

Supervisory Statement | SS13/16

Underwriting standards for buy-to-let mortgage contracts

September 2016



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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1 Introduction

1.1 This supervisory statement (SS) is relevant to all firms regulated by the Prudential Regulation Authority (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;¹² this SS does not apply to either of these types of lending. The PRA expects regulated firms to ensure that the standards contained in this SS are adopted by other firms undertaking buy-to-let lending within their groups.

1.2 The purpose of this SS is to:

- (a) outline the PRA's expectation of minimum standards that firms should use to underwrite buy-to-let mortgage contracts; and
- (b) clarify the PRA's expectations in relation to the application of the small and medium-sized enterprise (SME) supporting factor on buy-to-let mortgages.

1.3 For the purposes of paragraph 1.2(a) firms should consider a buy-to-let mortgage contract as a contract under which:

- (a) the lender provides credit to the borrower;
- (b) the obligation of the borrower to repay is secured by a mortgage on land in the United Kingdom and in pounds sterling;
- (c) at least 40% of the land is used, or is intended to be used, as or in connection with a dwelling; and
- (d) the land subject to mortgage cannot at any time be occupied as a dwelling by the borrower or by a related person, and is to be occupied on the basis of a rental agreement (however for the purposes of this SS, an agreement to dwell in a property or part of a property for less than one month is not 'occupation on the basis of a rental agreement')

but excludes:

- (e) corporate lending (for the purposes of this SS 'corporate lending' is lending conducted by firms' corporate or commercial banking divisions using their specialist underwriting processes, including where lending is for mixed purposes (eg, commercial real estate) or where the purpose of the lending is investment or development finance);
- (f) an application from an existing borrower for consent-to-let,³ however existing consent-to-let exposures should be taken into account when assessing affordability for a new buy-to-let mortgage contract; and
- (g) a buy-to-let mortgage contract with a term of 12 months or less.

1 Mortgage Credit Directive Order 2015 (S.I. 2015/910) (as amended): www.legislation.gov.uk/ukdsi/2015/9780111127742.

2 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.

3 A consent-to-let product is a residential mortgage contract where the borrower is an owner-occupier and applies to let property on a temporary basis.

1.4 To avoid existing borrowers being adversely affected when re-mortgaging, the expectations referred to in paragraph 1.2(a) do not apply to buy-to-let remortgages where there is no additional borrowing beyond the amount currently outstanding under the existing buy-to-let contract to the firm or to a different firm. In determining the amount of borrowing on the new buy-to-let contract, arrangement fees, professional fees and administration costs can be excluded.

1.5 Firms should assess all buy-to-let mortgage contracts from the perspective of whether the borrower will be able to pay the sums due. The underwriting standards set out in this SS should form minimum standards, regardless of whether the borrower is an individual or a company.

2 Affordability testing

2.1 When assessing the affordability of a buy-to-let mortgage contract, the PRA expects firms to use a method which will include:

- (a) whether the income derived from the property is sufficient to support the monthly interest cost of the mortgage payments using an interest coverage ratio (ICR) test; and/or
- (b) if firms are taking account of personal income as a means for the borrower to support the interest and capital (if applicable) monthly mortgage payments, whether that income, in addition to any income derived from the property, is sufficient to support the mortgage payments using an income affordability test.

2.2 Firms should not base their assessment of affordability on the equity in the property which is used as security under the buy-to-let mortgage contract, or take account of a future increase in property prices.

Interest coverage ratio (ICR) calculation

2.3 The PRA expects firms to define the ICR as the ratio of the expected monthly rental income from the buy-to-let property to the monthly interest payments which take into account likely future interest rate increases as set out in paragraphs 2.11 to 2.17.

2.4 When assessing their minimum ICR threshold, firms should take into account rental demand and typical rent levels within the property's locale. Expected rental income should be verified by a suitably qualified valuer who is independent of the borrower, automated valuation models or evidence of an existing rental agreement, subject to appropriate policies, controls and risk management.

2.5 Firms can use a variety of data and information to determine the minimum ICR threshold, including portfolio level data and data based on models. When determining the minimum ICR threshold, consideration should be given to the following costs where the borrower is responsible for payment: management and letting fees, council tax, service charge, insurance, repairs, voids, utilities, gas and electrical certificates, licence fee, ground rent and any other costs associated with renting out the property irrespective of whether the borrower is an individual or a company.

2.6 The PRA also expects firms to take into account any tax liability that is associated with the property. For the avoidance of doubt, this should include mortgage interest tax relief. Firms may make a simplifying assumption that all borrowers are subject to higher rate tax but this

may result in firms declining otherwise eligible borrowers. Capital gains tax does not need to be included in the assessment of affordability.

2.7 The current industry standard is to set the minimum ICR threshold at 125%. The PRA does not expect these proposals to reduce minimum ICR thresholds and furthermore, some of the factors above may lead to higher minimum ICR thresholds.

Income affordability test

2.8 Firms may use personal income as a means for the borrower to supplement the rent within their affordability test.

2.9 If firms use personal income as a means for the borrower to supplement the rent, the PRA expects firms to conduct a detailed affordability assessment of the borrower taking into account the following:

(a) Income:

- (i) Examples of sources of personal income include employment income, rental income (from all of the borrower's properties), pensions, savings and investments.
- (ii) Personal income should be net of income tax, national insurance payments and any tax liability that is associated with financing the property as referred to in paragraph 2.6.
- (iii) Firms should assess any rental income by taking into account rental demand and typical rent levels within the property's locale. Expected rental income should be verified by a suitably qualified valuer who is independent of the borrower, automated valuation models or evidence of an existing rental agreement, subject to appropriate policies, controls and risk management.
- (iv) If a firm is aware that there is likely to be a future change in the income of the borrower during the term of the buy-to-let mortgage contract, such as retirement, the firm should take this into account.
- (v) For 'high net worth borrowers' firms may use the borrower's wealth in assessing the affordability for the buy-to-let mortgage contract (for the purposes of this SS 'high net worth borrower' means a borrower with an annual net income of no less than £300,000, or net assets of no less than £3,000,000, or whose obligations are guaranteed by a person with an income or assets of such amount).
- (vi) Firms should obtain evidence of the income or wealth of the borrower using appropriate methods of validation.

(b) Credit commitments:

- (i) Examples of credit commitments include mortgages (from all of the borrower's properties), loans, motor finance and credit cards which will continue after the buy-to-let mortgage contract is entered into.
- (ii) Firms should stress mortgage payments in line with the guidance and/or rules set by the FCA, PRA and the Financial Policy Committee (FPC).

- (iii) Firms should obtain evidence of the borrower's credit commitments, for example by making a credit reference agency search or checking credit card or bank statements.
- (c) Essential expenditure and living costs:
- (i) Examples of essential expenditure related to the borrower are food, utilities, telephone, council tax, buildings insurance, ground rent and service charge for leasehold properties, essential travel and childcare.
 - (ii) Examples of essential expenditure related to the borrower's rental properties include management and letting fees, council tax, service charge, insurance, repairs, voids, utilities, gas and electrical certificates, licence fee and ground rent.
 - (iii) Living costs are expenditure which is hard to reduce and gives a basic quality of life (beyond the absolute essential expenditure in (i)), such as clothing, household goods and repairs, personal goods and basic recreation.
 - (iv) In taking account of essential expenditure and living costs, the PRA expects firms to either obtain details of the actual expenditure from the borrower, or to use statistical or other modelled data appropriate to the composition of the borrower's household, including the borrower, dependent children and other dependents living in the household.
- (d) Other committed expenditure: examples of committed expenditure are school fees, child and/or spousal maintenance costs which will continue after the buy-to-let mortgage contract is entered into.

2.10 Firms should put in place, and operate in accordance with, a written policy detailing how income and expenditure is to be assessed.

Interest rate affordability stress test

2.11 When assessing affordability in respect of a potential borrower, firms should take account of likely future interest rate increases on affordability.

2.12 In taking account of likely future interest rate increases for the purposes of its assessment of whether the borrower will be able to pay the sums due, the firm should consider the likely future interest rates over a minimum period of five years from the expected start of the term of the buy-to-let mortgage contract, unless the interest rate is fixed or capped for a period of five years or more from that time, or for the duration of the buy-to-let mortgage contract if less than five years. The PRA also expects firms to consider the borrower's refinancing risk at the end of the fixed or capped rate period.

2.13 In particular, in coming to a view of likely future interest rates, the PRA expects firms to have regard to:

- (a) market expectations;
- (b) a minimum increase of 2 percentage points in buy-to-let mortgage interest rates;¹

¹ 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.

(c) any prevailing FPC recommendation or direction on the appropriate interest rate stress tests for buy-to-let lending; and

(d) firms should also be able to justify the basis it uses by reference to (a), (b) and (c).

2.14 Even if the interest rate determined in paragraph 2.13 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%.

2.15 An example of market expectations is the forward sterling rate published on the Bank of England website.¹ A firm should not rely only on its own forecasts. A firm should not link its determination to market expectations without considering the likely effect of rate changes in accordance with the market expectations on the specific buy-to-let mortgage contract in question.

2.16 If firms expect increases in rental income will partially mitigate likely future increases in interest rates, this may be taken into account when assessing affordability however, the assumption for increases in rental income should not exceed 2%, in line with the Government's inflation target, as measured by the 12-month increase in the Consumer Prices Index (CPI).

2.17 Firms should put in place, and operate in accordance with, a written policy detailing how future interest rates are to be taken into account when assessing affordability.

3 Portfolio landlords

3.1 In addition to the affordability testing outlined in Chapter 2, the PRA expects firms undertaking buy-to-let lending to have regard to its potential business characteristics. The PRA considers that borrowers with four or more distinct mortgaged buy-to-let properties², either together or separately, in aggregate, should be treated as 'portfolio landlords'.

3.2 The PRA expects firms to recognise that existing experience and skills acquired in buy-to-let lending do not automatically translate into equivalent skills when assessing portfolio landlords. Lending to portfolio landlords is inherently more complex given the quantum of debt in aggregate, the cash flows and costs arising from multiple tenancies and potential risks of property and/or geographical concentrations.

3.3 These complexities mean that a specialist underwriting approach is appropriate. Firms' underwriting process for portfolio landlords should take a proportionate approach based on their knowledge of the borrower, their portfolio and alternative sources of income they have. Examples of additional information firms may request from the borrower are as follows:

- (a) the borrower's experience in the buy-to-let market and their full portfolio of properties and outstanding mortgages;
- (b) the assets and liabilities of the borrower, including any tax liability referred to in paragraph 2.6;

¹ Available at www.bankofengland.co.uk/statistics/pages/yieldcurve/default.aspx.

² Firms may use their judgement when determining how to verify the number of mortgaged buy-to-let properties the borrower has. The PRA recognises that there are a variety of suitable ways to do this including using credit bureau data.

- (c) the merits of any new lending in the context of the borrower's existing buy-to-let portfolio together with their business plan; and
- (d) historical and future expected cash flows associated with all of the borrower's properties.

3.4 Firms should put in place, and operate in accordance with, a written policy detailing the differentiation between underwriting standards for buy-to-let lending and lending to portfolio landlords.

4 Risk management

4.1 The PRA expects firms to have adequate risk management and controls specifically for buy-to-let lending, including:

- (a) risk appetite limits on the flow and stock of buy-to-let lending, including ICR and loan-to-value (LTV) limits;
- (b) appropriate oversight and monitoring of the risk profile of lending introduced by third party intermediaries;
- (c) monitoring of portfolio concentrations and high risk segments; and
- (d) controls to ensure that any fraud risks associated with buy-to-let lending are effectively managed.

5 The SME supporting factor in relation to buy-to-let mortgages

5.1 The PRA expects that the SME supporting factor (Article 501, Capital Requirements Regulation (575/2013) (CRR)) should not be applied where the purpose of the borrowing is to support buy-to-let business. This means that, in general, the PRA expects firms not to apply the SME supporting factor to exposures secured on residential property that is let out by the borrower.

5.2 There may be some limited circumstances where it is permissible for firms to apply the SME supporting factor to exposures secured on residential property that is let out. Firms should consider the intended purpose of the loan before applying the SME supporting factor in this way. If the primary purpose of the loan is to support buy-to-let business, the PRA would not expect the SME supporting factor to be applied.

5.3 As an illustration, an SME borrower might take out a loan for the acquisition of a residential property that it intends to let out, and the loan may be secured using that residential property as collateral. In such a circumstance the PRA would consider that the purpose of the loan is to support buy-to-let business, and the PRA would not expect the SME supporting factor to be applied to that exposure.

5.4 As another illustration, an SME borrower may take out a loan with the purpose of investing to adopt new technologies and equipment to increase the competitiveness of the SME, and the loan may be secured on a residential property which they already own and let out. In such a circumstance, and where the other requirements for applying the SME supporting factor are met, the SME supporting factor could be applied.

6 Implementation timescales

6.1 Firms should meet the principles and expectations set out in this SS on a phased basis, as follows:

- (a) regarding 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.

6.2 Firms should contact their supervisor if they consider that circumstances exist which suggest a divergence from the timescale above on any of the expectations.