DRN-4857185

The complaint

Miss P complains that Pepper Money Limited (Pepper) irresponsibly lent her a second charge mortgage.

What happened

In 2018, Miss P took out a second charge mortgage with Pepper. She borrowed money to consolidate and repay existing debts elsewhere. She borrowed around £28,500 not including fees over a term of 13 years. The interest rate was fixed for the first five years of the loan at 7.73% making a monthly repayment of £329.32, after which it would revert to a variable rate.

Around £28,500 of existing debts were consolidated into the loan but Miss P was left with around £12,000 which remained outside of this loan, costing her approximately £399 per month – which could fluctuate in line with the variable rates charged and the balances.

In 2022, Miss P complained. She said that the lending was irresponsible and unaffordable. Pepper doesn't agree. It said it had checked Miss P's income and expenditure and the lending was affordable. It significantly improved Miss P's circumstances because her monthly expenditure on the debts consolidated reduced by around £499. It said that since taking out the loan, Miss P has kept up with her repayments which would suggest it is affordable for her. While it acknowledges Miss P may well have taken out further debt since this loan, it does not consider it is responsible for this.

Dissatisfied with Pepper's response, Miss P referred her complaint to our Service.

I issued a provisional decision in March 2024, upholding the complaint. While I could see Miss P had passed Pepper's affordability assessment based on her circumstances at the outset of the loan, I was not persuaded it had considered whether the loan would be sustainable for Miss P across the full length of its term.

I highlighted that, at the point the loan reverted to the variable rate, Miss P would also lose her child benefit income – and given her disposable income had been listed by Pepper as £8.88, I was not persuaded the loan was affordable and sustainable for her across the full loan term. To add to this, Miss P's existing borrowing and credit file showed a high reliance on high-cost debt, a pattern of continuous borrowing and evidence of defaults on relatively low balances. Suggesting Miss P was unable to absorb any unexpected outgoing – no matter how small.

Both parties responded to my provisional decision. Miss P agreed with my conclusions and shared further detail as to the severe financial difficulty she is and has continued to be in since taking out this loan.

Pepper disagreed with the conclusions reached in my provisional decision. In summary, it said:

- It would have been the broker's responsibility to check if the mortgage was suitable for the consumer's needs, highlighting the risk of consolidating debt over a longer period and what the customer's plans were with the revolving credit remaining and the cards which were being cleared. As a lender, Pepper is responsible for assessing the affordability of the mortgage.

- Although the application shows a disposable income of £8.88, this was the worst-case scenario and had it used the full income declared and the actual expenditure declared by the consumer, this would have increased.

- While it considered future interest rate increases, it is important to note that no financial institution could have predicted what has happened since 2020.

- The consumer has not defaulted on any payments with Pepper or notified it that she is struggling financially.

- The consumer's credit file showed she had last taken credit in 2015 and that the debt she had by 2018 had been amassed since 1997.

- It was satisfied with the explanations the consumer gave as to the most recent defaults on the consumer's credit file, particularly given their age, balances and that there was no other erratic payment history noted.

As both parties have now responded to my provisional decision it is appropriate for me to proceed to 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.

Pepper says that much of the complaint made should be directed to the broker involved in the sale of this loan. While some of Miss P's complaint did relate to the sale, she also spoke of the loan being unaffordable for her from the outset and that, had an appropriate affordability assessment been carried out, this would have been shown to be the case at the time.

As the lender, Pepper is required to consider whether it is responsible to lend. This includes considering whether it is affordable and sustainable for Miss P – irrespective of the loan being recommended to her by another party. It is Pepper's decision to lend that I am commenting on in this decision – not the suitability of the loan.

I set out in my provisional decision that, while Pepper did assess Miss P's income and expenditure, I had some concerns as to whether the loan was really affordable for her across the full 13-year term.

Pepper's recorded assessment of Miss P's income and expenditure at the time left a disposable income of £8.88. And while this demonstrates that the loan may have been affordable at outset, I am not persuaded it would be across the full term. After the first five years, the interest rate on this loan was set to revert to a variable rate, meaning it could (and likely would) increase in the future, and there was little surplus to absorb that.

Given a substantial amount of Miss P's income came from child benefit payments which would cease at the same time that the loan reverted to the variable rate, this would further hinder Miss P's ability to maintain her loan repayments for the full term and ought to have led to Pepper concluding that the loan was not sustainable for her.

Pepper says it took a conservative view of Miss P's income and increased her expenditure by using ONS data where this was higher. So, the actual amount of disposable income Miss P was left with post consolidation was sufficient and it maintains the loan was affordable for her.

I have considered the comments and information it has shared on this carefully. But having done so, I remain of the opinion that this loan was not sustainable for Miss P and that Pepper ought to have known this at the time. I will set out why below.

In terms of income, Pepper has highlighted several forms of income it did not consider when it assessed Miss P's affordability for the loan in 2018. It believes this should be taken into account when evidencing that Miss P was left with more than the £8.88 in disposable income indicated by its application system.

First, it points to Miss P's wage slips highlighting that in the past nine months she had earned around £877 more than the two wage slips used to evidence income had shown she had received in the months prior to the application. I can see this on the wage slip, but I'm not persuaded this means Miss P was set to receive an increased amount to this effect each month – particularly given that the two months prior to the loan being granted she did not receive said income. So, this does not persuade me that Miss P's monthly salary ought to have been recorded as being higher than it was.

Secondly, Pepper says that it did not take into account the child tax credit Miss P was in receipt of and it only took into account 50% of the child maintenance she was receiving each year as per its lending policy. Had it taken the full amount of both, this would have significantly increased Miss P's disposable income post consolidation.

I agree with this comment. But what I set out in my provisional decision was that these two forms of income were set to stop at the same time as the loan reverted to a variable interest rate and would not be income upon which Miss P could rely on for the remaining eight years of the loan. So, whether Pepper took the full amount or a reduced amount of this income at outset, does not change my concern that Miss P would lose a significant part of her income mid-way through the loan term. And I can't see Pepper assured itself that despite this, the loan would remain affordable and sustainable for her for the full 13 years.

It has also said that one of Miss P's unsecured loans was due to be repaid 29 months into the term of this loan. Reducing Miss P's expenditure by around £332 which could be offset or cover the loss of her child benefit and maintenance payments. But I disagree on two grounds.

The amount Miss P would gain by virtue of the unsecured loan reaching the end of its term is almost the same as the amount she would lose when her children turned 18 and she ceased to be entitled to claim child maintenance and tax credits. So, the absence of both items essentially cancels one another out. Particularly when the loan with Pepper reverted to the variable rate and as such could reasonably be expected to increase.

In addition, Pepper is assuming that Miss P would not replace this unsecured debt with another in the same timeframe. And while I agree it could not be expected to know what Miss P would or would not do in the future and her actions in this regard are not within its control, the evidence it did have is that Miss P has consistently been reliant on high-cost debt to fund day-to-day essentials. She can also be seen to receive money from friends and family in her bank statements which Miss P says was necessary for her to get by and were to be repaid.

The information Pepper had at the time of granting this loan to Miss P suggested a heavy reliance on debt, a pattern of debt consolidation and an inability to meet both small outgoings and any unexpected expenditure (such as the disputed transaction and phone contract default). So, I am not persuaded it would have been a reasonable or safe assumption that Miss P's debt position would only decrease during the term of this loan to such an extent that she would be able to cover a reasonably anticipated and substantial shortfall in her income.

Pepper has also said that while it stress-tested Miss P's first-charge mortgage at 1%, this was just a buffer and as such, it could be argued that Miss P's disposable income was £32.29 higher than it declared. I disagree. The rules of mortgage regulation require a second charge mortgage lender to take account of the likely future interest rates of the first charge mortgage for the purposes of its assessment of whether the customer will be able to pay the sums due. So, to suggest that such an amount can be added to Miss P's disposable income at the time is misguided.

In reaching my decision that Pepper did not lend responsibly in this case, it is also relevant to note that, while the minimum amount set out in MCOB that a lender should stress-test by is 1%, it goes on to say that in coming to a view as to likely future interest rates, a mortgage lender must have regard to both market expectations and any prevailing Financial Policy Committee recommendation on appropriate interest-rate stress tests. It should also be able to justify the basis it uses by reference to both factors.

The recommendations at the time of the application set out that, when assessing affordability, lenders should apply an interest rate stress test to assess whether borrowers could afford their mortgage if the interest rate was 3% higher. Whilst Pepper was not bound by this as it was a recommendation, and it did not need to stress-test the mortgage it was providing by virtue of it being subject to a five-year fixed-rate, it would have been good industry practice at the time to stress-test Miss P's first-charge mortgage by 3% rather than 1%. So, I would expect to see a detailed and robust reason as to why the recommendation was not followed. Such rationale has been absent in its submissions and the contemporaneous information from the time. Had it stress tested at 3% in its initial application, it likely would have resulted in the application failing its criteria given that stress testing at 1% only left Miss P with £8.88 in disposable income.

I'm aware Pepper has said that Miss P's first-charge mortgage was set to be repaid seven years into the term of this lending. And as such, would again reduce her outgoings in a way that may help compensate for the loss of child maintenance and tax credit income. But this would be two years after Miss P's income was due to reduce substantially and two years after the loan was set to revert to the variable interest rate which would likely have led to an increase in payments. So, I am not persuaded this leads to the loan being sustainable for Miss P across its full term.

Finally, I note Pepper has reiterated that Miss P is up to date with her repayments on this loan. However, this in itself does not mean that it lent responsibly in 2018. Miss P has evidenced that since taking out this loan she has entered a debt management plan, has fallen into arrears on her first charge mortgage and is in arrears on her council tax bill and utilities. She says she has prioritised the loan with Pepper through fear that it would not help her in the way that her first charge lender has. While these events all took place post Pepper's decision to lend to Miss P, they are helpful context in response to its suggestion that Miss P maintaining her payments means she has not experienced financial difficulty as a result of its lending decision.

To summarise, taking into account the information Pepper had at the time, I am not satisfied its decision to lend was reasonable. The evidence from the time suggests the loan would not have been affordable and sustainable for Miss P across its full term and I am not persuaded that the arguments Pepper has subsequently made about how it took a conservate view of her finances changes this. So, for the reasons I've set out above, I uphold this complaint.

Putting things right

To put things right Pepper should remove all interest, fees and charges it applied to the loan balance. It should treat all payments Miss P has made to date as repayments of the capital. It should then recalculate the outstanding balance and reach a sustainable arrangement with Miss P for the repayment of the remaining capital balance. It should also remove any adverse entries associated with this loan from Miss P's credit file if there are any.

My final decision

For the reasons I've given, I uphold this complaint and direct Pepper Money Limited to resolve the complaint in the way I've set out above.

Under the rules of the Financial Ombudsman Service, I'm required to ask Miss P to accept or reject my decision before 26 July 2024.

Lucy Wilson
Ombudsman