

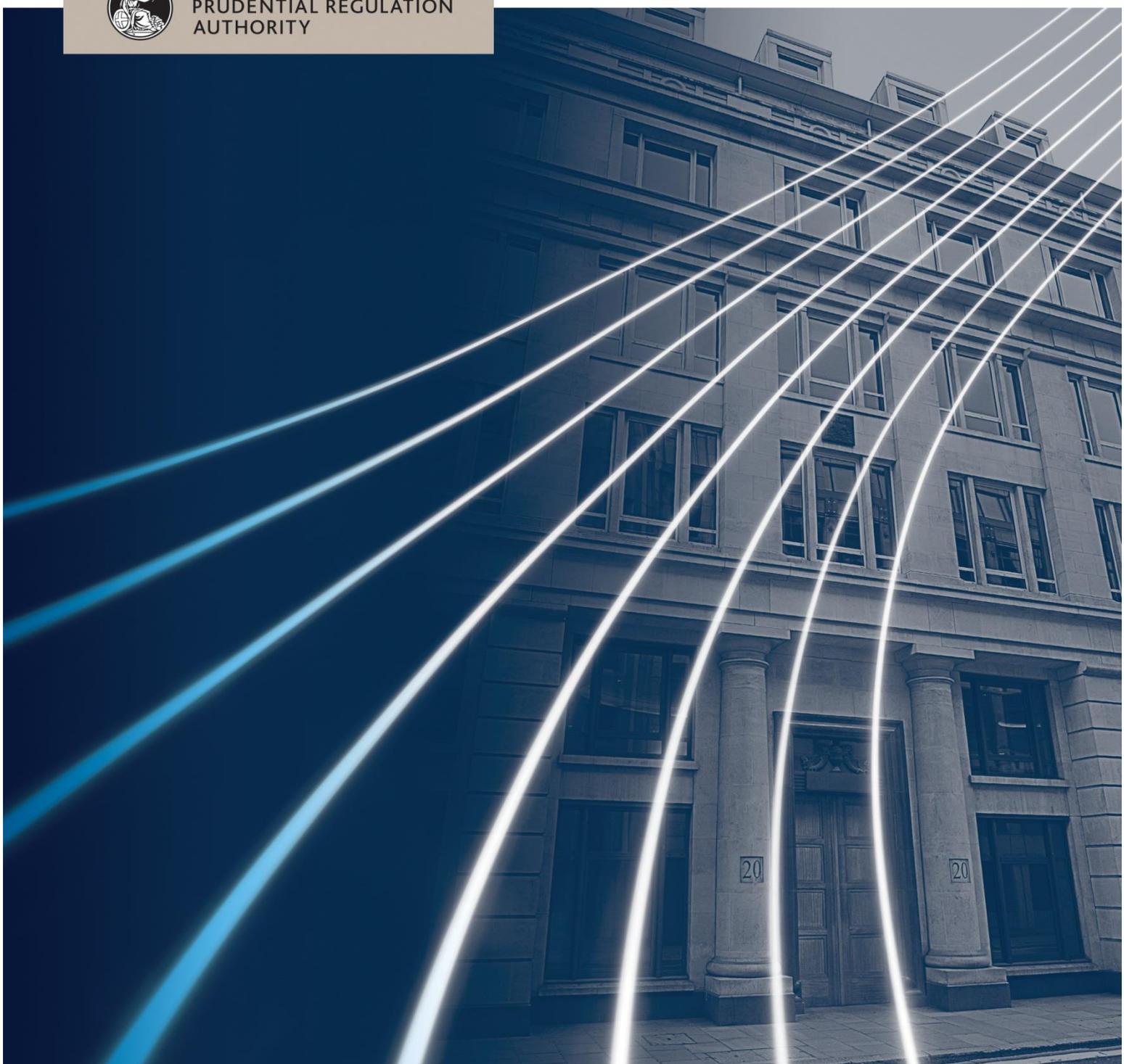
Policy Statement | PS28/16

# Underwriting standards for buy-to-let mortgage contracts

September 2016



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This policy statement sets out the PRA's feedback to responses and final policy on underwriting standards following Consultation Paper 11/16 'Underwriting standards for buy-to-let mortgage contracts'.



## Contents

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<b>1</b>	<b>Overview</b>	<b>5</b>
<b>2</b>	<b>Feedback to responses</b>	<b>5</b>
	<b>Appendix</b>	<b>13</b>



## 1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to the responses to Consultation Paper (CP) 11/16 'Underwriting standards for buy-to-let mortgage contracts',<sup>1</sup> and the final Supervisory Statement (SS) 13/16 'Underwriting standards for buy-to-let mortgage contracts' (Appendix 1). The aim of the SS is to prevent loosening in current industry standards for buy-to-let underwriting and to curtail inappropriate lending and reduce the potential for excessive credit losses.

1.2 This PS is relevant to all firms regulated by the PRA that undertake buy-to-let lending that is not already subject to Financial Conduct Authority (FCA) regulation. The FCA regulates buy-to-let lending to related persons through their Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) and lending in relation to consumer buy-to-let mortgage contracts through the Mortgage Credit Directive Order 2015:<sup>23</sup> SS13/16 does not apply to either of these types of lending. The PRA expects regulated firms to ensure that the standards contained in the SS are adopted by other firms undertaking buy-to-let lending within their groups.

1.3 The PRA's clarification on the small and medium-sized enterprise (SME) supporting factor is relevant to all firms within the scope of the Capital Requirements Regulation (575/2013) (CRR).

1.4 The PRA carefully considered all comments received on the proposal. The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to publish a statement on the impact of rules on mutuals where the final rule differs from the draft of the proposed rule. In the PRA's opinion, the changes made to its expectations in relation to buy-to-let lending do not impact mutuals differently to other firms.

1.5 The PRA is also required by FSMA to publish a cost benefit analysis (CBA) of any changes to the consultation proposals which the PRA considers to be significant. The PRA has considered the impact of the changes to its proposals, and comments from respondents on the CBA in the CP, in this PS.

1.6 After reviewing the feedback received, the PRA has made amendments to the proposal for the implementation timeline and provided further clarifications. Responses to feedback and details of the changes are set out in Chapter 2.

## 2 Feedback to responses

2.1 The PRA received 34 responses to the CP from banks, building societies, associations and private individuals. While respondents expressed support for buy-to-let underwriting standards, some respondents challenged specific aspects of the proposal or asked for further clarification. These are discussed below by topic.

### Implementation timescales

2.2 Chapter 6 of the SS sets out the PRA's expectations relating to implementation timescales.

1 March 2016; [www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp1116.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp1116.aspx).

2 Mortgage Credit Directive Order 2015 (S.I. 2015/910) (as amended); [www.legislation.gov.uk/ukdsi/2015/9780111127742](http://www.legislation.gov.uk/ukdsi/2015/9780111127742).

3 A 'consumer buy-to-let mortgage contract' means a buy-to-let mortgage contract which is not entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower.

2.3 The CP did not provide specific expectations regarding when firms should implement the changes to their underwriting standards, rather the PRA's expectation was that each firm would agree an implementation plan directly with their PRA supervisor. A number of responses included feedback on this topic.

2.4 Respondents suggested that if the PRA did not provide an explicit effective date for the final SS, the industry may implement the standards using different approaches and on varied timescales, which could distort competition during the implementation period. Respondents stated that there should be a phased implementation where straightforward changes could be implemented within reasonably short timescales, and more complex changes could follow later.

2.5 As a result of these responses, the PRA has amended the draft SS to include the expectation that firms will implement these changes to their policies and systems on a phased-in basis, as follows:

- (a) regarding interest cover ratio (ICR) tests (including the impact of the personal tax changes) and interest rate affordability stress tests, by 1 January 2017; and
- (b) the remaining expectations by 30 September 2017.

2.6 Some respondents asked for longer timescales to implement the changes than those set out in the final SS. Firms should contact their supervisor if they consider that circumstances exist which suggest a divergence from the timescale above on any of the expectations.

2.7 Respondents also asked for a postponement of the final SS until the impact of other forthcoming regulatory developments, changes to tax law (eg stamp duty and personal tax relief for buy-to-let properties), and the impact of the EU referendum result, are more certain. In the PRA's view, the expectations for minimum underwriting standards included in the final SS broadly reflect existing practice for most lenders in the market today (with the possible exception of firms' incorporation of the recent personal tax changes). Therefore, the PRA believes that it is appropriate to finalise the standards at this time.

## Scope

2.8 The CP proposed that the SS would cover all PRA regulated firms that undertake buy-to-let lending that are not already subject to FCA regulation. The PRA also stated that regulated firms should ensure that the standards contained in the SS are adopted by other firms undertaking buy-to-let lending within their groups. The CP also proposed that remortgages where there was no additional borrowing were not subject to the underwriting standards expectations.

2.9 Respondents asked if there could be an impact on competition, and the market more generally, if firms outside the scope of the SS were to lend in the buy-to-let market. The PRA has consulted with the FCA, which regulates some of the firms outside the scope of PRA regulation, on this issue. The FCA continues to monitor this section of the market closely. The PRA notes that the Financial Policy Committee (FPC) of the Bank of England has recommended to HM Treasury that it be given powers of Direction<sup>1</sup> over the PRA and FCA in relation to loan-to-value (LTV) and ICR measures on the buy-to-let market.

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1 FPC, July 2015; [www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement010715.pdf](http://www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement010715.pdf), and HM Treasury, December 2015; [www.gov.uk/government/consultations/consultation-on-financial-policy-committee-powers-of-direction-in-the-buy-to-let-market/financial-policy-committee-powers-of-direction-in-the-buy-to-let-market](http://www.gov.uk/government/consultations/consultation-on-financial-policy-committee-powers-of-direction-in-the-buy-to-let-market/financial-policy-committee-powers-of-direction-in-the-buy-to-let-market).

2.10 Respondents queried whether a small or low volume lender would be exempt from the underwriting standards. The PRA has confirmed in the SS that all PRA-regulated firms, and other firms undertaking buy-to-let lending within their groups, are expected to meet the underwriting standards as described there, irrespective of the lender's size or volume of transactions.

2.11 Respondents asked if the PRA would be publishing a separate set of expectations for buy-to-let mortgages subject to FCA regulation. As these mortgages are already subject to regulation, the PRA does not anticipate publishing a separate set of expectations.

2.12 Respondents queried the PRA's rationale for excluding remortgages where there is no additional borrowing from the expectations of minimum underwriting standards. The PRA considers that increased standards for certain lenders (noting that many lenders are already meeting these standards) could create inertia in the market, which could in turn limit the options for existing borrowers to refinance. Notwithstanding this, the PRA will continue to monitor firms as part of regular supervision to ensure that individual firms are not writing a disproportionate amount of higher risk mortgages for existing buy-to-let borrowers.

2.13 Respondents asked for clarification regarding whether holiday lets, bridging loans, property investment lending and corporate lending were exempt from the underwriting standards. The SS has been updated to clarify that these loans are not considered to be buy-to-let. The PRA will monitor these segments to ensure that prudent underwriting standards are maintained.

### **Affordability testing**

2.14 Chapter 2 of the SS sets out the PRA's expectations in relation to affordability testing.

2.15 Affordability tools constrain the value of the loan that a firm can extend for a given income. Such tools are designed to reduce the probability of default on the loan, particularly when in an environment of rising interest rates. The PRA considers that at higher levels of indebtedness, borrowers are more likely to encounter payment difficulties in the face of shocks to income and interest rates.

2.16 The CP proposed that all firms use an affordability test when assessing a buy-to-let mortgage contract in the form of an:

- (a) ICR test; and/or
- (b) income affordability test, where firms take account of the borrower's personal income to support the mortgage payment.

2.17 The CP also proposed that any tax liability associated with renting the property should be taken into account when assessing affordability.

2.18 Respondents requested clarification on a number of issues, and the draft SS has been updated for these, including whether:

- (a) either or both of these two tests should be performed on all applications;
- (b) a capital repayment mortgage should be subject to the ICR test; and
- (c) automated valuation models and evidence of existing rental agreements were permissible when verifying the expected rental income.

2.19 Respondents asked for more information on how firms should implement these affordability tests, and specifically, how tax bands should be verified. The PRA does not wish to be prescriptive regarding how firms implement the tests and therefore lenders should use their judgement, based on the principles outlined in the SS.

2.20 Respondents sought clarity on whether the PRA's expectations would be met if firms assumed that all borrowers were higher-rate tax payers for the purposes of their affordability assessment. The PRA has confirmed that this would meet expectations. The PRA notes, however, that under this approach lenders may decline applications from some otherwise eligible but lower-rate tax payers. It will be for the firm to decide if the costs associated with verifying the tax status of lower-rate tax payers outweigh the benefits to the firm of lending to them.

2.21 Respondents asked if capital gains tax should be included in their assessment of affordability. The SS now reflects that, as capital gains tax only becomes liable when the property is sold, future increases in property prices should not be taken into account in the affordability calculation. Therefore, any capital gains tax liability will be covered by the associated appreciation in the property price, neither of which should be factored into the affordability assessment.

#### **Interest coverage ratio (ICR) calculation**

2.22 The CP outlined a standard set of variables that should be reflected within the ICR test including all of the costs associated with renting the property and any tax liability associated with renting the property.

2.23 Respondents asked about the impact of including the changes to personal income tax relief in the ICR calculation and questioned whether a gross of tax ICR should be used instead. The draft SS set out the PRA's expectation on this issue and remains unchanged.

2.24 Respondents questioned why the PRA had not set a minimum ICR threshold or had been more specific in what costs should be included. The PRA does not want to be prescriptive in how firms implement the ICR threshold, and expects firms to adopt the principles outlined in the SS and apply them to their specific businesses. The PRA, however, does not intend for these expectations to result in a reduction in ICR thresholds and notes that some elements in the SS may lead to higher ICR thresholds.

2.25 Respondents requested clarification on a number of issues, and the draft SS has been updated for these, including:

- (a) whether firms conduct a debt service ratio (DSR) test (Chapter 2 of the SS sets out the PRA's expectations in relation to affordability testing. At their discretion, firms may wish to use DSRs as an additional test for assessing affordability); and
- (b) if data used at the portfolio level and data based on models would be sufficient when setting the ICR threshold (Paragraph 2.5 of the SS sets out the PRA's expectations of firms when setting the ICR threshold).

#### **Income affordability test**

2.26 The CP proposed a standard set of variables that firms should reflect within the income affordability test, which included all costs associated with renting the property (including tax liability), the borrowers' income net of tax and national insurance payments, credit commitments, committed expenditure, essential expenditure and living costs.

2.27 Respondents asked if, for high net worth individuals, wealth could be taken into account as a means to support the mortgage payments. The PRA has confirmed in the SS that wealth can be included as measure in the income affordability test.

2.28 Respondents sought clarification that credit commitments and other committed expenditures that were due to cease before the buy-to-let mortgage contract was entered into could be excluded from the affordability assessment. The PRA confirms that these commitments do not need to be included in the SS.

### **Interest rate affordability stress test**

2.29 The CP proposed that firms take account of likely future interest rate increases over a minimum five year period, unless the mortgage interest rate is fixed for a period of five or more years or for the duration of the mortgage contract if less than five years. In coming to a view on likely future interest rates, the CP proposed that firms have regard to:

- (a) market expectations;
- (b) a minimum increase of 2 percentage points in buy-to-let mortgage interest rates;<sup>1</sup> and
- (c) any prevailing FPC recommendation and/or direction on the appropriate interest rate stress tests for buy-to-let lending.

2.30 Even if the interest rate determined above indicates that the borrower's interest rate will be less than 5.5% during the first five years of the buy-to-let mortgage contract, the firm should assume a minimum borrower interest rate of 5.5%.

2.31 Respondents asked if rent rises could be included in their assessment of an appropriate stressed rate for assessing affordability. The PRA confirms that this is acceptable, subject to a maximum assumption of annual rises of 2%, in line with the Government's inflation target, as measured by the 12-month increase in the Consumer Prices Index (CPI), and has included this in the SS.

2.32 Respondents asked for more information on the rationale regarding calibration of both the 5.5% minimum and a minimum increase in mortgage interest rates of 2 percentage points. The PRA's overriding objective in issuing the SS was to ensure that there was not a loosening of underwriting standards to meet firms' growth plans as submitted in the PRA's 2015/2016 review of underwriting standards in the buy-to-let sector which covered 31 firms (92% of the market). Therefore in calibrating the stressed rates, the PRA reviewed current stressed rates adopted by firms and considered the impact of interest rate changes, and calibrated the stressed rate accordingly. Respondents asked if the minimum stressed rate of 5.5% was likely to fall or rise in line with the Bank of England Base Rate (BBR). The PRA does not consider that there should be a mechanical linkage between the minimum rate and the BBR. The PRA will monitor the calibration of the stressed rate expectations set out in the SS to ensure its ongoing appropriateness.

2.33 Respondents queried whether the PRA would provide sufficient notice to firms if the stressed interest rate expectations were to change, as firms would need to change their affordability tests. The PRA confirms that the PRA will consult before making any change to stressed interest rate included in the SS.

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<sup>1</sup> Buy-to-let mortgage interest rates can refer to either origination rates or reversionary rates. The PRA is not prescribing a specific interest rate, but lenders should be able to justify the approach taken for the purposes of the affordability test.

2.34 Respondents sought clarification regarding five-year mortgage products and whether they were excluded from the stress testing expectations as drafted in the CP. The draft SS has been updated with this expectation and the PRA expects firms to consider the borrower's refinancing risk at the end of the five-year fixed rate. Respondents voiced concern that this could lead to a fall in underwriting standards if firms were to move their product mix to five year products and reduce their stress rates accordingly. The PRA will monitor the market and act accordingly if there is evidence that firms' safety and soundness is at risk.

2.35 Respondents sought clarity on whether lenders could decide which mortgage rate (origination or reversionary) they would use when setting the stressed interest rate. Respondents asked whether that decision would apply across all buy-to-let mortgage contracts or if they could tailor the approach to specific segments. The PRA does not want to be prescriptive in defining exactly how firms set their stressed rates. Therefore, lenders should use their judgement, based on the principles outlined in the SS, to decide which mortgage rate (origination or reversionary) to use, as well as whether or not they apply the same rate to all buy-to-let contracts.

### **Portfolio landlords**

2.36 The PRA's expectations on buy-to-let lending to portfolio landlords are set out in Chapter 3 of the SS.

2.37 In the CP, the PRA proposed to define a portfolio landlord as a landlord with four or more mortgaged buy-to-let properties across all lenders in aggregate. Reflecting the commercial nature of this type of business, the PRA proposed an expectation that firms lending to portfolio landlords should do so according to a specialist underwriting process.

2.38 Respondents requested more information regarding the rationale behind why a portfolio size of four or more was used to define a portfolio landlord.

2.39 When putting together its analysis for the CP, the PRA reviewed data as of year-end 2014 collected from firms that participated in the 2015 concurrent stress test.<sup>1</sup> That data showed that arrears rates increase as portfolio size increases. The PRA also reviewed and considered existing industry practices across the buy-to-let market, where lenders had maximum portfolio size policies based on the number of properties and/or outstanding aggregate mortgage balances already in place. The PRA found that lenders generally referred mortgage applications above certain levels to specialist underwriting teams. The PRA's analysis was subject to the caveat that, in some cases, lenders' policies were based on lending within the firm, rather than across all lenders.

2.40 The PRA also considered the impact that the personal tax changes would have on landlords, and particularly those landlords using their personal income to supplement the rent. For portfolio landlords, who are not set up as limited companies, this additional tax burden will be considerable and so a portfolio view becomes even more relevant for new borrowing.

2.41 From analysis of the information above, the PRA concluded that for the purposes of prudent underwriting standards for portfolio landlords, the number of properties at which landlords would become more reliant on income from those properties, was four.

2.42 Respondents requested access to the data, which informed the CP proposals. The data and other information were provided to the PRA as part of its supervisory activity under FSMA.

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<sup>1</sup> December 2015, [www.bankofengland.co.uk/financialstability/documents/fpc/results011215.pdf](http://www.bankofengland.co.uk/financialstability/documents/fpc/results011215.pdf).

The data and information were not prepared on a consistent basis and it would not be appropriate to publish them for individual firms on an anonymised basis or in aggregate.

2.43 The PRA also wanted to ensure that when defining portfolio landlords, that existing debts across all lenders were considered to ensure that borrowers with multiple buy-to-let mortgages across different lenders were also underwritten according to prudent standards.

2.44 Some respondents argued that the number of properties threshold used in the definition of portfolio landlords was set at the incorrect level. Respondents argued for alternative definitions below and above the definition of four or more mortgaged properties, with the range of responses between three and ten properties.

2.45 Respondents queried whether it was appropriate to define portfolio landlords by the number of properties held as a stand-alone measure. These respondents suggested that the definition also be based on whether the properties were unencumbered, ie where there are no outstanding mortgages. The PRA recognises that there may be complex cases based on other criteria where firms' risk management standards require specialist underwriting standards for landlords with fewer than four mortgaged buy-to-let properties. However, the PRA does not want to be prescriptive and firms should decide what additional criteria they wish to use when defining portfolio landlords.

2.46 Respondents asked about the PRA's expectation on the process that should be used to verify any supporting information provided by a borrower, such as the number of properties held. The PRA expects firms to take a proportionate approach to verify borrower supplied information, including the use of credit bureau data where appropriate. The PRA notes that while the credit bureau data is not presently able to determine if a mortgage is owner-occupied or a buy-to-let, it may provide some useful information to verify the total number of mortgaged properties. The PRA expects firms to use their judgement in determining when borrower supplied information is significantly out of line with credit bureau data and therefore when additional information is required from the borrower.

2.47 Respondents asked for clarity regarding any changes to the capital treatment under PRA rules for exposures to portfolio landlords covered by the expectations in the SS. The PRA can confirm that the SS does not include changes to the capital treatment of buy-to-let mortgages, except for the clarification of the SME supporting factor (see paragraphs 2.53-2.58 below).

2.48 Respondents requested clarification on a number of other issues, and the draft SS has been updated for these, including:

- (a) the PRA's expectations of information requirements for portfolio landlords and whether this always needed to include a business plan;
- (b) how the definition of portfolio landlords works for multiple borrowers with multiple properties; and
- (c) whether the underwriting standards for portfolio landlords outlined in Chapter 3 of the draft SS were in addition to affordability testing in Chapter 2.

### **Risk management**

2.49 The PRA's expectations on firms' risk management of controls for buy-to-let lending are set out in Chapter 4 of the SS.

2.50 In the CP the PRA outlined expectations of firms regarding the adequacy of their buy-to-let lending controls including risk appetite limits, oversight and monitoring, portfolio concentrations and high risk segments, and fraud controls.

2.51 Respondents were broadly supportive of these proposals.

2.52 Respondents asked for the PRA to be more specific regarding the definition of high-risk segments. The PRA does not want to be prescriptive in defining high-risk segments and how firms should monitor them. The PRA allows for firms, in accordance with the established principles and minimum standards, to conduct their own analysis on their portfolios and to define and monitor these high-risk segments accordingly.

### **The SME supporting factor in relation to buy-to-let mortgages**

2.53 The PRA's final expectations on firms' use of the SME supporting factor in relation to buy-to-let mortgages are set out in Chapter 5 of the SS.

2.54 In the CP the PRA outlined its expectations that the SME supporting factor (CRR Article 501) should not be applied where the purpose of the borrowing is to support buy-to-let business.

2.55 Many respondents agreed with the PRA's expectations.

2.56 One respondent questioned whether the PRA's expectations are consistent with CRR Article 501, which in their view has wide applicability. Another requested that diversified, professionally-run buy-to-let businesses should be exempted from the exclusion, on the basis they have proven to be more resilient in market downturns compared to buy-to-let borrowing by individuals or buy-to-let borrowing by businesses where buy-to-let is secondary to their main business. The PRA does not consider that any borrowing where the purpose is to support buy-to-let business falls within the objective of the SME supporting factor described in CRR Article 501.

2.57 One respondent requested that the PRA consider an appropriate phase-in for this regulatory change, given it could have a direct impact on the capital position of some banks. After further consideration, the PRA has updated its expectation that firms comply with this change by 30 September 2017, in line with the implementation timescale of some other expectations in the SS.

2.58 Some respondents questioned whether the PRA's expectations are proportionate; arguing that undertaking changes to systems to implement the proposal would require potentially significant investment. The PRA does not accept that these expectations would require significant investment. Firms already face reporting requirements on their application of the SME supporting factor on exposures secured by property.

### **Cost benefit analysis**

2.59 Respondents also asked for clarity regarding the PRA's assessment of the costs associated with the expectations that portfolio landlords would be subject to a specialist underwriting process (see paragraphs 2.36-2.48 above). The PRA noted that given the expectation to include all buy-to-let mortgages in the definition of portfolio landlords, rather than just where the aggregate exposure/number of mortgages within the lender exceeded this level, this would lead to additional volumes of applications being processed through specialist underwriting. However, the PRA does not expect this additional cost to be significant.

## Appendix

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- 1** **Supervisory Statement 13/16 'Underwriting standards for buy-to-let mortgage contracts', available at [www.bankofengland.co.uk/pru/Pages/publications/ss/2016/ss1316.aspx](http://www.bankofengland.co.uk/pru/Pages/publications/ss/2016/ss1316.aspx)**