DRN-3833433

The complaint

Mr H complains that Funding Circle Ltd provided misleading information when he invested in a peer to peer (P2P) opportunity it promoted on its platform. He says the loan was misrepresented and negligently managed, and as a result he has suffered a financial loss.

What happened

Funding Circle provides a loan-based crowdfunding facility through a P2P platform in which investors can lend to borrowers in return for interest.

Mr H has been a lending member on Funding Circle's platform since 2014 and has invested in several different loans over a number of years. Mr H stopped investing on the platform in September 2017 when there was a change in the terms that meant he could no longer self-select the loans he invested in.

In March 2021, Mr H raised a complaint with Funding Circle about a property loan in which he originally invested in May 2016, with further loans parts acquired through 2016. He was unhappy as the loan failed to pay the interest agreed and left him with a significant loss to his original capital. In summary he said:

- Funding Circle, as his agent, had a duty to mitigate building risk but it released all funds to the borrower in staged amounts against construction progress – this led to an unfinished building of unsatisfactory quality which sold for less than 20% of the intended value.
- The loan promotion document was misleading in material ways – including:
  - insufficient checks on the borrower's ability to support the personal guarantee (PG) for the loan.
  - He has recently discovered the maximum PG required from borrowers is only 10% of the loan value. This was not disclosed to lenders.
  - Funding Circle extended further loans to the borrower for different projects on its platform meaning the financial capacity would be very unlikely to meet any claim on the PG for this loan.
  - Funding Circle appear to have reduced the security offered for this loan part way through by allowing the borrower to carve out a portion of the freehold and use that as security for a fresh loan on its platform.
  - The flats were described as 'pre-sold' in the promotion were not.
- If he had known the actuality of all of this, he would not have lent into this loan or other loans on Funding Circle's platform which are affected by similar misleading promotions and negligent management.

Funding Circle responded to the complaint but did not uphold it. In summary it said:

- Capital is at risk when investing in P2P loans and therefore unfortunately losses are a natural part of lending. When it does experience loans being unable to repay as planned, it seeks the best viable route to obtain funds to repay the loan. But unfortunately, there will be occasions where there will be a shortfall to the recoveries, and this was particularly relevant for this loan.

- It doesn't produce misleading material as it is regulated and authorised by the FCA; so it has an obligation to carry out true and transparent procedures.
- It doesn't lend to businesses recklessly and conducts very rigorous checks. The main considerations when offering a loan, is the affordability for the borrower and whether they will be able to make the monthly repayments. When this loan was assessed it was decided that the borrower could afford the monthly repayments which is why it was approved.
- When lending, Mr H agreed for Funding Circle to manage the repayment of the loan and to take, or not take, any action that it deemed necessary to recover outstanding debts. This is clear within the terms and conditions.

Mr H didn't agree with the response, so referred his complaint to this service for an independent review.

One of our investigators looked into the complaint. Initially he didn't uphold it as he hadn't identified failings by Funding Circle that would have led to Mr H making a different decision to invest. Mr H didn't accept this assessment and provided further arguments to be considered. In summary he said:

- He noted Funding Circle had provided evidence to indicate a valuation of the development property had been obtained. He said valuations should be taken at arm's length compared to actual market transactions, which can be taken as fairly good evidence of value. So, the purchase figure of £1.6 million for the whole site was credible for his investment calculus and that is what he reasonably understood from the loan promotion.
- He viewed any 'part-completed project' valuations as meaningless as the valuer has no market comparable to produce hard evidence for a partially completed build.
- He would not have been equally happy if he had known the £2 million value referred to in the loan promotion was actually a part-completed projected valuation. He would have completely dismissed it from his lending calculus and not lent.
- The value of the security was important to him as this was the amount that he believed might be obtainable in the worst case if the project failed and the security had to be enforced.

Following this the investigator issued a revised assessment upholding the complaint. In summary he said:

- Funding Circle provided misleading information within the loan promotion about the value of the security. The promotion indicated that the security was for the whole site, but Funding Circle has since clarified this it is only for the development property (and not the other buildings on the site).
- The investigator was persuaded by Mr H's testimony that he relied on the information in the promotion relating to the security before deciding to invest. He was also persuaded by Mr H's explanation of why he relied on the £1.6 million sale price, rather than the £2 million valuation of the development property, when he decided to invest.
- Overall, he was satisfied Funding Circle's promotion was misleading in that it seemed to claim security was held over the whole site. He was also satisfied that, if the true position had been made clear, Mr H wouldn't have invested as a reduction in his understanding of the value of the security would have made a difference to his decision.
- He recommended Funding Circle compensates Mr H by comparing the position if he hadn't invested in this opportunity with what he would have received from the average returns on similar property loans of the same risk profile that were available

on the platform.

- He also thought Funding Circle should pay £150 compensation to recognise the inconvenience Mr H suffered as a result of the impact on him because of Funding Circle's handling of his queries about this loan.

Funding Circle didn't agree with the investigator's conclusions. In summary it said:

- Mr H allegedly based his investment decision on the 2015 sale price (£1.6 million) of the whole site. However, the value of the development property represented approximately 89.5% of the value of the whole site – not a third of the value as has been assumed. It is confident that given the value of the development property, Mr H would still have invested in this loan had the true position of the security been clearer.
- In February 2017, Mr H invested in another loan that was promoted on Funding Circle's platform for the other two buildings that were on the same site. This suggests he likely understood there were two separate developments on the same site, funded by separate limited companies, with separate security across the two developments. If Mr H understood the loan subject to this complaint held a first legal charge over the whole site, Funding Circle question why he didn't raise any concerns about how this would impact his position as an investor on the first loan when he decided to invest in the second loan promoted on the site.
- Mr H's claim that he would not have invested in either of these developments is made only with the benefit of hindsight. There is always a risk the proceeds after enforcement may not be enough to discharge all obligations by the borrower to lenders on the platform. It has always been clear that security does not equal repayment and it never guarantees repayment as when lending through Funding Circle, an investor's capital is at risk.

Mr H also responded with further comments. He reiterated his concerns that Funding Circle had failed to manage the loan correctly and had misrepresented the loan to him on a number of occasions within the Investor Report ("IR"). As no agreement could be reached, the complaint has been passed tome to reach a decision.

What I've decided – and why

I've considered all the available evidence and arguments to decide what's fair and reasonable in the circumstances of this complaint.

Through his P2P account, Funding Circle provided Mr H with the opportunity to invest in the loans it was promoting on its platform. Mr H selected to invest in this loan based on the information he saw on the platform. I've reviewed the relevant investor terms and conditions that applied when Mr H invested as they form the basis of this relationship.

In reaching my decision, I've also considered Funding Circle's wider obligations. At the time of promoting the loan on its platform, Funding Circle was authorised and regulated by the Financial Conduct Authority (FCA). The relevant rules and regulations FCA regulated firms are required to follow are set out in the FCA's Handbook of rules and guidance.

The FCA Principles for Business ("PRIN") set out the overarching requirements which all authorised firms are required to comply with. PRIN 1.1.1G, says *"The Principles apply in whole or in part to every firm".* The Principles themselves are set out in PRIN 2.1.1R. The most relevant principles here are:

- PRIN 2.1.1R (2) *"A firm must conduct its business with due skill, care and diligence."*

- PRIN 2.1.1R (6) *"A firm must pay due regard to the interests of its customers and treat them fairly."*

- PRIN 2.1.1R (7) *"A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading."*

Funding Circle was also required to act in accordance with the rules set out in the Conduct of Business Sourcebook (COBS). And the most relevant obligations here are:

- COBS 2.1.1R (1) *"A firm must act honestly, fairly and professionally in accordance with the best interests of its client."*

- COBS 4.2.1R (1) *"A firm must ensure that a communication or a financial promotion is fair, clear and not misleading."*

So, before making the loan available on the platform for investment, Funding Circle needed to satisfy itself that the information it collected and used to promote the loan was fair, clear and not misleading. And it also needed to be satisfied that by providing an opportunity for its customers to invest in the loan it would continue to be acting in its client's best interests.

In order to satisfy itself of the fair, clear and not misleading nature of the claims or assertions made in the promotional material itself, Funding Circle would need to carry out reasonable checks. What these reasonable checks involve, or indeed what they might be in any given case, is something which is very much left to each provider to determine and would vary according to the particular circumstances.

I've also borne in mind that the FCA said the following in its July 2018 consultation paper on loan-based ('peer-to-peer') and investment-based crowdfunding platforms:

"It is our view that it will be unlikely that a platform could argue that it has met its obligations under Principle 2, Principle 6 (PRIN 2.1.1R) and the client's best interests rule (COBS 2.1.1R), if it has not undertaken enough due diligence to satisfy itself on the essential information on which any communication or promotion is based."

Whilst I appreciate Mr H had invested prior to the publication of the consultation paper and guidance, I still feel it is relevant as it provides clarity as to the interpretation and application of the existing rules and guidance which were applicable to Funding Circle at the time.

I've considered the circumstances surrounding the promotion of this loan – paying particular attention to the IR as this was the information Funding Circle provided to set out the details of the opportunity, and from which Mr H made his investment decision.

This is a property loan on a building with residential and commercial units – which was part of a site containing three adjacent buildings. Only one of the buildings was to be developed using the crowdfunding for the loan – I'll call this the "development building" and the other two buildings I'll call 'other building H' 'other building C' or 'the other buildings' for ease of reference. One of the key considerations and points Mr H has raised relates to how the security was described in the IR.

I've considered whether Funding Circle provided clear, fair and not misleading information to Mr H about the security before he first invested in the loan. The IR describes the security as 1st legal charge. In the summary it says:

"The borrower purchased the property in 2015 for £1.6m with the help of a bridging loan and has also funded the costs of gaining the planning permission.
The subject property comprises 3 buildings:

- *The [development building], with primary frontage onto [X Street]*
- *[other building H]*
- *[other building C]*

While the planning permission allows for the development of [other building H] and [other building C] as well, at this stage FC investors are only being asked to fund the redevelopment of the [development building]."

And when describing the site, it says:

"All three buildings are situated within the [a] Conservation Area, with [other building H] and [other building C] being Grade II listed. The properties have a GIA of c32,000 sq ft and other than the commercial units (which have been let to secondary tenants) have been largely vacant and disused."

And when referring to the value it says:

"We have received an independent valuation and monitoring surveyor report validating the following figures:

Current site value £2,000,000

GDV £5,447,375

Development costs (incl contingency) £1,700,000

The GDV of £5.447m mentioned above breaks down as follows:
- The value of the resi units total £4,497,375 (breakdown per flat in the table below)
- The commercial units have been valued at £685k
- The freehold has been valued at £265k.

The total value is thus £5,447,375 as mentioned above.

The resi units plus the freehold have been pre-sold for £4,376,500, with the resi units having been sold at 10-20% discounts to their OMV as is normal for pre-sales of this nature. As we have security over the whole site we have based our ratios on the £5.447m GDV figure, but it is comforting to know that the resi units alone cover the proposed debt more than 1.5x."

In its submissions to this service Funding Circle has confirmed the security over the whole site, means the development building only – and not the other buildings detailed in the IR - so the charge it held was over that building only. Funding Circle maintains the information in the IR was clear in stating the loan was only to fund the development building. And the key loan features table which detailed that the security obtained was a first legal charge only referenced the development property address. But it concedes the IR could be clearer in describing the property versus the development site.

But I'm not persuaded things are as clear as Funding Circle suggest. The IR is clear that the funding is for the development for only one of the buildings – but all the way through it mentions the site contains three buildings. There is a clear reference to having security over the whole site too – this provides a strong suggestion that the security isn't limited to one building but rather all three it describes throughout the promotion. The use of the terms "site" and "building" is informative, so I think this would lead a reasonable person to consider "site" to mean all three buildings and "building" just means the one being developed. I don't think it reasonable to rely solely on the information in the key features table to show the security was set out clearly, when the other information in the IR doesn't make it clear the security is only the development property. The IR also provides a visual description of the site using a map, which highlights all three buildings. If two of the buildings weren't considered to be part of the site or security, I wouldn't have expected them to be mentioned and highlighted so prominently. I have also seen an extract from Q&A section on the loan profile from Funding Circle's website, which contains a comment from Funding Circle saying "*security will include a first charge over the entire development site."* This again gives the impression the security for the loan isn't just the development property.

While I appreciate Funding Circle says the security was always over just the development building, the IR doesn't make this clear. This is something I would have expected it to provide full clarity about, so investors like Mr H could make an informed decision before they became lenders. Having considered the information provided to Mr H before he invested, I think it was reasonable for him to understand the security to be the whole site when he decided to invest. Having considered all of the evidence provided, I've reached the finding that the information Funding Circle provided about the security wasn't clear. For these reasons, I think it failed to meet its obligation to provide clear, fair and not misleading information to Mr H.

I need to decide whether the failure to provide clear information about the security would have made Mr H make a different decision on whether to lend. The value of the security is a very important piece of information as it allowed Mr H to understand the protection available should the loan not perform as expected.

Funding Circle has argued that the value of the development building was clear in the IR. So, despite the concessions made about the wording used in the IR, it still thinks Mr H would have been aware of the value of the security. It has provided the valuation report it received from a surveyor to support that the £2m value detailed on the IR was for the development property and not the whole site. It says whether the security was over one building or three, investors invested in this loan on the basis that the security was valued at £2 million and this is what is relevant.

But Mr H says when deciding to invest he relied on the information about the price that the site was bought for. He says he viewed the sale price as good evidence of value as it was a market transaction. So, the figure of £1.6 million for the whole site (plus a slight uplift for planning) was credible for his investment calculus and that is what he reasonably understood from the IR. He says he views part completed project valuations to be meaningless as the valuer has no market comparable to produce hard evidence for a part completed build. So, this valuation – even if he understood it was for the development property – wasn't something he would have relied on to make his investment decision. He says the value that was important to him was the amount that he believed might be obtainable in the worst case if the project failed and the security had to – and this was the initial site value from the sale price plus the value of any other security.

I'm satisfied that Mr H has made a plausible argument for his decision to invest, it light of the information contained within the IR. In response to the investigator's findings, Funding Circle has provided two main arguments for why it doesn't think clearer information about the security would have made a difference to Mr H's decision to invest. Firstly, it says Mr H would still have invested in the loan had he been aware that the true position of the security, because the development property represented 89.5% of the value of the whole site. It has calculated this value using the predevelopment valuation it obtained on the different buildings and made some assumptions to calculate this percentage. It says there is an assumption that the value of the security was reduced by two-thirds as it only held security over one of the three buildings on the site. But it has calculated the value of the development building represented approximately 90% of the value of the whole site. It says given this figure; it believes Mr H would still have invested if the position on the security was clearer.

The key point Funding Circle is making here is that the development building represented virtually all of the value of the whole site, so the unclear information in the IR about the security wouldn't have impacted Mr H's decision to invest. But I don't think the assumptive figure of 89.5% is clear cut as it has suggested. It has relied on separate valuations of the properties completed a year apart rather than an evaluation of the whole site done at once. It has also used assumed regional increase in property prices in the intervening year between valuations. Mr H's argument, that he doesn't think it is reliable to rely on valuations of underdeveloped properties, is also a factor I've considered. Funding Circle says it believes there is an assumption that the value of the security was reduced by two-thirds to £500,000 as it only held security over one of the three buildings on the site. The figures Funding Circle use here aren't something that has been mentioned by Mr H. But regardless the unclear information in the IR means there was still a reduction in his understanding of the value of the security – exactly by how much is less clear. I understand the argument Funding Circle make but in my view there is uncertainty about the comparative valuations it presents and the reasons Mr H has given for his investment decision mean I don't think it is a strong enough argument to say Mr H would still have invested despite the information failings I've identified.

The second main argument relates to the fact Mr H made subsequent investments in the loan Funding Circle promoted for the other buildings on the site in 2017. Funding Circle say this brings into question Mr H's claims that his decision to invest was based on the 2015 sale price and also what he has said about his understanding of how the security was split across both developments. Funding Circle, say Mr H is likely to have understood from the IR for the loan on the other buildings there were two separate developments on the same site, funded by separate limited companies, with separate security across the two developments. It questions if Mr H didn't understand this and believed the loan for the development building held a first legal charge over the whole site, why he didn't raise any concerns about how this would impact his position as an investor before he decided to invest in the second loan.

I've considered this point and also taken into account Mr H's comments on his understanding when making his decision to invest in the second loan. He says when he first invested in the loan on the development property in May 2016, he relied on what the IR said as accurate, then later when he invested in the other loan in 2017 in the same way he relied on the IR to be truthful and on that basis invested. He says when he made the 2017 investment, he didn't re-read the 2016 loan IR to scrutinize it for misrepresentations. He says he invested in well over 100 loans with Funding Circle, so doesn't think he can be expected to recall details of every previous loan document he's read. He says when he became aware of the problems with the loan, he later complained in about 2019. This was around the same time his wife became concerned over a similar investment she made into the loan on the development property.

Again, I understand the argument that Funding Circle is putting forward here to say Mr H would have invested despite the unclear information I've identified. It's not possible that viewing the second loan IR would have prevented Mr H from investing in the first, but it could have led him to question his understanding of the security on the first loan sooner. I accept it is possible Mr H could have drawn a link between the security of the two loans, but I can't say it is clearly obvious that he should have. The investments were made several months part – around nine months between the first investment into each of the loans. The information in the second IR also doesn't provide any clarity on securities held across the site and various buildings. I also take Mr H's point that he had invested in a large number of loans on the platform, so recollection of individual IRs after the decision to invest may have been difficult. I need to decide whether it is reasonable to question why Mr H didn't raise his concerns sooner without the benefit of hindsight. Mr H says his understanding came from when wife investigated the failure of the loan and researched the security when funds didn't look like being repaid. In my view, the fact Mr H didn't query the security when he invested in the second loan doesn't mean is arguments made on this complaint are unreliable or made with hindsight.

Overall, the question of whether Mr H would likely have still invested, but for the failings I've identified, is finely balanced. But clear information about the value of the security is something that I'm satisfied would have been very important to his decision to invest. I'm satisfied a reduction in his understanding of the value of this would be a significant factor. Having considered the arguments put forward, I've reached the conclusion that this would have made a difference and had Mr H had clearer information about the first charge security, I think he would have made a different decision and not invested.

Mr H has made other arguments why he believes Funding Circle failed to provide clear information and also failed to manage the loan correctly contributing to the losses he suffered. I haven't needed to reach a conclusion on these points - because - for the reasons explained above - I've found a reason why the complaint should be upheld.

To confirm, for the reasons described above, I find that Funding Circle failed to provide Mr H with clear, fair and not misleading information when promoting this loan. But for these failings, I don't think Mr H would have invested in this loan. I uphold this complaint.

As I've reached the finding that Mr H would not have invested in this loan, I next need to decide what she would have done with the money he invested. I think it likely that he would have invested in further crowdfunding opportunities. I'm satisfied that he had an interest in using Funding Circle's platform as a way of seeking a return on his money. It's difficult to know exactly what other loans he would have invested in – as that would depend on what other loans were available.

Having carefully considered all the available information and evidence, I think the fairest way to compensate Mr H is to assume a rate of return that is equal to average return on loans of a similar risk profile on Funding Circle's platform. I say this because I'm satisfied that he would have continued to invest on the platform, but I take the view that he would have invested differently. It is not possible to say precisely what he would have done differently but loans of the same risk rating is a good starting point. I am satisfied that what I have set out below is fair and reasonable given Mr H's circumstances when he invested.

Mr H says it is reasonable to say he would have invested alternatively on the platform and achieved returns of 7%. He says this is based on information provided by Funding Circle for property loans in April 2017.

Mr H's proposal isn't completely unreasonable – particularly if Funding Circle verify the 7% returns for property loans is correct. But in my view a more accurate assumption would be to use a methodology of comparing loans in the same risk banding when deciding what he is most likely to have invested in. If Funding Circle is unable to calculate returns on the same risk banding at the time of investment, then as an alternative it can use the 7% proposal that Mr H has put forward.

Putting things right

To compensate Mr H fairly, Funding Circle must:

- calculate how much Mr H has received back from his initial investment into the loan - including any interest and funds that have been recovered and returned to him (A) - the actual value;

- then calculate how much Mr H would've received had he received an *average rate of return for A+ rated loans** (excluding the loan subject to this complaint) across the platform from the date he invested in the tranches of the loan until the date in September 2017 when Funding Circle changed its terms (the end date) *** (B) - the fair value.

If B is greater than A, Funding Circle should pay Mr H the difference. It should add additional interest at a rate of 8% simple per year on any loss from the end date to the date of settlement. If A is greater than B, then Mr H hasn't suffered a financial loss and there will be no financial compensation to pay.

* The average return means the net return – so incorporates positive performing loans and any default rates.

** If Funding Circle is unable to calculate the average rate of returns for A+ rate loans, it can use the 7% rate Mr H has proposed.

*** Funding Circle has confirmed Mr H stopped investing in the platform when it introduced new terms in September 2017, I think it's reasonable to assume he wouldn't have invested further on the platform after this date, so any loss should be crystallised from this point.

Finally, I have considered the impact on Mr H from how Funding Circle has dealt with request for clarity about this loan.   While perusing the matter Mr H faced uncertainty about the return of his investment and he has spent considerable time seeking information to understand the position of the investment. This isn't something he would have needed to do but for the failings I've identified that led to him making this investment. I'm conscious that any investment in a crowdfunding platform isn't guaranteed to be successful and there is always a risk to capital. But taking into account the impact of all of this I direct Funding Circle to pay Mr H £150 compensation to recognise the distress and inconvenience he has suffered.

My final decision

For the reasons set out above, I uphold this complaint. My decision is that Funding Circle Ltd should pay the amount calculated as set out above.

Under the rules of the Financial Ombudsman Service, I'm required to ask Mr H to accept or reject my decision before 16 June 2023.

Daniel Little
Ombudsman