Lender bulletin

This is the latest in our series of lender bulletins setting out key issues for lenders to be aware of.

Implications of the building safety legislation on secured lending against residential assets

The Building Safety Act 2022 (BSA) implemented wholesale reform of the legislative landscape governing the design, construction and management of tall residential buildings in England and Wales, in response to the Grenfell Tower fire in June 2017. Specifically, the BSA has imposed strict requirements for "higher-risk buildings" which are at least seven storeys or 18m in height and contain two or more dwellings. The obligations are imposed on different "dutyholders" during the construction and in-occupation phases of the building's lifecycle, and enforced by the new Building Safety Regulator, which sits within the Health & Safety Executive.

Since receiving Royal Assent on 28 April 2022, the BSA has come into force in stages and has been supplemented by numerous statutory instruments which set out the detailed application of the new regime.

The provisions governing the design and construction of new higher-risk buildings, or the undertaking of material works to existing higher-risk buildings, came into force on 1 October 2023 but were subject to a transition period which ended on 6 April 2024.

The provisions governing the ongoing management of occupied higher-risk buildings, which apply not only to newly constructed buildings but also to the estimated 12,500 existing higher-risk buildings, came into force on 16 January 2024, with the deadline for registering all such higher-risk buildings having passed on 1 October 2023.

The BSA also introduced new and enhanced legal remedies for leaseholders, building owners and other interested parties to seek compensation for the cost of works to remedy historic defects in buildings that are at least five storeys or 11m in height and contain two or more dwellings. This area has been a source of much debate and litigation since the legislative provisions came into force on 28 June 2022.

As the new regime is now fully in force, lenders will need to factor these legislative duties and associated risks into the terms of new loans, both for development finance and acquisition finance or refinance where tall residential buildings are involved. In particular, the BSA's reforms to the building control process may lead to developers and borrowers incurring significant cost overruns and delayed programmes in the construction of higher-risk buildings, with longer peak debt exposure. For occupied buildings, lenders will need to ensure that their valuers have considered ongoing building safety compliance costs in the management of the assets, and the potential consequences for the saleability of any non-compliant assets in an enforcement scenario.

Whilst it is unlikely that loan documentation will require a large amount of bespoke drafting (as reflected in the LMA's Building Safety Act guidance note which was issued in April 2024), lenders and their valuers will still need to take appropriate advice to understand the risks and ensure that appropriate safeguards are in place. Enhanced due diligence may be necessary and crucially, certain requirements may need to be incorporated into facility agreements to ensure that borrowers are fully aware of (and in compliance with) their obligations under the BSA. Each borrower will need to ensure that it is able to satisfy any BSA related conditions precedent, can comply with any BSA related laws and authorisations and can comply with BSA related information undertakings, particularly with regard to creditors and maintaining a "golden thread" throughout the life cycle of the building.

Personal guarantees strengthened in new measures

Lenders are having to navigate new provisions in respect of personal guarantees provided by small and medium-sized enterprises (SMEs) following the announcement on 12 September 2024 by the Lending Standards Board (the LSB) that guarantors will be afforded greater protection.

The regulation of SME lending continues to be a topic of discussion, particularly in light of the House of Commons Treasury Committee's report published in May 2024 on its long-running inquiry into SME's access to finance. The LSB, formally recognised by the Financial Conduct Authority, is a voluntary self-regulatory body for the banking and lending industry. Within its Standards of Lending Practice for business customers (the Standards), it aims to protect SMEs with a turnover of up to £25m across loan, commercial mortgage, overdraft and credit card products.

In early 2024, the LSB's review of its business standards and ongoing compliance work highlighted a need for updated guidance on guarantees. To ensure that lenders are clear with guarantors about their obligations under a personal guarantee and to help avoid situations where a guarantor – often a company's director – is unaware that they are personally liable in the event that the company is unable to repay their loan, the LSB has now tightened provisions on personal guarantees within the Standards.

What are the updates?

The updated Standards now include improvements to existing protections and guidance on personal guarantees and the introduction of new requirements for lenders to ensure (i) that the information held by lenders remains current and (ii) that guarantors are kept informed. The updated Standards include:

- A new requirement for lenders to provide guarantors with annual reminders that a personal guarantee remains in place. This means that lenders will need to maintain up-to-date records on who is liable for a guarantee, which will in turn allow guarantors to keep track of any liability and notify lenders if they are no longer associated with a business in receipt of lending;

- updates to the requirements for lenders on advising potential guarantors of the need to seek independent legal advice to establish whether becoming a guarantor is the right choice for them; and

- enhanced guidance on providing information to a guarantor about how the personal guarantee will function and their obligations under it.

Timeline for implementation

The updates to the Standards and the accompanying guidance took effect immediately from 12 September 2024, however, the new requirement on annual reminders will apply from 8 September 2025 to allow lenders the time to implement the necessary processes.

Default interest, penalties and extortionate credit transactions

This article explores when a default interest provision in a finance document would constitute a penalty or an extortionate credit transaction, and what a lender may be able to recover if the provision is deemed to be a penalty or an extortionate credit transaction.

Key terms explained:

Default interest – an additional rate of interest payable on a default by a party under a finance document.

Penalty – this is a clause that operates on a breach of contract which, due to its extravagant, oppressive and unconscionable nature, is deemed to be unenforceable.

Extortionate credit transaction – a transaction where the terms either require the company to make grossly exorbitant payments or otherwise grossly contravene the ordinary principles of fair dealing.

When would a default interest provision constitute a penalty?

The test for whether a provision is a penalty comes from *Cavendish Square Holding BV v El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67 and* is:

"whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulting party. His interest is in performance or in some appropriate alternative to performance"

In simpler terms, you must consider whether there is a legitimate interest served and protected by the default interest provision. If there isn't, the provision is likely to be construed as a penalty. If there is, the question then becomes whether the default interest provision is so detrimental to the contract breaker (i.e by being extravagant, oppressive or unconscionable) that it is disproportionate to the interest served.

Default interest provisions are commonplace in finance documents of any kind and lenders are generally permitted to charge an additional amount or rate of interest on default.

Lenders can, for example, justify a default interest amount at an increased rate following the occurrence of a continuing payment default in a finance document. This is because when a party fails to pay when required, it becomes a higher credit risk to the lender. It is accepted by the courts that money is "more expensive for a less good credit risk than a good credit risk" (see *Lordvale Finance Plc v Bank of Zambia [1996] Q.B. 752*).

But at what point does the default interest provision become so detrimental to the contract breaker, that a legitimate interest, such as the one considered above, cannot justify it?

In *Ahuja Investments v Victorygame Ltd [2021] EWHC 2382 (Ch)*, Judge Hodge QC was prepared to accept, without supporting evidence, that a 200% increase in the applicable interest rate on a default was sufficient to reflect the greater credit risk presented by a defaulting borrower. He went on to state that, as a rule of thumb, a lender would need to provide evidence to explain any greater increase, and that the evidential burden would pass over to the lender in this instance.

The decision in Ahuja Investments was that a 400% increase in the applicable interest rate on default constituted a penalty. Amongst the reasoning, was that there was:

- no evidence that the default interest rate was fixed to reflect the lender's genuine assessment of the borrower's creditworthiness in default;
- no consideration of the security already provided when assessing the default interest rate; and
- no legitimate interest identified by the lender.

In *Houssein v London Credit Ltd [2024] EWCA Civ 721*, the decision of the High Court in *Houssein v London Credit Ltd [2023] EWHC 1428 (Ch)* that a default interest rate of 4% per month (which was quadruple the normal interest rate of 1% per month) was a penalty was overturned by the Court of Appeal. The Court of Appeal concluded that the High Court Judge did not apply the correct test regarding legitimate interest, and that it was inevitable a legitimate interest did in fact arise here. The question of whether the default interest provision in this case was so extravagant, oppressive or unconscionable to justify the legitimate interest of the lender was remitted back to the High Court for further deliberation. It will be interesting to see the approach the High Court takes in this instance, and whether a default interest rate which is four times greater than the normal interest rate could ever be justified.

When would a default interest provision constitute an extortionate credit transaction?

Section 244(3) Insolvency Act 1986 sets out that a transaction is extortionate if, having regard to the risk accepted by the person providing the credit the terms of it:

- are such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of credit; or
- otherwise grossly contravened the ordinary principles of fair dealing;

and it shall be presumed, unless the contrary is proved, that a transaction with respect to which an application is made under this section is or, as the case may be, was extortionate.

It is difficult to quantify what level of default interest the courts would consider to be extortionate, given that they have previously upheld a 48% per annum default interest rate (*Ketley v Scott [1980] 6 WLUK 217*), yet in *Clark v Finnerty [2010] EWHC 2538 (Ch)*, the Judge considered in obiter that a 42% per annum default interest rate would be presumed to be extortionate, unless proven otherwise.

The court instead take the following factors into account when making their decision:

1. **Security** – has the extent of security provided been factored into the default interest rate?
2. **Risk** – where a lender is exposed to a higher level of risk, it is to be expected that the default interest rate would be higher.
3. **Urgency** – where a borrower requires funds urgently, it leaves the lender less time to do their usual credit checks, and so the rate of interest can be expected to be higher.

If a default interest provision is deemed to be a penalty, what happens next?

Where a default interest provision constitutes a penalty, that provision becomes unenforceable. In such a scenario, no other contractual interest rate will be due on an unpaid loan following its repayment date. However, the lender could still be entitled to claim statutory interest.

If a default interest provision is deemed to be an extortionate credit transaction, what happens next?

The court has a wide range of powers to adjust the transaction at its discretion. It may even decide not to make an order.

Section 244(4) Insolvency Act 1986 sets out that the court may make any of the following orders:

- a provision setting aside the whole or any part of any obligation created by the transaction;
- a provision otherwise varying the terms of the transaction or varying the terms on which any an order security for the purposes of the transaction is held;
- a provision requiring any person who is or was party to the transaction to pay to the liquidator/trustee any sums paid to that person, by virtue of the transaction, by the debtor;
- a provision requiring any person to surrender to the liquidator/trustee any property held by him/her as security for the purposes of the transaction; and/or
- directing accounts to be taken between any persons.

Renters Rights Bill

Reform of the law applicable to tenants is back in the form of the Renters Rights Bill. . As with the previous Government's similarly named Renters Reform Bill, most attention has concerned the abolition of "no fault evictions" by removing a landlord's ability to serve a section 21 notice to terminate a tenancy and obtain vacant possession even where the is no breach.

At present lenders to buy to let landlords can exercise ground 2 in Schedule 2 of the Housing Act 1988 to obtain vacant possession by giving the tenant two months notice provided that each of the following circumstances apply:

(i) the property is subject to a mortgage or charge granted before the tenancy started;

(ii) the lender is entitled to exercise a power of sale requiring vacant possession; and

(iii) the landlord must also have informed the tenant in writing before the start of the tenancy that they might use ground 2.

The proposed amendments to ground 2 in the proposed new legislation is of most relevance to lenders. Ground 2 is a mandatory ground for possession, meaning the Court must award possession if the ground is established.

If the Bill is passed in its current guise, the notice period will increase to four months.

However, more importantly for lenders, the Bill proposes to remove the words "granted before the beginning of the tenancy" from ground 2, meaning the ground 2 will be able to be relied upon where a property is subject to a mortgage or charge, irrespective of when the mortgage or charge was granted. This is good news for lenders, as the wider scope of ground 2 should lessen any impact from the removal of a landlord's current right to end a tenancy by serving a valid section 21 notice.

The Mortgage Charter – new data from September 2024

The Mortgage Charter was introduced in mid-2023 by the previous government and contains commitments, over and above FCA requirements, made by mortgage lenders. There are 49 signatories, representing approximately 90% of the mortgage market.

Mortgage Charter commitments

Signatories to the Mortgage Charter commitments include:

- Not forcing customers to leave their home without their consent unless in exceptional circumstances, in less than a year from their first missed payment. (Although note that this is not applicable to customers who own Buy to Let properties).

- Allowing customers approaching the end of a fixed rate deal to have the right to lock in a new deal up to six months before the end of the current deal. Customers will also be able to manage their new offer and request a better like-for -like offer from their existing lender right up until their new term starts, if one is available.

- Customers who are up to date with their payments can (without lenders being able to assess affordability):

  i. switch to interest-only payments for six months; or

  ii. extend their mortgage term to reduce their monthly payments and have the option to revert to their original term within 6 months by contacting their lender.

New data

On 9 September 2024, the FCA updated its data in relation to the Mortgage Charter. Key takeaways are as follows:

- Approximately 1.4 million mortgages have benefited from one or more of the options set out in the Mortgage Charter.

- Approximately 132,000 mortgages have temporarily reduced monthly payments via the new FCA rules.

- Between July 2023 and July 2024, the monthly payments on approximately 188,000 mortgages were reduced as people switched to temporarily paying interest only or extended their mortgage term. This is approximately 2.1% of all regulated mortgage contracts. The data shows that only 401 term extensions were reversed, which may indicate that borrowers seeking a temporary reduction in their payments are more likely to opt for an interest only period.

- Only 133 properties were repossessed within 12 months of missing the first payment. Lenders report these were for customer-driven reasons, such as abandoned/vacant properties or voluntary possessions.

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