders may postpone possession action
<ul style="list-style-type: none"> ▪ Where there is a possibility of a claim for mortgage protection or other insurances. ▪ Where the borrower is taking reasonable steps to sell their home.
Sanctions under Civil Procedure Rules (from April 2009)
<ul style="list-style-type: none"> ▪ Costs may be awarded against lenders for non-compliance (although the application of this in court is unclear and subject to a decision by the Minister of State).

Source: Ministry of Justice, Pre-action Protocol for Possession Claims Based on Mortgage Arrears or Home Purchase Plan Arrears in Respect of Residential Property.

but another thought that the protocol and other regulation was good because it codified what was expected from them. One organisation suggested that lenders were now forced to re-emphasise forbearance tools that had always been available but not widely used for some time. There was also a degree of cynicism among lenders, but overall the evidence suggests that the protocol, coming as it did at a critical time in the market cycle, encouraged lenders to review their practices.

It was beyond the scope of the study to capture how the protocol had been received by the judiciary and how it is applied in individual court cases. Some lenders were taking a more cautious approach to litigation, putting more cases on hold, for example while possible employment or house sales came to fruition. Other lenders reported that the protocol had not led to any change to their practices in respect of the courts.

In conclusion, the downturn in the housing market, the degree to which a lender is exposed to risky loans, the costs of possession, regulatory change, and government scrutiny, have all shaped the changes to lenders' forbearance practices. These changes feed into lenders' strategic aims and shape the practices necessary to achieve these aims.

The strategic response

Lenders provided clear evidence that they had made or were in the process of confirming a strategic shift in their approaches to arrears recovery. The changes date from summer 2008 and are an ongoing process. The strategic aim is to limit possessions, and thereby losses, by providing:

- support for borrowers to 'rehabilitate' their accounts
- an opportunity for lenders to minimise arrears by modifying loans on terms that are more favourable over the long term
- a sound basis for possession in cases where the home is no longer sustainable.

This strategic shift from a 'pay or possess' approach to one more focussed on supporting arrears recovery through forbearance is rooted in the economics of the balance sheet. As reiterated by several interviewees, there is now a business case against possession. This strategic shift also represents a cultural change among lenders, in that it reflects a different approach and attitude to borrowers. This increased consumer focus is supported by regulations, in the form of MCOB and the pre-action protocol. A lender's priority is, and always has been, to have debts repaid, but repayment is now sought through changed structures and processes of collection. As one lender noted, 'Recovery practice [in the past] was largely calls, letters and litigation, but [we] can't [just] do that now.' Another noted that previously 'to forbear', in effect, meant doing nothing with the account, besides sending the automated letters to the borrower required by regulation and watching the arrears rise in an uncontrolled fashion.

The degree of change in this respect varies across and within lenders' organisations. There are a number of reasons behind this variety:

- some lenders' policy and practice in relation to arrears recovery were already close to the position that is now becoming more widespread, and/or they had lower levels of arrears on their books
- some lenders are making the changes to their arrears management more gradually, over a period of time
- new forbearance practices continue to be proposed and introduced
- it takes time for new practices to filter through to the 'front line', and some staff continue to operate in the traditional way.

The persistence of these changes once the current conditions of the housing market improve is an area for concern. Given the influence of the market in driving the changes, how willing will lenders be to continue with the current pattern of forbearance once the market recovers and potentially drives a different business case?

Forbearance in practice

New strategic objectives have required a new range of forbearance options and a different set of operating practices. Figure 4 illustrates the range of lenders' arrears recovery practices over the last year. These are then discussed in more detail.

The evidence suggests that lenders are continuing to develop new products and forbearance services. These services are being made available to greater numbers of borrowers in arrears, bringing these new practices from the 'margins to the mainstream'.

Figure 4: Arrears recovery practices adopted by lenders

Operational changes
<ul style="list-style-type: none">▪ Increase staff resources for arrears collection.▪ Additional training and staff given more discretion over arrears management.▪ Extend hours of contact centres into evenings and weekends.▪ Greater use of new technology with outbound calls from contact centres and text messaging.▪ Improve management of information in relation to arrears (eg to record details of changes in agreements with borrowers).▪ Revise bonuses to collections staff to reward customer focus.
Extending forbearance
<ul style="list-style-type: none">▪ Greater emphasis on early collections.▪ Development of forbearance toolkit.▪ Product and service innovation.
Avoiding possession
<ul style="list-style-type: none">▪ Additional resources at pre-litigation stage.▪ Extend period before litigation.

Source: Lender interviews

Operational changes

Over the last 12 months, lenders have increased the capacity of their arrears collection teams, responding to the already rising levels of arrears and in anticipation of further increases during 2009. Furthermore, the shift in emphasis towards customer-focused practices in the early stages of arrears means that even if arrears were to remain stable, collections would require extra resources. Many lenders, but not all who participated in this study, had expanded their collections teams substantially over the last 12 months, some even doubling or tripling the number of staff. The more customer-focused approach, the pre-action protocol and the Government's recent initiatives, have all come with increased requirements in terms of information management: for example, to record details of changes in agreements with borrowers, to provide the documentation for court applications, and to fulfil the data monitoring requirements associated with some of the Government's new schemes. These have meant alterations to IT systems and increased staff resources.

Frontline staff now often have greater discretion, although within tight boundaries, and are increasingly charged with working with borrowers to discuss refinance or forbearance methods appropriate to the borrowers' individual circumstances. One lender adjusted bonus systems for collection staff to incentivise greater customer focus and quality of service, allowing longer calls to borrowers, encouraging 'friendliness', and fact-finding about borrowers' circumstances. Another lender described changes to frontline services as moving towards a case management approach. Lenders have also extended their contact hours into evenings and weekends both to receive calls from borrowers and to make outbound calls to borrowers in arrears who have not yet made contact with the lender. A collector observed that once she had become used to the new system, it was much better and that she experienced fewer disagreements with borrowers. Her manager explained further:

‘Previously calls were to be as short as possible, arrangements were made but not based on much [information]. And if these arrangements broke down, cases were sent to litigation to deal with.’

Extending the forbearance toolkit

Lenders repeatedly reported that they were offering a growing range of forbearance options to borrowers who could not repay their arrears in full. One lender outlined the rationale:

‘It is preferable to have some servicing of the loan rather than nothing, and the psychological contract with the customer is improved if the lender has agreed to [...] something like reduced interest rates or payment holidays, where none existed in the contract. The borrower feels more committed to do something to maintain mortgage payments in return. Other approaches often attract negative reactions from borrowers who don’t pay. [They] go to possession or declare themselves bankrupt, which is no gain for the lender.’

As already noted, the development of forbearance options is ongoing. Figure 5 shows the range of tools now commonly used by lenders who participated in the study.

Figure 5: Forbearance toolkit

- Contractual monthly payments plus an amount towards the arrears.
- Payment holidays.
- Capitalising the arrears.
- Converting a capital and interest loan to an interest-only mortgage.
- Extending the period of the mortgage.
- Concessionary payments below the contractual amount for a limited time.

Source: Lender interviews

The tools outlined in Figure 5 are not necessarily applicable to all borrowers. These tools are most frequently employed in the early stages of arrears collection – staff will consider a hierarchy of options using guidelines or decision matrices that include factors such as:

- present and anticipated loan-to-value ratio
- length of time the borrower has had the loan
- years left on the mortgage
- anticipated duration of the borrower’s payment problems.

Ultimately, lenders are still concerned with achieving the earliest possible repayment of arrears alongside the contractual payment, but some will now consider payment holidays or agree more favourable interest rates as ways of achieving this. Such approaches would previously not have been allowed contractually or would have attracted early redemption charges.

Extending forbearance is not an easy or risk-free option for lenders or borrowers. In some instances, both borrowers and lenders could end up worse off if arrears are allowed to rise but ultimately forbearance fails and possession follows. Losses would be exacerbated if property values are falling. Some lenders used information systems, accessible from the desktop, that provided property valuations to support collectors in making forbearance decisions. One lender suggested that in the current market they were likely to err towards forbearance, especially if there was an indication that the borrower’s circumstances might change. However, the evidence from interviews with lenders, borrowers and advice workers, and the case files data indicated that it was also recognised that some loans were unsustainable.

Moving borrowers onto interest-only mortgages as a route out of payment problems is also problematic and some lenders have stopped offering this option routinely or only offer it for short periods. It is a regulatory requirement that lenders must inform borrowers of the consequences of a change to an interest-only mortgage to ensure a suitable repayment vehicle is in place (such as an endowment or an individual savings account). However, some lenders were concerned that many borrowers in financial difficulties would not have these instruments in place or be able to afford them, and could either suffer payment shocks when reverting to a capital and interest contract at a later date, or would be unable to repay the outstanding balance at the end of the mortgage term. One lender described it as a ‘dangerous long-term tactic’.

Litigation

Lenders reported that they were making greater efforts prior to litigation to resolve the problem with borrowers. A few lenders also reported that the pre-action protocol meant that they had more cases 'on hold' because it was not worth issuing court proceedings where, for example, they had agreed that borrowers could have additional time to sell or to start new employment.

In general, litigation now commences later than previously. Litigation used to commence after only two or three months of arrears, but lenders' policies may now specify litigation at four, five or six months and, furthermore, interviews with borrowers indicated that the period before litigation was often longer. One lender had made a formal announcement that they would not possess before six months of arrears, while another estimated that cases ending in possession typically took 15 months from the start of arrears to the home being possessed. Given that this was historical analysis, the period may even be longer now.

One lender noted that the decision to issue or adjourn proceedings was constrained by the long delays in the court system. In some places, court hearings could not be obtained earlier than four or five months in the future, and therefore delaying or cancelling court dates was a risk for the lender. This was particularly so where the case had been adjourned on the basis of a revised arrangement with the borrower: if this was subsequently broken, the court case could then take several months to reinstate.

Innovative approaches to recovery and forbearance

While the above options are increasingly standard among lenders, new approaches to arrears recovery continue to develop. Examples include:

- service-level agreements with a national advice service to provide direct advice to borrowers in arrears
- waiver of early redemption charges for borrowers on high fixed-rate loans
- pre-emptive credit risk assessment of borrowers not yet in arrears and selective approaches to borrowers deemed at risk (eg letters encouraging borrowers to overpay while interest rates are low)
- assisted voluntary sales.

Partnerships with advice services

Professional advice is playing an increasingly important role in forbearance. One key player noted that, while in the last recession advice services had been 'part of the problem' (seen as adversarial on behalf of borrowers), they were now regarded as 'part of the solution'. This shift reflects the overall strategic shift towards increased customer focus designed either to rehabilitate the situation or legitimate the decision to possess.

Example 1: Working with advice services

Two lenders participating in the study had made agreements with a national advice service to support borrowers in mortgage arrears who have multiple debts and need comprehensive advice. Lenders have negotiated direct access to advisers and collection staff can transfer the calls of borrowers who agree to use the service directly to an adviser. Borrowers can decline the service, and some do, but those borrowers who are transferred benefit because the lenders automatically accept the advice service's assessments of the borrower's ability to repay the loan. The advisers can also agree repayment plans over longer periods than commonly available via the in-house collections staff. Lenders reported benefits too, in that advisers' income and expenditure appraisals were more comprehensive and accurate because borrowers often have a better relationship with the advice service than with their lender. Overall, lenders perceived that agreements made through advice services were more realistic and sustainable.

New lower interest rate products

Some borrowers in arrears are on fixed-rate mortgages and so have not benefited from the recent fall in interest rates. Several lenders reported that they will now waive penalty or early redemption charges to allow borrowers to transfer to deals with more favourable interest rates, in preference to pursuing possession and incurring a loss.

Pre-emptive risk assessments

A small number of lender respondents are using internal or external data to identify borrowers potentially at risk of developing arrears. This assessment is made on the basis of whether borrowers have missed payments or are not paying direct debits on other credit or banking accounts, or by reviewing information about borrowers' circumstances, their property and type of loan. These initiatives are more effective where borrowers

have both mortgage loans and banking facilities with one lender. Approaches to these potentially 'at risk' borrowers were made in a number of ways. For example, lenders had offered 'recession planning' advice, sent letters asking borrowers to use the opportunity of interest rate reductions to overpay their accounts, or sent simple letters about options available and how the lender can help in cases of payment hardship.

Example 2: Pre-empting arrears

One lender sent letters offering advice and support to 12,000 borrowers whose risk profile was high and compared the outcomes of this group to a control group of 1,000 borrowers with the same risk profile who did not receive the letters. The lender reported that accounts of the borrowers who received the letter performed seven per cent better over their assessment period than the control group, suggesting that the letter had assisted in preventing around 800 borrowers from developing mortgage arrears. Another organisation is planning to provide a service that combines a risk assessment of borrowers with a tie-in to a national advice agency to provide a preventative approach to borrowers with multiple debts, including the prioritisation of debts.

Assisted voluntary sales

It was widely recognised by lenders and advice service respondents that some loans were unsustainable and that in such cases the property would have to be possessed. In these circumstances, there are benefits if the borrower can sell the property themselves because possessed properties do not always achieve the same values as properties sold privately. Several lenders mentioned extending the time available for borrowers to sell the home before seeking possession, in line with the protocol.

Example 3: Assisting with property sales

One lender was offering to pay the Home Information Pack (HIP) fee required to market the property, as well as the legal costs associated with the sale. The lender also provides an estimate of the likely residual loan repayment so that the borrower knows in advance what their financial situation will be after the property has been sold. This provides a more structured exit from home ownership, benefitting both the lender and the borrower by increasing the chances of achieving the best price for the property and reducing any residual loans.

Forbearance on buy-to-let mortgages

All the lenders in the study had some experience of buy-to-let mortgages and for a minority, buy-to-let was their main market. Arrears recovery in this sector was largely approached in the same way as in the residential sector, despite buy-to-let loans not being subject to FSA regulation. However, a number of differences do occur in the detail of the risk and recovery processes.

Forbearance

Lenders reported that they sought to establish early and regular contact with buy-to-let borrowers because there were concerns that these borrowers were likely to give priority to any residential mortgage they had over their investment (buy-to-let) mortgage. Some lenders had experience of such borrowers 'disappearing'. Some forms of forbearance were also precluded; for example, most buy-to-let loans are interest-only mortgages from the outset, so reducing the borrower's costs by changing the type of mortgage was not possible. One lender noted that they had greater flexibility to renegotiate high interest rates on buy-to-let loans because the losses are potentially greater in this sector.

Position of tenants

There was concern about the position of tenants in buy-to-let properties that are either in arrears or possessed. Key players and lenders noted that the industry was only beginning to recognise this issue and it was evident that practice varied. A number of lenders had no special arrangements for notifying tenants of problems with the mortgage, citing data protection problems. One lender said that they were more likely to move to possess a buy-to-let property and would not collect rent or allow tenants to stay in that situation.

However, other lenders routinely attempted to contact the tenant and/or manage the tenancy. Several lenders mentioned the use of Law of Property Act receivers, where the lender appoints a receiver, normally a solicitor, to act in the interests of the borrower to manage the property and the tenancy. Some lenders were only recently moving towards this practice. In this way, lenders can accept the rent as payment towards the mortgage and even if it is less than the contractual amount of the loan, lenders indicated that this was often sufficient to prevent possession and losses being incurred in the short term. Lenders noted that they would be guided by the receiver as to the best action at the end of the lease period.³¹

31 Communities and Local Government (CLG) announced on 13 May 2009 that proposed legislation will mean lenders will be required to give tenants at least two months' notice that the property is to be possessed.

One lender mentioned that a greater problem for them was when a borrower on a normal residential mortgage sublet the property. The lender is often unaware of any tenant and the tenant is unaware of any problems with the mortgage. This situation was not uncommon and the lender implied that, at the time of the interview, it was an issue that was yet to be resolved.

Conclusions

Lenders have largely responded to the housing market downturn by reviewing their strategic aims in the arrears and possession process. The emphasis has shifted away from payment in full or possession as their priority, to minimising or stabilising arrears and supporting the borrower through difficult circumstances, in the context of an appropriate level of repayment and commitment to recovery. Where possession is sought, the lender's objective was for this decision to be fully legitimate and only occur after unsuccessful forbearance.

This change has been driven by market circumstances and balance sheet losses, reinforced by the influence of the pre-action protocol and increased government scrutiny. Forbearance options and practices have been modified or new options

introduced to achieve these strategic objectives. The degree of change and practices do vary between and within lenders, and change is most apparent among those lenders most exposed to potential losses across their mortgage book. The cultural shift that the changes signify is taking some time to embed itself within organisations.

It is uncertain whether the changes in arrears recovery policy and practices will be sustained when the housing market recovers. Presently, lenders' responses to the market downturn and the Government's expectations of lenders are largely synchronised. However, as the economy moves out of recession, the current business case supporting the shift towards forbearance may be challenged. There are a number of critical points at which it will become apparent whether lenders' new strategies have merely delayed possessions or have been successful in securing the repayment of arrears. The potential for rising possessions and significantly higher levels of exits from home ownership, and the way they should be managed, is of critical importance.

Borrowers' responses to arrears and possession

This chapter examines the strategies borrowers use to manage their arrears, the constraints that they encounter, and the nature of their contact and agreements with lenders. It details the situation as it stood in early 2009, drawing on evidence from interviews with borrowers and the analysis of advice case files.

Earlier research into the borrowers' perspective on arrears management has shown that although the majority of borrowers thought lenders were, or tried to be, helpful, the extent and nature of the forbearance offered was limited.³² Faced with arrears, borrowers sought to reduce expenditure, increase income, or trade their way out of problems by selling their home.

Studies looking at the perspective of borrowers just prior to the financial market turmoil note little change, stressing that lender's approaches remained depersonalised and inflexible, with a perception that lenders advanced quickly to the possession stage.³³

In this study, borrowers' responses to arrears predominately consisted of one or more of the following:

- increasing income
- negotiating with the lender on the level of repayments or the terms of the loan
- seeking professional advice to avoid possession or, when resigned to losing their home, on rehousing options
- voluntarily selling their home.

However, borrowers faced considerable constraints in pursuing each of these options.

Increasing income

The evidence from the advice case files and interviews (see Methodology on page 9) indicates that borrowers tried to increase their household income as a means to address repayment difficulties.

Household members sought new employment if it had been lost, increased their hours at existing jobs or took on additional part-time jobs. However, the poor state of the labour market meant that not all borrowers could find alternative or additional employment to supplement the household's income.

A significant minority of borrowers in the study had claimed additional benefits, with varying degrees of success. Recipients of certain benefits, including Jobseeker's Allowance, may be eligible for assistance with their mortgage payments through SMI, but not all benefits provide eligibility to SMI. This was particularly the case for those who were self-employed and claiming Working Tax Credit, and who were resistant to the closure of their businesses because of the potential for economic recovery in the future. Dual-income households who have lost one income are also only eligible for SMI in very limited circumstances. Moreover, the receipt of SMI does not necessarily prevent arrears or possession. Borrowers were still having to pay the capital repayment part of their loan and some were being threatened with litigation or had possession orders already awarded against them.

The advice case files indicated that two-thirds of those in receipt of benefits, including SMI in some cases, were anticipating their homes being possessed because court orders had already been awarded against them. Some claimants were not eligible for SMI, while others who did claim SMI found the entitlement to SMI was insufficient to prevent possession action by the lender. Most of these cases pre-date the amendments to SMI in January 2009 (see page 32 for details); however, the interviews reveal

³² Ford, J, Kempson, E, and Wilson, M, *Mortgage arrears and possessions; perspectives from borrowers, lenders and the courts*, Department of the Environment, 1995.

³³ Illuminas, *Mortgage effectiveness review: Arrears finding*, FSA, 2008; National Association of Citizens Advice Bureaux (NACAB), *Set up to fail: CAB clients' experience of mortgage and secured loan arrears problems*, 2007.

lenders still chasing borrowers for capital repayments after this date. The case study below describes the situation of a borrower who was a long-term recipient of SMI.

Case study 1

Mandy, a single borrower aged 45, lives with her daughter and two grandchildren. She has been claiming SMI since becoming disabled in the mid-1990s. She has five years remaining on a repayment mortgage with a balance of around £11,500.

She accrued arrears of around £750 during 2008 when she developed cancer. She has to pay £252 per month on 'top up' fees towards her treatment drugs until September 2009. There is no provision to help patients on benefits to cover these costs, consequently she can no longer afford the £160 monthly capital repayments she has been making towards her mortgage. The lender is still insisting on these repayments being made.

Very few of the borrowers interviewed or in the case files had private payment protection policies on their first or second charge loans, but a small number were claiming on such policies successfully. Several borrowers interviewed reported being unaware that the payments only covered half of their mortgage payments or were for a fixed period. One claim was refused because the borrower resumed employment on 16 hours per week rather than the 15 hours or fewer required by the policy, while other borrowers found their policies did not pay out because their loss of income related to caring responsibilities, relationship breakdown or self-employment, which were not covered.

Seeking advice

Generally, the borrowers interviewed had tried to resolve their arrears problems without seeking professional advice, believing that they would be able to conduct negotiations with lenders themselves. They suggested that they would only seek advice if the situation reached a critical point. The analysis of advice case files confirmed this, indicating that most borrowers sought advice late in the arrears process, often in relation to court hearings and after possession orders had been obtained.

Most of the borrowers interviewed who had sought advice had approached not-for-profit voluntary sector services. One borrower had obtained advice from an independent financial advisor attached to an estate agent and another from a private debt management company.

The case files demonstrated the benefits of advice. For example, many court actions were adjourned after agreement on repayment terms was reached with the lender; additional time was allowed for more detailed advice and/or to explore rehousing or to allow voluntary sales. In some cases suspended orders had been obtained instead of the outright orders sought by lenders. Some cases ended in possession in spite of the advice, but it is unclear whether this was because alternative resolutions were not available or whether these cases were unsustainable. Some borrowers interviewed were unaware that money advice could help them avoid possession and, having become resigned to losing their home, instead approached advice services for help regarding rehousing options.

The interviews reveal that borrowers can encounter a number of problems when trying to obtain advice. Several respondents reported delays in accessing advice services: lengthy waits to obtain an appointment and then again on the day of the appointment itself, and not being able to get through on the telephone. Some borrowers had no advice service locally accessible to them.

Concerns were also raised about the quality or suitability of the advice received. Self-employed people were more likely to feel that local advice workers did not appreciate their experiences and were unable to assist them. One self-employed borrower waited three weeks for an appointment and then found that they knew more than the adviser. Another self-employed borrower had felt pressured into declaring himself bankrupt:

'I would like to avoid bankruptcy. I felt the [advice centre] lady put me under a bit of pressure... None of my creditors are being that nasty to me yet, even though I owe them a few months' arrears. None of them have threatened me with court action yet. I would be happy for the [advice centre] to write to them all and offer a £1 a month or week, whatever the minimum offer is, but she wouldn't do that.'

Another borrower was dismayed to find that when trying to gain advice about exiting home ownership because of an enduring arrears problem, the frontline advice staff were unaware of MRS and, since she was not yet facing the bailiffs, made her feel that she had sought their help prematurely. Another borrower had responded to a pre-recorded message on his telephone from a private debt management company, who helped him prioritise his debts but then called him persistently trying to sell him a debt consolidation loan.

Voluntary property sales

Some borrowers recognised that their situation was unsustainable and chose to sell their home to repay their arrears or take some control over their exit from home ownership. Nineteen borrowers in the case files wished to sell their home. Although several achieved this, some borrowers interviewed had been unable to do so because of the current market conditions. One interviewee had had his home on the market for nearly a year, and although he was aware property in the same street had been sold for less than the amount he was asking, he was trying to secure the maximum price to avoid a shortfall. In practice, this tactic served to delay any sale and increase the risk of loss.

Borrowers often employ the arrears management strategies described in this chapter concurrently. Most borrowers also negotiated with their lender. The lender's ability and willingness to engage in negotiations was a critical issue in the borrowers' management of arrears and avoidance of possession.

Borrowers' contact with lenders

Most borrowers interviewed had made early contact with their lender. The majority of lenders reported that their message to borrowers – to contact the lender as soon as problems arose – was being heard. Lenders had experienced an increase in early contacts in arrears cases and calls from borrowers anticipating payment difficulties in the future. Almost all borrowers interviewed wanted meaningful communication with their lenders, but their experiences in trying to achieve this varied. Some borrowers had not had any contact from their lender, while a few borrowers admitted that they had not handled the situation well, either by being in denial about the extent of their problems and not making contact, or by being too depressed and ill to manage their affairs adequately, which inhibited any resolution to the arrears problem.

The case files and borrower interviews reveal positive and negative experiences of both prime and non-prime lenders, although the lenders that failed to respond to borrowers were more often specialist, non-prime lenders. A complete lack of response from lenders was uncommon. Most borrowers had several discussions and communications with their lenders, and several spoke highly of their lenders and how they had dealt with the problem:

'When you make that initial contact it is not as bad as you think it's going to be.'

'[The Lender] was very helpful, they suggested lots of things.'

'[I was] more than happy with my lender, they lent me money even though I'm self-employed and they've been good. I'm still in my home! When I phone it's like talking to my mum.'

There were a number of suggestions, however, that came up repeatedly in the borrower interviews as ways to improve lenders' contact with borrowers. These are outlined in Figure 6. It is important to remember that these findings are generally drawn from cases where borrowers are currently in contact with lenders, and so potentially experiencing the new more customer-focused approach, but that some cases pre-date these developments.

Figure 6: Improving lenders' contact with borrowers

Lenders' staff should:

- be willing to listen
- be willing to negotiate
- be empathetic
- be well trained
- not ask borrowers to repeat their story on each contact
- not send repeat letters and make calls asking for money without offering options
- offer face-to-face discussions in local branches.

Source: Borrower interviews

Some borrowers felt that the lenders did not take account of their personal circumstances. For example, one borrower's husband had suffered a stroke resulting in impaired speech and functioning, but he was repeatedly called by collectors at his place of work. It took some time for his wife to get the lender to agree to stop these calls. Another borrower noted (in relation to their second charge lender):

'Their staff could do with more training as they weren't very helpful at all. They know people are struggling at these times, we can't be the only ones in this situation. They should help instead of panic and take everyone to court.'

Some borrowers recognised their own role in the communication failure. One borrower reported how communication with his lender had broken down and become confrontational and that he was awaiting a warrant for his eviction:

‘It would be nice to have some options. They have been antagonistic, but to be fair, so have I. It would be nice to sit down and try and resolve it... All the advice people tell people about letting the lender know sooner... I haven’t.’

Forbearance

Borrowers made a range of agreements with their lenders to manage arrears. These depended on their circumstances and the willingness of lenders to agree to payments short of the immediate and full repayment of arrears. Participants in this study had been offered the following:

- no forbearance
- contractual payment plus a sum towards the arrears
- payment holiday
- extending the mortgage term
- converting a capital and repayment mortgage to an interest-only agreement
- payments below the contractual amount
- alterations to the terms and conditions of the loan.

Repayment plans

Repayment agreements are applicable in situations where arrears have developed following short periods of income loss, but the borrower has now restored their income to former levels and can rehabilitate the account. Several borrowers interviewed indicated that the reductions in interest rates over the last few months have contributed to making repayment plans manageable and enabling them to avoid litigation. The analysis of case files revealed that two out of every five cases had a repayment plan, but that they were frequently reinforced by a suspended possession order. Few of the borrowers interviewed had suspended orders against them and when they did they were on second charge loans.

Repayment agreements were not always feasible or even if feasible initially they became unsustainable. This was usually because the borrower’s circumstances became more complex and longstanding. For example, several borrowers experienced multiple problems over time, including loss of overtime, ill-health and redundancy, rendering the original agreement inapplicable in light of the new circumstances. However, it was not always clear how successfully borrowers had renegotiated these agreements. It was apparent from borrower case files and interviews that in such circumstances, lenders treated broken agreements as grounds for changing their forbearance approach.

Borrowers were also sometimes guilty of making over-optimistic repayment agreements that were unsustainable from the start. Respondents from the advice sector reported that one of the first things they were frequently called on to do was undo agreements made by borrowers and renegotiate more sustainable repayment terms with the lenders.

A number of self-employed borrowers felt that lenders did not appreciate the circumstances of self-employment and, in particular, that the receipt of income by self-employed people could be irregular. Mortgage accounts are monitored monthly, but one self-employed borrower noted that if her account was monitored over quarterly periods her repayment history would be stronger.

The case files indicated that some borrowers had ‘chaotic’ or irregular payments, while others appeared to have sufficient income but did not meet their agreed payments. In these cases it is difficult to see how alternative arrangements could be made and home ownership could be sustained.

Other forbearance options

The advice case files and borrower interviews support the lenders’ claim that they were employing a range of forbearance tools, as discussed in the previous chapter (page 21). Among borrowers in the case files, one in five had experienced changes to the terms and conditions of their mortgage and around half of interviewees had agreed modifications to their loans. The case study opposite illustrates how a range of forbearance tools can benefit borrowers with complex problems.

Case study 2

John and Carol bought their home in 1974, but subsequently remortgaged to help Carol's parents to buy a home and to secure a further loan for themselves. They have a repayment mortgage of £164,000 and a £20,000 secured loan on a property worth £200,000.

John is self-employed but the volume of business has dropped and so he is working part-time. Carol was working in financial services but has retired following ill-health. These changes in both their incomes have led to mortgage arrears of around three months.

The second charge loan on John and Carol's property includes contractual payment holidays, which has helped them manage what otherwise would have been missed payments. The first charge lender offered to convert their mortgage to an interest-only loan, but because the duration of the loan already takes them beyond retirement they declined this offer. They reported that the lender was very helpful explaining different options to them and offering support. They have capitalised the arrears and are now maintaining payments because of the substantial reduction in interest rates. John noted the difference in their lenders' attitude towards their most recent predicament from a previous time when the lender was distinctly less sympathetic and 'came down on us like a ton of bricks'.

A number of borrowers on SMI had been offered the opportunity to change their loan to an interest-only arrangement, which would mean that the payments from SMI would be sufficient to keep their arrears from escalating. There were, however, cases where the lender did not offer this forbearance option, even though it might have helped the borrower overcome a period of reduced income without jeopardising their home. When lenders did agree forbearance options, some of these arrangements were for limited periods only: borrowers welcomed these concessions, but in a number of cases it was clear that their problems were more enduring and could not be solved in the short term.

Many borrowers participating in the research reported that they had refused these forms of forbearance. These cases included:

- borrowers on high fixed-rate loans who were unable to get their lender to agree to transfer them to lower variable rates
- borrowers unable to change to interest-only loans
- borrowers unable to secure an extended mortgage term or a payment holiday.

In some cases, lenders had not offered these options in spite of the fact that it would clearly have benefited the borrower, such as during the SMI waiting period (13 weeks) or to stabilise the arrears or overcome a reduction in income. It must be acknowledged, however, that in some instances the lender's options were constrained: for example where a borrower already had an interest-only mortgage or their mortgage terms were already over 30 years or extended into their retirement.

The case study below describes the situation of a household with unresolved arrears because of the lender's limited and short-term use of forbearance tools.

Case study 3

Will and Kim, who have a young child, bought their home in 2007 on an 80 per cent loan-to-value 30-year repayment mortgage with a niche lender. They have around £50,000 equity in their home.

When Will changed jobs, his hours were cut and he was subsequently made redundant. Kim does not work. The couple are now three months in arrears. They are waiting for SMI.

The lender agreed to a three-month interest-only period, but they have not been able to make up the rest of the payments. Kim's parents paid two months of repayments for them to prevent the lender taking further action. The lender has refused to accept an arrangement of reduced payments while they wait for SMI to come through.

The situation described in the case study is not unique. This research has revealed a small number of instances suggesting the continuation of 'old' practices: lenders had not been prepared to negotiate to help the borrower to manage their payment problems, but at the same time had not proceeded to litigation. This had left the borrowers in unsatisfactorily unresolved positions. These borrowers felt that they should be offered more options to try and manage the situation, such as renegotiating the terms of the loan, converting to an interest-only mortgage, or other forbearance tools, although in some cases the options were limited because of the nature of the existing mortgage.

It is important to note that interest-only options are not risk free for borrowers because they often involve payments being deferred, which can end up merely postponing the problem. Some borrowers were aware of this and chose not to take this type of option, but to struggle to repay what they could.

Arrears charges

Most borrowers were not unduly concerned about the charges lenders made for managing arrears, but there were some notable exceptions. In a few cases, a third of the total arrears accrued were made up of penalty charges. In one instance, a borrower had had a suspended possession order awarded against her on terms of the contractual mortgage payment, plus £50 a month to make up the arrears. At the same time, a further £50 a month was being added to her account in the form of arrears charges, making it impossible for her to rehabilitate her account on those terms. One key player was concerned about marginal lenders who gave the appearance of forbearing, but in fact their business models were predicated on the basis of the income stream from mortgage arrears charges.

Mortgage book sales

There were also some concerns about forbearance in situations where specialist lenders had sold on their mortgage books, sometimes to investment companies whose core business was not mortgage lending. One borrower interviewed had originally taken out his loan with a major specialist lender, who had subsequently sold on his mortgage to a company he did not know. This new lender sent automated arrears letters that formally offered a range of forbearance tools, but the lender did not respond to the borrower's letters requesting to take up these options. When the borrower telephoned, the lender was unable to provide a person to help with his problem. The lender failed to complete the forms required for the payment of SMI and instead had sent the case to their solicitors.

'I ended up with a useless company through no fault of my own... The mortgage companies have to fill in these forms, they have to communicate with people better, and respond to our letters... It's the basics.'

Conclusions

The findings from the analysis of borrower interviews and advice case files illustrate that the transition from traditional policies and practices whereby lenders required borrowers to pay the mortgage or lose their home, to improved practices of managed forbearance and a stronger customer focus, is incomplete and variable.

Some borrowers had had positive experiences of helpful lenders willing to discuss options to support them to rehabilitate their account, but other borrowers had still had to deal with intransigent lenders who were unwilling to engage with their personal circumstances or suggest solutions appropriate to their needs and situation. The nature of some borrowers' original loans means that there are fewer opportunities for forbearance open to them if they experience payment difficulties. Few borrowers suggested that their original or subsequent borrowing was unaffordable (in contrast to the views of some advisers), but some borrowers clearly faced risks that were difficult for them to overcome and their ownership was, in practice, unsustainable.

There are clear benefits to seeking advice with the management of arrears, but some borrowers raised issues about the standard and accessibility of advice services. The increased resources now being directed at advice services should help to accelerate the transition within lenders to more appropriate forbearance arrangements. Advice services also play an important role in assisting some borrowers to accept that their loans are unsustainable and that selling their home is the best option.

Self-employed borrowers experienced difficulties claiming SMI; sometimes found that the advice available was not tailored to assist them; and that lenders did not appreciate their specific circumstances, namely that their income could be irregular.

Preventing possessions

This chapter examines the initiatives introduced by the Government to reduce possessions in the current economic climate. It discusses the scope and likely impact of the initiatives and, crucially, the response of lenders and borrowers to the schemes. The chapter also looks at how these new initiatives fit with lenders' ongoing policies and practices and whether further actions might be considered.

During the last major housing market recession in the early 1990s, the Government's interventions to prevent people from losing their homes were relatively limited. It introduced the direct payment of interest to people in receipt of income support (Income Support Mortgage Interest, now known as Support for Mortgage Interest) and supported a mortgage rescue scheme that enabled 2,000 households to remain in their home as tenants.³⁴ Stamp duty was suspended for a time to encourage purchasers and a housing market package enabled housing associations to buy up new private sector stock. However, the Government only took this action towards the end of the recession.

The current housing market downturn has seen an earlier and more concerted attempt by the Government to reduce possessions. It has introduced the Pre-action Protocol for Possession Claims Based on Mortgage Arrears; improved state Support for Mortgage Interest (SMI); implemented a scheme to assist borrowers with reduced income who are not eligible for income-related benefits, Homeowners Mortgage Support (HMS); and funded a Mortgage Rescue Scheme (MRS) – see Figure 7 overleaf for more details. In addition, but outside the scope of this study, funding has been brought forward to support the wider housing market by enabling registered social landlords to purchase newly completed private sector properties.

Government action and lenders' strategic response

Lenders and key players interviewed in the study (see Methodology on page 9) noted, almost without exception, that the Government recognises the detrimental social impact of the housing market downturn and particularly the impact of rising mortgage possessions and homelessness. In addition, most institutional interviewees noted that there is now a greater understanding of the synergy

between the housing market and the wider economy. A housing market slowed by possessions, falling prices, limited transactions and restricted credit has profound implications for the health of the 'real' economy. More cynically, many interviewees noted the proximity of a general election and/or the recognition that government policy was implicated in the current housing market deterioration as factors influencing the Government's response to the situation. One respondent summed up the prevailing mood by noting that the Government was 'damned if they do [intervene] and damned if they don't'.

Lenders' strategic responses to the Government's interventions were complex. Initially the Government had sought 'in-principle' support from lenders for joint action and particular initiatives, which meant that lenders had few, if any, grounds for withholding support for the new initiatives. A number of lenders were now effectively government-owned institutions, while others noted that their reputation would suffer if they were seen to be unwilling to support actions to limit possessions. Some of the proposed initiatives addressed issues that lenders or their trade bodies had campaigned for, such as the reinstatement of SMI payments at 13 weeks. Overall, for a range of reasons, lenders expressed in-principle support for the Government's approach.

As the detail of initiatives developed, typically involving joint working, the in-principle support gave way to a more considered assessment of both the nature and likely impact of the initiatives. Overall, there was a high degree of consensus among lenders and key players about the advantages and limitations of the schemes, but there were some important divergences of opinion in a few areas. The limitations identified are important not only in terms of their immediate impact, but also because they identify those issues that remain to be addressed in respect of any longer-term safety net to underpin sustainable home ownership as the economy and housing market recover.

³⁴ Williams, P, and Wilcox, S, *Minimising repossessions*, Centre for Housing Policy/CLG, 2009.

Figure 7: Government initiatives to reduce the number of possessions

<p>Support for Mortgage Interest (SMI)</p> <p>SMI is available to borrowers in receipt of income support or jobseeker's allowance. From January 2009, SMI is paid direct to the lender, after a waiting period of 13 weeks since claiming, on mortgage capital up to £200,000 at a standard interest rate of 6.08 per cent. This interest rate will be retained until December 2009. Only new claimants will benefit from the £200,000 limit. The Government estimates that the scheme will benefit an additional 10,000 homeowners, of whom 1,500 will benefit from the raised capital limit.</p>
<p>Homeowners Mortgage Support (HMS)</p> <p>HMS, launched in April 2009, is available to households who have experienced a temporary loss of income and who are not eligible for SMI. At the discretion of the lender, a proportion of the mortgage interest is deferred for up to two years (with a review after one year), being added to the overall mortgage loan to be repaid in the future. Borrowers must have an interest-only mortgage (or convert to one), have received money advice, and maintained regular payments for the past five months (although these can be partial – even zero – payments as long as they were agreed by the lender). Lenders should have exhausted routine forbearance approaches. Lenders are guaranteed 80 per cent of the interest due if borrowers default. The scheme excludes borrowers with buy-to-let mortgages. The Government estimates that the scheme will assist 42,000 mortgagors over the two-year period, assuming 50 per cent of mortgage market is covered.</p>
<p>Mortgage Rescue Scheme (MRS)</p> <p>MRS is available to borrowers who have exhausted forbearance options and who would be in priority need for accommodation under statutory homelessness provisions if they lose their home. Two forms of MRS are available: sale of the property to an RSL with the borrower becoming a tenant, or sale of an equity share to lenders with the borrower/tenant leasing this share back as shared owners. Subsequent to the scheme's launch in January 2009, the scheme has been opened up to borrowers with loans from second charge lenders and borrowers in negative equity. An estimated 6,000 households will benefit. The scheme excludes borrowers with buy-to-let mortgages.</p>

General issues associated with the initiatives

The implementation of the Government's initiatives raised various issues for lenders, from which a number of key themes emerge:

- The process of developing the schemes had been too 'top down', had not always been well informed, and had failed to build on lenders' knowledge and experience. The schemes had been announced with little consultation, without notice, and lacking in clarity.
- The schemes had become increasingly complex as they were developed. This was often a result of the need to ensure that new initiatives complemented lenders' existing forbearance practices (and the regulations) and did not advantage (or disadvantage) unduly any of the key parties (lenders, borrowers or the Government).
- The schemes require lenders to establish new administrative structures or onerous data collection procedures.
- There is tension between the pressure to forbear and the disadvantageous financial consequences of forbearance if possession ultimately followed.
- Advice services may not be of sufficient capacity or quality to fulfil the advice requirements for borrowers to access the schemes.
- There is uncertainty about the numbers likely to benefit from the initiatives, either because of the conditions of the schemes and/or because some of the proposals duplicate existing forbearance options offered by lenders.
- There is a concern that the initiatives focus too heavily on the short term and fail to address longer-term issues.

How have the initiatives been received?

Support for Mortgage Interest (SMI)

There was widespread support for the changes to SMI (formerly ISMI) from lenders and key players participating in the research. Comments included 'welcome and overdue' and 'very real, very tangible and very useful'. Respondents applauded the Government's recognition of the limitations of existing SMI provision, but some were frustrated by the slow speed of interdepartmental actions to address this. The changes to SMI were announced in October 2008, but confusion followed about the likely date of

implementation. Furthermore, it became clear after the April 2009 Budget that only new claimants would benefit from the increased capital threshold of £200,000.

The main concern identified in this study related to the two-year time limit on the reduction of the waiting period before payments can commence (to 13 weeks rather than 39 weeks). Other issues raised concerned the possibility that once claimants stop receiving SMI payments (Jobseeker's Allowance claimants can only receive SMI payments for a maximum of two years) lenders might have to consider possession; the long-term impact of the practice of converting borrowers eligible for SMI to interest-only mortgages in the absence of a repayment vehicle; the potential for accumulating shortfalls if SMI did not meet full payments: and the exclusion from SMI of interest charges from any secured second charge loans.

As discussed in the previous chapter, it was unclear to what extent the SMI changes will help borrowers avoid possession in the long term. Furthermore, a small number of key players and lenders highlighted that SMI did not cover households whose income had been reduced rather than lost completely. The recognition of this limitation led to the rapid development of HMS.

Homeowners Mortgage Support (HMS)

Most lenders and commentators were surprised by the announcement of HMS in December 2008 and concerned about the assumption that they were already signed up to the scheme. After detailed development work the scheme was officially launched on 21 April 2009 with eight lenders signing up, including all of the nationalised banks. Some large lenders have, however, declined to join the scheme: namely, Nationwide, HSBC, Barclays, and the Santander group. Given that many of these lenders, in general, applaud the Government's ambition to support the housing market and, in particular, homeowners, it is important to understand their reservations. A number of these reservations were also raised in the interviews with key players.

The reservations about HMS are best understood in the context of the evidence reported earlier in the report (see page 18) where we described the current trend in lenders' policies and practices in relation to arrears and possession. Many lenders interviewed (including some that had joined HMS) believed that the scheme duplicated much that was already on offer through their own forbearance practices, while adding a number of disadvantages. These included the two-year limit on assistance, the requirements for additional information in different formats with consequential implications for their management

information systems, and concerns about how the approach would interlink with MCOB and TCF:

'We have a small number of possessions each month [under 50]. It is disproportionate to provide all the data and spend time in meetings when perhaps two cases a month could benefit.'

'There is some tension between MCOB and HMS about how to treat customers with interest-only mortgages.'

Lenders noted that MCOB requires borrowers to be informed that they need a repayment vehicle alongside an interest-only mortgage. A condition of access to HMS was that borrowers should be placed on an interest-only mortgage (if they were not already on one), but it was unclear whether this included acquiring a repayment vehicle. Purchasing an Individual Savings Account, endowment or other repayment vehicle would add to a borrower's costs and potentially be unaffordable.

Despite these reservations, the assessment from those lenders who had agreed to implement the scheme was that it was a further tool that might reduce possessions slightly. Given that it followed routine forbearance procedures, and that eligible borrowers had to have maintained agreed payments for five months, the pool of borrowers to which it applied was limited. Several lenders noted that these borrowers included a high proportion who were 'hard to reach' and with whom there had been little, if any, contact. Such borrowers might be encouraged to approach their lender on the (mistaken) assumption that the scheme offered a two-year payment holiday. Lenders reported that this was how some borrowers had initially understood the scheme.

Respondents also highlighted that while the scheme offers lenders the benefit of a guarantee in the case of default, HMS offered no guarantees to borrowers. In fact it placed the bulk of the risks with them if after two years their income had not recovered and they were still unable to repair their mortgage. As a result, borrowers could find themselves facing possession with higher arrears than before joining the scheme (because of the deferred interest payments) and possibly less equity as deferred payments are capitalised and thus the loan increased. In this situation lenders too might experience a loss.

In light of these concerns, lenders and key players were generally sceptical about the Government's ambitious estimates of the numbers of borrowers that HMS would assist.

Lenders reported that when HMS had been first announced, they had experienced a flurry of enquiries, but had had limited information to give borrowers at that stage. At the time of writing, it is too early to say whether the scheme will attract more enquiries from borrowers and how lenders will respond, but the prevailing view can be summed up by a respondent (whose organisation was participating in the scheme) who suggested that the scheme would be 'enquiry heavy, but implementation light'.

The timing of the study meant that among the borrowers interviewed for the study, and the case files examined, few had heard of HMS and among those who had, understanding of the scheme was poor. Over time this should change. Several borrowers who were interviewed had suffered a partial loss of income, either through the loss of one partner's employment or because of a decline in self-employed trading, and could potentially benefit from such arrangements. However, their lenders have not signed up to the scheme, nor agreed to implement similar concessionary arrangements. A small number of borrowers interviewed had concerns about the extent to which HMS might lead to an increase in their arrears and preferred other forms of forbearance.

Mortgage Rescue Scheme (MRS)

This initiative was, in general, well received by lenders and key players. It was assessed as a good use of public funds, as well as socially beneficial by potentially preventing homelessness. Early concerns about the exclusion of borrowers in negative equity were addressed by the removal of this criterion in the April 2009 Budget.

Eligibility for MRS is dependent on having exhausted the lender's forbearance options, a requirement that was thought potentially to worsen borrowers' debts before they could be 'rescued'. In addition, all lenders interviewed expressed reservations about the administration of the scheme. They had to deal with many different local authorities in England and Wales; there was a different scheme in Scotland; and there was likely to be a further separate scheme in Northern Ireland. Every lender and every local authority had to learn about the scheme. Although it was early days, lenders had detected varying degrees of engagement across local authorities, which, in any case, worked at different speeds. There was some tension between what was seen as the local authority preference for conversion to social renting and some lenders' and key players' preference for the shared equity option,

because it protected a proportion of the value for borrowers when the market improves. Some lenders were actively 'cultivating' or establishing working relationships with large local authorities, but there was concern that the number of borrowers likely to be helped was determined by the funding available and not by need and eligibility.

The scheme was announced in October 2008, but by April 2009, lenders had still seen only a few enquiries and none of the lenders interviewed had any confirmed cases in progress. As a result, there was some scepticism about the Government's estimate that 6,000 households would be 'rescued' by the scheme. A recent report raised concerns about the number of applicants finding themselves ineligible for the scheme, but this may be premature.³⁵ In May 2009 the access criteria were relaxed to include borrowers' already in arrears and those in negative equity. This could change the level of acceptance quite significantly, not least among borrowers at the riskier end of the market, almost all of whom were in negative equity according to lenders. Monitoring data recently released by Communities and Local Government (CLG) shows interest and applications increasing, although only two households had been accepted on the scheme at the time of writing.³⁶

Again few borrowers consulted in this study had heard about MRS. A high proportion of the borrowers in the case files were potentially eligible for the scheme because they would be considered in priority need for housing (due to ill-health or the presence of children in the household). A third of the case files featured households comprising a couple with children, one-fifth were single parents, and one-third were in ill-health or had a disability. However, only eight of the borrowers in the case files were interested in participating in a rent-back scheme such as MRS.

As with HMS, the borrower interviews revealed that borrowers generally considered the scheme a 'good thing', but that few wished to give up their status as homeowners. Where they realised that their situation was unsustainable, some expressed a preference for the shared equity option. Three borrowers were interested in the scheme: one had approached her local authority in 2009 but was told it was not implementing the scheme; one had approached her local authority for rehousing, also in 2009, but was not advised about the existence of the scheme; and another had sought advice but could not obtain any further information about the scheme.

35 Inside Housing [online]: Birch, J, 'Rescue go slow', 30 April 2009: <http://tinyurl.com/rescuegoslow>

36 CLG [online], Live tables on housing: Table 1303 (accessed June 2009): <http://tinyurl.com/livetables1303>

Unresolved issues and ideas for future initiatives

Lenders and key players were asked to propose further initiatives that might contribute to reducing arrears and possessions, over and above actions they could take individually in terms of developing their forbearance toolkits or changing the implementation criteria of the Government's initiatives to reduce possessions.

Early in the discussions with the Government about HMS, one key player had proposed an alternative approach for households experiencing a reduction in income. This suggested a further change to SMI to allow such borrowers to receive support with their mortgage interest, but with it being secured on their mortgage as a second charge. This approach was rejected by the Government, but remains an area for discussion as a potential longer-term solution.

Lenders did not have any new initiatives to propose, but they did suggest enhancements to the existing initiatives. Several suggested that more centralised coordination of MRS would be beneficial and looked towards the model in Scotland, which has a central Scottish Government office acting as a clearing point for all applicants, advisers, housing associations, solicitors and lenders, as one option. The criticism by lenders that the initiatives burdened them with extra administrative procedures implies that they would welcome streamlining of, and reductions to, the administrative demands of the initiatives.

All key players and lenders interviewed highlighted the heightened role given to the provision of advice and information. MCOB, the pre-action protocol, HMS and MRS all encourage or require the provision of advice. Lenders had different approaches to this and were clear that the ability of the advice services to negotiate across lenders, to adopt a holistic approach to borrowers' debts, and to reach borrowers who were reluctant to make contact with their mortgage lender were all of significant benefit to lenders and borrowers alike. However, some concerns were expressed about the capacity of advice services and, potentially, the quality of advice that would be available given the rapid expansion to provision that would be required. When pressed to specify their concerns about the quality of advice, lenders indicated that there could be 'an indulgence' of what they regarded as unnecessary expenditure, such as Sky subscriptions being allowed in income and expenditure assessments, or that advice was sometimes given to support possession when forbearance might address the problem. Some

borrowers also expressed concerns about the quality of, and access to, advice (see page 26), although many respondents were very positive.

The key unresolved issue raised by key players and some lenders was the relatively short-term approach that the Government was adopting in its management of the housing market crisis. One concern was the two-year time limit that had been imposed on some of the initiatives (HMS and the revisions to SMI) and the absence of consideration of an exit strategy at the end of the two years and the associated consequences of the schemes coming to an end.

Similarly, a number of lenders saw the likely upward trajectory of interest rates as a predictable but unexplored issue. There was a danger that the current low level of interest rates, particularly in the context of an interest-only mortgage, could lull borrowers into a false sense of financial well-being. Some, particularly those in employment, might be encouraged to increase their financial commitments, which could prove unsustainable in the face of a two or three per cent rise in interest rates. Those already struggling to repay could also find their payments even harder.

More generally, the issue of what principles should inform the design and implementation of a comprehensive, effective and fair safety-net for homeowners under stable housing market conditions was not being addressed by key players or lenders and remains a significant policy vacuum.

Conclusions

This research indicates that the Government's interventions were broadly welcomed by lenders and key players in the mortgage industry, as well as by borrowers, particularly in relation to SMI and MRS. Lenders and key players had reservations about the way the initiatives had been developed and felt that the process had been counterproductive. Most respondents were more cautious than the Government about the level of take up of the schemes and many argued that HMS overlapped with the forbearance options they were developing individually.

Borrowers welcomed the Government initiatives but to date had found difficulty in accessing information. They expressed reservations regarding the still limited coverage of SMI and the lack of lenders joining HMS. In respect of the Mortgage Rescue Scheme borrowers preferred the shared equity option.

Conclusions and implications for policy-making

This chapter provides an overview of the conclusions from the research and supplements the conclusions at the end of each chapter. It then raises a number of the key issues that have emerged from the research.

The current housing market downturn involves a complex and unprecedented set of circumstances. More than at any other time, there is recognition of the full costs to borrowers and lenders of mortgage arrears and possessions, and the powerful connections between the housing market and the fortunes of the wider economy. As a result we are seeing a considerable impetus to act to limit the damage.

Lenders and the Government were relatively slow in recognising the likely extent of the growth of arrears and possessions. Since the summer of 2008, when this became apparent, lenders have been running to catch up and take the necessary action. Today a wider set of tools and approaches are in place to deal with the situation and are gradually being rolled out to borrowers in arrears. Further innovations are being developed. Arrears are still rising, but possessions to a lesser extent, suggesting that lenders are currently forbearing.

The upturn in the number of arrears pre-dates the financial turmoil in early 2007. Structural changes in the market signifying lenders' willingness to extend and tolerate risk and borrowers' acceptance of risk (for a range of reasons) increased the vulnerability of both parties. The rapid reduction in credit availability from 2007, and the withdrawal of lenders from the market, closed off an avenue whereby many borrowers had previously managed their risk (namely a refinancing loan to support and consolidate arrears and debt). Over-indebtedness and then unemployment, in the context of the proliferation of high loan-to-income ratios, made an increasing rate of arrears inevitable. High loan-to-value ratios made losses on the part of lenders and borrowers more likely. Both lenders and borrowers, encouraged by

market conditions, were complicit in a degree of borrowing that was unsustainable, but this should not detract from the more important conclusion that market structures and processes have widened the risk to borrowers in general. Statutory regulation came late, and while it has had some positive impact, it also has some inadequacies.

There has been an increase in more marginal borrowers, more risky products, and a degree of income inflation through self-certification mortgages. Some lenders believe that property values have also been inflated by the valuation process. This has led some to present the current problems as only affecting the margins of the mortgage market, characterised as consumer irresponsibility and/or fraudulent or negligent behaviour by fringe players in the mortgage and housing markets. The evidence from borrowers and lenders indicates, to the contrary, that the problem extends to the mainstream. Given the developments of the last few years, lenders drawn from across the market noted that it was not only marginal borrowers that were experiencing arrears, but that increasingly they were spread across a wider range of borrowers. Similarly, the evidence from borrowers supports this view.

The potential for significant losses and their implications have resulted in a strategic policy shift in lenders' management of arrears and possessions. This is characterised, simplistically, as a shift from a 'pay or possess' approach to an increased emphasis on forbearance, support and recovery of the account. Regulation has contributed to the shift and has certainly improved transparency in lenders' processes. The shift in lenders' policies and practices is still in transition and not all borrowers are yet benefitting from earlier intervention and the new

forms of forbearance and support. It remains to be seen how well or how swiftly borrowers can stabilise and recover full payments, and how long it takes to draw all borrowers into this new consumer-focused approach.

Current fiscal policy at the level of the wider economy is having an impact on alleviating arrears and possessions. The reduction in interest rates has made a significant contribution to helping borrowers already in arrears pay them off and reducing the risk of default among many other borrowers.

The Government has been proactive in implementing initiatives to address and limit arrears. However, in the rush to respond to the situation, some initiatives have been poorly thought through on announcement and they have required much subsequent work. The development of the initiatives have been too government led and lenders felt that their expertise had not been tapped into until too late. This approach has not encouraged buy-in from lenders and the announcements have raised (sometimes false) expectations among borrowers. Nevertheless, in principle, lenders and borrowers welcome the initiatives. There are significant reservations about the Government's estimates of the number of households that will be assisted by the schemes. Lenders are concerned about the level of bureaucracy associated with the schemes and question the value of HMS in comparison to the forbearance approaches already being developed within lending institutions.

There is no conclusive evidence that the growth in second charge lending and remortgaging has meant that second charge lenders have been driving possessions (as is sometimes claimed). However, second charge lending complicates the situation of households in arrears and there is the potential for conflicting or uncoordinated approaches to the management of arrears from different lenders.

Most lenders report that arrears are still rising, if at a slower rate. New cases of arrears continue to arise, but it is also taking borrowers longer to pay off their arrears. The changes in forbearance are contributing towards this. As long as the new strategy of repayment and recovery is sustained, this will have an influence on reducing possessions. At the same time, in so far as forbearance can highlight where a mortgage loan is unsustainable, this will bring forward cases more likely to result in possession.

Future risks and issues for policy-makers

The success of the initiatives and of improved forbearance practices will become clear over time. However, regardless of the degree of take up of the initiatives, the current increase in arrears and possessions alongside the initiatives, raises some medium-term issues that both lenders and key players identified. However, they noted the current lack of any discussion in relation to these. These issues are raised here as a platform for debate.

Future interest rate increases

It is likely that the inevitable, and potentially rapid, increase in interest rates in due course will trigger a surge in arrears. Households may find it difficult to meet the resulting increased mortgage payments and indirectly higher interest rates may lead to a rise in unemployment as a result of adverse impacts on the wider economy. The current low interest rate environment may lead those who have secure employment to increase their borrowing beyond levels that can be serviced when rates rise. Those trying to recover from arrears will find meeting the terms of agreements more difficult.

Planning beyond two-year initiatives

The time-limited nature of the current initiatives suggests that the Government and lenders should already be considering the exit process. Over the duration of HMS and the modified SMI, the arrears of many borrowers may increase. Depending on the state of the market and/or their balance sheets lenders may feel some pressure to limit their losses with a spike in possessions in 2011/12. Initiatives designed to address possessions may even end up increasing them in due course. A key issue will be how to assist people whose mortgages are unsustainable even given the assistance on offer and how to structure and achieve a housing career outside home ownership for such people.

Implications of market recovery

Given that the changes in lender's policies and practices are significantly related to the current circumstances of the mortgage and housing market, there is an issue as to how likely they are to continue their current range of in-house forbearance practices as the markets recover. Regulation is one potential means of ensuring the current changes become

embedded as a permanent feature, but there needs to be consideration of what regulatory changes might be desirable or feasible to secure this. Thus the outcome of the Turner Review³⁷ is critical. To date, discussions have focused on the advantages and disadvantages of limiting loan-to-value ratios and income multiples as ways of reducing risk. However, arrears stem frequently from a reduction or loss of income, and while the lending pattern is an important issue, work to ensure that lenders offer appropriate opportunities for borrowers to manage and recover from income loss is also required.

Sustainability of interest-only mortgages

Current lender forbearance practice and the Government's initiatives to avoid possessions, increasingly lead to borrowers switching to interest-only mortgages. Concerns about the regulatory requirement for a capital repayment vehicle to be in place have already been raised. There is the likelihood that some borrowers will not have repayment vehicles on grounds of cost or uncertainty about future pay out. Returning to a capital and interest mortgage at a higher cost after an interest-only period may be difficult for some borrowers. So, while borrowers will benefit in the short term, the conversion to interest-only agreements is likely to prove disadvantageous in the longer term.

Demands on advice services

Another area for discussion is how advice services are going to be able to respond to the increased demands and responsibility being placed on them by the requirements of the regulations and rescue initiatives. Extra funding has been made available to support the necessary increase in resources, but core issues remain around training and the quality of advice in the context of more complex debt structures and the need to negotiate with a number of lenders. What further initiatives or support are needed to deliver a high-quality, widely accessible advice service? How can more borrowers be encouraged to seek advice early when problems start to emerge?

Protection of tenants in private rented properties

Arrears on buy-to-let mortgages (and on residential mortgages where the property is let without the borrower having sought consent to do so), raise issues for lenders in respect of the tenants living in those properties. Best practice is developing

in the industry and will be assisted by proposed new legislation, but the effectiveness of these new approaches will need to be evaluated.

Long-term safety nets and sustainable home ownership

The current housing market downturn has demonstrated the poor performance of existing safety net provision for borrowers. This has been addressed to some extent by the changes to SMI. However, SMI can only help a small proportion of borrowers (which will grow as unemployment rises) and is in any case currently time limited. Borrowers reported problems with claiming on mortgage payment protection insurance and its take up is falling. There is, however, no evidence of any medium-term thinking, anywhere in the sector, about future safety-net options. While a mortgage market less characterised by risk will be an important form of safety net, more needs to be done to provide borrowers with sufficient protection. Arrears frequently stem from a reduction or loss of income, and further safety-net provision is necessary to help borrowers sustain home ownership when such circumstances arise. In the context of current welfare policy and provision, work is needed to determine what type of circumstances need to be covered, for how long, and what the cost of various options might be. Whether these are forms of partnership insurance or an improved structure of flexible tenure, or indeed something else, work on future safety-net provision must be a priority if an effective, comprehensive system is to be established and piecemeal tinkering with the existing, broken, system avoided.

This research shows that many lenders are seeking to support borrowers to recover from mortgage arrears and are introducing new ways of achieving this end. However, the study has taken place at a particular point in an unfolding process. For this reason it remains open and inconclusive about the final degree of change with respect to forbearance among lenders and the success of the Government's initiatives.

Given considerable uncertainty about the future trajectory of the recession and housing market downturn, issues relating to the response to both further deterioration and rapid improvement need to be explored. Both scenarios could constitute further risks for lenders, borrowers and the Government. Underpinning these more immediate issues is the fundamental question about how to secure sustainable home ownership.

³⁷ Turner, A, 'The mortgage market: Issues for debate', Speech at FSA Mortgage Conference, 12 May 2009: <http://tinyurl.com/fsaconference>

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