Risks in interest-only lending

There has recently been a decision from the Financial Ombudsman Service (FOS) regarding the broker Express Mortgage Solutions, which sheds further light on the expectations of what an adviser needs to consider when supporting a lending application, which includes an interest-only element, particularly with limitations on how the capital will be repaid.

FSCS v Emptage

This decision is based upon the 2013 Court of Appeal case which is known as the Financial Services Compensation Scheme (FSCS) v Emptage where the Scheme failed in its defence that the adviser had acted appropriately. The facts of the case are that Ms Emptage and her partner lived at a property in Berkshire which was subject to a repayment mortgage in Ms Emptage's name, with an outstanding balance of around £40,000 and about 10 years left to run. In 2005, they were advised to remortgage the Berkshire Property for a much larger sum on interest-only terms. The second piece of advice was the purchase of a (yet-to-be-built) property in Spain with the proceeds of the remortgage. The hope was that the Spanish Property would provide rental income and capital to service and redeem the increased interest-only mortgage and yield a surplus. Unfortunately the Spanish Property's value fell to almost zero and Ms Emptage was unable to redeem her new mortgage. Ms Emptage brought a claim as a result of the bad advice she had been given. As the advice firm could not meet Ms Emptage's claim themselves and had no relevant insurance, the complaint from Ms Emptage and Mr Ball moved from FOS to the FSCS.

Advising about mortgages, when they are first legal charges, is a regulated activity. Advising about purchasing property, whether in the UK or not, is not a regulated activity. The FSCS provides compensation only in respect of regulated activity. The FSA (now FCA) MCOB contained provisions setting out the manner in which advisers should conduct themselves. MCOB 4.7.2R stated, that a firm should ensure a mortgage is suitable for a borrower. A mortgage might not be suitable for a borrower if they do not have the means to repay the loan on the agreed terms. In June 2010, the FSCS rejected Ms Emptage's complaint, saying that it was based on advice to purchase property in Spain, which was not a regulated activity. After further correspondence, in August 2010 the FSCS accepted that the adviser had failed properly to consider and advise on the suitability of an interest-only mortgage, in light of their circumstances, and the recommended repayment method from the Spanish Property. When the case came to the Court of Appeal they had to consider what was the nature of the adviser's duty of care; was this breached and if so what were the losses flowing from this breach.

In deciding this case it was found that the mortgage advice was unsuitable "not because she could not meet the monthly interest payments, but because she had no prospect of paying back the loan if her investment failed to live up to expectations." Accordingly, the judge viewed the adviser's bad advice about the interest only mortgage as inextricably bound up with the purchase of the Spanish Property.

The Court of Appeal found that the losses relating to the Spanish Property flowed from the advice in relation to mortgaging the Berkshire Property. Without the loan, the loss could not have occurred. The industry had considered that the fact that the investment advice and mortgage advice flowed from the same advice firm contributed to the successful claim.

These decisions of the High Court and the Court of Appeal in Emptage also serve as reminders of the importance of establishing precisely the duty of care and any breach of that duty in any claim against a professional. The adviser's breach of duty was of crucial importance in this case and was at the heart of the differences between the parties.

FOS case

This was followed recently by a FOS decision involving the directly authorised firm Express Mortgage Solutions late in 2015. In 2009 Mrs H decided to buy two investment properties, one in the UK, and one in Bulgaria following advice from an IFA firm. The mortgage was for a total of £195,000. £80,000 of this went towards paying off her existing mortgage, around £28,000 for a deposit for the UK investment property, and £90,000 towards the Bulgarian property. Mrs H found the remaining sum herself. £80,000 (the sum of the existing mortgage) was on a repayment basis and £115,000 was interest only. The Bulgarian property investment wasn't completed and Mrs H lost her money.

The adviser argued that the complaint was outside the scope of the FOS, but the Ombudsman disagreed. Firstly, although the sale of the investment was unregulated, this complaint was about the mortgage advice and given this was partly an interest-only mortgage that was sold, a key consideration is the suitability of the repayment strategy. As the Ombudsman was satisfied that the adviser recommended a mortgage with an unsuitable repayment strategy, then it was open to come to the conclusion that the mortgage was mis-sold. In coming to this conclusion they have taken account of the Emptage decision. One wrinkle not yet extracted is that Express was only regulated for insurance mediation and this was not factored into the case.

The facts of these two cases are similar, where the Court found that advice to enter into a mortgage backed by an investment was mortgage advice. In the second case the property investments were advised by a different firm and the adviser argued that therefore the facts of that Emptage case were different to the current complaint. It was clear in this later case the adviser didn't sell the investment, nor was there evidence that it knew of the investment in the Bulgarian property. However, the evidence in this case indicated that the "mortgage" adviser didn't pay enough attention to the reason for raising the finance, or the effectiveness of the repayment strategy. It seems from the findings that the adviser never met Mrs H, nor asked the introducer enough questions about the loan. In its arguments, the adviser relied on the fact that Mrs H holds a professional financial qualification and that the introducer was himself an Independent Financial Adviser. The Ombudsman found that this doesn't absolve the mortgage adviser of the obligation to make its own checks. As it advised Mrs H it was under an obligation to obtain enough information to ensure it was making a suitable mortgage recommendation.

Of key significance is that although Mrs H had already decided to buy the property, without the mortgage she wouldn't have been able to afford to do so. Because a partly interest-only mortgage was recommended without appropriate checks to see if there was a plausible and realistic repayment strategy, the adviser is responsible for the losses flowing from that decision. Although Mrs H bears some responsibility for choosing to make the investment, she would not have been able to do so without the mortgage. The Ombudsman was satisfied that Mrs H would have re-mortgaged her property in any event to fund the investment in the UK property.

That was the reason she approached the investment adviser in the first place. However that was for a much smaller sum. She was persuaded to take out a significant amount of extra money to fund the Bulgarian investment. The Bulgarian property now has no value, and at the time represented a risky investment. So although the loss she's suffered is because of the failure of the investment, it flows directly from the unsuitable mortgage that was recommended. Accordingly, £90,000 of the £195,000 advance was for the property in Bulgaria. The remainder was for Mrs H's own purposes. So the adviser has been ordered to compensate her for that part of the mortgage that was used to make the investment in Bulgaria.

Conclusion

These are both cases based on the rules that precede the changes under the Mortgage Market Review in 2014 which introduced new rules and clarified roles and responsibilities. These make it clearer that the adviser must assess the suitability of the mortgage. These rules also clarify that the lender must make a responsible lending decision and is responsible for assessing affordability, more specifically than previously. The assessment of whether the loan can be repaid sits with the lender. The complaint in both cases was made against the broker who provided the advice. The firms could have considered if they had wanted to join the lender in the complaint at the Ombudsman as the decision to lend on this basis was with the lender.

There will always be a more significant duty of care where an adviser or property broker has suggested the investment and funding route, rather than the consumer coming to a mortgage broker looking for interest only funding for a transaction. In addition, whilst an overseas property may be the main repayment source, advisers should ensure that through income, other capital or downsizing, there are alternative exit routes.

Next steps

Following these decisions, advisory firms will need to ensure that they have robust processes in place to enquire as to the purpose of the loan and to assess the risks attached to the repayment vehicles for both interest and capital. Care will have to be taken where the purpose is to invest in another property, overseas or in the UK. Following the introduction of the Mortgage Credit Directive in March 2016, there may be more calls to raise money in the UK to fund overseas property given the rules on foreign currency mortgages. Finally adviser firms facing similar claims will need to consider if the lender needs to be joined in the complaint.

We are continuing dialogue with FCA and FOS on both the jurisdiction aspects of this case as the firm was not authorised. We are also looking at the implications for advice on lending to individuals in the UK to fund oversees property purchase which may become more prevalent following the introduction of the MCD foreign currency lending rules.