DRN-5624461

The complaint

Miss C and Mr W complain that Lesley, Stephen & Co. Limited (LSC) irresponsibly lent them a third charge mortgage.

What happened

Miss C and Mr W bought their property in 2018, with the aid of a standard first charge mortgage and a help to buy shared equity loan secured as a second charge. They borrowed around £219,000 on the mortgage and around £70,000 on the help to buy loan.

In 2019, Miss C and Mr W took out a secured loan with LSC. This loan was secured by way of a third charge over their property, ranking behind the main mortgage and the help to buy loan. They borrowed £34,450 over a 20 year term, with an initial fixed rate of 15% for the first five years and monthly payments of around £522. The purpose of the borrowing was to consolidate other unsecured debts.

Miss C and Mr W now complain that LSC shouldn't have lent to them. They say, in summary, that:

- They've now discovered that taking out a third charge loan was a breach of the terms and conditions of their help to buy loan. LSC ought to have known that and ensured they got consent from the help to buy lender. They're now worried about the consequences of being in breach.

- The loan payments are unaffordable for them and have put them under significant financial strain, especially now they are required to pay interest on the help to buy loan. They're concerned their home is at risk as a result. LSC should have taken into account the requirement to make payments to the help to buy loan.

LSC said an independent broker recommended the loan and it didn't give Miss C and Mr W any advice. They chose to accept the broker's recommendation. It said it was up to Miss C and Mr W to make sure they were complying with the terms of their help to buy loan. It said it reviewed the documentation they provided and was not aware of any issues, or any obligation to make regular payments to the help to buy loan – so it could not have taken that into account. It said that the loan improved their financial situation by consolidating their unsecured debts, reducing their outgoings. When LSC spoke with them before the loan completed, they said they understood the loan and the monthly payments and that the payments were affordable and would save them £600 per month. Payments were made to their creditors and the loan achieved its purpose. It meant Miss C and Mr W were substantially better off each month – the loan solved their existing financial difficulties.

Our investigator didn't think that LSC had lent responsibly. She said it hadn't fairly taken into account the impact of future interest rate rises on Miss C and Mr W's main mortgage – known as stress testing – and hadn't taken into account the payments they would have to make to the help to buy loan at all. She said that if LSC had properly considered those factors, it would have found the loan to be unaffordable and wouldn't, acting fairly, have lent. She said that it should bring the agreement to an end and re-work the balance, removing

interest and fees and treating all payments as reducing the capital. It should then work with Miss C and Mr W to reach an affordable payment plan for the remaining balance (or refund any overpayments to them). And it should amend their credit files.

LSC didn't accept that. It said it had lent responsibly. It had made sure the loan was affordable based on what Miss C and Mr W had said. The loan met their objectives, allowed them to repay their unsecured debt, and made their financial situation much better. LSC wasn't responsible for them having taken on all that unsecured debt. Miss C and Mr W hadn't said that they were liable to make payments to the help to buy loan, so it couldn't have taken that into account. It was for Miss C and Mr W to make sure they understood their obligations under the help to buy loan, not for LSC.

LSC said it had followed the regulator's rules when carrying out the stress test, and had chosen to do so by adding 10% to the amount of the monthly payments – it said this more than covered the minimum requirement of assuming the interest rate would increase by 1%. The loan was affordable at the outset – as evidenced by the affordability assessment – and remains affordable now, as evidenced by the fact that Miss C and Mr W have kept up with all their payments throughout. The payments on the first charge mortgage have in fact increased by less than the figure LSC used for the stress test.

As no agreement could be reached, the complaint comes to me for a final decision.

What I've decided – and why

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

It's important to separate the roles of the broker who sold this loan and LSC, which lent it. The broker acted as Miss C and Mr W's agent, not LSC's agent, in selling the loan. Whether or not the loan was suitable for Miss C and Mr W, whether or not it met their objectives and was appropriate for their needs and circumstances, and whether or not they understood the loan and how it worked – these are all matters for the broker, not LSC. LSC did not give Miss C and Mr W any advice or make a recommendation.

Miss C and Mr W have complained that LSC shouldn't have lent because the help to buy loan said that further borrowing was not permitted. I'm aware from my knowledge of complaints about help to buy loans that part of the standard terms and conditions applicable to help to buy lending is that further borrowing secured against the property by way of third and subsequent charges is permitted, but only with the consent of the help to buy lender and only in very limited circumstances. So it may well be the case, as Miss C and Mr W say, that by taking this loan they've put themselves in breach of the terms of their help to buy loan.

However, that's not a matter I can hold LSC responsible for. I agree that it was primarily their responsibility to make sure they were complying with the terms of their existing loans before taking another. This may also be relevant to the question of whether this loan was suitable for their needs and circumstances – one of their circumstances being that taking it would put them in breach – but that's a matter for the broker that advised them, not the lender.

As lender, LSC's obligations were to consider the application presented to it and assess whether or not it was responsible to lend. That includes considering whether the loan was affordable and could be repaid.

The rules of mortgage regulation are found in the MCOB section of the Financial Conduct Authority's Handbook. Section 11.6 of MCOB deals with responsible lending. It says that a lender should assess whether the customer will be able to pay the sums due, and not enter

into the loan unless it can demonstrate whether it is affordable. In doing so, it should take full account of income, and of committed, basic essential and basic quality of living expenditure; assess affordability on the basis of repayment of capital and interest over the term; and take account of the impact of likely future interest rate increases on affordability.

The rules say (at MCOB 11.6.14 R) that

> "If a firm is, or should reasonably be aware from information obtained during the application process, that there will, or are likely to, be future changes to the income and expenditure of the customer during the term of the regulated mortgage contract…the firm must take them into account when assessing whether the customer will be able to pay the sums due".

In respect of future interest rate increases (stress testing), the relevant rule is MCOB 11.6.18 R, which said at the time of this lending decision:

> "(1) … in taking account of likely future interest rate increases for the purposes of its assessment of whether the customer will be able to pay the sums due, a mortgage lender must consider the likely future interest rate rises over a minimum period of five years from the expected start of the term of the regulated mortgage contract (or variation), unless the interest rate under the regulated mortgage contract is fixed for a period of five years or more from that time, or for the duration of the regulated mortgage contract (or variation), if less than five years.
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> (2) In coming to a view as to likely future interest rates, a mortgage lender must have regard to:
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> (a) market expectations; and
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> (b) any prevailing Financial Policy Committee recommendation on appropriate interest-rate stress tests;
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> and must be able to justify the basis it uses by reference to (a) and (b).
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> (3) For the purposes of this rule, even if the basis used by the mortgage lender in (2) indicates that interest rates are likely to fall, or to rise by less than 1%, during the first five years of the regulated mortgage contract (or variation), a mortgage lender must assume that interest rates will rise by a minimum of 1% over that period.

MCOB 11.6.18A R says that when carrying out this assessment, a second charge lender must also consider the impact of interest rate rises on any regulated mortgage contract in existence at the time of the assessment and which will remain in existence after the lending. Although this is a third charge mortgage not a second charge mortgage, I think the intention behind this rule applies equally in this case – that in making its lending decision, LSC ought to take account of future interest rate rises on the main mortgage as well as its own lending.

I've borne these rules in mind when thinking about whether LSC fairly considered whether the lending would be affordable for Miss C and Mr W.

LSC verified Miss C and Mr W's income as £3,038 per month. This consisted of Mr W's salary – Miss C was not working at the time. It noted that she received child benefit of £137 per month, but it didn't take that into account because, given the ages of the children, the child benefit would not be payable for the remainder of the term.

I think that was a fair and reasonable approach. The child benefit would not be payable for

the whole term, and therefore it would be a "future change to the income ... of the customer during the term". And the amount received would, in real terms, be less than £137 per month in any case. That's because the application records Mr W's gross income as £52,500 – meaning that 25% of the child benefit Miss C received would be clawed back from Mr W via the higher income child benefit charge. The net figure would be £112 per month.[1]

LSC also verified Miss C and Mr W's expenditure as £1,454 per month, excluding the first charge mortgage, its own loan and the debts to be consolidated. It made no allowance for any payment to the help to buy loan. For the first charge mortgage, it noted that the actual payment at the time was £902 – it added 10% to that by way of stress testing, to give £992. And its own loan was £522 – adding 10%, that gives £574.

LSC therefore concluded that total expenditure, after stress testing, was £3,019 per month. As this was £19 more than income, it concluded the lending was affordable.

However, I'm not persuaded that this was enough to show that the loan was affordable. There are, in my view, two key issues with the approach taken by LSC – not including the help to buy loan, and the level of the stress test. I'll deal with each in turn.

The help to buy loan

Help to buy loans are a form of shared equity loan, designed to help borrowers with purchasing property. The lender is a government agency. It lends a percentage of the purchase price, and the same percentage of the value at the time of redemption must be repaid on redemption. In the meantime, interest is charged on the sum borrowed – but only from the sixth year. For the first five years, help to buy loans are interest free. From year six onwards, interest is payable monthly. The interest rate is 1.75% in year six, increasing by the consumer price index plus 2% per year thereafter.

LSC was aware there was a help to buy loan. It says it's familiar with help to buy loans and how they operate – but it also says that it wasn't aware that interest was payable.

LSC says that the only information it had about the help to buy loan was a copy of a "form of authority to proceed" document. This set out that Miss C and Mr W would be borrowing £70,000, being 20% of the purchase price of their property. The document says that the same percentage of the sale proceeds would be repayable when the property is sold. And it says:

> "FORECAST INTEREST CHARGE YEAR 6: £101.60
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> (This will be collected by the National Homebuy Agent in year 6)"

LSC says that it therefore understood that there would be no ongoing costs associated with the help to buy loan until it was repaid, other than a single one-off fee of £101.60, payable in the sixth year of the agreement. There was no mention of any other payment, either on the application form or in its conversation with Miss C and Mr W. On that basis, it was not aware that there would be any ongoing costs associated with the help to buy loan to be payable by Miss C and Mr W, and no costs were included in the affordability assessment. It says that this was, as far as it understood, a copy of the help to buy agreement. The agreement did not say interest was payable. And therefore it didn't and couldn't have known that interest was chargeable.

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[1] At the time, 1% of child benefit would be clawed back for every £100 of income over £50,000 – gross income of £52,500 therefore means a 25% reduction in child benefit. The full award for two children was £1,790 per year, or £149 per month. Less 25%, that equates to £112 per month.

I'm not persuaded by this. In the first place, I would expect a lender operating in the second charge market to be aware of help to buy loans and how they operate generally. By 2019, a substantial number of people had taken these loans out. It would not have been unusual for a second charge lender to have encountered applications from potential customers with a help to buy loan. I'd therefore have expected LSC, as a responsible lender in the second charge market, to be familiar with the operation of a type of loan a proportion of its customer base had in place before applying to LSC, and to have taken that operation into account in its lending decisions. If LSC had that general understanding of the wider lending market, it would have known that help to buy loans were interest bearing after the first five years.

Secondly, the document LSC refers to, that it saw at the time of the lending decision, is not a copy of the help to buy loan agreement. That's very clear from the document itself and I don't think there's any reasonable basis on which LSC could have thought it was the contract. It's clearly a letter setting out next steps as the loan proceeds to completion.

LSC says it didn't think it needed to make further enquiries because it had seen the loan agreement and the loan agreement didn't say interest was chargeable. But it hadn't seen the loan agreement, and if the reason it didn't enquire further was because it thought it had, I don't think that was a reasonable decision to have made.

Thirdly, the document itself is not silent about interest. As I've quoted above, it says, in capitals, "FORECAST INTEREST CHARGE YEAR 6: £101.60". LSC says it noted this and understood it to mean that Miss C and Mr W might – if the forecast came true – have to pay a single one-off payment of £101.60 in year six of the help to buy term, around four years after the LSC loan completed.

But I don't think that's a reasonable interpretation of what the document says. As an experienced lender familiar with how lending operates, I don't see how LSC could have concluded that the "interest charged" on a long term loan would be more likely to be a single one-off payment rather than a periodic payment. The document doesn't say that interest would be charged monthly from year six – monthly interest is standard for most forms of lending, but if there was doubt about that LSC could have enquired further into what the interest period was. It didn't do that. It assumed – without any reasonable basis for doing so, in my view – that Miss C and Mr W would have to make a single one-off payment of £101.60 in a few years' time, and that the help to buy loan could therefore safely be ignored when considering their future committed expenditure.

In my view, acting fairly and reasonably, I think LSC ought to have noted that Miss C and Mr W had a help to buy loan. It ought therefore to have enquired when interest would start to become payable, how much that interest would be, and considered whether to factor those payments into its affordability assessment as a "future change to the expenditure of the customer … during the term" of the loan. But it didn't do that.

LSC says that Miss C and Mr W didn't tell it that they would have to pay interest. It relied on what they said and had no reason to question it. But I'm not persuaded by that either. Miss C and Mr W weren't paying interest at the time of the application, so it didn't form part of their expenditure. And the mortgage rules say that a lender can rely on the information about expenditure it is given – unless there are common sense reasons for doubting it. In my view, given what I've said above about what I think LSC ought to have known about how help to buy loans operate generally and what the document LSC was given said, there were common sense grounds. LSC should not have assumed that there was no future expenditure on the help to buy loan. To the extent that Miss C and Mr W's application could be understood as saying not just that there were no *current* payments due on the help to buy loan but also that there never would be, there were common sense grounds for doubting that – which should have led LSC, acting fairly, to have made further enquiries.

In its correspondence with the investigator, LSC made much of the distinction between repayment of the capital of the help to buy loan – only due at the end of the term or when the property is sold – and payment of interest. I don't see the relevance of such a distinction. There is an obligation, from year six onwards, to make periodic payments of interest. Those payments form part of Miss C and Mr W's future committed expenditure which LSC, acting fairly, should have known about and taken account of in the affordability assessment.

LSC also says that Miss C and Mr W didn't start to make payments until year six of the help to buy loan – some four years after the lending decision. It says that no doubt their income would have increased in the meantime. That may well be true – but so would their expenditure. The mortgage rules require lenders to take known future changes into account, and LSC didn't do that.

The stress test

LSC says it applied a stress test of 10% to both the first charge and its own mortgage payments as part of the affordability assessment. This does not mean it applied an interest rate of 10% - it means it calculated affordability as if the payments increased by 10%. At the time the payments on the first charge mortgage were £902, so LSC increased that by 10% and used a payment of £991 for the stress test.

I've quoted above the relevant rules for stress testing. LSC says it complied with the rules. It did have regard to the FPC recommendation. Having done so, it decided instead to adopt its own approach of adding 10% to the current payment as being more than sufficient to meet the requirement in the rule of assuming interest rates would rise by 1%.

However, I'm not persuaded that LSC acted fairly here. The FPC's recommendation, at the relevant time, was that lenders should apply a stress test of increasing the reversion rate – not the current rate – by 3%. The FPC is an independent body considering prudential standards for mortgage lending. Its recommendation includes detailed explanations of how and why it arrived at the 3% on reversion recommendation. I think it is authoritative and persuasive.

While the rule does not say lenders *must* follow the recommendation, merely that they must have regard to it, I'd expect a lender choosing not to follow it to explain the reasons for not doing so, and explain why it preferred its own approach to stress testing having regard to market expectations. Beyond asserting that it had regard to the FPC recommendation, LSC hasn't provided any evidence of the decision it made at the time, or any explanation of why it chose not to follow the recommendation, or why its own approach of adding 10% to current payments was, at the relevant time, a better understanding of market expectations than the FPC's. LSC says that the FPC recommendation was withdrawn in 2022. That's correct, it was. But that's irrelevant; it was in force at the time of this lending decision.

Secondly, LSC's approach of adding 10% to current payments did not, in any case, meet the minimum requirement of assuming a minimum 1% rise in interest rates during the first five years of the term.

Miss C and Mr W's first charge mortgage was on a fixed rate of 1.77% until 31 July 2020, reverting to a variable rate of 3.99% thereafter. Their monthly payment on the fixed rate, which was in place at the time of the application, was £902. Their mortgage offer said that on reversion in July 2020, the payment would increase to £1,133.

If 1% is added to their existing fixed rate – so that the rate would increase from 1.77% to 2.77% (instead of the contractual reversion rate of 3.99%) from July 2020, that would give a new payment of £1,010. If, however, 1% is added to the reversion rate – so the mortgage

would revert to 4.99% not 3.99% from July 2020 – then the monthly payment would rise to £1,248. In my view that's the better approach, since the reversion rate is the contractual rate that will apply from July 2020 unless Miss C and Mr W actively choose to try to re-finance and are successful in doing so. And if the FPC recommendation of adding 3% to the reversion rate is followed, then the monthly payment would rise to £1,493 from July 2020. All of those figures are higher than the £992 LSC used.

LSC says that, according to a recent credit check it has carried out, Miss C and Mr W's current mortgage payment is only £968 – less than the amount it allowed for in the stress test. It says this shows that its approach of adding 10% to the payment in 2019 was justified and more than enough to cover what actually happened to Miss C and Mr W's mortgage. But that's an argument from hindsight. At the time of its lending decision, adding 10% to the monthly payment wasn't enough to meet the minimum requirement of adding 1%, let alone the FPC recommendation of adding 3%. In considering whether LSC lent responsibly, I think it's fair and reasonable only to consider what it knew or ought reasonably to have known at the time it made its lending decision in light of what the regulator said was responsible lending practice at the time.

LSC also stress tested its own loan – by adding 10% to the monthly payments. But there was no requirement for it to do so, because the interest rate was fixed for five years – the rule says that a stress test is not needed in those circumstances.

For those reasons, I'm not persuaded that LSC acted fairly in applying the stress test it did apply. It underestimated the stress test needed for the first charge mortgage, and unnecessarily stress tested its own loan.

Should LSC, acting fairly, have concluded that the loan was affordable?

Taking all that into account, I've revisited the affordability assessment LSC carried out.

As I said above, LSC verified Miss C and Mr W's income as £3,038 per month, excluding the child benefit (which I think was reasonable). LSC verified Miss C and Mr W's expenditure as £1,454 per month, excluding the first charge mortgage, its own loan and the debts to be consolidated. It made no allowance for any payment to the help to buy loan. For the first charge mortgage, it noted that the actual payment at the time was £902 – it added 10% to that by way of stress testing, to give £992. And its own loan was £522 – adding 10%, that gives £574.

LSC therefore concluded that total expenditure, after stress testing, was £3,019 per month. As this was £19 more than income, it concluded the lending was affordable.

I'm not persuaded that this was a fair and reasonable conclusion, even if LSC had correctly assessed income. The affordability assessment only takes into account committed, basic essential and basic quality of life expenditure. It doesn't include allowance for any of the other expenses of day to day life, or provision for emergencies. In those circumstances, I don't think a buffer of £19 – just 0.6% of Miss C and Mr W's basic and committed expenditure – was adequate to show that the loan was affordable.

And in any case, for the reasons I've given above, I don't think LSC did accurately assess Miss C and Mr W's expenditure. It took no account of the help to buy loan. At the time of the lending assessment they were paying £1 per month in management fees, rising to £102.50 (£101.50 interest plus £1 management fee) from October 2023 – within the first five years of the loan term. Although Miss C and Mr W's income might have been expected to increase between 2019 and 2023, so might their expenditure. So I think it would have been reasonable to have assumed those increases would balance out and simply add the £102.50

to the existing affordability assessment.

In addition to that, the first charge mortgage should have been stress tested not at £992, but at between £1,248 and £1,493 – depending on whether 1% or 3% is added to the reversion rate. But no stress test on the LSC loan was required, so that payment reduces from £574 to £522.

Factoring all that in, that means that LSC ought to have assessed Miss C and Mr W's expenditure as being £1,454 per month on essentials and cost of living, plus either £1,248 or £1,493 on the main mortgage, plus £102.50 on the help to buy, plus £522 for LSC's loan. That gives a total of either £3,326.50 or £3,571.50 – both of which are substantially in excess of the verified income of £3,038 per month. And still substantially in excess of income even if child benefit of £112 was added.

On that basis, I don't think that LSC – acting fairly – could reasonably concluded that the lending was affordable for Miss C and Mr W. It follows that the lending was irresponsible and that LSC should never have lent.

Putting things right

LSC says that, in any case, Miss C and Mr W have not missed any payments either on their first charge mortgage or this loan – which shows that the loan was in reality affordable for them, or that they've suffered no detriment from it. However, Miss C and Mr W have said that, while they've managed not to miss any payments, keeping up with the loans has been a struggle for them, especially since the interest on the help to buy loan became payable, and has caused them financial difficulties.

Even if Miss C and Mr W haven't missed any payments or fallen into arrears, that doesn't mean that the loan hasn't caused them difficulties. In my view, the detriment is that they are now tied into a loan secured against their property for another fourteen years which – had LSC acted fairly – they wouldn't have had.

It's true that the lending consolidated their existing unsecured debt, reducing their monthly outgoings. And LSC isn't responsible for the existence of that other debt, or the difficulties Miss C and Mr W faced in servicing it. However, by converting that debt to a secured loan Miss C and Mr W now have no option but to keep paying it or lose their home. Had the debt remained unsecured, it could have been managed in other ways – either they could have kept paying it or, if that wasn't sustainable, they could have sought debt advice, come to arrangements with their creditors or even entered insolvency of one form or another. That's no longer open to them without the significant risk of losing their home.

To put things right, LSC should bring the loan agreement to an end. It should remove all interest and charges added to the balance, including fees paid to lender and broker, so that the starting balance is only the amount released direct to Miss C and Mr W or paid direct to their creditors. It should then apply all the payments Miss C and Mr W have made to date as reductions to the capital balance, without interest being charged.

Having paid £522 per month for six years, that's likely to mean that Miss C and Mr W have broadly repaid the around £35,000 they borrowed. But LSC will need to calculate the exact current position.

If there is still a balance outstanding, LSC should work with Miss C and Mr W to come to an affordable payment arrangement for the remaining capital sum without further interest. It can retain the charge over their property until the capital is ultimately repaid.

If, however, Miss C and Mr W have now repaid more than the capital balance – minus interest and charges – they originally borrowed, then LSC should refund any additional payments to them. It should add simple annual interest of 8% running from the date of each overpayment to the date of refund – LSC may deduct income tax from the 8% interest element, as required by HMRC, but should give Miss C and Mr W a tax deduction certificate so they can reclaim the tax if they're entitled to do so. In this case, LSC should also remove its charge over their property.

LSC should also remove the record of the loan from Miss C and Mr W's credit files once the capital is repaid in full (if it has not yet been).

I don't require LSC to pay compensation for distress and inconvenience in addition to the above redress. Had it not lent, Miss C and Mr W would still have the unsecured debt which was consolidated. They may have continued to pay it; they may have dealt with it in other ways. Had they managed to continue to pay it rather than defaulting on it or entering some form of insolvency procedure, they would have continued to pay interest while those debts remained outstanding. I've said that it's not fair and reasonable for LSC to collect or retain interest on a loan it should never have lent. But that's likely to result in a saving to Miss C and Mr W of interest they might otherwise have paid to their unsecured creditors. That saving outweighs any award for distress and inconvenience I might otherwise have made, and so I make no award for that.

My final decision

My final decision is that I uphold this complaint and direct Lesley, Stephen & Co. Limited to put matters right in the way I've set out above.

Under the rules of the Financial Ombudsman Service, I'm required to ask Miss C and Mr W to accept or reject my decision before 16 October 2025.

Simon Pugh
Ombudsman