DRN-4629101

The complaint

Mrs J and Mr L complain that UK Mortgage Lending Ltd trading as Pepper Money irresponsibly lent them a second charge mortgage (secured loan).

What happened

Mrs J and Mr L applied, via a broker, for a loan with Pepper Money (then trading as Optimum Credit) in November 2020. Pepper Money assessed their application and lent them £28,000 over 20 years. The interest rate was fixed at 12.7% for the first two years. The purpose of the loan was to consolidate existing unsecured debt.

In 2023, Mrs J and Mr L complained that the loan had been irresponsibly lent. They said that Pepper Money didn't carry out adequate checks of their income and expenditure, and if it had done so it wouldn't have lent to them. They said the loan wasn't affordable and they had struggled to keep up with the repayments. They're now paying higher interest on both this loan and their main mortgage and their mortgage lender has refused them further borrowing to repay this loan. They've had to take on additional work to keep up with the payments.

Pepper Money said it had looked at their income and expenditure and assessed affordability appropriately. It didn't agree the loan was irresponsibly lent.

Our investigator thought the complaint should be upheld. He noted that Pepper Money checked evidence of Mrs J and Mr L's income, but relied on what they had declared about their expenditure. He said that because on Pepper Money's affordability assessment the loan was only marginally affordable, Pepper Money should have been prompted to carry further checks to make sure it would be sustainable for them. If it had done so, for example by asking for bank statements, it would have discovered other expenditure which would have showed the loan wasn't affordable. Pepper Money didn't agree and asked for an ombudsman to review the complaint.

Having considered everything, I reached a different view of the complaint. So I issued a provisional decision to allow the parties a chance to comment on my thinking before I make a final decision.

My provisional decision

I said:

> "I agree that, taking into account all Mrs J and Mr L's expenditure, it's unlikely this loan would be considered affordable. Mrs J and Mr L haven't actually missed any payments, but they say they've struggled with it and had to take on extra jobs to stay on top of things.
>
> The result of the affordability assessment Pepper Money carried out showed that it took into account monthly income of £2,763.95 and that, after including stress tests on both this loan and their main mortgage, it took into account monthly expenditure of £2,762.48 – leaving a surplus, after paying all commitments including this loan, of

£1.47 per month.

However, it seems the reality is that Mrs J and Mr L's expenditure was somewhat higher than this. In their application they declared their existing debt (including debt which wasn't going to be consolidated into this loan), household expenditure such as food and utilities, and other items such as travel and leisure costs. But their expenditure statement didn't include childcare costs, debts owed to HMRC and being repaid, or rental payments while they were renovating their own home, as well as other regular outgoings.

When these matters are taken into account, the loan is clearly unaffordable. But they weren't considered by Pepper Money at the time. To be able to uphold this complaint, it's not enough for me to show that the loan was unaffordable based on the true facts; I also need to be satisfied that Pepper Money knew or ought reasonably to have known that at the time and therefore didn't assess affordability appropriately.

The rules of mortgage regulation require a lender to obtain evidence of income, but only require information about expenditure. A lender may rely on information about expenditure provided by the customer unless, taking a common sense view, it has reason to doubt it.

When considering expenditure, a lender must take into account actual committed expenditure (such as credit repayments) but may take into account either actual essential and quality of living expenditure, or rely on statistical or modelled data about typical expenditure for a household of this type.

In assessing Mrs J and Mr L's income, Pepper Money obtained payslips. It didn't, however, take into account all the information shown on Mr L's payslips. His payslips showed that he was receiving substantial overtime – and his P60 showed that his overtime in the last financial year was less than in the financial year at the time of the application. In calculating Mr L's income for the purposes of the affordability assessment, Pepper Money included only his basic salary and 50% of the average overtime he'd earned in the previous year.

This meant that the £2,763.95 used for the affordability assessment was significantly less than Mrs J and Mr L's actual household income at the time – around £700 per month less after tax.

I think this was reasonable. The rules require Pepper Money to have a policy on what sort of income it does and doesn't accept. Its policy in respect of income that's variable and not guaranteed – such as overtime – is only to take into account 50% of any amount that's evidenced as being reliably paid over a period of time. This ensures that it doesn't lend based on spikes of income that aren't sustainable. But it meant that, in this case, the income taken into account for the affordability assessment was significantly less than Mrs J and Mr L's actual household income at the time of their application.

In respect of expenditure, Pepper Money took account of their actual credit commitments that wouldn't be consolidated into the loan – evidenced by their credit files. For their basic and other expenditure, it compared what they'd declared on the expenditure form they completed with the broker with modelled typical expenditure for a household like theirs. Its policy is to use the higher of those two figures, and as in this case the modelled expenditure was higher than the actual expenditure Mrs J and Mr L declared, that's what it used. The modelled expenditure was just under

£250 higher each month than the actual expenditure.

Pepper Money did take account of Mrs J and Mr L's overdrafts; they were included in the amounts to be consolidated into this loan, and the overdraft balances were paid into the relevant accounts on completion.

So while it's true to say that based on the affordability assessment Pepper Money carried out Mrs J and Mr L only had £1.47 left per month after taking into account both mortgages (including stress test) and other expenditure, that was in reality a pessimistic view of their situation – since it disregarded much of Mr L's overtime income and, by using modelled rather than actual expenditure, overstated their income. If all the overtime Mr L had earned in the current financial year, and their actual expenditure, were taken into account the surplus would have been near £1,000 a month.

I've reviewed the expenditure information on the form Mrs J and Mr L completed with the broker and submitted to Pepper Money. It doesn't include the additional expenditure contained on their bank statements that the investigator identified.

Had this additional expenditure been included in the affordability assessment the application would not have passed the affordability assessment – and might well have exceeded the surplus even if Pepper Money had used full actual income and expenditure figures.

I'm satisfied that Mrs J and Mr L didn't declare this additional expenditure at the time of the application, and therefore Pepper Money didn't in fact know about it when carrying out the affordability assessment.

But it's important to think about not just what Pepper Money actually knew, but what – acting fairly as a responsible lender – it ought reasonably to have known at the time.

Mrs J and Mr L didn't declare this extra expenditure. The only way Pepper Money would have learned about it was if it had made further enquiries, for example for asking for bank statements.

I've said that the mortgage rules require evidence of income. Pepper Money had this in the form of payslips and P60s. So it didn't need to ask for bank statements to evidence income.

The mortgage rules also say that Pepper Money only needs information – not evidence – of expenditure. In other words, it can ask Mrs J and Mr L what their expenditure is, and can rely on what they say when assessing affordability – unless there are common sense grounds for doubting what they say.

I've not seen anything that leads me to conclude that there were common sense grounds for doubting what Mrs J and Mr L said. Their expenditure was plausible, and while it was lower than typical modelled expenditure for a household of their type, Pepper Money used the higher modelled figure. There's nothing in what Mrs J and Mr L said that doesn't look plausible or realistic and no obvious gaps that Pepper Money ought to have questioned. It accepted what it was told on the application form – that Mrs J and Mr L worked different shifts so had no need of childcare. I don't see any common sense basis on which Pepper Money ought to have doubted that.

The investigator said that Pepper Money ought to have asked for bank statements to verify the expenditure because the gap between income and expenditure was so very small and as a result any error or missed item would make the loan unaffordable – so, acting responsibly, it ought to have made sure there was in fact no scope for error.

I see the force in that argument, in general terms. But in the particular circumstances of this case, I don't find it persuasive. While the gap in the affordability assessment was only £1.47, that was because Pepper Money had taken a conservative approach to income and a generous approach to expenditure. Had it used the higher actual income and lower actual expenditure figures (as declared at the time), the gap would have been very substantial, around £1,000.

In those circumstances, I don't think it was unreasonable that Pepper Money didn't request bank statements to verify expenditure. Its approach to income and expenditure meant that a substantial buffer was built into the assessment and therefore affordability wasn't as marginal as it appeared from the headline result of a £1.47 gap. In those circumstances I don't think it was necessary to request detailed expenditure evidence to guard against small errors having a big impact on affordability.

Overall, therefore, to the extent that this loan was unaffordable, that was because of additional expenditure that Mrs J and Mr L didn't tell Pepper Money about. It wasn't required to obtain detailed evidence of expenditure; it was entitled to rely on what they said – and if Mrs J and Mr L chose not to give full and complete information, I can't hold Pepper Money responsible for not taking into account what it wasn't told and didn't know.

That means that I can't fairly uphold this complaint that Pepper Money didn't properly assess affordability and didn't lend responsibly. Based on what it knew and could reasonably have been expected to know, it did.

However, it does appear that the loan might in fact have been unaffordable, and Mrs J and Mr L say they've struggled to maintain it. Though they hadn't missed any payments prior to making this complaint. If they are experiencing difficulty managing the loan they should speak to Pepper Money about their current circumstances. Pepper Money will need to consider what they say and offer reasonable forbearance where appropriate. But it can only do that where Mrs J and Mr L engage openly and honestly with it."

Pepper Money had no further comment to make. Mrs J and Mr L didn't accept my provisional decision. They said:

- Pepper Money offered this loan to Mrs J and Mr L even though two other lenders had declined to lend to them and even though their property was valued at less than they'd said they thought it was worth.

- Because of the lower valuation, the loan to value increased and so Pepper Money increased the interest rate. This shows that it thought this was a high risk loan. Their credit file also ought to have shown that this was high risk. As a result, it should have carried out more rigorous checks.

- The broker had warned Mrs J and Mr L that Pepper Money had issues with the affordability of the loan.

- The fact that Mr L was doing substantial overtime is also a sign of financial stress that ought to have led Pepper Money to look more closely.

- Mrs J and Mr L didn't conceal anything and provided all the information they were asked for. They relied on the broker to pass things on to Pepper Money.

- Pepper Money failed to properly scrutinise their application.

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.

I've also considered again the findings in my provisional decision, as well as Mrs J and Mr L's response to it. But having done so I haven't changed my mind.

Whether or not the responsibility for that lies with Mrs J and Mr L or with the broker, the fact is that Pepper Money wasn't made aware of all their expenditure. It could only take into account things it was aware of. While, as I said in my provisional decision, it shouldn't have relied on what it was told if there were common sense reasons to doubt it, I don't think such reasons were present in this case. For example, Pepper Money wasn't told about Mrs J and Mr L's expenditure on childcare. But it was told they didn't have any, because it wasn't needed due to their shift patterns. In light of what it was told, it was reasonable for Pepper Money to accept that – and so it couldn't have been expected to take into account childcare expenditure it wasn't told about. Nor do I think overtime is of itself a sign of financial difficulty or a reason Pepper Money couldn't rely on what it was told. Many people work overtime either through choice or because it's part of their job.

I don't think it's relevant that Mrs J and Mr L had been declined by other lenders. Even if Pepper Money knew that at the time, it was required to consider the application against its own lending criteria and risk appetite. Providing it lends within the rules, it doesn't have to reach the same outcome as other lenders with different criteria would.

The reduced valuation does carry additional risk. But that's a risk related to Pepper Money's ability to recover the loan balance via repossession should that ever be necessary. A higher loan to value carries a greater risk that there won't be enough equity to repay. But that's not directly related to affordability at the time the loan is lent – which is a question of income and expenditure, not of the property's value.

I don't think the email from the broker adds anything either. It sets out Pepper Money's approach to assessing overtime and discusses affordability based on how much debt Mrs J and Mr L would be consolidating. The email concludes "it's looking good". I don't think this is evidence that the loan as finally lent was unaffordable; rather, it's a progress update while the broker works with the lender to identify what would be acceptable.

For all the reasons I've given here and in my provisional decision, I'm satisfied Pepper Money made a reasonable lending decision based on what it knew and could reasonably have been expected to have known, within the mortgage lending rules as they were at the time. I don't therefore uphold this complaint.

My final decision

My final decision is that I don't uphold this complaint.

Under the rules of the Financial Ombudsman Service, I’m required to ask Mrs J and Mr L to accept or reject my decision before 18 March 2024.

Simon Pugh
Ombudsman