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Mr John McGuinness TD  
Chairman  
Joint Committee on Finance, Public Expenditure and Reform, and Taoiseach  
Leinster House  
Dublin 2

22 June 2018

Dear Chair,

I refer to your request dated 18 May 2018 for a briefing note in relation to instances where institutions have incorrectly calculated arrears levels on mortgage accounts. In particular, you referenced previous Court judgements on the matter.

Automatic Arrears Capitalisation refers to a methodology used by some lenders to recalculate borrowers' contracted monthly installments ("CMI") on their mortgage, following a trigger event (such as an interest rate change). In this regard, the lenders' mortgage systems recalculated borrowers' CMI on the basis of each borrower's overall outstanding mortgage balance (i.e. mortgage principal + arrears). This differs from the 'traditional method' of calculation in Ireland, whereby lenders calculate CMI on the mortgage principal only, with the arrears remaining outstanding pending agreement of an Alternative Repayment Arrangement with the borrower. Please see **Appendix 1** for a worked example of both calculation methods.

Automatic Arrears Capitalisation originally existed in the UK. The practice is driven by lenders' historical calculation systems, which aim to ensure the CMI is sufficient to ensure the overall



outstanding mortgage balance (including any arrears) is repaid fully by the end of the mortgage term.

The High Court in Northern Ireland handed down a judgement in a test case (Bank of Scotland Plc. V Rea, McGeady, and Laverty) concerning the mortgage arrears practices of Bank of Scotland Plc. ("BOS"). The primary issue considered by the High Court was whether BOS may both:

- consolidate arrears with the mortgage balance upon which CMI's are calculated with the effect of increasing the CMI to spread those arrears over the remaining term of the mortgage; and
- rely on those arrears for the purpose of repossession proceedings.

The Judge ruled that the practice adopted by BOS was a capitalisation and that the capitalisation of the arrears, in essence, resulted in the arrears being extinguished. As such it should not be permissible to rely on such arrears to ground repossession proceedings.

The Central Bank commenced a program of engagement with relevant regulated entities (including the main mortgage lenders) to determine whether this practice was used in Ireland.

Our supervisory work is at an advanced stage and remains ongoing. However, based on our supervisory work to date, we are in a position to advise the Committee as follows:

- Having considered the findings to date in the context of the regulatory framework in Ireland, we are of the view that the practice of Automatic Arrears Capitalisation is not in the best interests of consumers.
- The practice is not widespread in Ireland. Where the practice was identified, we intervened to ensure that the practice ceased.
- We do not have concerns that borrowers were overcharged, rather we are not satisfied that borrowers' arrears were presented in a fully transparent manner.
- Borrowers in arrears, who have an agreed Alternative Repayment Arrangement with their lenders are not affected. Furthermore, borrowers who are not in arrears on their mortgages are also not affected.



- To date, we are aware that lenders have used this methodology on c.5,400 accounts (further cases may be identified as our supervisory work concludes). In relation to these accounts:
  - borrowers were in arrears and were not in an agreed Alternative Repayment Arrangement (for example, in many of these cases, the borrowers were not engaging or co-operating with their lenders);
  - borrowers' overall indebtedness is not impacted nor are the interest calculations on the mortgage accounts (see Appendix 1 for worked examples);
  - Lenders have communicated with affected borrowers.
- Lenders have confirmed that no repossessions have occurred solely as a result of this calculation methodology.
- Repossessions that had commenced were paused to facilitate the practice being ceased and to allow the lenders to reconstitute the affected borrowers' accounts.
- All repossession cases will be re-assessed by the lenders on a case-by-case basis, following which:
  - some will be dropped. Repossession cases have been dropped in c.100 cases (of c.5,400). These repossession proceedings have been dropped where, for example (i) the borrower re-engaged with the lender or (ii) the borrower had met the CMI since the date of the last trigger event or (iii) the reconstituted arrears balance fell below the lender's internal limit for commencing possession proceedings; and
  - some will recommence. Where repossession proceedings recommence, lenders will inform the courts that the borrower's account has been reconstituted.

We would encourage all borrowers to engage with their lenders on this issue, and if not satisfied with how they are being treated, to make a complaint to their lender, after which they can refer their complaint to the Financial Services and Pensions Ombudsman, who has the statutory remit to consider their individual complaints.

Yours sincerely,

  
**Gráinne McEvoy**  
Director of Consumer Protection

**Appendix 1:**

**Method 1 (Automatic Arrears Capitalisation):** under the Automatic Arrears Capitalisation method, a borrower's accumulated arrears up to the date of the recalculation is added to the mortgage principal when recalculating the CMI following a trigger event. In these cases, the regulated entity used the borrower's overall outstanding mortgage balance to recalculate the CMI. This method ensured that the borrower's repayments were calculated to clear the full outstanding mortgage balance (including any arrears) by the end of the mortgage term.

**Method 2 (Traditional method):** the traditional method does not add arrears to the mortgage principal when recalculating the CMI following a trigger event. The arrears figure remains independent of the CMI but part of the borrower's overall outstanding mortgage balance. The arrears balance will remain outstanding at the end of the mortgage term (unless an Alternative Repayment Arrangement is agreed with the borrower in the interim).

	<b>Method 1</b> <b>Automatic Arrears</b> <b>Capitalisation</b>	<b>Method 2</b> <b>Traditional Method</b>
Mortgage Principal	€100,000	€100,000
Arrears	€5,000	€5,000
Overall Outstanding Mortgage Balance	€105,000	€105,000
CMI Calculation	Overall outstanding mortgage balance (€105k) divided by remaining term	Principal (€100k) divided by remaining term
End of mortgage term balance (where all remaining CMIs due are paid)	0	€5,000 Plus accrued interest on €5,000

**Note:**

- Outstanding balance remains the same irrespective of which method is used. However, under Method 2 the full outstanding balance is not cleared within the term of the mortgage.
- Interest due on accounts is calculated on the borrower's overall mortgage balance, regardless of which method is applied. As the overall outstanding mortgage balance includes the borrower's arrears, both it and the interest calculated on it remained unaffected by the practice.