

**TECH 20/01**

**MORTGAGE LENDERS –  
ACCOUNTING FOR SELF INSURANCE OF LOAN RISK**

*Guidance issued in December 2001 by the Financial Reporting Committee of the Institute of Chartered Accountants in England and Wales to assist Chartered Accountants working in or auditing the financial statements of enterprises in the mortgage-lending industry*

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## **INTRODUCTION**

- 1 Many mortgage lenders have historically limited their risk in relation to the repayment of mortgage loans by requiring borrowers to pay for Mortgage Indemnity Guarantees (MIG) from third parties in respect of high-loan-to-value loans (high LTV loans), where there is a high ratio of the loan granted to the value of the security held. This MIG cover, whilst paid for by the borrower, actually indemnified the lender and, in periods of economic recession, provided significant protection to lenders in restricting the losses incurred in respect of loans that were impaired or written off. In some cases, the lender, while charging borrowers for the MIG premiums, described the charges as a high lending fee. The accounting principles remain the same, regardless of the description applied to the fee.
- 2 In recent years, two developments have combined to complicate the position of lenders in relation to MIG cover:
  - firstly, continuous pressures in the insurance market make it more difficult for lenders to obtain third party MIG cover as extensive as in the past. MIG policies now often include ‘co-insurance’ clauses leaving an element of the risk with the lender. This has led lenders to ‘self-insure’, on a full or partial basis, usually by the identification of certain sums collected from borrowers (accounted for as deferred income), in some cases in conjunction with the use of captive insurance entities;
  - secondly, ‘MIG-free’ mortgage products have emerged in response to competitive market forces and criticism of MIG policies because they result in borrowers paying for insurance that is solely for the benefit of lenders. The trend towards MIG-free products has increased such that a sizeable proportion of high LTV loans are now provided without any identifiable additional charge being made to the borrower. As a result, there is no identifiable income to defer when compared to an external MIG premium that was specifically charged to the borrower.
- 3 It has become increasingly clear that guidance would be helpful on accounting for notional or actual fees charged on high LTV loans and the deferral of income for MIG-free products or loans not covered by external MIG insurance. There is also a need to clarify the relationship between income deferral policies on high LTV loans and accounting for credit loss provisioning. In this context, guidance is already provided on loan loss provisioning by the Statement of Recommended Practice ‘Advances’, issued by the British Bankers Association and the Irish Bankers Federation (the SORP on Advances).

## **MIG-FREE PRODUCTS**

- 4 Paragraph 2 above refers to the emergence of MIG-free products as one of the incentives increasingly used by mortgage lenders. Other incentives have included cashbacks, fixed and capped rates, interest discounts, free valuations and contributions

towards legal costs. The most difficult issue that has arisen in relation to MIG-free products has been the desire by some lenders to set aside part of the income from high LTV loans as a deferred fund to provide cover against losses which may arise in the future.

- 5 The issue has been made more complex by the variety of accounting treatments adopted for other mortgage product incentives, ranging from the immediate write off of cashbacks to their amortisation over an appropriate period. Guidance in this area is already provided in paragraphs 41 and 42 of the SORP on Advances, which set out the principles relating to the amortisation or immediate write off of incentive costs. Guidance given in the SORP is not prescriptive, but provides an appropriate framework for accounting for mortgage incentives.
- 6 Where an amount (which may be called a fee) is charged which relates to any risk of default by the borrower on a mortgage (which may be directly related to the loan to value ratio on a loan), this should be offset against the initial loan balance and released to income over the period of the loan. In this context, the relevant period is the expected life of the loan, which may be shorter than its contractual life. The release should be on a systematic basis consistent with the principles set out in paragraph 41 of the SORP on Advances and in paragraph 14 of the Appendix to IAS 18, so as to achieve a level yield. A similar treatment should be adopted where lenders charge a higher initial rate of interest on high LTV loans, reflecting the increased credit risk associated with such loans.
- 7 Where a borrower is granted a MIG-free loan, generally accepted accounting principles preclude deferring any of the interest income from such loans as a deferred fund to cover future mortgage losses. Therefore, even if internal or notional entries are made on a borrower's account, no income should be deferred other than in accordance with paragraph 8 below and no mortgage incentive charge should be recognised. Loan loss provisions should be assessed separately to take account of the impairment, if any, that exists at the balance sheet date. Guidance on provisioning is provided in this respect in paragraphs 11 to 18 of the SORP on Advances.

### **CAPTIVES AND CONSOLIDATION**

- 8 Where lenders have underwritten MIG business through captive insurers, many of the same issues described in paragraphs 4-6 above arise when the captive is consolidated in a lender's group accounts, because the group as a whole is not insured except to the extent that such cover is reinsured externally with a third party. Regardless of whether any income is received from the borrower, the transactions between the lender and the captive should be eliminated on consolidation, and any provisioning within the captive should be replaced by a mortgage loss provision calculated on a basis consistent with the requirements of paragraphs 11 to 18 of the SORP on Advances, just as for any other loans that are uninsured. Any premium received from the customer should be accounted for as fee income and deferred as described in paragraph 6 above. This approach does not affect the re-insurance accounting in the underlying captive insurer, which continues to follow re-insurance principles that require it to recognise the

external premium expense over the period of the re-insurance contract and to recognise claims when recovery is virtually certain (in accordance with FRS 12).

### **TRANSITIONAL ARRANGEMENTS**

- 9 Lenders which have already set up deferred premium or other reserves without having received specific premiums or similar income from the borrower should consider how to comply with the guidance set out above. In most cases, the deferred income will already have been partially released to income and the sums involved may not be sufficiently material to warrant a restatement of prior years to comply with the new accounting policy. However, where the amounts involved are material, a restatement of prior periods should be made in accordance with FRS 3.

### **CONCLUSION**

- 10 Accounting for mortgage risk is a matter for the lender's bad debt provisioning policy. A lender provides against loans that are impaired at the balance sheet date and accepted provisioning practice does not extend to making provision for future impairment. Fee income relating to any mortgage risk that is deferred should be reported in interest income on a systematic basis in accordance with paragraph 6 of this technical release.

FJB/T:2056-3