DRN-4427884

The complaint

Mrs A complains about her mortgage with Mortgage Agency Services Number Five Limited (MAS5).

This complaint was originally prompted because Mrs A's mortgage had reached the end of its interest only term, she was unable to repay the capital and MAS5 refused a term extension. She complains that it has not treated her fairly when she was unable to repay the capital. Mrs A also complains about the fairness of the standard variable interest rate that MAS5 has applied to the mortgage, and that it has failed to offer her a new fixed interest rate in place of the standard variable rate.

Summary of my final decision

I'll begin by summarising my conclusions before setting out my findings, and the reasons for them, in more detail below.

1. This complaint is about the interest rate Mrs A paid on her mortgage after her initial fixed rate period came to an end.
2. It is also about action MAS5 has taken since the end of her interest only term in 2016, Mrs A not having repaid the capital balance. Mrs A doesn't think it's fair that MAS5 hasn't agreed to extend the mortgage term and has threatened her with repossession action if the capital remains unpaid.
3. Since December 2008, Mrs A has been charged interest at MAS5's standard variable rate (SVR). She complains that the SVR was too high, that changes MAS5 made to it were unfair, and that it was not fair she was not offered an alternative fixed rate by MAS5 or its parent company.
4. MAS5 says that the SVR was properly charged in line with the mortgage offer and terms and conditions. It says that any changes it made to the SVR over time were made in line with its contractual powers to vary the SVR and those changes were justified at the time. It says it doesn't offer new interest rates to existing customers. It doesn't agree Mrs A was treated unfairly in respect of the interest she was charged.
5. MAS5 says it acted fairly following the end of the mortgage term. It reviewed Mrs A's circumstances and offered forbearance to allow her time to repay the capital. But when Mrs A didn't make any payments towards the capital or put forward any acceptable proposals for repayment, it acted fairly in obtaining a possession order in 2019. Since then it has not enforced the possession order and is continuing to offer forbearance during this complaint. But it does require the capital to be repaid.
6. Because of the time limits which apply to complaints made to the Financial Ombudsman Service, my jurisdiction to consider this complaint is limited.
7. In particular, I can only consider the fairness of the SVR Mrs A paid from 31 October 2012 onwards. But in doing so, it is appropriate to take into account all the circumstances of the complaint – which includes decisions MAS5 took before 31 October 2012 to the extent that they may have contributed to the SVR charged from 31 October 2012 onwards.

8. I can consider whether MAS5 has acted fairly in the action it has taken following the end of the mortgage term.
9. MAS5 has invited me to decline to consider this complaint, on the basis that the Financial Ombudsman Service has considered similar complaints in the past. But I don't think that's appropriate, since (amongst other things) Mrs A has not herself complained to us about this before. So we have not previously considered *her* complaint.
10. For reasons I explain in more detail below, I have upheld part of the complaint about the interest rate and I require MAS5 to pay Mrs A compensation in respect of this. Having considered all the evidence, argument and relevant considerations, my findings on the evidence that has been provided in summary are that:
    (i) MAS5 was not required to offer Mrs A a new interest rate on her mortgage, and it did not act unfairly when it did not do so. MAS5 did not offer fixed interest rates to existing customers at the end of an initial preferential rate period and all customers reverted to the SVR. It is not relevant that other lenders do offer rates to existing customers. That includes other lenders in the same group as MAS5, since they are separate corporate entities. It is therefore fair that Mrs A remained on the SVR after December 2008.
    (ii) The increases MAS5 made to the SVR between 2009 and 2012 are out of time as complaints in their own right. But they are relevant as part of all the circumstances contributing to the interest rate it charged to Mrs A after 31 October 2012, and relevant to whether that interest rate was fair and reasonable in all the circumstances.
    (iii) MAS5 increased the SVR between 2009 and 2012 relying on its contractual right to change the SVR to reflect changes in the cost of the funds it used in funding its mortgage lending business.
    (iv) I am not persuaded that there were changes in the cost of the funds MAS5 used in funding its mortgage lending business at the relevant times – the evidence doesn't show that there were changes in the overall costs MAS5 was liable itself to pay for the funds that it used.
    (v) To the extent that the wider banking group of which MAS5 was a part did experience changes in cost of funds, the group structured itself in such a way that MAS5 did not itself incur additional interest or similar charges. Under the contract, I consider those changes to the wider group's cost of funds are not directly relevant to the costs of funding MAS5's mortgage lending business.
    (vi) As a result, the changes to the SVR MAS5 made between 2009 and 2012 – which collectively added 2.76% to the SVR – were not made for reasons permitted by the contract.
    (vii) However, in determining whether the interest rate charged to Mrs A after 31 October 2012 was fair and reasonable in *all* the circumstances, the earlier changes to the SVR and their contractual effect are only one of the factors to be taken into account. I am required to take into account relevant law – including the law of contract – but that alone isn't determinative of the complaint as it's necessary for me to consider the wider circumstances in deciding what's fair and reasonable in the period I can consider.
    (viii) Other relevant factors include the broader circumstances in which MAS5 operated including: the nature of its lending business and whether there might have been other valid reasons for varying the interest rate; Mrs A's own circumstances; the passage of time – both between the individual variations and 31 October 2012, and between the individual variations and now; and the

circumstances in which the loan moved from the previous owner to MAS5.

(ix) The effect of the increases to the SVR in 2009 was to return the SVR to normal parameters following a period in which it had been set at an artificially low level as a consequence of an agreement between MAS5 and the original owner of this mortgage (entered into before the impact of the global financial crisis could have been foreseen). Mrs A was not a party to this agreement and had no rights under it, but she benefitted from it in that it resulted in the interest charged to her mortgage being lower than it would otherwise have been during the term of the agreement. When the agreement with the previous lender came to an end, MAS5 increased the SVR to broadly reflect what it would have been but for that agreement, reflecting the SVRs charged by other similar lenders in the group.

(x) It would not be fair and reasonable to conclude that MAS5 should reduce the interest rate charged to Mrs A after 31 October 2012 as if none of the increases had taken place; that is, to require that it should be reduced by 2.76%. I am satisfied that in the circumstances this would amount to an unfairly high amount of compensation, and would require MAS5 to put Mrs A back in a better position than she might have been able to expect based on the operation of the mortgage terms and conditions alone (without the distorting effect of the separate agreement between MAS5 and the previous lender). I am satisfied that for the purposes of calculating redress, MAS5 should not reduce the interest rate charged after 31 October 2012 to reflect the total 1.51% increase in 2009.

(xi) Similar considerations don't apply to the ongoing impact after 31 October 2012 of the later increases, which took place in 2011 and 2012. Those increases were significantly closer in time to the period from 31 October 2012, and more likely to have had a direct impact on it going forward. The agreement with the previous lender was no longer a factor. For the purposes of calculating redress, I am satisfied that it is fair and reasonable to direct that MAS5 should reduce the interest rate charged to Mrs A from 31 October 2012 as if the 2011 and 2012 increases had not happened; that is, to require the interest rate charged from 31 October 2012 to be reduced by 1.25%. I am satisfied this would not result in an interest rate that was unfairly low taking into account MAS5's broader position in the market.

(xii) It is fair and reasonable for MAS5 to compensate Mrs A for overpayments made after 31 October 2012 resulting from the increases in 2011 and 2012.

11. For reasons I explain in more detail below, I have not upheld the part of the complaint about the end of the interest rate term. I conclude that MAS5 has acted fairly in offering Mrs A forbearance following the end of the term. It is reasonably entitled to expect her to pay the outstanding balance and she had options available for doing so. Mrs A owns a substantial portfolio of other properties. If she is unable to sell another property to repay this mortgage, or repay it in some other way, and her only option is to sell this property (as she agreed to do when taking out the mortgage), her ownership of a portfolio of other properties mitigates the harm to her and husband of doing so and so the impact of selling the property does not outweigh MAS5's entitlement to be repaid within a reasonable period. It would not be in Mrs A's best interests to delay matters further and I do not require MAS5 to offer a term extension – though it should continue to show reasonable forbearance while Mrs A puts plans for repayment in place.

12. To put things right, MAS5 should rework Mrs A's mortgage as if the interest rate it had charged her from 31 October 2012 onwards was 1.25% less than it actually was.

Leaving the payments Mrs A made unchanged, this means that her current outstanding balance will reduce. MAS5 should also ensure that the interest rate it charges while the mortgage remains outstanding is reduced by 1.25% (without prejudice to MAS5's ability to vary the interest rate in line with its contractual powers in the future). And it should pay Mrs A £250 compensation for the distress and inconvenience she has suffered.

What happened

Mrs A took out this mortgage in 2006 with another lender, GMAC-RFC Limited. The mortgage transferred to MAS5 in 2007 and has been with MAS5 ever since.

Mrs A borrowed around £131,000 over ten years on interest only terms. It's a residential mortgage. Mrs A took an initial fixed rate of 5.64%. Since the fixed rate expired in December 2008 the mortgage has been on MAS5's standard variable rate (SVR). MAS5 does not offer new fixed rates to existing customers so while Mrs A remains with MAS5 the SVR is the only option open to her.

Mrs A says that as a result of the global financial crisis, shortly after she took the mortgage out, property prices crashed in the area where she lives and have never recovered. She believes the property has been in negative equity ever since. And this has resulted in her being unable to move her mortgage to another lender – so she's had no choice but to pay the MAS5 SVR since 2008. The SVR has increased from 2.99%, peaking at 6% by the time of her complaint, over that time. Mrs A doesn't think this is fair.

The term of the mortgage ended in October 2016. Mrs A says she had no means of repaying the capital at that time. Mrs A says that she can't sell the property to repay the mortgage, because it's in negative equity. She can't re-finance with another lender because of that and because her age means she couldn't get a mortgage elsewhere. And while she doesn't live in the property her husband does – he is in poor health and any move would be difficult for him (although he's not a party to this mortgage). For all those reasons Mrs A wants an extension of the term.

In 2017, Mrs A sent MAS5 a valuation of the property. MAS5 looked at Mrs A's income and expenditure, and said she had a substantial disposable income. It said that she could have made overpayments to reduce the mortgage balance, and it asked her to consider doing so now. But Mrs A said she was unable to make overpayments, though she continued to pay the interest. MAS5 wasn't prepared to extend the term of the mortgage on this basis, with no reduction in the balance and no plan to repay the capital.

As a result no agreement could be reached, and by late 2018 MAS5 was threatening legal action to recover the balance. In 2019 it obtained a possession order, though it hasn't yet enforced the order.

Mrs A brought her complaint to us. Her complaint was in two parts – about the end of the term, the action MAS5 was taking and the failure to agree a term extension. And secondly, about the level of the SVR charged – Mrs A felt that the SVR was unfair and too high, that it had been unfairly increased from 2.99% to 6%, and that MAS5 had acted unfairly in not giving her access to new lower fixed rates.

MAS5 said the second part of Mrs A's complaint was out of time. It said that we shouldn't consider the interest rate part of the complaint, since the changes to the SVR complained of happened between 2009 and 2012, which was more than six years before Mrs A complained. And it said that in any case the Financial Ombudsman Service had considered those increases in other, earlier, complaints and shouldn't consider them again.

Another ombudsman issued a jurisdiction decision, in which she concluded:

- Under our time limit rules, we could only consider Mrs A's complaint in respect of things that happened from 31 October 2012 onwards;

- That means that we would only consider the fairness of interest charged to Mrs A's mortgage since that date;

- In considering the fairness of interest charged since 31 October 2012, we could take into account matters that occurred before that date insofar as they impacted the fairness of the interest charged since that date;

- That means we can consider changes to the SVR made by MAS5 between 2009 and 2012, but only to the extent that they impact the rate charged after that date – any complaint about those changes as events in their own right is out of time;

- The complaint about action taken around and since the end of the term in 2016 is not out of time and can be considered.

Our consideration of the merits of this and similar complaints has been delayed following a challenge by MAS5 in the High Court to the correctness of that approach to our jurisdiction in cases such as this. The court found that this is in principle a legitimate approach to take to the consideration of fairness, and so I set out my preliminary thoughts on the merits of this complaint in a provisional decision to allow both parties to comment and to provide any further evidence, or make any further arguments they wish, before I reach a final decision – which will mark the end of our consideration of this case. Both parties have now responded, and in this decision I'll set out my further thoughts on the case in light of those responses, and explain my final decision.

Background to the mortgage and the complaint

The history of the mortgage and SVR

Mrs A took this mortgage out with another lender, GMAC-RFC, on interest only terms with an initial fixed rate until December 2008. At the end of the initial rate, the mortgage offer said the loan would revert to the GMAC-RFC standard variable rate.

In the meantime GMAC had sold a group of mortgages, including this one, to the then Britannia Building Society group – and specifically to a firm within the group, Mortgage Agency Services Number Five Limited, or MAS5. From the time of the transfer, MAS5 took over from GMAC as the regulated firm which owned Mrs A's mortgage and acted as her mortgage lender.

This means that since the mortgage was then owned by MAS5, it was the MAS5 SVR rather than the GMAC SVR that Mrs A reverted to in December 2008.

MAS5 gave notice to its customers that it was increasing the SVR, and the increase took effect from 1 July 2009.

In August 2009 Britannia merged with The Co-operative Bank plc, and as a subsidiary of Britannia MAS5 became part of the wider Co-op group of companies. The group comprised the merged Co-op / Britannia entity (which took the legal name of The Co-operative Bank plc, but traded under both the Co-op and Britannia brands), as well as a number of subsidiary companies, several of which were, like MAS5, special purpose vehicles for holding books of bought-in mortgages.

Thereafter there were three further increases to the SVR – in October 2009, March 2011 and May 2012. All four of these increases happened at a time when the Bank of England base rate was static at 0.5% (where it had been since March 2009).

There was then no change to the MAS5 SVR until 2016, at which point further changes took place in line with changes to Bank of England base rate. More recent changes, after the Bank of England base rate from late 2021 onwards, post-date this complaint and so fall outside its scope.

MAS5 is a closed book lender – it is a vehicle for holding loans originated elsewhere and later bought up by the then Britannia Building Society group. Following the merger of Britannia and The Co-operative Bank plc, MAS5 continued as a subsidiary firm within the wider Co-operative Bank group. Though part of the Britannia and then Co-op groups, it was at the time of the transfer and remains to this day a separate firm and regulated entity in its own right.

MAS5 manages its existing portfolio of loans but has never been an active lender seeking customers in its own right on the open market. And while it allows customers to make changes to existing mortgages, these do not include changing the interest rate – MAS5 has no fixed or other preferential rates available to any customers. All customers whose initial rates expire will then remain on their contractual reversion rate (in the case of Mrs A, the SVR) unless and until they pay their mortgage off or re-mortgage away to a different lender. Mrs A did not do this, and remains with MAS5.

<u>The mortgage terms and conditions</u>

Although now owned by MAS5, the mortgage continued to be governed by the GMAC terms and conditions.

The mortgage offer says the interest rate will be

> A fixed rate of 5.64% until 31 December 2008
>
> From the 01 January 2009 the rate that will apply is GMAC-RFC Ltd standard variable rate, currently 6.74%, for the remaining term of the mortgage.

It also says that the mortgage is subject to the terms of the offer, and to the conditions set out in the terms and condition booklet.

Condition 3.1 of the terms and conditions says:

> 3.1 If the *interest rate* is the *standard variable rate* we may vary it for any of the following reasons:
>
> (a) to reflect a change which has occurred, or which we reasonably expect to occur, in the *Bank of England base rate* or *interest rates* generally;
>
> (b) to reflect a change which has occurred, or which we reasonably expect to occur, in the cost of the funds we use in our mortgage lending business;

(c) to reflect a change which has occurred, or which we reasonably expect to occur, in the interest rates charged by other mortgage lenders;

(d) to reflect a change in the law or a decision by a court; or

(e) to reflect a decision or recommendation by an ombudsman, regulator or similar body.

There are other related terms, dealing with matters such as notice of changes and the time they come into force, which are not relevant to this complaint.

Certain words have specified meanings in the terms and conditions:

- "*we*", "*us*" and "*our*" refers to GMAC-RFC Limited and anyone who at any time in the future is entitled to exercise our rights under the *mortgage* including:

    (a) any *transferee*;

    (b) anyone who is entitled to exercise our rights because of an amalgamation or take over; and

    (c) anyone who is entitled to exercise our rights because of a reorganization of our group.

- *Interest rate* means "the rate or rates of interest shown in the offer which we charge on the *amount owed*. The rate or rates of interest may change under the conditions of section 3

- *Standard variable rate* means "our standard variable rate of interest which can be changed by us at any time before and after completion under condition 3 of section 3. If we enter into a *transfer*, the standard variable rate will be set by or on behalf of the *transferee*. The *transferee* can set the *standard variable rate* independently of any rate set by GMAC-RFC Limited or any other *transferee*."

- *Transfer* "includes a mortgage agreement to sell, legal or equitable assignment, transfer, charge, or other disposition of our rights under the mortgage.

- *Transferee* means "anyone who is entitled to exercise any of our rights under the mortgage as a result of a transfer by us."

In this case, there was a transfer to MAS5, which therefore became the transferee and gained the power to set the standard variable rate, subject to the terms of condition 3.1.

There are other related terms, dealing with matters such as notice of changes and the time they come into force which are not relevant to this complaint.

<u>*Mrs A's complaint*</u>

Mrs A makes this complaint with the assistance of a representative. On her behalf, he has said that the level of interest Mrs A has been charged is unfair, particularly following the increases in the SVR up to 2012. He said that we should investigate:

- Whether the interest variation term is a fair term and whether MAS5 have applied it in a fair way.

- What specific reasons MAS5 gave for each increase.

- What MAS5's funding costs are and whether they have increased over time.

- Why the MAS5 SVR charged to Mrs A was higher than the SVR The Co-operative Bank plc (MAS5's parent company) charges to its customers – 6% for MAS5 compared to 4.99% for The Co-op at the time Mrs A first complained, for example. (I understand this to be an alternative complaint – in the event that the individual increases to the MAS5 SVR were not unfair of themselves, there should be a cumulative cap such that the MAS5 SVR should not in any case be higher than The Co-operative Bank plc SVR).

- Whether MAS5 is taking advantage of Mrs A as a trapped borrower.

- Why The Co-operative Bank plc does not allow Mrs A to access its fixed interest rate products – taking into account the mortgage industry voluntary agreement entered into in 2018.

He also said that MAS5 was unfairly taking action to repossess Mrs A's property and had refused to consider reasonable proposals such as a term extension.

MAS5's response

MAS5 provided detailed evidence and argument in support of its position. In summary, it said:

- As the Financial Ombudsman Service has considered the increases in SVR before in other cases which were not upheld, we should either dismiss this complaint on the basis that it has already been considered, or to ensure consistency should not uphold this complaint either.

- The term allowing MAS5 to vary the SVR is a fair term within the meaning of the Unfair Terms in Consumer Contracts Regulations 1999 ("UTCCR") because:

    - Terms like this are standard in mortgage contracts across the industry.

    - The FCA in its guidance[1] recognises the legitimacy of such terms. In particular, the guidance says

        - Unilateral variation terms are common, especially in long term contracts. They have the benefit of allowing the contract to be changed over time and allow firms to vary interest rates to reflect changes in circumstances.

        - A term allowing changes based on costs of funding is likely to be valid, since such costs are outside the firm's control but likely to impact the costs of providing the product and the term allows firms to manage

[1] *Fairness of variation terms in financial services consumer contracts under the Consumer Rights Act 2015*, FG18/7, Financial Conduct Authority, 2018, available at https://www.fca.org.uk/publication/finalised-guidance/fg18-07.pdf

risk. Therefore a fairly drafted variation term is likely to be appropriate.

    - The Financial Ombudsman Service has previously found the term MAS5 relied on in this case to be a fair term.

- MAS5 relied on condition 3.1 (b) – to reflect a change in cost of funds – to increase the SVR in 2009, 2011 and 2012.

- When MAS5 took over its mortgages from GMAC in 2007, there was a restrictive covenant in place limiting the SVR MAS5 could charge to 2% above base rate. This was not a feature of individual mortgage contracts (and so not in Mrs A's terms and conditions) but was an agreement in place between MAS5 and GMAC.

- As a result, when base rate fell to 0.5% between 2007 and early 2009, the MAS5 SVR also fell to keep within the 2% cap.

- In 2009, the restrictive covenant came to an end. By that point, changes in the mortgage funding markets meant that the costs of running a mortgage business had not fallen in the same way and so the SVR no longer related to the costs of funding MAS5's business.

- At the same time, again because of the cap, the MAS5 SVR had fallen to a much lower level compared to Britannia and the rest of the group, and compared to the wider mortgage market.

- Following the end of the restrictive covenant, therefore, a decision was taken to increase the SVR. To assist customers by not making the increase in one go, it was spread over two raises in July and October 2009.

- This was necessary and justified as the increase reflected the increased cost of funds MAS5 had been exposed to since the start of the financial crisis relative to the level of its SVR before the increase.

- It is not correct to say that MAS5 is not engaged in a "mortgage lending business". It might not be lending to new customers. But that is only one part of running a mortgage lending business; "lending" encompasses the life of a mortgage from when the money is first paid out to when it is fully repaid at the end of the term. MAS5 managed its existing mortgage portfolio including dealing with customers.

- MAS5's mortgage lending was funded through a number of methods, standard to the mortgage industry. Those funding streams are shorter term than the mortgages they fund, and have to be renewed before the customer debts they finance are repaid. For both those reasons – managing its existing portfolio and customers, and refinancing its funding streams while mortgage debts remain outstanding – MAS5 is engaged in a "mortgage lending business" even though it does not offer new loans to new customers.

- MAS5 mortgages are not managed separately, or financed separately, from other loans held by Britannia and then the Co-op group. The mortgage lending business, and the funding of it, are managed at a group level rather than individually within subsidiary firms (such as MAS5). Where the cost of funds increases at group level, that means the cost of funds of the MAS5 part of the business also increases and that justifies the increases to the SVR proportionate to those increases in costs of funds. It is not possible to separate out MAS5's cost of funds since the group did not manage its business in that way. It is therefore necessary, and reasonable, to consider costs at group level to determine whether variations to the SVR were justified.

- MAS5 recently commissioned a report from a third party analysing funding costs over the period in question. It says this shows that in 2009:
  - The restrictive covenant meant that the MAS5 SVR was set at too low a level compared to cost of funds.
  - At the same time, the impact of the global financial crisis was further impacting cost of funds. Cost of funds was not linked to, and increasingly divorced from, base rate.
  - Competitor lenders with similar borrower profiles had increased their SVRs, or reduced them more slowly ending at a higher level than MAS5. This shows that cost of funds was impacting the industry more generally and that MAS was an outlier while the restrictive covenant was in place.
  - Once the restrictive covenant was removed, MAS5 was able to increase its SVR to a level that better reflected cost of funds at that time, and that was more in line with the SVR charged on similar loan books within the group.
  - The SVR was therefore increased to reflect changes in costs of funds which had already occurred, and which it was reasonably expected would continue.
  - But to balance that with the interests of customers and the obligations of fairness, the increase would only take the SVR to parity with the SVR of other bought in loans, just above the Britannia SVR, and would be implemented in two stages. The second stage increase was reviewed again before it was implemented and was still justified.
- And MAS5 says the analysis shows that, in 2011:
  - After the 2009 SVR increases, the cost of funds had continued to increase over 2010 and 2011. Costs were higher in comparison with base rate and LIBOR than previously.
  - Again, cost of funds was considered at group level rather than firm level.
  - The impact of increasing cost of funds was such that a further increase in SVR was needed to maintain the group's margin and prudential position.
  - A decision was taken to apply a greater increase to the SVR of acquired "sub-prime" mortgage books (such as MAS5) than to "prime" mortgages originated by Britannia / The Co-op, to reflect the greater cost of re-financing these mortgages associated with their higher credit risk, and to reflect the costs associated with increased defaults on these loans since the financial crisis.
  - A decision was therefore made to apply an increase to the SVR of those parts of the group, including MAS5, which had those characteristics.
- In 2012, MAS5 says, the analysis shows:
  - Cost of funds was again assessed at group level as the group did not fund its

mortgages at firm level.

- The cost of refinancing expiring funding streams had significantly increased, and some options for refinancing were no longer available.
- Increased costs overall meant increased costs for that part of the business within MAS5.
- The increase to the SVR was justified by and proportionate to those increased costs.

Summary of my provisional decision

In summary I said:

1. Because of the time limits which apply to complaints made to the Financial Ombudsman Service, my jurisdiction to consider this complaint is limited.

2. In particular, I can only consider the fairness of the SVR Mrs A paid from 31 October 2012 onwards. But in doing so, it is appropriate to take into account all the circumstances of the complaint – which includes decisions MAS5 took before 31 October 2012 to the extent that they may have contributed to the SVR charged from 31 October 2012 onwards.

3. I can consider whether MAS5 has acted fairly in the action it has taken following the end of the mortgage term.

4. MAS5 has invited me to decline to consider this complaint, on the basis that the Financial Ombudsman Service has considered similar complaints in the past. But I don't think that's appropriate, since Mrs A has not herself complained to us about this before. So we have not previously considered her complaint.

5. I was minded to uphold part of the complaint and to require MAS5 to pay Mrs A compensation. In summary, having considered the evidence and arguments submitted so far, I was minded to conclude that:

    - MAS5 was not required to offer Mrs A a new fixed interest rate on her mortgage, and so it did not act unfairly when it did not do so. MAS5 did not offer fixed interest rate products and all its customers paid the SVR after their initial fixed rate periods came to an end. It is not relevant that other lenders, including other lenders in the same group of companies as MAS5, may offer new fixed rates to existing customers. It is therefore fair that Mrs A remained on the SVR from December 2008.

    - The increases MAS5 made to the SVR in 2009, 2011 and 2012 were not made for reasons permitted by the mortgage terms and conditions.

    - But it was fair and reasonable for MAS5 to charge an SVR from 31 October 2012 that reflected the 2009 variations. This is because the effect of the increases in 2009 was to return the SVR to normal parameters following a period in which it had been set at an artificially low level as a consequence of an agreement between MAS5 and the original owner of the mortgage.

- It was, however, not fair and reasonable for MAS5 to charge an SVR from 31 October 2012 that reflected the 2011 and 2012 variations. This is because I am not persuaded on the evidence currently available to me that MAS5 has shown that its cost of funds increased so as to permit these variations under the terms and conditions.

- MAS5 has acted fairly in offering Mrs A forbearance following the end of her interest only term. It is reasonably entitled to expect her to repay the outstanding capital balance and I do not require MAS5 to offer her a further extension of the mortgage term. I'm satisfied on the evidence available to me that Mrs A has options for repaying the balance. If the only means of doing so is to sell this property (as was the plan when the mortgage was taken out), Mrs A's ownership of a substantial portfolio of other properties means the impact on her and her husband of doing so does not outweigh MAS5's entitlement to repayment, and it would not be in her best interests to delay matters further.

6. To put things right, I said MAS5 should rework and reduce Mrs A's mortgage balance so that it is as if MAS5 had charged interest at a rate 1.25% lower than it actually did from 31 October 2012 onwards, leaving the payments Mrs A made unchanged. It should ensure that it reduces future interest charged until the mortgage is repaid by 1.25% (subject to its contractual right to vary the SVR in the future). And it should pay Mrs A £250 compensation for the distress and inconvenience she suffered.

The responses to my provisional decision

Both parties responded to my provisional decision, and neither accepted my provisional conclusions. I have summarised their responses below for reasons of space, but in reaching my decision I have carefully considered everything that has been said in full.

MAS5 said:

- My findings on the 2009, 2011 and 2012 variations meant that I was assessing out of time complaints, in a way not permitted by our rules, by the jurisdiction decision in this case or by the recent High Court judgment.

- In any case, given I had previously decided the underlying issue in another complaint in 2014, it was not appropriate to revisit the issues now.

- I had interpreted clause 3.1 (b) of the terms and conditions too narrowly, and that changes to funding costs for the wider group which impact the cost of funds MAS5 uses in its mortgage lending business can justify varying the SVR.

- I had placed too much reliance on MAS5's accounts, which cannot be used to assess changes in its costs of funds. And in doing so, I had not given MAS5 the opportunity to comment on or explain the content of the accounts prior to reaching my findings.

- I had not taken sufficient account of other evidence, and had given insufficient weight to the lack of availability of evidence because of passage of time.

- The MAS5 mortgage book presents a higher credit risk compared to the wider market, and it would have been – and is – fair and reasonable for MAS5 to take this into account too in setting the SVR.

- Even if I were to uphold the complaint, my proposed remedy is not fair and reasonable. It has the effect of reducing the SVR to the level of the average SVR in the market – but MAS5's book is a higher risk book and is priced to reflect that risk.

- It's also relevant to note that MAS5 has not passed on the recent Bank of England base rate rises, since December 2021, in full. As a result, the difference between the SVR and base rate has reduced to 3.88% over that period.

Mrs A said:

- MAS5 had been shown to be in breach of contract, and had lied to Mrs A about the reasons for increasing the SVR.

- As a result, Mrs A should be refunded all overpaid interest, including the impact of the 2009 variations as well as the 2010 and 2011 ones.

- It was not fair to remove the restrictive covenant – so MAS5 should be required to treat Mrs A as if she had been charged no more than 2% above base rate throughout. The covenant did not come to an end in 2009; it was removed by MAS5.

- It is not fair to limit the redress period to six years before Mrs A's complaint. MAS5's conduct in breaching the contract and then concealing that it had done so amounts to exceptional circumstances which allow us to put the time limits aside.

- It is wrong to say that it is fair for MAS5 to increase the SVR because other lenders charge more, or to match the SVRs of other lenders in the market, or to say that Mrs A benefitted from a windfall. The covenant may have been inconvenient for MAS5, but it was designed to protect customers and should not be ignored.

- There cannot be a "good objective reason" for increasing the SVR if doing so is not permitted by the terms and conditions. It is not fair and reasonable to allow MAS5 to make up a reason not in the contract to justify its actions.

- The evidence referred to in my provisional decision shows MAS5's costs declining, not increasing – so it was actually MAS5 which received a windfall. This is not a justification for increasing the SVR in 2009.

- There is no evidence to show that the MAS5 book was high risk or sub-prime. Therefore this is not a relevant factor.

- Most mortgage customers don't pay the SVR for any length of time – they switch to new fixed rates. By not allowing this, MAS5 trapped its customers on the SVR to maximise its profits.

- I had underestimated the impact of MAS5's actions on Mr and Mrs A and the distress they have suffered. Appropriate compensation would be in the region of £5,000 not £250.

- Had MAS5 charged a fair rate of interest, Mrs A would have been able to pay off much of the capital or remortgage. As a result, it was not fair to take repossession action in 2019 and the costs of that should be refunded to Mrs A.

- MAS5 did not treat repossession as a last resort, it did so before considering Mrs A's other proposals for repayment and without offering her other options.

- MAS5 has given Mrs A an “open-ended informal extension” and should allow her time to make arrangements to repay the mortgage before considering any future action – giving at least 18 months after the conclusion of the complaint.

- In particular, the stress involved in any house move, however carefully planned, would seriously risk Mr A’s health and mean he was no longer living close to Mrs A who is acting as his carer.

Is it appropriate for me to consider this complaint?

Time limits

Another ombudsman has already decided that everything from 31 October 2012 is in time. That is the basis on which I approached my provisional decision.

As the ombudsman who decided our jurisdiction said, and as I reiterated in my provisional decision, in considering the fairness of interest charged from 31 October 2012, it is necessary to consider all the circumstances of the case. This includes the history of the SVR up to that point – since past variations, while they are out of time as matters to be complained about in their own right, are relevant context for what came later. MAS5 did not set the SVR from scratch on 31 October 2012, it continued to charge the SVR as it was prior to that date. And the reason it was at that level was, in part, because of the cumulative effect of the previous variations. It follows that if, for some reason, MAS5 was not entitled to have made one or more of those previous variations, the SVR *may* have been lower on 31 October 2012 and subsequently than it in fact was. And that is a relevant consideration in thinking about whether it *may* not be fair and reasonable to charge interest which depends, in part, on that previous variation.

I remain satisfied, therefore, that it is appropriate for me to consider the previous variations – including the increases between 2009 and 2012 – as part of all the circumstances of whether interest was fairly and reasonably charged from 31 October 2012.

I don’t agree with MAS5 that this approach – either in general, or in the specific way I went about it in my provisional decision – is incompatible with the High Court’s decision. The judge found that it was right to say that those earlier variations were out of time insofar as they were complaints in their own right. But that nevertheless,

> “the definition of a complaint is not so strictly confined to events… The ombudsman accepts that no complaint can be made about changes made before 31 October 2012. It is in my judgment wrong to say that it is *Wednesbury* unreasonable, or otherwise unlawful, for her to consider, when deciding ‘what is, in [her] opinion… fair and reasonable in all the circumstances of the case’ that the prevailing rate itself should be examined, from the outset, and also that the prior history should be investigated to see what impact, if any, it had on the rates applied on and after 31 October 2012.”

MAS5 quotes the High Court Judge saying

> “The relevance of the rate prevailing and charged on and after 31 October 2012 is obvious. It is a little harder to see what assistance the ombudsman will gain from looking at the rate setting as far back as 2008”.

But it does not quote the rest of that paragraph:

> "The relevance of the rate prevailing and charged on and after 31 October 2012 is obvious. It is a little harder to see what assistance the ombudsman will gain from looking at the rate setting as far back as 2008, but what she makes of that remains to be seen. For example, she might find it instructive to learn what the pattern of rate setting is, how closely it aligns to the cost of funds, or other prevailing rates, or how quickly it adjusts to changes in circumstances, and she might find a longer history useful in that respect. I do not suggest that she will, or should; nor do I limit her room for manoeuvre. All I have to decide is whether the course she proposes in her final decision, including those passages affirmed and repeated from her provisional decision, as explained in her witness statement, demonstrate an irrational, unlawful or otherwise judicially reviewable error. I have concluded that they do not."

I'm therefore satisfied that the approach I took in my provisional decision is consistent with the decision of the High Court. In order to consider the fairness of interest charged since 31 October 2012, it was necessary – among other things – to consider the impact of variations prior to that date including "how closely it aligns to cost of funds", and including examining the "prior history to see what impact, if any, it had on the rates applied after" that date. The Judge was satisfied that such an approach would not obviously be unlawful in principle, and is a legitimate matter for the ombudsman's discretion in considering what is fair and reasonable in all the circumstances.

In addition, given that I am required to take into account relevant law, I am satisfied that it is necessary for me to consider certain matters that pre-date 31 October 2012 – such as

(i) the fact that the parties entered into a contract

(ii) the terms of that contract

(iii) legal issues around the fairness of those terms

(iv) the extent to which variations to the prevailing interest rate were for reasons allowed by those terms.

As I explain further below, (iii) and (iv) are in my view particularly relevant to whether as a matter of law the interest MAS5 charged Mrs A from 31 October 2012 was effective as opposed to a demand for payment with no legal basis.

Ultimately, however, what I have to decide is whether it was fair and reasonable in all the circumstances for MAS5 to charge Mrs A the interest that it charged during the period that was in time. The lawfulness or otherwise of earlier variations to the SVR which contributed to the SVR being set at the level it was during the period I can consider are, in my view, potentially relevant to what is fair and reasonable in all the circumstances. But they are not the only factor, and the passage of time between any variation and the period of time I can consider is also relevant to the weight to be attached to that as one of the factors influencing the fairness of the rate charged during the period I can consider.

Nor do I agree with Mrs A that I should set aside the time limits. The arguments made now are substantially the same as those made before the jurisdiction decision, and were dealt with in that decision – and implicitly approved, at least to some extent, by the High Court. So I don't intend to deal with them at length here.

For the reasons that have already been set out, I'm satisfied that the three year rule does not give Mrs A more time to complain than the six year rule. While she may not have known of all the arguments that she could have made, or of all the evidence considered in my provisional decision, she knew what interest rate she was paying, she knew that she considered it unfairly high, and she knew that MAS5 was responsible for that. That was enough to give her knowledge of cause for complaint.

And I don't agree that if – as I found in my provisional decision – the complaint should be upheld, that would amount to exceptional circumstances which would allow me to set aside the time limits. I did not find that there was evidence of bad faith, or dishonesty, on MAS5's part. And in any case the time limit rules require there to be exceptional circumstances which explain why Mrs A did not bring her complaint to us in time – they give the example of being incapacitated for medical reasons. I don't think the mere fact that MAS5 did not agree with the complaint (whether or not it was justified in doing so) amounts to 'exceptional circumstances' which prevented Mrs A from referring her complaint to us before she did.

Dismissal

I said in my provisional decision that I didn't consider it an appropriate exercise of my discretion under DISP 3.3.4 R to dismiss the complaint on the basis that considering its merits would seriously impair the effective operation of the Financial Ombudsman Service, because the subject matter of the complaint has previously been considered or excluded under the Financial Ombudsman Service.

I said that because I did not think that the subject matter of this complaint *had* previously been considered. While we had considered similar complaints from different complainants – upholding some and rejecting others – the identity of the complainant is inherent in a complaint. We have not previously considered a complaint on this issue from *this complainant*, and it would not be appropriate to deprive *this complainant* of the opportunity to complain merely because other unrelated complainants have already done so.

MAS5 said that interpreting the rule in this way fettered my discretion in a way that is contrary to the intention of the rule. MAS5 says that it is established Financial Ombudsman Service practice to deal with complaints in this way. It says that, for example, where a claims management company brings high volumes of identical complaints on behalf of different customers, it is our practice to select a lead case and then dismiss the remaining complaints.

But I don't agree with MAS5 about this. It misunderstands our rules and processes. Where we have a high volume of similar complaints – often, but not always, brought by the same representative – it is indeed sometimes our practice to select a lead or representative case. We then investigate the issues on that individual case and let the parties know our conclusions.

But it is not true to say that, having done so, we proceed to dismiss the remainder. Rather – in situations where the complaints are identical and there are no individual variations of underlying facts that would impact the outcome – we invite the parties to learn from the approach we have applied to the lead case and the conclusions we reached. If the lead case is upheld, it may be that the firm then agrees to make settlement offers on the remainder in line with the lead case. And if the lead case is not upheld, it may be that the representative agrees to withdraw the remainder. In both cases, the respondent or complainants' representative comes to a pragmatic conclusion having learned from the approach we set out in the lead case[2], avoiding the need for individual investigation. But should either party not be willing to resolve matters on this pragmatic basis, we would not dismiss the other complaints, but would go on to resolve them individually.

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[2] As, indeed, they are required to do applying DISP 1.3 (in the case of firms) and CMCOB 2.1.7 R and 2.1.8 G (3) (in the case of regulated claims management representatives)

MAS5 also says that it is unfair to deal with this complaint now having not upheld other complaints in the past, including the 2014 decision I referred to in my provisional decision. It said we must have been satisfied by the evidence at the time; to the extent that we are not satisfied now, that must be because the evidence has deteriorated in the meantime, and so it is unfair for the issue to be revisited now.

As I've explained, even if I were minded to dismiss this complaint for that reason (which I am not) I don't think I have the power to do so under our rules, since *this complainant* had not previously brought *this complaint*. Rather, matters such as the passage of time and the availability of evidence go to my decision making on the merits – they are questions relevant to the weight I give the evidence and the outcome I reach, not to my ability to consider the complaint at all.

As I said in my provisional decision, part of reaching a fair and reasonable – and rational – outcome is an expectation that like cases be treated alike. But that does not mean that past cases make a binding precedent. My primary obligation is to decide this complaint based on what I consider to be fair and reasonable in all the circumstances of this complaint. Both parties have referred me to past cases supportive of their opposing positions, so it is not possible to reach the same outcome in this case as in all past cases. And where my conclusions in this case differ from conclusions reached in the past, what is important is that my conclusions in this case are reached on a sound and rational basis in all the circumstances.

I've revisited again the 2014 decision MAS5 referred me to. As I explained, I have no recollection of reviewing the complaint at the time and the case file does not survive.

It appears from that earlier decision that the case advanced by the complainant was different to the case advanced in this complaint. The 2014 complainant appears to have argued that MAS5 was contractually obliged to tie its SVR to base rate. I found that there was no such obligation and noted that MAS5 had given a credible explanation of why its SVR had increased absent changes to base rate – but (unlike in this case, where the actual justification MAS5 gave is central to the complainant's argument) did not consider it necessary to analyse that alternative explanation in detail since it was not central to the complaint that had been made.

There is no suggestion in the body of the earlier decision that – for example – I considered MAS5's accounts at that time. So it may be (though I don't know this for sure) that I took the explanation of cost of funding MAS5 provided at face value. Unlike in this complaint, it does not appear that I went on to consider whether and the extent to which MAS5 itself experienced an increase in its costs of funds. In my provisional decision in this case, I found that MAS5's accounts suggested it did not.

As I explained in my provisional decision, one case does not act as a binding precedent for another. The imperative is to decide what is fair and reasonable in all the circumstances of the individual case, taking into account the evidence available in the individual case. In doing so, I'm satisfied I've given appropriate weight to the existence of past cases involving other complainants where different conclusions were reached – in both directions – but that ultimately I am deciding this case on the basis of the evidence before me.

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.

There are three separate issues to resolve in this complaint – whether Mrs A should have been on the SVR at all, or whether MAS5 should have offered her a new interest rate; if she was fairly on the SVR, whether the interest MAS5 charged her was fair during the period I can consider; and whether the action MAS5 taken since the end of the mortgage term has been fair. The first two issues – the interest charged – are subject to the time limits I've set out above. In other words, I can only consider the fairness of the interest charged to Mrs A since 31 October 2012.

<u>The complaint about access to a new interest rate product</u>

I'll deal with this part of the complaint first, since if I find that Mrs A should not have been on the SVR at all, but should have been offered a new preferential interest rate product, the second complaint about the level of the SVR falls away.

When she took the mortgage out with GMAC, Mrs A took an initial fixed interest rate.

The mortgage offer says:

> A fixed rate of 5.64% [is applicable] until 31 December 2008
>
> From the 01 January 2009 the rate that will apply is GMAC-RFC Ltd standard variable rate, currently 6.74%, for the remaining term of the mortgage.

By 1 January 2009, the mortgage had been transferred from GMAC to MAS5. Such a transfer is permitted under the terms and conditions and therefore MAS5 was now legitimately Mrs A's lender. And the terms and conditions allow for the GMAC SVR to be substituted for the SVR of the transferee in those circumstances. I'm satisfied that MAS5 is properly Mrs A's lender and is entitled – acting fairly and in line with the terms and conditions – to set the SVR on her mortgage.

Therefore from January 2009 Mrs A's mortgage reverted to the MAS5 SVR. This is what the mortgage offer said would happen. There is no breach of contract in reverting to the SVR. And neither the mortgage offer nor the terms and conditions say that GMAC, or a later transferee, was required to offer Mrs A a new fixed rate once she was on the SVR. Nor was GMAC or MAS5 required to make rates available for her to apply for.

Mrs A's mortgage has therefore operated throughout in this respect in line with the terms and conditions and the terms of the mortgage offer – it consisted of an initial fixed rate, followed by the SVR for the remainder of the term. (Whether it operated in line with the terms and conditions in respect of changes to the SVR during the period Mrs A was subject to it is a separate question I deal with below.)

There is not and never has been any other obligation for a lender to offer its borrowers new or preferential interest rates to replace a reversion rate. Just as there was no contractual term, there is no law, or rule of regulation, that compels this.

Where a lender chooses to make preferential rates available to some customers, there are obligations which apply to how it considers applications from its customers for such a rate and to the fair treatment of customers who may be eligible or ineligible for any rate their lender offers.

However, where a lender chooses not to make preferential rates available to any customer, there is nothing to say that it must do so. And I'm satisfied that – legal and regulatory obligations aside – lenders aren't required to do so as a matter of general fairness.

MAS5 is a firm in its own right – though it was part of the wider Britannia and then Co-op groups, it is a separate entity to other firms in the group. MAS5's business model is the acquisition of loans originally lent by other lenders and the management of those loans through to redemption. It is not in the business of originating new loans in its own right and therefore does not offer preferential rates to attract new customers or retain existing ones. In my opinion in adopting this business model MAS5 did not act unfairly or unreasonably.

In those circumstances, I don't think it was unfair that MAS5 did not offer new preferential interest rates to Mrs A after she reverted to the SVR. It did not have such rates available; it was not obliged to make them available. And this did not result in Mrs A being treated less favourably than any other MAS5 customer also on a reversion rate.

Mrs A has also pointed to the availability of preferential rates from other firms in the wider Co-op group, not least The Co-operative Bank plc itself. But I don't think that is a consideration of weight in this case. MAS5 says that, as The Co-operative Bank plc is a different firm, with a different business model, if Mrs A wanted to move her mortgage to The Co-operative Bank plc she would need to apply as a new customer for a The Co-operative Bank plc mortgage. While The Co-operative Bank plc has chosen to offer new preferential rates to its own existing customers, I don't think it follows that other separate firms in the group are also obliged to do so or are acting unfairly if they do not. As I discuss in more detail elsewhere in this decision, as distinct legal entities, the separation between MAS5 and other companies in the group is an important feature of this complaint.

And if Mrs A's complaint is that The Co-operative Bank plc did not offer her a rate – rather than a complaint that MAS5 ought to have offered her a rate because The Co-operative Bank plc offered rates to its customers – then that is a complaint that would need to be made to The Co-operative Bank plc as a separate regulated entity and a firm in its own right. I cannot make any findings about The Co-operative Bank plc in a complaint against MAS5.

For those reasons, I'm satisfied that, in not offering Mrs A a new preferential interest rate MAS5 was not acting unfairly or unreasonably in all the circumstances. And I don't uphold this part of the complaint.

That means I need to go on to consider the fairness of the SVR that Mrs A was charged from 31 October 2012 onwards.

The complaint about the level of the SVR

In determining this part of Mrs A's complaint, I remind myself again that I am only considering the fairness and reasonableness of the interest Mrs A was charged from 31 October 2012 onwards.

In considering the fairness and reasonableness of interest charged since 31 October 2012, I am required to take into account, in determining what is fair and reasonable in all the circumstances:

- 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.

As I have set out above, consideration of all the circumstances of the complaint includes consideration of matters that happened before 31 October 2012 to the extent that they are relevant to the fairness of the interest rate charged after 31 October 2012, even though a complaint about such matters would itself be out of time – to see what impact, if any, they had on the rates applied on and after 31 October 2012 and whether that in turn had any effect on whether the rate charged after 31 October 2012 was fair and reasonable in all the circumstances.

But my consideration of the fairness of the interest rate charged on and after 31 October 2012 is not limited to those matters which led up to, and may have impacted, the level of the rate on 31 October 2012. I also need to consider any subsequent actions by MAS5 to vary the interest rate, as well as the wider circumstances in which MAS5 operated and the broader context of the mortgage lending environment at the time.

In considering whether the interest rate charged from 31 October 2012 was fair and reasonable in all the circumstances, therefore, I will need to take into account:

- Whether MAS5 acted within the terms of the mortgage contract in varying the SVR such that it reached the level it did on 31 October 2012.

- Whether there are any other reasons that would justify the SVR being at the level it was on 31 October 2012 and thereafter – bearing in mind that while I take into account the law, I must ultimately consider what is fair and reasonable in all the circumstances.

- The lawfulness and fairness of any actions MAS5 took after 31 October 2012 in changing the level of the SVR – or not changing the level of the SVR.

This necessarily means taking into account the decisions by MAS5 to vary the SVR in 2009, 2011 and 2012. In considering those matters, I must bear in mind that they are not the subject of a complaint in their own right – such a complaint would be out of time – and that those decisions were taken some years ago, potentially impacting the quality of the evidence now available.

And even if I find that MAS5 increased the SVR for a reason not permitted by the contract in increasing the SVR in 2009 2011 and / or 2012, it would not *automatically* follow that the rate charged from 31 October 2012 was not fair and reasonable in all the circumstances. The validity of those variations is one of the circumstances to be taken into account in the broader assessment of what is fair and reasonable in all the circumstances for the rate charged from October 2012. It's also necessary to consider wider factors, including matters such as the passage of time (the longer the gap between any unjustified variation and the period I can consider, the less directly causative effect it may have, for example); and the wider commercial reality of MAS5's position within both the wider group and the mortgage market as a whole.

It's also necessary to think about not just those wider circumstances, but the circumstances of this case – whether Mrs A was treated fairly and reasonably in all the circumstances during the period I can consider. Her own position is a relevant consideration; both that she was unable to move the mortgage elsewhere and therefore obliged to remain with MAS5 regardless of the decisions it took, and that the term of the mortgage came to an end in 2016 but that Mrs A has not yet repaid the capital balance.

I'll start by considering whether I'm satisfied that MAS5 was permitted by the terms of the contract to increase the SVR when it did – and if not, what the effect of that is as a matter of law.

The terms and conditions

MAS5 has told us in its submissions that on each occasion it increased the SVR – in 2009, 2011 and 2012 – it did so relying on condition 3.1(b) – cost of funds. The evidence of the decisions it took at the time confirms that cost of funds was MAS5's motivation for increasing the SVR in 2011 and 2012 (at this stage I do not find that changes to cost of funds actually justified the increases; I merely note that the evidence shows that was the motivation recorded in the contemporaneous documents). For 2009 the evidence shows that the internal discussion at the time was focussed primarily on increasing the SVR from a low level to a level more in line with other firms in the group, though MAS5 says in its submissions that the primary motivation was cost of funds but that with the passage of time further evidence confirming that might not survive. I'll discuss the reasons for each of the increases below.

In my provisional decision, I found that – although it was not an active lender, in the sense that it sought out and took on new business – MAS5 was nevertheless engaged in a "mortgage lending business" in acting as the lender of the mortgages it acquired from GMAC. It is therefore entitled in principle to rely on condition 3.1(b).

Since this is not something either party took issue with in their responses to my provisional decision, I confirm that finding here but don't consider it necessary to go into further detail about that.

I then went on to consider the remainder of the relevant term. In my provisional decision, I said:

> *"[C]ondition 3.1(b) refers <u>solely</u> to increases in the costs of "our" mortgage lending business. "Our" is a defined term in the contract, and means "GMAC-RFC Limited and anyone who at any time in the future is entitled to exercise our rights under the mortgage including: (a) any transferee".*
>
> *The transferee is MAS5. So "our" mortgage lending business includes MAS5. It does not include Britannia or any of its other subsidiary firms. While I acknowledge what MAS5 says about group funding costs, and I address that for completeness's sake where I consider it appropriate, I am satisfied that I need to focus on MAS5's own funding costs; the terms and conditions don't provide for increases to cross-subsidise group funding costs. I don't consider it reasonable to suggest that customers agreed for their SVR to be varied by reference to the costs of funds of a legally distinct company. The terms don't say that."*

I then went on to consider whether the evidence – including the evidence of MAS5's corporate accounts – showed that MAS5 had been subject to increased costs, noting that MAS5 relied on condition 3.1(b) when making the increases in 2009 – 2012.

MAS5 says that this is too narrow an interpretation. It says that the term and conditions make no reference to MAS5's accounts. And it says that condition 3.1 (b) does not say that funding costs must be exclusive to MAS5. It says that "*a change … in the cost of the funds we use in our mortgage lending business*" clearly includes funds held within or sourced by the wider group but "*used*" by MAS5 – and that this is the commercial reality of MAS5's position.

MAS5 also says that it does not agree it would not be "*reasonable to suggest that customers agreed for their SVR to be varied by reference to the costs of funds of a legally distinct company.*" It said that it thought customers are more likely to "equate" their mortgage with being held by The Co-op / Britannia than by MAS5 as a separate entity in its own right. Their mortgage being transferred from GMAC to a "*holding company*" in an "*established group*", it's reasonable to expect customers would understand their mortgages were being influenced by group wide factors, rather than operating in isolation.

Condition 3.1 of the terms and conditions says:

> 3.1 If the *interest rate* is the *standard variable rate* we may vary it for any of the following reasons:
>
> (a) to reflect a change which has occurred, or which we reasonably expect to occur, in the *Bank of England base rate* or *interest rates* generally;
>
> (b) to reflect a change which has occurred, or which we reasonably expect to occur, in the cost of the funds we use in our mortgage lending business;

I've considered again what MAS5 says about this. But I don't agree. I think the clear meaning of the clause is that MAS5 can *only* make changes to the SVR to reflect changes which have occurred, or which MAS5 (in substitution for GMAC) reasonably expects will occur, in the cost of funds that MAS5 used in its mortgage lending business (again, MAS5 in succession to GMAC). What happened after the contract was entered into – post-contractual events such as the transfer to MAS5 and MAS5's wider ownership – does not affect the clause's meaning.

While MAS5 appears to suggest that customers might have expected, once their mortgage was transferred to MAS5, that their interest rate might vary based on what happened in the wider group, that isn't part of the contract or relevant to its meaning.

I remind myself that section 1 – definitions and interpretation – says:

> "we", "us" and "our" refers to GMAC-RFC Limited and anyone who at any time in the future is entitled to exercise our rights under the mortgage including: (a) any transferee

The mortgage was transferred from GMAC to MAS5 – not to Britannia, to the wider group or to any other company in the group. MAS5 became the new owner of the mortgage under the transfer agreement and is the transferee. And the words "we", "us" and "our" have a defined specific meaning – GMAC-RFC Limited and any transferee, not the wider Britannia or Co-op groups.

I think it is clear, therefore, that condition 3.1 (b) – "*to reflect a change which has occurred, or which we reasonably expect to occur, in the cost of the funds we use in our mortgage lending business*" means

> to reflect a change which has occurred, or which MAS5 reasonably expects to occur, in the costs of the funds MAS5 uses to fund MAS5's mortgage lending business.

I don't think it can reasonably be argued that the words "we" and "our" have any other meaning, and I think it's important to underline that the clause talks about funds that "**we** use".

MAS5 says the word "*uses*" includes funds held or sourced by the wider group but which are used by MAS5 for the purpose of MAS5's mortgage lending business.

I don't disagree about that. I don't think there's anything in the contract – or elsewhere – which requires MAS5 to raise or service its funding costs directly and wholly independently of the rest of the group. I accept that, for reasons including practicality and economies of scale as well as ease of regulatory compliance, it's legitimate for Britannia and then Co-op to manage its funding on a group basis. And I'm satisfied that this is what actually did happen. But that is not the end of the matter.

I agree that the word "*uses*" is sufficiently broad to cover cost of funding incurred on a group basis where MAS5 is part of the group as well as cost of funding incurred directly by MAS5.

However, in my view the change must be one to the costs of the funds MAS5 uses, so that there must be some linkage between changes to the group's funding arrangements and the costs that MAS5 itself incurs via the mechanism of condition 3.1(b) for that condition to be met. MAS5 itself ("we") needs to "use" those funds to fund its mortgage lending business, and the costs of those funds must be incurred by MAS5.

If the group experiences changes to costs of funding that part of its mortgage business which does not include MAS5 (changes solely affecting the "prime" retail mortgages held by The Co-operative Bank plc, for example), it would not in my view be permitted to use those changes to justify a change to the MAS5 SVR – because they would not be changes which have occurred in the costs of funds used in "our" (MAS5's and MAS5's alone) mortgage business.

Whereas if there were changes in the costs of funds of all the group's mortgage business, or part of the group's mortgage business which did include MAS5's mortgages, that would <u>potentially</u> be a change in the costs of funds used in "our" mortgage business. But while necessary that's not enough of itself.

In order to meet the requirements of condition 3.1(b), in my view, what's required is a change in the costs of funds used in MAS5's own mortgage business. That requires a change to cost of funds MAS5 incurs itself, otherwise there is not a sufficient nexus between the funds sourced at group level and MAS5's own mortgage lending business.

In the circumstances of the present complaint, the only way in which MAS5's costs of funds might have increased for the purposes of 3.1(b) is, broadly, if either (i) it was required to pay an increased amount to third parties (whether part of the group or otherwise) in respect of existing funds it used in its mortgage business, or (ii) it had to source new funds elsewhere (and subsequently, having done so, facing increased associated costs). The fact that other companies in the group faced increased costs is not relevant in and of itself unless MAS5 had to bear all or part of those increased costs.

If the group faces changes in costs of funds of the group's mortgage business which only impact the cost of certain parts of the group mortgage business not including MAS5 – changes which only affect the prime "retail book", for example – it wouldn't in my view be permissible under condition 3.1 (b) for MAS5 to change the interest rate. That's because such a change would not be reflective of changes in the cost of funding MAS5's mortgage business – only of changes in the cost of funding other parts of the group.

And if the group faces changes in costs of funds of the groups mortgage business which do impact the cost of the group mortgage business including MAS5 – changes which affect the sub-prime "optimum" book of which the group considers MAS5 a part – it would only in my view be permissible under condition 3.1 (b) for MAS5 to change the interest rate <u>if MAS5 itself had to bear all or part of those increased costs</u>.

If those changes were absorbed in full by other parts of the group, then changes to group funding would not translate into changes to the costs of the funds MAS5 itself incurs and "uses" to fund its own mortgage lending business. In order to "use" something, there must be a connection between the user and the thing used. In addition, I don't agree that clause 3.1(b) should be interpreted as though it reads "to reflect a change which has occurred, or which MAS5 reasonably expects to occur, in the costs of the funds related companies in the Co-Op group use to fund the mortgage lending business of which MAS5 is a part." I don't read clause 3.1(b) as envisaging that MAS5 could be some sort of passive 'middleman' whereby customers can be required to pay for the increased costs of funds of separate companies which MAS5 itself does not incur. I need to be satisfied that MAS5 in fact "used" the funds whose costs had been impacted in its mortgage lending business, and that there was a change to MAS5's own liabilities, whether to other firms in the group or to firms outside the group.

This last consideration led to the focus of my provisional decision being, in part, on the evidence of MAS5's accounts. The evidence of the accounts did not persuade me that MAS5's own costs had changed at the relevant times justifying the changes to the interest rate. MAS5 has provided further evidence about that, which I'll review below.

Ultimately I think the reality is that this is not a question of contractual interpretation; it's a question of whether, on the facts and evidence of the case, MAS5 has shown that it itself did in fact experience changes in the costs of funds it used in its mortgage lending business.

<u>*Is this a fair term?*</u>

In my provisional decision, I considered whether a court would be likely to find condition 3.1, or parts of it, to be an unfair term applying the Unfair Terms in Consumer Contracts Regulations, which is the relevant law applying to this agreement. I considered the wording of the term alongside the regulations and relevant caselaw.

Neither party has made any further substantial points about the fairness of the term. Mrs A referred to an FCA discussion paper from 2014, which said that using the right to vary the SVR to "*take advantage of the fact that many of its customers are 'trapped' borrowers and will be unable to exit the contract and refinance…may be in breach of Principle 6*." She said that MAS5 took advantage of borrowers like her who were unable to re-mortgage. I've noted what she has said about this, but in my view this doesn't go to the fairness of the term as a matter of law; rather, it's relevant to the way in which MAS5 may have exercised the term, which is a separate question.

As there are no further arguments about the fairness of the term itself, I don't intend to go into further detail about this; I merely note that my conclusion – which I see no reason to depart from – was:

"I think it's likely that a court would conclude that the variation terms were not unfair and would not fall within the Schedule 2 'grey list' I am satisfied that overall they do not create a significant imbalance between the parties contrary to the requirement of good faith, or that at the time the mortgage was taken out there were foreseeable barriers to exit were MAS5 to rely on the term, and that a consumer in a hypothetical negotiation, understanding that over the course of an agreement as long as a mortgage a lender's costs might change, would have agreed to the term. Bearing that in mind, I will proceed on the basis that the variation terms I have discussed above are not unfair as a matter of law.

I've also considered whether the concept of an SVR, or a variable reversion rate, is an inherently unfair one. But I don't think it is. It's a standard feature of the UK mortgage lending market. An SVR reversion rate allows a lender to attract new customers with a preferential initial rate, while building in the flexibility a variable rate allows to manage its longer term costs after the initial preferential interest rate period. Many borrowers treat the reversion point as an opportunity to shop around for another preferential rate – either with their existing lender or moving to another lender.

In this case, MAS5 did not offer new rates and Mrs A didn't or couldn't move elsewhere. But that doesn't affect my conclusions that maintaining her mortgage on the SVR was not inherently unfair and not a breach of contract. Their mortgage was operating as it should under the terms and conditions when she reverted to and remained on the SVR.

If I am wrong about that, I've reminded myself that legally, the effect of a term being unfair as a matter of law is that it won't apply. But that wouldn't necessarily mean that there has been unfairness. Under our rules I am required to consider what is fair and reasonable in all the circumstances. That includes – but is not limited to – relevant law.

I've also thought more broadly about whether, and the extent to which, the way in which the terms have been used has resulted in unfair treatment for Mrs A in the interest charged from 31 October 2012 onwards. That is the ultimate question I need to answer in deciding whether to uphold the complaint. But before I come to consider that question, I must first look at the historic context which may have contributed to the interest rate charged from then on. And of particular relevance as part of that context are the four variations to the SVR MAS5 made from 2009."

<u>History of the SVR</u>

The following table summarises the changes to the SVR which impacted Mrs A:

BoE base rate	Date base rate changed	Change to SVR	Date SVR changed	New SVR
2.00% (reduced from 3.00%)	4 December 2008	-1.00%	13 January 2009	3.99%
1.5%	8 January 2009	-0.5%	24 February 2009	3.49%
1.00%	5 February 2009	- 0.5%	1 March 2009	2.99%

0.5%	5 March 2009	No change	No change	2.99%
0.5%	No change	+ 0.75%	1 July 2009	3.74%
0.5%	No change	+ 0.76%	1 October 2009	4.50%
0.5%	No change	+ 0.75%	1 March 2011	5.25%
0.5%	No change	+ 0.50%	1 May 2012	5.75%
0.25%	4 August 2016	- 0.25%	1 September 2016	5.50%
0.5%	2 November 2017	+ 0.25%	1 December 2017	5.75%
0.75%	2 August 2018	+ 0.25%	1 August 2018	6.00%
0.25%	11 March 2020	- 0.5%	1 April 2020	5.5%
0.1%	19 March 2020	- 0.15%	1 May 2020	5.35%

Until 2009, the restrictive covenant was in place, and the SVR reduced in line with changes to base rate. From 2009, the restrictive covenant was no longer in place.

The four variations in the SVR which did not reflect changes in base rate, in July and October 2009 and in 2011 and 2012, were active decisions taken by MAS5 after the end of the restrictive covenant. In each case, although there was not specific reference to the particular contractual terms of MAS5 mortgages recorded in the internal discussions at the time, it now says it relied on condition 3.1(b), which permitted it to vary the SVR to reflect a change which had occurred, or which it reasonably expected to occur, in the cost of funds used in its mortgage lending business.

It is important to underline that MAS5 has no freestanding right under the contract to decide on the level of its SVR afresh each month before calculating the interest to be added to Mrs A’s mortgage.

Rather, the contract gives it the power to change the SVR from time to time *if and only if* specific circumstances arise. The SVR then remains at that revised level unless and until a further permitted variation occurs. Therefore, the SVR charged from 31 October 2012 can be considered to be “the sum of the parts” of the history that went before. If there were problems with any of those parts - for example, because the SVR was varied for a reason not set out in the terms and conditions - that might be relevant to whether Mrs A was treated unfairly from 31 October 2012 onwards.

The interest rate reductions prior to May 2009

Prior to Mrs A’s reversion to the SVR, and again in December 2008 and the early months of 2009, the SVR had reduced in line with reductions to Bank of England base rate. MAS5 says that these reductions were not reflective of reductions in its cost of funds, but were driven by the restrictive covenant by which its SVR could not exceed 2% above Bank of England base rate.

This meant that prior to 2009, the MAS5 SVR fell in line with base rate when other SVRs within the wider Britannia group had not fallen to the same extent – and neither had the GMAC SVR. I think it's likely that the existence of the restrictive covenant meant that, by June 2009, the MAS5 SVR was lower than it would otherwise have been and to that extent Mrs A benefitted from its existence. But she does not have any rights under it directly and it is not a term of her mortgage.

Nevertheless, I'm satisfied that the variations up to March 2009 were permitted by the terms of the contract, even if they were driven by the restrictive covenant – since condition 3.1(a) allows MAS5 to vary the SVR to reflect changes in the Bank of England base rate.

MAS5 did not pass on the final base rate cut, in March 2009. But under the terms and conditions it was not obliged to do so – since the terms say that it "may" (not "must") vary the SVR to reflect changes in base rate. The SVR is not a tracker rate and the terms and conditions do not oblige MAS5 to treat it as such.

MAS5 noted at the time that not passing on the final base rate cut meant that the SVR went above the cap in the restrictive covenant. But while that might have put MAS5 in breach of its obligations to GMAC under the covenant, the covenant was not part of its contract with Mrs A and I've not seen anything to suggest that she had any enforceable rights under it. MAS5 was not in breach of its contractual obligations to Mrs A.

I'm therefore satisfied that in passing on the base rate reductions prior to March 2009, and in not passing on the March 2009 base rate reduction, MAS5 acted in a way permitted by the contract.

The interest rate increases from 2009 to 2012

I considered the evidence for changes – or anticipated changes – to the cost of funds around the time of the increases from 2009 to 2012 in my provisional decision. I said:

> *"MAS5 has sought to argue that its mortgage lending business is not managed or funded independently, but rather that this is done on a whole group basis (first across Britannia and then, since 2009, across the Co-operative Bank group). Group mortgage lending and the acquisition of mortgages originating with other lenders (such as, in this case, GMAC) is funded through three main sources – capital held at group level, capital raised through retail customers (such as savings deposits) and capital raised through wholesale sources. The latter includes a mix of short term and longer-term funding streams including borrowing – though the longer-term funding streams are still substantially shorter than the term of a mortgage – and securitisation.[3] As I discuss further below, I am not satisfied that this accurately reflects how MAS5 was in fact funded. However, I have set out MAS5's position for completeness.*
>
> *Britannia and then the Co-op group had a rolling program of renewing funding streams. MAS5 says that following the global financial crisis the group faced significant challenges in raising and renewing funding. These included challenges faced across the industry, as well as specific challenges related to the market's perception of Britannia and Co-op. MAS5 argues that these resulted in an additional premium that attached to group funding, as well as difficulties in raising longer term*

[3] In simple terms, securitisation is a common arrangement whereby a lender sells the beneficial interest over a defined period in a package of loans to third party investors to raise funds. The lender generally retains legal title and acts as lender, but passes on payments received to the holder of the beneficial interest.

funding and a greater reliance on more expensive shorter-term funding. In addition to specific funding costs, Britannia also entered into financial arrangements to manage its risk exposure, at further cost.

Contemporaneous documents from MAS5's parent company refer to the impact of the reducing base rate on Britannia's business, and show that the cost of raising external funds rose during the financial crisis despite the reduction in base rate. As well as increased costs of raising funds from the markets, Britannia was also faced with reductions in the capital it held which needed to be replaced, such that there was overall pressure on its margins. By 2009, funding costs began to fall back, but did not reduce at the same level or the same rate as reductions in Bank of England base rate and LIBOR at this time.

MAS5 has also provided us with a detailed third-party analysis of funding constraints across the mortgage market at this time. Although the analysis was prepared recently rather than at the time, I've taken account of it as providing useful context on the environment Britannia was operating in at the time.

I'm aware not just from this analysis but from my knowledge of the mortgage market that this period was a time of significant change in the wider market as a result of the financial crisis. This impacted on the funding costs of businesses and was reflected in changes to a number of lenders' interest rates charged across the market at the time. Sources of market analysis since then have reflected on the increasing difference between the Bank of England base rate and costs of funding. For example, the Bank of England has said:[4]

> *"Prior to the 2007–08 financial crisis, bank funding costs largely moved in line with 'risk-free' interest rates set by central banks, such as Bank Rate in the United Kingdom — the rate paid on reserves held by commercial banks at the Bank of England. In this environment, movements in risk-free rates provided a reasonably good guide to assessing both the transmission of monetary policy and changes in the profitability of banks. All of this changed with the onset of the financial crisis, however. Some sources of funding evaporated rapidly. And measures of bank funding costs rose sharply relative to risk-free rates. There was a sharp increase in a range of funding 'spreads' — the difference between funding costs and the risk-free rate — during the period from 2007 to 2011. This range has since fallen back somewhat but remains higher than in the period prior to the crisis."'*

Whilst the base rate did reduce significantly during this period, the costs to many lenders of funding their business changed, as did their prudential requirements. These are made up of several factors that are not directly linked to base rate. There was a substantial increase in risk to most lenders during that period which led to them having to mitigate that risk in different ways.

As a result, I don't think that it's necessarily true that falls in base rate or LIBOR inevitably meant funding costs reduced too, as at a general level funding costs were increasingly divorced from base rate at this time. So I don't think it's accurate to suggest that a fall in base rate would necessarily have equated to a corresponding fall in the cost of funds.

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[4] Quarterly Bulletin, Q4 2014, Bank of England - https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/bank-funding-costs-what-are-they-what-determines-them-and-why-do-they-matter.pdf

And I don't think it's necessarily helpful to look at this issue in the abstract – condition 3.1(b) says that one the reasons MAS5 may vary the SVR is to reflect a change which has occurred, or which MAS5 reasonably expects to occur, in the cost of the funds MAS5 uses in its mortgage lending business. So I think it is essential to look at what the drivers of MAS5's <u>own</u> costs of funds were.

In considering this, I reviewed not only the evidence MAS5 has provided on this case, but also other relevant evidence in the public domain – which includes its accounts. I have reviewed MAS5's published audited accounts for the end 2007 onwards.

The accounts show MAS5's income, assets and liabilities for each accounting year. They also provide commentary on MAS5's funding and business model at the time.

The accounts show the total value of the assets held by MAS5 (the outstanding mortgages) and its expenditure and liabilities. The vast part of its expenditure is described as "interest expense and similar charges", and by far its largest liability is "deemed loans due to group undertakings". The "deemed loans" appear to relate to payments due to securitisation vehicles in respect of future interest from customers of securitised mortgages. And most of the "interest expense" is on these "deemed loans". There is also expenditure on "other payables", which is largely money owed to its holding company (at this time Britannia, later The Co-op), charged at an effective interest rate of 1 month LIBOR plus 0.21%.

Virtually all of the income MAS5 received was interest paid by mortgage customers.

MAS5's liabilities can be summarised as follows:

- *At all times: An on-demand loan from MAS5's parent company on which it paid interest of 1 month LIBOR plus 0.21%.*
- *Derivative financial instruments – swaps and hedges used to manage interest rate risk, predominantly on fixed rate loans. According to the accounts, this expenditure ceases altogether after 2008.*
- *Payments to securitisation vehicles. From 2008 onwards, this is the largest contributor to MAS5's liabilities, representing over 75% of the total, though the absolute amount payable reduces each year in line with the reduction in the size of the loan book.*

MAS5's accounting year is the same as the calendar year – its accounts are made up to 31 December each year. The following table summarises the assets and liabilities reported in its accounts for each year from 2007 onwards.

Year	*Loan book value*	*Derivatives*	*Securitisations*	*Loan from parent company*
2007	*£3,050m*	*£21m*	*£583m*	*£2,472m*
2008	*£2,768m*	*£39m*	*£2,253m*	*£500m*
2009	*£2,548m*	*£0*	*£2,110m*	*£432m*
2010	*£2,383m*	*£0*	*£1,990m*	*£366m*
2011	*£2,217m*	*£0*	*£1,847m*	*£319m*

2012	*£2,060m*	*£0*	*£1,719m*	*£300m*
2013	*£1,884m*	*£0*	*£1,507m*	*£315m*
2014	*£1,707m*	*£0*	*£1,369m*	*£219m*
2015	*£124m**	*£0*	*£0*	*£10m*

*During 2015, MAS5 re-securitised £1.5bn of loans which were removed from its balance sheet

As far as LIBOR is concerned, as 1 month LIBOR fell from November 2008 onwards, the cost of the first tranche of funding would also have fallen.

Although I note that MAS5 has argued that over the period from the start of the global financial crisis up to the decision to increase the SVR in 2009 the Britannia group (as it then was) faced significant increases in funding costs, I'm not persuaded that even if this was the case that resulted in increases in the costs specifically of MAS5's mortgage lending business.

The third-party report MAS5 has provided cites a May 2011 inflation report from the Bank of England that indicates that marginal funding costs actually decreased from late 2008 to June 2009 (and were also lower than in 2006, when the GMAC restrictive covenant took effect).

In addition, that report shows how it finds "MAS5 Average Funding Costs" to have moved over time. It isn't apparent how these costs have been derived, or whether in fact this is referring to group funding costs, as the report fails to refer to MAS5's financial statements. In any event the report shows a substantial decline in funding costs over the period which is said to have been relevant to the 2009 changes, notwithstanding that average funding costs diverged more substantially from base rate and three-month LIBOR than was the case before 2009. The report shows that market (marginal) funding costs also decreased between the start and the end of the period over which MAS5 was bound by the restrictive covenant.

While I note the arguments MAS5 makes about group funding costs, condition 3.1(b) refers solely to increases in the costs of "our" mortgage lending business. "Our" is a defined term in the contract, and means "GMAC-RFC Limited and anyone who at any time in the future is entitled to exercise our rights under the mortgage including: (a) any transferee".

The transferee is MAS5. So "our" mortgage lending business includes MAS5. It does not include Britannia or any of its other subsidiary firms. While I acknowledge what MAS5 says about group funding costs, and I address that for completeness's sake where I consider it appropriate, I am satisfied that I need to focus on MAS5's own funding costs; the terms and conditions don't provide for increases to cross-subsidise group funding costs. I don't consider it reasonable to suggest that customers agreed for their SVR to be varied by reference to the costs of funds of a legally distinct company. The terms don't say that.

It might in principle be permissible to vary the SVR to take account of changes in group funding costs insofar as the variation represents the apportioned share of cumulative group costs apportioned to MAS5. That is what I understand MAS5 now *says happened. However, I'm not persuaded that the evidence shows this was in fact the case.*

As set out above, I've not seen any evidence of an increase, or the extent of an increase, in the costs specifically of MAS5's mortgage lending business. MAS5 has explained that its mortgage portfolio and funding costs were managed and accounted for at group level, not firm level. But I'm not satisfied this adequately explains whether any variation of the SVR was for a reason permitted by the contract.

MAS5 is a limited company incorporated under the Companies Act. It has its own financial statements, which record its assets, liabilities, revenues and expenditure in detail. Its directors have signed off those statements as giving a true and fair view of the state of affairs of the Company, and those statements have been audited in accordance with the applicable law. I don't believe that MAS5 is suggesting that those statements do not present a true and fair view of its business. It would have been open to MAS5's parent company to adopt a different corporate structure where it apportioned its costs of funds differently, but it didn't.

While MAS5 has concentrated its representations on what is says were the pressures on the groups which successively owned MAS5, I'm not satisfied that those pressure were, in and of themselves, relevant to whether MAS5's own funding costs increased. I note that MAS5 and the expert report it has provided have said little if anything about MAS5's own costs of funding as set out in the accounts. I think that this means that their representations miss the central point regarding what MAS5 was permitted to do under the contract. While MAS5 has argued that it is not possible to separate out MAS5 cost of funds since the group did not manage its business in that way, I am not persuaded by this. I am satisfied that the accounts show that in fact MAS5's business was managed separately from the group, and its costs of funding were also separate. And this means that it is MAS5's own costs that are relevant so far as the terms and conditions were concerned, notwithstanding that MAS5 is a subsidiary within a wider group.

Even if what MAS5 now says about funding pressures on the wider groups is correct, that does not reflect the position in respect of the costs specific to MAS5, as MAS5 itself reported in its accounts <u>at the time</u>.

Even though MAS5 was not engaged in new lending, it could still have faced costs in managing its existing portfolio of loans. That might have included renewing underlying funding streams that operated on a shorter-term basis than the mortgages themselves. However the accounts indicate that MAS5's own costs of funding – through the loan from the parent company and the 2008 securitisations – remained stable (and in fact reduced over time). Those costs are all that MAS5 reported at the time – and therefore do not support the need for an increase in the SVR relying on increased cost of funding.

I bear in mind that these decisions were made thirteen years ago. MAS5 has said that it has provided all the evidence it has available, but with the passage of time there may be further evidence that is no longer in existence. That's a relevant consideration, and I've taken into account the difficulties of reviewing a complex decision so long after the events.

However, I think that the report MAS5 has provided and its own financial statements provide enough evidence to satisfy me that MAS5's costs of funds did not rise during this period.

The report demonstrates that MAS5's costs of funding (even if they are taken to be the same as those of the groups of companies to which MAS5 belonged) did not rise, but fell, over the period relied upon. The apparent justification for the rise in the SVR is not that the funding costs rose, but that the SVR had previously fallen further than the funding costs because of the restrictive covenant. The accounts show that MAS5 did have its own funding, that this was all in place by end 2008 and was never refinanced thereafter (until 2015) and was not on terms that had reference to wholesale funding costs of banks generally, or costs of the owning groups. In my opinion, the data and arguments about market funding costs that MAS5 have provided shed little light on the costs of funding MAS5's own mortgage lending business.

I think that better evidence of MAS5's costs comes from its own accounts, audited and filed at the time – at least in respect of the period before 2015, when it moved securitised loans out of the accounts. I've summarised what these accounts show above. It seems to me that in these annual accounts, MAS5 did separate out its own income and costs from that of the wider group – notwithstanding what it now says. The separate accounting by MAS5 for its own assets, liabilities, income and expenditure (including its costs of funding its lending business) is as would be expected and indeed required, given its separate legal identity. The accounts say that its costs were monies paid out to securitisation vehicles and loan repayments to the wider group.

As I'll note below, in relation to the 2011 and 2012 increases, re-securitisation of the loans held by MAS5 does not seem to have been possible at this time. But existing securitisations were continuing, and MAS5 was making payments to those vehicles in the form of the repayments and interest on the "deemed loans" provided at the time of securitisation.

Based on the accounts, it appears to me that these securitisations were the main driver of MAS5 funding costs, though the other part of its funding – 1 month LIBOR plus 0.21% - became significantly cheaper over the course of the global financial crisis. Even if there were significant pressures on wholesale funding at this time which affected the Britannia group as a whole, based on the evidence of the accounts it doesn't appear to me that MAS5 specifically was exposed to these pressures. And the accounts filed by MAS5 at the time bear this out – with costs associated with securitisation making up the large part of its expenditure (along with payments on the low-rate loan from the parent group).

Over time, the accounts show both that MAS5's assets declined, and so did the balance of, and interest payments to, the "deemed loan". And this is not surprising, since MAS5 was not taking on new business and some existing mortgages would be repaid each year.

What the accounts also show, however, is that the interest payments were declining not just in absolute terms, but also in proportion to the value of MAS5's assets.

MAS5's accounts were prepared on the basis that its assets, liabilities, income and expenditure were separate from that of the wider group. Even if funding costs were managed over the group as a whole those costs appear to have been specifically apportioned out across the firms in the group in the annual accounts filed by each of them. And it appears that in the specific case of MAS5, since its lending was securitised, its own exposure to wholesale funding from sources other than securitisation was negligible beyond the LIBOR-linked loan.

MAS5's own evidence makes clear that new securitisations and re-securitisations of the sorts of sub-prime lending held in the MAS5 book wasn't possible following the global financial crisis. There were no new securitisations between 2008 and 2015. So it doesn't seem likely that the costs of securitisation to MAS5 changed over this period – and this is what the accounts say."

In respect of the increase in 2011, I went on to say:

Again, MAS5 has sought to provide evidence and an explanation of the cost of funds across the group, and suggested that MAS5's costs were subsumed within them.

If that is correct, I'd expect to see evidence that wider costs of funding increased for the group as a whole at this time, and I'd expect to see evidence of how that translated into an increase of 0.75% on the MAS5 SVR specifically.

With that in mind, I've reviewed the available evidence – not just that provided by MAS5 but also that available more generally.

MAS5 has not provided me with any direct evidence of reasoning behind the decision to increase the rate in March 2011 – whether in the form of numerical evidence, or internal papers or documents.

It has provided an email exchange from December 2010 in which an individual with a Britannia email account offers a broad estimate of increased costs on a group wide basis and is then pushed into a more specific estimate by another individual, whose starting point appears to be that a 0.75% increase has been decided on and that evidence to support that is needed. That appears to me to be the wrong way round. I would have expected the group to first identify any increase in costs that had occurred/was anticipated and then decide what level of SVR increase that justified. This is limited evidence that at the time group funding costs had increased, though I don't think I can place a great deal of weight on the identification of 0.75%.

There is also an internal discussion paper about the group's "Optimum" portfolio (covering "non-conforming" businesses which included, but was not limited to, MAS5), but that dates from December 2011, nine months after the SVR increase. There is also a summary document from March 2011 relating to the Optimum portfolio, which asserts that funding costs have increased in a single bullet point, but provides no supporting evidence or discussion of how that resulted in an increase specifically of 0.75%.

MAS5 has also provided the third-party analysis I referred to above, which discusses this period.

As things stand, I am not satisfied that these documents show that MAS5 was entitled to rely on condition 3.1(b) to increase the SVR. The discussion paper points out the notional increase in securitisation costs of loans of the type included within MAS5 – but also points out that securitisation of non-conforming / sub-prime loans was not possible at that time. This is confirmed by the analysis paper, which concludes "the increase in the MAS5 SVR in March 2011 cannot be explained by increases in the costs of securitisation". But as I've said, its accounts show that MAS5's funding costs largely were securitisation costs.

The paper also refers to retail deposits – but only in terms of what it would cost to attract more deposit funding. This is not evidence that this cost was actually incurred. And the analysis paper concludes "the increase in the MAS5 SVR cannot be *explained by increases in retail funding costs". MAS5 was solely a mortgage lender and did not hold retail deposits.*

The third-party analysis does conclude that the cost of obtaining new wholesale funding at this time had increased – though only on one of the two measures it uses. But there is no linkage between this general market analysis and the specific costs MAS5 faced, other than the statement that it "could motivate an increase in the SVR" – though on the other measure "it is not consistent with an increase in funding costs".

The internal discussion paper also refers to increases in costs of wholesale funding – though noting this is a small proportion of the overall funding profile, it does say that the cost of renewing the expiring part of this small proportion is significantly higher than in the past.

And the paper concludes "In short a 50bps [0.5%] increased SVR rate could be rationalised as reflective of an increasing cost base". But this analysis seems to have been carried out in December 2011, and in fact, the SVR was increased by 0.75% in March 2011.

This is the extent of the evidence MAS5 has provided for 2011. I have no evidence of the actual decision that was made at the time other than the single bullet point in the March 2011 summary document. The third-party analysis paper does not provide direct evidence, and its analysis of the wider marker supports the view that there was not significant pressure on MAS5's funding costs at this point – in submissions to our service these costs do not appears to have been analysed separately from those of the wider group, and I note that the third-party analysis doesn't address MAS5's own audited accounts in its analysis. The internal paper from December 2011 is a retrospective justification, itself limited in evidence, and not in my view evidence that at the time it was taken the decision to increase the SVR was based on, or justified by, increases in funding costs.

I've also considered other information available to me, including that which is in the public domain. I've cited above the Bank of England report which noted the increasing difference between base rate and funding costs extending to 2011 – but this is only evidence of broad market trends, not specific funding pressures on MAS5.

In its submissions in the earlier case one of our investigators upheld, MAS5 cited a reduction in the group's net interest margin around this time. Net interest margin (in very simple terms) is an expression of the difference between income from interest on lending and expenditure on interest on deposits, and is to that extent a measure of financial health and profitability. This does tend to support the suggestion that there was pressure on retail deposits at a group level – though as I've said above this wasn't reflected in the documents from the time.

And in any case, MAS5 as an entity did not hold deposits (but did separate its costs out in its accounts) so in my view this is of limited relevance. The third-party analysis also concludes that pressure on retail deposits funds does not explain the increase in the SVR at this time.

I've also considered MAS5's annual accounts, filed at Companies House, for this period. I've set out above, in the section on 2009, what in my view those accounts show. And based on what I've said, I think it's fair to conclude that what MAS5 reported in its annual accounts each year accurately represented its own financial position – including its costs of funds. And that those costs were separate and *identifiable at the time – notwithstanding that MAS5 now says they were subsumed within group costs.*

Based on the accounts, MAS5 appears to be funded substantially by securitisation (along with a low-rate loan to its parent company). It does not appear to have been exposed to wholesale funding pressures (which in any case according to the documents it has provided were a small part of overall group costs at this time – so are unlikely to have had a significant impact on MAS5). And the documents MAS5 has provided and its recent third-party analysis show that the increase can't be explained by the cost of retail deposits either.

That leaves securitisation as the driver of MAS5's costs. The accounts filed by MAS5 at the time bear this out – with costs associated with securitisation making up the large part of its expenditure (along with payments on a low rate loan from the parent group).

Over time, the accounts show both that MAS5's assets declined, and so did the balance of, and interest payments to, the "deemed loan". And this is not surprising, since MAS5 was not taking on new business and some existing mortgages would be repaid each year.

What the accounts also show, however, is that the interest payments were declining not just in absolute terms, but also in proportion to the value of MAS5's assets.

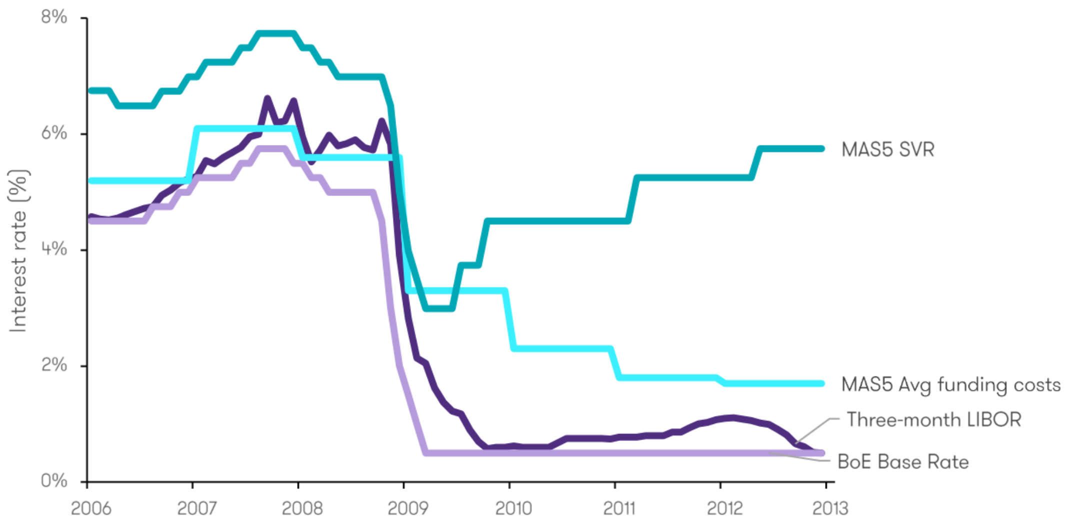
At the time it filed these accounts, MAS5 was required to do so on the basis that its assets, liabilities, income and expenditure were separate from those of the wider group. It had no option – for example – to treat the liabilities of a legally distinct entity (for example, another company within the group) as its own. Even if funding costs were managed over the group as a whole, those costs appear to have been apportioned out across the firms in the group in the annual accounts each filed. And it appears that in the specific case of MAS5, since its lending was securitised, largely in 2008, its own exposure to wholesale funding from sources other than securitisation was negligible.

MAS5's own evidence makes clear that new securitisations and re-securitisations of the sorts of sub-prime lending held in the MAS5 book wasn't possible following the global financial crisis. So I am not satisfied that the costs of securitisation to MAS5 changed over this period. The accounts make this clear, as in the notes on 'Related Party Disclosures' that itemise the securitisations under MAS5's liabilities each year, showing that (i) there were no new securitisations during the period in question, and (ii) the amount outstanding under each securitisation actually reduced year on year as a result of mortgage repayments.

On the face of the accounts therefore, the cost of funds appears to be reducing each year, in both absolute and relative terms. For example, in 2009 the interest expense was 3.5% of MAS5's overall assets, but in subsequent years that fell – 2.4% in 2010, 1.9% in 2011 and 1.8% in 2012.

In support of that, the third-party analysis MAS5 has provided says that MAS5's costs were reducing at that point. I reproduce here a graph from the paper illustrating the trend:

Figure 8: The Co-operative Bank average funding cost analysis



Note – although the graph refers to "MAS5 average funding costs", the accompanying text suggests that the figure is actually for the group as a whole. But since MAS5 has sought to say that the SVR increase was related to group funding costs, this does not support its case that those costs were increasing at this time.

Taking all that into account, I'm not persuaded that MAS5 has provided sufficient evidence to show that its decision to increase the SVR in 2011 was for one of the reasons set out in the contract. It has provided very little in the way of contemporaneous evidence of or justification for the decision it took at the time. The third-party analysis – which is not contemporaneous, but was prepared recently as part of MAS5's response to this complaint – shows some support for there being wider funding pressures in the mortgage market at this time, but little support for that feeding through to pressures on MAS5's own costs.

And the evidence of MAS5's annual accounts filed at the time shows that any pressure on costs of funds the wider group may have experienced did not feed through to MAS5 itself, since the reported expenditure and liability does not show such an impact.

Whether or not the wider group experienced increased pressure on the cost of funds, (which the chart above suggests was not the case) it wouldn't in my view be in line with the terms and conditions for MAS5 to increase its SVR because of changes to cost of funds of the wider group – when the evidence of the accounts shows that even if there was that increased pressure, it was not reflected in the costs MAS5 reported at the time.

And even if it could be said that the only reason that MAS5 did not itself face pressure on its costs of funds was due to how the wider group was structured, that is how MAS5's parent chose to structure its business. Condition 3.1(b) only allows for changes to the cost of "our" (that is, MAS5 and MAS5 alone) funds to be used as justification for varying the SVR. MAS5's customers did not enter into a contract that allowed MAS5 to vary the SVR to reflect the costs of funds of legally distinct companies.

I note that MAS5 disputes the calculation above – "*For example, in 2009 the interest expense was 3.5% of MAS5's overall assets, but in subsequent years that fell – 2.4% in 2010, 1.9% in 2011 and 1.8% in 2012".* The figures quoted were based on a comparison of the interest expense as a proportion of the loan book. Even adding back to the interest expense the accounting adjustment referred to as the "adjustment to the carrying value of the deemed loan", though, the same trend can be seen. In 2009, the percentage is 3.85%, in 2010 it is 2.71%, in 2011 2.35% and in 2012 2.25%. If the costs paid by MAS5 as a result of the securitisations (net of its receipts from them) are to be taken as MAS5's cost of funds, therefore, the cost is falling year on year.

In respect of the increase in 2012, I said:

> *I have been provided with a paper from March 2012 to the Co-op group board which sets out the considerations which led to the decision to increase the SVR from May 2012. The paper shows that by this time the Co-op group managed its mortgages in two tranches. These were prime mortgages mainly lent directly by Britannia and The Co-op, and sub-prime and specialist mortgages (the "Optimum" portfolio) mainly lent by other parts of the group, or by other lenders and then acquired by the group. This latter tranche includes the MAS5 mortgages, one of which was Mrs A's.*
>
> *On this occasion, it was proposed to increase the SVR by a further 0.5%. The paper records that the justification for the increase was cost of funding, primarily driven by trends in wholesale funding. However, the discussion of costs is very short. It simply notes that in the past these loans were funded by securitisation, but that this has not been possible since 2007. The paper notes that were securitisation to be possible in 2012, the costs would be likely to be 4-5% above LIBOR, based on trends in the secondary market, but that securitisation was not possible at this time.*
>
> *There is no discussion in the paper of what other funding mechanisms were proposed to be used, given that securitisation was not possible, or what the impact of the costs of those mechanisms would be. It simply records that "A 50bps [0.5%] increased SVR rate is reflective of an increasing cost base". But other than noting the hypothetical costs of an impossible securitisation, it gives no indication of what that increasing cost base is or how it relates to the need for an increase of 0.5% in the SVR. And the costs and justification are not broken down to firm level – only to the prime and specialist parts of the group.*
>
> *I also note that it appears from MAS5's accounts that its loan business was securitised by 2008 and not re-securitised between then and 2012. And so even if, hypothetically, it would have cost more to re-securitise its loan book, this is not relevant to its actual costs at this time.*
>
> *I also have a summary note, recording the decision reached, which summarises the reasons for the decision, noting that "since the last SVR change, funding costs have increased, which will be addressed by this rate change".*
>
> *MAS5 has not put forward any further evidence regarding the 2012 rate increase. On balance, I'm not persuaded that it has shown evidence, beyond the contemporary record of an assertion that it was so, that cost of funding had increased at this time. I've taken into account what MAS5 has said about the passage of time. But it has provided more detailed evidence in respect of the 2009 changes. I don't think it's likely it would have retained 2009 evidence but not 2012 evidence. And so I think it's likely MAS5 has provided what existed at the time of this decision.*

The third-party analysis also covers this period. It concludes that the SVR increase cannot be explained by increases in the cost of securitisation and cannot be explained by increases in retail funding costs, since these were stable at the time. It does note that on one measure wholesale funding costs had risen since the last SVR increase, though on the other measure they had fallen. It concludes that the gap between funding costs and the SVR had fallen since 2011, supporting an increase to the SVR to reduce pressure on the interest margin, though it also notes that a decrease in the other measure of funding costs is not consistent with an increase.

I don't find the third-party analysis persuasive in support of MAS5's own position at this time. It has not closely analysed MAS5' funding costs specifically, or even those of the wider Co-op group. It has merely noted general trends in the wider market and found that there is some support for the suggestion that MAS5's (or the group's) costs may therefore have increased at this time – though only on one measure of one type of funding cost. I've noted that the terms and conditions allow MAS5 to increase the SVR where it reasonably expects funding costs to increase (whether or not that reasonable expectation later comes to pass).

Therefore there does not need to have been an actual increase in costs of funding – provided MAS5 reasonably expected one to occur. However, I've not seen any evidence that MAS5 had such a reasonable expectation at this time.

At the heart of this part of my provisional decision, therefore, was what I saw as being the inconsistency between the case MAS5 has made – that it experienced increases in the cost of funds it used at the relevant time justifying the increases to the SVR – on the one hand; and the available evidence – the lack of specific contemporaneous evidence for an increase specifically in those costs, and the evidence of the statutory accounts suggesting there was no such increase – on the other hand.

MAS5 does not agree with either the weight I attached to, or the interpretation I put on, its statutory accounts.

In response to my provisional decision, MAS5 provided more detail about the specific funding arrangements it said MAS5 and the wider group had in place at the relevant times. MAS5 has explained that when the Britannia group acquired the mortgages which included Mrs A's from GMAC, legal title to the mortgages was placed in MAS5 and MAS5 acted thereafter as the lender and the counterparty to the mortgage contract.

But the benefit of the mortgages was transferred on to five other entities, also within the group – three "warehouse facilities" and two "securitisation vehicles". MAS5 describes these transfers as a "sale" – the inverted commas are MAS5's own – but since MAS5 retained legal title to the mortgages and continued to act as lender and as counterparty to the mortgage terms and conditions, I understand that it is referring to a transfer of the beneficial interest in the loan book to other entities within the group (while the loans remained on MAS5's balance sheet and it retained legal title).

This is the tranche of loans captured under the heading "securitisations" in the table in my provisional decision, reproduced above.

Each of those five entities were separate firms in their own right, and each was part of the wider Britannia (later Co-op) group. It seems the intention was to offer the loans via securitisation to investors in the open market, but that was not possible because of the impact of the global financial crisis and instead they were retained within the group and used as collateral for the group's other activities.

The warehouse facilities funded their acquisition through loans from third party commercial funders at LIBOR plus an additional margin, as well as a smaller loan from Britannia, also at LIBOR plus an additional margin (later extended to repay part of the external lending). Following the global financial crisis, MAS5 says that short term funding of the sort previously used by the warehouse facilities pending securitisation was no longer available and as those external funding lines expired (and could not be replaced by securitisation on the open market, also because of the crisis) they were replaced by an intra-group loan facility.

The securitisation vehicles funded their acquisition through a combination of loans and debt notes. The loans were lent by Britannia at LIBOR plus margin, and the notes were also issued at LIBOR plus margin and held by Britannia (later The Co-op) to use as collateral in wider activities as – because of the global financial crisis – they could not be offered to investors on the open market.

MAS5 says that the majority of the funding of the five entities was from intra-group rather than external sources. Both funding streams were at set margins over LIBOR which did not change over time (save for the re-financing of some of the external funding as it expired). It notes that over the relevant period the group did not increase the margin over LIBOR on the intra-group funding at a time when margins over LIBOR charged to the group by external funding sources were increasing substantially.

This is borne out by the third party analysis, which refers to pressures in marginal funding costs at group level. MAS5 therefore says that what it calls the nominal cost of funding MAS5's mortgages does not reflect market rates at the time.

It says this measure of cost of funding relies on the intra-group loans provided by the group to the entities that held the beneficial interest in the MAS5 mortgages. The group provided lending on these terms – that is, at the margins above LIBOR the group initially set – as standard practice before during and after the global financial crisis, including throughout the period of the 2009-12 SVR variations. Indeed, this stayed in place until the MAS5 loans were moved off balance sheet through external securitisation in 2015.

MAS5 says that while this was the marginal rate nominally charged on an intra-group basis, it would have been impossible for MAS5 (or the entities which held the benefit of its mortgages) to raise funds at that margin on the open markets. It says that in previous intra-group arrangements a higher margin had been charged, and it can't now explain why it was reduced before the MAS5 arrangements were put in place. And it said that because of the mis-match between the short-term nature of LIBOR and the long-term nature of the mortgage book, a term premium would normally be added to cost of funding – but again this wasn't done.

MAS5 says that with the passage of time, it's not now entirely clear why the group set the intra-group funding arrangements at such a low cost rather than a cost more reflective of wider commercial realities. But it says there is no requirement to fully apportion and reflect group costs across the accounts of subsidiaries, and adopting a single loan rate allowed a more administratively simple basis for the reporting required of the various legal entities. And the reality is that it cost the group more to fund each entity than was apportioned to the entity via the terms of the intra-group arrangements.

MAS5 says that, in reality, the group did not approach its funding costs on a legal entity basis – that is, separating out and managing funding for each separate firm within the group. Rather, at group level funding costs were managed on a segment basis; that is, the group –

for example – treated all mortgages of a certain type together. Across the various firms in the group, there were prime retail mortgages and sub-prime mortgages (the latter, which the group calls the "Optimum" segment, is the segment which includes MAS5), and the group managed its funding across those segments. Group level accounts – the reporting of the parent company – show this approach to funding. But until 2016 (when the taxation regime changed), there was no need for the group to revise its approach to better reflect the actual cost to the group in the nominal apportionment via the intra-group loans reported in the accounts of each entity. So in practice there was no need for the group to ensure the intra-group arrangements reflected wider commercial realities and it did not do so. But those wider commercial realities still existed.

MAS5 says the evidence from the time of its internal discussions and board and discussion papers shows that the group did consider there to be an increase in cost of funding at the relevant time; that that increase impacted the segment of the group's business which included MAS5, and therefore that the increases to the SVR were justified as reflecting increases or anticipated increases in the cost of funds MAS5 used in its mortgage lending business. The changes to cost of funding were actually incurred, even if the accounting within the group wasn't adjusted.

In respect of the limited external funding direct to the entities I've mentioned above, this was largely in place before the financial crisis and not renewed on expiry. And MAS5 says the particular entity concerned was only able to access funding on such relatively good commercial terms because of the wider credit rating of the group as a whole – again illustrating the inter-connected nature of funding arrangements across the group.

MAS5 also says that under banking rules, the Co-op Bank as the parent company was required to report on a segment basis – a requirement that didn't apply to the entities within the group. In the Co-op Bank group's consolidated accounts, it reported on the sub-prime segment (including, but not limited to, MAS5). This reporting was not based on the intra-group loans reported in the accounts of each constituent entity, but rather on transactions between segments (rather than legal entities – each segment might be several legal entities, or only include part of a legal entity).

Using the accounts filed by MAS5 and the other five entities, it's possible to calculate the interest margin (a measure of the difference between income and expenditure) on the MAS5 book. Using the group accounts, it's also possible to calculate the interest margin on the segment that included MAS5, and to isolate a figure specifically for MAS5 on a pro rata basis from the wider segment.

These calculations show that the interest margin for the segment as a whole as derived from the accounts of the individual entities was significantly higher than the interest margin derived from the segment reporting in the group accounts. The entity interest margin increased year on year between 2009 and 2012, but the group reporting interest margin decreased over the same period.

MAS5 says that, since the interest income is the same in both the entity and group accounts, the difference is because the interest expense reported in the group accounts is substantially higher than that recorded in the entity accounts. It says this further demonstrates that the entity accounts, based on the intra-group loans, do not reflect the reality of the funding costs incurred at group level in respect of this segment of mortgages.

MAS5's submissions on this part of the case end thus:

> *"In conclusion, whilst MAS 5's financial statements may not provide direct evidence of an increase in cost of funding, reviewing them in isolation leads to an*

unrepresentative view that is not reflective of how the Group actually funded the mortgages held by MAS 5 (and the Optimum portfolio more generally). It does not seem reasonable to conclude that the cost of funding MAS 5's mortgages reduced over time when the statutory intercompany funding arrangements that at face value 'funded' MAS 5's mortgages did not fully reflect the underlying commercial funding costs that the parent company would have had to incur in refinancing the underlying funding liabilities on its own balance sheet in a stressed market."

In summary, therefore, MAS5's argument seems to me to present three alternatives:

- There was an increase in the MAS5's cost of funding its mortgage lending business; or

- The cost of funds of the five entities should be taken to be the cost of funds of MAS5, and those costs increased; or

- The cost of funds of the wider group increased, and MAS5's cost of funds should be understood as being part of that wider group increase – since MAS5 was part of the wider group and treated as such, and since if MAS5's own costs viewed in isolation did not increase, that was only because the group had chosen to structure itself in that way. It could have adopted an alternative structure that did result in increases being passed on to MAS5.

I've carefully considered these arguments, and the supporting evidence MAS5 has provided. But for the reasons I have given above, I'm not persuaded by its approach to clause 3.1(b). I think condition 3.1(b) is clear. There has to be a change in MAS5's own cost of funding. The costs <u>MAS5</u> is required to pay must change (or be anticipated to change) for it to change what it in turn charges its customers to cover those costs.

The evidence of the accounts shows that even if the costs of funding the five entities did change, there was no relationship between the cost of funding them and the cost of funds MAS5 incurred in its mortgage lending business. The evidence shows that MAS5's own cost of funds – the liabilities it incurred in funding its mortgage lending business – did not change over this period. And while this may be because MAS5 or the wider group had previously decided to structure its business in such a way that MAS5 was not exposed to wider changes in group cost of funds, the fact is that this was the case, and whether or not there were wider commercial benefits of operating in this way isn't relevant to what condition 3.1(b) itself means. Condition 3.1(b) only entitles MAS5 to change the SVR if its cost of funds change or are reasonably expected to change; it does not entitle MAS5 to change the SVR because it considers that in a hypothetical / alternative business model that it could have adopted (but didn't), its cost of funding would have been different.

I also note that MAS5's own evidence shows that, on the facts of the case, the cost of funding of the five entities did not increase over the period from 2009 to 2012. So in order to find that there was an increase in the cost of funding MAS5's mortgage lending business if those costs were represented by the five entities, I would have to accept that MAS5 was entitled to look to changes which were at least two removes from MAS5. The evidence shows MAS5's cost of funding did not increase; the evidence shows the cost of funding the five entities did not increase. What may have changed is the cost of funding at group level – but that was not passed on to MAS5, either directly or via the five entities. If there was such a change, that is in my view too remote to come within the scope of condition 3.1 (b) and not something that could have been in the contemplation of the parties at the time the contract was entered into.

As I explain in more detail below, therefore, I'm not persuaded that the conditions for MAS5 exercising condition 3.1(b) to change the SVR were met in 2009, 2011 or 2012.

I'm satisfied that the evidence does show that there was some funding pressure at group level – including the evidence of the parent company accounts for the same period as well as the board and discussion papers and internal documents MAS5 has supplied. MAS5 accepts that MAS5's accounts don't provide evidence of an increase in the cost of funding its mortgage business. But it says that should not be determinative of the issue – because the accounts don't reflect the wider commercial reality of the situation, and were not required to do so.

MAS5, as a legal entity in its own right, had a statutory obligation to report its financial position in its statutory accounts. And this is therefore relevant primary evidence of its financial position at the relevant time, and I'm satisfied it's reasonable to take the accounts into consideration.

MAS5 was part of a wider group. I accept that the group approached funding at the group or segment, rather than entity, level – that much is confirmed by the group accounts from the time, as well as other material such as a statutory declaration prepared for an unrelated matter in 2010.

But, as I said above, in order to meet the requirements of condition 3.1 (b), what's required is a change in the costs of funding MAS5's mortgage business which are incurred by MAS5 itself. That requires a change to the cost of funds MAS5 itself is liable for – whether a change in the costs of obtaining finance on the open market itself, or a change in what it is required to pay under intra-group funding arrangements because those other group entities pass changes in their own funding costs on to MAS5.

If another group entity experiences a change in its own cost of funds (which it uses in turn to fund MAS5) but absorbs that change rather than pass it on to MAS5 via changes in the intra-group arrangements, I am not satisfied that can be properly characterised as a change in the cost of funds used by MAS5 in its mortgage lending business for the purposes of condition 3.1 (b). What is required is a change in the costs borne by MAS5 itself. I am not persuaded that a distinction can be drawn between the costs of funds that MAS5 "uses" and what it is liable to pay as the costs of funding its business. MAS5's accounts set out its liabilities and expenditure; those are the costs of funding its mortgage lending business.

If the group passed on any changes in wider cost of funding, either for the group as a whole, or for that segment of it which included MAS5, then it's reasonable to expect that those changes in cost of funding would be reflected in MAS5's own financial statements. They would form part of MAS5's liabilities and expenditure. But the accounts do not reflect this, and it appears from the accounts that the cost of funds used by MAS5 in its mortgage lending business were broadly static.

I note MAS5 says there was no obligation, under the relevant rules applying to banking financing or as a matter of company law, for the group to break down its funding costs in that way – such that they were accurately apportioned between the constituent entities within the group.

And I accept that. But in my view that's not the end of the matter. MAS5 also had obligations under the specific terms and conditions of the mortgages it took over from GMAC – including Mrs A's. The terms and conditions are clear that it's only if the cost of funds MAS5 itself uses to fund its business change that condition 3.1 (b) can be relied on to change the interest rate.

Those terms and conditions were not entered into by MAS5. They were drawn up by GMAC and entered into by GMAC and its customers before the transfer to MAS5, and likely before the transfer to MAS5 was contemplated. But as the transferee MAS5 is bound by them, whether or not they reflect how the group MAS5 is part of has chosen to organise its business.

If MAS5 is right that the cost of funding the Optimum segment increased, the group would need to pass those increases on to MAS5 before condition 3.1 (b) could be triggered.

I don't think, therefore, that the cost of funding the Optimum segment or the group as a whole justified the increase to the MAS5 SVR as far as the terms of the contract are concerned. MAS5 appears to accept that the group did not pass on those changes to MAS5, because there was no change to MAS5's own obligations or the broader intra-group funding arrangements – notwithstanding the commercial realities the group faced at the time.

I don't think that's enough for me to conclude that there was a change in the cost of funds MAS5 itself used in MAS5's mortgage lending business.

The group had chosen to structure itself in a particular way. On MAS5's case, the consequence of that was that MAS5 was shielded from the wider commercial realities of the cost of funding mortgage lending because the group maintained intra-group funding arrangements at an artificially low level and did not increase them either to reflect increased costs faced by the group, or to reflect the commercial reality of what it would have cost the parts of the group funded in that way to instead raise funds on the open market.

But if the effect of the group's choice to operate in that way was that it put itself in a position where increased cost of funds more broadly were not directly passed on to MAS5, it follows that MAS5 could not rely on condition 3.1(b) to increase the SVR when the costs of funds MAS5 itself used in funding its mortgage lending business had, as a result, not changed in the same way.

MAS5 or the group could have structured its business in such a way that MAS5 was directly exposed to commercial funding costs – and therefore entitled to rely on condition 3.1 (b) when those costs changed. But the fact that it chose not to do so means that it is not so entitled; and it is no argument to say that condition 3.1(b) could have been engaged if funding arrangements were different. The fact is, they weren't.

I'm therefore not persuaded by what I understand to be MAS5's suggestion, at least implicitly, that I should consider the arrangements MAS5 might have had to make if it had needed to source funds directly in determining whether condition 3.1(b) was satisfied when MAS5 varied the SVR. Condition 3.1(b) does not allow MAS5 to change the SVR to reflect changes that did not occur but might have occurred had MAS5 structured itself in a different way. It only permits MAS5 to vary the SVR to reflect changes in the cost of funding its mortgage lending business – that is, the costs it itself is liable to pay. Nevertheless, as I explain further below, I've taken the wider funding position into account in determining what's fair and reasonable in all the circumstances of the case.

I'm therefore satisfied that it's necessary to review MAS5's financial statements as part of considering whether MAS5 acted within the terms and conditions when increasing the SVR in 2009 to 2012. And I'm further satisfied that if the evidence – of the accounts or otherwise – shows that MAS5 itself did not face changes in the cost of funds it used in its mortgage lending business, that cannot be remedied by pointing to increases that the group could have, but didn't, pass on to MAS5.

I'll turn now to the evidence and whether it shows that MAS5 did in fact experience (or reasonably anticipated that it would experience) changes in the cost of the funding it used at the relevant times.

I referred in my provisional decision, in the extracts quoted above, to the more recent analysis of the third party MAS5 provided in support of its wider position. In response to my provisional decision, the third party has provided some commentary on my findings – that commentary largely confirms that I interpreted the analysis correctly.

But it also says that the third party proceeded on the basis that MAS5 was funded at group level, as it was instructed by MAS5 that this was the case – "*with regards to group funding costs we have been informed that this was the basis of MAS5's funding and therefore it is not feasible or appropriate to attempt to analyse any MAS5-specific funding costs that is distinct from those for the group as a whole.*"

I've said that I'm satisfied that the terms and conditions mean that it *is* necessary to analyse MAS5-specific funding costs. Changes in group level funding are only relevant to the extent that MAS5 was itself subject to them (for example, because MAS5 was required to pay one of the five securitisation entities an equivalent increase).

And for that reason, the third party analysis is of limited value to my consideration of this complaint – because the third party did not attempt to analyse MAS5 specific funding costs, having been instructed by MAS5 that it was not funded on that basis. The report is of value in considering the funding pressures the group may have been subjected to – though it's largely a retrospective analysis of that – but it is of limited value in deciding whether those cost pressures were passed to MAS5 such that they represented a change (or anticipated change) in the cost of funds MAS5 used in its mortgage lending business.

I've also considered the further evidence MAS5 has provided about its own position. I've referred above to the five entities to which MAS5 "sold" the beneficial interest in the mortgages it continued to hold legal title to. It's not clear whether or not Mrs A's mortgage was included in this cohort – most but not all of MAS5's mortgages were – but I don't think that makes a substantial difference to the broader point that (as I set out in the table in my provisional decision, above) – treating the securitisations and its intra-group loan as the sources of funding to MAS5 – MAS5's liabilities were the net payments it was required to make to the five entities and the payments falling due under the LIBOR-linked loan owed to its parent company.

I've set out above what MAS5 has said about how the five entities were in turn funded – by a mix of low rate external loans and intra-group lending, and debt notes, all at margins over LIBOR.

MAS5 says – for reasons it can't now explain, with the passage of time – the group set the intra-group funding margins charged to the five entities at an artificially low level and did not increase those margins when the group as a whole faced increased funding pressure following the financial crisis. As a result, the intra-group funding arrangements did not reflect the commercial reality faced by the group – either in the funding pressures the group as a whole did face, or what the entities would have faced had they sought to refinance the intra-group funding on the open market rather than from the group. The same is true of MAS5's own LIBOR-linked loan from its parent company; the margin over LIBOR did not change even when external funding margins over LIBOR increased following the global financial crisis.

The intra-group funding arrangements that MAS5 refers to – which it says were at artificially low margins over LIBOR compared to what would have been obtainable on the open market, and compared to what it cost the group to obtain the funds used in those arrangements – are the costs paid by the five entities to the wider group. MAS5 refers me to those funding arrangements because it "sold" (MAS5's quotation marks) much of its mortgage book to those entities.

I've already said that it's necessary to consider what the funding arrangements for MAS5 actually were, not what they might have been had the group chosen to structure or fund itself in a different way. Whether or not there was some commercial advantage to the group in operating in this way, or whether it simply wasn't something the group considered changing at the time, I don't think that has any relevance to the issues of what the contract permitted. As I've said, what's important are the actual costs of funding MAS5 faced (and changes to those costs). The reasons why the group chose to structure itself in this way, and chose not to change the intra-group arrangements over time, don't change the reality of what the cost of funds actually borne by MAS5 was.

But in any case I don't think that the cost of funding faced by the five entities was the cost of funding used by MAS5. The "sale" is the transfer of the beneficial interest in MAS5's mortgages to the five entities, MAS5 retaining legal title. And the cost of funding of the five entities is the cost of the funds they used to purchase the beneficial interests of the various mortgages they securitised, including those of MAS5, in the form of loans and debt notes. But that is the cost of the purchase of those beneficial interests by the entities, not the cost of funds MAS5 used in its mortgage lending business.

The five entities did not therefore provide loans or funds to MAS5, other than as consideration for the purchase of the beneficial interest (which gave rise to a "deemed loan" recorded in MAS5's accounts because it retained continuing economic risks and benefits under the terms of the securitisations). After the "sale", MAS5 was obliged to pay over the money received from customers in respect of those mortgages to the five entities, receiving some of it back as "deferred consideration".

MAS5's ongoing liability to the five entities was solely to pay over to them the income received from customers. In other words, its liability to the entities was determined by the returns received from its mortgage book, not by the cost of funding of the five entities for their acquisition of the beneficial interest or the costs the five entities were required to pay under intra-group funding arrangements.

In MAS5's accounts, the "deemed loan" which is the largest liability on its balance sheet is, in effect, the value of the expected receipts from the mortgages securitised into the five entities, which MAS5 will be required to pay to the entities over the lifetime of those mortgages – with the income in any given year forming part of the "interest expense" which is the largest item of expenditure, subject to the "deferred consideration" repayable from the five entities in respect of "interest expense" payments which exceed the five entities' own costs.

MAS5 has explained how the five entities were funded, through the intra-group funding arrangements at margin over LIBOR I've explained above. But it hasn't shown that the five entities passed their cost of funding on to MAS5.

MAS5's own liabilities were a loan from the group at 1 month LIBOR plus 0.21%, and the obligation to pass on the "interest expense" to the five entities. The amount of the "interest expense" was determined by the amount received in mortgage payments from customers, not by the funding costs of the five entities.

And even though in certain circumstances part of the "interest expense" was rebated to MAS5 in the form of the "deferred consideration", the amount of the "deferred consideration"

– or even whether it is payable at all – depends on (according to MAS5's accounts) whether and the extent to which the interest paid over exceeds "the administration costs of each mortgage book".

It's important to note too that MAS5's own submissions, which refer to the funding costs of the five entities rather than of MAS5 itself on the basis that the five entities "bought" the MAS5 mortgages, don't show there was an increase in cost of funds. MAS5's own analysis of the "blended" cost of funding of the various funding streams involved shows a fall throughout 2009 – when the first SVR increase happened – followed by a small and slow increase (less than 0.5% over more than two years) between 2009 and 2011 which fell back in 2012. So if the funding costs of the five entities as shown in these submissions had represented the cost of funds used by MAS5 in its mortgage lending business – which I'm not persuaded of – then on MAS5's own evidence, the increases in the SVR did not reflect increases in that cost of funds.

And MAS5 accepts this – it invites me to conclude first that the cost of funding the five entities was the cost of funding MAS5's mortgage lending business, and second that the increases in the SVR were justified because the intra-group arrangements it chose to put in place didn't reflect the true commercial reality. But I'm not persuaded that the changes to the cost of funding the five entities was the same as changes to the cost of funds MAS5 used to fund its mortgage business.

And even if that was the case, I don't think it's appropriate to consider what the group could have done – but didn't – when thinking about whether MAS5 acted in accordance with the terms and conditions. It's necessary to think about what actually happened, not what could have happened had a different approach been taken.

Taking all that into account, I'm not persuaded by what MAS5 says about the intra-group funding arrangements and their relationship to the funding pressures faced at group level amounting to increases in the cost of funds "used" by MAS5 in MAS5's mortgage lending business, for any and all of the following reasons:

- The five entities were funded at fixed margins over LIBOR, and those margins did not change over time (other than the re-financing of some external loans into intra-group funding).

- Changes to group fundings costs – other than variations in the LIBOR rate – were not passed on to the five entities in the form of re-financing or changing the margin of the intra-group funding arrangements.

- As MAS5's own submissions show, the result was that the five entities' cost of funding did not change over time to an extent that justifies the SVR increases even if those costs could be said to be MAS5's costs.

- While that may be because the intra-group funding arrangements were set at what MAS5 now says was an artificially low level compared to the commercial reality the group faced at the time, and compared to what it would have cost the entities to replace that funding on the open market, the group chose to manage its finances in that way. When deciding whether – under the terms of the contract – condition 3.1 (b) was engaged, I can only consider the cost of funds MAS5 actually used in its mortgage lending business, not what might have happened had the wider group chosen to arrange its business in a different way.

- In any case, the five entities did not in turn pass on their own cost of funding to MAS5.

- MAS5's liability to the entities was determined by the payments received from its customers, not the cost of funding the five entities.

- The transfer of the beneficial interest to the five entities meant that the five entities gave MAS5 consideration up-front in return for the right to receive payments from the customers of those mortgages, subject to the "deferred consideration" rebate. How those entities raised and funded the costs of that transfer, or any of their other operating costs, has no impact on MAS5's liability to pay over interest received from customers, or the extent of that liability. If the group had – which it didn't – changed the funding arrangements of the five entities, that would have had no impact on the amount MAS5 was liable to pay the entities.

- The closest linkage between the cost of funding of the five entities and MAS5 itself is the "deferred consideration" rebated to MAS5, but that is relatively small and only indirectly linked (if at all) to the cost of funds of the five entities. And it does not impact or change the amount MAS5 is required to pay over to the five entities or the relationship between them – it merely affects the extent to which the entities are entitled to retain all of that interest expense – and is offset against the total "deemed loan".

- Even if the cost of funding of the five entities is linked to MAS5's cost of funding via the "deemed consideration" (and it's not clear that it is in any significant way), that did not form part of MAS5's considerations at the time of the SVR increases, or the case it has made now.

- In any case, the "deferred consideration" does not justify the increases in the SVR in 2009, 2011 or 2012. The following shows the change in "deferred consideration" over the relevant period, compared to the size of the loan book in which the five entities had a beneficial interest (as measured by the size of the "deemed loan").

Accounting year (ends 31 December)	Deferred consideration	Deemed loan	Ratio
2008	£13.5 million	£2,261.1 million	0.6%
2009	£13.5 million	£2,124.8 million	0.6%
2010	£19.3 million	£2,003.6 million	1.0%
2011	£29.4 million	£1,863.1 million	1.6%
2012	£27.8 million	£1,734.7 million	1.6%

It can be seen that the deferred consideration receivable each year increases both in absolute terms and as a proportion of the size of the loan book in which the five entities hold a beneficial interest. The deferred consideration is a rebate to MAS5 of the excess by which the interest paid by MAS5 customers exceeds the administration costs of the five entities. But to the extent those costs include the cost of funding of the five entities, an increase in the excess receipts which is rebated to MAS5 is not consistent with an increase in cost of funding relative to income.

> The deferred consideration is also a benefit to MAS5, in that it represents a rebate of the sums it was liable to pay the five entities. So an increase in the deferred consideration is ultimately a reduction in MAS5's net costs, not an increase.

For any and all of those reasons, I'm not persuaded that the funding arrangements of the five entities change my view as to whether the cost of funds used in MAS5's mortgage lending business increased. Changes to their funding arrangements, or the cost of those arrangements, did not result in changes to MAS5's own costs or liabilities, since their cost of funds was not passed on to MAS5. To the limited extent that the deferred consideration impacted MAS5's own funding position, the amounts involved are very small, it's not clear there's a direct or causal link with the five entities' cost of funds, and in any case the evidence of MAS5's accounts suggests that the amount the five entities were able to rebate increased – which does not support an increase in their own cost of funds or MAS5's costs.

I reviewed the contemporaneous evidence, including internal documents and papers, in my provisional decision. MAS5 says that there are documents I must have not considered because I didn't mention them in my provisional decision – but that's not the case. I considered all the evidence provided, even if I didn't consider it necessary to refer to every document individually.

I've included above extracts from my provisional decision which includes my consideration of the evidence, and I don't propose to go over it again. MAS5 has referred me to a further document, not provided in relation to this complaint but included in its submissions to the earlier 2019 complaint – this is a board paper from January 2011 recording the decision to increase the SVR across the segment of the group's business which included MAS5 (the Optimum segment).

The paper records that most of the Optimum segment is on fixed rates or rates linked to LIBOR or base rate. Only around 16% of the segment is on SVR – consisting of mortgages (such as MAS5's) purchased from GMAC. The paper records that funding costs have increased and that the SVR should be increased by 0.75% as a result. It notes that following the increase the SVR would still be in line with similar lenders in the market and lower than that currently charged by GMAC.

The paper is supported by the internal email chain I referred to in my provisional decision. The start of that email chain discusses the cost of renewing funds on the wholesale markets. And it also discusses the challenge of retail funding, as well as regulatory requirements.

I'm not persuaded this materially affects the analysis of MAS5's cost of funds in its mortgage lending business. MAS5 did not take retail deposits – and even at group level, it was part of the Optimum segment not the retail segment. And while the email chain is evidence that the group faced wholesale funding cost increases at this time, there needs to be evidence that those costs were incurred by MAS5 in some way for there to be evidence of a change in the cost of funds MAS5 used in funding MAS5's mortgage lending business.

Having reviewed all the evidence again, I remain of the view that there is evidence that the group considered that funding costs were increasing around the time of the decisions to increase the SVR in 2011 and 2012. There is less evidence of that in respect of the 2009 increases, though there is evidence the SVR had fallen to an artificially low level in 2007 and 2008 because of the effect of the restrictive covenant (I'll discuss the relevance of that below).

But those increases, or anticipated increases, at group level don't translate into increases, or anticipated increases, specifically in the cost of the funds MAS5 used in its mortgage lending business.

By 2008, MAS5's own funding position was stable. It had securitised most of its loan book into the five entities (presumably using the consideration received to pay off the costs of acquiring the book, since there is no other expenditure to cover this element in the accounts). MAS5's only obligations – as recorded in its accounts – were to pay the LIBOR-linked loan to its parent company and to pass interest income from its customers to the five entities. There were no changes in its funding or other arrangements between then and 2015.

I'm therefore satisfied on the evidence available that there is no evidence that MAS5 itself faced in an increase in the cost of the funds MAS5 used in funding its mortgage lending business. To the extent that the wider group experienced increases, they were not passed on to MAS5.

And for the same reasons, I don't think there's evidence that MAS5 reasonably anticipated an increase in the cost of funds it used in its mortgage lending business. There is evidence that the group anticipated such a change – but no evidence that the group sought to pass any such increase on to MAS5 or that MAS5's own funding arrangements were changed, or anticipated to change, as a result. I don't therefore think that it can said that MAS5 reasonably anticipated changes in the cost of funds it itself used in its own mortgage lending business, even if the group reasonably anticipated changes at group level.

It follows that I'm not persuaded that, at the relevant times, MAS5 was entitled to increase the SVR relying on condition 3.1 (b).

The position of MAS5 in the wider market

In its response to my provisional decision, MAS5 also pointed to other factors which it said justified the level of SVR it charged. I noted in my provisional decision that if the interest rate charged to Mrs A after 31 December 2012 was reduced as if the 2011 and 2012 increases had not taken place, the rate would then be broadly in line with the market average SVR.

In its response, I think MAS5 misunderstood the point I was making. I was not suggesting that the SVR should be reduced to the market average as an end in itself (that is, that charging more than that was not fair and reasonable or because there was any obligation on MAS5 to charge no more than the market average). Rather, I noted that the proposed reduction would move the rate from a position towards the top of the market to a position closer to the average. I did so as a sense check on my proposed redress, noting that if the SVR was reduced to remove the ongoing impact of the 2011 and 2012 rises that would not result in an artificially low SVR that would amount to an unfair windfall that Mrs A would not have been reasonably able to expect.

In response, MAS5 said this was an unfair approach. Its mortgages are not average mortgages, they are specialist sub-prime mortgages – which have higher risk and higher funding costs. MAS5 provided a further report from its third party expert on the role of credit risk when analysing SVRs. Although the report is premised on the same misunderstanding of my provisional decision, and therefore is aimed at rebutting an argument I had not in fact made, I have taken it into account.

The report sets out a series of factors that it says are relevant to the credit risk a lender faces, and therefore to its SVR. These include loan to value, loan type, and the typical credit scores of a firm's borrowers. It provides data on the credit scores of MAS5 customers since 2016, and compares that with a survey of the UK population carried out in 2021 to show that MAS5 customers, in general, had a worse credit position than the UK population as a whole between 2016 and 2021. The report says that over 70% of MAS5 mortgages are interest only, compared to less than 18% of all UK mortgages. And it says that MAS5 mortgages are substantially more likely to be in arrears than mortgages with The Co-operative Bank plc, and than mortgages with a series of other lenders. It therefore concludes that MAS5 mortgages have a significantly higher credit risk than other parts of the mortgage market.

The report also analyses mortgages offered by a range of lenders over time, and concludes that products available to borrowers with a history of adverse credit charge an SVR which is 0.68% to 0.85% higher than the SVR on products not available to borrowers with adverse credit. It concludes that a comparison between the MAS5 SVR and the market average is therefore not appropriate.

As I said above, I did not conclude in my provisional decision – and do not conclude here – that the interest charged to Mrs A after 31 October 2012 was unfair *because* it was above market average. I concluded it was unfair for other reasons, and then noted that were I to require MAS5 to reduce Mrs A's interest rate to take into account that unfairness, the result would not be an interest rate that was disproportionately low compared to the market average. I'll say more about that below.

In the context of the SVR variations between 2009 and 2012, I note that condition 3.1 (c) of the terms and conditions allow MAS5 to change the SVR to reflect "a change which has occurred, or which we reasonably expect to occur, in the interest rates charged by other mortgage lenders". In its submissions in respect of this complaint, MAS5 says that it relied on condition 3.1 (b) for all four increases between 2009 and 2012. The internal evidence from the time – which I accept might not be complete, because of the passage of time – does not specify the particular contractual provision relied on. The board papers for 2009, for example, discuss the rationale for increasing the SVR but do not link that to a particular term of the contract. And while the 2012 executive paper quotes the terms of Britannia and The Co-operative Bank plc mortgages, it does not cite those of MAS5 – though the later board paper does say that contracts in the Optimum segment allow changes to the SVR for "several reasons, including an increase or expected increase in the market costs of funding". This is not strictly accurate, since as I've noted above the MAS5 terms and conditions allow a change to reflect changes in the cost of funding MAS5 uses in its mortgage lending business, not to reflect changes in market conditions (unless MAS5 is exposed to those market conditions). But since MAS5 has been clear in its submissions that it exclusively relied on condition 3.1 (b), I have proceeded on that basis.

The decision paper for May 2009 is largely focused on the position of the MAS5 SVR relative to the SVRs of other firms in the group – including other acquired books as well as Britannia itself – as well as the then current GMAC SVR. The decision taken was to increase the MAS5 SVR (then 2.99%) to match the Britannia SVR (then 4.24%) in two stages. The decision was revisited and confirmed in August 2009, ahead of the second stage increase – with the amendment that the MAS5 SVR should be increased to 4.5% not 4.24% as previously planned (taking it to 0.26% above Britannia's SVR rather than parity with it). The rationale for amending the second increase was to generate further income, and to reflect the difference in risk between the MAS5 and Britannia books.

MAS5 says that this decision was taken because of cost of funds. It says this notwithstanding the rationale given in the papers, because the May 2009 paper

> "*was written at a time with the increased cost of funding was no longer a new development. As explained above, BBS* [Britannia Building Society] *had been under pressure as a result of increased funding costs since the onset of the GFC* [global financial crisis]*. The significant development at this point was BBS's ability to react to the increased cost of funding due to its re-negotiation of the GMAC Covenant. It was*

accepted that funding costs had increased and it is understandable against the wider backdrop of the GFC, the GMAC Covenant and their impact on BBS that the May 2009 paper is not more explicit in its reference to the increased cost of funds. It is of course possible that other documents were created at the time which also explained the rationale for the increase but are not available today due to the passage of time."

In essence, therefore, MAS5's submissions are that cost of funding was the reason for the 2009 increase, but that cost of funding was not the main focus of the May 2009 board paper because it went without saying as part of the obvious backdrop of the times. And that's why in the discussion above I've largely focused on the evidence of whether there were in fact in changes to the cost of funding MAS5's mortgage lending business.

However, the wider circumstances and context in which MAS5 made the decision to increase are relevant to my consideration of what's fair and reasonable in all the circumstances in respect of the complaint about the fairness of interest charged after 31 October 2012. And so I'll say more about this below.

In respect of the later increases, the January 2011 board paper noted that there had been no SVR increases in the specialist lending market – which is the part of the market MAS5 says I should consider as the appropriate comparison (rather than the average across the market as a whole). The decision taken at this time was to increase the SVR of the Optimum segment (including MAS5) only, relying on changes to cost of funding.

In 2012, the increase to the MAS5 SVR was part of an increase in SVRs across the group – including both The Co-operative Bank plc as well as the Optimum segment which included MAS5. The decision taken was to increase SVRs across the group by 0.5%. The evidence of the time – and MAS5's submissions now – show that the group relied on cost of funding.

MAS5 also says that its position in the wider market – including that its mortgage book was generally more risky than other books – is also relevant to whether it's fair and reasonable to require it to reduce the interest rate now. The extent to which any redress would result in an interest rate below what ought to be expected for a mortgage of this type is a question for me to consider when I come to decide what is fair and reasonable in all the circumstances of Mrs A's complaint about the fairness of the interest charged after 31 October 2012. But it is not relevant to the question of whether MAS5 was entitled under the contract to change the SVR for the reasons it did.

The effect of acting outside the terms of the contract

First of all, I remind myself that I am only considering the fairness of the interest rate charged from 31 December 2012. I have considered whether the variations to the SVR between 2009 and 2012 were carried out within the terms and conditions as part of all the circumstances of the case. But a complaint about those variations in and of themselves is out of time – they are only relevant to the extent that they contributed to the level of the SVR charged in the period that is in time.

I have found that in changing the SVR for the reasons it relied on at the time, MAS5 acted in a way that was not authorised by the contract because there was no change or anticipated change to the cost of funds that MAS5 used to fund its mortgage lending business.

I therefore need to consider what the effect of that is, as a matter of law, before I can go on to consider the extent – if any – to which those circumstances are relevant to whether the interest rate charged to Mrs A after 31 December 2012 was fair and reasonable in all the circumstances. That's because I'm required under DISP 3.6.4 R to take into account relevant law, among other things, in determining what is fair and reasonable in all the circumstances.

I remind myself of the wording of the term MAS5 relied on in increasing the SVR:

Condition 3.1 of the terms and conditions says:

> 3.1 If the *interest rate* is the *standard variable rate* we may vary it for any of the following reasons:
>
> (a) to reflect a change which has occurred, or which we reasonably expect to occur, in the *Bank of England base rate* or *interest rates* generally;
>
> (b) to reflect a change which has occurred, or which we reasonably expect to occur, in the cost of the funds we use in our mortgage lending business;
>
> (c) to reflect a change which has occurred, or which we reasonably expect to occur, in the interest rates charged by other mortgage lenders;
>
> (d) to reflect a change in the law or a decision by a court; or
>
> (e) to reflect a decision or recommendation by an ombudsman, regulator or similar body.

This condition limits the circumstances in which MAS5 can vary the SVR. The effect of the condition is that MAS5 can <u>only</u> vary the SVR for one of the reasons contained in condition 3.1 – where one of the circumstances set out exists. And even if one of those circumstances exists, MAS5 can only vary the SVR to reflect those circumstances. It has no power to change the SVR if those circumstances do not exist, and no power to change the SVR in a way which does not reflect those circumstances.

It follows that if those circumstances do not exist, MAS5 cannot vary the SVR.

In this case, MAS5 relied on condition 3.1 (b) on each of the occasions it increased the SVR between 2009 and 2012 – to reflect a change which had occurred, or which it reasonably expected to occur, in the cost of the funds which it used in its mortgage lending business.

In respect of the other parts of condition 3.1, I don't think what MAS5 could potentially have relied on (but didn't in fact rely on) would necessarily have any impact on the lawfulness of purporting to rely on condition 3.1 (b). Such considerations may however potentially be relevant to the broader question of whether the interest rate it charged from 31 October 2012 onwards was fair and reasonable in all the circumstances (relevant law being only one of the considerations I must take into account in determining that).

The fact is that MAS5 didn't rely on any of the other parts of condition 3.1, it relied on condition 3.1 (b). I've found that the evidence does not show there was a relevant change in the cost of funds which it used in its mortgage lending business, and no such change that it could reasonably have anticipated. And in the absence of such a change, or the reasonable anticipation of such a change, MAS5 had no power under the contract to vary the SVR relying on condition 3.1 (b).

In these circumstances, a court may well find that where one party has no power to take a step, because the conditions contractually limiting its ability to do so are not fulfilled, then any action it takes to do so is of no effect. MAS5's decision to increase the SVR in the absence of a justification under condition 3.1 (b) was therefore potentially of no effect, a nullity, and would therefore result in for payment with no basis (rather than, for example, a breach of contract). I referred to this in my provisional decision.

Either way, I don't think that changes my overall conclusions. That is because the SVR payable at any moment in time is the sum of the original rate and all changes made to it thereafter. If some of those SVR changes were either a nullity or made in breach of contract then they can nonetheless contribute to unfairness in the later interest rates built upon them.

As I have said, relevant law is a matter for me to take into account. But the changes to the SVR took place before the period that falls within my jurisdiction. Those changes, and the relevant law applicable to them, are part of all the circumstances of the case which I am required to take into account in determining what is fair and reasonable in all the circumstances. So the legal points I've just explained would be of importance in court proceedings, but they aren't decisive of this complaint. Because of the extent to which the terms and conditions are central to the nature of the agreement between the parties, I think this is a factor that carries significant weight. But I would reach the same ultimate decision on what's fair and reasonable in all the circumstances even if I am incorrect in my analysis of whether as a matter of law the changes were of no effect.

My view of what is fair and reasonable in all the circumstances

I remind myself that my obligation is, as DISP 3.6.1 R and 3.6.4 R say, to determine this complaint by reference to what is, in my opinion, fair and reasonable in all the circumstances of the case. In considering what is fair and reasonable in all the circumstances of the case, I take into account:

- 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.

Mrs A's complaint, which I have to determine, is that the interest rate she was charged by MAS5 from 31 October 2012 onwards was not a fair rate of interest.

As at 31 October 2012, the level of the SVR was 5.75%. I've set out above why it's my view that the increases MAS5 made to the SVR between 2009 and 2012, which increased it from 2.99% in 2009 to 5.75% by 31 October 2012, were not permitted under the terms of the mortgage contract. Those increases, while they fall outside the time period I can consider, are nevertheless part of all the circumstances of the case since they can be considered to be contributing factors to the SVR being charged at 5.75% from 31 October 2012 onwards.

The terms and conditions of the contract, and the fact that in my view MAS5 acted outside the terms and conditions are therefore matters of relevant law for me to take into account. However, these matters are relevant but not determinative of themselves – they are among the factors I have to weigh in the balance in deciding what is fair and reasonable in all the circumstances. Given that my remit is to take into account relevant law but also, where necessary, to look beyond it as part of the wider fairness exercise, I think there are other matters that are also important for me to consider.

The restrictive covenant

Firstly, I've considered the wider context in which MAS5 made the increases – as even if as a matter of law it was not entitled to rely on them, it might nevertheless be fair and reasonable in all the circumstances for the interest rate charged to Mrs A after 31 October 2012 to reflect those increases.

The 2009 increase took place shortly after the end of the restrictive covenant between GMAC and MAS5 which limited the SVR MAS5 could charge customers to a cap of 2% above Bank of England base rate. This was a contractual agreement between GMAC and MAS5. It did not lead to a variation of the terms of Mrs A's mortgage agreement and Mrs A was not a party to it – indeed, it's very unlikely she would have known of its existence until this complaint.

In my provisional decision, I said:

> *I think that the restrictive covenant – which I am satisfied was a matter between GMAC and Britannia, and was not drafted or designed for the benefit of customers such as Mrs A or designed to give her enforceable rights – is an unusual feature of the case that in my opinion kept the SVR artificially low.*
>
> *Without it, I have little doubt that the SVR would not have reduced to the level it did. The 2009 changes are some time before the period I am considering. But for the restrictive covenant, it's likely MAS5 either would have increased the SVR or at least not reduced it as much as it did before 2009.*
>
> *I have therefore reminded myself that Mrs A derived a significant benefit from the restrictive covenant that might be categorised as a 'windfall' in that her SVR was kept artificially low from the time of reversion in December 2008 to the time of the second increase in October 2009. And, given that SVR rates are not set on an individual level, it's also a relevant consideration that other customers, who reverted to SVR before Mrs A, had benefitted from that 'windfall' for a longer period. I don't think, as a matter of wider fairness, that Mrs A could reasonably expect MAS5 to make that 'windfall' available indefinitely at its own cost.*

I concluded that it wasn't unfair for the SVR after 31 October 2012 to reflect the 2009 increases, even if the 2009 increases were made otherwise than in accordance with the terms and conditions.

MAS5 did not make any further submissions on this. But Mrs A did, via her representative. She said that the restrictive covenant limited the interest rate on her mortgage to no more than 2% above the Bank of England base rate, and MAS5 should be required to comply with that. Removing the restrictive covenant is unfair and a breach of the FCA's Principles 6 7 and 8.

Mrs A said the covenant was put in place to protect borrowers following the transfer from GMAC, and she referred to the securitisation prospectus for one of the five entities, which included reference to a group of mortgages "*which have (currently or after a specific period) a variable interest rate that may not exceed a margin of 2 per cent above the Base Rate".* She also said that a number of MAS5 customers had received key facts illustrations when taking out their mortgages which "*project that the SVR will be 1.99% above the Bank of England base rate*". Mrs A said the covenant was therefore communicated to customers.

Mrs A said that MAS5 knew it was in place and agreed to abide by it when purchasing the loans from GMAC, and it did not come to an end; it was removed by MAS5. In doing so, MAS5 only considered its own interests and not those of its customers, and that there was a conflict of interests between it and its customers which it failed to manage. Mrs A also said that MAS5 acted in breach of the covenant in failing to reduce the SVR to 2.5% when base rate fell to 0.5% in March 2009.

Mrs A said it was wrong to consider the covenant to be a “windfall”; to do so is to assume that it was unfair on MAS5 to be bound by the covenant. But the fact is the covenant was in place, MAS5 agreed to it and should be treated as bound by it. And if it was not permitted by the terms and conditions to increase the SVR as a result, then MAS5 should not have done so. MAS5 was only entitled to increase the SVR in limited circumstances and the end of the covenant was not one of those circumstances.

I’ve carefully considered what Mrs A has said about this. But I don’t think it would be fair and reasonable to treat her mortgage as if the restrictive covenant was still in place after 31 October 2012.

I remain of the view that Mrs A wasn’t a party to the covenant – and so had no contractual rights under it and couldn’t enforce it or require MAS5 to abide by it. The covenant was an arrangement between GMAC and MAS5. Under the terms and conditions of the mortgage agreement with Mrs A MAS5 as the transferee had the right to change the interest rate if the circumstances in condition 3.1 arose. But MAS5 agreed to further limit its freedom to do that by undertaking to GMAC that it would also keep the SVR no more than 2% above base rate.

I’m not persuaded that Mrs A was aware of the covenant at the time, or at any time before this complaint. And I don’t think there’s any evidence that either GMAC or MAS5 led her to believe that the interest rate on her mortgage was capped to 2% above base rate. I note she says that other customers were given key facts illustrations to that effect – but she doesn’t provide copies of those illustrations, or suggest that she was given one herself. As I’ve said above, Mrs A’s mortgage offer and terms and conditions do not suggest that the SVR tracks base rate, that there is a cap of 2% above base rate, or that there is any other linkage between the SVR and base rate.

That means that in terms of the contractual relationship between Mrs A on the one hand and GMAC as her original lender and MAS5 as the transferee on the other, the SVR on her mortgage was not limited to 2% above base rate at any time. To the extent that MAS5 agreed with a third party to manage her mortgage in a particular way for a particular time, Mrs A may well have benefitted from that arrangement – but it was not one that she was aware of, that she was party to or that she had any rights arising from beyond those set out in her own mortgage contract.

It’s important to note that the right to fair treatment and the other obligations set out in the FCA’s Principles are not contractual or actionable legal rights – but even if Mrs A had no rights under the restrictive covenant as a matter of law, the covenant might still be relevant (as she has argued) to whether she was treated fairly.

In the period I can consider, from 31 October 2012, the restrictive covenant had not been in place for more than three years. MAS5 was under no contractual or regulatory obligation to limit the SVR on her mortgage to no more than 2% above the Bank of England base rate. There had been a great deal of change in the mortgage and financial markets both between when the covenant was agreed in 2006 and when it ended in 2009, and between 2009 and 2012.

While the covenant was in force, I think Mrs A benefitted from its existence in that the SVR on her mortgage was lower than it otherwise would have been. But the covenant did not alter the terms of her mortgage; it was an agreement with a third party not with her; and I don't think it would be fair and reasonable to require MAS5 to proceed as if the covenant was still in force after 31 October 2012.

However, I do think the covenant has some relevance to this complaint. As I said in my provisional decision, the effect of the covenant was to reduce the level of the SVR to a level that was lower than it would otherwise have been. It meant that the SVR had reduced to 2.99% by the time Mrs A reverted to it in December 2008. This was lower than the SVR of any other firm in the group, and lower than the mortgages that remained with GMAC. I think it's likely that without the restrictive covenant the SVR would have reduced between 2007 and 2009 – but that it would not have reduced as much as it did. And so Mrs A would have paid more than 2.99% after the end of her fixed rate in December 2008.

Mrs A did therefore benefit from the existence of the covenant, in that the SVR she reverted to was lower than it would have been otherwise.

I've said above that, following the wording of the contract, I don't think MAS5 acted within its powers in increasing the SVR in 2009, since there was no change to its cost of funds (or other relevant circumstance) at this time.

While MAS5 may not have had any contractual justification for increasing the SVR once the covenant came to an end, I have to take all the wider circumstances into account when thinking about what's fair and reasonable more broadly during the period I can consider. And for the reasons I have given, I am satisfied that directing MAS5 to essentially deduct the 2009 increases from interest charged from November 2012 onwards would provide Mrs A with a level of compensation that I think goes beyond what is fair and reasonable in view of (i) the age of the increases and (ii) the 'windfall' element in the restrictive covenant. To do so would result in the interest rate after 31 October 2012 being lower than Mrs A could have expected it to be by operation of the mortgage terms and conditions alone, and would result in over-compensation.

Credit risk and the position of MAS5 in the wider market

I've discussed above the evidence MAS5 has provided in response to my provisional decision, including the further third party report, which it says shows that a) its own credit risk was high, given the nature of its loan book, and b) that pricing for credit risk is part of the mortgage market and that higher risk loans generally.

The third party credit risk report submitted in response to my provisional decision says that "the MAS5 book consists of non-conforming loans", though it doesn't evidence that – the evidence it does include is based on an analysis of MAS5 customers' credit risk from 2016 onwards, not at the point at which the mortgages were taken out. A "non-conforming" loan generally refers to the underwriting standards applied at inception, not to the borrower's circumstances many years later.

I've considered that report. But despite what it says, I think the contemporary evidence suggests that in fact not all the MAS5 book was non-conforming at inception. I'm aware that GMAC lent on both a prime and sub-prime basis. The securitisation prospectuses for two of the five entities, including one which took almost half of the MAS5 book, suggests that the loan book wasn't entirely sub-prime or non-conforming. For example, the entity which took the largest part of the MAS5 book reported that 94% of its loans were from GMAC – and cross-referencing this with what MAS5 has told us where the beneficial interest of its loans were transferred into the five entities, around 75% was MAS5 loans. Of this securitisation vehicle, then, 75% of its total value was MAS5 loans. But it also reported that it included 57% prime retail lending, 22% non-conforming residential loans, and 21% buy to let mortgages. This suggests that a majority of MAS5 lending was not underwritten on a non-conforming basis – though 74% of the vehicle was made up of interest only lending, and 76% self-certification or where no income was verified on origination.

Similarly, the January 2011 board paper I've referred to above says that the "Optimum" segment of the group (which included MAS5) was 36% prime residential, 35% self-certification, 3% non-conforming and 25% buy to let.

And Mrs A's own mortgage offer does not appear to have been issued on a sub-prime or non-conforming basis – in my experience, it was usual for a mortgage offer at this time to include a statement to the effect that "the terms of this mortgage reflect current or past financial difficulty" or similar if that was the case, but Mrs A's offer does not say that.

Mrs A's mortgage was taken out on a self-certification basis – and, as is well known, self-certification carries its own risks – but not on a sub-prime basis. It appears many other MAS5 mortgages were taken out on a similar basis.

I'm aware from my knowledge of the mortgage industry and my experience of mortgage complaints that the distinction between sub-prime or non-conforming loans on the one hand, and prime loans on the other, refers to the underwriting standard – with sub-prime / non-conforming loans available to customers with problematic credit histories who would not qualify for prime lending. Self-certification of itself does not mean a loan is sub-prime; a prime mortgage could be self-certified (and at the time, a number of high street lenders offered self-certification mortgages to otherwise prime customers). Self-certification does not necessarily mean the borrower is held to a lower underwriting standard or requires specialist or credit-impaired lending; it simply means that they do not have to provide evidence in support of their application.

I don't therefore think the evidence shows that all MAS5's lending was on a non-conforming basis – though there were other risk factors such as a high proportion of self-certified and interest only mortgages also present.

It's also fair to say that even in the higher risk end of the marker there is a variation of rates charged. For example, the non-conforming lenders MAS5 used to benchmark against in the January 2011 board paper had, at that time, SVRs ranging from 4.49% to 6.11% (MAS5's increased from 4.75% to 5.5%).

The third party's report does show that by 2016 a substantial proportion of MAS5 borrowers had an adverse credit history – between 20% and 25% over the period looked at. This is high compared to the UK population as a whole, but is not evidence of the level of credit risk those borrowers presented a decade or more earlier when their loans were taken out and underwritten.

The third party report provided in response to my provisional decision also analyses lending criteria and SVRs between 2012 and 2020, and concludes that products available to applicants with adverse credit were charged at an interest rate between 0.68% and 0.85% higher than products that were not available to such applicants.

I've taken this into account too, though I think it's of limited utility. I'm aware that credit risk is one factor many lenders take into account in setting the level of their SVRs – though I also note that (other than as a contributor to cost of funds) it's not something that the terms and conditions of this mortgage allow MAS5 to take into account when varying the existing SVR.

However, I approach the usefulness of the specific premium of 0.68% to 0.85% that the report found with a degree of caution. That's because the report was based on an analysis of products available to new customers as reported in an industry publication between 2012 and 2020. As a result, it excluded the interest rates of closed book lenders – which it seems to me is the cohort of firms most like MAS5, and therefore the group to which MAS5 ought best to be compared if a comparison of SVRs between lenders is to be done. As I said in my provisional decision, the regulator found in 2021 that only 3.3% of borrowers of mortgages with closed book lenders (such as MAS5) were paying an interest rate above 5%[5], at a time when MAS5's SVR was 5.35%. Although this post-dates the period of the analysis in the third party report, it shows that at that time MAS5's SVR was higher than the interest rate charged by other firms to which it was most similar.

Secondly, the third party's report is based on new products offered to new customers between 2012 and 2020. But MAS5's mortgages – like those of most closed book lenders – were originated before the global financial crisis, when lending standards and risk appetite were very different to the period considered in the report. The report conducts an analysis of the difference between SVRs offered to new customers from 2012 on an adverse credit versus a prime basis. But the SVR in this case was not set as being appropriate to new customers from 2012 onwards, it was set as being appropriate to new customers before the financial crisis of 2008 (and varied since). Comparison of underwriting decisions made before and after the financial crisis and the resulting change in market appetite and lending regulations creates a risk that like is not being compared with like.

And thirdly, the report is premised in part on MAS5 customers having adverse credit from 2016 onwards – which, since it is a closed book lender, is many years after their mortgages were taken out – whereas the SVR comparison exercise is based on new customer lending criteria.

I think it's reasonable to conclude that by 2016 many of MAS5's customers who could have moved their mortgages elsewhere had done so (its loan book had been shrinking year on year and more competitive deals were available elsewhere) – meaning that by this time the customers who remained within MAS5 were likely to be largely those unable to move elsewhere for reasons of current (in 2016) affordability or credit problems (or, as in the case of Mrs A, negative equity). This might include customers who were non-conforming at the time of the lending decision – but it could also include customers underwritten on a prime basis before the financial crisis whose circumstances have changed in the decade since. This means that there's a risk that by the period under analysis, from 2016 onwards, MAS5's remaining customer base is not representative of the breadth of the customer base when the loans were originated before 2008. Again, this risks leading to a situation in which a comparison between MAS5's residual book on the one hand and new lending by other lenders on the other hand does not represent a like for like comparison, meaning the results carry less weight.

As I've said above, the evidence available suggests that by no means all of MAS5's mortgages were lent on a non-conforming / sub-prime / adverse credit basis and all were taken out before 2008, so MAS5's SVR (as set by GMAC before the financial crisis based on lending risk at inception and subsequently varied by MAS5) is not directly comparable with the SVRs of lenders who lend to new customers on an adverse credit basis in the very different market of 2012 onwards as set (and subsequently varied) at the time that lending was entered into after 2012.

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5 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1036355/Mortgage_Prisoners_Review_CP576_FINAL.pdf - see Section B of Annex 1

For those reasons, I think an analysis of new lending offered by active lenders underwriting in a very different market after 2012 is of limited value in predicting what might be a reasonable level of SVR for MAS5 to charge to customers whose loans originated before 2008.

Taking all that evidence into account, I think it's reasonable to conclude that some – but by no means all – of the MAS5 loan book was lent to customers on a sub-prime / non-conforming basis. And it's also reasonable to conclude that the book included a high percentage of interest only, and a high percentage of self-certified mortgages. As a general principle, one might expect that lenders with mortgages of those types charge, on the whole, higher SVRs than ones that have a greater proportion of lower risk mortgages. But I don't think it's possible to extrapolate a specific premium or uplift which it would be reasonable for MAS5 to charge – even if the terms and conditions allowed the interest rate to be varied in that way (which they don't).

MAS5 also says that a greater proportion of its mortgages were in arrears than was the case for either the group's retail lending, or for the rest of the "Optimum" segment. It says that this is evidence MAS5 presented a higher credit risk – justifying the charging of a higher SVR – than was the case either for the group's other loan books, or compared to the wider market.

The third party compares arrears rates on the MAS5 book with other lenders between 2012 and 2020, and reaches a similar conclusion.

I'm satisfied that, in general, it's reasonable for lenders to price for arrears risk. In general, the riskier a loan book is the more likely it is that borrowers will miss payments or default altogether – and so the interest rate would be expected to be higher to ensure that the lender can recover sufficient income.

In the circumstances of this particular complaint, though, it's not as straightforward as that. The terms and conditions of this mortgage do not permit MAS5 to change the SVR to reflect changes in credit risk (other than indirectly if credit risk impacts MAS5's cost of funding), or to benchmark itself against the market (though they do permit changes to reflect changes other lenders make). So if the SVR was lower than it would otherwise have been because of the restrictive covenant, adjusting it to reflect the credit risk of the mortgage book might be a rational course for MAS5 to take – but not one permitted by the terms and conditions, absent movement in interest rates elsewhere.

There is also a question of causation. MAS5's evidence is that the arrears rate on its mortgages only exceeded that of the rest of the Optimum segment from 2010 – after the increases in the SVR in 2009.

Although the 2009 increases aligned the MAS5 SVR with the rest of the group, they amounted to a 1.51% increase in MAS5's SVR, from 2.99% to 4.5% – which, for an interest only customer such as Mrs A, represented a 51% increase in their monthly payments over a short period. So it's possible that the increase in arrears across the MAS5 book was a consequence of the 2009 SVR increases.

Nevertheless, the overall credit risk of the MAS5 book – including the profile of its borrowers at origination, as well as the level of arrears and defaults – is a relevant factor to take into account in thinking about what's fair and reasonable in all the circumstances of this complaint.

The structure of the wider group and MAS5's place in it

I’ve set out that I’m satisfied that issues relating to the wider group and any increases in cost of funds it may have faced are not in and of themselves relevant for the purposes of the terms and conditions of Mrs A’s mortgage agreement to the cost incurred by MAS5 in the funds used to fund its mortgage lending business; it would only be relevant if the group passed those changes on to MAS5 such that the cost of funds MAS5 itself incurred changed.

However, MAS5 also says I should take this into account as part of my wider consideration of what’s fair and reasonable in all the circumstances. For example, it appears to argue that the structure and funding arrangements the group adopted were such that MAS5 was not exposed to the sorts of pressures on its costs that the group faced, or that MAS5 would have faced had it tried to fund itself on the open market. But I don’t think I can reasonably give substantial weight to what the group or MAS5 could have done but chose not to in determining what is fair and reasonable during the period I can consider. In my view, what’s fair and reasonable should be judged in all the circumstances as they are, not as they might have been had MAS5 structured its business in a wholly different way. In any case, since MAS5’s SVR was not outside the range of that of other similar lenders that it identified at the time, I don’t think there is evidence that its chosen structure and funding model resulted in its interest rate being substantially lower than it would have been had it done something different.

The passage of time between the 2009 to 2012 variations and the period that falls within my jurisdiction

As I said in my provisional decision, I think it’s relevant to note that the 2009 changes were a considerable time before the relevant period. Conversely, the 2012 changes were only a short time before the relevant period and it’s therefore reasonable to conclude that the SVR charged from 31 October 2012 was substantially influenced by these changes.

The passage of time and the risk of deterioration of evidence

This is more a question of the weight I give to evidence of what happened longer ago than it is a factor in its own right.

I’m mindful that while I’m only considering the fairness of interest charged since 31 October 2012, that is itself over ten years ago. And in considering that, I have also taken into account matters which took place before that, between 2009 and 2012. MAS5 says that given the passage of time it’s likely that the evidence has deteriorated and that – for example – persuasive evidence that led me to reject the 2014 complaint is no longer available.

I’m conscious of that risk. I recognise I have to be careful in drawing conclusions about what happened some years ago when relevant evidence might no longer be available. But this complaint is one that falls within my jurisdiction, and therefore I do have to reach a conclusion on it – which entails doing the best I can with what’s available.

Having reviewed the conclusions I’ve set out above, I don’t think MAS5 has been prejudiced unduly by the passage of time. Insofar as I’ve considered its actions before 2012, it has been able to provide detailed evidence from the time, supported by recent expert analysis. And while I haven’t accepted what it has said, I don’t think it has been hampered in its ability to make its case.

My reasons for finding that MAS5 did not act in a way permitted by the contract between 2009 and 2011 are not because of gaps in the evidence – there are no unexplained discrepancies, obviously missing documents or unexplained decisions. Much of the evidence

I have considered is contemporaneous – both the internal documents MAS5 has provided, and its accounts and other publicly available information.

MAS5 has been able to present a clear and evidenced account of what it did, and make arguments about why it did so. There is no missing evidence such that I am unable to understand the actions MAS5 took at the relevant times or its reasons for doing so. Rather, we simply disagree about whether it was entitled to do what it did.

If there is additional evidence that is no longer available, I don't think it's likely that it would have changed my mind for the following reasons. MAS5's central argument in respect of the period before 2012 is that in looking at whether clause 3.1(b) was satisfied it's necessary to look at the cost of funds of the group as a whole rather than the cost of funds of MAS5 individually. My decision is that I don't accept that as a premise, rather than that MAS5 has not sufficiently proved the group's cost of funds changed. Further evidence not now available would most likely give further information about group funding costs, rather than show that they were passed on to MAS5 after all (since if that was in fact the case, it would more likely than not be reflected in MAS5's accounts – but it isn't).

For that reason, I don't think the passage of time has prejudiced MAS5's ability to provide relevant evidence or make its case, or has impacted my ability to take into account the earlier variations as part of all the circumstances of the complaint in a fair and reasonable way.

The previous cases

I have referred to past cases – including a final decision issued by me in 2014 – where apparently similar complaints were not upheld, as well as a more recent one which was upheld by an investigator at a preliminary stage but never considered by an ombudsman.

MAS5 says that given the past cases not upholding other complaints, it is not appropriate to depart from them. There is a need for consistency and finality – not just with respect to individual complaints but also where issues "with significant wider ramifications" are involved. Were I to reconsider the 2014 case today, adopting the approach I have now taken, I might reach a different outcome. It says that would be irrational.

I have noted what MAS5 says about this. I dealt with this in my provisional decision too. I explained that cases are considered individually, on their own merits and in their own circumstances, and that no one case sets a binding precedent for any other. There is a broader expectation that an ombudsman's decision will be reasonable and rational – which includes an expectation that like cases will be treated alike – but I am not bound to reach the same outcome as past cases if that is not the fair and reasonable outcome to this complaint.

I do not recall the 2014 case and neither MAS5 nor the Financial Ombudsman Service has any record of what evidence was provided at that time. Having reviewed the decision, I've noted that case was about a buy to let mortgage not a regulated residential mortgage. It appears from that earlier decision that the case advanced by the complainant was different to the case advanced in this complaint. The 2014 complainant appears to have argued that MAS5 was contractually obliged to tie its SVR to base rate. I found that there was no such obligation and noted that MAS5 had given a credible explanation of why its SVR had increased absent changes to base rate – but (unlike in this case, where the actual justification MAS5 gave is central to the complainant's argument) did not consider it necessary to analyse that alternative explanation in detail since it was not central to the complaint that had been made. I've also noted that while I appear from the decision to have reviewed the evidence MAS5 provided I did not – for example – consider the wider circumstances such as MAS5's published accounts. So it is possible that I took what MAS5 may have said about changes to its costs of funds at face value, and it appears from that earlier decision that the arguments advanced in that case differed from the arguments advanced in this one. It may be that if I were to consider that case again, in the way I have considered this one, I would reach a different outcome. I do not know.

But I'm satisfied that I am not required as a matter of binding precedent to reach the same outcome as I did in the previous case, and that I can reach a different outcome provided the evidence in this case rationally entitles me to reach the outcome I have reached and that is the fair and reasonable thing in all the circumstances. I have given careful consideration to all the evidence and all the circumstances of this complaint and I am satisfied that I have reached an outcome which I consider to be fair and reasonable in all the circumstances of this case. I do not think that the existence of the previous cases prevents me from reaching that outcome.

More recent changes to the SVR

MAS5 says it's relevant to take into account that since the Bank of England started increasing base rate in late 2021, it has not reflected the full extent of those increases in changes to its SVR. It says that as a result while the SVR has increased, the margin between the SVR and base rate has reduced to 3.88%.

I have taken this into account, but ultimately I don't think it alters my overall opinion of what is fair and reasonable in all the circumstances of the case. The more recent changes to base rate and the SVR fall outside the period covered by this complaint and so I have not reached any conclusions on the fairness or otherwise of those increases in themselves. I don't think actions MAS5 has taken since late 2021 have any particular bearing on the lawfulness of actions it took prior to that date, or the fairness of interest charged in the period covered by this complaint. And if reducing the interest charged to Mrs A as a result of this complaint impacts whether the interest rate going forward reflects more recent changes to MAS5's cost of funds, that is something it potentially has the contractual power to rectify. But it is not a reason to withhold or reduce redress for the period covered by this complaint.

Mrs A's personal circumstances

When MAS5 increased the SVR, and indeed when the SVR remained at 5.75% after 31 October 2012, I am conscious that Mrs A was in a difficult position because, due to stricter rules, she could not move her mortgage to a different lender (and MAS5 was not a lender offering new interest rates). The fact that she did not necessarily remain on the SVR out of choice means that it was paramount that MAS5 treated her fairly in accordance with the FCA's principles for business.

It does not follow that MAS5 had an obligation to reduce her interest rate, or charge her less than it would otherwise have done, merely because she was unable to move her mortgage elsewhere. But given she lacked the choice to move elsewhere and mitigate any impact, decisions MAS5 made would have a particular impact on her and therefore it had a particular obligation to ensure fair treatment.

But it's also important to note that Mrs A's mortgage has never been in arrears. And while I don't have details about her financial situation as far back as 2012, when MAS5 looked at this following the end of the term in 2016 it found that she had a surplus of income over expenditure and could have made overpayments had she chosen to do so. I don't think there's evidence that Mrs A was ever in financial difficulties such that she was unable to maintain her mortgage payments, or that the interest rate she was charged was unaffordable for her. Her representative says that because the SVR was higher than it should have been that prevented her reducing the capital through overpayments. But I don't think that's the case given the evidence that she could have afforded to make overpayments after 2016 but chose not to do so.

My conclusion on what's fair and reasonable in all the circumstances

I've reminded myself again that I am only considering the fairness – in all the circumstances – of the interest charged to Mrs A since 31 October 2012.

I think it is reasonable to take into account the earlier variations as part of all the circumstances. The SVR charged on 31 October 2012 was not set from scratch on that day; it was the sum of the parts of what had gone before. And it was at the level it was, in part, because of the increases between 2009 and 2012.

I've concluded on the evidence provided to me that MAS5 was not permitted to increase the SVR in the way it did, for the reasons it did, at those times. And therefore that, on a strict reading of the contract, MAS5 could not rely on those increases in charging the SVR that resulted from 31 October 2012 onwards. That's relevant law, and I've taken it into account.

But I do think, for the same reasons as I gave in my provisional decision, that it's reasonable to take the wider context into account too.

I'm satisfied that there were broader circumstances beyond the strict application of the contract which were relevant to what happened in 2009. The restrictive covenant – agreed between GMAC and MAS5 before the global financial crisis but applying during it – meant that because of its contractual obligations to GMAC (entirely separately to its obligations to Mrs A), MAS5 was obliged to reduce its SVR at the same time and to the same extent that the Bank of England base rate reduced. I'm aware from my knowledge of the mortgage market and of other complaints that this was highly unusual. Most other lenders also reduced their SVRs (or equivalent rates) around this time – but not to the same degree that base rate fell. Prior to the global financial crisis (when the covenant was entered into), a margin of around 2% between base rate and SVRs was not unusual in the mortgage market. By 2009 that was no longer the case. That couldn't have been foreseen by MAS5 or GMAC when the covenant was entered into.

The effect of the 2009 increases was to bring the SVR to a level it would likely have been but for the restrictive covenant. Mrs A benefitted from that reduction between reversion and the second increase in October 2009 – but it wasn't something she was entitled to and it doesn't follow that she can reasonably expect to continue to benefit from it in the same way.

Taking a step back and looking at things in the round, I think the SVR was artificially low by reason of the restrictive covenant. And even if there wasn't a direct linkage with an increase in cost of funds at the time of the increases in 2009, it's likely that the SVR had reduced further and faster compared to reductions in cost of funds in the years since 2007 than it would have done but for the covenant.

Mrs A would not have benefitted from that covenant had her mortgage stayed with GMAC, as it was not something she was contractually entitled to. I think that directing MAS5 to treat the mortgage as if the 2009 increases had never happened would risk over-compensating Mrs A during the period in question.

I've also borne in mind that the MAS5 book did include a significant element of higher risk lending – and while this is a complaint about Mrs A's mortgage alone, that's a relevant consideration because SVRs are not set individually – and while it's possible the increase in arrears was driven by the 2009 SVR increase rather than the other way round, it's not unreasonable that the level of the interest rate takes into account the risks presented by the mortgage book. The 2009 increases moved the SVR to the same level as similar firms within the group – it having been much lower before that because of the covenant.

It's also relevant to note that the 2009 increases were more than three years before the period I can consider – and their direct causative effect lessens over time as other circumstances influence the choices MAS5 did and didn't make (and things it might have done instead).

And I think it's also fair to take into account that were I to require MAS5 to reduce the interest rate charged to Mrs A after 31 October 2012 by the amount of the 2009 increases as well as the 2011 and 2012 increases, that would have the effect of reducing the interest rate to a level which is significantly lower than might otherwise be expected from a closed book lender with a relatively high volume of interest only mortgages, as well as other higher risk lending. As I've said above, I think this is a useful 'sense check' when deciding what is fair and reasonable.

Balanced against that I note that Mrs A had no option but to pay the SVR – she couldn't move her mortgage elsewhere – which means MAS5 had a particular obligation not to take advantage of her position. But I also note that the SVR was not unaffordable for her even before any redress I award – and, indeed, that by 2017 if not before she was in a position to make substantial overpayments if she chose to (as I explain in more detail below).

Taking everything into account, I do not intend to require MAS5 to reduce the level of interest charged to Mrs A after 31 October 2012 as if the 1.51% increases in 2009 had never happened. Given the broader circumstances in which those increases happened and the distance between 2009 and the period I can consider, I'm not persuaded that doing so would be fair and reasonable in all the circumstances. To do so would amount to over-compensation.

However, I do think it would be fair and reasonable to require MAS5 to reduce the rate charged to Mrs A by 1.25% since 31 October 2012. This reflects the SVR increases in 2011 and 2012, to which I don't think the same considerations apply. Again, there was no contractual justification for these increases, and I am therefore satisfied that from a legal perspective they may be of no effect, or could otherwise be a breach of contract. They are much closer in time to the period I can consider.

I have considered the effect of the increases MAS5 made in 2011 and 2012 in the same way as the effect of the increases in 2009, though having done so I have come to a different conclusion about what is fair and reasonable because the circumstances are different.

As I've said, I don't think the 2011 and 2012 increases were contractually permitted and so as a starting point it wouldn't be appropriate for the interest rate charged from 31 October 2012 onwards – as the sum of past variations – to be set at a level that incorporated those increases. But, as required by our rules and as with the 2009 increases I've then gone on to think about whether there are any other factors – in addition to relevant law – which mean that it would not be fair and reasonable to require MAS5 to reduce the interest rate from 31 October 2012 as if those changes had not happened.

By the time of the 2011 and 2012 increases, the wider circumstances were different. The SVR was not lower than it would otherwise have been, since the effect of the restrictive covenant had been corrected for in 2009. There were no changes to the Bank of England base rate, or to SVRs in the market generally or among comparable lenders. While the group appears to have experienced increased funding costs at this time, as I've set out above MAS5 was insulated from those pressures by the structure the group had chosen to adopt. Unlike 2009, there's no evidence that the SVR was artificially low or out of line with that of other lenders (including – as the 2011 board paper showed – comparable lenders with higher risk loans), or that Mrs A was by then being charged an SVR that was lower than it would have been had something such as the covenant not limited MAS5's room for manoeuvre further than the contractual constraints did. And the 2011 and 2012 increases were much closer in time to, and therefore of stronger direct causative effect on, the interest rate charged from 31 October 2012.

Board papers from the time note the group faced "pressure on income", but I've found the group had not structured itself in a way that led to those pressures being passed on to MAS5, such that MAS5 did not experience changes in its cost of funding its own mortgage lending business. I think there is a sense in which MAS5 considers I should take the wider group structure into account, on the basis that the group of which MAS5 was a part did face increased funding costs and there was something artificial about the structure it adopted which meant those increases were not passed on to MAS5. I understand that MAS5 considers that this is relevant to whether it would be fair and reasonable to require MAS5 to absorb the cost of reimbursing Mrs A when it is part of a group that did face increased funding costs and which could have structured itself on an alternative basis whereby MAS5 would itself have faced those increased costs.

I have considered that. But ultimately, I don't think it would be fair not to direct that MAS5 pays Mrs A redress because the costs of a different company – not MAS5 – increased. I'm not satisfied that the fact that the group might have structured itself differently significantly impacts on this conclusion, given that the choice of structure and group funding arrangements is a complex, multi-factored matter where any of the options the group did or did not choose would be likely to have their own advantages and disadvantages. The group had its reasons for adopting the structure it did, which I consider are likely to have been beneficial to it in some way. I don't think it would be fair and reasonable for MAS5 to take the benefits it obtained from that structure as well as the benefit it could have obtained (in the sense of the ability to legitimately change the SVR relying on condition 3.1 (b)) had it not structured the group in that way – to have its cake and eat it.

I think what's important is that I consider what is fair and reasonable in all the circumstances as they are, not in all the circumstances of some hypothetical counterfactual situation. The circumstances actually were that MAS5 did not face changes to its cost of funding its mortgage lending business.

It follows that I don't think it was fair and reasonable to charge Mrs A an interest rate that was 1.25% higher than it would have been after 31 October 2012 had the 2011 and 2012 increases not happened, and so MAS5 should refund the additional interest charged accordingly.

<u>The complaint about actions since the end of the term</u>

In dealing with this part of the complaint in my provisional decision, I said:

> *The term of Mrs A's mortgage expired in late 2016, at which point the capital of around £130,000 was due to be repaid.*
>
> *At that time, MAS5 said it would consider a one year term extension, provided Mrs A had a strategy to repay the balance at the end of that time. Alternatively, it would*

consider converting the mortgage to repayment and granting an extension for a maximum of five years on those terms.

In 2017, Mrs A had an estate agent's appraisal carried out, which estimated that the property was worth £120,000. When she originally took the mortgage out, Mrs A said the repayment strategy was sale of the property. But she said this was no longer possible – because the property was in negative equity, and because her husband lived in it and having to move would have a serious impact on his health.

In 2018, MAS5 looked at Mrs A's income and expenditure and noted that she had disposable income (after other commitments) of around £11,000 per year. It asked her to consider making overpayments to reduce the mortgage balance, but Mrs A didn't feel able to do so.

Following a further review of her income and expenditure in 2019, MAS5 asked Mrs A to make overpayments of around £400 per month. Mrs A offered to pay an additional £200 per month and asked MAS5 to agree a term extension for five years – she said this would allow her to reduce the balance and then either sell the property or switch to a lifetime mortgage.

MAS5 didn't agree to this proposal. It said the mortgage was now over two years past the end of the term and while it would consider short term forbearance, it needed to find a solution for the mortgage to be repaid within a reasonable time. And Mrs A did not go on to make overpayments on a voluntary basis outside a formal agreement either.

In June 2019, MAS5 went to court and obtained a possession order. Mrs A then offered to pay an additional £500 per month alongside a term extension. Again, MAS5 didn't agree to a term extension. And again Mrs A did not in fact make any overpayments.

In December 2019, MAS5 sent a field agent to visit the property. He noted that the property was on the market with an asking price of £160,000 but had not sold. Mrs A was unable to provide updated income and expenditure information.

Mrs A took a three month coronavirus payment deferral in 2020, and then resumed making payment.

Throughout this time, Mrs A has only made the monthly interest payments – despite proposing to make overpayments several times, she has not in fact done so. Both parties have recently confirmed to us that this remains the case. And although MAS5 obtained a possession order in 2019, it has not taken steps to enforce the order pending the outcome of this complaint.

In considering this part of the complaint, I take as my starting point the fact that, in taking out this interest only mortgage, Mrs A agreed to repay the capital in 2016. And, all other things being equal, it's reasonable to expect her to have done so.

However, if she reached the end of the term and found herself unable to do so, I would expect MAS5 to look fairly at her circumstances, show appropriate forbearance and try to work with Mrs A to find a way for the mortgage to be repaid. Repossession of the property should always be a last resort. But forbearance does not mean that MAS5 cannot collect the outstanding balance, or must wait indefinitely for it to be repaid. Forbearance means working with Mrs A to find a way for it to be repaid without the need for repossession. And there may come a point where, if *there's no prospect of the mortgage being repaid within a reasonable time, repossession becomes a reasonable step for it to take.*

In saying that, I've taken into account the FCA's rules and guidance, including the guidance on Dealing Fairly with Interest-Only Mortgage Customers Who Risk Being Unable to Repay Their Loan[6], as well as its later Thematic Review, The Fair Treatment of Existing Interest-Only Mortgage Customers.[7] I've also taken into account MCOB 13, which, as the guidance points out, does not strictly apply in this situation since an outstanding capital balance does not constitute arrears or a payment shortfall – but which nevertheless represents good practice in the collection of sums due.[8] And MCOB 13 does apply to any repossession action.

Mrs A said that she found herself in this position because of the global financial crisis. Following the crisis her property fell in value and never recovered, which restricted her ability to sell or refinance. And it meant that she found herself trapped and paying a high interest rate with MAS5, restricting her ability to make overpayments to reduce the capital. She blames, in part, MAS5 and GMAC for her situation – as, she believes, contributors to the causes of the financial crisis, and as the firm that has charged her such a high rate.

I don't think I can make the sort of broad findings about the impact of the financial crisis, and any part MAS5 or its parent company might or might not have played, of the sort that Mrs A has raised. The global financial crisis was an exceptional event with a range of complex causes. It's not possible to identify any causative link between MAS5's actions and the price of Mrs A's property. It's very unfortunate that following the crisis Mrs A's property fell into negative equity, but that's not something I can hold MAS5 responsible for.

I've already found that there was no unfairness in the fact that Mrs A was on the SVR or in MAS5 not offering her a new interest rate. I have found that the level of the SVR was unfairly high from 31 October 2012 onwards – in that I don't think it was fair for MAS5 to rely on the 1.25% increase from 2011 and 2012 as part of the rate that it charged her over this period.

Had those increases not formed part of the rate Mrs A was charged from 31 October 2012, her monthly payment would have reduced. On a balance of £131,000, an extra 1.25% on the interest rate approximates to an extra £135 on each monthly payment.

But I'm not persuaded this was the reason Mrs A didn't make overpayments to reduce the capital. According to the income and expenditure information she gave MAS5 in 2018, Mrs A had almost £1,000 per month in disposable income after meeting all her expenditure. In 2019, MAS5 calculated that Mrs A could afford to pay just over £400 per month on top of her regular monthly payment – and later that year she offered to pay an extra £500 per month.

This was in addition to the higher monthly payment MAS5 charged her at the time – not the lower monthly payment as I have found it ought to have been. So even after paying £135 more than she fairly ought to have done, it seems Mrs A had the resources to make further overpayments had she chosen to do so.

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[6] FG13/7, Financial Conduct Authority, 2013 - https://www.fca.org.uk/publication/finalised-guidance/fg13-07.pdf
[7] TR18/1, Financial Conduct Authority, 2018 https://www.fca.org.uk/publication/thematic-reviews/tr18-1.pdf
[8] See for example para 4.4 of the 2013 guidance

Given what I understand of the nature of her occupation as a long term professional landlord, I think it's unlikely that those figures represent a sudden increase in her financial resources from 2018. I think it's more likely that even before 2018, during the term of the mortgage, Mrs A was in a position to have made regular overpayments to reduce the mortgage balance had she wanted to do so. And as she was on the SVR, there was no early repayment charge or other barrier preventing her making overpayments at any time. Such overpayments, had she made them, might not have resulted in the capital balance being paid off altogether – but might well have lifted the property out of negative equity.

I'm satisfied that Mrs A wasn't prevented from reducing her mortgage balance over the years because of the interest rate she was charged by MAS5. And I'm satisfied that my findings that the interest rate was unfairly high from 31 October 2012 are not the cause of Mrs A's inability to repay the capital at the end of the term.

Notwithstanding that higher rate, Mrs A was in a position to make regular overpayments to reduce the balance. However, she has not at any time done so – despite knowing when the term would end, and despite making several offers to do so since the end of the term. It's now over six years since the term ended, and the balance remains at the same level as when Mrs A first took the mortgage out.

Mrs A says the property was in negative equity at the end of the term, and therefore she was unable to sell it and repay the capital that way. The mortgage balance was £131,000, and Mrs A said the property was worth £120,000 in 2017 – this was supported by an estate agent's appraisal (though not a formal valuation). In 2019 Mrs A marketed the property for £160,000 – this was rather more than the mortgage balance, and though the property didn't sell at that time it may well no longer have been in negative equity by then.

I've not seen evidence of a more recent valuation, though the Nationwide House Price Index suggests it might now be worth around £220,000. On the evidence available to me, it seems more likely than not that the property is not currently in negative equity. When Mrs A applied for the mortgage in 2006 she indicated on the application form that she intended to repay it by selling the property – and there is currently sufficient equity in the property for her to do so.

I'm satisfied that for over two years after the end of the term, MAS5 tried to work with Mrs A to find a solution. Mrs A wanted it to consider a term extension of at least five years, with monthly overpayments during that time. MAS5 didn't agree to an extension, and I don't think that's unreasonable. I'll explain why.

As I say, the starting point is that the mortgage needs to be repaid, and MAS5 is entitled to expect that. Mrs A didn't have a proposal for repaying the capital at the end of any extended term – there was, for example, no investment due to mature at that time.

The level of overpayments discussed in 2018 and 2019 would have reduced the balance by around £20,000 to £30,000 over a five year extension – but that would still leave a balance of over £100,000 to repay. It's unlikely Mrs A would have been able to re-finance that amount – whether by conventional mortgage or equity release – given her age and the loan to value.

This means that at the end of any extended term she would be in the same position as in 2016, 2018 and 2019; with a substantial capital balance and no means of repaying it other than selling her property.

If the only option to repay the mortgage is the sale of the property, then I don't think it's unreasonable to conclude that it would be better to do that sooner rather than later. Mrs A says that Mr A is living in the property and is in poor health – but that would still be the case five years later, and at that time he would be five years older and possibly in poorer health.

So while from that point of view selling the property in 2017 or 2018 might not have been what Mrs A wanted, and was a difficult thing to do, I think the reality is that hard as it might have been then it would only be harder five years later.

With that in mind, I'm not persuaded that a term extension of five years or more would have been in Mrs A's – or Mr A's – best interests; it was more likely to make a bad situation worse.

Therefore, given that MAS5 was entitled to expect the mortgage to be repaid, and given that extended forbearance in the form of a term extension wouldn't resolve the problem – and risked making it worse – I think it was fair that it didn't agree to a term extension.

I think it's also reasonable to be concerned about how practical this proposal was in any event. Although Mrs A's income and expenditure showed she could afford to make overpayments, and she offered to do so once MAS5 took repossession proceedings, I note she was reluctant to do so in 2018, and she hasn't in fact done so since. And so, with the benefit of that hindsight, there's a risk that even if MAS5 had agreed to a term extension Mrs A wouldn't have made the overpayments she proposed. It's now 2023, and MAS5 hasn't taken any action to recover the capital while this complaint continues. Mrs A has therefore had five further years since 2018 to overpay or make other arrangements to repay, but hasn't done so – despite saying that was her plan at the time.

In any case, I'm not persuaded that Mrs A was in reality as short of options as has been suggested, even in 2016. While it seems she didn't have the capital to repay the mortgage in readily accessible savings, she is a professional landlord who owns at least 15 other properties, in addition to the two properties she and Mr A live in.

Mrs A says that her property portfolio was overall in negative equity, for the same reasons as this property was. I haven't seen evidence of that – and even if the portfolio as a whole in negative equity, that might not be true of individual properties. So it's possible that Mrs A could have repaid this mortgage by selling some of her other property rather than this property.

And even if that wouldn't raise sufficient funds to repay this mortgage, the existence of Mrs A's wider portfolio does in my view make it easier to repay this mortgage by selling this property.

I've taken into account what Mrs A has said about Mr A's health (though I don't have any medical evidence, I've no reason to doubt what she says). He's not a party to this mortgage, however, and so MAS5 doesn't owe him any obligations as its customer – though I'd expect it to take into account the potential impact of any action it might take on him as a resident of the property.

But while I understand he has a heart condition, and needs to avoid stress where possible, that doesn't mean a planned house move is impossible if managed carefully. As they do not regard themselves as separated, it's not clear to me why Mr A and Mrs A each require a house of their own to live in. And even if they cannot *live in the same house, Mrs A has a substantial number of other properties Mr A could move to, enabling this one to be sold. I also bear in mind that the mortgage will need to be repaid at some point – and if selling this property is the only means of doing so any impact on Mr A is likely to be worsened by further delay.*

So I think it would also have been possible for Mrs A to consider selling this property at the end of the term. That was the plan she gave when she took out the mortgage. The property may have been in negative equity by that point – but MAS5 may still have considered a sale followed by a shortfall agreement. By 2018 or 2019, in any case, it was not in negative equity.

Given the availability of other properties, I don't think Mr A's residence in the property – even taking into account his health – meant that it was unfair for MAS5 to expect Mrs A to sell if she had no other way of repaying. Further delay would not have solved the underlying issue – the mortgage would always need to be repaid at some point. And further delay risked making the situation worse. It's not reasonable to expect MAS5 to agree to an indefinite delay in repayment.

The regulator's guidance which I've cited above sets out examples of potential options for firms to consider when a capital balance cannot be repaid. These include:

- *Switching to repayment terms*
- *Extending the term, including a switch to full or part repayment terms*
- *Extending the term to provide more time to repay the capital or sell the property*
- *Accepting overpayments to reduce the balance*
- *Part redemption alongside any of the above*
- *Extending the term on an interest only basis*
- *Any combination of the above*

Although the guidance points out these are examples and not an exhaustive list, these are the principal options open to a lender in a case like this.

In this case, MAS5 offered to consider converting the mortgage to repayment terms, but Mrs A didn't want to consider that as she didn't think the monthly payments would be affordable. She offered to make overpayments, but then didn't do so. And while the term could have been extended on interest only terms, there would still need to be a means of repaying the capital at the end of any extended term.

As I've already explained, there wasn't going to be any means of repaying the capital at the end of any extended term which wasn't already available to Mrs A when the term ended in 2016, or when she was in discussion with MAS5 in 2018 and 2019. And a term extension going beyond initial forbearance to give her time to find a way to repay or sell the property was likely to make her and Mr A's situation worse in the long term.

For all those reasons, I'm satisfied that it was fair and reasonable in all the circumstances for MAS5 to expect Mrs A to repay her interest only mortgage.

MAS5 showed reasonable forbearance for over two years, trying to work with Mrs A to find a solution that would allow the mortgage to be repaid within a reasonable time. But when that wasn't possible, MAS5 started repossession action to recover the balance in 2019.

I note the court granted a possession order, but with a six month delay before it could be enforced to give Mrs A further time to find a solution, including by selling the property. She did then put the property on the market – albeit at a much higher price than it had been valued at two years earlier – but was unable to sell.

I don't think it was unfair for MAS5 to have taken court action when it did. By then the term had ended more than two years previously and no solution had been found. Mrs A was still unable to repay the capital and hadn't taken steps to do so, such as marketing this or another of her properties or making overpayments.

I think it was reasonable for MAS5 to conclude that it had offered reasonable forbearance to allow her to find a solution without success and that taking court action was an appropriate next step. It had given Mrs A enough time to find other options and the longer the mortgage went unpaid, the worse the situation was likely to be when action was taken. In all the circumstances I don't think MAS5 acted unfairly here, and so I don't uphold this part of the complaint.

The mortgage remains outstanding, and once this complaint is concluded MAS5 will want to resume recovery action. It has a possession order in place, but will need to go back to court to enforce it. Acting fairly and reasonably, it should engage with Mrs A first to see if she is now in a position to repay the capital balance. Mrs A will need to work constructively with MAS5 and find a way forward. But ultimately if the mortgage balance remains unpaid MAS5 will be entitled to take action to recover it.

Mrs A didn't agree with my conclusions on this part of the complaint. Her representative said:

- Mrs A would have paid off more of the capital had she been charged a fair rate of interest. This would also have meant she would no longer have been in negative equity and could have remortgaged.
- It is not true to say that Mrs A has not made overpayments – she has, because she has been overcharged interest.
- MAS5 has not exhausted all other options – MAS5 has refused to engage with her.
- Mrs A has made a reasonable request for a term extension and to make overpayments, which MAS5 should have agreed to.
- MAS5 should not have taken repossession action and should refund all fees it has charged in connection with the action. It refused to put the repossession action on hold even though Mrs A had brought this complaint.
- Mrs A believes that being required to move house risks severe consequences for Mr A and it's not appropriate for me to conclude otherwise as I have no medical training.
- More recently, MAS5 has given Mrs A an "open-ended informal extension" which should be allowed to continue. At the very least she should be given 18 months after the conclusion of this complaint to seek advice and consider her options.

I've considered what has been said. But I haven't changed my mind about this part of the complaint. No new arguments have been presented, and I've already explained that I'm satisfied that MAS5 did try to explore options with Mrs A and that she agreed to make overpayments and then didn't do so. For the reasons I explained, I don't think it's unreasonable that MAS5 wasn't willing to agree to a further term extension, and Mrs A didn't want to consider converting the mortgage to repayment terms.

While I don't underestimate Mr A's health condition, he isn't a party either to the mortgage or this complaint and I haven't seen any medical evidence as to his condition or the impact of this situation on it. I don't think there's any basis on which I can reasonably conclude that MAS5 is not entitled to repayment of the mortgage because Mr A is living in this property rather than one of Mrs A's other properties.

In 2020, MAS5 agreed to an "open-ended informal extension" for Mrs A to seek financial advice and consider her options. I understand from her representative that she has not yet done so, preferring to wait for the outcome of this complaint.

Once the complaint is concluded, MAS5 will continue to have obligations to treat Mrs A fairly, give fair consideration to any proposals for repaying the mortgage she might make, and treat repossession as a last resort. I'm satisfied that is what it did in the period before this complaint, as I've set out above, and I'm not going to make any specific directions about a term extension for a set period now. It will be for Mrs A to engage with MAS5 and explain how she proposed to repay the mortgage, and for MAS5 to consider what she says before deciding what further action it will take.

Putting things right

In my provisional decision, I said:

> *In my view the fair way to resolve this complaint is for MAS5 to re-calculate Mrs A's mortgage as if the interest rate charged was 1.25% lower than it actually was from 31 October 2012 onwards. And while the mortgage remains outstanding, it should reduce the rate charged to Mrs A by 1.25% going forwards – though that does not stop MAS5 fairly and lawfully exercising its contractual rights to vary the interest rate in the future if the terms and conditions allowing it to do so are satisfied.*
>
> *This will result in Mrs A having made overpayments since 31 October 2012. Working through the mortgage month by month from that date, MAS5 should take the following approach:*
>
> - *Each monthly overpayment should be put towards any arrears outstanding at that date, and the mortgage balance and interest charged amended accordingly. My understanding is that in Mrs A's case the mortgage has never in fact been in arrears, though I include this part for completeness.*
>
> - *If there were no arrears, MAS5 should treat each monthly overpayment as a capital overpayment to the mortgage balance, and reduce the balance accordingly from that month forwards.*
>
> - *For the following month, it should re-calculate the monthly payment based on the lower balance, and apply the additional payment for that month as a further overpayment to the mortgage balance, reducing the balance carried forward accordingly.*
>
> - *It should continue this calculation, month by month, from 31 October 2012 to*

now.

- *It should then write to Mrs A, telling her the revised outstanding balance and the revised monthly payment she will need to make – based on the reduced balance and reduced interest rate – until such time as the remaining capital is repaid.*

I'm satisfied that it's fair to take this approach, rather than asking MAS5 to refund the payments direct to Mrs A, since the mortgage is now out of term and needs to be repaid. And therefore the redress for this complaint should be used for the purpose of reducing the capital balance outstanding.

Finally, I've considered whether Mrs A is also entitled to some compensation for non-financial loss – for the stress and upset of having to make higher monthly payments than she otherwise ought to have done over several years.

I've thought about this carefully. I accept that Mrs A has paid more than she needed to do – but nevertheless she has been able to keep up with the payments asked of her and has, as far as I am aware, never fallen into arrears. Nor have I seen any evidence that making the required payments caused her any financial difficulty – she had a substantial surplus of income over expenditure when MAS5 assessed this in 2017 and 2018, for example.

Mrs A says that having to pay more interest deprived her of the chance to reduce the mortgage balance by making overpayments. As I said above I'm not persuaded by this, since she had a substantial surplus in 2017 and 2018, and offered to overpay by £500 per month in 2019, but never in fact did make any overpayments.

In any case, my proposed redress puts Mrs A back in that position – it will result in her having been treated as having made regular overpayments for ten years since 31 October 2012, with a significant reduction in her mortgage balance as a consequence. My proposed redress therefore puts right the impact of not having made overpayments at the time – to the extent not doing so was caused by the higher interest rate.

I do think Mrs A has been caused some upset by this complaint, and her belief that she has been overcharged over the years – which I have found is, to some extent, likely to have been the case. But I'm not persuaded the financial impact of it on her and her circumstances was substantial, in that it didn't cause financial difficulty and wasn't a major factor in her not making overpayments to reduce the balance. Taking all that into account, I think £250 compensation is fair in all the circumstances. This sum should be paid to Mrs A direct rather than applied to the mortgage balance (unless she asks MAS5 to use it in that way).

MAS5 did not agree it would be fair to reduce the interest rate charged to Mrs A by 1.25%. It said I had noted this would bring the interest rate down to one in line with the market average SVR – but MAS5's mortgages are not average mortgages, they are high risk and priced accordingly. It also said that it had not passed on more recent increases in Bank of England base rate, between December 2021 and January 2023, in full – with the result that the difference between the SVR and base rate had already reduced from 5.25% to 3.88% by May 2023. It said that even if I were to uphold the complaint, any remedy should be reduced to account for the benefit this has given to customers.

Mrs A did not agree either. She did not agree that it was fair and reasonable only to reduce the interest rate by 1.25%, rather than the 3.01% that would also include the impact of the

2009 increases. Her representative said that she has suffered detriment now for many years and that MAS5 took advantage of her being trapped with them and unable to re-mortgage elsewhere. Despite knowing of Mr A's vulnerabilities it took enforcement action in 2019 – which could have had very serious consequences, and did result in him being admitted to hospital. The representative also said that compensation of up to £5,000 would be more appropriate than the £250 I had proposed to award.

I've considered the arguments both parties have made, but I haven't changed my mind about the fair way to put matters right. I've already explained why I don't think it would be fair and reasonable to reduce the interest rate Mrs A paid from 31 October 2012 by the amount of the 2009 variations. So I don't intend to require MAS5 to reduce the interest rate by more than 1.25%.

I've also already considered above MAS5's argument about the credit risk its mortgages present. I don't intend to repeat what I've said. Given that I've found that it was not fair and reasonable to charge Mrs A an interest rate that reflected increases of 1.25% in the SVR after 31 October 2012, notwithstanding the arguments on credit risk, I don't think it would be reasonable to refuse to award redress based on the same arguments I've already said don't persuade me it was reasonable to charge that element of the rate in the first place.

I note that MAS5 has not passed on all the increases in base rate since late 2021. But that post-dates the period of this complaint and is not a factor that I consider should alter any redress I award.

Finally, I turn to my proposed award for distress and inconvenience. I've taken into account what Mrs A's representative says. But I can't make an award for anything experienced by Mr A, since he is not a party to this complaint. And much of what is said about the distress Mrs A has experienced relates to the actions MAS5 took following the end of the term – but I haven't upheld that part of the complaint. If MAS5 acted fairly and reasonably at that time, as I've found it did, I can't award Mrs A compensation for the upset those actions caused.

The only part of this complaint I have upheld is that MAS5 unfairly charged 1.25% more interest than it should have done after 31 October 2012. Mrs A is very exercised about the fairness of her interest rate, and it undoubtedly had some impact on her. But it did not make the mortgage unaffordable, it was not what prevented her moving the mortgage elsewhere (given she was in negative equity anyway), and – judging by her finances from 2017 onwards which I don't think had significantly changed from before that – it didn't prevent her making overpayments had she wanted to do so. I'm still satisfied that £250 is fair compensation in all the circumstances.

My final decision

For the reasons I've given, my final decision is that I uphold this complaint and direct Mortgage Agency Services Number Five Limited (MAS5) to re-work Mrs A's mortgage by reducing the interest rate it charged her from time to time by 1.25% with effect from 31 October 2012. In doing so, it should take the following approach:

- It should calculate what Mrs A's monthly payments would have been from 31 October 2012 had the interest rate from time to time been 1.25% lower, and compare that with what she actually paid. This means she will have made overpayments each month.

- MAS5 should treat each monthly overpayment as a capital overpayment to the mortgage balance and reduce the balance accordingly from that month forwards. It is fair and reasonable to use the overpayments to reduce the capital balance rather than refund them to Mrs A because the mortgage term has expired and the entire capital is now due.

- For the following month, it should re-calculate the monthly payment based on the lower balance and apply the additional payment for that month as a further overpayment to the mortgage balance, reducing the balance carried forward accordingly.

- It should continue this calculation, month by month, from 31 October 2012 to now, resulting in a reduced current mortgage balance.

- It should reduce the interest rate going forwards, until the mortgage is repaid, by 1.25%, and then re-calculate Mrs A's contractual monthly payment based on the revised balance and reduced interest rate.

- It should then write to Mrs A, telling her the revised outstanding balance and the revised monthly payment she will need to make until such time as the remaining capital is repaid.

- It should also pay Mrs A £250 compensation. This should be paid to Mrs A direct unless she asks MAS5 to apply it to the mortgage balance.

Nothing in this decision prevents MAS5 from exercising its rights under the terms and conditions to vary the interest rate in the future.

Under the rules of the Financial Ombudsman Service, I'm required to ask Mrs A to accept or reject my decision before 4 December 2023.

Simon Pugh
Ombudsman