

Policy Statement | PS12/20

Responses to Occasional Consultation Paper 25/19 – Chapter 5: Retirement interest-only mortgages

May 2020



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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Chapter 5 of Consultation Paper (CP) 25/19 ‘Occasional Consultation Paper’.¹ It also contains the PRA’s final policy, as follows:

- update to Supervisory Statement (SS) 11/13 ‘Internal Ratings Based (IRB) approaches’ (Appendix 1); and
- update to SS10/13 ‘Standardised approach’ (Appendix 2).

1.2 This PS is relevant to all banks, building societies and PRA-authorised investment firms offering retirement interest-only (RIO) mortgages. It is also relevant to firms that have offered RIO mortgages in the past, or may do so in the future.

1.3 This PS should be read in conjunction with PS11/20 ‘Credit risk: Probability of Default and Loss Given Default estimation’,² which also makes an update to SS11/13.

Background

1.4 In the CP, the PRA set out its proposals to address potential inconsistencies in practices across firms in relation to the capital treatment of RIO mortgages. The PRA proposed:

- the circumstances in which firms should classify conversions of exposures to RIO mortgages as being distressed restructuring;
- the conditions for defaulted interest-only (IO) mortgages to return to non-defaulted status following conversion to a RIO mortgage; and
- that firms should be able to demonstrate the appropriateness of the treatment of IO mortgages that are converted into RIO in their Internal Ratings Based (IRB) models through robust analysis.

1.5 The proposals were intended to produce consistent and prudent treatment across firms in their treatment of IO and RIO mortgages.

1.6 The PRA has already published the final policy for Chapter 4, and Chapters 2 and 3, of the CP in PS27/19 ‘Responses to Occasional Consultation Paper 25/19 – Chapter 4: Reporting updates for Capital+ and ring-fenced bodies’, and PS3/20 ‘Responses to Occasional Consultation Paper 25/19 – Chapters 2 and 3’ (see footnote 1).

Summary of responses

1.7 The PRA received two responses to Chapter 5 of the CP. The respondents generally supported the PRA’s efforts to promote consistency in practice across firms, but raised a number of issues and requested clarification on the proposals. The PRA addresses these points in Chapter 2.

¹ October 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/occasional-consultation-paper-october-2019>.

² May 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-risk-probability-of-default-and-loss-given-default-estimation>.

Changes to draft policy

1.8 After considering the responses, the PRA has decided to maintain the proposals as consulted, but has provided additional clarification in the SS as follows:

- the material payment amount could be zero, provided a borrower meets the lender’s RIO underwriting criteria;
- when approving a RIO mortgage for a borrower with a defaulted IO mortgage, a new lender does not need to treat the new RIO mortgage as a distressed restructure as a result of the original loan being converted to RIO, provided that the firm’s underwriting practices consider fully the IO default in the credit decision process; and
- the PRA is open to firms modelling RIO mortgages along with other mortgages once they have sufficient data to demonstrate they meet CRR requirements and have received permission to do so.

1.9 The PRA considers that the above changes are not significant, and benefit firms by providing further clarity on the original proposals. The changes would not have a differential impact on mutuals than on other firms.

Implementation

1.10 The policy presented in this PS will take effect on Saturday 1 January 2022, in order to align with the proposed implementation date of the relevant European Banking Authority (EBA) Guidelines on the definition of default (Guidelines),³ as set out in PS11/20 ‘Credit risk: Probability of Default and Loss Given Default estimation’.

1.11 The policy set out in this PS has been designed in the context of the UK’s withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.12 The PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 ‘The Bank of England’s amendments to financial services legislation under the European Union (Withdrawal) Act 2018’⁴ for further details.

³ [https://eba.europa.eu/sites/default/documents/files/documents/10180/1597103/004d3356-a9dc-49d1-aab1-3591f4d42cbb/Final%20Report%20on%20Guidelines%20on%20default%20definition%20\(EBA-GL-2016-07\).pdf](https://eba.europa.eu/sites/default/documents/files/documents/10180/1597103/004d3356-a9dc-49d1-aab1-3591f4d42cbb/Final%20Report%20on%20Guidelines%20on%20default%20definition%20(EBA-GL-2016-07).pdf).

⁴ April 2019: <https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018>.

2 Feedback to responses

2.1 The PRA has considered the responses received to Chapter 5 of the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions.

2.2 The sections below have been structured broadly along the same lines as the proposals in the CP, with some areas rearranged to better respond to related issues. The responses have been grouped as follows:

- distressed restructuring;
- criteria to return to non-defaulted status;
- IRB modelling; and
- monitoring and reporting.

Distressed restructuring

2.3 The PRA proposed that firms should classify conversions of IO mortgages to RIO mortgages as distressed restructurings in cases where the:

- exposure is in default as a result of being a past-term interest-only (PTIO) mortgage;⁵ or
- firm has assessed that the obligor is unlikely to be able to make outstanding principal payments in respect of the exposure.

2.4 The Guidelines state that in these cases borrowers can return to non-defaulted status after passing at least a 12-month probation period and meeting five further conditions as specified in paragraph 73.

2.5 One respondent noted that its members had different views on whether it is appropriate to classify borrowers with PTIO mortgages that convert to RIO mortgages as distressed restructurings. Some agreed with the proposals, but others challenged them on the basis that:

- there is currently no loss data to ascertain the risk profile of a RIO exposure;
- lenders apply prudent scoring and underwriting criteria to assess ability and willingness to pay; and
- there should be no difference in treatment between existing borrowers switching to RIO mortgages and new RIO borrowers as long as loan-to-value (LTV) and affordability requirements are met.

2.6 After considering these points, the PRA has decided not to make a change to the draft policy. The PRA maintains its position that an IO borrower that triggers the default criteria in CRR Article 178 should be classified as being in default. There is no clear prudential rationale to apply the definition differently to RIO exposures, and the PRA considers that to do so would be non-compliant with the Capital Requirements Regulation (CRR).

⁵ PTIO mortgages are IO mortgages where the borrower has not paid full the principal amount when due at contractual maturity of the exposure but continues paying interest on the mortgage.

2.7 For a borrower classified as being in default, paragraph 54 of the Guidelines state ‘Any concession extended to an obligor already in default, should lead to classifying the obligor as a distressed restructuring’. While ‘concession’ is not defined in the Guidelines, the PRA considers that converting a PTIO mortgage to a RIO mortgage, and therefore delaying a payment of principal due on the IO mortgage to a date in the future, should be considered a concession.

2.8 For the avoidance of doubt, the PRA considers that the conversion of an IO mortgage into a RIO mortgage is not in itself necessarily a distressed restructuring. It is a distressed restructuring if the obligor is already in default on the IO mortgage or unlikely to repay the principal of the IO mortgage.

Criteria to return to non-defaulted status

2.9 The PRA proposed that in order for an IO mortgage classified as a distressed restructuring to return to non-defaulted status (‘cure’) following conversion to a RIO, the borrower should make a material payment of the principal such as is necessary to meet the lender’s RIO underwriting criteria. In particular, the payment would be sufficient to reduce the mortgage’s LTV ratio to the maximum at which the lender will offer a RIO.

2.10 The same respondent as above noted that some members agree with the PRA proposals that the conversion to RIO should not automatically result in a cure and that the borrower should not cure until at least 12 months have passed with no triggers of default. Others argued that a material payment is unnecessary on the basis that:

- the repayment of principal through sale of the property is an integral part of the RIO product and not a trigger of unlikeliness to pay, so the design of the product means no indication of default remains; and
- if the defaulted IO borrower meets the lender’s RIO underwriting criteria, but the borrower can only cure if there is a material payment, it follows that a different lender would need to treat such mortgages as ‘purchased or originated credit impaired’. This could increase the cost of lending, change the market dynamic and result in unfair customer outcomes.

2.11 The respondent also requested clarification that where the defaulted IO borrower already meets the lender’s RIO underwriting criteria, a zero material payment is acceptable, regardless of whether RIOs are offered to new customers.

2.12 After considering the responses, the PRA has decided to make no changes to the draft policy that a material payment should be made for a distressed restructuring to cure. This is consistent with the Guidelines, which impose additional conditions in order for distressed restructurings to cure compared to other types of default. The PRA considers this to be prudentially justified given that the concession offered to the borrower via the restructuring means additional evidence should be required of the borrower’s ability and willingness to pay.

2.13 The PRA also considers that the material payment should be an amount that ensures the proposed RIO mortgage meets the lender’s underwriting criteria, in particular the LTV limit. The material payment amount could be zero, provided a borrower meets the lender’s RIO underwriting criteria. The PRA has clarified this point in the SS.

2.14 The respondent also sought clarification as to whether the policy applied to a new lender offering a RIO to a defaulted IO exposure of another firm. They were concerned that the proposed policy might result in the same customer receiving different treatment from its current lender and a new lender.

2.15 The PRA considers that when approving a RIO mortgage for a borrower with a defaulted IO mortgage, a new lender does not need to treat the new RIO mortgage as a distressed restructure as a result of the conversion to RIO. However, we would expect a firm's underwriting practices to consider fully the IO default in the credit decision process.

2.16 The PRA notes that current market practice is to offer RIO mortgages at LTVs below 60%. The PRA will continue to monitor underwriting criteria, in particular LTV limits. Should it observe a weakening of standards, it may review the policy relating to the return to non-defaulted status.

IRB modelling

2.17 The PRA proposed expectations around: (i) IRB modelling of IO mortgages that convert to RIO mortgages; and (ii) IRB modelling of RIO mortgages. No responses were received to (i) and the PRA will implement the policy as proposed.

2.18 In respect of IRB modelling of RIO mortgages, the PRA proposed that firms should seek PRA permission to move RIO mortgages to IRB, and that as such RIO mortgages should remain on the standardised approach (SA) unless PRA approval has been received. The PRA also proposed that RIO mortgages should be modelled separately from other mortgages, as it considered it unlikely that RIO mortgages could form part of the same exposure type as other mortgage exposures under the CRR.

2.19 Two respondents raised concerns about this proposal:

- **Modelling:** One respondent objected to the proposals on the grounds that RIO mortgages are identical to other IO mortgages, with the exception that there is no contractual end date. They considered that existing IRB models would be suitable, provided an additional default criterion connected to the need to settle the debt within a reasonable period following death was introduced. They also noted that IO mortgage models are likely to be conservative, as RIO properties are more likely to be sold on the open market. The other respondent acknowledged that there may be reasons why existing IO models are not suitable for modelling RIO exposures, but argued that it might be valid to treat RIO mortgages as a subset of IO mortgages if limited data are available.
- **Loss-given-cure (LGC):** One respondent argued that the calculation of LGC for defaulted IO mortgages converted to RIO would be excessively penal if the proposals on LGC in PRA CP21/19 were applied.

Modelling

2.20 The PRA does not accept the argument that RIO mortgages are nearly identical to IO mortgages, as RIO mortgages do not have a fixed term or repayment vehicles and this will be reflected in underwriting processes.

2.21 The PRA considers that there may be some circumstances where it may be appropriate to model RIO mortgages with other mortgages, but it considers that firms should be able to justify this. The PRA has therefore clarified in the SS that the PRA would not expect firms to apply to use the IRB approach for RIO mortgages until they have sufficient data to demonstrate that their approach is prudentially appropriate and consistent with the requirements of the CRR.

LGC

2.22 The PRA has confirmed its approach to LGC in PS11/20, published alongside this PS. The PRA has made some changes to the proposals consulted on, in light of feedback received. These changes

should result in LGC more appropriately reflecting the economic substance of defaulted exposures that subsequently cure.

Monitoring and reporting

2.23 The PRA reminded firms in the CP that they should monitor the profile and performance of their RIO lending as a matter of good practice and isolate those borrowers transferring from existing IO stock to RIO mortgages. The PRA proposed that firms give appropriate consideration to borrowers' previous IO credit history (including principal payments) in RIO underwriting standards. Firms were also reminded that they are already required to report data on RIO mortgages in their PSD001 submissions.

2.24 Respondents commented that:

- reporting of RIO mortgages to the FCA via the Mortgage Product Sales Data form PSD001 is not yet robust; and
- not all firms will have the capability to isolate borrowers transferring from existing IO stock (pre- and post-maturity) to new RIO lending. Firms will know if the customer seeking a RIO mortgage has a defaulted IO mortgage when underwriting the new contract, however there is little capability for firms to track the borrowers' previous IO mortgage history unless the customer is seeking an internal product transfer.

2.25 The PRA notes these comments but would reiterate its previous statements on good practice and on existing requirements, and encourages firms to develop their capabilities in this area.

Appendices

- 1 SS11/13 'Internal Ratings Based (IRB) approaches', available at: www.bankofengland.co.uk/prudential-regulation/publication/2013/internal-ratings-based-approaches-ss

- 2 SS10/13 'Standardised approach', available at: www.bankofengland.co.uk/prudential-regulation/publication/2013/credit-risk-standardised-approach-ss
