Good Practice Lending Guide

RM11 Arrears and Collections Strategy

September 2025

Disclaimer

This Guide is provided purely for informational purposes, has been prepared for general use only, and does not constitute legal, financial or other professional advice.

All information contained in this Guide is based on the laws and regulations applicable to England and Wales and which are current as of the date of publication. This guide is not maintained regularly, but we will endeavour to update it when relevant laws or regulations are amended, varied, or supplemented. We aim to review the Guide annually to reflect any relevant legal and/or regulatory changes.

Fair4All Finance Limited make no representations or warranties of any kind, express or implied, about the accuracy, completeness, suitability, or reliability of the information contained herein. Fair4All Finance Limited shall not be liable for any loss or damage arising from the use of, or reliance on, this Guide. This Guide does not create an advisor-client relationship between you and Fair4All Finance Limited.

You are advised to consult with suitably qualified legal, financial or professional advisors to obtain advice tailored to your specific circumstances. You should not rely on the content of this Guide and any reliance on any information provided in this Guide is done at your own risk.

By accessing and using this Guide, you acknowledge and agree to the terms of this disclaimer.

This Guide must not be amended, copied, reproduced, distributed or passed on at any time without the prior written consent of Fair4All Finance Limited.

Note on legal and regulatory updates

This note should be read alongside the Disclaimer at the start of this Guide.

Laws and regulations can change. While this Guide is reviewed periodically, it may not always capture the latest developments.

For the most up to date information, please refer to the relevant official sources, including (but not limited to):

- **Financial Conduct Authority (FCA)**
  - FCA Handbook
- **UK Government**
  - Government policy papers and consultations
  - Credit union common bond review
- **Bank of England / Prudential Regulation Authority (PRA)**
  - PRA Rulebook for Credit Unions
  - PRA Supervisory Statements for credit unions
  - Policies relating to credit unions
  - Annual Assessment of the Credit Union Sector
  - Regulatory expectations
- **UK Legislation**
  - The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 – (see RM6)
  - UK's Data Protection – (see RM 12)
- **Financial Reporting**
  - Financial Reporting Standards (FRS) – (see RM14)

Contents

1 Introduction 6

1.1 Why has Fair4All Finance commissioned this guide? 7

1.2 Purpose of this document 7

1.3 Legislation and regulation 8

2 Defining arrears 9

2.1 Days past due 9

2.2 Contractual arrears and contractual arrears status 9

2.3 The Stages of arrears 12

2.4 Identifying pre-delinquency 13

2.5 Default, default notices and bad debt 15

3 Options for dealing with arrears 18

3.1 Pre-delinquency activities 18

3.2 Early stage arrears 19

3.3 Late stage arrears (collections and debt recovery) 22

3.4 Write-off 25

3.5 Debt sale 25

3.6 When action cannot be taken (or must be paused) to recover a debt 26

3.7 Referral to Debt Advice Services 28

3.8 Choosing the right option(s) for the customer 29

4 Building an arrears strategy 30

4.1 Arrears paths (strategies) 30

4.2 Communicating with customers 33

4.3 Optimising arrears paths – a champion / challenger approach 34

4.4 Risk based segmentation (arrears & collections scoring) 35

5 Reporting of arrears and write-offs 37

5.1 Management reporting (board and/or sub-committees) 37

5.2 Data submissions to Credit Reference Agencies 38

5.3 Regulatory reporting 38

6 Appendices 39

6.1 Appendix A: glossary of terms used in this document 39

1 Introduction

No matter how good a lender is at assessing customers' creditworthiness when they apply for credit, there will always be some borrowers who fall behind with their repayments. When this occurs, their account is classified as being "delinquent," "past due" or "in arrears."[1] If further payments are missed, then the level of arrears increases. Ultimately, if the customer continues to miss repayments and the loan isn't repaid, it will be classified as "bad debt" and written-off resulting in a loss for the lender.

Losses due to bad debts represent one of the biggest (if not the biggest) costs of doing business in consumer credit markets. Therefore, any action lenders can take to reduce arrears and recover the monies owing will have a very significant impact on the profitability of their business.

For not-for-profit community lenders including credit unions and CDFIs, optimising arrears processes is arguably even more important than for mainstream profit-orientated firms. This is because losses due to bad debt often translates into fewer loans being granted, and on worse terms, to those in the community who need them most and often struggle to obtain affordable credit from mainstream sources such as the high street banks and building societies.

There are many reasons why a customer falls behind with their repayments such as a change in financial circumstances, ill health, death, overspending, simple forgetfulness, or a deliberate decision not to repay what they have borrowed. Consequently, when a customer is in arrears, a lender needs to understand the customer's situation to determine the best action to recover the funds owing, whilst ensuring that the action is appropriate given the customer's circumstances.

From a regulatory perspective, this understanding of the customers situation is vital in ensuring that the recovery action is appropriate and leads to the right outcome for customers as well as the business. However, this doesn't, mean a lender shouldn't take assertive action to recover a debt where necessary. Rather, it means that the action should be appropriate and proportionate given the customer's circumstances. For example, the type of action and format of the communications taken to recover a debt from a customer who is found to have been spending irresponsibly could be quite different from that of a customer who can't pay after losing their job due to ill health.

[1] All these terms are used within the UK credit industry to mean broadly the same thing. Which term is used where, is often lender, and department specific.

1.1 Why has Fair4All Finance commissioned this guide?

In our work with community finance lenders, those we have made significant investments into, and those we have funded through grants and capability support, we have come across a range of approaches to credit risk and provided some consulting support to enhance them. This guide reflects our intention to document what good practice looks like on arrears and collections practices, to share the insight that has been developed for specific lenders more broadly with the sector.

1.2 Purpose of this document

This document is intended to support Community Finance lenders in defining appropriate strategies to undertake when a customer enters arrears, and at different stages of arrears.

Every lender has their own arrears and collections policies that are appropriate for their business. However, when a customer is in arrears a lender needs to understand the customer's circumstances and deal with them appropriately. At the same time, the lender needs to act in a competent and professional way to recover as much of the debt as reasonably possible. A balance is required to ensure that the interests of both parties are served. Both these perspectives are recognised by the FCA in their principles of business[2].

To evidence good practice in these areas, it is important that firms clearly define and comprehensively document their arrears and collections policies and processes. They then need to monitor operational adherence to these to ensure they are running their business in an appropriate manner that applies with FCA principles and expectations.

The approaches to arrears and collections described here are generally applicable to all UK lenders, but it is primarily intended for small to medium sized organisations who are working to provide fair and affordable credit to sectors of the community who may otherwise struggle to obtain it. For example, not-for-profit community lenders and credit unions. Therefore, it adopts a proportionate approach suitable for these types of organisations.

Organisations can use the Guide in one of two ways:

1 As a reference manual, to help them enhance their own lending policies and to provide assurance that there are no gaps or shortcoming

2 To support new organisations in setting up appropriate credit risk-based lending policies

The focus of this document is arrears and collections. However, there are clear overlaps with other areas

[2] The Consumer Duty principle focuses on good outcomes for customers. Principles 3, 4, and 5 focus on good and prudent business practice, which can be taken to includes having a suitable arrears policy in place to minimise the loss of financial resources.

of lending, such as Consumer Duty, Management Information, governance etc. These are signposted within the relevant sections throughout this guide.

1.3 Legislation and regulation

The FCA defines the processes that lenders should follow when pursuing delinquent customers in the FCA handbook (CONC section 7.3). This incorporates compliance with the FCA's general principles of business, and specifically the Consumer Duty principle to align their arrears and collections activities with the "four outcomes" specified by the FCA, as detailed in Table 1.

Table 1. Outcomes for Consumer Duty

Outcome	Detail	Application for Arrears and Collections
Price and value	Consumers receive fair prices and quality	Fees and charges applied during collections activity reflect the costs to the business and are only charged where necessary
Products and services	Consumers are sold and receive suitable products and good service	Staff steer customers towards the most appropriate remediation activity to deal with and manage their delinquency. It's not a one size fits all arrears process
Consumer support	Consumers receive good customer service	Staff are trained to deal with customers who are struggling, identify if they are vulnerable, and provide or direct them to appropriate support services (ie not-for-profit debt advice services)
Consumer understanding	Consumers increase their confidence in financial services markets and can make better, more informed decision about the products and services they need	Customers are provided with the appropriate information in the appropriate format, and via a channel that works best for them at the relevant points throughout the arrears process

More information about Consumer Duty is provided in the Consumer Duty and Complaints Handling Component of the Guide.

2 Defining arrears

2.1 Days past due

Days past due is the number of days after a customer's repayment is due that it remains unpaid.

Days past due is used operationally in managing arrears and collections actions paths, with specified actions occurring when a customer is a specific number of days past due. For example, make first contact with the customer X days after they miss their payment. Then, make a second contact after Y days, initiate court action after Z days and so on.

Days past due are also useful in management reporting where a lender wants to report on accounts with any arrears at all, eg total number of customers 1+ days in arrears, rather than (or in addition to) the contractual monthly arrears position (see below).

2.2 Contractual arrears and contractual arrears status

2.2.1 Accounts on monthly repayment terms

Contractual arrears are the shortfall in payments made by the customer at a given point in the credit agreement. If, nine months into a loan agreement they should have made say, 9 payments of £100 (£900 in total) but have only paid £750, then the contractual arrears are £150.

The contractual arrears status is a measure of the number of missed payments. It is calculated as:

Contractual Arrears Status = (CP - AP)/(CPA)

Where:

CP is the amount a customer should have paid

AP is the amount a customer has actually paid

CPA is the Contractual Payment Amount, ie the amount they should pay each month[3]

Consider a borrower whose monthly repayment is £25. They have paid to terms for the first 8 months of

[3] For the purposes of this document, it is assumed that loan repayments are monthly, but some loans may be on other terms eg weekly or 4-weekly. In these cases, the values would be converted to a monthly equivalent.

their agreement. They then miss a payment the next month, followed by a partial payment of £10 the following month. Over the ten-month period they should have paid £250 (10 * £25). What they have actually paid is £210 (8 * £25 + £10), so their contractual arrears are £40.Their contractual arrears status is calculated as:

(250 – 210) / 25 = 1.6

The customer is 1.6 months in contractual arrears. In many organisations, for standard reporting purposes, the arrears status is rounded down to the nearest whole number. Therefore, in this example, the customer's account would be recorded as 1 month in arrears. What this means in practice, is that for some types of management reporting, for accounts that have small arrears balances that are less than their contractual repayment, the contractual arrears status will be <1. These are therefore included in the zero arrears group for reporting purposes.

Contractual arrears status is used for a variety of purposes that includes internal management reporting as well as reporting to credit reference agencies, regulators and other third parties.

From a contractual perspective, if a customer in arrears resumes their normal repayments, then they continue to be in arrears until they have fully caught up with what they should have paid under the terms of their agreement. To put it another way, in addition to resuming their repayments, they will need make extra payments to cover the ones that they missed[4] before they are classified as up to date. There can be exceptions to this where debt is "re-aged," or the arrears are capitalised[5]. This will be discussed later in this document (Section 3.2.2 Forbearance).

Confusingly, some regulations talk to 30, 60, 90 in contractual arrears which can become confused with days past due – such as in IFRS9 accounting standards and PRA capital requirements for Deposit Taking Institutions[6]. However other publications, such as the PRA Rule Book for Credit Unions (section 3.11) talks to 1/2/3 months in contractual arrears.

From a practical perspective, lenders can align with either terminology. ie they can use 30/60/90 in contractual arrears or 1/2/3 months in contractual arrears. Going forward we shall refer to "arrears" to mean either of these.

2.2.2 Accounts on weekly (or other) repayment terms

Where a credit agreement has weekly repayment terms, then for accounting purposes, and for reporting to credit reference agencies and regulatory reporting (PRA/FCA), arrears is calculated on a monthly

[4] This is normal practice across the credit industry, but there are some specialist loans where the customer is allowed some degree of latitude with their repayments, such that missing one or more payments is catered for in the terms of the agreement, provided that the loan is eventually repaid within a specified timeframe.
[5] This means that the arrears owing is added to the balance and the arrears amount is set to zero.
[6] Such as the PRA supervisory statement SS 11/13

equivalent basis. The monthly equivalent is then reported at the same time as other loans (eg month end position). Monthly equivalent amounts are calculated as 4.33 times the weekly repayment amount[7].

Consider a loan repaid in 24 instalments of £50 per week. The customer makes their first payment, misses their second payment but then makes their third and fourth payments. At month end, they are 7 days past due. The customer should have paid £200 but has only paid £150. Therefore, they are £50 in arrears. The contractual arrears position is calculated as:

- Monthly equivalent repayment amount = £50.00 * 4.33 = £216.50
- Contractual arrears = (£200.00-£150.00) / 216.50 = 0.231

This is less than one. Therefore, this would be reported as zero contractual months in arrears for reporting purposes.

If we extend this example, assume that continuing to week 20, the customer has missed 8 of their weekly repayments of £50: They should have paid £1,000 but have only paid £600 and they are 56 (8*7) days past due. The contractual monthly arrears position is now calculated as:

- Monthly equivalent repayment amount = £50.00 * 4.33 = £216.56 (as before)
- Contractual arrears = (£1000.00-£600) / 216.50 = 1.85

The customer is 1.85 months in contractual arrears, which would be reported as 1 month in arrears.

If repayment terms are some other period (such as fortnightly or 4-weekly), similar principles apply to produce an equivalent monthly contractual arrears position).

Reporting requirements are covered in more detail in Section 5.

2.2.3 Negative contractual arrears

Technically, accounts can be in negative arrears if they have paid more than the contractual amount (referred to as overpayment or pre-payment). This is relatively unusual for unsecured loans but quite common in the residential mortgage market and for some revolving credit products. Some lenders will calculate and report on negative arrears statuses, while others report the contractual arrears status at 0.

[7] Principles-for-the-Reporting-of-Arrears-Arrangements-and-Defaults-at-Credit-Reference-Agencies-version-2a-final-updated-to-refer-to-GDPR-and-DPA-2018.pdf

2.3 The Stages of arrears

"In arrears," "Past due" and "Delinquency" are general terms used to mean that someone is behind with their repayments. This could be a single day past due or many months or even years in arrears. To aid with the treatment of customers and management reporting, lenders classify the type and severity of arrears into several categories, as detailed in Table 2.

Table 2. Stages of Delinquency

Delinquency Stage	Description
Performing	An account that is up to date with payments, ie is not past due and not in arrears.
Pre-delinquency	A performing account, where there is some indication that the borrower *may* miss a payment in the near future (typically the next 1-2 months) but has not done so yet. For example, they have had a recent CCJ registered against them (indicating they may be struggling financially) or they have been identified as having vulnerabilities but have so far kept up with repayments. Frequent changes in payment date, erratic payments and returned direct debits are other common indicators of potential delinquency. Lenders who have "grace periods[8]" before formal arrears activity begins may also classify customers in the grace period as pre-delinquent.
Early Arrears (<~3 payments in arrears)	When the arrears are low, which is commonly defined as the arrears being more than 3 regular payments[9], the goal is to help the customer to recover their account to a good paying status (or "cure") and to resume paying in line with their credit agreement. Customer engagement is designed to support customers in achieving this outcome.
Late Arrears / In collections / Debt Recovery (>= ~ 3 payments in arrears).	Once an account moves beyond early arrears, it is classified as a "Bad Debt[10]. The emphasis shifts towards debt recovery (collections). A borrower may recover their account after this time, but the focus for the lender at this stage shifts to recovery of the total outstanding debt rather than returning the account to an up-to-date status. This may be via some form of repayment plan, court action, or a "full and final" lump sum payment. A lender may at this point issue a Default Notice, which a requirement for regulated lending under the Consumer Credit Act, before they can move to terminate the agreement and instigate recovery action. Credit unions are not usually required to issue default notices because most credit union lending is unregulated.
Written-off	When all reasonable attempts to recover the outstanding debt are exhausted, the loan is written-off and the loan is removed from the balance sheet. Accounts are not usually written off if there is outstanding court action, or the customer is paying to the terms of an agreed repayment plan.

[8] Some lenders will wait a few days (typically 3-7 days) after a customer has technically missed their payment date, before they start attempting arrears action and/or charging late payment fees.
[9] 3 months is a common choice for "standard" loans paid monthly over terms of more than 12+ months. This is because it aligns with regulatory definitions of default that are based on 3 months (90 days) in contractual arrears. However, there is no regulatory obligation to do this, and a lender may apply a different definition such as 2 or 4 months.
[10] For credit unions, the PRA Rulebook defines any loan that is more than 3 months in arrears as bad debt.

From an operational customer management perspective, the arrears stages, and their definitions, as described in Table 2, are widely adopted across the credit industry. However, there is no regulatory definitions of these. For example, if a lender wanted to define an additional "mid-arrears" stage then they could do so. Consequently, it is up to each lender to define each stage of arrears based on its products and customer profiles in a way that meets its business objectives and supports Customer Duty outcomes. For example, for a lender that offers short term loans over say, 3 – 6 months on weekly repayment terms, the move to late arrears may come after only 2 or 3 weeks. This compares with a lender offering longer term loans with monthly repayment terms who might wait 3 or 4 months before moving to the late arrears stage.

2.4 Identifying pre-delinquency

The FCA requires that a firm monitors a customer's repayment record and takes appropriate action where there are signs of actual ***or possible*** repayment difficulties[11]. Identifying arrears (actual repayment difficulties) when someone misses a payment is usually straightforward. However, identifying struggling customers before they become delinquent (possible repayment difficulties) can be difficult.

Sometimes, a customer will proactively establish contact with their lender before they miss a payment and hence "self-identify" as pre-delinquent but, in most cases, customers become delinquent before contact is established. Consequently, pre-delinquency is about identifying the customers that are highly likely to miss their next payment, but it is not guaranteed that they will do so.

Generally, there are two ways that customers are identified as part of a pre-delinquency process. Rule sets and scoring models (predictive models). Regardless of whether rule sets or scoring models are employed, a considerable amount of data is required to establish which items of data are most predictive of imminent delinquency. Therefore, establishing a proactive pre-delinquency strategy can be challenging for lenders with limited data.

2.4.1 Indicators and rule sets

For revolving credit, increasing trends in credit limit utilisation or use of cash withdrawal facilities can be a strong indicator of financial difficulty. When it comes to unsecured loans, sometimes a single indicator like this can be used to identify a potential problem. However, most struggling customers won't be identifiable using a single piece of information unless a flag has already been set within the lender's customer management system to indicate a high-risk customer. Instead, lenders often use rule sets, which consider several different risk indicators in combination to identify those customers most likely to experience repayment difficulties in the next 1-2 months.

[11] FCA Handbook. CONC 6.7.2

Some typical indicators that are used to identify at-risk customers include:

- Change in repayment method. For example, cancelling their DD and making cash or bank transfers instead
- Change in repayment frequency. For example, ceasing to pay monthly, but making several payments over the month, often at irregular intervals and for differing amounts
- Recent or frequent arrears with this loan product. If they were overdue making their last payment (but are now up to date)
- Current, recent, or frequent arrears with another current or previous loan product that the customer has or had with the lender
- Certain vulnerabilities. Some, but not all, vulnerabilities may contribute to a pre-delinquency contract strategy. For example, if a customer has cognitive difficulties, a rule in place to deliver an extra reminder to pay on time may prove helpful to the customer
- Evidence of problems with credit products with other lenders. This includes high utilisation of revolving credit and/or arrears with other products. Likewise, the presence of a new IVA, DRO, CCJ or bankruptcy. This information can be obtained through a regular (monthly) update of customers credit report from a credit reference agency[12]
- Where open banking data is readily available, changes in bank account behaviour such as a sharp reduction in funds flowing into the account (a sharp drop in income or the timing of that income)
- A change in a customer's behavioural score. For organisations that score customers each month, then a significant deterioration in the monthly credit score may indicate a problem

2.4.2 Pre-delinquency scoring

In the Lending Policy (Credit Risk) Component of the Good Practice Lending Guide, credit scoring was described as a way of representing the long term (12+m) default risk of a customer as a credit score. The credit score then forms one of the key pieces of information that lenders use when deciding to accept/decline a loan application. Pre-delinquency scoring follows the same principles as credit scoring. Only, in this case, the score predicts how likely an existing loan customer is likely to miss their next repayment, rather than default over a much longer period.

Pre-delinquency models are constructed using similar data as credit scoring models, but also incorporate

[12] For most banks and building societies, obtaining a monthly update of all their customers' credit reports is standard practice. For example, via Experian's Delphi for Customer Management (DCM) product. This is less common in the Credit Union and CDFI sectors.

data about customer behaviours that are known to correlate with imminent default, such as the variables used to define rule sets discussed in the previous section. Like credit scores, pre-delinquency scores don't provide a concrete outcome, only a measure of likelihood. A high pre-delinquency score means that someone is highly likely to miss a payment, a low score that they are unlikely to do so but it is not certain that these outcomes will result given the score someone gets. The score allows lenders to rank all their customers from highest to lowest risk, so that they can target help at those most likely to need it, ie those at the top of the list. This helps to optimise resource by not contacting those who are probably not in any difficultly and are unlikely to have any problems meeting their loan repayments.

When implementing a scoring-based approach, a lender will need to decide on the relevant thresholds to apply based on the trade-offs that different thresholds (cut-offs) yield. If the pre-delinquency score cut-offs are extremely strict, resulting in a high proportion of customers being flagged as at-risk, then nearly all cases that would have eventually gone into arrears will be identified. However, this will be very resource intensive to action and a substantial proportion of these case would have paid anyway – there was no need to contact them. At the other end of the spectrum, if very few cases are flagged as at-risk, this will save costs, but a lot of cases will be missed because they don't score highly enough to exceed the cut-off.

2.5 Default, default notices and bad debt

When talking about arrears, the terms "Default" and "Bad Debt" will inevitably appear at some point in the discussion.

Conceptually, default is the point where a lender believes that the arrears have reached a point where it is unlikely that the debt will be repaid in full, ie a "bad debt" occurs resulting in a potential loss for the lender. Default definitions are primarily based on contractual months (or days) in arrears, but other conditions are often included in default definitions. For example, if a customer notifies the lender that they have been declared bankrupt, or the customer dies, then these "unlikeliness to pay" indicators are often considered to be default conditions too.

It is up to each lender to determine their own definition of default. However, for banks and building societies the PRA sets several regulatory requirements for lenders' default definitions[13]. The main ones being that accounts should be classified as in default once they are 3+ months (90 days) in contractual arrears, or if one or more unlikeliness to pay indicators exist.

For credit unions the term "Bad debt," as referenced in the PRA rulebook for Credit Unions[14], can broadly be taken to be equivalent to the term "Default" that is used when discussing capital requirements for other

[13] See SS11/13 published by the PRA.
[14] PRA Rulebook for Credit Unions 1.2

deposit taking institutions, ie banks and building societies.

2.5.1 Default notices

For internal reporting purposes, for any type of lending, be it a regulated or unregulated credit agreement, a lender will define default based on arrears status and unlikeliness to pay indicators. However, before a customer with a regulated credit agreement (as defined by the Consumer Credit Act) can formally be considered in default for collections purposes they must be sent a default notice.

A default notice, is a formal letter[15] to a customer telling them that:

- They are in default and the reasons why, ie how they have not complied with the terms of their credit agreement, such as missing agreed payments
- Detailing the action they must take, and by when, to remedy the breach of their credit agreement. The lender must give the customer a minimum of 14 days to undertake the required actions
- Details of the action that will be taken if they don't remedy the breach. ie the agreement will be terminated, and the lender will pursue the customer for the full value of the outstanding debt, including any accrued interest and fees that apply

Default notices are important because until they have been issued and a customer given time to respond, a lender can only seek to recover the arrears owing on the customer's account, plus any associated fees or charges. The lender cannot pursue the customer for more than this.

In theory, a default notice can be issued immediately upon a breach of a credit agreement occurring. This means a lender can legally issue a default notice if a customer is only 1 day late with their payment and without sending the customer any prior reminders or warnings[16] However, in issuing a default notice, lenders need to be able to demonstrate that they are acting in consumers' interests in compliance with the FCA's Consumer Duty principle. Consequently, default notices are not normally be issued until the lender has attempted to resolve the arrears with the customer, and not before the arrears have reached at least 3 missed payments (60+ days past due for agreements with monthly repayment terms or 14+ days for weekly repayment terms). However, some lenders will wait as long as 6 months before issuing a default notice for larger, longer term, agreements.

Standard credit union lending is not classified as regulated lending under the Consumer Credit Act. Therefore, credit unions are not required to issue default notices for their unregulated lending products. Consequently, they can specify the conditions under which the loan agreement terminates within the

[15] See sections 87-89 of the Consumer Credit Act for further details.
[16] No time requirements are specified by the consumer credit act (article 87) or by the FCA in terms of the timing of default notices.

terms and conditions of the original agreement. In practice, many credit unions include clauses in their terms and conditions stating that the full loan amount becomes due, upon any payments being missed.

3 Options for dealing with arrears

Lenders have a range of options when a customer may be about to miss a payment or is already in arrears. In this section, we describe what these options are and the circumstances where they are appropriate. Section 4 then goes on to describe how these activities can be used as part of an arrears strategy.

3.1 Pre-delinquency activities

3.1.1 Outbound activities

Where a lender has a pre-delinquency strategy, the goal is to use rules or pre-delinquency scoring to identify and contact at-risk customers while they are still up to date before they miss a payment.

Good practice is to contact high-risk customers a few days before their payments are due, reminding them that their next loan repayment is due, and encouraging customers to get in touch if they think they will have a problem making their payment. The precise timing of when to contact the customer will depend on the nature of the product and the customer's repayment method. It needs to be sufficiently near to the payment date to be immediately relevant to customers, but long enough away to give the customer time to respond. Most pre-delinquency activity occurs between 1 and 7 days before the payment due date.

Given that at this stage there is no certainty that a customer is struggling, communications should be designed only to indicate the help that is available, not state categorically that the lender thinks they have a problem or that a missed payment is expected.

Note that there is nothing to stop a lender sending reminders to all customers that their payments are due. However, most lenders refrain from this due to cost, or because they don't want to appear to be "nagging" most borrowers who are not struggling, which could be viewed as poor customer service. Having said this, some lenders do take this approach, but adopt a differentiated messaging strategy. Low risk customers get a simple "*Just a reminder that we'll be taking your loan repayment soon*" type text message, whereas the communication sent to higher risk customers is a more forthright e-mail, letter or phone call that includes links / contact details to the lender's call centres and/or third-party debt advice organisations.

3.1.2 Responding to customers (inbound activity)

If a customer gets in touch before they miss a payment, then this is a positive outcome because it indicates that the customer is acting proactively, rather than waiting until they are in arrears.

When a customer makes contact, the approach should be like that for cases already in arrears (as described in section 3.2 below). The lender should first establish what the customer's circumstances are and the cause of the problem. They then work with the customer to determine what the most appropriate forbearance strategy (see below) should be and if it would be appropriate to refer the customer to a debt advice organisation such as StepChange or Citizens Advice.

3.2 Early stage arrears

When a customer first misses a payment, they are often described as being in "early arrears." At this stage, the primary goal is to try and help the customer to recover the account to an up-to-date status and the agreement to resume operating to its original terms.

While in early arrears, lenders look to either seek an arrangement to pay, offer forbearance, or a renegotiated agreement. These are described in the following sections.

3.2.1 Arrangement to pay (payment plan)

An arrangement to pay is where the customer agrees to temporarily increase their repayments to cover the payments they have missed. Typical, arrangements last from between 1 and 12 months depending on the amount of arrears, the remaining term of the loan and, most importantly, what the customer can afford to pay.

If the customer sticks to the term of the arrangement, then by the end of the arrangement they should be back up to date with their repayments, and there should be a corresponding zero contractual arrears position reported internally and to external third parties, such as CRAs.

Arrangements to pay are usually applied during the early arrears phase, while the customer remains <~3 payments in arrears and the primary goal is to recover the customer's account to an up-to-date status.

When an arrangement is being discussed, the affordability of those changes need to be assessed. Due to possible changes in customer circumstances and cost of living expenses, a lender cannot rely on the original affordability assessment undertaken when the customer applied for the loan but will need to undertake a new assessment to determine if the repayments are affordable.

There isn't a prescribed way in which this new affordability calculation should be undertaken. However, many lenders either reapply the affordability calculation that they use for new loan applications or use the Standard Financial Statement Calculation tool, developed by the Money and Pension Service (MaPS). This tool is widely used by organisations to assess peoples' income and outgoings when they are needing debt advice.

More details about affordability calculations are provided in the Affordability component of The Guide.

3.2.2 Forbearance

Forbearance means a lessening, reduction, or suspension of the terms of a loan agreement to make the loan more affordable and/or more convenient for the customer.

As with arrangements to pay, it is important to establish the affordability of any forbearance action, even though forbearance often results in reduced payments for the customer compared to the original terms of the agreement. This is because it would be unfair, and not in the best interests of customers, for them to be encouraged to agree to something that is unaffordable even though it is cheaper than their original contractual obligation.

As for arrangements, forbearance actions are usually applied during the early arrears phase to encourage account recovery or provide a breathing space, rather than as a late arrears/debt collection action, and to do this in a way that works best for the customer. To comply with the FCA's Consumer Duty principle, at each decision point in the arrears process, the lender should assess the options available in the context of the customers circumstances and then choose the option that fits those circumstances the best, leading to the best possible outcome for the customer.

The types of forbearance activities available are detailed in Table 3.

Table 3. Types of Forbearance Activities

Activity	Description
Reduced payments (Arrangement to pay)	A lender may agree a temporary reduction to a customer's repayments. Depending on the affordability, this may equate to a suspension of interest or a more substantial reduction to the contractual payment. As a temporary agreement, the customer may see their contractual arrears continue to increase, but further action would not be taken while the agreement was in force. At the end of the arrangement, the customer will still be in arrears and therefore the lender will need to consider this when deciding if an arrangement is appropriate.
Payment holidays	A payment holiday can be seen as the extreme version of a reduced payment. The lender agrees to suspend all repayments for a time. This is usually for between 1 and 3 months although it could be longer. Lenders can decide whether it is appropriate for interest to continue to accrue or if interest charges are also suspended during the payment holiday period. Sometimes lenders will include payment holiday options within the standard terms and conditions of a loan agreement. Therefore, customers can "self-select" to have a payment holiday when they need it.
Suspension of interest	A lender may agree to a temporary suspension of interest accrual, with a corresponding reduction in the customers repayments.

Activity	Description
Term extension	A term extension is where a lender agrees that the customer can take longer to repay the loan than originally agreed. For example, extending the term from 2 to 3 years. This may be to allow time for the customer to pay any arrears that have accrued, or to restructure the loan so that the monthly payments are lower.
Breathing space	The account is "frozen" for a short period (usually 1-2 months). During this time no further action is taken by the lender and no further fees or interest are added to the account. The customer then resumes payments once the breathing space is over. (See also section 3.6 regarding the debt relief scheme).
Re-aging	Re-aging is the process of resetting a customer's arrears status to zero once a customer resumes making normal payments. After several high profile cases of lenders applying re-aging inappropriately, re-aging is generally frowned upon unless it is well-controlled and reported upon, with the re-aging suitably visible from a management reporting, regulatory reporting, and provisioning perspective[17].
Capitalisation of arrears	If a customer's circumstances have improved so that they can afford a larger repayment, then the lender may agree to capitalise the arrears. This means adding the arrears to the balance and the customers repayments increased over the remaining term of the agreement. In practice, this is like an arrangement to pay but is permanent rather than temporary.
Capital forbearance	This is where a lender agrees to write-off a proportion of the debt, with a corresponding reduction in the borrower's repayments. This option is not commonly offered by UK loan providers except in relation to a "full and final" settlement agreement (see below).

These days, arrangements, suspension of interest and payment holidays are the most widely applied forms of forbearance for consumer credit agreements. Capitalisation and Term extensions can be applied, but they are more common for mortgages and other secured lending. For consumer credit, it is more common to renegotiate the agreement (ie transfer the debt to a new credit agreement) if a longer term / reduced payments are agreed on a permanent basis.

3.2.3 Renegotiated agreement

If a customer's affordability has reduced and this looks like it will be for the long term, a lender may agree to renegotiate the agreement if the new payments are affordable. The old agreement is closed, and the outstanding balance transferred to the new agreement.

[17] For example, see the case of Cattles and its subsidiary Welcome Finance. Incorrect re-aging resulted in a distortion to the accounts (under reporting of provision). The business subsequently went bust and several directors were banned by the FCA.

Typically, setting up the new agreement involves extending the term and/or rolling up (capitalising) any arrears into the balance. As a completely new agreement, the customer begins in the position of being fully up to date at the start. They only become in arrears if they miss their new payments going forward.

3.3 Late stage arrears (collections and debt recovery)

For regulated credit agreements, once a customer has missed several payments and is in serious arrears, a lender will notify the customer that their account is in default via a formal "Notice of Default" letter. They will then look to terminate the agreement and recover the outstanding debt in full, rather than recovering the account to an up-to-date status.

For unregulated lending, which covers most credit union lending, a notice of default is not required. In practice, this means that credit unions have greater freedom of action when it comes to debt recovery action because they can move to recover the full debt at any stage of arrears, provided this is stated in the terms of the original agreement and complies with FCA guidance. They are not required to wait before issuing a Default Notice and then allowing time for the customer to respond. However, credit unions should still make all reasonable efforts to support customers in returning their agreements to a good paying status if this leads to the best outcome for the customer.

3.3.1 Repayment plan

A repayment plan is an agreement to pay a certain amount against the outstanding debt. Usually, this will be interest free and may extend well beyond the terms of the original agreement and be for only a nominal amount, dependent upon the size of the debt and the customers finances and ability to pay.

3.3.2 Full and final settlement

If a customer has funds available, a lender may agree to a single lump sum payment equal to a proportion of outstanding debt. A customer may owe say, £1,500 but the lender is willing to accept a one-off payment of say, £750 to settle the debt.

Lenders will often accept a full and final settlement that is less than the outstanding debt due to the costs of further recovery action. ie the cost of court action, the fees paid to debt collection agencies and internal costs mean that accepting a reduced settlement is the most cost-effective option.

Similarly, there may be cases where the debt is unrecoverable by normal means. Therefore, any payment offered by the customer is deemed acceptable. For example, if someone emigrates then court proceedings in the UK will be unenforceable overseas. Hence, there is no point in the lender incurring the cost of court action in this case.

3.3.3 County Court Judgements

A court judgement is where a lender takes the customer to court to obtain the money that they owe. Depending on the circumstances, the lender can ask the court to enforce the debt in several ways that

include:

- **Repayment plan.** The court agrees a repayment plan with the borrower. If the borrower has limited funds, then this could be a token amount repaid over many years
- **Attachment of earnings.** As for a repayment plan, but the regular repayments are taken directly via the customer's payroll before they are paid
- **Direct payment from savings / bank account.** If a customer is believed to have funds saved in a bank or building society account, the court can order the debt be paid from those funds
- **Charging order.** The court may decide the debt should be secured against the customer's property, ie their home if they own it. If the customer sells the property at some point in the future, then the debt is paid from the proceeds18
- **Bailiff action.** Bailiffs are appointed to recover goods from the customer to the value of the debt (plus costs). Usually, this option is only taken if a repayment plan or charging order cannot be agreed, or the customer has broken the terms of a previous repayment plan, meaning that the case has had to come back to the court to be reviewed

In deciding what action (if any) should be taken the court will consider the customers income and expenditure to determine what they can afford to pay.

Industry parlance is to refer to all court rulings for unpaid debts as "County Court Judgements (CCJs)" However, if a debt is more than £5,000 then it must be dealt with via the high court, rather than the county court.

For regulated lending, court action should only be considered once a default notice has been issued and the agreement terminated. For unregulated lending, court action can in theory begin as soon as the customer breaches the terms of the agreement (ie when their account is 1 day past due if that is stated). However, court action is an expensive "late stage" action that should only be undertaken if it has not been possible to come to some other agreement with the customer, or the customer has proven unwilling to engage with the lender over their debt.

Moving too rapidly to court action, without making all reasonable attempts to find a solution with the customer first, could be construed as not providing good customer outcomes, resulting in them incurring disproportionate costs (and distress) in relation to their arears status.

Before commencing court action, lenders must follow the "pre-action protocol for debt claims" published

[18] If the property is mortgaged, then the mortgage provider will have priority, with the charging order only applying to any residual funds once the mortgage has been repaid. This is termed a "Second charge"

by the Ministry of Justice[19], which oversees the court process in England and Wales. This provides a final 30-day window of opportunity for the customer to settle the debt or negotiate a repayment plan.

3.3.4 Eligible Loan Deduction Scheme (ELDS)

The ELDS is a joint initiative by the Department for Work and Pensions (DWP) and Treasury that supports lenders operating in the not-for-profit sector such as credit unions and community development finance institutions (CDFIs).

Lenders who join the scheme can apply to the DWP to recover debts from customers who are in serious arrears, and where the lender-customer relationship has broken down. Lenders therefore typically refer cases to the scheme when other recovery options have been exhausted.

If debts are sold (see below), they are no longer legible for ELDS.

3.3.5 Debt Collection Agencies

Specialist debt collection agencies (DCAs) have resources and sophisticated IT systems that enable them to be highly effective at debt collection. For example, due to the economies of scale, they can make home visits at extremely low cost and have advanced dialler technology that enables them to optimise customer contact activity more effectively than most individual lenders can.

Agencies typically agree to collect debt on a "% in the £" basis; for example, they keep 30% of the monies recovered and give 70% back to the lender. The specific fees will depend on the nature of the debt, customer profiles, the size of the debt and any debt collection activity already undertaken.

The use of DCAs can increase the amount of funds recovered, but it is important that while the debt remains on the lender's books (ie has not been sold to a third party) the lender remains responsible for how the customer is treated during the debt collection process. Therefore, there should be a governance process in place to monitor the behaviour of the DCA to ensure that it is complying with both FCA regulations and the lender's own standards of behaviour.

3.3.6 Insolvency (bankruptcy)

If a borrower owes more than £5,000[20] then it is possible to make a bankruptcy petition against them. This means their assets will be sized and used to repay their debt. Given that the total cost to a lender of making a bankruptcy petition is several thousand pounds[21] and there is no guarantee that sufficient assets will be recovered, it is relatively rare for bankruptcy proceedings to be taken due to an unpaid

[19] https://www.justicegov.uk/courts/procedure-rules/civil/pdf/protocols/debt-pap.pdf. The protocol states that if there is any conflict between it and the FCA Handbook, then the FCA handbook takes precedence.
[20] As of July 2023. The value is updated regularly, usually annually. In Scotland, the minimum debt for is £3,000 for sequestration.
[21] As of July 2023, the petition fee is £1,500 and court costs are £302. There is then the lenders internal costs to consider.

unsecured loan. A county court judgement is the preferred route in most cases.

Moving to bankruptcy for an unsecured personal loan also carries a risk of being non-compliant with the FCA's Consumer Duty. This is because it could be seen as disproportionate and/or inappropriate unless the amount owing is very large and all other routes to recover the debt have been exhausted[22].

A key difference between bankruptcy and the other two forms of insolvency (IVAs and DROs) is that a lender can apply to make someone bankrupt[23]. Only the customer can move to enact an IVA or DRO.

3.4 Write-off

When all reasonable channels for recovering an over-due debt have been exhausted it is good practice to move to write-off the debt. Write-off is important for two reasons.

1 The loss is crystallised in the lenders' accounts and the debt is removed from the balance sheet

2 Having increasing amounts of old bad debt on the books can distort management reporting. The total amount of bad debt continually increases, biasing the reporting of some metrics, unless older bad debt is specifically reported upon as separate item. Therefore, removing this debt allows reporting to focus on the active portion of the book

There are no specific UK regulations as to when write-off must occur. However, most organisations will seek to write-off unsecured debts when accounts are somewhere between 6 and 24 months in arrears.

Note that once cases are written-off or sold, they are no longer legible for the DWP's ELDS scheme.

3.5 Debt sale

Debt sale is where a loan is sold to a third party, often a specialist debt collection agency (DCA). The original terms of the loan remain in force (if the loan has not been terminated), but the management of the loan becomes the responsibility of the new owner. Debt sale is common practice in the wider consumer credit market but is not normal practice for credit unions. This is because of the specialist terms under which credit unions operate in the UK, ie there may be scope to transfer debt between credit unions, but not outside the credit union movement.

The main rationale for debt sale is that the third party can recover more of the outstanding debt than the original lender could, due to economies of scale, combined with specialist recovery teams and IT systems. Therefore, the new owner can recover a lot more of the debt than the original lender.

For seriously delinquent debt, the debt can be expected to fetch 5-10%of its face value. The precise value

[22] FCA Handbook (CONC 7.3.14 & 7.3.15)
[23] An individual can also make a bankruptcy petition themselves to be declared bankrupt.

will depend on the degree of arrears, the size of the debt, previous collections activity undertaken, and recovery estimates based on customers with similar geodemographics.

Once debt sale occurs, all responsibility for dealing with the customer (including regulatory compliance) passes to the third party.

3.6 When action cannot be taken (or must be paused) to recover a debt

3.6.1 Breathing space

The Debt Respite Scheme[24] gives someone in problem debt the right to legal protections from their creditors for a period of time. This is often referred to as a "Breathing Space." A standard breathing space is 60 days in length, but in some cases can last indefinitely. If a lender is notified that a breathing space is in force, then:

- No collections or debt recovery action can be taken, and no interest or other fees charged during that period
- If a customer has multiple loans, the breathing space applies to all loans/debts, not just the one(s) referenced in the notification.
- If the debt has subsequently been sold to a third party, then it the original lender is obliged to pass on the details of the notification to them.

The contractual arrears status of the account can continue to be reported to credit reference agencies during a breathing space, ie arrears can continue to increase if no payments are received.

3.6.2 Repayment planning

The FCA Handbook states that a lender must suspend the active pursuit of recovery of a debt from a customer for a reasonable period where the customer informs the firm that a debt counsellor or another person acting on the customer's behalf or the customer is developing a repayment plan. A reasonable period is taken to be 30 days.

If there is evidence after that period that the customer has made progress in developing a repayment plan, then the lender should consider extending that time by up to another 30 days. However, if the borrower has already had a Breathing Space, then this can be taken into account by the lender[25].

[24] Applicable in England and Wales. www.legislation.gov.uk/uksi/2020/1311/made/data.pdf. In Scotland, a similar scheme is the Debt Arrangement Scheme but operates differently.
[25] FCA Handbook (CONC 7.3.11 & 7.3.12)

3.6.3 Insolvent customers

If a customer is subject to a bankruptcy order, an IVA, or a debt relief order[26] then the only recourse for a lender is to register as a creditor who is owned money by the customer[27].

In cases of Bankruptcy, a lender registers their interest by submitting a proof of debt form to the Insolvency Service. The debt will then be considered alongside those of other creditors. This means that the debtors' assets will be distributed amongst the creditors on a priority basis, once the government's costs of managing the insolvency have been deducted. Usually, any tax liabilities or secured debts (eg mortgage) will be a higher priority than any unsecured debts.

For IVAs and debt relief orders, the lender should be contacted by the borrower's insolvency practitioner, the lender then needs to agree (or refuse) to the terms of the repayment plan for the IVA/DRO that is put forward.

3.7 Referral to Debt Advice Services

At any stage of arrears, be it pre-delinquency or following court action, good practice is to refer customers to free, third party, debt advice services if it is believed that this would be helpful and is appropriate to do so.

When discussing a customer's situation, a good strategy is to try and establish the scope of the customers debts, and the customers understanding of those debts in relation to their financial circumstances. Good times to introduce debt advice services into a conversation with a customer are if:

- The customer indicates that they have multiple debts/debt problems with multiple lenders.
- The customer demonstrates a poor understanding of their own finances.
- The customer asks for help with their finances.
- There is evidence that the customer has been helped by debt advice services in the past (such as via comments in case notes)

Information about free debt advice services can also be provided as part of letters, e-mails, and texts.

More details of the help that can be provided to customers from third party agencies is provided in the Debt Advice and Financial Literacy component of the Guide.

---

[26] This applies to England and Wales. In Scotland, the legal process and terminology differ somewhat. For example, "Sequestration" is Scottish equivalent of Bankruptcy. However, from a collections processing perspective the outcome is the same, ie a lender must go through that process rather than seeking to collect an outstanding debt directly from the customer.
[27] FCA Handbook. CONC 7.3.16

3.8 Choosing the right option(s) for the customer

To be able to deliver the right outcome for customers, it is important that the lender has a complete understanding of the customers circumstances before deciding which forbearance or arrangement option is best. This should include the following:

- **Assessing the customer's current financial position**. In particular, where changes to customers' payments are being considered, an affordability assessment to determine how much disposable income they have and hence how much they can afford to pay should be undertaken. Where an affordability assessment is required, good practice is to apply the Standard Financial Statement produced by the Money Advice Trust[28]
- **Consideration any vulnerabilities or special circumstances and the on-going impact of these.** For example, a payment holiday of say, 3 months, could be right for someone who is currently off work, is about to have an operation be back at work in a few weeks. However, this may not be appropriate for someone who has become permanently unable to work due to illness/disability. This is because after the payment holiday finishes their situation won't have changed. The core issue remains unresolved
- **Consideration of the customers views.** Often more than option is available to a customer. They may be eligible for a payment holiday, but extending the loan term to reduce their monthly repayments may also be an option. Good practice is to discuss each available option with the customer before a final decision is made as to which one is best

In some cases, there may be no viable option for agreeing a recovery plan with the customer. It may be appropriate to move quickly to court action or to write-off the debt, rather than dragging out the collections process (which may end in court action anyway). From a customer perspective, moving quickly to an end point like this can be the best outcome for the customer because a short process usually means less total cost, less distress and, once a resolution is reached, they can then move on with their lives.

[28] http://www.cfs.moneyadvicetrust.org/

4 Building an arrears strategy

4.1 Arrears paths (strategies)

As part of their arrears and collections management process, lenders define arrears paths. An arrears path defines what action should be taken, when to attempt to contact customers, and, at later stages on the arrears path, when to terminate agreements, take enforcement action or move to write-off debt. Arrears paths are important because the timing and nature of communications with customers can have a significant impact on how many customers recover their accounts, and how much of the delinquent debt is collected.

Once a customer becomes delinquent, they progress along the arrears path until the lender manages to establish contact with them. If contact is made, then the lender engages with them to discuss their circumstances and decide upon the best course of action to follow, given their personal situation and the severity of their arrears position, as discussed in previously.

If, after multiple attempts, a dialogue with the customer cannot be established and a resolution path agreed, then various enforcement actions are undertaken at later stages of the arrears path.

An arrears path comprises two elements:

- **Deciding what action to take.** During the early stages of the arrears path, this will focus on the wording and format of the communications sent to customers, and the channel(s) used to deliver those communications. For example, sending them a text, e-mail, letter, or even calling on them at their home[29]. At later stages, the actions will focus more on enforcement action such as termination of the credit agreement, use of DCAs and court orders
- **The timing of each action.** This is in terms of how many days after the customer misses a payment the action is taken. For example, send reminder text when 1 day past due, a letter when 14 days past due, instigate court action at 120 days past due and so on

[29] This is relatively rare and is an expensive activity for most lenders to undertake. However, it can be cost effective for larger DCAs who may have tens of thousands of debts on their books. Consequently, they often have several delinquent customers all living in close proximity or the same street and can all be visited in quick succession, making it cost justifiable.

A full arrears path contains several different actions, starting with when a customer first misses a payment and ultimately concluding with the debt being written-off or sold.

Smaller lenders with relatively few new arrears cases each month (<~100), usually only have one arrears path. Lenders with larger portfolios may have several arrears paths for different customer segments, including longer paths for lower risk customers without previous arrears history and no warning indicators, and shorter paths for higher risk customers who have a history of arrears or display other behaviours indicating that it is best to act more quickly.

Lenders may also "fast track" certain cases along the arrears path. If a customer re-enters arrears one month after recovering from a previous arrears position, then the lender may start their arrears journey at a later point in the arrears path. For example, reverting to the point in the arrears path that the customer was previously at before they repaid, rather than starting right at the beginning.

The arrears path also needs to cater for cases where a remediation plan (arrangement or forbearance action) has been agreed with a customer, but the customer then fails to adhere to the terms of that agreement.

Finally, before commencing arrears action, the lender needs to check if there are any special circumstances requiring the customer to be dealt with outside of the standard arrears process. For example, if there is a deceased indicator recorded on the customer's account record, then an appropriate action would be to contact their estate and seek to settle the debt when the estate is settled; not to send threatening reminder letters to the decreased. Likewise, specialist treatments may be required for certain vulnerabilities, and some borrowers may be ineligible for arrears action due to breathing spaces under the debt relief scheme or because they are insolvent.

An example of an arrears path for a credit union customer, who had previously paid to terms and entering arrears for the first time is shown in Table 4.

Table 4. Arrears path for a credit union.

Days past due	Action (if no customer contact or no arrangement in place)	Action Details
1	Text & email 1	A reminder email and text sent to the customer, reminding them their payment is overdue, but that no late payment fees will apply if they make their payment within 3 working days. Asks them to get in touch to discuss if they have any problems paying. Note that late fees could be applied on day 1 but the credit union has decided give members a grace period of 3 days before doing so.
4	Text & email 2	Send a further reminder, notifying the customer that they are past due and that a late fee now applies. Again, ask them to get in touch if they have any problems.
7	Call 1	Attempt phone call to contact the customer.
10	Letter 1	A more formal communication, stating that the account is in arrears, and that it is important that the customer contacts the lender to discuss their options.
10	Freeze savings	At the same time as Letter 1 is sent, the members savings account is suspended. This is so that the any funds held in savings can be used to offset the arrears, if required.
14-21	Call 2	Customer details loaded into lender's automated dialler, which attempts to call them once a day during this period. If the customer answers, then the customer's circumstances are explored and an attempt to find an acceptable option going forward, ie create an arrangement or grant forbearance.
22	Letter 2 (and e-mail)	A second letter at this stage will arrive before the customer misses the next payment (at 30 or 31 days past due depending on month). Firmer wording applied, noting the impacts of continued non-payment could have on their credit report.
32-39	Call 3	Further attempts to call the customer and speak with them on the phone.
42	Text & email 3	The content of the text now expresses increasing urgency, with the focus more on the consequences of non-payment, but still encouraging the customer to make contact to try and resolve.
49	Letter 3 (and e-mail)	Similar content to text & e-mail 3.
62 days	Court action	At this stage, the borrower has missed 3 payments and is classified as "Bad debt" (defaulted) under PRA definitions[30]. If outstanding debt is >£100 then preliminaries for court action commence, beginning with "Letter of Claim" as required by the pre-action protocol. For debts below £100, or where the borrower is known to not be in employment, continue to send weekly reminders via e-mail and text.
120	DWP refer (ELDS)	If member is not in full time employment and no court action, then referral made the DWPs ELDS scheme, seeking payments via benefit deduction.
180	Write-off	If account not accepted on ELDS, and no outstanding court action, then move to write-off.

The arrears path for a non-credit union would be very similar to that in Table 4, but with the following

[30] PRA Rulebook for Credit Unions 1.2 and SS11/13 for other deposit taking institutions.

modifications:

- The member's savings account would not need to be suspended, as it would not exist for non-credit union lenders
- To include an extra action to send a default notice terminating the agreement. In practice this would likely extend the arrears path by up to 30 days, usually occurring when the account is between 2 and 4 months in contractual arrears, ie 31-90 days past due
- Unless the lender is a Community Development Finance Institution (CDFI) then there will be no option to refer to the DWP's ELDS
- If the loan is for a mortgage (for any type of lender), then the lender must inform the customer of the arrears within 15 days of their missed payment

4.2 Communicating with customers

4.2.1 Content and format of letters, texts, and e-mails

The FCA provides regulatory guidance for the timing and content of communications in relation to arrears in the FCA handbook (CONC 7). Lenders have some leeway in how they word their communications but there are some general principles that should always be adhered to, to comply with Consumer Duty and wider FCA guidance. This includes:

- Any communication should clearly detail the amount of arrears, and what a customer needs to do to bring their account up to date. This should be in simple, non-technical language that a layperson can be expected to understand
- The wording should not use threatening language, or text formatting that could be considered aggressive. For example, using capital letters for key phrases such as "COURT ACTION!" Or "YOU MUST PAY OR ELSE…."
- The communication should provide clear details as to how the customer can contact the lender to discuss their situation
- Details of free to access debt support services such as debt charities and citizens advice should be provided

4.2.2 Timing and frequency of outbound customer contacts

Lenders are within their rights to pursue delinquent customers for the money they owe, but they must not harass customers by contacting them too frequently, or at unsociable hours. As a rule, collections actions such as phone calls, personal visits, e-mails, and texts should not be undertaken more than once a day, and customers should only be contracted during normal working hours (9-5). However, if a customer has informed the lender that they would like to be contacted at other times, for example because they work nights, then the lender must take this into account.

4.2.3 Fees for arrears action

Lenders can only charge fees that are representative of their costs. If it costs say, £7 to send a customer a letter notifying them that they are in arrears, then that is the maximum that the lender should charge.

For regulated credit, The FCA has capped charges for late fees at £15; ie a customer can be charged no more than £15 for each action taken by the lender. Lenders can also only charge fees for recovery action that is specified in the terms of the credit agreement, ie the agreement should tell the customer what late fees the lender will charge if they default.

4.2.4 First payment defaulters (never pays)

A "never pay" is someone who defaults on their first payment and makes no further payments. Often, these will be cases of fraud where a customer has applied for a loan knowing that they won't repay it. However, this won't be the case for all customers. If a customer misses their first repayment it is impossible to be sure at that point if the case is fraudulent or not. Therefore, lenders must not assume the case is fraud until further attempts to contact the customer and discuss their situation have occurred.

When faced with first payment default, most lenders adopt an "accelerated" arrears strategy. They will still try and contact customers and resolve any genuine problems that they may have, but if customer contract cannot be established quickly, then the arrears actions (as per Table 4) occur more rapidly, and some steps may be skipped. Cases therefore move to default and debt recover far sooner than for established customers.

If at any stage fraud is confirmed beyond reasonable doubt, then the case will be referred to the lender's fraud department and processed as a fraud case from that point on, rather than an arrears case.

4.3 Optimising arrears paths – a champion / challenger approach

It is almost impossible to design an optimal arrears path without detailed knowledge and experience of how customers respond to different types of communications, the timing of those communications, and the channel used to communicate with customers.

Consequently, good practice is to adopt a trial-and-error approach to test alternative arrears paths. This is referred to as the "Champion/Challenger" approach.

The champion/challenger approach begins with the lender's standard (champion) arrears path that is being applied to everyone[31]. The lender then decides upon one (and only one) element of that process to experiment with. This "challenger" path is applied to a small segment of the population initially, often 5-

[31] Excepting special cases that are dealt with outside of the standard process, or cases that cannot be actioned such as bankruptcy.

10% of randomly selected arrears cases[32]. The champion and challenger then run in parallel for a few weeks or months. At the end of that time, the recovery rates for customers in each group are compared. If the challenger strategy has outperformed the champion, then it replaces the incumbent champion. A new challenger is then selected, and the process is repeated. Some examples of the types of things that are trialled as part of champion/challenger testing in an arrears environment include:

- Changing the timing of arrears actions and/or the intervals between different arrears activities. For example, instead of sending formal letters on day 10 and 20, send letters on days 7 and 21
- Increasing the frequency of communications. For example, attempt to phone the customer four times a month rather than twice
- Changing the wording on the letters sent to customers at different arrears stages
- Using different channels to communicate with customers at different stages. For example, replacing a phone call with a letter or vice-versa

For champion/challenger to work well, a lender needs to use a disciplined approach and be patient. They need to maintain records of each different challenger strategy they have tried and how well each performed against the metrics that are important for the business[33]. It can be very tempting for lenders to continually modify their arrears paths based on "gut feel" but without proper recording of outcomes and/or a statistically robust analysis of performance, making it impossible to make an informed assessment of how well each strategy is performing.

4.4 Risk based segmentation (arrears & collections scoring)

Larger lenders, who see hundreds of arrears cases a month, often use a risk-based approach to defining their arrears paths. Different arrears paths will be defined based on the level of risk (probability of increasing arrears). The most common way that this is done is via the use of arrears scoring.

Arrears scoring is another variant of credit scoring. It seeks to predict the likelihood that customers will recover their accounts in the short term (3-6 months). When an account first enters arrears, it will be assigned an arrears score. A high arrears score means a customer is highly likely to recover their account with little or no support from the lender. A low score means that the customer is more likely to be struggling and are less likely to recover without help, and hence are more likely to go further into arrears. customers are then segmented, typically into two or three groups, based on the score they receive, with a different arrears path applied to each customer segment. In particular, the arrears scores can be used at

[32] The challenger needs to have enough cases to allow a statistically sound evaluation of how it performs to be undertaken. Typically, a minimum of 30-50 cases are required for this.
[33] Direct business measures, such as funds recovered or changes in arrears status are important, but other measures such as customer feedback or complaints should also be considered.

the start of the arrears path to identify:

- **Low risk "self-cure" cases**. These have a high probability (high score) of recovering their accounts. Therefore, many lenders adopt a "do nothing" strategy at first, in the expectation that the customer is late with their repayment rather than unable or unwilling to pay. For example, well-off customers who have gone on holiday and forgotten to pay their bills but do so as soon as they return
- **High risk "urgent" cases.** These are where the probability of them recovering their account in the next few months is very low. Typically, these are cases where there have been multiple payment issues in the past and/or indicators exist on credit reports or open banking indicating financial difficulty. These cases are usually "fast tracked" (have a shorter arrears path) to try and contact the customer as soon as possible deal with the problem rather than taking a more "wait and see" approach

Setting the relevant score cut-offs to identify each group, will depend on each lender's customer profile, the resources that the company has to manage customers and the costs associated with the different arrears and collections actions that the company uses.

5 Reporting of arrears and write-offs

5.1 Management reporting (board and/or sub-committees)

The board or delegated sub-committees (such as risk committee) should be provided with details of the arrears position of the loan book as a standing item at governance forums. The reporting should be sufficiently detailed to provide information about:

- New arrears (by number and value) that have emerged during the current reporting period
- The arrears profile of the book, ie number and value cases at each arrears status
- The arrears position of the book segmented by key population segments eg product type
- The arrears profile of different cohorts of business over time. For example, for accounts originated 12, 15 and 18 months ago, the arrears position after 3,6,9 and 12 months on the books. This allows performance profiles to be compared considering changes in the economy or changes in lending policy over time
- The recovery profile of customers, ie for customer in given arrears positions in previous reporting periods, how many recover, how many stay the same and how many move to a worse arrears position
- The proportion of arrears cases being written off
- Details of the number and type of arrears and collections actions being undertaken each reporting period. Eg number of court actions, arrangements and so on
- The performance of arrangements and forbearance actions. In particular, the number of agreements that are performing to plan Vs the number where the customer has not kept to the terms of that agreement. This should also include the total amount collected against what was agreed
- Where a champion / challenger approach is being applied, reporting on the performance of different challenger approaches, and any changes to arrears paths and actions as a result

Reporting should be provided for the current reporting period and previous reporting periods (covering at

least one full year) to allow trends to be observed.

See the Portfolio MI component of the Guide for further information on reporting requirements.

5.2 Data submissions to Credit Reference Agencies

The most detrimental information that can lead to a customer being refused credit or having a reduced credit score is evidence of arrears and/or enforcement action to recover debt (such as court judgements). Consequently, it is important lenders ensure that their reporting to the Credit Reference Agencies (CRAs) accurately reflects the arrears status of customer accounts. A poor credit report and/or credit score can also impact employment, ability to rent a property, and even contracts for phones and utility bills.

When it comes to reporting the arrears status of customer accounts, each of the CRAs provides details of how it expects the information to be reported. In practice, the specific formatting requirements for each CRA can differ, but way the data is calculated is the same.

Arrears should be reported based contractual arrears (as discussed earlier) ie 1 month in arrears means at least 1 but less than 2 missed payments. 2 in arrears at least 2 but less than 3 missed payments, and so on.

Where forbearance action has/is being undertaken, then the way that the arrears is reported depends on if the forbearance represents a temporary or permanent adjustment.

- **Temporary.** If forbearance results in reduced payments for a time, but the arrears is allowed to increase, then the contractual arrears may increase during the forbearance period, and this can be reported to the CRAs
- **Permanent.** If the forbearance activity results in a permanent change to the customer's loan repayments, such as a new loan agreement with extended terms, with the arrears are re-aged or capitalised, then the arrears (as reported to the CRA) should be reset to zero to reflect the new terms that have been agreed. However, arrears reported prior to the new agreement being created should not be retrospectively adjusted or set to zero. They are left unchanged to reflect the status of the arrears at that time

Further information about the reporting of arrears is provided in the document "Principles for the Reporting of Arrears, Arrangements and Defaults at Credit Reference Agencies" produced by the ICO in collaboration with the credit industry. See also the Credit Reference Agency component of the Guide.

5.3 Regulatory reporting

The FCA and PRA specify a range of regulatory reporting that includes account performance and arrears positions. The FCA provides detailed instructions as to how each type of regulatory reporting should be completed.

6 Appendices

6.1 Appendix A: glossary of terms used in this document

Term	Description
Arrangement	A temporary agreement between a lender and a borrower for the borrower to pay a different amount to the contractual terms of their loan agreement. Most often, arrangements are temporary, and are used to allow the borrower to overpay for a time, to make up for any missed payments. However, arrangements can also be used as a forbearance measure to provide reduced payments temporarily.
Bankruptcy	A form of insolvency where a borrower's assets are seized (except things deemed essential for living such as clothes or tools required to do your job) and the funds distributed amongst the bankrupt's creditors. Normally, bankruptcy last for 12 months, after which all debts are written-off and can no longer be collected against.
Capitalised	Where the arrears owing on the account are added to the original loan, and the arrears is set to zero.
Community Development Financial Institution (CDFI)	A not-for-profit financial organisation, providing loans and other services to customer segments who are traditionally excluded from mainstream financial products.
Contractual arrears	The difference between what someone should have paid according to their credit agreement and what they have actually paid.
Credit Reference Agency (also known as a Credit Bureau)	An organisation, licensed under the Consumer Credit Act 1974, to hold information about individuals' repayment behaviour when using credit products such as mortgages, loans, and credit cards. Nearly all UK-based Lending institutions provide details of the balances and arrears status of their customer accounts to one or more of the UK credit reference agencies each month. When a new customer applies for a loan, a lender will purchase a

Term	Description
	copy of the customer's credit report from the CRA, which details the balances and arrears status of the customers current and previous loan agreements with other lenders. The 3 main credit reference agencies in the UK are Experian, Equifax, and TransUnion (formally CallCredit).
Credit Score	A credit score is a number which provides a holistic view of a customer's creditworthiness based on several different features (characteristics). Typically, these are a mixture of geo-demographics (eg age, occupation, residential status) and financial history (eg number of existing credit agreements, credit card utilisation, defaults, and court judgements). Credit Reference Agencies each provide their own credit scores and the scores differ between agencies due to the different data and methodologies used to create them. Individual lenders often develop their own Credit Score(s), which are tailored to their customer base and may incorporate additional data sources that they have available.
Credit Scoring	An algorithm (mathematical formula) that creates a credit score for an individual by assigning weights to the different pieces of information that are known about them.
Debt Collection Agency (DCA)	A firm specialising in collecting past due and defaulted debts. This may be on behalf of a lender on a commission basis, or via debt sale, where the DCA purchases portfolios of delinquent debts from lenders. All DCAs must be registered and regulated by the FCA.
Debt Relief Order (DRO)	A form of insolvency (bankruptcy) for debts of up to £30,000 where a borrower does not have significant assets, such as a property, savings, or car (worth more than £2,000). Given the borrower has few assets, no monies are collected to repay creditors once a DRO has been granted, and all outstanding debts are written off.
Default	Default is defined as the point where the lender believes that the arrears have reached a point where it is unlikely to be repaid in full. Consequently, default is often the point at which a lender's arrears

Term	Description
	strategy switches to one of debt recovery rather than returning the customer to a good paying status. Default is primarily based on months in arrears, but other conditions (termed unlikeliness to pay indicators) can also be included. For example, if a customer notifies the lender that they have been declared bankrupt or if a customer dies, then these are usually considered to be default conditions. Most definitions of default adopted by lenders align with regulatory definitions defined under IFRS9 accounting standards or PRA defined capital requirements. These both set 3 months (90 days) as primary definition of default.
Eligible Loan Deduction Scheme (ELDS)	This is a government initiative to support the expansion of affordable credit to people on low incomes. It is part of the government strategy for reducing financial exclusion. It allows credit unions and CDFIs to refer serious arrears cases to the Department for Work and Pensions DWP, to allow debts to be collected directly via benefit deductions by the WP, who then passes on the payments to the lender.
Financial Conduct Authority (FCA)	This is the regulatory body responsible for the functioning of the UK financial markets. This includes the regulation of firms providing consumer credit products and services.
Forbearance	A relaxation of the original terms of a credit agreement to help a financially struggling customer. This could be in the form of reduced payments for a period of time, a payment holiday, or a suspension of interest charges.
Individual Voluntary Agreement (IVA)	A form of insolvency, where a debtor agrees a repayment plan with their creditors for a proportion of the total debt that they owe. Usually, the plan will cover only a proportion of the debt owed and at the end of the plan the outstanding debt will be written-off. An IVA can only be put in place if 75% of the creditors (by value) agree to the repayment plan. An IVA is managed by an independent insolvency practitioner (IP), who acts as an intermediary between the debtor and their creditors. The IP is responsible for the collecting and distributing funds to creditors. The individual does not deal directly with their creditors

Term	Description
	once the IVA is up and running. If the debtor breaks the terms of the IVA, then the IVA can be terminated. The outstanding debts to individual creditors become due once more (ie as if the IVA never existed, less any payments that were made while the IVA was in force)
Impairment	A loan is said to be impaired if there is evidence of increased risk that the loan will not be repaid. The most obvious indicator of impairment on a loan is when the loan enters arrears due to non-payment, by there are a range of additional indicators that may indicate potential non-payment and hence impairment.
Initial Recognition	Initial recognition refers to when a loan first appeared on the balance sheet. This is usually when a new loan is granted and added to a lender's portfolio. However, it can also refer to other ways in which a loan can be added to a portfolio, such as through the purchase of a loan book from another lender, or when an existing loan is consolidated or replaced by a new loan.
Insolvency	A general term that covers bankruptcy, IVAs, and DROs.
Net Present Value (NPV)	A method of calculating how much future revenues should be accounted for in the present, taking into account the time value of money. For loans, this typically, this involves discounting future income based on the interest rate charged on the loan. The higher the interest rate the less future revenues are worth today.
Provision (Impairment charge)	An amount "put aside" to cover a loss event that has not yet occurred but may happen in the future.
Prudential Regulatory Authority (PRA)	The PRA is a part of the Bank of England and is regulatory body responsible for ensuring the soundness of the UK financial system. For example, ensuring that companies hold enough capital reserves and have sufficient liquidity to remain solvent.
Re-aged	This is where the arrears on an account are set back to zero.
Reporting period	The frequency with which accounting figures are updated. This is usually monthly, but could be four-weekly, quarterly or another period.

Term	Description
Sequestration	The Scottish term for the equivalent of Bankruptcy in England and Wales