DRN-3916006

The complaint

Mr G and Ms L complain about their mortgage with Kensington Mortgage Company Limited. They complain it has refused to offer them a new, lower, interest rate.

What happened

Mr G and Ms L took out their mortgage with Kensington in 2007, borrowing around £270,000 on interest only terms. They took an initial fixed rate of 6.54% over three years, after which their mortgage reverted to Kensington's standard variable rate (SVR) plus 1.25%. The mortgage offer said that the terms of the mortgage reflected past financial difficulty.

Mr G and Ms L say they've been asking Kensington for a new interest rate off and on ever since 2010, but it has always refused to offer them a new rate.

Mr G and Ms L brought their complaint to us. They said they were unhappy with how Kensington had treated them and that it wouldn't offer them a lower interest rate. They believe it is "profiteering" from them – had it offered them lower rates, they would have been able to pay more to reduce the capital and wouldn't be approaching the end of the term with such a high balance.

Kensington didn't think it had treated them unfairly, and said Mr G and Ms L weren't eligible for a new interest rate. However, it had separately reviewed historic arrears fees applied to their mortgage account but not yet paid, and offered to remove £550 of fees, as well as pay £250 compensation.

Our investigator said Kensington didn't offer new interest rates to any customers until 2017. But once it did so, it wasn't fair to refuse a rate to Mr G and Ms L. So it should re-work their mortgage as if it had offered one to them. As no agreement could be reached, the complaint came to me for a decision to be made.

My provisional decision

I issued a provisional decision setting out my thoughts on the case. I said:

> *Mr G and Ms L's mortgage was taken out in 2007. Under the terms and conditions and the mortgage offer, they had a fixed rate until 2010, after which the mortgage would revert to the SVR with a premium of 1.25%.*
>
> *The mortgage offer says that its terms reflected past financial difficulty – this is what was, at the time, known as a sub-prime mortgage. I don't have the details of Mr G and Ms L's circumstances at the time, but this generally means that a borrower has experienced problems with either a previous mortgage or with unsecured credit which would make it difficult for them to get a more mainstream mortgage. As there's additional risk to a lender in granting a mortgage in such circumstances, it's not unreasonable that the resulting mortgage is more expensive – reflecting that extra risk. It's for those reasons that the mortgage reverted not just to the SVR, but to the SVR plus a premium of 1.25%.*

Mr G and Ms L have said that since they became subject to the SVR in 2010, they've noted that the rate they have been paying is much higher than the Bank of England base rate than the difference between base rate and the SVR when they took the mortgage out in 2007. And they question whether that was fair.

The mortgage terms and conditions make clear that the SVR is not linked to the Bank of England base rate. And mortgage lenders' costs are not generally linked to base rate either. So the Bank of England base rate is not a factor in the level of interest Mr G and Ms L were charged.

The mortgage terms and conditions say that the SVR is a variable rate, which doesn't directly track any external rate. But they also say that while the rate can vary, it will never be more than 3% above or less than 1% above the LIBOR rate – and so, with the addition of the 1.25% premium, Mr G and Ms L's mortgage will never be more than 4.25% above LIBOR, and never be less than 2.25% above LIBOR . And I can see from the history of the mortgage that in fact the interest rate has in fact has stayed within that range.

So the mortgage offer says that the mortgage would revert to the SVR plus 1.25% from 2010, and this in fact happened. And the SVR has stayed within the range – relative to LIBOR – set out in the terms and conditions. Neither the mortgage offer nor the mortgage terms and conditions say that Kensington has to make another fixed rate available after the initial one ended, or that it has to offer Mr G and Ms L any rate other than the SVR plus premium.

This means that their mortgage has operated as the contract says it would, on the terms they agreed to when they borrowed the funds in 2007.

And there's nothing beyond the mortgage terms which says Kensington has to offer new rates either – there's no law, or rule of mortgage regulation, which says that a lender has to offer new rates to existing customers.

Another ombudsman has said that we can only consider the fairness of interest charged since 2012, and I agree with her conclusions about that.

From 2012 onwards, until 2017, Kensington did not offer new rates to any existing customers. As I've said, it was not obliged to do so. Mr G and Ms L were not therefore being treated any differently to any other Kensington customer. Their mortgage was operating as it should have done according to its terms and conditions. And therefore I don't think Kensington treated them unfairly in the interest it charged them in this period.

From 2017 onwards, however, Kensington did start to offer new interest rates to some customers. But it continued to refuse to offer one to Mr G and Ms L – and so I need to think about whether that was fair.

Even where it does offer new rates to existing customers, there's no obligation on a lender to pro-actively contact its customers and invite them to apply for a rate – it's up to customers to make an application.

There's a note in Kensington's records of a conversation on 7 December 2017 in which Mr G asked for a new interest rate. He was told he needed to speak to another department, and that department would call him back. When it didn't, Mr G called in again in early January 2018. He was told that no new rates were available, and that he should seek independent financial advice to discuss his options.

This is the first time after Kensington started to offer rate switches that Mr G and Ms L asked about a new rate. And so I will consider whether it approached their request fairly at that time.

Kensington's policy on rate switches

Before 2017, Kensington did not offer new interest rates to existing customers. An existing customer whose introductory rate had expired and wanted a new rate would either have to move lender, or would have to re-apply to Kensington as a new customer for a new mortgage.

From 2017, however, Kensington began to offer new interest rates to some existing customers. It has explained to us that its criteria for offering new rates are that:

- *At the point at which the mortgage was taken out, the customer would have passed the affordability and regulatory requirements in place now;*
- *The customer's credit risk is in line with Kensington's current credit risk appetite;*
- *There is no history of arrears on the mortgage;*
- *The original mortgage lending was by Kensington – not another lender with the mortgage later moving to Kensington;*
- *The mortgage was taken out no earlier than 1 January 2010.*

Kensington has explained that its business model relies on securitisation. This is a relatively common model in the mortgage industry. In essence, once it has lent a mortgage and is entitled to receive the repayments, Kensington sells the beneficial interest (the benefit of the repayments) to a third party in order to fund further lending to other customers. Loans are not securitised individually, but packaged into groups called special purpose vehicles.

Under this model, Kensington remains the owner of the mortgage, remains the lender of record, and continues to be the firm that the borrower deals with. But once it has collected the payments, it passes the benefit of them on to the investor which bought the vehicle including that loan.

Kensington has explained that under the terms of its agreements with the investors which bought the securitisation vehicles, it cannot make changes to existing mortgages – such as offering new interest rates. It may be able to offer new rates when securitisations expire and are re-financed onto terms that do allow variations to the mortgages.

And it may be able to offer a new rate if a loan meets the current criteria that investors will accept as part of a securitisation vehicle – which explains the criteria around passing current requirements even on loans that were taken out some time before. It can offer a rate if it can extract a loan from a securitisation and then re-securitise it with a new interest rate – but only if the loan would be acceptable to a new securitisation vehicle. Loans taken out before 2010, and loans taken out which, at the time, did not meet regulatory requirements now in place do not meet that standard.

Such customers include those whose loans were underwritten based on the *standards which applied before the financial crisis of 2007/8 – including customers who self-certified their income, who did not have to show that they had a repayment strategy for an interest only mortgage, and so on.*

Because these customers cannot be re-securitised, they are not eligible for a new interest rate. And because Mr G and Ms L's mortgage was taken out before 2010 and is on interest only terms, it falls into this category.

I've set out Kensington's policy, and the rationale for it, at some length above because it's important context for the actions it took in this case. However, it's important to note that I'll be focussing on whether Kensington treated Mr G and Ms L fairly in their individual circumstances – not on whether its policies and procedures are fair more broadly.

<u>Regulatory considerations</u>

In deciding whether Kensington treated Mr G and Ms L fairly and reasonably in all the circumstances, I also need to take into account the regulator's rules and guidance, to be found in the MCOB section of the Financial Conduct Authority Handbook.

In my view, of particular importance in this case are the provisions to be found in section 11 of MCOB, especially MCOB 11.8.1 E. The suffix E denotes an evidential provision not a rule (suffixed R).

MCOB 11.8.1 E says

> *Where a customer is unable to:*
>
> > *(1) enter into a new regulated mortgage contract or home purchase plan or vary the terms of an existing regulated mortgage contract or home purchase plan with the existing mortgage lender or home purchase provider; or*
> >
> > *(2) enter into a new regulated mortgage contract or home purchase plan with a new mortgage lender or home purchase provider;*
>
> *the existing mortgage lender or home purchase provider should not (for example, by offering less favourable interest rates or other terms) take advantage of the customer's situation or treat the customer any less favourably than it would treat other customers with similar characteristics. To do so may be relied on as tending to show contravention of Principle 6 (customers' interests).*

Principle 6 says:

> *A firm must pay due regard to the interests of its customers and treat them fairly.*

As I've noted, MCOB 11.8.1 E is an evidential provision – not a rule – but it says that treatment of the kind set out in the provision may tend to show unfairness. In some situations, therefore, it also may not show unfairness – much will depend on the individual circumstances.

Further relevant provisions include MCOB 11.6.3 R – which says that a lender need not carry out an affordability assessment when varying an existing mortgage or *replacing it with*

a new one, provided there is no further borrowing or other change to the contract material to affordability. And MCOB 11.7.3 R says that a lender need not carry out an assessment of interest only repayment strategy when varying an existing mortgage or replacing it with a new one, provided the change is otherwise in the borrower's best interests.

There are therefore two ways Kensington could have given effect to their request for a new rate – either by a rate switch varying their existing mortgage, or by offering a new mortgage to replace the old one. But neither of these options were actually made available to Mr G and Ms L, and so I'll consider whether that was fair and reasonable in all the circumstances.

<u>Re-mortgaging rather than a rate switch</u>

Kensington has explained that, as an alternative to a rate switch, Mr G and Ms L could have applied – via a broker – for a new mortgage with Kensington to replace this one. But in order to successfully do this, according to its policy at the time, Mr G and Ms L would have to pass full new borrower lending criteria – including an affordability assessment and an assessment of interest only repayment strategy.

Mr G and Ms L have explained that they've tried to move their mortgage elsewhere, without success. While they might be able to pass a modified affordability assessment aimed at "mortgage prisoners", they can't take advantage of that – because Kensington is not a closed book lender and therefore they don't come within the scope of these provisions. And they haven't been able to pass a full unmodified affordability assessment.

Because of that, and because they have an interest only mortgage with no repayment strategy, I think that had they applied to Kensington for a new mortgage to replace this one, and had Kensington applied full new borrower criteria to them, it's likely it also would have refused their application. And therefore access to a new interest rate by this route would not have been available to them.

However, there is provision in the mortgage rules for Kensington to set aside the need for both an affordability assessment and an interest only repayment strategy assessment, where a new mortgage is taken to replace an old one with the same lender and with no further borrowing. That would have been the case here.

While these rules do not require a lender to set aside these assessments, they enable to it to do so. And in circumstances like this, I think it would have been fair and reasonable for Kensington to do so.

I say that bearing in mind the regulator's guidance that it does not consider an affordability assessment should be needed for a rate switch – and while this would have been a re-mortgage, the only purpose for it would have been to take a new rate with the same lender. Reducing their monthly payments via a new rate would clearly have been in Mr G and Ms L's best interests. And refusing to use these rules would have meant that Kensington required Mr G and Ms L to remain on the higher SVR plus premium they were paying.

Kensington has said that it didn't give advice at this time, so Mr G and Ms L would have needed to take advice from a mortgage broker. But that is not incompatible with offering them a re-mortgage under this route. The rules allowing the setting aside of *affordability and interest only assessments do not require advice direct from the lender (or at all), and could have been given effect via a broker application. And in any case, a re-mortgage without further borrowing to facilitate a rate switch is permitted on an execution only (that is, non-advised) basis under MCOB 4.8A.10 R (2) – so Kensington could also have offered this option directly without needing to give advice.*

When Mr G and Ms L asked Kensington about a rate switch in December 2017, therefore, it could have told them that they could access a new interest rate (if necessary, via a broker) by applying for a re-mortgage under which Kensington would set aside the need for an affordability assessment or an assessment of interest only repayment strategy.

Taking this route would have created a new mortgage, which would have avoided the issues caused by varying an existing securitised mortgage I refer to below. But Kensington did not make this possibility available to them. In my view, if a rate switch wasn't available to Mr G and Ms L, it wasn't fair and reasonable that this alternative wasn't offered to them instead.

<u>*A rate switch rather than re-mortgaging*</u>

By December 2017, Kensington was offering rates to some existing borrowers who met its eligibility criteria. But Mr G and Ms L did not meet its criteria, and it did not make a new rate available to them via this route.

So the question I have to consider is whether, in offering rates to other customers but not to Mr G and Ms L, Kensington acted fairly and reasonably in all the circumstances.

Kensington has explained that they were not eligible for a rate, under its eligibility criteria, because their mortgage was taken out before 2010, when lending standards were very different to today. As a result, their mortgage no longer meets Kensington's current risk appetite – in part because of difficulties in re-securitising it based on current investor risk appetite.

And, as I've said this was a sub-prime (based on past financial difficulty) mortgage. So I agree that this mortgage, while acceptable in 2007, would not be lent today.

However, I'm not persuaded that's a fair basis on which to refuse Mr G and Ms L a new rate in 2017, ten years after their mortgage was taken out.

In saying that, I've taken into account MCOB 11.8.1 E, which I've quoted above. In my view, what's relevant for the purposes of the comparison envisaged by MCOB 11.8.1 E are Mr G and Ms L's characteristics at the time of their attempted application in 2017 – not their characteristics as they were ten years earlier.

An assessment of the fairness of Mr G and Ms L's treatment in comparison to the treatment of other borrowers is to be based on their situation at the time of the assessment. I understand Kensington considers the circumstances in which the mortgage was taken out to be relevant to its business model of securitisation. That may well be the case – but, as I explain below, that's not relevant to the question of whether it treated Mr G and Ms L fairly in their particular circumstances.

I also note that there is no evidence from the transaction history provided by Kensington that this mortgage has ever been in significant arrears. There are no *arrears at all since 2010.*

Before that date, there were sporadic and occasional arrears – but as Kensington itself has said, that was because Mr G and Ms L didn't always make payment by the due date, rather than failing to make payment at all. It's refunded arrears fees on that basis. Given the passage of time and the nature of the historic arrears, therefore, I don't think it's fair and reasonable to use this as a basis to refuse a new interest rate.

Because no application was actually made in December 2017 / January 2018, there was no wider credit risk assessment – and so we don't know whether or not Mr G and Ms L would have passed it. Though I'm not aware of any specific issues that make it likely they wouldn't

have done – and from what Kensington has said, this is a check that they've not been made bankrupt or entered an IVA rather than a more detailed credit check.

Taking into account Kensington's rate switch criteria, then, I think Mr G and Ms L's mortgage met some of them in January 2018. The mortgage was not in arrears, and the nature of the arrears over seven years earlier was not such as to fairly be used as a bar to a rate switch. And I've no current basis for concluding they would have failed a credit risk assessment.

Therefore, based on their circumstances and the circumstances of their mortgage at the time, I think it's fair to say Mr G and Ms L met that part of the criteria based on their circumstances at the time.

It seems that the reason Kensington says no new rate was available to them was because they did not meet the rest of its criteria, relating to when their mortgage was taken out. In particular, that their mortgage was taken out before 2010 on a sub-prime basis.

But I'm not persuaded that the circumstances in which Mr G and Ms L took out their mortgage, many years ago, are relevant to the fairness of how they were treated in January 2018.

I've referred above to MCOB 11.8.1 E, which I think is relevant in this situation. MCOB 11.8.1 E is an evidential provision – not a rule – but it says that treatment of the kind set out in the provision may tend to show unfairness. Though equally it may not, depending on the circumstances.

The provision says that where a borrower either can't vary their mortgage with an existing lender, or can't move their mortgage to another lender, it may be unfair for their existing lender to treat them less favourably (for example, by offering less favourable interest rates) than it would treat other customers with similar characteristics.

In my view, this provision is aimed at the unfairness that might result where a borrower is unable to move their mortgage and shop around for a better deal – having no choice but to remain with their existing lender, and being treated less favourably than other customers who are otherwise similar to them.

Mr G and Ms L have provided evidence that they've been unable to move their mortgage to another lender, despite seeking advice. That brings them within the ambit of MCOB 11.8.1 E.

Kensington would offer rates to other customers in January 2018 – but not Mr G and Ms L. I've explained that I'm satisfied that Mr G and Ms L ought fairly to be considered as having satisfied Kensington's criteria about the current position of their mortgage – but that it didn't consider them eligible for a rate switch because of how their mortgage originated.

I'm not persuaded – taking into account MCOB 11.8.1 E – that this was fair. MCOB 11.8.1 E refers to the treatment of borrowers with similar characteristics. In my view, what's relevant to this exercise is Mr G and Ms L's characteristics at the time they asked for a rate – not their characteristics as they might have been ten years earlier when the mortgage was taken out.

I'm not persuaded the date their loan was taken out, or the nature of the mortgage they applied for, was any longer relevant at the time they made their application. What was relevant were their circumstances at the time of their application. In my view, it is fair and reasonable to regard their current circumstances as the characteristics which are relevant for the purposes of the comparison in MCOB 11.8.1 E, and therefore fair and reasonable to consider whether Mr G and Ms L were treated less favourably than other customers to whom they were similar at that time.

It follows that Mr G and Ms L were treated differently – less favourably, by being offered less favourable interest rates – than other customers with similar characteristics to them. They were unable to move their mortgage to a new lender or shop around for a better deal; they had no option but to remain with Kensington regardless of what decisions it made; and by refusing them a rate that it would offer to other, similar, customers Kensington didn't treat them fairly.

<u>What ought Kensington, acting fairly, to have done?</u>

In my view, acting fairly, Kensington ought to have enquired into their circumstances at the time they asked for a rate in December 2017 and January 2018. Having learned that they were unable to move their mortgage to another lender it then ought, acting fairly, to have either recognised that MCOB 11.8.1 E was relevant to their situation and ensured they were offered a rate no less favourable than other, similar, customers – or offered to consider a re mortgage without affordability or repayment strategy assessment.

Kensington says that the reason for its rate switch criteria is that it has securitised its mortgages. Different groups of mortgages are in different securitisation vehicles. And the terms of its agreements with those vehicles limit what it can offer existing customers – it cannot vary the terms of a mortgage while securitised, and cannot re-securitise the mortgage of a customer which does not meet the risk appetite of its investors.

I've taken that into account. I recognise the constraints under which Kensington operates. And I understand that securitisation is a recognised and relatively common business model within the mortgage market – and not inherently unfair.

However, I'm not persuaded that this explanation as to why Kensington considers them ineligible for a new rate changes my conclusion that Mr G and Ms L were not treated fairly when it refused to consider a rate.

MCOB 11.8.1 E refers to customers of a firm. In my view, this makes it clear that the comparison envisaged is to be done across all the customers of the firm – Kensington – not sub-sets of those customers (subject to them having similar *characteristics). Whether or not their loan had been securitised, Kensington remained Mr G and Ms L's lender and it remained the firm which owed them obligations of fair treatment – including treatment of the sort envisaged in MCOB 11.8.1 E.*

The mere fact of being a securitised customer, or a customer securitised in one vehicle rather than another, is not of itself a characteristic of difference that can in and of itself justify different treatment. If that were treated in and of itself as a different characteristic, it would prevent there being a comparison between customers of the firm merely because of the way the firm has dealt with them internally, since customers in different vehicles would be treated as not having similar characteristics simply because the lender has chosen to separate them. That would seem to me to defeat the purpose of 11.8.1 E.

I also think it's clear from the wording of MCOB 11.8.1 E that what matters is whether Mr G and Ms L, as individual mortgage customers, had similar characteristics to other individual customers of Kensington – taken as a whole. And if they have similar characteristics to those other customers, but are being treated less favourably than those other customers, that may tend to show a breach of Principle 6 and unfair treatment in their individual case.

I therefore do not think that the mere fact that the mortgage of one customer but not another has been securitised, or securitised in a different way or different vehicle, can of itself amount to a characteristic of either customer. Securitisation is a unilateral step taken in relation to an existing borrower's loan by a lender for the lender's prudential and commercial purposes, not a characteristic of the borrower themselves (as loan to value or credit score might be).

And in my view the existence of contractual terms agreed between Kensington and a third party by which Kensington has chosen to constrain its options for managing Mr G and Ms L's mortgage is also not a relevant consideration in deciding what are the characteristics of Mr G and Ms L and their mortgage. Nor is it relevant to considering whether Kensington's treatment of them was fair – if Kensington has obligations to treat them fairly, those obligations cannot be dis-applied because of an agreement Kensington has separately entered into with a third party which does not change its relationship with or obligations to Mr G and Ms L.

In other words securitisation is something done to the borrower by the lender rather than a characteristic of the borrower. The lender's decision to securitise might be driven in part by its perception of the characteristics of the borrower, or at least the average characteristics of the part of the lender's business the borrower sits within. But if that is the case, it is those characteristics that may be relevant, not the securitisation itself. It is therefore necessary to identify what Mr G and Ms L's characteristics were, and the extent to which they have similar characteristics to other customers of Kensington. I've set out above my analysis of that, and why I consider that Mr G and Ms L had similar characteristics to other customers who would have been eligible for a rate switch in January 2018.

I recognise that the fact of the securitisation made it more difficult for Kensington to offer Mr G and Ms L a new rate. But that is a choice Kensington made when it decided to securitise their mortgage. Doing so does not lessen Kensington's obligations in fairness to them. To the extent this is relevant to their situation at all, it is relevant as a practical matter which might impact on the options for putting things right. It is not relevant to whether Kensington's treatment of them was fair and reasonable or not.

Acting fairly and reasonably, therefore, in my view what Kensington ought to have done in January 2018 was to have looked at Mr G and Ms L and their circumstances and considered whether the application of its rate switch criteria, resulting in the refusal of a new rate, would have brought them within the scope of MCOB 11.8.1 E. Acting fairly and reasonably, it would have concluded that it did – since they could not move to another lender, could not vary their mortgage with Kensington, and were potentially being offered less favourable rates than other customers with similar characteristics.

I've noted that MCOB 11.81 E is an evidential provision tending to show unfairness – which means that there may be situations in which treatment of the sort described in the provision may nevertheless not result in unfairness too. But in this case, where Mr G and Ms L were unable to move their mortgage, unable to shop around for a better deal, and left with no choice but to remain with Kensington whatever happened, it was not fair and reasonable in all the circumstances to refuse to consider their request for a new interest rate. Kensington could have offered Mr G and Ms L a new rate on their existing mortgage. Or if it felt it could not do that because of the securitisation, it could have offered them a re-mortgage onto a new rate using MCOB 11.6.3 R and 11.7.3 R. But it did neither of those things.

In my view, in simply applying its policy without considering these broader issues and whether they resulted in unfairness in Mr G and Ms L's specific circumstances, Kensington did not act fairly and reasonably.

Conclusion

When Mr G and Ms L asked Kensington for a new rate in December 2017 and January 2018, it told them there were no rates available to them. But – as I've found – it did make rates available to other customers with, at that time, similar characteristics to them. As Mr G and Ms L were also unable to shop around for a better deal by moving their mortgage to another lender, that left them with no option other than to remain on their existing reversion rate. As a result, they were treated less favourably than other customers with similar characteristics, and I don't think that was fair and reasonable in all the circumstances.

Acting fairly, I think Kensington ought to have looked at their situation at the time and understood they had no other options and that refusing them a new rate would leave them in a less favourable position than other customers with, at the time, similar characteristics.

Had it done that, it could have offered them a new rate by means of a rate switch, of the sort offered to other existing customers. Kensington has explained that this might have caused it practical difficulties because of its agreement with the securitisation vehicle not to change the interest rate. I've explained why I don't think that's a relevant consideration in deciding whether Mr G and Ms L were treated fairly. But in any case, Kensington could have avoided this issue by offering Mr G and Ms L a new mortgage to replace the old one in any event – which would therefore have repaid the securitised mortgage without the need to vary its interest rate.

Either of these options would have resulted in fair treatment of Mr G and Ms L at this time, and I'm satisfied that in the particular circumstances of this complaint it's fair and reasonable to say that is what Kensington ought to have done.

Putting things right

In order to put matters right, therefore, Kensington should put Mr G and Ms L back in the position they would have been in had it offered them a new interest rate when they asked about it in December 2017. Had Kensington acted on their request at this time, a new rate could have been in place within a few weeks. And so Kensington should re-work their mortgage as if a new interest rate had been in place from 1 February 2018.

When it replies to my provisional decision, Kensington should provide me with a list of the rates it made available to existing customers taking a new interest rate in December 2017, and should explain which of them it believes Mr G and Ms L's loan to value qualified them for at that time. I will then select an appropriate rate from that list.

On the assumption that Kensington offered two, three and five year fixed rates to existing customers at this time (as is standard), a fixed rate from 1 February 2018 would expire in February 2020, 2021 or 2023. As the term of Mr G and Ms L's mortgage came to an end in 2022, they would not therefore have been eligible for a five year rate in 2018 (because an interest rate term cannot exceed the term of the mortgage itself).

They also would not have been eligible to take a new rate from February 2021 – following a three year rate in 2018 – for the same reason. But if Kensington offered two year rates in 2018, and also did so in 2020, Mr G and Ms L may have been able to take a second two year rate from February 2020.

Therefore, if the rate list for December 2017 includes two year rates, Kensington should also provide me with the list of rates available for existing customers in February 2020, again identifying which loan to value band it believes they fell into at that time.

If, however, there is no rate available on the expiry of the rate that should have been offered in December 2017 then thereafter the mortgage would have reverted to the reversion rate for that product, rather than current reversion rate of SVR plus premium.

Kensington will need to rework Mr G and Ms L's mortgage, taking into account the rates I tell it to put in place in due course. That will result in them having made overpayments in the months since February 2018.

Ordinarily, I would then offer Mr G and Ms L the choice of having the overpayments refunded to them, or used to reduce the mortgage balance. However, as in this case the mortgage term has now come to an end, I think it's fair for Kensington to use the overpayments to reduce the balance each month, with the compounding effect of reducing the consequent interest charged in subsequent months reducing the balance further. This will result in Mr G and Ms L having a lower capital balance to repay.

Now that the term has ended, Mr G and Ms L will need to discuss with Kensington their plans for repaying the capital. Kensington should look at their circumstances fairly and sympathetically, offering reasonable forbearance where appropriate, so that agreement can be reached if possible.

Separately, during the life of this complaint, Kensington has offered to refund historic arrears fees and pay £250 compensation. I'm satisfied that's fair. But in addition to that, I think it should offer further compensation for the distress and inconvenience *caused by unfairly refusing a new rate in December 2017 / January 2018, leading to Mr G and Ms L having to make higher mortgage payments than they otherwise would since then. While there's no evidence that caused immediate financial hardship, or that Mr G and Ms L were unable to make those payments, I do think this caused them considerable upset. In the circumstances, I think Kensington should pay them a further £400 compensation.*

The responses to my provisional decision

Kensington did not accept my provisional decision. In summary, it said:

- The regulator said that MCOB 11.8.1 E was not compulsory, and it is for lenders to make lending decisions[1].

- When considering a request for a product switch, Kensington applies its criteria. It offered rates to all customers who met its criteria – but Mr G and Ms L didn't meet them.

- Since it offers rates to all customers who meet the criteria, and Mr G and Ms L didn't meet the criteria, it can't reasonably be said that they have similar characteristics to those who do. It is a requirement under Kensington's lending criteria that to access a product switch the mortgage must have completed in 2010 or later – and Mr G and Ms L's mortgage didn't.

- Kensington has developed an offering for customers not eligible for a standard product switch – which it calls its mortgage prisoners regime. It has negotiated with the securitisation vehicles to offer a variable rate to such customers. But Mr G and Ms L didn't qualify for that either because of the limited time left on their mortgage term. And in any case at the time their existing mortgage rate was lower than the "mortgage prisoner" variable rate, so it wouldn't have benefitted them.

- My decision is not in accordance with our rules and creates new regulatory obligations that don't currently exist, and is in conflict with Kensington's prudential obligations.

- In any case, Mr G and Ms L wouldn't have been eligible for a product switch at the time, because their loan to value was too high.

Mr G and Ms L also replied. They said that an important consequence of Kensington's refusal to offer new rates was that they were unable to make regular overpayments to reduce the balance. And they said Kensington was unwilling to consider extending the term to give them more time to repay the capital balance. They want Kensington to convert the mortgage to one on repayment terms, over a term of 15 years from 2018.

Mr G and Ms L also said that they had approached another lender to re-mortgage, and that lender was willing to offer them a new loan using the modified assessment allowed for in the mortgage rules – if Kensington issued them a "mortgage prisoner" letter. But they said Kensington refused to do so. This prevented them re-mortgaging on better terms with another lender.

Mr G and Ms L were concerned that Kensington has very recently told them it is moving their mortgage to another lender.

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[1] It cited para 60 of *Mortgage Market Review: Feedback on CP11/31 and final rules*, PS12/16, Financial Conduct Authority

I asked Mr G and Ms L for further evidence about their property's value to investigate what their loan to value was in 2017, and they also provided that evidence.

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.

In doing so, I've taken into account – as required by our rules – relevant law and regulations, regulators' rules guidance and standards, codes of practice and, where appropriate what I consider to have been good industry practice at the relevant time. But while I take those matters into account, ultimately I am deciding what I consider to be fair and reasonable in all the circumstances.

I've set out in detail in my provisional decision why I think this complaint should be upheld. I've reproduced the relevant sections above so I won't repeat them here. Having reconsidered matters carefully, and taken into account what Kensington has said in reply, I haven't changed my mind either about the fair outcome to this complaint or my reasons for reaching it.

Kensington pointed to PS12/16. The passage it cited comes in a section dealing with the regulator's assessment of the responses to its consultation on the introduction of new rules. The passage Kensington quoted says:

> *We do not believe it is appropriate to make these transitional arrangements compulsory. Ultimately, it is for lenders to make lending decisions, and there may be sound reasons for not proceeding with individual transactions.*

Kensington says this means that MCOB 11.8.1 E is not compulsory. But placed in its wider context I don't think this is what the relevant passage says.

In the first place, this section refers to the "transitional arrangements". The transitional arrangements are to be found in MCOB 11.7, not MCOB 11.8.1. That is the chapter title of MCOB 11.7.

Secondly, the full section says

> *The changes we are making to the application of the affordability requirements for contract variations, as set out in Chapter 2, along with the revised transitional arrangements, will make it easier for lenders to help existing borrowers.*
>
> *We will continue to expect lenders to treat their customers fairly, in according with Principle 6 ('treating customers fairly'). In response to feedback, we are strengthening the protection for existing borrowers, by changing the guidance to an evidential provision (MCOB 11.8.1E). Under this provision, if the existing lender takes advantage of a 'trapped' borrower or treats them any less favourably than other customers with similar characteristics – for example, by offering less favourable interest rates or other terms – then this may be relied on as tending to show contravention of Principle 6.*
>
> *As we explain further in the introduction, we are implementing this provision with immediate effect.*
>
> *We do not believe that it is appropriate to make these transitional arrangements compulsory. Ultimately, it is for lenders to make lending decisions, and there may be*

sound reasons for not proceeding with individual transactions.

In context, therefore, this passage is responding to concerns expressed in the consultation that making 11.7 non-compulsory might lead to consumer detriment for borrowers unable to switch away from their existing lender. The regulator responded to this by stating that a strengthened 11.8.1 will nevertheless create an expectation of fair treatment. I don't therefore think this passage says what Kensington says it does, or that it means that Kensington is not required to take account of MCOB 11.8.1 E. I think the regulator's intention is that a lender should have regard to MCOB 11.8.1 E in dealing with customers unable to move elsewhere, and that treatment of the kind outlined in the provision may tend to show unfairness – as indeed the provision itself says. It is therefore a relevant consideration for me to take into account in this case.

I also referred to MCOB 11.6.3 R and 11.7.3 R in my provisional decision. These are rules allowing a lender to set aside an affordability assessment and an assessment of interest only repayment strategy when varying an existing mortgage or replacing it with a new one. MCOB 11.7.3 R is part of the transitional provisions.

I acknowledged in my provisional decision that these rules are not compulsory, in the sense that they do not oblige a lender to set aside these assessments. But they enable it to do so. Under these rules, Kensington could either vary Mr G and Ms L's existing mortgage – for example by a product switch – or replace it with a new one either without carrying out these assessments or by carrying them out but not using any failure to prevent the change. In my view, it's no answer to say that because Kensington is not obliged always to do something, not doing so can never be unfair. These provisions are all relevant considerations, and in my view it's open to me to find that a decision by Kensington not to follow a course that was open to it – even it was not required to follow it – resulted in unfairness in the particular circumstances of this case.

For those reasons, I don't agree with Kensington that MCOB 11.8.1 E is not something Kensington had to have regard to in thinking about whether its decision to refuse Mr G and Ms L a rate was fair and reasonable in all the circumstances. In my view, it is a relevant matter and something that Kensington ought to have considered.

In my provisional decision, I said that if Kensington had given consideration to MCOB 11.8.1 E then, acting fairly, it would have understood that:

- Mr G and Ms L were unable to move to another lender or shop around for a better deal;

- Mr G and Ms L were being refused a rate by Kensington because of when their mortgage was taken out – other than that (subject to what I say below about loan to value) they met all Kensington's product switch criteria.

In those circumstances, I think it's a reasonable conclusion that – with the exception of when their mortgage was taken out – they shared similar characteristics to a borrower who did meet Kensington's product switch criteria. I don't think it's in dispute that (subject to loan to value, discussed below), it was only the date of origin of their mortgage which meant they didn't meet the product switch criteria.

The application of the date of origin criterion was the reason Mr G and Ms L were refused a product switch. It was the reason they were on less favourable rates compared to borrowers who – as Mr G and Ms L also did – met the remaining criteria.

And therefore the crucial question is whether date of origin is a relevant matter to be taken into account in determining whether Mr G and Ms L had “similar characteristics” to borrowers who would be offered a rate – or not.

I explained in my provisional decision that in my view the circumstances in which a mortgage was taken out many years before are not relevant to that question. Much can change in the meantime. What’s relevant, in my view, are Mr G and Ms L’s circumstances – their characteristics – as at the time they made their application, not their circumstances as they were many years before. And having considered what Kensington has said in reply to my provisional decision, I haven’t changed my mind about that.

Nor do I think that the fact that Kensington has chosen to securitise their mortgage, or do so on particular terms, is relevant. It’s entitled to operate its business in that way. But there may be circumstances – and I think this is one – where a firm’s legitimate decisions to operate its business in a particular way nevertheless produce an unfair result in the particular circumstances of an individual customer.

And for the same reasons I don’t think Kensington’s prudential obligations are a relevant matter for me to consider. I recognise it has those obligations. But I am not concerned with those obligations; I am concerned with what is fair and reasonable in the circumstances of this complaint. It’s a matter for Kensington to find a way to manage both its prudential obligations and its obligations of fairness to Mr G and Ms L.

I’m therefore satisfied that it wasn’t fair for Kensington to refuse a product switch based on when the mortgage was taken out. Leaving that aside, Mr G and Ms L passed Kensington’s eligibility criteria. Insofar as relevant, therefore, they had similar characteristics to borrowers who would have been offered a product switch. And in refusing them a product switch, Kensington offered them less favourable rates than other borrowers with similar characteristics. I’m satisfied that wasn’t fair and reasonable in all the circumstances.

That being the case, I don’t need to comment further on Kensington’s “mortgage prisoner” product offer or why it wasn’t made available to Mr G and Ms L. If, as I’ve found in fairness it should have done, Kensington had offered Mr G and Ms L a product switch it would not have been relevant to their circumstances in any case.

Putting things right

Kensington has said that even if I remain of the view that MCOB 11.8.1 E is relevant and that Mr G and Ms L weren’t treated fairly as a result, they wouldn’t have been offered a rate switch in any case because of their loan to value.

Kensington has provided me with a copy of the mortgage valuation from when the mortgage was taken out in 2006. It values the property at £300,000. Kensington says that using an industry standard property price indexing tool, that means that in December 2017 the loan to value on Mr G and Ms L’s mortgage was 91.3%. At this time, it did not offer product switches above a loan to value of 85%, and so Mr G and Ms L weren’t eligible.

I put this to Mr G and Ms L, and asked them for any evidence of the property’s value. They’ve provided me with evidence that they had substantial works carried out in 2014 which they believe would have increased the property value. And they’ve also provided me with a recent estate agent’s appraisal. Using the valuation in the appraisal, and projecting backwards using the same indexing tool Kensington used produces a loan to value of 84% - which is within the acceptable band.

There’s a difficulty here. It turns on whether, in December 2017, Mr G and Ms L had a loan to value of 85% or below – or above that level. And that now can’t be known for certain.

Kensington's approach – of using the last known value plus indexation – is a legitimate one, and one that's standard across the industry for calculating loan to value for product switches.

But where there are grounds for disputing a valuation – for example, as is the case here, because of works to the property in the meantime – our approach is that it's fair for the lender to commission a new formal valuation by a surveyor (at the borrower's expense) to determine the correct loan to value.

We can't now know what a valuer would have said in December 2017 if that had happened. So I need to weigh up all the evidence and decide whether I think it's fair to say that, at that time, the loan to value was likely to be above or below 85%.

Having considered this carefully, I think it's fair in all the circumstances for me to find that Mr G and Ms L's loan to value did fall below the threshold.

As I say, taking the initial value indexed is a reasonable starting point. But in this case, given the works in 2014, there are reasonable grounds for saying that by 2017 the property would be worth more than the indexed value – so I think the loan to value would have been below the 91% produced by indexation alone.

The value Mr G and Ms L have now provided dates from around six months ago. So it's reasonably contemporary. It takes into account the impact of the 2014 works. To that extent it might be a more reliable starting point than the 2006 valuation. But I also need to take into account that it's an estate agent's appraisal rather than a formal valuation – though prepared by a firm qualified to carry out formal valuations – and therefore is less reliable than a formal valuation would be.

Taking those two alternative starting points into account, it's likely the loan to value in December 2017 was somewhere between 84% and 91%. It's difficult to be more precise than that – because deriving the loan to value involves either projecting forward ten years from a valuation that doesn't reflect changes to the property, or projecting backward five years from a value that isn't a formal valuation.

I need to bear in mind too that property valuation is never an exact science; there's always a margin of error in that a valuation represents a surveyor's professional opinion rather than a precise and definitive measurement. In the end, a property's value is what someone is prepared to pay for it, and that can't be known for certain in the absence of a sale.

I've also borne in mind that had Kensington approached Mr G and Ms L's 2017 application as I've said it ought fairly to have done, with MCOB 11.8.1 E in mind, Mr G and Ms L would have had the chance to challenge the index valuation at the time through a formal valuation. They don't have that chance now.

Taking all the evidence into account, and recognising that it's imperfect, but also recognising that the need for me to make this determination derives ultimately from unfairness on Kensington's part, I'm satisfied that it's fair and reasonable in all the circumstances to proceed on the basis that Mr G and Ms L's property value in December 2017 was such that they qualified for the 85% loan to value product switch.

That being the case, they met all of Kensington's product switch criteria other than the one relating to the date the mortgage was taken out. I've already explained why I don't think it was fair to take that into account and that – taking account of MCOB 11.8.1 E – doing so resulted in a refusal that wasn't fair and reasonable in all the circumstances.

I'm therefore satisfied that it's a fair and reasonable outcome to this complaint for Kensington to treat Mr G and Ms L as if it had offered them a product switch in December 2017, taking effect from 1 February 2018.

To put things right, Kensington should re-calculate Mr G and Ms L's mortgage as if they had taken a two year fixed rate of 3.24% from 1 February 2018 to 31 January 2020, followed by a two year fixed rate of 3.9% from 1 February 2020 to 31 January 2022 – these are the two year rates for the up to 85% loan to value bands at each time.

The reversion rate for the 2020 rate is LIBOR plus 4.2%; this is very similar to the current rate Mr G and Ms L are paying before the impact of the redress – they are on the SVR plus 1.25%, and the SVR is 3% over LIBOR, making 4.25% over LIBOR in total. Nevertheless, an adjustment to the reversion rate will also be required. Since 2021, LIBOR has ceased to exist so Kensington will need to treat Mr G and Ms L's ongoing interest rate as if their mortgage had reverted to what it used to replace the LIBOR plus 4.2% reversion rate.

I understand that Kensington has very recently transferred Mr G and Ms L's mortgage to a new lender, notwithstanding this ongoing complaint.

I said in my provisional decision that, given Mr G and Ms L's mortgage is now past the end of the interest only term, it's fair that the redress is used to reduce the capital balance outstanding. It's unfortunate the loan was transferred before this complaint was resolved. Now that it has transferred the loan, therefore, Kensington will need to pay the redress to the new lender so the balance can be reduced. Kensington will also need to make arrangements with the new lender to reduce the ongoing interest rate as set out above.

Mr G and Ms L also asked that in resolution of this complaint, their mortgage be converted to repayment terms and the term extended. But that's not something I can fairly do here. The compensation I've awarded puts them back in the position they would have been in if they'd made overpayments since 2018 – to the extent them not doing so was caused by the interest rate. And changing the mortgage to repayment terms and extending the term is a separate matter for which a full application would be needed. If that's something they want to do, Mr G and Ms L will need to discuss that with the new lender.

Finally, I said that Kensington should pay Mr G and Ms L a further £400 compensation for the distress and inconvenience caused. I still think that's a fair amount of compensation.

Other matters

In response to my provisional decision, Mr G and Ms L raised further matters.

They are concerned that Kensington is moving their mortgage to a new lender. And they say that Kensington refused to issue them a "mortgage prisoner" letter allowing them to move to a different lender in 2021.

Neither of these matters are part of this complaint, and they're not things we have investigated.

Clause 60 of the mortgage terms and conditions gives Kensington the right to move the mortgage to another lender. But whether it was fair that it did so is not something I've considered as part of this complaint. Mr G and Ms L would need to make a new complaint about that.

A "mortgage prisoner" letter is something the regulator required lenders to send to customers who were unable to change their mortgage with their existing lender but who might benefit from moving to another lender – it tells the new lender that it might be appropriate to use the flexibility allowed by the modified assessment rules to take on the mortgage, allowing the lender to access new terms.

Mr G and Ms L say they tried to do this, and a new lender was willing to take them on if Kensington would provide a letter. They've shown me extracts from emails in which it appears Kensington was confusing their request for this letter with a request for a new interest rate from its "mortgage prisoner product switch" range, which was not what Mr G and Ms L were asking for. However, I've only seen those email extracts and as this doesn't form part of this complaint, I've not made any findings on whether Kensington acted fairly in this respect. If Mr G and Ms L think that Kensington failed to issue the letter it was required to issue, and that this failure caused them a loss, they will need to make a separate complaint about that too.

My final decision

For the reasons I've given, my final decision is that I uphold this complaint and direct Kensington Mortgage Company Limited as follows:

- Kensington should re-calculate Mr G and Ms L's mortgage as if the following rates had applied:
    - 3.24% fixed from 1 February 2018 to 31 January 2020;
    - 3.9% fixed from 1 February 2020 to 31 January 2022;
    - Variable LIBOR plus 4.2%, or the replacement for this rate on the withdrawal of LIBOR, from 1 February 2022 to the date redress is paid.

  In each case, Kensington should treat the amounts Mr G and Ms L paid above the revised monthly payments as overpayments towards the capital each month, reducing the interest charged in subsequent months.

- This calculation will produce a revised mortgage balance as at the date of the calculation. Kensington should pay the difference between the revised balance and the actual balance on that date to Mr G and Ms L's new lender to reduce the balance of their mortgage to what it would be had the interest rates set out above been in place.

- Kensington should make arrangements with the new lender to ensure that the interest rate, and monthly payments, going forward from the calculation date are based on the reversion rate for the January 2020 rate (as amended following LIBOR withdrawal) rather than on the rate set out in the 2006 mortgage offer. If Kensington is unable to arrange this with the new lender, it will need to find another way to ensure that Mr G and Ms L are compensated for the difference in payments going forward, until such time as the new lender offers them a new rate (if it has them available) or until the mortgage is paid off, whichever is the sooner.

- Kensington should pay Mr G and Ms L £400 compensation, in addition to the £250 separately offered in respect of the historic fees. This should be paid direct to them rather than added to the balance reduction (unless Mr G and Ms L ask for it to be added to the balance reduction) and should be paid within 28 days of the date we notify Kensington Mr G and Ms L have accepted this decision, if they do. If payment is not made within 28 days, Kensington should add simple annual interest of 8%* running from the date of notification to date of payment.

* *If payment to Mr G and Ms L includes an 8% interest element, Kensington may deduct income tax from the 8% interest element as required by HMRC. But it should tell Mr G and Ms L what it has deducted so they can reclaim the tax from HMRC if they are entitled to do so.*

Under the rules of the Financial Ombudsman Service, I'm required to ask Mr G and Ms L to accept or reject my decision before 31 March 2023.

Simon Pugh
Ombudsman