CONNECT mortgages

A COMPREHENSIVE GUIDE TO:

Buy to Let Mortgages

by Liz Syms
CEO, Connect Mortgages

Buy-to-let Mortgages

Liz Syms, by CEO of Connect for Intermediaries and specialist mortgage advisor to property investors

Introduction

This guide outlines the basics of mortgages, and considerations for individuals when evaluating their existing property portfolio or considering a new BTL property purchase. The guide also focusses on the mortgages that investors use for the purchase of a buy-to-let property and outlines some information around residential and commercial mortgages for comparative purposes.

Different property types

Residential property

This is a property being used as an individual's principle primary residence.

Buy-to-let property

Also referred to as a 'residential investment property', buy-to-let (BTL) property may be owned by an individual or company, which is then subsequently let to 'tenants'. These tenants have an agreement to occupy the property as their home, via a contract such as an assured shorthold tenancy (AST) agreement.

An AST agreement is the legal contract between the landlord who is the owner of the property, and the tenant who occupies the property. This contract sets out the length of time the tenant may occupy the property for, the monthly rent they must pay and any other conditions the tenant and landlord must adhere to.

The term of the AST agreement will normally grant the tenant occupation for a minimum of six months but could be agreed on a longer basis.

Commercial property

Commercial property is defined as a property where the occupants are a business rather than an individual, such as shops, warehouses and offices. The property can be just a commercial premise or it may be of 'mixed use' or 'semi-commercial' by including a residential element on its legal title such as a residential dwelling above or adjacent to the commercial dwelling.

An individual or company may occupy the premises to run their own business, and this would be called a commercial trading property.

Alternatively, an individual or company may purchase the property to let to another business, and this would be called a commercial investment property. Similar to an AST agreement on a BTL property, a contract will be entered into between the owner and occupier of the property to set out the terms of occupation. The minimum term is usually three years, and will often be considerably longer.

Comparison between a residential mortgage and a buy-to-let mortgage

Residential mortgage

An individual looking to purchase a property to live in will need to arrange a residential mortgage. The loan approval amongst other things will be subject to the lender's affordability criteria.

In the past, some lenders have been guilty of adopting a relaxed attitude to assessing affordability. Some would offer loans that were based on an individual's own self-declaration of income, without requesting evidence of this income.

This and other lending practices were seen to contribute to the crash of the market. As a consequence, the industry regulators, the Financial Conduct Authority (FCA), conducted a review of the market and implemented tighter controls, particularly around affordability.

Each application to a lender for a residential mortgage now consists of an assessment of the applicant's income and outgoings to determine if the mortgage they require for a property they wish to live is affordable. The lender also requires full evidence of the declared income and declared outgoings to justify the decision and meet the regulator's requirements.

There are wide variants, however, between lender offerings in terms of how much they deem affordable and are prepared to lend. This is because each lender has created its own affordability model, and will assess affordability and risk based on their own interpretation and experience. An applicant looking to borrow a specific sum may be declined that sum by one lender but approved by another.

Whilst lenders do not share the algorithms around their own affordability model, many now have a 'calculator' on their website that an individual can use to get a guide of the mortgage amount that lender may consider.

Buy-to-let mortgages

BTL mortgages are used to buy a residential investment property. The BTL mortgage was specifically created for the residential investment market by residential lenders. BTL loans are similar to a residential mortgage; however, they are unique in that the lender gives specific permission within the loan agreement for the property to be let to a tenant.

The loan agreement may also specify conditions, such as the type of tenant. For example, not all lenders will allow lettings to tenants who are in receipt of housing benefits.

The loan agreement will specifically prohibit the borrower from occupying the property themselves. The reason for this is that the lender is not assessing the borrower's affordability to meet the monthly payments from their own income.

Instead, the loan approval is assessed based on the anticipated rent exceeding the expected monthly mortgage payment (or an anticipated monthly payment with an assumption the rate will rise) with an additional margin on top to cover increasing of typically 25-45% to cover running costs.

Note

Because the lender is not assessing affordability, there is a risk that some borrowers may view a BTL mortgage as an easier way of obtaining a mortgage for a property they actually wish to live in. This risk is present because of the more stringent requirements implemented by the FCA around affordability for

a residential loan, meaning some applicants are unable to borrow via a residential mortgage.

BTL lenders are actively looking for risks of this nature and may decline an application if they suspect the applicant does plan to occupy the property. They may be suspicious that this is the case in circumstances such as a proposed BTL purchase being of higher value than the applicant's current residence, or larger or closer to the applicant's workplace.

Lenders will also complete checks after the mortgage has completed, to determine who is occupying the property. Where it is found that the borrower has taken occupation, the lender is likely to demand that the loan is repaid and is also likely to share negative information about the borrower with other lenders, making it very difficult for that borrower to secure further loans.

Background to changes to buy-to-let affordability and underwriting

In March 2016, The Bank of England and the Prudential Regulation Authority (PRA) issued a consultation paper seeking views on its proposals around the standards that it felt lenders should adhere to when underwriting BTL mortgages. The aims of the proposals were to curtail inappropriate lending and the potential for excessive credit losses.

In September 2016, a supervisory statement was issued which finalised the rules. The rules require that the lenders should consider the impact of future rate rises and the additional costs that the tax relief changes could have on the borrower's future ability to meet mortgage payments.

The rules require lenders to apply special underwriting to portfolio landlords. Portfolio landlords they have determined are those that own four or more properties. The special underwriting should consider the makeup of the existing portfolio, such as the average loan to value (LTV), other assets and liabilities and how the new acquisition or refinance sits within the overall business plan.

One other key requirement is that BTL mortgages should be stressed tested at a rate of 5.5%, to allow for potential future rate rises. They then require the lender to further factor in the costs of running the portfolio, such as management and service fees, maintenance, future tax liabilities and voids. The reality, therefore, is that lenders may require the rent to be as high as 145% of an assumed mortgage payment at a rate of 5.5%

See the BTL affordability section and portfolio underwriting section for more detail.

Borrowing criteria for a buy-to-let mortgage

Applicant types

Owner occupiers

For BTL, in general, lenders prefer the applicant to be an existing homeowner, and many of these lenders insist that there is also an existing residential mortgage in place.

It is common for a BTL landlord to hold a portfolio of property, yet be a tenant rather than the owner of the property they live in. There are some lenders who will cater for this type of borrower.

First-time buyer

Lenders, in general, are not keen to lend on a BTL basis to a first-time buyer. This is because of the perceived increased risk that the applicant may subsequently move into the property.

Some lenders do offer a solution by assessing the applicant's individual affordability to meet the mortgage payments in addition to the rental assessment.

Other lenders (but not all) will allow a first-time buyer to be a second applicant.

Identifying lenders who will consider first-time buyers as the main or second applicant may be useful for tax planning. It could be beneficial, for example, for a sibling of a property investor who is maybe a student or a low-income earner to be added to the property to mitigate some tax.

Consumer buy-to-let borrower

This is a borrower looking to raise a BTL mortgage on a property they either currently live in or used to live in.

If this is the first BTL property they will own, and they are having to do this out of restricted choice (eg being unable to sell the property), this BTL mortgage will be treated as a 'consumer BTL'.

Some, but not all lenders will consider consumer BTL applicants. If the lender accepts these types of applicants, it means the lender has some additional regulatory responsibility to ensure the loan is appropriate and lending is responsible.

The borrower would then qualify for some recourse via the Financial Ombudsman should problems arise in the future. A standard BTL mortgage in the main does not have such recourse with the Financial Ombudsman if they need to complain about the lender or mortgage adviser.

Expats and foreign nationals

An 'expat' is a UK citizen who no longer resides in the UK. There is a pool of lenders that do cater for an expat applicant looking to buy a BTL property in the UK. Sometimes, the criteria or products on offer from these lenders will be different to that on offer to UK residents.

Foreign nationals who wish to invest in a BTL property in the UK can also be catered for. However, lenders will decline applicants from sanctioned countries.

Creditworthiness

The best mortgage rates will be available to applicants with good credit ratings. However, some lenders will now consider past credit blips, especially when these are historic.

The degree of the credit issues will dictate both the interest rate offered, and also the maximum LTV offered.

Companies

Many lenders (but not all) now have an offering for applicants who wish to purchase a property with their company or limited liability partnership as the purchase vehicle.

This has become increasingly popular due to taxation changes to mortgage interest relief, and so is explored in greater detail further on in this guide

Repaying a buy-to-let mortgage

Whilst it is common for most BTL borrowers to take a BTL mortgage on an interest-only basis, all lenders do offer the choice of interest only or a capital and interest mortgage (often referred to as a repayment mortgage).

(a) A capital and interest mortgage is where the borrower pays a monthly payment that consists of both payments of the capital sum owed and the cost of the interest for the loan. The amount of capital outstanding gradually diminishes over the mortgage term. A capital and interest mortgage is a guaranteed way to ensure that the mortgage is paid off in full at the end of the term, providing each required monthly payment is met in full, as it falls due.

EXAMPLE:

£150,000 mortgage; interest rate 3.99%; mortgage term 25 years.

Total monthly payment £791.11

Mortgage point			
(subject to no interest rate changes)	Interest repaid	Capital repaid	Outstanding balance
Month one	£498.87	£292.25	£150,000
Month 60	£28,096.04	£19,370.67	£130,664.33
Month 180	£70,587.56	£71,844.05	£78,190.95
End of mortgage	£87,394.05	£150,035	Nil

(b) An interest-only mortgage is where the monthly payment to the lender consists only of the interest on the loan amount, with no element of ongoing repayment of the outstanding capital.

Using the example above, the monthly payments for an interest-only mortgage would be £498.75, subject to no changes in the interest rate.

The significant attraction of an interest-only mortgage for BTL borrowers is that the monthly payments are considerably lower than a capital and interest mortgage. However, the whole mortgage debt will still be outstanding at the end of the mortgage term.

The total cost of the interest, however, over the 25 years would be £149,625, because nothing has been repaid off the capital during the 25 years.

Lenders are willing to offer this option to BTL borrowers as the property is not their main residence. The borrower could choose to sell the property at the end of the mortgage term to repay the loan. Lenders are far more cautious in offering an interest-only option for a residential mortgage as the borrower may be forced to sell the property they actually live in to repay the mortgage at the end of the term, an issue they do not have for a BTL borrower.

Age and term requirements for a buy-to-let mortgage

Age

BTL is seen as a long-term investment. Investors are not always keen to sell their properties at retirement. Access to capital sums from pension schemes have fuelled the interest of older borrowers looking to invest in BTL property.

Due to demand therefore, more and more lenders have adjusted their criteria and look to accommodate older applicants. Whilst some lenders still have some catching up to do and offer mortgages that run to the maximum age of 65, others are willing to go to age 85 and beyond.

While it is legal for an 18-year-old to take a BTL loan, and some lenders will consider these applicants, BTL lenders typically prefer to lend where the applicants are over 21.

Term

A typical lender will offer a mortgage term between five and 25 years. Some lenders, however, do cater for terms as low as three years or as high as 35 years.

Most BTL mortgages are arranged on an interest-only basis. This means that the monthly payments will remain the same, regardless of how long the mortgage is taken for. As the mortgage capital sum would, however, need to be repaid at the end of the term taken, selecting the longest possible term would provide the greatest flexibility over the longer term.

Loan sizes

Deposits

Currently, a borrower will need a minimum of 15% of the lower of the property's purchase price or property value as a deposit in order to secure a BTL mortgage. This increases to 20% if the borrower is not an existing landlord. A 15% deposit means a maximum loan size of 85% of the property purchase price or valuation and this is referred to as 85% loan to value (LTV).

LTV of 85% for a BTL mortgage is available from a limited panel of lenders. More lenders become available at 80%.

A higher deposit of say 25% (equating to a 75% LTV mortgage) will substantially increase the lender choice and the interest rates will become more competitive.

The most competitive mortgage interest rates, however, are available for loans at a 65% LTV or less.

Lenders will ask the applicant to provide documentary evidence to prove where their deposit is coming from. This is to mitigate any risks of money laundering or non-transparent transactions.

It is acceptable for the deposit to come from savings, refinance or sale of another property, and some lenders will also accept the deposit coming from gifts of money or equity from immediate family members.

Equity in an existing property

Many borrowers will look to start their property portfolio by raising some capital from the equity in their own home. This strategy can be used to either fund the purchase of one property outright or as the deposit for several purchases.

An 'offset' mortgage is a specific type of residential mortgage that is ideally suited to help property investors fund a deposit. In simple terms, an offset mortgage is secured on the residential home but gives the option to draw down money in stages as and when required. This means the borrower will only pay interest on the specific monetary amounts as they are drawn down.

Loan size

Whilst the borrowing sum is dictated by the rent achievable on the property, lenders do also have minimum and maximum loan sizes, as well as minimum property values.

A property value of £50,000 would have a restricted lender choice, as would loan requirements that exceed £1,000,000.

Some lenders require a bigger deposit if the loan size is higher. They may, for example, lend up to 80% for loans sizes not exceeding £300,000, but limit the borrowing to 75% for loan sizes higher than this.

Some lenders favour higher loans more than others, so it is worth the investor shopping around if they are buying higher value properties.

Buy-to-let affordability calculations

Lenders calculate if the loan size required on a BTL mortgage is affordable by the use of a formula that compares the potential rental income against the mortgage payments taking into account costs and potential rate rises. This is called the 'stress test'

The PRA supervisory statement specifically requires lenders to take into account rate rises. This means that when a lender is looking at the affordability of a BTL mortgage, the lender needs to make an assumption that the mortgage interest rate would increase specifically to a rate of 5.5%. The 'notional' monthly mortgage payment based on this interest rate would need to be fully payable from the anticipated rent. However, there also needs to be a further amount of rent above this, called the 'margin', to cover the costs the applicant may incur while letting the property which includes void periods, maintenance, letting agents fees and tax. The PRA also directed lenders to consider how the applicant's tax position may change following the change to tax on BTL with the gradual withdrawal of the mortgage interest relief for higher rate taxpayers.

In relation to the amount allowed for the margin, the PRA did not dictate to lenders what the additional margin would need to be, leaving lenders to make their own interpretation of the costs different borrowers may incur. This has meant the actual calculation method does vary between lenders and is based on the lenders own affordability modelling and risk assessment. It can also vary between applicant types. The lender may require the rent payments to be 25% more than the notional mortgage payment for basic rate taxpayers but 45% for higher rate taxpayers based on the anticipated increasing tax costs.

This could make a significant difference to the size of a mortgage that may be approved, as demonstrated in the following example.

Example Affordability of a BTL loan

- Property purchase price: £200,000
- Loan required: 75% LTV (e.g. £150,000)
- Loan on an 'interest only basis' for 25 years

Actual monthly mortgage payment based on taking a 2.59% 2 year fixed interest rate =

£323.75 per month

(150000 x 2.59% /12)

Notional monthly mortgage payment at 5.5% PRA required calculation rate

£687.50 per month

Rent needed at 125% margin for costs **£860 per month** (£697.50 x 125% and rounded)

Rent needed at 145% margin for costs **£997 per month** (£697.50 x 145% and rounded)

Using the notional rate and at 145%, the affordability calculation in this example means the rent the property can achieve needs to be over 3 x the actual mortgage payment!

The impact of this is that some borrowers with lower rental yields are having to put down larger deposits and other borrowers are looking at higher yielding property like multi-lets in order to cover the affordability margins needed.

There however some exceptions to the rules. The rules do allow for longer term fixed-rate mortgages of five or more years to be excluded from the minimum 5.5% stress testing, because of the security of payments against rate rises. Therefore, the same loan in the example above, with say a 5-year fixed rate of 3.59%, would cost £448.75 per month.

The lender can use the actual rate taken to calculate the rent needed against this actual payment rather than a notional payment which would mean rent

of £561 for 125% margin and £651 for the 145% margin, considerably less than the method based on a notional interest rate of 5.5%.

Thus, we have seen an increase of lenders offering five-year fixed-rate mortgages with rental calculations based on the actual pay rate taken. We have also seen lenders introduce products that allow personal income to make up any shortfall in rent. At this moment in time, therefore, the market has adapted to continue to offer mortgage products to serve investors who wish to buy a property for capital growth potential, rather than the strength of the rental income.

In addition to the 5-year fixed rate exception, there are some other exceptions. For example, the PRA allows lenders to use a more favourable calculation method for like for like re-mortgages, which means a re-mortgage where the investor is not raising any additional capital above the existing amount outstanding.

There are also some lenders who are not regulated by the PRA who may offer other methods of calculation and certain property and loan types such as bridging, Holiday let property and commercial property are exempt from the PRA rules.

Income requirements

Although the affordability for a BTL loan is based on the rental income covering the mortgage payments, many lenders do still require that the applicant is able to evidence an income. Whilst they may not complete an affordability assessment against this income, the level may be required to be of a minimum amount, such as £25,000.

It is also a requirement of some lenders that this income is derived from non-property related activities. This is to ensure that should the borrower struggle to rent a property, that they have other income sources with which to ensure they can meet the mortgage payments.

When considering income, it is worth noting that lenders also have criteria in relation to how long the applicant has been employed or self-employed for. Applicants with self-employed status of one year or less will have a more limited pool of lenders to choose from.

Portfolio landlords and underwriting

Portfolio limits

If an investor is looking to build a portfolio, lenders will limit the number of loans that a borrower may have with them. This varies by lender, depending on the lender's own appetite to lend. The limit may be based on the number of loans, or a total monetary amount, or both. Once the lender's limit is exhausted, the borrower will need to find an alternative lender to continue to grow their portfolio.

It is important to note that some lenders also restrict the number of loans the applicant can have with other lenders. For example, they may refuse to lend if the applicant already owns ten or more BTL properties.

This type of lender is only targeting the smaller landlords, so professional landlords looking to grow substantial portfolios should look for lenders with no limit to the existing portfolio size.

Portfolio underwriting

Since the introduction of the PRAs supervisory statement, lenders have had to develop how they underwrite portfolio landlords to satisfy the PRA requirements. A portfolio landlord is a landlord that has 4 or more BTL properties. The following should be taken into account when establishing if someone is or isn't a portfolio landlord:

- The landlord has 4 or more BTL properties
- Including the subject property being financed
- Includes part owned property
- Includes property inside a Ltd company
- Includes existing 'consent to let' loans
- Does not include unmortgaged property
- Does not include the main residential property

When it has been established that a landlord is a portfolio landlord, The supervisory statement gave the following guidance with regards to underwriting the application:

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.

With this part of the requirements, the PRA gave limited guidance and examples and again lenders have each interpreted the rules differently and vary greatly in respect of the documents and information required to underwrite the portfolio landlords application.

Typical documents a portfolio landlord may be asked to provide include:

- A full summary and breakdown of the whole of the existing portfolio
- A business plan
- An assets and liability statement
- A cash flow statement

Lenders will often then complete detailed checks on the information presented. This includes assessing the existing portfolio, often referred to as the 'background' portfolio, to see what the impact would be against the landlord's finances if interest costs and tax costs increased. As with the subject property, this may involve 'stress testing' the portfolio against a notional mortgage interest rate and applying an additional margin.

Property types

The location of a property, the type of property and how new or old the property is, can have an implication on the lenders and products that may be available.

Investors can increase their income by picking certain property types. Properties that are let to multiple tenants can increase the yield and profits that the property generates.

Properties in need of refurbishment can be a good investment to gain capital value, as can properties that can be added to or developed.

These types of properties require more specialist lenders and market knowledge.

Houses in multiple occupation

A property that is let to multiple individuals and unconnected tenants, such as student lets, may be classed as a house in multiple occupation (HMO).

Some HMOs require the landlord to hold a licence. The implications of this are that they would need to adhere to regulatory requirements, such as building and fire regulations.

Since the changes in October 2018 to the HMO licence rules, it is mandatory for a landlord to have a licence on a property if there are five or more non-related tenants and shared facilities. Where a mandatory licence is not required (e.g. a property with 4 non-related tenants), the local authority can still require a licence by using additional licencing powers.

If an investor plans to let to multiple tenants, he will need to check with the local authority for that property to establish the licence requirements.

It is important to understand the licence requirements prior to sourcing a mortgage, as this can dictate the lender's willingness to lend.

Where some lenders are happy to lend on all HMO types, some lenders will only consider HMO property that does not require a licence. Other factors of criteria are also taken into account, such as the number of tenants, if there are locks on the internal doors, if the tenants are all named on one tenancy agreement (AST) or several agreements, and also the experience of the landlord.

Many high street BTL lenders will consider a four-bedroom HMO to students all on one tenancy agreement, but a ten-bedroom HMO with locks on doors and needing a licence will mean a different and more specialist lender will be needed.

Leasehold property

It is normal for a flat to have a 'leasehold' title, which means that the owner of the land the flat sits on leases the right to the owner of the flat to occupy a share of that land. How long the lease is for does vary and could be for as much as 999 years.

Leases that have less than 70 years left to run can be more problematic for lenders as the value of the property can go down the shorter the remaining lease term becomes. It is possible for leasehold property owners to approach the freeholder and ask for the lease to be extended – at a cost.

Most houses have a 'freehold' title which means the house also owns the land it is built on. However, a few locations in the UK do also have leasehold houses due to the history of land ownership in that area.

Multi-unit freehold blocks (MUFB)

This type of property is a single freehold legal title, but the property is divided into multiple self-contained flats, that have not been granted long leases. For example, an old Victorian house that has been converted into 3 flats each with their own entrances and facilities.

For mortgage purposes, as there is only one legal freehold property title and no leases, this will one be just one mortgage transaction.

Many BTL lenders will now consider this type of property but do vary in the maximum number of self-contained flats allowed on the freehold title.

Properties in need of renovation

Many investors look to buy property that requires work which they hope will then create additional capital value. If the investor has cash available to them, the investor could simply purchase the property outright. Finance can then be arranged on the property when the renovations are complete or close to completion.

If the investor does not have cash available to purchase the property outright, he would need to consider some form of finance to assist.

Lettable condition

BTL mortgages are generally only available for properties that are in a 'lettable' condition. This means there will need to be a working kitchen, a bathroom, and the roof and windows etc. will need to be in a reasonable condition.

Even where the property is of a lower standard than the investor would like to live in for themselves, providing the lender's surveyor confirms it is 'lettable' and of a 'suitable security' they will be able to arrange a BTL mortgage on it.

The surveyor may still recommend that a retention is made until certain works, often damp proofing, is carried out. It is worth noting that the lender will only lend based on the property's value as it stands today, not the projected value after any work has been completed.

In April 2018, rules were introduced that meant any property with an Energy Performance Certificate (EPC) rating of F or G could not be legally let out to tenants until the standard of the property had been improved to above the F rating. Most lenders will, therefore, treat these properties as not currently in a lettable condition.

Light/cosmetic refurbishment

Some lenders offer a mortgage product where the valuer will give two valuation figures on the first visit to the property, one for its current condition, and one on the anticipated value once the schedule of works is completed. On this scheme, they will accept properties that are not in an immediately lettable condition, as long as the works can be completed in a short period of time (e.g. a maximum of three months).

When the work is complete, the investor can ask the lender to request that the surveyor revisits the property and checks the work that has been done. If

the work has been done to the surveyor's satisfaction and the property value has increased as anticipated, the lender will release additional funds based on the increased value. This will be subject to the lender's rental calculation being met at the increased property value.

Alternative ('bridge') finance

If the property is deemed to be in a currently 'unlettable' condition a BTL mortgage will not normally be an option if it will take some time to bring the property up to a lettable condition.

This is because the affordability for the BTL loan is based on the rental income. If the rent cannot be received because of the work required, the mortgage will not be deemed affordable. Bridge lenders can offer short-term finance to enable the property to be purchased and then work can be carried out to bring the property up to lettable condition.

Short-term finance is typically offered between three and twelve months. The interest cost is higher than a BTL mortgage to reflect the shorter term the lender has to make a return and the additional risks involved.

A form of bridge finance is also used where a property is to be developed, for example, the conversion of a three storey terrace into three flats.

The cost of the bridge finance has come down, but is still more expensive than a standard BTL mortgage, so work should be completed as quickly as possible.

Once the work is complete, the property can then be re-mortgaged to a standard BTL mortgage, although not every lender will allow an investor to do this until they have owned the property for a minimum of six months.

If a more substantial amount of work is required, that requires planning permission, including when houses or flats are being built from scratch, then a specific type of bridge loan called 'Development Finance' will be needed. With development finance, not all of the loan is released on day one but instead is released in stages as the development progresses.

Other restrictive property types

Property that used to be in ownership of the local authority, particularly ex-local authority flats, are not considered by every lender. Those lenders who will consider these properties often have additional rules that require a specific percentage of the properties in that location to now be in private ownership.

Properties with mixed-use, such a freehold property consisting of both a shop with a BTL flat, above is not considered by most BTL lenders, however, the commercial lending market can consider these property types.

A house or a flat on its own leasehold title, but located above or next door to a commercial outlet such as a shop, is catered for, but not by every lender. The lenders reduce further when the commercial outlet is less desirable such as a takeaway or hairdressers or other commercial outlets that involve food, smells or chemicals.

Costs associated with a buy-to-let mortgage

Survey Fee

It is a requirement of any BTL lender that the property is surveyed before they will approve the lending. The cost of the survey will vary depending on the property's value and the lender chosen but is typically around £350 for a £100,000 property. This price is for a general valuation for mortgage purposes only, and although the borrower would normally get a copy of the report, there would be limited comeback in the event of future problems with the property, such as damp or structural issues.

A more comprehensive survey called a 'homebuyers report' could be considered, although this can cost up to twice the amount of a standard survey. This type of survey will provide the investor with greater detail about the property's general condition as well as the valuation for the lender.

Mortgage lender fees

Generally, all lenders have some sort of fee for providing a mortgage or loan. If the fee is described as an 'arrangement fee' it can often be added to the borrowing, but this will increase the loan and it will attract interest charges by becoming part of the overall loan amount.

If the fee is described as a 'booking fee' it is usually payable up front, when a full mortgage application is submitted to the lender. This fee is not normally refundable if the mortgage does not proceed for any reason.

Mortgage lender fees can range from several hundred pounds up to 3.5% of the amount being borrowed. Investors should add in the cost of these fees when comparing mortgage products.

Stamp duty land tax and land and buildings transaction tax

Stamp duty land tax (SDLT) is payable via the solicitor on the completion of a purchase. The SDLT cost is broadly calculated by multiplying the chargeable consideration against the percentage payable for each appropriate rate band (although a different basis of calculation will generally apply if an existing property portfolio is transferred to a company). From 1 April 2016, BTL and second home purchases are generally charged an additional 3%.

In Scotland, stamp duty land tax was replaced by land and buildings transaction tax (LBTT). An additional dwellings supplement of 3% applies to second home purchases in Scotland.

A useful tool to calculate SDLT can be found on the Connect website:

connectbrokers.co.uk/calculators/stamp-duty-calculator

It is worth noting that commercial property does not carry the additional 3% stamp duty surcharge.

Legal costs

Solicitor's legal fees will vary depending on the type of property transaction. For example, a solicitor may charge more for a commercial or bridging transaction than they would for a standard BTL transaction because of the different levels of complexity.

The solicitor's bill will always also include what is known as 'disbursements'. These disbursements include the Land Registry fees, telegraphic transfer fees and search fees. The amounts vary depending on the purchase price and location of the property, so investors should seek a quote for the costs in advance of instructing a solicitor.

For standard BTL mortgages, in many cases, the lender will allow the solicitor that the client has picked for themselves to also act on the lender's behalf. There are some lenders however who restrict the solicitors they will allow to act for them and this could result in the investor paying for both theirs and the lender's solicitor fees.

Mortgage broker fees

A mortgage broker fee is normally charged for the expertise of researching and arranging a mortgage with the most appropriate and competitive lender. An independent mortgage broker can save the investor time and money by searching through the majority of the lenders in the market place and advising how each product differs with its rates and terms.

A good broker will also deal with all the paperwork and administration, plus liaise with all the associated professionals such as the solicitor, accountant and estate agent to help achieve a smooth completion.

Other buy-to-let considerations

Interest rates

All lenders have a standard variable rate (or reversion rate) which is priced at a margin above the Bank of England base rate, London interbank offered rate (LIBOR), or using their own method of calculation to give a variable rate.

As the Bank of England changes the base rate, lenders will increase or decrease their standard rate to maintain their profit margin. The current Bank of England rate is 0.75%. (February 2019). LIBOR is priced each quarter and is set by the banks themselves.

Note

To attract business, lenders will often forgo some of their profit margins in the early years of the mortgage and offer an interest rate 'deal'.

The two main types of mortgage rate 'deal' are explained below:

(a) Fixed: The lender will offer a fixed rate of interest that will not increase or decrease during the initial fixed-rate term, even if there are changes to their standard variable rate. If market interest rates rise, borrowers will benefit from cheaper than average payments; or if interest rates fall, they may end up paying over the odds. They will, however, have the security of knowing exactly what the monthly mortgage payments will be for a set period of time.

(b) Trackers (and discounts): Often slightly cheaper (but not always) than fixed rates. If the rate is lower than a fixed rate it will mean initial lower monthly payments. However, payments may go up during the initial rate term. Likewise, payments can also go down if interest rates are reduced. The terminology 'discount' means a discount is taken off the lender's standard variable rate. The terminology 'tracker' means that the interest rate is set at a margin above or below the current Bank of England base rate or LIBOR rate.

Early repayment charges

Many mortgage deals have an early repayment charge if the investor pays off some or all of their mortgage early. It is important to consider the impact of these charges against a purchase strategy.

For example, if a property is being purchased to renovate and sell on, it would be important to avoid any early repayment charges (ERCs), which can potentially run into thousands of pounds and severely impact on the profit margins.

Early repayment charges usually only apply for the period of time the investor takes an initial rate deal for. For example, there may be a penalty of 3% of the loan within two years on a two-year fixed rate.

Investors should also look out for mortgage product interest rates with an initial very attractive rate, but then have an early repayment charge that extends beyond the initial rate deal, committing the loan to a less competitive lender rate.

Protecting the buy-to-let portfolio

The only compulsory requirement in relation to insurance that is set by the mortgage lenders is that the property must be insured against fire, theft and subsidence. This plan, called buildings and contents insurance, can be taken with the lender or can be taken with any provider in the market.

The lender may charge an administration fee if their insurance plan is not used to cover the costs of 'checking' the plan is suitable to cover their security.

Borrowers should consider a range of other insurances to protect their property. For an additional premium to the property insurance, borrowers can protect their rental income if a tenant doesn't pay.

Borrowers should also consider the impact on their portfolio in the event of death, serious illness or other incapacity. If ill-health causes financial difficulty in meeting personal commitments such as loans, credit cards or mortgage payments this could affect the borrower's credit rating, and in turn affect their ability to raise further finance or renegotiate finance on the portfolio.

Mortgages held in an individual's name cannot be transferred to another party and therefore would have to be repaid in the event of that individual's death. This could be through selling the property or through life cover.

Increasing the buy-to-let portfolio

To build a substantial portfolio, investors will need access to additional funds on an ongoing basis to cover deposits and fees. This can be achieved using their existing portfolio in the following ways.

Further advances

If the property has increased in value, perhaps through refurbishment or a general inflationary increase over time, it is possible to go back to the existing lender and ask to borrow more money. This is called a 'further advance'.

A new survey will normally be required to check the current value of the property, and the loan will be restricted to the maximum LTV (loan to value) the lender offers. The rent will need to be sufficient to meet the lender's criteria for a higher amount of borrowing.

Most lenders will not allow further advances until the property has been owned by the investor for at least six months.

Re-mortgages

Where additional borrowing requirements cannot be met by the existing lender using a further advance, or perhaps if a competing lender offers a better interest rate, it may be possible to re-mortgage.

This means a new lender will grant a mortgage which will be used to repay the existing lender. If a higher loan sum is taken than needed to repay the existing lender, this is called 'capital raising'. The capital raised in this way could be used to fund additional property purchases.

As this is a new legal transaction, a new survey will be required and a solicitor will be needed to complete the legal work. The costs of the survey and legal work may make this option more expensive. However, some new lenders will offer to pay some or all of the costs to re-mortgage to them.

Many lenders will not normally allow a re-mortgage to them until the investor has owned the property for at least six months. There are some specialist lenders however who will consider re-mortgages at an earlier point.

Second charge loans

These are loans that are secured on a BTL, residential or commercial property but sit behind the primary mortgage lender as a 'second charge' on the Land Registry.

The interest rates charged by these lenders are generally higher than a first charge mortgage. This is because in the event of disposal of the property, the first-charge lender is always paid first from the proceeds. There may be insufficient funds to repay the second-charge lender once this is done, especially if the property has been repossessed.

These types of loans can be useful and attractive if the mortgage interest rate being charged by the first-charge lender is highly competitive, but this lender does not offer any further borrowing options.

It allows the investor to leave the first mortgage untouched, but still gain access to the equity in the property from capital raised for further property investment.

A standard second charge loan works in the same way as a mortgage in that monthly payments are made to cover the cost of the interest.

Some second charge loans have no monthly payments. This is because instead of paying monthly interest, the lender rolls the cost of the interest into the loan and it is paid when the capital of the loan is repaid.

This is a useful way for investors to raise capital from their portfolio whilst still maintaining the property's cash flow. Because there is no rental calculation affordability test (as there are no monthly payments), it can increase the size of loan available when compared to other options.

Bridging finance

Bridging finance is a short-term loan raised on either a BTL, commercial or residential property. As a short-term solution, the loan term is usually for a maximum of 12 months. Bridging finance can usually be arranged much more quickly than BTL finance.

It can be used for a variety of reasons but is often used when funds are required quickly. They are a suitable means of finance to acquire a property at auction, as a purchaser at auction often only has three or four weeks to complete on the property purchase.

Another common use for bridging finance is to fund the purchase if the property is not in a suitable condition for a normal BTL mortgage, such as a property requiring refurbishment or development as detailed in the previous paragraph.

In some cases, bridging can be used to arrange up to 100% of a property's purchase price, with a loan secured on the subject property and/or cross-charged on one or more other properties in the existing portfolio.

Taxation and mortgage implications

Mortgage advisers should have a basic knowledge of the tax implications affecting a decision on how a mortgage is set up. However, they cannot give tax advice, so they should also look to recommend that the investors seek professional property tax advice from a qualified adviser, before proceeding with a mortgage

Whether a mortgage is done in joint or single names or in the name of a company, the way the mortgage is set up in the first place is important, as changes cannot be done easily or without cost after the mortgage is in place.

Prior to April 2017, landlords could offset all of their mortgage interest payments against the rental income before paying tax. For example, if their rent was £1000 per month and the mortgage interest cost was £400, only £600 x 12 months would be added to any other income to calculated the total income for tax purposes.

From April 2017, this mortgage interest relief is being restricted to just basic rate tax. It is being fully phased in over 4 years, which means that higher rate taxpayers will be paying more tax and this will gradually increase until it is fully phased in by the year ending 2021.

The introduction of these tax changes around mortgage interest relief etc for those investors who hold property in their individual names has resulted in mortgage advisers seeing increased enquiries for loans for companies. This is because companies are taxed differently from individuals and can still benefit from offsetting all of the mortgage interest payments against the rental income before paying tax.

In turn, more lenders have entered this market by introducing BTL loans for companies where they previously only offered loans to individual applicants. Products and criteria available for company transactions have also become more competitive, increasing the availability of funding.

What types of company are acceptable?

The company can be a new company, an existing company or a subsidiary.

Whilst some lenders will consider lending to an existing trading company, not all lenders will consider trading companies due to the complications of recovering the property if the trading business fails.

Most lenders prefer to lend to a special purpose vehicle (SPV) set up solely to own, buy, sell and let property.

At the start of the mortgage application, the company should be registered at Companies House and should also have an appropriate SIC code in place. A SIC code determines what the company can do.

The SIC codes typically accepted by the lender are:

- 68100 – Buying and selling of own real estate;
- 68209 – Other letting and operating of own or leased real estate;
- 68320 – Management of real estate on a fee or contract basis;
- 68201 – Renting and operating of Housing Association real estate.

As with other criteria, this does vary from lender to lender and should be checked in advance of a mortgage application.

If the location of the company is in England or Wales, there will be a greater choice of lending options than if the company is located outside the UK. Whilst some lenders will consider offshore companies, this is a far more specialised area than a UK company and usually only available via more commercially minded lenders.

That said, an Indian national, living and working in Dubai and buying a property in the UK via an Irish company would still be able to source a lending option!

How is the mortgage underwritten?

Subject to the company meeting the lender's criteria in terms of its type and SIC codes, the remaining underwriting is identical to an individual BTL application as the underwriting is based on the applicants who will be the directors and shareholders.

The affordability is still calculated using the lender's rental calculation method, however, because the company will not be affected by the tax changes, the margin of rent above the mortgage payments required by the lenders is typically 25% rather than 45% giving another reason as to why Limited Company applications have increased in popularity.

The lenders will expect all directors of the company to be party to the mortgage and will underwrite all directors in this way. The individual Director/s are still assessed in relation to their income and credit status.

Lenders may also expect all majority shareholders to be party to the mortgage. They deem this as typically any shareholder with 20% or more shared in the company. However, this can vary from lender to lender.

If one of the shareholders is another company, where the lender will consider this, they will insist on tracing back to the individual(s) who are the beneficial owners so that they can be underwritten in accordance with the lender's criteria.

Note

It is worth noting that the individual directors and shareholders of the company will be required in almost all cases to offer a personal guarantee for the loan.

In addition, the lender may also request a floating charge or a debenture against the company.

How do company mortgage products compare?

If having spoken to their accountant, the investor decides that using a company is the most effective tax solution for new purchases going forward, the investor should then consider how the mortgage costs and features differ.

The below table outlines where there is no difference and where there are areas for consideration.

Mortgage feature	Individual loan versus a company loan
Interest rate	A range of rate types for both, but company rates typically slightly higher than individual rates
LTV (loan to value)	No difference, up to 85% for both company and individual applications
Age and term	No difference
Property types	No difference
Applicant income and credit status	No difference
Fees and costs	Lenders arrangement fees are typically a little higher and most lenders will not allow the applicant's solicitor to act on the lender's behalf for a company loan resulting in higher legal fees.
Repayment method	No difference
Rental calculations	Some lenders calculations for companies are more favourable, due to the more favourable tax treatment.

The main consideration is cost in relation to mortgage fees and mortgage interest payments, which are in addition to any costs incurred for setting up and running a company.

The investor can ask the mortgage broker or lender to supply an illustration outlining the costs for both the most suitable lending option when taking out the mortgage in an individual name(s), and also the most suitable when taking out the mortgage in the name of a company.

That way, the additional mortgage costs can be compared and considered with the tax implications as part of a whole assessment.

The demand for company mortgages has been increasing over the last 12 months, so at the same time, we have seen increased competition and a closer alignment between the interest costs and fees for company mortgages versus individual mortgages.

Moving an existing portfolio into a company

If holding properties inside a company is decided as the correct solution for an investor, new purchases can be made fairly simply this way. However, moving an existing property or portfolio from the name of an individual to a company does come with potential additional costs and complications.

As the company is a separate legal entity to the individual name, the existing lender who has lent money to the individual on that property, will not simply transfer the mortgage to the company.

The lender will treat the transaction as a sale of the property by the individual and a purchase of the property by the company.

Without any mitigation or planning, the incorporation of a property portfolio can create substantial costs in capital gains tax and SDLT (or LBTT in Scotland).

If this route is chosen, investors should seek guidance on any strategies via advice from their tax specialist or their accountants that may help them mitigate such costs. However, care must be taken to ensure that any such strategies are transparent and acceptable to the lender.

One other example of complications relates to the deposit. The lender and solicitor will still require a transparent transaction that requires the company to have the required deposit as per the lender product chosen to make the purchase.

Clearly, if the company is a newly set up SPV, the funds are unlikely to be available in the company to demonstrate this. Lenders would normally look for a company's bank statement to demonstrate these funds.

Many lenders have given some consideration on how this potential complication can be overcome. The three main options that some lenders will consider approving are outlined below.

Director's loan

A director of the company that has been set up for the purchases could look to transfer money into the company as a director's loan.

This relies on the director(s) having sufficient capital of their own to be able to lend to the company. Again, for one or two small transactions this may be more viable than a larger number of transactions or larger value properties.

The director(s) would need to demonstrate the availability of the funds by showing a copy of their own personal bank statement.

It may be that they could have an option to take a director's loan by way of a loan to themselves first via another company if they are a director of another company that does hold sufficient funds.

As long as they can provide evidence via a paper trail of bank statements, the lenders will be satisfied with this.

Director's loan – 'Paper' transaction

Some of the more flexible lenders will allow the director's loan to be a 'paper' transaction.

This means they will take into consideration any retained profits held within the purchasing company or other companies connected to the director(s).

They will consider accepting this as evidence of deposit, subject to receiving confirmation from the applicant's accountants that the deposit will be managed through the accounts this way.

While the lender will instruct the solicitor managing the transaction of the acceptance of the source of deposit funds, the solicitor is also responsible for ensuring that they are happy with the transparency of the transaction.

Equity gift

One other option is to source a lender that will accept an equity gift as the deposit.

This means the current individual property owner 'gifts' equity to the company. As a gift of equity, this eliminates the need to demonstrate for either the individual or the company to have the capital for the deposit.

A lender will normally look to lend against the lower of the valuation of the property or the purchase price actually paid.

Instead, with an equity gift, they lend against the valuation. They will accept that the physical transfer of cash between the parties will be lower. The equity gift amount still needs to be at the sum required to at least cover the lender's minimum deposit required (e.g. 25%).

Example —Incorporation: equity gift

Value – £200,000

Equity gift (25%) – £50,000 (cash sums not required)

Mortgage loan – £150,000

Funds transferred to the individual by the company £150,000

The lender will, however, expect the Land Registry to reflect the total cost the company has had to pay to acquire the property, plus the value of the equity gift.

SDLT (or LBTT) implications will generally need to be considered also.

Capital raising

Irrespective of the strategy adopted, the reality is that the sum actually paid by the company to the individual only needs to be enough to allow the individual to clear any existing mortgage held against the property in their own name.

They may, however, want to use the exercise to capital raise additional funds for further property investment. Most lenders are happy to lend additional sums for this purpose within their LTV limits and subject to satisfactory rental income to meet their affordability requirements.

Commercial property

It is worth noting that properties meeting the definition of a commercial property, that is being let to or occupied by a business rather than an individual on a residential basis, fall outside the tax relief restriction for finance costs.

Therefore, these type of properties held in individual names may not need to consider incorporation, if the sole or main purpose of incorporation would otherwise be to continue to benefit from tax relief for interest payments.

Applicants for commercial loans are very similar to BTL loans. Commercial loans are offered by lenders who specialise in commercial lending, and include both high street banks with traditional commercial offerings and specialist ‘challenger’ banks who offer products with more flexibility and are similar to BTL lenders, for example, higher LTVs and interest only terms.

In addition to the standard BTL underwriting, applicants looking for a commercial loan will typically need to show experience in their field and a business plan.

Holiday Let Property

Property that is let on a short term basis such as a holiday let or an Airbnb property, if let within the requirements are treated as businesses, and therefore can still benefit from offsetting all of the mortgage interest payments against tax even when the property is held in an individual name.

The requirements include the property being fully furnished, how long the property is available to be let for and the maximum period for each letting.

Not all lender offer mortgages for Holiday Let or Airbnb property, but again it is one area lending options are increasing. Holiday Let property does also sit outside of the PRA rule changes, so some of the more commercially minded lenders can look at the affordability based on the profits the business is producing rather than the traditional rental calculation method.

Getting the lender right

It is important for an investor to consider the strategy in advance of making an application to a lender. The lenders’ criteria vary greatly in respect of the deposit requirements.

If a lender is selected that does not allow, for example, gifted equity, and this is the only option for the transaction to be successful, the lender will decline the application. There is a risk that this does not get uncovered until the legal point of the transaction, by which time legal and mortgage costs, as well as time, will be lost.

It is expected that the lender criteria will continue to develop and change over the coming years, as more investors look to incorporate their portfolios as the finance costs restriction is gradually phased in.

Alternatives to incorporation

The investor may conclude, after seeking advice, that whilst new purchases should be made via a company, it is not practical or financially viable to incorporate the existing portfolio.

Some options an investor could consider to cover the increased taxation costs include:

1. Re-evaluate the mortgages on the existing portfolio. Can the properties be re-mortgaged to benefit from lower mortgage interest costs?
2. Is there a margin to increase rents? Demand is strong in a number of areas, and the rents on properties with long-standing tenants may not have been increased regularly to the market level.
3. Consider incorporating a clause in future tenancy agreements that outline a regular review and increase of the rent.
4. Where a property is held in joint names between husband and wife and one party has a lower tax rate than the other, consider transferring the ownership into the owner with the lower tax rate. This is called a ‘transfer of equity’ and it is usually accepted by the lender, although lender approval will need to be sought.
5. Investors could consider converting or extending existing properties, so that they can be let on a multiple occupancy basis, potentially generating higher rental yields.

The mortgage process via a broker

Working with a specialist mortgage broker

A mortgage broker that specialises in mortgages for property investment should be able to help the property investor navigate through the lenders’ criteria on all points, to reach the most suitable lender for the overall circumstances and requirements.

The mortgage process is outlined below:

- The mortgage broker completes a full fact-find on the investor.
- The fact-find includes basic details, an income and outgoings assessment and details of any existing properties and mortgages.
- The details of the proposed transaction are gathered.
- Research is completed by the broker, and a lender is sought that meets the applicant’s requirements from the fact-finding.

- An independent broker will source options from the range of products and lenders available in the market.
- The broker makes a recommendation of the most suitable option found through the research.
- The broker applies to the lender for a decision in principle' on the applicant's behalf.
- The lender completes a credit check and considers the merits of the application information submitted, and if satisfied, confirms an agreed decision in principle.
- The broker collates with the applicant the supporting documents required by the lender. This typically includes identity and address proof, income evidence, deposit evidence and bank statements.
- The broker submits a full mortgage application to the lender with the supporting documents the lender requires, on behalf of the applicant.
- The lender instructs a surveyor to complete a valuation of the property.
- The surveyor prepares a property report and sends it to the lender.
- The lender's underwriter assesses all the documents and the survey report to make a lending decision.
- The lender issues a binding mortgage offer which outlines the terms of the loan.
- The above applies to all mortgage applications, regardless of whether they are purchase or re-mortgage transactions, and also regardless of whether they are residential, BTL or commercial transactions.

Once the mortgage offer has been issued, the applicant's solicitor will complete the legal work required, such as searches, Land Registry and drafting contracts. It is at this point, for purchases, the deposit requirements will need to be satisfied.

The mortgage broker will be less involved during the legal stage but will liaise with the solicitor to assist if any lender issues arise.

Once the legal work is completed, the funds will be released by the lender and legal completion will take place.

The accountant's role in the mortgage process.

The accountant can assist their client by researching suitably knowledgeable mortgage brokers to whom they can refer their clients.

This can often be a reciprocal arrangement as mortgage brokers, in light of the various tax complexities, are looking for accountants that are knowledgeable in property tax to refer their own clients.

Accountants can also assist brokers greatly when gathering information about an applicant's income or company details.

Whilst applicants will have an understanding of their income, it is not uncommon (but perhaps understandable) for applicants to be unable to recall, for example, their exact net profit for the last three years. An application submitted to a lender without accurate information stands a much higher potential to be declined by that lender when the documentary evidence does not match the initial proposal.

Whilst applicants can produce employed income evidence easily such as payslips and P60 certificates, the documents required from self-employed applicants or company directors are often more complex.

A lender may request any combination of the below documents as income evidence for a self-employed applicant or a director:

- Form SA302.
- Tax Calculation and Overview documents.
- Tax return.
- Accounts.
- Management accounts and projections

Portfolio landlords will also often be asked for documents such as Asset and Liability statements, Business Plans and Cashflow statements that may require assistance from their accountant.

Where a mortgage broker can work directly with the accountant to gather the correct income details and documents, this can greatly increase the application's chances of success.

Summary – Advising in the current BTL market.

There have been raft of changes over the last few years for property investors which have included the additional 3% stamp duty for second property purchases, changes to the mortgage interest tax relief for higher rate taxpayers, the PRA rule changes to affordability calculations and underwriting for portfolio landlords and also changes in other areas such as HMO licencing rules and EPC rating requirements.

Some landlords have chosen to exit the market, but in the main, these have been the smaller landlords with other income and businesses elsewhere. The professional landlords have adapted to the changes as any professional business would adapt to market and regulatory influences.

Many have looked to diversify their investment strategy by considering higher yielding HMO property, completing new purchases via companies, creating capital growth via development or refurbishment and considering other property types such as holiday lets or commercial property that still carry some tax and underwriting advantages.

For mortgage advisers who take the time to fully understand the market, working with landlords can be very good for building a business. Portfolio landlords in particular, who are growing the size of their portfolios, will need continuous advice in navigating the specialist lenders criteria as they find each new property. Compare this to a residential mortgage client who may need advisers services only every 2-5 years. The landlord's portfolio will also need regular reviewing creating re-mortgaging and further borrowing opportunities.

Advisers who work with professional property landlords often become their 'financial' partner for the life of the landlords business and therefore do not need a considerable volume of landlords to grow their own successful mortgage business.

©2020 - Liz Syms - Connect Mortgages