DRN-5098362

The complaint

Mr and Mrs G complain that UK Mortgage Lending Limited trading as Pepper Money gave them a loan that was unaffordable and would not give them a new concessionary interest rate.

What happened

In 2018, Mr and Mrs G took out a secured second charge loan with Optimum Credit. Optimum Credit was subsequently bought by UK mortgage Lending and operated under the brand name of Pepper Money. I will refer to "Pepper" throughout this decision.

The loan was for £96,090 repayable over 16 years. That included a lender fee of £595 and a broker fee of £3,995. The loan had a fixed interest rate of 6.78% for five years from completion. It then changed to a variable rate of 6.268% above the "Optimum Base Rate". The purpose of the loan was primarily to repay unsecured debt.

Mr and Mrs G complain that the loan is unaffordable and has caused them a huge amount of financial stress. They consider that Pepper did not fairly assess their income. They also said that the loan has reverted to the variable rate – and that has made the loan even more unaffordable. But Pepper will not offer them a new interest rate because of adverse information on their credit files.

The investigator thought the complaint should be upheld. She said that Pepper had unreasonably included Mr G's pension and share shave contributions in its income calculations – and that the lending wasn't affordable. And Pepper had reason to doubt the information provided because of what it knew about Mr and Mrs G's credit history. In view of that Pepper ought to have asked for bank statements. If it had done so, it would have seen that Mr and Mrs G's expenditure was higher than figure it used in its affordability assessment.

The investigator said that Pepper should:

1. Calculate the amount borrowed without any fees and charges. It should then treat any payments made to it by Mr and Mrs G as payments towards the capital amount.

2. If this results in an overpayment, Pepper should pay Mr and Mrs G simple annual interest of 8% on any overpayments, running from the date they were paid to the date of settlement.

3. If there is still a balance outstanding, Pepper should agree a suitable repayment plan with Mr and Mrs G.
4. Pepper should remove any adverse information about the loan from Mr and Mrs G's credit file.

Mr and Mrs G accepted what the investigator said. Pepper did not. It made a number of points, including:

Income

- The income was reviewed in line with Mortgages and Home Finance: Conduct of business sourcebook (MCOB) rules and payslips were reviewed to support the income declared.

- The pension and savings could be stopped at any time and are not considered committed expenditure in line with Financial Conduct Authority (FCA) guidance, because borrowers can flex payments or prioritise mortgage payments.

- The NI save is a credit on the payslip not a deduction.

- Pepper used £3,228.42 net income. It did not take into account other income including £149 per month child benefit, £400 per month housekeeping and £2,000 annual bonus.

Expenditure

- The broker had an in-depth discussion with Mr and Mrs G regarding their expenditure, including their credit commitments. The committed expenditure was supported by the credit searches carried out – so it had no reason to doubt the information it was provided.

- Mr and Mrs G declared household expenditure of £836.30 a month in addition to a further £131.36 on the payslips – so a total of £967.66. the Office for National Statistics (ONS) average household expenditure in their postcode was £948.76. Pepper used the higher of those figures, with the exception of utilities as Mr and Mrs G provided up to date utility statements to show the payments were £241.30 a month ongoing. So Pepper used a monthly expenditure figure of £1,181.40.

- Pepper had no reason to doubt the expenditure figures based on the ONS data. That is in line with MCOB 11.6.12. Had Mr and Mrs G declared much lower figures, which were not plausible based on the make-up of the household then Pepper would have asked for bank statements.

- Pepper queried the household size and Mr and Mrs G said their adult children who were not dependent on them lived at the property and provide £400 a month housekeeping – which Pepper did not take into account. But they were able to offset that amount against any higher expenditure that it did not account for as part of the household income.

- There was no requirement for it to obtain bank statements. Its decision was based on the information available to it at the time.

- Mr and Mrs G failed to disclose a payday loan of £1,000 that was taken out on 18 July 2018. It was their responsibility to do so in line with the declaration they signed. In any event, that may not have affected the affordability of the loan. MCOB allows lenders to take a common-sense view if a credit commitment is due to end shortly after the loan begins. It would not be reasonable to decline a mortgage application because of an item of credit with less than six months remaining. Because it was more than six years ago the payday loan no longer shows on the credit file. Therefore there is no evidence the payday loan was settled after September 2018.

- Mrs G had lost her job shortly before the application and that had impacted their expenditure due to the loss of income. But Mrs G was looking for employment and confirmed their circumstances might improve.

- Mr G said that as the loan allowed him to make overpayments without penalty, he would be looking to make a lump sum payment from his pension in three years' time. That would reduce the monthly payments and alleviate any concerns when the loan switched to a variable rate.

- Although the residual income was low Pepper had no concerns on the affordability of the mortgage throughout the term.

Credit file

- Pepper asked questions about the recent credit taken out and was satisfied with the response.

- The loss of Mrs G's job had put a strain on Mr and Mrs G's finances. That is why they wanted to consolidate debts to relieve the stress and make things more affordable. They were only making minimum payments and could not see an end in sight.

- The credit file showed Mr and Mrs G were paying out more than they were getting in. Despite that, Mr and Mrs G maintained their credit balances with no adverse recorded.

Summary

- Pepper is a specialist lender that looks to assist customers who may be experiencing financial difficulty and want to consolidate their debt into one payment. It accepted that customers may have a lot of debt, but it does not mean they can't afford a second charge loan and that is not a reason to decline an application. Customers take out a second charge loan to consolidate debts and to improve their financial situation.

- Mr and Mrs G were experiencing difficulties because Mrs G had been made redundant. They saved over £950 a month by consolidating their debt. The affordability assessment used a higher expenditure than declared by Mr and Mrs G and showed a positive residual income. That is all that is required under MCOB rules. There is no requirement to ask for bank statements as there was no reason to doubt the information provided after comparing the information against ONS data.

- Mrs G was actively looking for work and Mr G said he would make a lump sum payment from his pension to the loan in three years. So Pepper had no concerns about the sustainability or affordability of the loan over its full term.

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 agree with Pepper that there is nothing fundamentally wrong with a borrower with a lot of debt looking to consolidate their debt and reduce their outgoings. But there are also significant risks in securing previously unsecured debt and potentially increasing the total amount payable.

In any event, my decision is not about Pepper's business model. I am only determining what I consider to be fair and reasonable in the individual circumstances of this complaint.

Rules

The relevant rules in this case are the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB). I must take those rules, amongst other things, into account in deciding what I consider to be fair and reasonable in the individual circumstances of this complaint. MCOB 11.6 covers responsible lending. Its requirements for lenders include:

- Before agreeing a mortgage, a lender must assess whether a customer will be able to pay the sums due under the mortgage and be able to demonstrate the mortgage is affordable.
- A lender must take full account of the net income of a customer, their committed expenditure, and the basic essential expenditure and basic quality-of-living costs of the customer's household.
- A lender may generally rely on any evidence of income or information on expenditure provided by a customer unless, taking a common-sense view, it has reason to doubt the evidence or information. A lender must have evidence of income and take reasonable steps to obtain details of a customer's committed expenditure. A lender can either obtain details of a customer's expenditure or use statistical data.
- If a lender 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 mortgage, the lender must take them into account when assessing affordability.
- A lender must take account of the impact of likely future interest rate increases on affordability by applying a stress test. The lender must have regard to the prevailing Financial Policy Committee recommendation on interest rate stress-tests, which at the time was 3%. This applies to all regulated mortgage contracts, not just first charge mortgages. A second or subsequent charge lender must also apply any stress test to the first and any subsequent charge loans as well as its own lending.

<u>Income</u>

Pepper used a net income of £3,228.42 a month in its affordability assessment. It said it reached that figure by dividing Mr G's gross income by 12. It ignored Mr G's contributions to pension as they could be stopped at any time. Other deductions were taken into account in the expenditure. Then its systems automatically deducted tax and national Insurance based on salary and household.

It is not clear how Pepper reached the figure of £3,228.42. Even if we use the highest net figure showing on Mr G's pay slip of £2,805.79 and add the (gross) pension contributions of £150 a month that only totals £2,955.79.

I don't consider that was a fair or reasonable way to calculate Mr G's income. His pay slips showed a net income of £2,795 a month as an average of June, July and August 2018. That seems to me to be a more realistic way of looking at things.

Pepper included the deductions for medical insurance in its expenditure. They totaled £131.86 a month net. I will deduct that from the expenditure later.

I do not consider it was reasonable to include the amount Mr G was contributing to his pension in the income. I accept that in some circumstances it could be reasonable to include that amount. But in this case, Pepper has explained that its assessment on the sustainability of the loan was based on Mr G making a lump sum payment from his pension in the future. Presumably Mr G was basing that on projections based on the amounts he was contributing to his pension. That might change if the amount he contributed changed. And that was the likely impact if Pepper's affordability calculations were correct.

In the circumstances of this case, it was not reasonable for Pepper on one hand to assess Mr G's income on the basis that he would not contribute to his pension and on the other hand take into account that Mr G planned to use a lump sum from his pension to reduce the impact of any increased payments when the loan reverted to variable rate.

Further, Pepper was assessing affordability on the basis that Mr G would stop contributing to his pension then it ought to have discussed that with him.

I think it was reasonable for Pepper not to include the child benefit and housekeeping money from their children. I say that as bearing in mind the ages of Mr and Mrs G's children those sums were unlikely to continue throughout the loan term.

Expenditure

Pepper calculated Mr and Mrs G's expenditure as £1,050.40 a month plus £131.36 for deduction from the pay slip. I can deduct that from my calculation.

Mr and Mrs G's first charge mortgage payment was £1,080 a month and the proposed second charge loan was £820.70 for five years. There was £7.32 unconsolidated debt. That is total expenditure of £2,958.42. Pepper also calculated a stress tested amount of £127.52 – giving an expenditure figure of £3,085.94.

Summary

I don't consider that Pepper fairly calculated what Mr and Mrs G's net income was. I consider a figure of around £2,795 is a reasonable amount based on the evidence we have – that is what Mr G was actually receiving and had to contribute to his mortgage. Even if I add the pension contribution at most that would make £2,955.79. And that does not take into account that the contribution came out of his gross salary.

So even on the most generous way of looking at Mr and Mrs G's income it was less than their expenditure even before taking into account the stress test. I don't consider that Pepper has shown that it carried out a fair and reasonable affordability assessment in the circumstances of this case.

Even if the above is not correct, and it was reasonable for Pepper to use the income and expenditure figures it did, I still do not consider Pepper's decision to lend to Mr and Mrs G was made fairly. I will explain why.

Pepper said that using its calculations Mr and Mrs G would be left with residual income of £11.48. I'm not sure that is correct. Using Pepper's figures, Mr and Mrs G would be left with £139 a month (£3,228.42 - £3,089.42).

The loan was taken out in August 2018. Mrs G's credit file showed that she had taken out unsecured loans in February, April and June 2018 and a credit card in April 2018, the credit card was near its limit. Mr G had taken out unsecured loans in February and March 2018. The total balances of the credit taken out in the previous six months was around £28,000. That was around 30% of the total debt that Mr and Mrs G were refinancing.

That is a significant amount of debt to take in such a short space of time. I don't consider the fact that Mrs G had lost her job recently would account for that amount of debt. I consider responsible lender acting reasonably would have reason to doubt the information that it had been provided. I say that as that level of debt was not required to support Mr and Mrs G's existing commitments. It could indicate that an unsustainable spiral of debt. Or it could indicate that Mr and Mrs G's expenditure was higher than stated.

As I said, Mr and Mrs G were securing previously unsecured debt – that had some risks. I think their credit profile alone was enough for Pepper to have doubts about the expenditure declared. And bearing in mind the potential harm to Mr and Mrs G based on what it knew about their circumstances, a responsible lender acting reasonably ought to have asked for bank statements to verify their expenditure further.

We have copies of Mr and Mrs G's bank statements for the three months before the loan was taken out. They show that the actual expenditure was higher than declared. For example, average spending on food, clothes and communication were all higher than declared – to the extent that it would mean that the loan was clearly unaffordable using Pepper's income figure.

And that does not take into account that there is other discretionary spending not declared on the expenditure and a reliance on credit – including a payday loan taken out in July 2018.

I consider if Pepper had asked to see Mr and Mrs G's bank statements it could not reasonably have thought the loan was affordable or sustainable.

Putting things right

I consider the redress proposed by the investigator is largely a fair way to put things right. Mr and Mrs G have had the benefit of the money they borrowed. So it is reasonable that they repay that. But I do not consider it would be fair for Pepper to charge a lending fee or any interest on the amount borrowed.

The broker fee is subject to a separate complaint – but I do not consider Pepper is responsible for the broker fee.

Pepper should recalculate and reschedule the loan as if it was interest free since inception, with equal payments towards the capital due over the originally agreed term, as set out below. If the resulting payments remain unaffordable for Mr and Mrs G, Pepper should work with them to agree a suitable repayment plan.

I do not agree that it would be fair for Pepper to remove the loan from Mr and Mrs G's credit files. There is potential for harm to them if other lenders could not see their significant ongoing commitment to this loan

My final decision

My final decision is that UK Mortgage Lending Limited trading as Pepper Money should:

1. Refund all interest and fees that were applied to the mortgage to date of settlement – apart from the broker fee of £3,995.

2. Reduce the capital balance by the amount in step 1.

3. If, after step 2, there remains an outstanding capital balance, it should not apply any future interest or fees to the mortgage balance.

4. Reschedule the mortgage – as set out above – as if only the original capital balance, less the lender's fee – was payable over the originally agreed term, with equal monthly instalments.

5. Deduct the total amount of payments made to the mortgage by Mr and Mrs G since inception from the revised capital balance.

6. Provide a breakdown of the revised position of the mortgage to Mr and Mrs G once the above steps have been carried out.

7. Correct Mr and Mrs G's credit files to in view of the revised payment schedule

Under the rules of the Financial Ombudsman Service, I'm required to ask Mrs G and Mr G to accept or reject my decision before 20 November 2024.

Ken Rose

Ombudsman