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Mortgages

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Mike Conen

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Mike Conen BEd (Hons) is a training and development consultant with more than 25 years' experience in the financial services industry, following a successful teaching career. He works closely with The London Institute of Banking & Finance on a range of projects, including learning resources, examination and syllabus development, and sample question banks.

Acknowledgements

The publisher gratefully acknowledges the contribution of Steve Dilks ACII APFS and Nigel Owens as technical reviewers of this text.

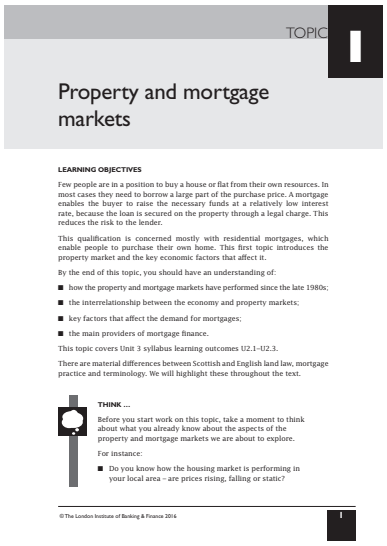
Contents

About this book

This book has been developed specifically to support you in your studies for the Mortgages module of the Certificate in Mortgage Advice and Practice (CeMAP®). In each topic, there are features to help you to break down your studies, absorb information and prepare you for your exam.

Learning objectives

These set out what you will be learning in each topic and how the topic content links to the syllabus requirements.



TOPIC 1

Property and mortgage markets

LEARNING OBJECTIVES

Few people are in a position to buy a house or flat from their own resources. In most cases they need to borrow a large part of the purchase price. A mortgage enables the buyer to raise the necessary funds at a relatively low interest rate, because the loan is secured on the property through a legal charge. This reduces the risk to the lender.

This qualification is concerned mostly with residential mortgages, which enable people to purchase their own home. This first topic introduces the property market and the key economic factors that affect it.

By the end of this topic, you should have an understanding of:

- how the property and mortgage markets have performed since the late 1980s;
- the interrelationship between the economy and property markets;
- key factors that affect the demand for mortgages;
- the main providers of mortgage finance.

This topic covers Unit 3 syllabus learning outcomes U2.1–U2.3.

There are material differences between Scottish and English land law, mortgage practice and terminology. We will highlight these throughout the text.

THINK ...

Before you start work on this topic, take a moment to think about what you already know about the aspects of the property and mortgage markets we are about to explore.

For instance:

- Do you know how the housing market is performing in your local area – are prices rising, falling or static?

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THINK ...

This feature, which appears at the start of each topic, is especially helpful if you are new to the financial services sector. It helps to provide a context for your studies by suggesting how the topic content might relate to your own experiences, to products and services that might already be familiar to you, or to your previous studies.

INFORMATION PANELS

These provide background or additional information. Content that appears in these panels may be covered in your exam, so you must make sure you read them.

% Calculate

Worked examples help you to understand how to carry out calculations.

KEY TERMS

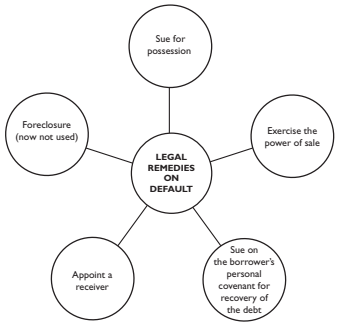
Key terms are explained alongside the content in which they are used.

! Notes

These draw attention to important information, usually relating to your preparation for your exam.

Figures

Most of the figures in this book provide visual summaries to help you to absorb information quickly. Try creating your own diagrams to help you with your revision. The source for all figures is The London Institute of Banking & Finance unless otherwise stated.



FACTFINDS

These provide useful links to authoritative sources of information where you can check current details, particularly relating to tax and benefit rates and to the progress of legislation that had not been implemented at the time this book was written. They also provide pointers to further information if you would like to find out more about a particular topic.

IN BRIEF

These provide short summaries of a process or issue.

✓ Check your understanding

These help you to make sure you understand what you have just read. Alternatively, they help you to check whether you can recall information from an earlier topic that is relevant to the current topic. Referring back to your earlier work and applying your learning in a different context helps you to assimilate the information. Where appropriate, answers are provided in the back of the book.

THINK AGAIN . . .

This feature encourages you to reflect on how much you have learned in each topic and to make sure you have really understood what you have been reading. It does not cover all the content of the topic but it prompts you to check your understanding.

? Test your knowledge

Confident you have understood and can recall the topic content? Test yourself before you move onto the next topic. Answers are provided at the back of the book. A good score will be a great confidence boost! If you don't do as well as you'd hoped, revisit the content areas where you got the answers wrong.

!

THE UK AND THE EUROPEAN UNION

EU Directives and regulations underpin much of the regulation of financial services in the UK. At the time of writing, the UK has left the EU but the full impact on the financial services sector is not known, nor the timing of any changes.

!

ADDITIONAL RESOURCES ONLINE

This book is supported by a dedicated course website available to students by logging on to **my.libf.ac.uk**.

Your course site contains additional learning materials that complement and enhance your understanding of the topics, including e-quizzes and case studies.

The course site may also include useful information released since the book was published.

Property and mortgage markets

LEARNING OBJECTIVES

Few people are in a position to buy a house or flat from their own resources. In most cases they need to borrow a large part of the purchase price. A mortgage enables the buyer to raise the necessary funds at a relatively low interest rate, because the loan is secured on the property through a legal charge. This reduces the risk to the lender.

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THINK . . .

Before you start work on this topic, take a moment to think about what you already know about the aspects of the property and mortgage markets we are about to explore.

For instance:

- Do you know how the housing market is performing in your local area – are prices rising, falling or static?
- Is there a good supply of housing in your area, or a shortage? How does this affect prices?

- What challenges do first-time buyers face in getting onto the property ladder?
- Which sorts of companies provide mortgage finance?

1.1 Introduction

The UK has a mature property market, with home ownership seen as both desirable and essential; in many cases, it is seen as an investment. Buying a house is seen by many in the UK as a natural step in the life cycle – like getting a job, marrying or having children.

The UK mortgage market is intensely competitive. In part, this arose from changes to regulation in the 1980s, which allowed new lenders to enter the mortgage market. It is also due to increasing demand and sophistication on the part of borrowers, who are now accustomed to shopping around for the best deal, and comparing features and price. As a result there is a wide array of products on offer from a range of financial institutions.

1.2 How did the credit crunch affect the mortgage market?

The 'credit crunch' of 2007 and the subsequent global financial crisis had a profound effect on the financial services sector. UK demand for mortgages stalled in early 2008, primarily as a result of the 'credit crunch', and remained at a relatively low level for several years. Much of the regulation that underpins the financial services sector, including mortgage lending, was introduced to remedy the problems that the crisis exposed. Understanding how the credit crunch arose and developed will help you to understand how the broader economic situation affects the mortgage market, so we are going to explore it in some detail.

HOUSING BOOM

The boom of the early 2000s led to increases in the value of assets, particularly residential property, in the USA and the UK. As a result of rapidly rising prices, many aspiring homeowners were unable to get on the housing ladder. Lenders addressed the problems by easing their lending criteria. US lenders dramatically increased the number of mortgages to customers with low incomes and/or poor credit ratings, known as sub-prime lending.

With a buoyant and growing housing market, sub-prime lending did not seem to pose significant risks – both lenders and borrowers were confident that the value of property would continue to increase, providing good security for lenders and sound investments for borrowers. At the same time, low interest rates encouraged people to borrow money at levels never seen before.

SECURITISATION

Mortgage providers packaged the mortgage loans they held – sub-prime as well as prime lending – into bundles and sold them to other institutions all over the world. This securitisation process removed the loans from the lenders' balance sheets, and the proceeds of the sale gave them more capital to invest.

The success of securitisation depended on a strong housing market to cover the risks of sub-prime borrowers defaulting. By the middle of 2007, money raised through securitisation underpinned half of the UK's mortgages.

'EXPLODING' MORTGAGES

Many US sub-prime borrowers took out 'exploding' mortgages, which started at a low rate and then moved to a much higher rate. When many loans were moving to a higher rate, interest rates were raised to counter inflation. Homeowners in general, and those with exploding mortgages in particular, found it difficult to meet their mortgage payments. Many brokers and lenders had acted irresponsibly by arranging mortgages for those who clearly could not afford them. Mortgage defaults rose dramatically, causing a dramatic reduction in house prices.

HOUSING HALT

Many medium-sized US mortgage companies failed and went into liquidation, with many banks also badly hit as a result of buying securitised debt – the income stream that they had expected to get from mortgage repayments was affected because people were defaulting on their repayments, and it became difficult to assess the true value of the securitised loans they were holding. Banks pulled back on lending, particularly in the sub-prime sector, and became reluctant to lend to each other. Interbank interest rates increased and the housing market ground to a halt. This sequence of events was repeated soon after in the UK. The confidence and trust that had underpinned the strong markets had disappeared.

WIDENING CRISIS

In August 2007 share prices fell across the world. The lending crisis hit businesses outside the mortgage sector as well, because it became difficult to borrow at all. Many companies started to fail as a result of cash flow problems, even though the businesses themselves were fundamentally sound. Lack of credit led to markets in general grinding to a halt, because it is freely available credit that keeps the wheels in motion.

BANK RUN IN THE UK

The problem of sub-prime lending was not as severe in the UK as in the US, because the UK market was subject to tighter controls. However, Northern Rock had a high proportion of risky mortgages due to its aggressive pursuit of market share and had taken advantage of securitisation.

In September 2007, Northern Rock had to ask the Bank of England for emergency funds to aid cash flow because it was unable to raise sufficient funds in the capital markets. Investors panicked and tried to take their money out of the bank, even though it was in a relatively solvent position. By February 2008, despite abortive attempts to find a buyer and a number of funding guarantees, the government decided to nationalise Northern Rock and then Bradford & Bingley.

GLOBAL FINANCIAL CRISIS

At the same time as the credit crunch began to bite, the world economy was hit by huge rises in the price of commodities, particularly oil, which caused general price rises just at the time when the markets were nervous.

Several large US financial institutions failed and either went under or had to be bailed out, and the problem spread to financial institutions across the world. In the UK a number of banks had to be bailed out by the government. Billions were pumped into the banks to increase liquidity and world interest rates were slashed in an attempt to stimulate lending.

CHECK YOUR UNDERSTANDING 1

From your studies for UK Financial Regulation, can you remember what liquidity is?

1.3 What happened to the UK mortgage market after the credit crunch?

The property market remained depressed after the credit crunch. A number of factors contributed to this:

- The UK economy went into recession during the financial crisis: confidence was low, job losses increased and many companies that did not shed staff imposed pay freezes or cut workers' hours.
- In the housing market itself, many would-be sellers decided to sit tight until things improved, and would-be buyers were reluctant to jump into the market when prices could go down further.
- Banks remained reluctant to lend, either to each other or to prospective homebuyers; instead, they were concentrating on building up their reserves. To address the problem, the government launched its 'Funding for Lending' initiative in August 2012, under which the Bank of England

RECESSION

A significant decline in economic activity, usually defined as a decline in gross domestic product (GDP – the value of all the goods and services produced within a country) for two successive quarters, ie six months.

lent money at below-market rates to financial institutions. The initiative enabled lenders to cut their interest rates a little, and inject more capital into mortgage loans. However, the focus of the Funding for Lending scheme was changed in November 2013 to provide funding for small businesses only.

- Lenders still active in the mortgage market adopted a safety-first approach, requiring much higher deposits and looking much more closely at potential borrowers' ability to repay their loans. Potential customers with small deposits, limited disposable income or poor credit histories were no longer seen as desirable. The lenders' approach was reinforced following the Mortgage Market Review, which required lenders to apply more stringent affordability criteria from April 2014.

1.4 How does the contemporary market look?

Lending gradually increased as confidence returned to markets and, from 2013, the UK housing market was recovering, although it took until the second quarter of 2014 for the average UK price to recover to the peak reached in the third quarter of 2007. However, recovery did not take place evenly, with prices in London and its commuter belt in particular far outstripping those in other areas of the UK, although this trend is changing.

FACTFIND

Nationwide's House Price Index publishes the latest house price growth rates at:

https://www.nationwide.co.uk/about/house-price-index/headlines [Accessed: 21 October 2020].

The accepted view is that the London market ('the London housing bubble') is subject to different forces to the rest of the UK, and should not be used to assess typical house prices.

Given the number of people who commute to the capital from further afield, prices in those commuter belts are impacted by the London effect. There are also other areas in England, such as Manchester, where house price increases are significantly higher than the average.

Key factors include:

- house prices increasing well ahead of wage rises;
- limited supply driving prices up;

- a lack of affordable homes;
- potential London buyers deciding to buy in the home counties, driving prices up in those areas when the market is thriving.

There has been a decline in UK average house price growth in recent years, as opposed to a fall in prices. A modest increase in prices in January 2020 suggested that uncertainty over the UK's exit of the European Union ('Brexit') was a contributory factor in the slowing of house price growth.

Another contributory factor was stamp duty land tax (SDLT) changing from a slab system to a tiered system. While those at the lower end of the property-buying scale now pay less SDLT, those in the upper price brackets pay considerably more than before the changes. This is likely to be causing a knock-on effect, where reluctance (or inability) to pay high levels of SDLT means properties at the higher end of the market are difficult to sell.

1.4.1 First-time buyers

A particular issue is the difficulty first-time buyers face in buying a home, resulting from a combination of more stringent checks on affordability, a requirement for larger deposits, and rising prices. The problem is especially acute in London and the south-east, because property prices in those areas are so high. However, the number of first-time buyers is increasing. First-time buyers are vital to the overall health of the housing market because without these new entrants, homeowners further up the chain are unable to sell and trade up.

Today's first-time buyers are older and have to find a much higher deposit than in the past. However, lower interest rates and government incentives have helped to stimulate the market.

Government efforts to support first-time buyers include measures to make buy-to-let investments less attractive (see section 1.5.5), an exemption from SDLT for first-time buyers, and planning rules requiring affordable housing to be included in new developments.

FACTFIND

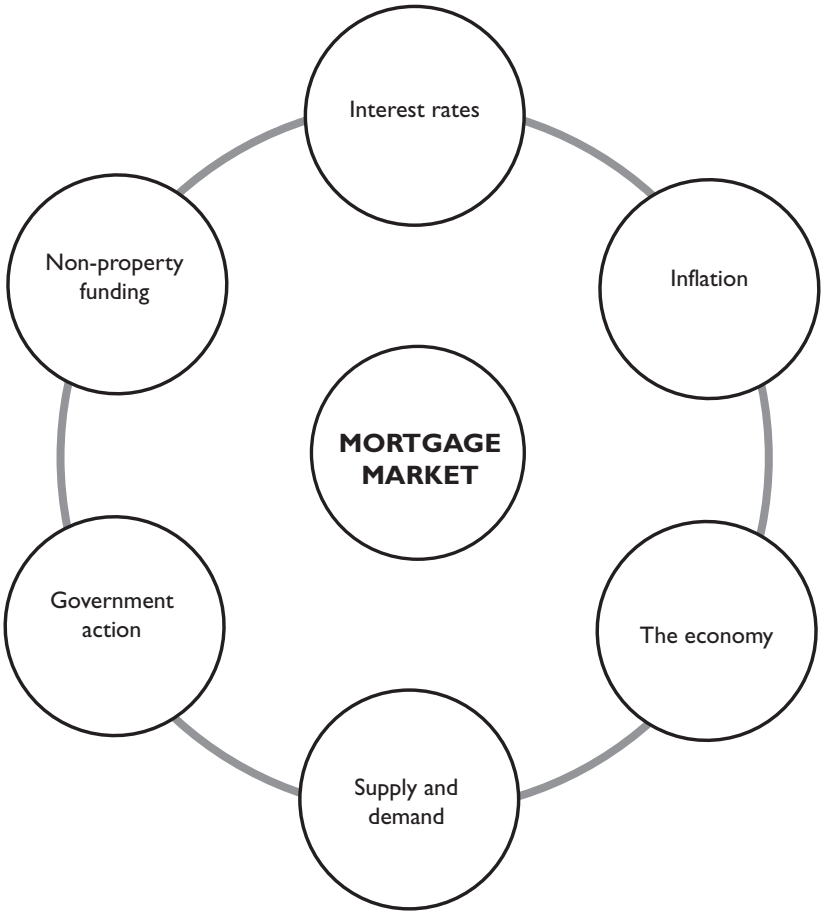
Plenty of data is available indicating market trends and the latest lending figures. For example, check the UK Finance market commentaries, available via https://www.ukfinance.org.uk/.

The Halifax House Price Index is another useful source: https://www.halifax.co.uk/media-centre/house-price-index.html [both accessed: 21 October 2020].

1.5 What issues affect the mortgage market?

Figure 1.1 summarises key factors that affect the mortgage market.

FIGURE 1.1 WHAT AFFECTS THE MORTGAGE MARKET?



1.5.1 Interest rates

Interest rates directly affect the cost of repaying a mortgage. When rates are high, as in the late 1980s and early 1990s, homeowners struggle to meet repayments, first-time buyers cannot afford to enter the market, and house prices are likely to fall. When interest rates are low, people find mortgage repayments affordable and will usually be prepared to commit to higher mortgages. This willingness to borrow lifts prices generally, resulting in a property boom, as in the late 1990s and early 2000s. While this relationship between interest rates and property prices is generally true, other economic factors, such as recession (or a less severe downturn), may lead to lower property prices even when interest rates are low. This was the situation following the financial crisis of 2007–09.

BANK RATE *V* LIBOR

Although mortgage interest rates are broadly linked to Bank rate, they are more directly affected by the three-month Libor. Historically the Libor has been between 10 and 20 basis points above the Bank rate. For example, if the Bank rate is 2 per cent, the Libor is normally expected to be between 2.1 per cent and 2.2 per cent. This means that, in normal conditions, mortgage rates go up and down broadly in line with the Bank rate. However, in difficult market conditions the differential can be wider.

KEY TERMS

LIBOR

London interbank offered rate, the rate at which banks lend to each other. 'Three-month Libor' means the rate for loans that will mature in three months' time.

BANK RATE

The rate at which the Bank of England lends to other financial institutions. You might also see it referred to as base rate.

BASIS POINT

One-hundredth of one per cent.

Many lenders have moved away from the traditional variable-rate mortgage in favour of tracker mortgages that follow Bank rate or Libor. During the boom times, it was common for trackers to be set slightly above, or even slightly below, Bank rate. Modern trackers have a much wider margin, offering rates as high as 3 per cent above Bank rate. In the past, Bank rate has been used as a crude but reasonably effective method of trying to calm or stimulate the housing market.

Sonia

The significance of Libor as a benchmark has reduced. There are two main reasons:

- The 2008 financial crisis led to banks relying less on the interbank market for borrowing, with Libor seen as less relevant than before.

- Misconduct relating to Libor and similar benchmarks, which came to a head in the UK in June 2012, when Barclays Bank was fined £270m for allowing some of its derivatives traders to attempt Libor manipulation.

A working group recommended using the sterling overnight index average (Sonia) benchmark as the preferred risk-free rate. Sonia has been used in markets for years, and is based on wholesale market overnight interest rates. It is seen as close to a risk-free measure of borrowing costs and is based on actual transactions, which makes it difficult to manipulate the figures.

The Bank of England, together with the FCA and market participants, is working on the transition from Libor to Sonia as the primary interest rate benchmark for sterling markets. The transition is expected to be completed by the end of 2021.

FIGURE 1.2 WHAT AFFECTS INTEREST RATES?

Level of government borrowing

When the government needs to raise money for public spending it can raise taxes or borrow; borrowing is less likely to cause political problems. Upward pressure is placed on interest rates when the government increases borrowing significantly.

Higher levels of individual borrowing

Rates tend to move up when there is high demand for borrowing. Too much borrowing at an individual level is a worry for governments, as money floods into the economy and prices creep up. If interest rates increase dramatically, many people will be severely overstretched financially.

Monetary policy

The government uses interest rates as a way of controlling the economy.

Foreign interest rates

The value of sterling against foreign currencies is affected by interest rates. When UK interest rates are higher than those abroad, the pound is popular and the exchange rate increases. This can have a negative effect on industry, because UK goods become expensive abroad and sales may be affected.

CHECK YOUR UNDERSTANDING 2

Can you recall from your studies for UK Financial Regulation which body is responsible for setting the Bank rate?

1.5.2 Inflation

There are two elements to inflation in the property market:

- **General inflation** – the decrease in the spending power of money over a period. For example, if inflation runs at 2.5 per cent over a one-year period,

£100 at the start of the period will buy goods worth approximately £97.50 at the end of the period, ie in order to buy the same goods at the end of the period, the buyer will need £102.50.

- **House-price inflation** – relates to the increases in the price of houses over a period. In general, house-price inflation runs well ahead of general inflation.

It is accepted that a small (2–2.5 per cent) amount of inflation is good for the economy. The government has set the Bank of England a target for inflation of 2 per cent, as measured by the Consumer Prices Index (CPI). Figures 1.3 and 1.4 outline how the Bank of England can control general inflation, to some extent, through its Monetary Policy Committee (MPC).

FIGURE 1.3 HOW CAN THE BANK OF ENGLAND REDUCE INFLATION?

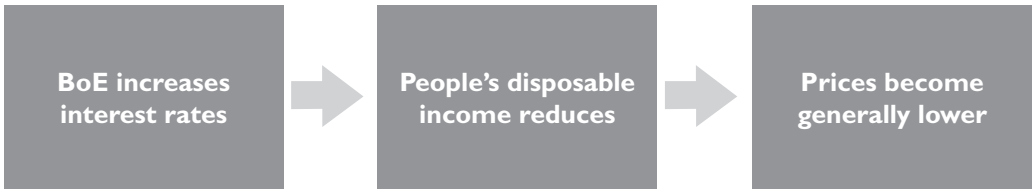
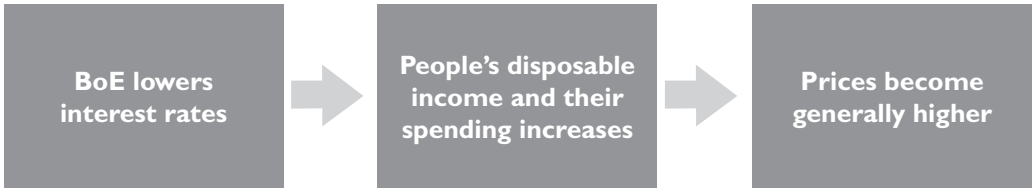


FIGURE 1.4 HOW CAN THE BANK OF ENGLAND INCREASE INFLATION?



A prolonged period of interest rate increases to control inflation will lead to stagnation, or even a reduction, in house prices because people will be reluctant to make major financial commitments. When interest rates are reduced in an attempt to promote inflation, property prices tend to rise as mortgage repayment becomes more affordable.

1.5.3 The state of the economy

When economic prospects are good, employment is high and stable, and interest rates are relatively low, more people have the confidence to enter into a substantial commitment such as a mortgage. When economic conditions are not so good, they may have to, or choose to, hold off any decisions. In periods of recession, unemployment rises and people worry about their jobs; they are certainly not looking to increase their mortgages.

Interest rates and inflation have been relatively low for a number of years and mortgage rates are at historically low levels. On the face of it, this is good for property sales and mortgage demand. Ever since the financial crisis of 2007–09,

however, worries about levels of personal debt, job insecurity, the impact of equity market turbulence on savings and pension plans and the likelihood of future interest rate increases have affected consumer confidence.

CASE STUDY: ECONOMIC INFLUENCES ON MORTGAGES IN THE LATE 1980s/EARLY 1990s

The late 1980s and early 1990s saw a housing market boom followed by a period of falling prices, with home owners trapped by negative equity. The following factors contributed to the turmoil:

- Tax relief on mortgages (mortgage interest relief at source, or MIRAS, abolished in April 2000) was reduced from £30,000 per individual to £30,000 per property in 1988. Between the announcement of the change and its implementation, there was a surge in first-time buyers taking advantage of the opportunity to claim double tax relief; increased demand led to a rise in prices and an overheated market.
- Interest rates rose as high as 15 per cent, partly to combat inflation and partly to maintain the value of sterling in parity with currencies in the European Monetary Union.
- The economy went into recession.

As interest rates rose, many home owners struggled to maintain repayments on their loans. In some cases, falling house prices meant that people's homes were worth less than the loans they had taken out to pay for them – in other words, they were in a position of negative equity. Those unlucky enough to have their homes repossessed found that they still owed money to their lender.

1.5.4 Supply and demand

Property is no exception to the laws of supply and demand, whether categorised by geographical area or type of property. Simply, if there are more buyers looking for one-bedroom flats in an area than there are flats available, the price will be driven up. Similarly, if there are too many executive detached properties, the lack of demand will drive down prices. Property prices in London and the south have been consistently higher than the

NEGATIVE EQUITY

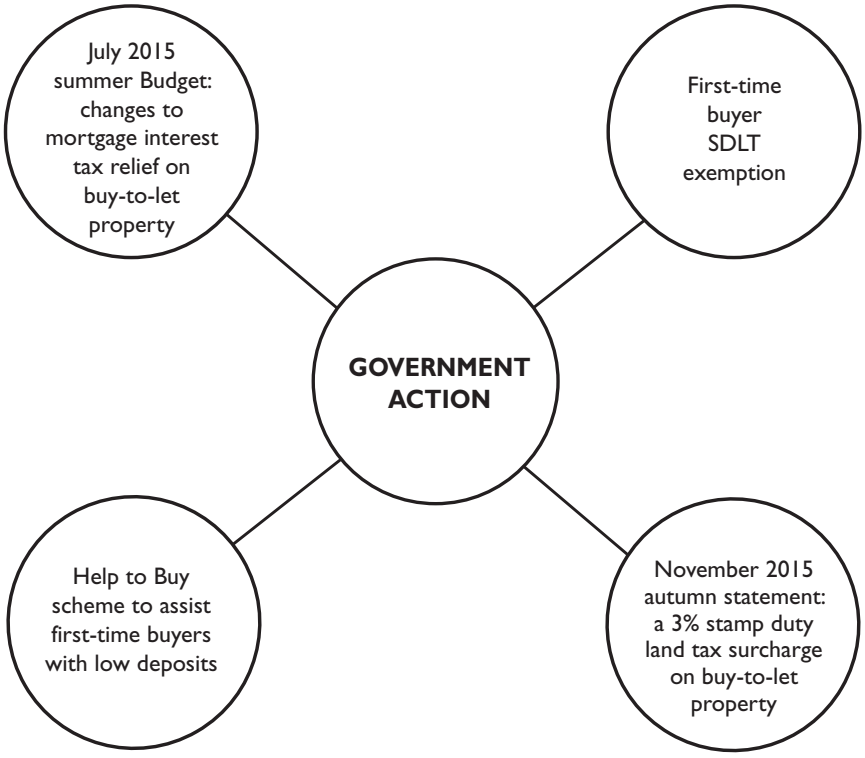
A situation in which the market value of a property falls below the outstanding amount of the mortgage loan secured on it.

rest of the UK; much of this is due to the dense population and lack of appropriate housing.

1.5.5 Government action

Some good examples of how government action can affect (or potentially affect) the property market are outlined in Figure 1.5.

FIGURE 1.5 GOVERNMENT ACTION AND THE PROPERTY MARKET



As a result of the changes to taxation of buy-to-let (BTL) property, investors are likely to have to pay more tax. This reflects the government's desire to mitigate the impact of BTL investment, particularly at the lower end of the property market, since demand from BTL investors is seen to be fuelling an increase in prices and contributing to the difficulties first-time buyers face in purchasing a home. In November 2017, the Budget contained the surprise announcement of a permanent exemption from SDLT on the first £300,000 of the purchase price for first-time buyers in England. Property purchase taxes are detailed in section 15.9.

1.5.6 Borrowing for purposes other than property purchase

Another factor that influences the amount of mortgage borrowing is the increasing use of mortgage-secured borrowing for purposes other than property purchase, or even for property improvement. A mortgage can provide funding at better rates, spread over a longer term than many other

forms of finance. Those consumers who are more sophisticated in the way they manage their finances appear to be seeking out the most cost-effective way to borrow, planning ahead and spreading their borrowing over time to minimise its immediate impact on their disposable income. Indeed, the early part of the calendar year is regarded as a traditional time for activity in the second-mortgage market, as families who have overstretched themselves for the seasonal festivities look to consolidate their credit card and other borrowings.

In an environment of rising house prices, consumers also use second mortgages on their existing property to release the increasing equity tied up in the value of their home – value that makes them feel richer but which, unless they borrow against it to translate it into cash, cannot be used to fund a better lifestyle.

1.6 Which types of provider offer mortgage finance?

Until 1980, the range of institutions offering mortgage finance was limited. Most banks did not offer mortgages and those that did were restricted by government policy on how much they could lend. Building societies were the main providers of mortgages but gave preference to their members because they are mutual institutions. Building societies were also subject to tight restrictions that prevented them from lending on non-residential property. As a result, the market was generally split into two – the building societies looked after the residential mortgage sector, and other institutions looked after everything else.

The mid-1980s saw a period of deregulation and increasing competition, with a blurring of the traditional divisions between the activities of different types of institutions resulting in a wider range of lenders entering the mortgage market.

1.6.1 Banks

Intense competition in the UK banking sector has led to an extension in the range of products on offer when compared with the position in the 1980s. In particular, banks now actively seek residential and commercial mortgage business, which is seen as relatively safe and profitable. They also work hard at cross-selling, ie trying to sell other products to existing customers. As large institutions, banks also enjoy considerable economies of scale; they benefit by virtue of their size, being able to raise money more cheaply and take advantage of efficiencies created by the effective use of information technology.

1.6.2 Building societies

Until 1986, building societies were legally restricted to lending on property in the form of freehold and leasehold estate (or its equivalent) in the UK. The Building Societies Act 1986 allowed building societies to diversify into new areas, including unsecured lending and banking services.

Building societies must still devote a minimum of 75 per cent of their total lending activities to residential mortgages, although they can convert to plc status if they wish to enjoy the same freedom as banks. Several did so in the late 1980s and 1990s, among them Abbey National, Northern Rock, Halifax, Woolwich, Cheltenham & Gloucester and Alliance & Leicester.

Despite their additional powers, many building societies are content to remain as specialists in residential lending. Some have ventured into corporate lending secured on land, although many feel this sector of the market presents an unacceptable risk.

1.6.3 Insurance companies

Insurance companies can be general insurers, life assurers or composites offering both types of business. Traditionally, life companies have occupied a small corner of the mortgage market. As the competition for mortgage business has intensified, insurers have lost some ground in the provision of loans, but have undoubtedly gained by selling services alongside mortgages offered by other providers.

1.6.4 Specialised mortgage companies and challenger banks

Specialised mortgage companies developed during the growth years of the late 1970s and early 1980s. They are invariably limited companies and are either independent providers or subsidiaries of larger financial institutions.

Known as 'centralised lenders', specialised mortgage houses are funded from the wholesale market and lend on a centralised basis; they have few, if any, branches and operate primarily through intermediaries.

The rise of challenger banks (the name used to describe new entrants to the banking arena) has also changed the face of the lending market and led to increased competition. Challenger banks and specialist mortgage lenders have increased their mortgage lending at a higher rate than more traditional lenders, and some of the original challenger banks, such as TSB, Virgin Money and Metro Bank have grown to the point where they are now seen as part of mainstream banking. Relatively newer entrants such as Aldermore, Atom Bank, Monzo, and Revolut are still building their mortgage business. The original challenger banks offer a branch network, though not as extensive as the major players, but later entrants tend to offer only online and mobile facilities.

Specialised lenders built a reputation for innovative mortgage products at attractive rates, a trend reinforced by challenger banks. However, the nature of their funding makes them more vulnerable to increased wholesale interest rates or when funding available from wholesale lending markets 'freezes up' due to difficult financial conditions.

It is quite common for specialist lenders to securitise their loan books. This means that they package up a number of existing mortgages and sell them to other organisations in return for a cash sum. The cash sum is typically slightly

more than the actual value of the mortgages to allow for the fact that future payments will be made to the new owner.

The cash raised can then be used to improve the original lender's balance sheet, reduce its risk profile and reduce the amount of capital it needs to meet capital adequacy requirements. The purchaser will receive all interest and capital payments from the borrowers, which will ensure a revenue stream for them over time. In most cases the original lender will agree a contract to administer the new mortgage, and so will generate regular income from that as well. From the borrower's perspective, little changes – the terms of the mortgage cannot be changed and they may well not notice any difference.

CHECK YOUR UNDERSTANDING 3

You covered capital adequacy requirements in your studies for UK Financial Regulation – can you recall what capital adequacy is and the key aim of capital adequacy requirements?

Mortgage packagers

Mortgage packagers are, in effect, middlemen who operate between the ultimate lender and the intermediary or customer. Their role is to undertake much of the administrative work, tailoring mortgage arrangements to specific situations. Their emergence represents an increasing move towards institutions specialising in what they do best: a particular lender may be good at managing its treasury operations and making funds available, but it may not have, nor wish to acquire, skills and capacity in distributing or processing loans. It makes sense for the lender to work with another organisation that has these skills but does not itself have the funds to lend. Typically a mortgage packager will make its money by charging between 1 and 2 per cent but it may pass some of this on as commission to the intermediaries who use its services.

Mortgage packagers generally operate in a particular area of specialisation, such as buy to let. The packager will have direct access to lenders and underwriters and will use knowledge of its particular market to present them with applications within their lending parameters.

1.6.5 Sub-prime and other specialist lenders

Certain potential borrowers have difficulty meeting the lending criteria for mainstream lenders. These include borrowers:

- with a poor credit history – for example, those with county court judgments against them or a number of previous payment defaults;
- who have difficulty proving certain elements of their income;

- who do not fit the lender's 'normal' borrower profile in terms of occupation, age, residency, type of income, etc;
- who are self-employed and either have a short track record in the business or cannot supply the required number of previous years' accounts.

Lending to such borrowers is called 'sub-prime lending'.

KEY TERMS

PRIME LENDING

Lending to borrowers who meet the lender's standard criteria and present a normal risk.

SUB-PRIME LENDING

Lending to borrowers who represent a higher risk than normal.

A potential borrower who does not meet the lender's standard criteria is not necessarily a poor business proposition – it just means that they require different and more specialised assessments. The lender may choose to charge a higher interest rate to compensate for any additional risk presented – this is often referred to as 'setting the rate for risk'.

The sub-prime problems associated with the 2007–08 credit crunch were caused by lenders, particularly in the USA, aggressively pursuing market share and failing to properly assess the risks presented. After the crisis, partly due to regulatory pressure and partly due to the cost of raising funds to lend, the sub-prime market significantly reduced.

This meant the end of a number of companies that specialised in the adverse credit market. However, a few sub-prime lenders have reappeared to mop up the demand for mortgages from applicants unable to get any form of credit in recent years. It is felt by many that a revival of this sector of the mortgage market is inevitable because, although lending conditions have changed dramatically, the concept of supply and demand will always apply. It is anticipated that some of these lenders will revisit their underwriting approaches and, together with risk-based pricing, start to capitalise on what has traditionally been one of the most profitable sectors of the mortgage market.

'Sale and rent back' arrangements involve a company buying a property from its owner, usually at below market value, and then renting it back to them. Although the former owner loses ownership, they are able to stay in their home, and must be given a fixed tenancy agreement of at least five years. These arrangements, which are regulated by the FCA, can represent a viable option for those with unmanageable mortgages. Short-term secured loans can help those wishing to repair their credit.

1.6.6 Buy-to-let

The buy-to-let market is generally regarded as a specialist market, and there are a number of lenders with particular expertise and product offerings for that market. Some of these, such as NatWest, are also substantial mainstream mortgage lenders, but many have established intermediary mortgage divisions, such as BM Solutions (Birmingham Midshires, part of HBOS) and Platform (part of the Co-op Bank), for which buy-to-let lending is a major part or the sole focus of their business. There are also brokers who focus on buy-to-let and/or commercial mortgages.

1.6.7 Other providers

Finance houses provide finance to those wishing to raise loans on the security of their property. Such loans will often be at fixed rates of interest for a limited term and may be for such things as home improvement. Some providers specialise in providing second-charge loans and others in providing bridging finance.

Second-charge loans

A second charge is a loan secured on a property but registered after a mortgage (first charge). It will rank second in line for repayment on sale or repossession. This means that it will be repaid from any money left over after the first-charge holder has been repaid. If there is insufficient money to repay the second-charge holder, the lender will lose out.

Bridging finance

Bridging finance may be required when a borrower wishes to move house but has not managed to sell their existing house, or the funds from the sale will not be available at the time completion of the new purchase is due. It is short-term lending that is repaid when the original property is sold and the owner is able to secure a mortgage on the new property.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the key factors that affect demand for mortgages?
- outline the economic factors that influence interest rates?
- explain how the government can use interest rates to try to control inflation?
- explain the effect that changes in interest rates have on the mortgage market?
- summarise the different types of mortgage provider?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 1. Review the text if necessary.

Answers can be found at the end of this book.

1) What factors hampered the recovery of the property market following the 2007–09 financial crisis?

2) What factors are contributing to the difficulties experienced by people seeking to buy their first home?

3) When interest rates are low for a prolonged period, what is likely to happen to property prices?

4) Interest rates on mortgage loans are closely linked to which interbank lending rate?

5) The level of government borrowing has no influence on interest rates in the UK. True or false?

6) Inflation can be reduced by reducing interest rates. True or false?

7) What percentage of a building society's total lending activities must be related to residential mortgages?

   a) 25 per cent.

   b) 50 per cent.

   c) 75 per cent.

   d) 90 per cent.

8) What is meant by 'securitised lending'?

9) Lending to people who have county court judgments against them is referred to as 'sub-prime' lending. True or false?

10) Lending to customers classified as 'sub-prime' is always an irresponsible decision. True or false?

TOPIC 2

Types of borrower

LEARNING OBJECTIVES

Mortgage customers are not all the same: people require mortgages for various purposes and in a range of situations. Lenders and advisers need to be aware of the different types of borrower and the specific rules that may apply to lending to each group. It is also vital to be aware of people who are not permitted, for legal reasons, to borrow.

By the end of this topic, you should have an understanding of:

- types of mortgage borrower;
- 'mortgage prisoners' and vulnerable customers;
- those who are not legally allowed to borrow and those who may have difficulty borrowing;
- the different forms of powers of attorney.

THINK . . .

Some of the content of this topic should be familiar to you from your studies for UK Financial Regulation. For instance, can you recall:

- the difference between a retail client and a professional client?
- the key differences, legally, between a sole trader, a partnership, a limited liability partnership and a limited company?
- who the FCA might regard as a 'vulnerable customer'?
- the difference between an ordinary and a lasting power of attorney?

In this topic we'll be focusing on the relevance of these issues to mortgage lending. (And don't worry if you can't remember much from your previous studies, as this topic covers the information you need.)

2.1 How is a mortgage application assessed?

In simple terms, a mortgage lender has to focus on three key factors, sometimes known as the three Ps, which are shown in Figure 2.1.

FIGURE 2.1 THE THREE Ps OF ASSESSING A MORTGAGE APPLICATION

We will look at each of these and how the lender reaches a decision in Unit 4, but for now we need to consider the main characteristics of the different types of borrower, together with those who, for a variety of reasons, are not able to enter into a mortgage contract.

There are several issues that all lenders have to address in assessing types of borrower:

- who may and may not borrow according to the law;
- if there are no legal barriers, whether the lender is prepared to lend to the applicant;
- whether funds should be allocated to, or earmarked for, particular groups or classes such as first-time buyers, professional introducers, and so on;
- how much the lender should consider lending to each applicant.

A sound lending policy considers these matters and others on an ongoing basis, taking into account:

- the lender's strategy, market positioning and required business levels in certain sectors;
- the risk profile of the applicant;
- the desired profit margin;
- arrears and recovery statistics and other circumstances.

2.2 What are the types of mortgage borrower?

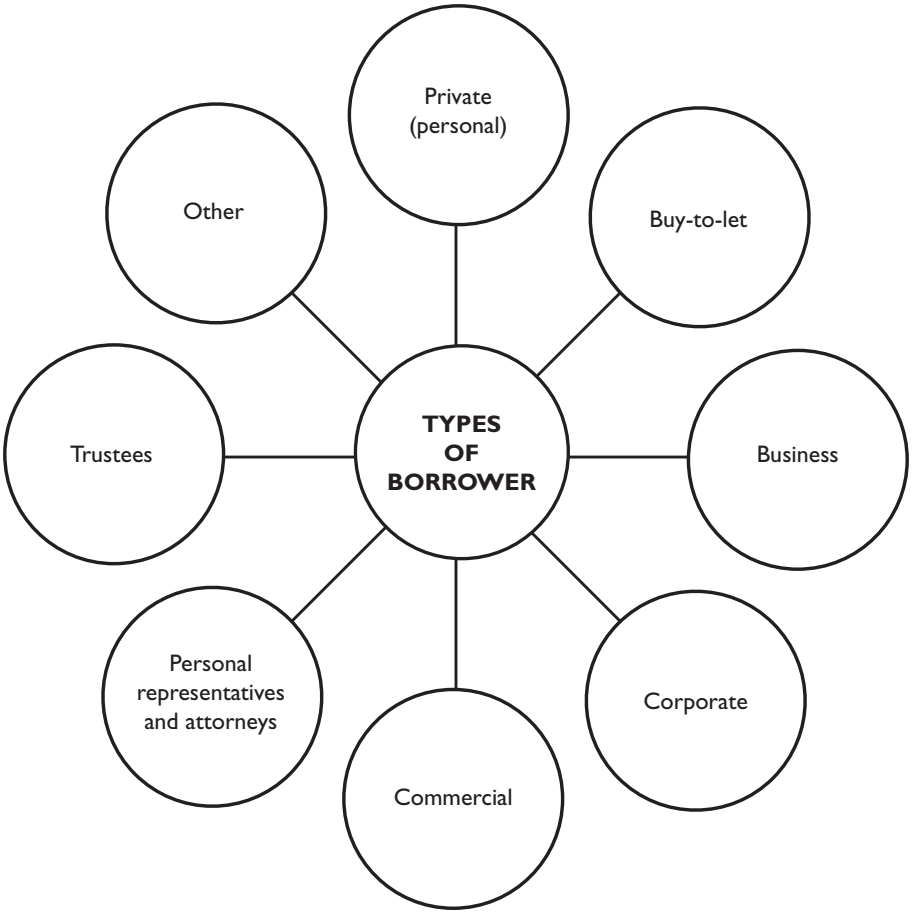
JOINT AND SEVERAL LIABILITY

Before we look at the different types of mortgage borrower, we need to be clear on a basic principle of mortgage law. If two or more people take out a mortgage, the mortgage deed (the contract) makes them jointly and severally liable for that loan. This means all parties are liable for the whole amount of the loan, not just their 'share' of it.

The parties to the mortgage can agree between themselves to share responsibility for the loan (and other outgoings as well) in whatever proportions they wish, but the lender can still pursue them individually for the whole loan.

So, a couple with a joint mortgage are both responsible for the mortgage, even if they split up. In the same way, if a borrower disappears, or refuses to pay the mortgage, the other borrower will be responsible for the payments.

FIGURE 2.2 TYPES OF BORROWER



We will discuss different types of business borrower in section 2.3, and corporate and commercial borrowers in section 2.4.

2.2.1 Private (personal) borrowers

There are three key reasons why private borrowers seek mortgage finance, as summarised in Figure 2.3.

FIGURE 2.3 REASONS FOR SEEKING MORTGAGE FINANCE

Family home

Those who are borrowing to buy a home for themselves and their family. These borrowers form the bulk of the residential mortgage market.

Second charges

Those who already have a mortgage and are seeking to arrange top-up finance from another lender on a second-charge basis.

Bridging finance

Those arranging a loan to finance a new purchase before they have sold their existing property, ie to 'bridge' the finance gap (covered in Unit 6).

2.2.2 Buy-to-let borrowers

Buy-to-let (BTL) borrowers are those buying a residential property with a view to letting (renting) it to someone else as a form of investment. BTL property purchases have increased as people have sought alternatives to the stock market for their investment funds. The investor hopes to make profits from a combination of rising house prices and regular rental payments, which are intended to provide a surplus after mortgage payments, management charges and maintenance costs are covered.

In most cases, the investor needs to raise some of the purchase amount through a mortgage. Responsibility for a BTL mortgage is exactly the same as for a 'normal' mortgage, in that borrowers are jointly and severally liable. Most lenders will not consider BTL mortgages for first-time buyers and those who do not own their own home.

The criteria for BTL mortgages tend to be a little different and, provided the applicant has a specified minimum level of income, the amount of the loan is determined by whether the rental income will be enough to service the loan repayments.

The PRA issued a supervisory statement (SS13/16) in September 2016, entitled *Underwriting standards for buy-to-let mortgage contracts*. This introduced requirements for lenders to assess more stringently a number of affordability factors when considering buy-to-let applications. The three main factors are:

- **Interest coverage ratio (ICR)** – the ratio of rental income to mortgage payments (including associated costs and tax). Each lender can set an ICR based on rental demand and typical rent levels in the area, with the PRA setting 125 per cent as a minimum industry standard, meaning that rent must be at least 125 per cent of the landlord's costs, although some lenders set a minimum as high as 145 per cent.

- **Income affordability test** – where the borrower will be using some personal income to support the mortgage, the lender must carry out a detailed affordability assessment.
- **Interest rate affordability stress test** – the lender is required to consider the effect of interest rate increases on the borrower's ability to service the mortgage over a minimum period of five years from the start of the mortgage, unless the mortgage is on a fixed or capped rate for at least five years or the mortgage term is less than five years.

SS13/16 is covered in detail in section 24.6.2.

Consumer buy to let

Since 21 March 2016, as a result of the Mortgage Credit Directive, there has been an additional category of buy-to-let mortgage called 'consumer buy to let' (CBTL). A CBTL mortgage is one where the purpose of arranging a mortgage is not 'wholly or predominantly' for business purposes. Borrowers in this category are sometimes described as 'accidental landlords' – in other words, they are people who need to let out a property because of personal circumstances rather than because they have made a conscious choice to buy a property for rental. Such circumstances might include those who inherit a property, or people who need to move quickly because they have a new job and do not have time to sell their family home before moving. Existing mortgages remain as 'normal' mortgages, but if they need to arrange a new mortgage on the property, it would be classed as a consumer buy-to-let mortgage.

IN BRIEF

REGULATION OF BTL AND CBTL MORTGAGES

In general, mortgages for BTL property are not subject to FCA regulation because they are defined as business loans and are not secured on the borrower's main residence.

However, CBTL mortgages are subject to legislation resulting from the Consumer Credit Directive 2015. Firms with Section 4a permission to carry out regulated activities that wish to deal in CBTL business must register as CBTL firms with the FCA.

CBTL mortgages are subject to the Mortgage Credit Directive Order 2015, but the requirements for firms are similar to the MCOB rules and, where advice is given, the firm must assess the client's circumstances, meet initial and product disclosure requirements and assess affordability.

Regulation of BTL and CBTL mortgages is covered in more detail in section 3.3.6.

2.2.3 High-net-worth customers

The FCA defines a high-net-worth customer as one with a minimum annual net income of £300,000, or minimum net assets of £3m. In the case of joint applicants, at least one of them must meet the definition in their own right. A high-net-worth customer can also be someone whose obligations under the mortgage contract are guaranteed by a person with a minimum annual net income of £300,000, or minimum net assets of £3m.

The rules allow lenders to apply more flexible processes to high-net-worth customers than for mainstream mortgages, as we will see in Topic 8.

2.2.4 Professional customer

The FCA defines a 'professional customer' as one who has worked in the home finance sector for at least a year, in a professional position that requires knowledge of the product or service to be arranged, and who the firm reasonably believes to be capable of understanding the risks involved in the proposed arrangements.

2.2.5 Personal representatives

Personal representatives (or executors in Scotland) act in managing the estates of deceased people. If the deceased person has left a will, the personal representative is called an executor and is named by grant of probate. If the deceased has not left a will, the representative is an administrator, appointed by letters of administration.

Lenders can lend to personal representatives of an estate if they need a loan to administer the estate or to buy property for a dependant of the deceased.

EXECUTORS IN SCOTLAND

In Scotland, if the deceased person has appointed an executor in a will, they are the executor-nominate. Otherwise, the executor is appointed by the court (executor-dative). Both generally need to obtain confirmation from the court to deal with the estate.

2.2.6 Attorneys

An attorney is a person who is given the responsibility to deal with someone else's financial or other personal affairs through a document called a 'power of attorney'. There are many users of attorneys, including elderly people who can no longer manage their own finances or people who live outside the UK for long periods. We look at powers of attorney in section 2.8.

2.2.7 Trustees

Trustees are people appointed in a document called a trust deed to hold a specific asset, or assets, on behalf of others called the beneficiaries, and to act for the beneficiaries according to the terms set out in the deed.

The property in the trust is called trust property. Generally, the terms of larger trusts allow the trustees to borrow money for certain purposes and up to specified limits. A good example would be where the trustees arrange a mortgage to buy a property for a beneficiary to live in. Before lending to trustees, a lender should examine that the trustees are specifically given the power to borrow, because not all trusts provide that power.

Trustees are often appointed to act on behalf of a disabled person, and can also arrange mortgages for them.

2.2.8 Clubs and associations

Clubs and associations are usually managed by elected committees on behalf of their members. The powers that the committee may exercise are often contained in a set of rules or other terms of reference under which they must operate. These rules will normally show whether the club may borrow and the extent to which it can do so. Lenders will need to make certain that the constitution allows the club to borrow, and that it will be able to repay the loan.

2.3 Business borrowers

Mortgages taken out by *individuals* for business purposes are regulated and subject to MCOB if:

- the borrowing is secured by a legal charge on a property where at least 40 per cent of the land is used as a residence (the standard definition of a regulated mortgage); and
- the sole purpose of the mortgage, remortgage or further advance is to raise funds for use by a small business (ie one with turnover of less than £1m per year and not an LLP or limited company).

If the mortgage is taken out by a business (ie an LLP or limited company), or by individuals in the business, and is secured on business premises, the mortgage is not a regulated mortgage.

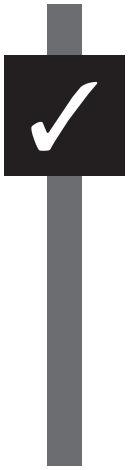
If the mortgage is regulated, the lender must have seen a business plan or other evidence that the loan is for business purposes, and must assess affordability based on the applicant's income and expenditure as usual. If the repayments are to be made from the business's resources, the strength of those resources must be taken into account. Where the borrower relies on the business for their personal income and the current and potentially increased mortgage

repayments, the lender must assess whether the business can support the customer's essential expenditure and basic quality of living costs.

2.3.1 Business partnerships

A business partnership is an arrangement between self-employed people to work together. Unlike a company, it is not a separate legal entity, and the assets of the partnership are owned jointly by the partners themselves. Each partner is also jointly responsible for the debts of the partnership, and lenders ensure that any lending contract makes them jointly and severally liable for the loan.

Mortgages for partners for business purposes are regulated if the criteria for regulated business mortgages are met.



CHECK YOUR UNDERSTANDING 1

Elena and Rita are in a business partnership together, and have arranged a mortgage loan of £240,000. They agree between them that Elena will pay for a third of the mortgage and Rita for two thirds.

However, Rita very suddenly leaves the country and does not leave any contact details. How much of the loan is Elena liable to repay?

a) £80,000

b) £160,000

c) £240,000

Partnerships should have a written partnership agreement, and the lender will need to check an up-to-date copy of the agreement to make sure that it can lend safely to the partnership. The partnership agreement will include:

- each partner's share of the profits;
- the arrangements if one partner retires, dies or becomes bankrupt;
- whether the partnership is able to borrow and, if so, whether individual partners can enter into contracts on behalf of the others, or whether all partners must sign for the contract to be legally binding.

2.3.2 Limited liability partnerships

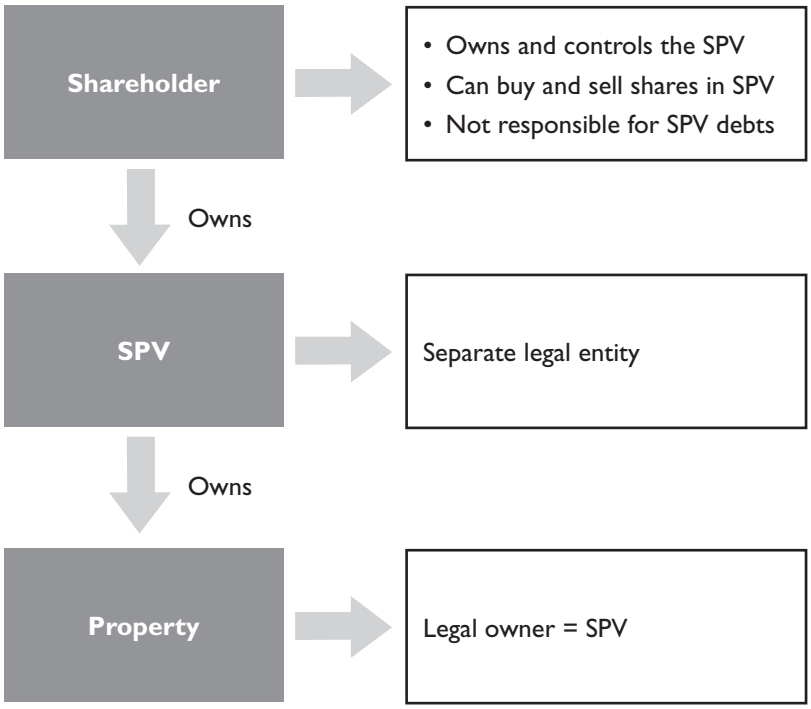
A limited liability partnership (LLP) is a form of partnership where the business is a separate legal entity from the partners, who act as agents of the partnership. This means that, just like a limited company, the partners do not have a direct liability for the debts of the partnership, over and above any capital they brought to the partnership when it was formed. Mortgage lending is provided to the LLP itself rather than to the individual partners. The lender may decide to take personal guarantees from the partners for any lending to the partnership, in much the same way as they would from the directors of a small limited company.

Mortgage lending to an LLP is not regulated.

2.3.3 Special purpose vehicles

A special purpose vehicle (SPV) is a way of holding business property through a limited company, rather than the individual(s) holding the property in their own name. The ownership structure is shown in Figure 2.4.

FIGURE 2.4 OWNERSHIP STRUCTURE OF AN SPV



The limited company is registered as the legal owner of the property, and directors are responsible for making sure the company meets all the normal legal obligations of a limited company. The people who would otherwise own the property in their own name become shareholders (and directors) of the company, so they own the company rather than the property.

The number of SPVs set up to hold BTL property has increased significantly in recent years, and experts suggest the trend will continue. Changes to the taxation of BTL property make it more attractive to hold the property in an SPV.

As the SPV is a business, any BTL mortgage would not be a regulated CBTL mortgage. In most cases, the lender requires personal guarantees from the directors before agreeing to a mortgage. By agreeing to a personal guarantee, the directors agree to take responsibility for the mortgage if the company fails to meet payments. The guarantee is usually arranged by the lender taking a legal charge over the directors' own main property.

We discuss the taxation of BTL property and SPVs in Topic 24.

CHECK YOUR UNDERSTANDING 2

From your studies for UK Financial Regulation, can you recall the key features of a limited company? In particular, can you remember how shareholders are remunerated and what liability they have for the debts of the company?

2.4 Corporate borrowers

Lending to a limited company is categorised as corporate borrowing, and may be for either residential or commercial purposes. Before making a lending decision, it is prudent for the lender to confirm that the company is permitted by its memorandum and articles of association to borrow, whether there are any restrictions or limits on such borrowing and whether the individuals the lender is dealing with have authority to commit the company to borrowing.

Many lenders will only lend to small companies if directors or shareholders give a personal guarantee to settle the debt if the company has insufficient funds or cannot meet the repayments.

Corporate mortgages are not regulated by the FCA, unless the loan is for a small business and secured on a residential property. MCOB rules then apply but firms can adapt some of the rules.

BUILDING SOCIETIES AND CORPORATE LENDING

Building societies are restricted under the provisions of the Building Societies Act 1986 (as amended by the Building Societies Act 1997) in respect of corporate lending. A maximum of 25 per cent of a building society's commercial assets can be held in loans to limited companies secured on land.

2.5 Commercial borrowers

A commercial mortgage is one that is secured on commercial property (for example, a shop or a factory) as opposed to residential property. A commercial mortgage can be offered either to an individual or to a company, but will not be a regulated mortgage.

2.6 Special FCA categories

There are also two categories of borrower specifically referred to by the FCA in MCOB, because their circumstances require careful treatment in relation to mortgages. They are 'mortgage prisoners' and vulnerable customers.

2.6.1 'Mortgage prisoners'

'Mortgage prisoners' is a term to describe customers who have a regulated mortgage and may be prevented from changing to another arrangement with their existing lender or moving to another lender if they are subject to the standard affordability requirements under MCOB.

Transitional rules allowed lenders a degree of flexibility in how they determined affordability for mortgage prisoners. Permanent changes were made to MCOB rules in October 2019, applying to borrowers wishing to switch to a different mortgage with their existing lender or to remortgage with a different lender without increasing their borrowing and monthly costs. The new rules only apply to those wishing to change a mortgage on their existing property; they cannot be used for those wishing to move to another property.

The new rules are contained in MCOB 11.9; we consider them in detail in section 10.7.1.

2.6.2 Vulnerable customers

The FCA's Occasional Paper No. 8 (2016) describes a vulnerable customer as someone who is "[. . .] especially susceptible to detriment as a result of their personal circumstances, particularly when a firm is not providing appropriate levels of care". An individual may be vulnerable because of a wide range of circumstances including (but not limited to) physical or mental disability, poor health, or weak numeracy and literacy skills. Their vulnerability might be short term, for example because of a job loss, a recent bereavement or release following a prison sentence. Firms have a responsibility to identify and deal appropriately with vulnerable customers, tailoring their service provision to customer needs.

For mortgages, the FCA regards the following as vulnerable customers because of the nature of the financial arrangement they are considering:

- those buying a property using the statutory right to buy;
- those entering a sale-and-rent-back agreement;
- equity-release applicants;
- customers whose main purpose is debt consolidation.

FACTFIND

If you would like to find out more about the FCA's guidance in relation to vulnerable customers, go to:

https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-8-consumer-vulnerability

[Accessed: 24 January 2020].

2.7 Which groups of people are unable to borrow?

We have looked at those who are able to borrow, subject to the lender's agreement. We now look at three groups of people who are unable, by law, to borrow or whose ability to borrow is restricted:

- minors;
- the mentally incapacitated;
- undischarged bankrupts and those with poor credit records.

2.7.1 Minors

A person under the age of 18 years (a minor) cannot hold a legal estate in land (property), and cannot normally enter into a contract unless it is for 'necessities'. For these reasons mortgages are only made available to persons of 18 years of age and over; lenders will check the applicant's age before agreeing to a mortgage.

MINORS

The law regarding minors is different in Scotland. Students taking the Scottish version of the examination should refer to the Appendix to Unit 1 for details.

2.7.2 Lack of mental capacity

A person who is mentally incapacitated cannot borrow in their own right – another person has to act for them. In England and Wales, a person of unsound mind who requires housing to be funded by a mortgage is represented by a deputy appointed by the Court of Protection, unless they have set up an appropriate power of attorney.

We look at powers of attorney in section 2.8.

2.7.3 Insolvency and bankruptcy

Insolvency occurs when:

- a person's liabilities exceed their assets; and
- a person cannot meet their financial obligations within a reasonable period of them falling due.

Under the Insolvency Act 1986 (England, Wales and Northern Ireland) or the Bankruptcy (Scotland) Act 1985, a bankrupt is any person who is insolvent and has been declared bankrupt by the county (or Sheriff) court. The court issues a bankruptcy order.

So, someone could be insolvent but not bankrupt – at least not until they or their creditors apply for a bankruptcy order.

SEQUESTRATION

Scottish law refers to bankruptcy as 'sequestration'. Scottish sequestration law is different from bankruptcy laws in the rest of the UK.

This text will focus on bankruptcy laws that apply to England, Wales and Northern Ireland.

A bankruptcy order results from a petition for bankruptcy, either from the individual or a creditor. An individual can petition for their own bankruptcy, regardless of how much they owe, and creditors can petition for a debtor's bankruptcy if the debt is at least £5,000 in England, Wales and Northern Ireland.

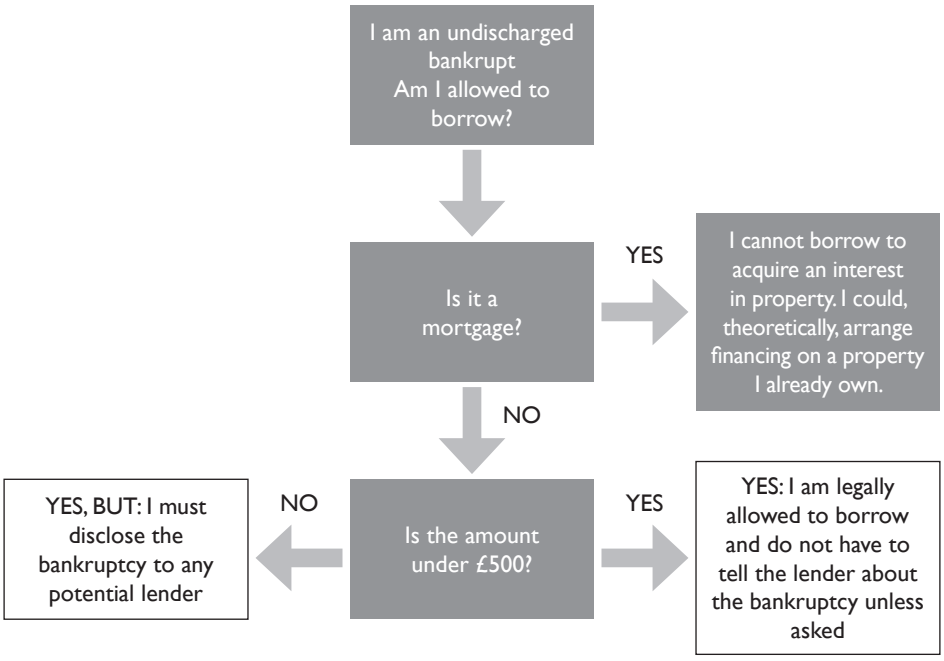
When someone is declared bankrupt, their case is in the hands of a trustee in bankruptcy, whose role is to seize their assets, sell them and use the proceeds to pay the court costs and settle as many of their debts as possible. The individual can keep some assets that they need for work or to provide a basic standard of living, but everything else, including property, may be at risk.

In most cases (including in Scotland), the period of bankruptcy lasts for 12 months. However, the bankruptcy order can be extended in certain situations – for example, if the individual does not co-operate with the trustee.

During the bankruptcy period an individual is said to be 'undischarged'. The law does not always prevent an undischarged bankrupt from borrowing, but it places significant restrictions on them (see Figure 2.5). In reality, few, if any, lenders would be prepared to lend to an undischarged bankrupt. An undischarged bankrupt cannot acquire an interest in property, which means that they cannot buy a property or apply for a mortgage to buy a property.

However, if they already own a property they can, technically, seek a further advance or remortgage on it, as they are not gaining an interest in a property they already own. In reality, though, it would be very difficult, if not almost impossible, for them to obtain that financing whilst undischarged.

FIGURE 2.5 WHEN CAN AN UNDISCHARGED BANKRUPT BORROW?



DISCLOSING A PREVIOUS BANKRUPTCY

Once discharged from bankruptcy, the individual is entitled to borrow, but they are likely to have difficulty finding a willing lender. A borrower must declare a previous bankruptcy if asked by the lender, and all lenders will ask on the mortgage application form as a matter of course. Failure to declare a previous bankruptcy when asked can render the person guilty of fraud.

Bankruptcy is recorded on the publicly available Insolvency Register until three months after discharge, and details of bankruptcy are held on the individual's credit file for six years from declaration of bankruptcy.

Many lenders will automatically decline applications from those with a previous bankruptcy. Some lenders require an applicant to have been discharged for a minimum period of years before they will consider lending. Lenders take each case on its merits.

2.7.4 Individual voluntary arrangements and debt relief orders

Bankruptcy is not always the best course of action for creditors or debtors. Some people may have debts that they could afford to repay in part, and an individual voluntary arrangement (IVA) or debt relief order (DRO) may be a more appropriate option for them. A similar arrangement known as a protected trust deed is available in Scotland.

An IVA or DRO does not legally prevent an individual from taking out a mortgage, but lenders may be unwilling to consider an application.

IVAs, DROs and protected trust deeds are covered further in Topic 11.

KEY TERMS

INDIVIDUAL VOLUNTARY ARRANGEMENT

A formal agreement between a debtor and their creditors to make reduced payments towards their total debt over an agreed period, typically five years, after which the debt is deemed to be settled.

DEBT RELIEF ORDER

An order granted by the official receiver to an individual with debts of less than £20,000 and limited assets who cannot repay their debts. It prevents creditors from seeking repayment without the approval of a court while the DRO is in place; after 12 months the debts are usually written off.

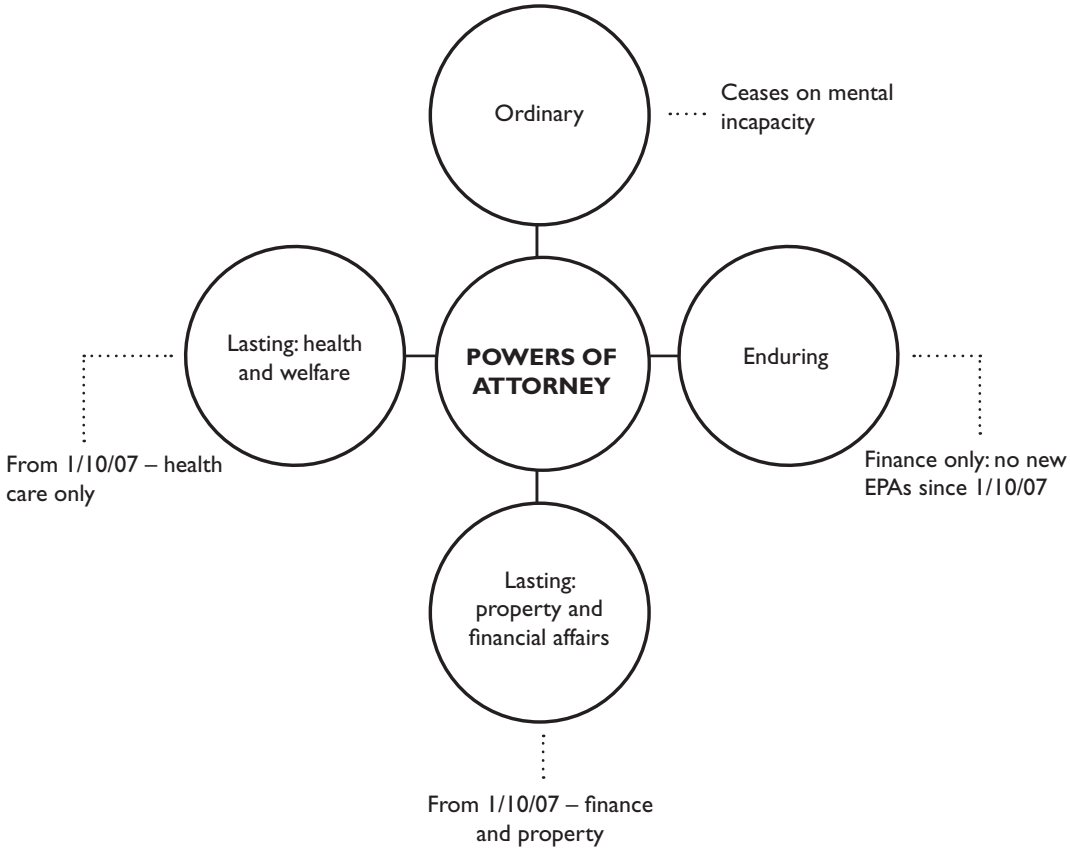
2.8 What are powers of attorney?

Someone who would like to be sure that a person they know and trust will be able to look after their affairs if they become unable to do so themselves should set up a power of attorney. The donor can control the amount of responsibility that is given to the attorney. Some give their attorney general powers, while others limit the powers to specific issues.

Someone who does not have legal capacity to contract is not able to appoint an attorney; for example, a minor cannot appoint someone else as their attorney and enter into a contract that way.

There are a number of different forms of powers of attorney. These are summarised in Figure 2.6 and described further below.

FIGURE 2.6 POWERS OF ATTORNEY



KEY TERMS

DONOR

The person granting powers to their representative.

ATTORNEY

The person granted the powers to act on the donor's behalf. Also sometimes referred to as the 'donee'.

DEPUTY

Appointed by the Court of Protection to look after the affairs of someone who becomes mentally incapacitated.

2.8.1 What is an ordinary power of attorney?

An ordinary power of attorney enables the attorney to carry out activities relating to the donor's financial and property affairs. It is typically used by

people who are mentally capable but physically infirm to enable someone to pay bills and carry out transactions on their behalf. It is also commonly used by people who are abroad for a while, allowing someone else to pay their bills and so on. The donor has complete control over their affairs, can carry out the same transactions as the attorney, and can revoke the powers whenever they wish. They can also limit what the attorney can do.

An ordinary power of attorney ceases when the donor becomes mentally incapable, and if they have not made other arrangements, the Court of Protection will appoint someone to look after their affairs. This will not necessarily be someone they know, and there will be fees for appointing a deputy, for the deputy's services and for ongoing supervision of the deputy.

2.8.2 What is a lasting power of attorney?

While an ordinary power of attorney ceases on mental incapacity, a lasting power of attorney (LPA) is specifically designed to enable people to decide who will look after their affairs if and when they are mentally unable to do so themselves, and to enable that person to take up those powers with minimal disruption. An LPA must be registered with the Office of the Public Guardian (OPG) before it becomes effective.

An LPA is available in two forms:

- **Property and financial affairs** – once the power has been registered, the attorney can look after the donor's finances and property, usually including borrowing unless it is specifically excluded. With the donor's agreement it can be registered and used before they lose mental capacity, and in this case they can still deal with their own finances if they wish. If the LPA is to be registered when the donor loses mental capacity, there is a set process that must be followed for registration, in order to protect the donor.
- **Health and welfare** – this allows the attorney to make decisions about the donor's medical treatment and care. It can only be used once the donor has lost mental capacity and is no longer able to make decisions for themselves.

FACTFIND

Further information about powers of attorney, including how to set up and register an LPA, is available at:

https://www.gov.uk/power-of-attorney [Accessed: 4 November 2020].

POWER OF ATTORNEY

In Scotland, the powers are known as:

- a continuing power of attorney, which is the equivalent of a property and financial affairs LPA;
- welfare power of attorney, which is the equivalent of a health and welfare power of attorney; or
- combined power of attorney, which combines property and welfare matters.

Note that in Scotland, it is necessary for the power of attorney to confer specific authority to borrow.

Powers of attorney in Scotland are dealt with by the Office of the Public Guardian (Scotland).

2.8.3 What is an enduring power of attorney?

Until 30 September 2007, it was possible to set up an enduring power of attorney (EPA). An EPA can be used like an ordinary power of attorney, while the donor has mental capacity; in other words, the attorney can assist the donor to manage financial matters. If the donor loses mental capacity, the EPA must be registered with the Office of the Public Guardian in order for the attorney to continue to act for the donor.

An unregistered EPA may be revoked, providing the donor has mental capacity. A registered EPA may be revoked, but only after confirmation from the Court of Protection that the donor fully understands the implications of doing so.

When an application is made to register an EPA with the OPG, the donor and at least three of the donor's relatives aged at least 18 and mentally capable must be informed.

Since 1 October 2007 it has not been possible to set up any new EPAs but those already in force at that date remain valid, and existing EPAs may continue to be registered with the OPG. Therefore, you may encounter EPAs when dealing with customers.

FACTFIND

Further information about using and registering an EPA is available at:

https://www.gov.uk/use-or-cancel-an-enduring-power-of-attorney [Accessed: 4 November 2020].

CONFIRMING AUTHORITY TO BORROW

Before agreeing to lend to an attorney who holds powers under an EPA or LPA, the lender must confirm that:

- the EPA or LPA is currently in force (ie not revoked, or unregistered where registration is required);
- the EPA or LPA gives the attorney authority to borrow;
- the purpose for which the borrowing is required is not excluded.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline three reasons why a personal customer might need a mortgage?
- explain the basic difference between a buy-to-let mortgage and a consumer buy-to-let mortgage?
- explain the situations in which a mortgage loan to a business is a regulated mortgage?
- describe how an SPV works?
- outline the bankruptcy process and how it affects the individual's ability to borrow?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 2. Review the text if necessary.

Answers can be found at the end of this book.

1) Helena and Cath have a £120,000 mortgage in their joint names on their flat, which they bought two years ago. Helena and Cath have split up, Helena has moved out and Cath has not been able to contact her about paying the mortgage. Who will the lender hold liable if the mortgage payments are not made? (Assume that Helena and Cath own the flat on a joint tenancy basis.)

   a) Cath for the whole amount, because she is the only person actually living in the flat.

   b) Helena and Cath, but the lender will pursue Cath for the whole amount if Helena cannot be contacted.

   c) Cath for 50 per cent of the outstanding payments and Helena for the remainder.

   d) Cath for 50 per cent because she is only liable for half the amount borrowed.

2) What are the three main reasons why a personal borrower might require a mortgage?

3) What must a lender establish before agreeing to lend to trustees?

4) A partnership business has a legal existence of its own, separate from that of the individual partners. True or false?

5) James wishes to raise £30,000 for his small business by arranging a further advance on the mortgage on his family home. Would the further advance be a regulated mortgage?

6) Vanda has mortgages on two BTL properties, which she owns via a special purchase vehicle. Are the mortgages regulated under MCOB?

7) An undischarged bankrupt cannot own property. True or false?

8) Alan was declared bankrupt for the first time in London on 5 May this year. He will be discharged on:

   a) 5 May next year.

   b) 5 May two years later.

c) 5 May three years later.

d) 5 May five years later.

9) A person who makes a power of attorney is known as a donor. True or false?

10) Jack established an enduring power of attorney in 2006, with his daughter as his attorney. Jack is now suffering from dementia and his daughter wishes to sell his house and use the proceeds to extend her own home so that Jack can move in with her. Is she permitted to do this?

TOPIC 3

Mortgage regulation

LEARNING OBJECTIVES

This topic looks at the principles of mortgage regulation and the importance of the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) in relation to mortgage regulation.

By the end of this topic, you should have an understanding of:

- the definitions of loans covered by MCOB;
- the structure of MCOB;
- other legislation affecting mortgages and property purchase.

THINK . . .

UK Financial Regulation introduced you to mortgage regulation, so to help you focus on this topic, think back to your early studies. For instance:

- What types of loan are covered by MCOB?
- What is the difference between a first-charge and a second-charge loan?
- Can you remember why there was a significant change in mortgage regulation in 2016?

All of these areas will be explored further in this topic.

3.1 Key terms relating to mortgages

3.1.1 What is a mortgage?

A mortgage is an arrangement where an asset is used by the lender as security for a loan. In the case of house purchase, the loan is secured on a property through a legal charge. Property is not the only asset that can be mortgaged: other assets, such as share portfolios, can be mortgaged too, and mortgage-backed loans may be used for purposes other than property

purchase. 'Secured' means that there is a legal agreement giving the lender rights over the property until the loan is repaid. This gives the lender some 'security' if the borrower fails to honour their part of the deal.

3.1.2 What is a legal charge?

A legal charge gives the lender certain rights over the property while the mortgage is outstanding. These include the right to take possession of the property (subject to court sanction) if the borrower fails to make payments or repay the mortgage as agreed. The security provided by the legal charge means that lenders are prepared to offer mortgages at lower rates than unsecured loans, because they have some protection against default.

It is possible to have more than one legal charge on a property.

- **First charge** – the charge that is registered first at the Land Registry has priority over other charges. This means that the debt to which it relates will be repaid first. This applies whether the owner sells the property or defaults on the mortgage, with the result that the property is taken into possession and sold to settle outstanding debts.
- **Second charge** – a legal charge that is registered after a first charge will rank second in line for repayment on sale or repossession. This means that it will be repaid from any money left over after the first-charge holder has been repaid. If there is insufficient money to repay the second-charge holder, the lender will lose out.

CHECK YOUR UNDERSTANDING 1

Is the lender holding a second charge against an asset likely to apply a higher or lower rate of interest to the loan than the holder of a first charge? Explain your answer.

3.2 How are mortgages regulated?

The Financial Conduct Authority (FCA) took over regulatory responsibility for the marketing and sales of mortgages and home finance from the Financial Services Authority (FSA) in April 2013.

MORTGAGES AND HOME FINANCE

This includes regulated mortgages, including lifetime and second-charge mortgages; bridging loans; home reversion plans; and home purchase plans (more commonly known as Islamic mortgages).

The regulations are contained in the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB), which forms part of the FCA Handbook. The Handbook contains all the regulatory rules for firms regulated by the FCA, together with guidance to help firms interpret the rules and put them into practice.

FACTFIND

You can find an overview of the content of the MCOB sourcebook in section 3.4, and you can find the MCOB sourcebook by visiting https://www.handbook.fca.org.uk/handbook [accessed: 22 October 2020] and clicking on Business Standards and then MCOB.

!

UK REGULATION

UK Financial Regulation introduced you to regulatory requirements in the UK, so rather than repeat what you have already learned, Figure 3.1 provides a brief summary as a refresher. You might want to reread some of the UK Financial Regulation text, too.

FIGURE 3.1 OVERVIEW OF UK REGULATION RELATING TO MORTGAGES

FSMA 2000	• 2000: Financial Services and Markets Act in force • Financial Services Authority (FSA): main regulator • Mortgages still subject to a voluntary Mortgage Code: not regulated
31 October 2004	• Mortgages regulated by the FSA • Only contracts entered into after that date and meeting the 'regulated mortgage' criteria fall under the FSA (and later FCA) regime
April 2007	• Home reversion plans and Islamic home finance plans regulated by FSA
FSMA 2012	• Regulatory system revised: Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) formed • FCA takes over regulation of mortgages sales and advice
1 April 2014	• The Office of Fair Trading closed • The FCA takes regulatory responsibility for consumer credit activities, including second-charge loans
21 March 2016	• EU Mortgage Credit Directive implemented

3.2.1 The EU Mortgage Credit Directive

The Mortgage Credit Directive (MCD) was published in February 2014, with member states required to implement its requirements by 21 March 2016. The Directive is designed to set minimum regulatory requirements in member states for credit agreements relating to residential property. The Directive also aims to provide a platform for a cross-border European mortgage market.

IN BRIEF

BREXIT AND THE MCD

On 31 January 2020, the UK left the European Union (EU). The government may make changes to MCD-related legislation, but given the complexity of doing so it is likely that the MCD requirements will remain as part of UK mortgage regulation for some time.

CHECK YOUR UNDERSTANDING 2

From your studies for UK Financial Regulation, can you recall why the UK government was able to incorporate the MCD into its existing regulatory framework instead of implementing it directly and in full?

In the UK, MCOB already covered most of the MCD's requirements. The government's approach was to minimise the Directive's impact on the UK mortgage industry and consumers by adapting the existing MCOB rules as far as possible. New MCD sections (usually as an a) or b) subsection) were added where the changes were more detailed. Additionally, there were some areas where new rules were required, specifically:

- buy-to-let mortgages;
- second charges.

A significant addition was the establishment of a new category of mortgage: consumer buy to let (CBTL).

CHECK YOUR UNDERSTANDING 3

Can you recall what a CBTL mortgage is? Try to write your own summary. Look back to your studies in Topic 2 to check your response.

BACK BOOK LOANS

In general, a new regulation covers only arrangements entered into on or after the implementation date.

However, second-charge mortgages entered into before 21 March 2016 are subject to MCOB, as 'back book loans', if they meet the criteria for regulated second charges that apply from 21 March 2016.

3.3 What is a regulated mortgage contract?

The FCA regulates the sale and administration of mortgages that meet the definition of a 'regulated mortgage contract'.

IN BRIEF

REGULATED MORTGAGE CONTRACTS

A regulated mortgage contract is one that, at the time it is entered into, meets the following conditions:

- a lender provides credit to an individual or to trustees (the 'borrower'); and
- the borrower's obligation to repay is secured by a mortgage on land in the European Economic Area, where at least 40 per cent of the land is used, or is intended to be used, as or in connection with a dwelling.

Contracts that were entered into before 31 October 2004 (ie before mortgages came within the remit of the then regulator, the Financial Services Authority) cannot be regarded as regulated mortgage contracts, even if they satisfy the required criteria. However, lenders may choose to apply MCOB rules and standards to these mortgages if it benefits the borrower.

3.3.1 Regulated mortgages and MCD regulated mortgages

All mortgages meeting the criteria in section 3.3 are regulated mortgages. Rather than apply the MCD rules to all previous mortgages, the FCA created a sub-category of regulated mortgages: 'MCD regulated' mortgages.

As of 21 March 2016, the MCOB sourcebook in the FCA Handbook contains two categories for mortgages:

- regulated mortgages;
- MCD regulated mortgages.

Regulated mortgages are those completed before 21 March 2016, when the MCD came into effect. In most areas of regulation, any matters that arise from a mortgage set up before 21 March 2016 will be dealt with under the MCOB rules that applied prior to implementation of the MCD. Any change to the mortgage that does not constitute a new contract, such as a further advance, will be subject to the original MCOB rules.

An MCD regulated mortgage is one entered into on or after 21 March 2016 and subject to the amendments made to MCOB in order to comply with the MCD. This includes remortgages because they will be a new contract. Lenders were allowed to put MCD-compliant systems and processes in place up to six months ahead of the MCD implementation date, to avoid having to run two separate systems, and to issue mortgages during that period as MCD regulated mortgages.

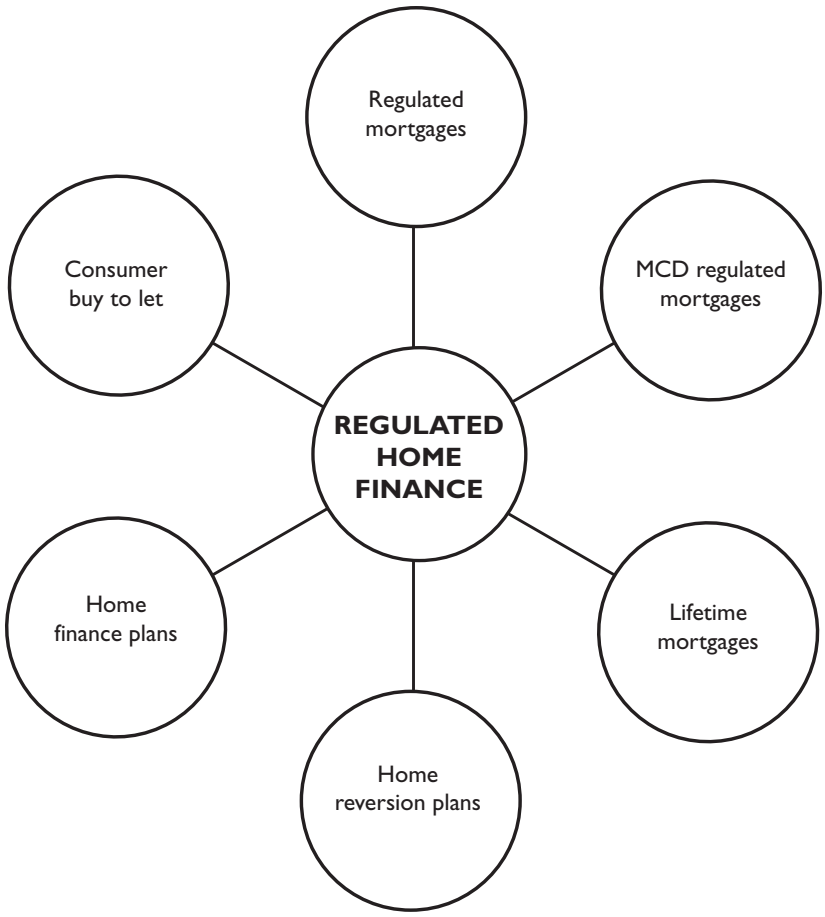
Most of the MCOB rules apply to both regulated and MCD regulated mortgages. Where there is a different requirement for MCD regulated mortgages, usually it is in a separate 'A' chapter. For example, the pre-application disclosure requirements for regulated mortgages are contained in Chapter 5, with the different requirements for MCD regulated mortgages in Chapter 5A.

The majority of new residential mortgages will meet the MCD criteria, as will some commercial mortgages where at least 40 per cent of the land is used as a dwelling. Buy-to-let mortgages used in connection with a letting business are not regulated mortgages, but consumer buy-to-let mortgages are. Corporate mortgages are specifically excluded from FCA regulation.

CHECK YOUR UNDERSTANDING 4

From your studies in Topic 2, can you recall what a corporate mortgage is?

FIGURE 3.2 WHICH TYPES OF HOME FINANCE ARE REGULATED?



3.3.2 Lifetime mortgages

A lifetime mortgage enables older homeowners over a certain age to release some of the equity in their property. Most people applying for a lifetime mortgage have no mortgage or only a relatively small mortgage. The lender agrees to advance a percentage of the property value on a first-charge basis, with the mortgage repaid when the borrower moves, goes into residential care or dies; a lender can exercise its legal right to take possession under the mortgage contract too.

FCA DEFINITION OF A REGULATED LIFETIME MORTGAGE

A regulated lifetime mortgage must meet the definition in section 3.3. There are two further key elements to the definition of a regulated lifetime mortgage. First, it must only be available to older borrowers over a certain (unspecified) age and the lender cannot seek full repayment until one of the following events occurs:

- the borrower's death;
- the borrower moves to live elsewhere without the reasonable expectation of returning – into residential care or sheltered accommodation, for example;
- the borrower moves to another 'main residence';
- the borrower sells the property;
- the lender exercises its legal right to take possession under the mortgage contract.

Second, although full repayment of capital is not required until the mortgage ends, during the term the arrangement can include the following:

- No capital repayments are made and interest is added to the capital to be repaid when the mortgage ends (interest roll-up).
- No regular capital repayments are required, but regular interest payments must be made (as with an interest-only mortgage) until the end of the mortgage.
- Some capital repayment and interest payments are required, but there is no requirement to make full capital repayment until the end of the mortgage.

In most cases, as long as the borrower occupies the property as their main residence no regular interest payments are required. The interest is rolled up and paid, along with repayment of the capital, when the arrangement ends. Alternative arrangements are also possible, where:

- payment of interest is required but the capital is not repaid until the end of the mortgage; or
- payment of interest and partial repayment of the capital is required, but full repayment of the capital is not required until the end of the mortgage.

However, these two options are much less common.

MCD EXEMPTION

A category of 'MCD exempt' lifetime mortgage was established from 21 March 2016. This means that lifetime mortgages continue to be regulated as a separate type of mortgage from MCD loans.

3.3.3 Retirement interest-only mortgages

The FCA introduced a new regulatory category of interest-only mortgage in March 2018 – retirement interest-only mortgages – due to demand from borrowers unable to repay, or finding difficulty in repaying, interest-only mortgages at the end of the term. Lenders are permitted to arrange mortgages on an interest-only basis for borrowers over an age specified by the lender. Affordability can be assessed on an interest-only basis, with no requirement to account for a repayment vehicle.

The retirement interest-only mortgage is defined in MCOB (FCA, no date) as "an interest-only mortgage:

- which is not an interest roll-up mortgage;
- entry into which is restricted to older customers above a specified age and;
- under which the lender is not entitled to seek full repayment of the loan until the occurrence of one or more of the specified life events, unless the customer breaches their contractual obligations (including any obligation to pay interest during the term) in a way which allows the lender to terminate the agreement."

3.3.4 Home purchase plans

A home purchase plan is defined as an arrangement where:

- one person (the provider) buys a qualifying interest in land;

- an individual or trustees (the home purchaser) is/are obliged to buy the interest from the provider during or at the end of a specified period;
- the home purchaser, a related person, a beneficiary of a trust or a person related to a beneficiary is/are entitled to occupy at least 40 per cent of the land as, or in connection with, a dwelling.

IN BRIEF

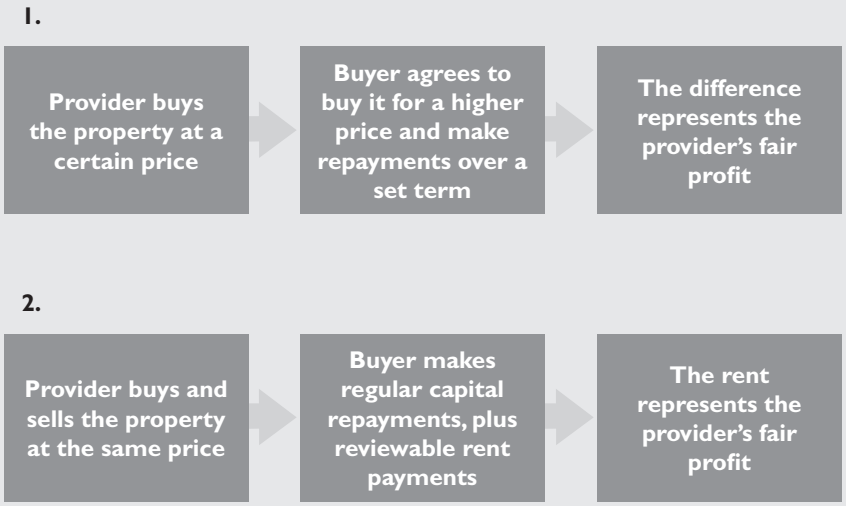
WHAT IS THE DIFFERENCE BETWEEN A HOME PURCHASE PLAN AND A REGULATED MORTGAGE?

- Home purchase plans involve the provider buying the property and then selling it to the ultimate owner via a special agreement, either through regular payments of capital, or a single payment at the end of a specified term.
- With a conventional mortgage the property buyer uses money borrowed from the lender to buy the property in their own name(s), and is usually required to pay interest on the outstanding loan.

ISLAMIC HOME FINANCE PLANS

Islamic home finance plans are covered by the category 'home purchase plan' because under Islamic law it is forbidden to take out a conventional mortgage requiring payment of interest to the lender. However, the provider can make a fair profit from the arrangement, so there are two ways in which the plan can work (Figure 3.3).

FIGURE 3.3 APPROACHES TO ISLAMIC HOME FINANCE

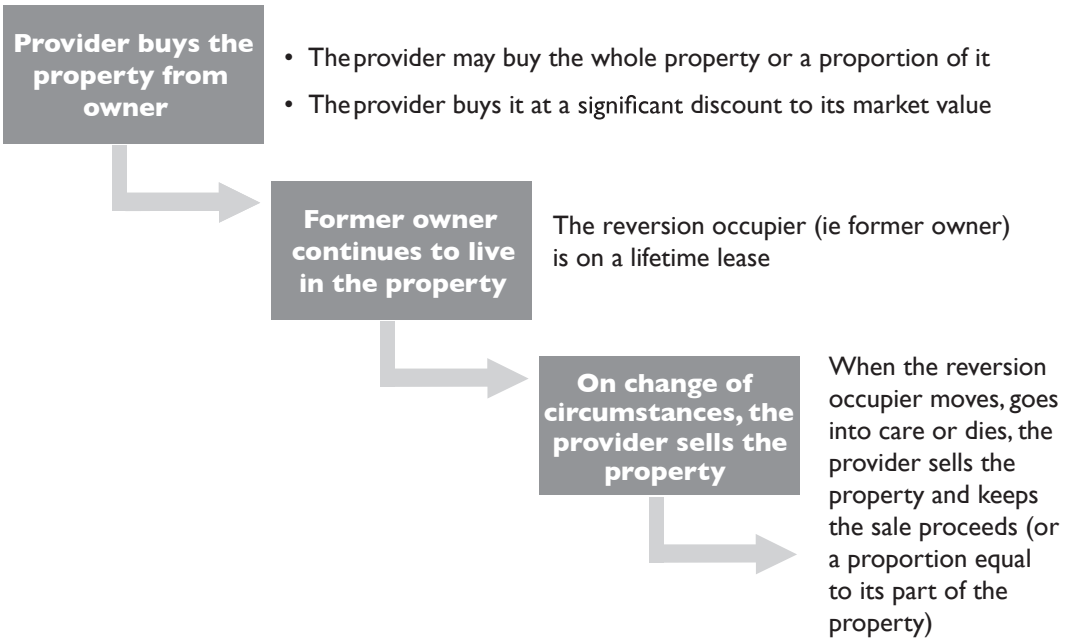


In practical terms, the second arrangement is similar to a conventional repayment mortgage, with rental payments substituted for interest.

3.3.5 Home reversion plans

Home reversion plans have been regulated since 2007. Figure 3.4 summarises the way a home reversion plan works.

FIGURE 3.4 WHAT IS A HOME REVERSION PLAN?



The FCA defines a regulated home reversion plan as one that meets the following:

- The reversion occupier, a trust beneficiary, or a related person must be entitled under the arrangement to occupy at least 40 per cent of the land as, or in connection with, a dwelling.
- The plan will end if the occupier* dies, enters residential care, or at the end of a specified term of at least 20 years from the date of the arrangement. (Most arrangements run until death or entering residential care.)

* The term 'occupier' has a wide meaning, including a spouse, civil partner, 'common law' partner, child, grandchild, parent or sibling. However, providers will limit those who can occupy the property to spouse or civil partner.

3.3.6 Buy-to-let mortgages

Put simply, the FCA definition of a buy-to-let mortgage is the same as that for a regulated mortgage, except that the property cannot be occupied as a dwelling by the borrower or a related person at any time, and will be occupied as a dwelling on the basis of a rental agreement.

Consumer buy to let

The MCD refers to mortgages on residential property, which includes buy to let. The UK government opted to use an exemption that allows it not to apply the MCD requirements to buy-to-let mortgages if there is an 'appropriate framework' in place. This led the FCA to put in place its CBTL mortgage regime. A CBTL mortgage contract is one "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" (Mortgage Credit Directive Order, 2015). We have already outlined in section 2.2.2 the circumstances in which a loan would be classified as a CBTL mortgage.

Mortgage brokers and lenders offering CBTL mortgages require specific authorisation from the FCA. Applications for CBTL mortgages must be treated in a similar way to those for residential mortgages in terms, for example, of the affordability assessments, documentation and processes.

Customers with unresolved complaints about CBTL mortgages can take their complaint to the Financial Ombudsman Service.

Those who already own buy-to-let properties as a business would not normally be treated as CBTL borrowers if they acquired a property in the circumstances described above.

CHECK YOUR UNDERSTANDING 5

Which of the following are 'accidental landlords'? What would the implications be for them if they needed to arrange a new mortgage on the property they are renting out?

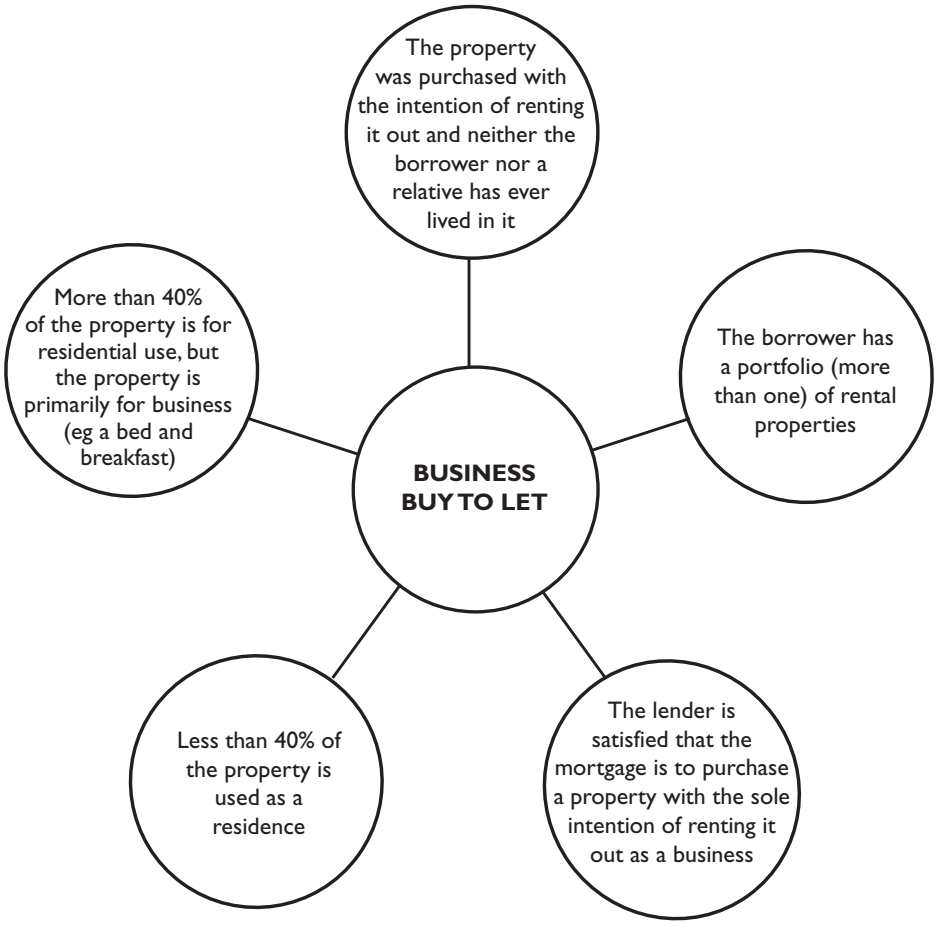
a) A son inherits his parents' house. He has his own property but does not wish to sell his parents' house yet because the market is poor. In the meantime, in order to cover the costs of maintenance, etc, he decides to rent it out.

b) A couple have moved to another area to work but have been unable to sell their house. In order to cover the cost of maintenance, etc, they have decided to rent it out while they settle nearer to work and perhaps buy another property in the area.

Business (professional) buy to let

A business buy-to-let mortgage is arranged to purchase or otherwise fund a property that is intended solely to be rented out as part of a business. These mortgages continue to be outside FCA regulation. Figure 3.5 summarises the criteria for a mortgage to be assessed as business BTL. In addition, the lender can also accept that a BTL mortgage is for business purposes if the borrower signs a declaration, which the lender has no reason to believe is untrue. The declaration should state that the loan is wholly or predominantly for business purposes, and that the borrower understands that this means they will forgo the protection offered by the CBTL regime.

FIGURE 3.5 BUSINESS BUY TO LET



3.3.7 Second-charge loans

A second-charge mortgage loan uses the borrower's home as security by taking a further charge over the property. The borrower's main mortgage is on a first-charge basis, which means that the main mortgage lender has priority over other charges if the borrower is unable to make their mortgage payments and the property is repossessed.

FROM CONC TO MCOB

Between 1 April 2014 and 20 March 2016, FCA regulations on second charges were contained in its Consumer Credit (CONC) sourcebook. Following the implementation of the MCD on 21 March 2016, second-charge regulation was incorporated into MCOB. Second-charge mortgages entered into before 21 March 2016 are subject to MCOB, as back book loans, if they meet the 2016 criteria for regulated second charges.

All second-charge lenders, administrators and brokers must be authorised by the FCA and have in place the appropriate permissions to carry out second-charge lending activities. Firms providing second-charge loans must apply for mortgage permissions, and those advising on and selling second-charge loans must have a Level 3 mortgage qualification.

3.4 How is the MCOB sourcebook structured?

MCOB forms a separate sourcebook within the FCA Handbook. It comprises the chapters summarised in Table 3.1.

TABLE 3.1 MCOB SOURCEBOOK – SUMMARY

Chapter	Title	Content
1	**Application and purpose**	▪ Helps firms understand which parts of the MCOB rules apply to them ▪ Provides guidance on the application of other parts of the FCA Handbook
2	**Conduct of business standards: general**	▪ General requirements that apply throughout the mortgage sourcebook ▪ Communications must be clear, fair and not misleading ▪ Rules on inducements

2A	**Mortgage Credit Directive**	▪ Remuneration and policies ▪ Tying practices ▪ Foreign currency loans ▪ Early repayment ▪ Variable rate credits ▪ Information free of charge
3A	**Financial promotions**	▪ Financial promotions of qualifying credit, home reversion plans and regulated sale-and-rent-back agreements ▪ Rules banning unsolicited real-time promotions (cold calling)
3B	**MCD general information**	▪ Provision of general information for MCD regulated mortgages
4	**Advising and selling standards**	▪ The initial disclosure document ▪ Standards ▪ Independence ▪ Suitability of advice ▪ Non-advised sales
4A	**Additional MCD advising and selling standards**	▪ Additional disclosure by MCD mortgage credit intermediaries ▪ Adequate explanations
5	**Pre-application disclosure**	▪ Timing and content of the key facts illustration (KFI)
5A	**MCD pre-application disclosure**	▪ Applying for an MCD regulated mortgage contract ▪ Information on MCD regulated mortgage contracts: general ▪ Provision and content of a European Standardised Information Sheet (ESIS)
6	**Disclosure at the offer stage**	▪ Content of the offer document

6A	**MCD disclosure at the offer stage**	▪ MCOB 6A.3 MCD mortgages: binding offer, content of the offer document and reflection period ▪ MCD mortgages: information to be provided in the offer document or separately ▪ MCD distance contracts with retail customers
7	**Disclosure at start of contract and after sale**	▪ Start of contract information requirements ▪ Annual statements ▪ Information requirements for post-sale contract variations (such as further advances)
7A	**Additional MCD disclosure: start of contract and after sale**	▪ Notification of interest-rate changes ▪ Foreign currency loans and significant exchange-rate movement disclosure ▪ Notification of changes resulting from auctions on the capital market
7B	**MCD: further advances**	▪ Information to be provided for further advances
8	**Equity release: advising and selling standards**	▪ A tailored regime for advising and selling lifetime mortgages and home reversion plans
9	**Equity release: product disclosure**	▪ Tailored product disclosure requirements for lifetime mortgages and home reversion plans
10	**Annual percentage rate**	▪ How to calculate the APR
10A	**MCD annual percentage rate of charge**	▪ Calculation of the APRC ▪ APRC: mathematical formula and assumptions ▪ APRC: additional assumptions

11	**Responsible lending and responsible financing of home purchase plans**	▪ A requirement for lenders to check the consumer's ability to repay
11A	**Additional MCD responsible lending requirements**	▪ MCD mortgage credit intermediary: submission of information to MCD mortgage lender ▪ Prohibition on cancellation or variation of MCD regulated mortgage contract on grounds of creditworthiness ▪ Obtaining information for, and assessment of, affordability from the consumer and rejecting an application
12	**Charges**	▪ Charges in key areas (eg arrears and early repayment charges) must be reasonable, based on the cost to the lender ▪ Charges must not be excessive
13	**Arrears, payment shortfalls and repossessions**	▪ Information requirements for fair treatment of borrowers in arrears and facing repossession
14	**MCD article 3(1)(b) credit agreements**	
15	**MCOB 15: P2P home finance activities**	

The key points of each relevant MCOB chapter will be covered in the appropriate section of this study text.

3.5 What other legislation provides protection for property buyers?

3.5.1 The Consumer Protection (Amendment) Regulations 2014

This legislation replaced previous legislation intended to control marketing and selling practices and covers all situations where professionals, including estate agents, engage with consumers.

The legislation gives consumers certain rights and remedies where a firm is in breach of the regulations, and right to redress if they have been subject to misleading or aggressive practices.

The legislation does not apply to financial services or consumer credit as these are covered by other regulations.

There are three main parts to the regulations:

- There is a general ban on unfair commercial practices.
- Misleading and aggressive practices are assessed to determine their influence on the average consumers' decisions, ie to assess whether their impact means that they are unfair.
- There is a 'blacklist' of practices that are banned because they are deemed to be unfair.

It is a breach of the regulations to omit or fail to disclose information that the average consumer would need to make an informed decision, or to provide information in a way that is misleading, unclear or unintelligible.

From an estate agent's perspective, a consumer can be expected to make their own enquiries and find publicly available information, but agents are expected to point out important or unusual matters to consumers. For example, failing to disclose information about the condition of the property would be regarded as misleading by omission, and significantly exaggerating the dimensions of a property would be providing misleading information.

If a business fails to follow a code of practice to which it has subscribed, it could be in breach of the regulations.

3.5.2 Consumer credit legislation

Consumer credit legislation is intended to protect ordinary consumers and small businesses, and uses the term 'individual' to define those borrowers. An 'individual' is defined as an 'ordinary' borrower, a partnership with three or fewer members or an unincorporated association. Other businesses are outside the legislation.

The key consumer credit legislation is the Consumer Credit Acts 1974 and 2006. In 2014, regulatory powers in relation to the Consumer Credit Acts were transferred to the FCA, with rules and guidance for lenders contained in the Consumer Credit sourcebook (CONC). The consumer credit legislation applies to unsecured loans, credit cards and similar lending.

A loan that is a regulated mortgage contract or an MCD mortgage contract, ie regulated under MCOB, is exempt from the Consumer Credit Acts of 1974 and 2006. Second-charge lending became part of the MCOB regime as regulated mortgages as part of the rule changes that implemented the MCD from 21 March 2016.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- define a regulated mortgage contract?
- summarise the types of home finance that are regulated?
- explain the difference between a lifetime mortgage, a home purchase plan and a home reversion plan?
- describe two different approaches to Islamic home finance?
- explain how 'buy to let' differs from 'consumer buy to let'?
- summarise the main areas covered by MCOB?
- explain how the CPRs affect the marketing activities of estate agents?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

FCA (no date) *Retirement interest-only mortgage* [online]. Available at: https://www.handbook.fca.org.uk/handbook/glossary/G3559r.html [Accessed: 4 November 2020].

The Mortgage Credit Directive Order 2015. SI 2015/910 [pdf]. Available at: www.legislation.gov.uk/uksi/2015/910/pdfs/uksi_20150910_en.pdf [Accessed: 4 November 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 3. Review the text if necessary.

Answers can be found at the end of this book.

1) Anita took out a second mortgage on her home in January 2016. Is her mortgage subject to MCOB?

2) Brian has just bought a three-storey property with the help of a mortgage. Two floors provide office accommodation and the top floor is a two-bedroom flat. Is the mortgage regulated?

3) Which category of lending became regulated under MCOB following implementation of the Mortgage Credit Directive?

4) All mortgages on BTL property owned by individuals are consumer buy-to-let mortgages. True or false?

5) Gabby, aged 56, has entered into an arrangement where a lender has given her a mortgage that must be repaid only when she moves, goes into care or dies. What type of arrangement does she have?

   a) A home reversion plan.

   b) A home finance plan.

   c) A lifetime mortgage.

6) Andy has arranged a home reversion plan, entering 50 per cent of his property into the plan in exchange for a lump sum of £80,000. On his death the property is valued at £300,000. How much, if any, of the property value would be included in his estate for distribution to his heirs?

   a) Nothing.

   b) £110,000.

   c) £150,000.

   d) £220,000.

7) Which of the following is **not** a chapter of MCOB?

   a) Application and purpose.

   b) Training and competence.

c) Financial promotions.

d) MCD: further advances.

8) Regulated mortgages of less than £25,000 on residential property are regulated under the Consumer Credit Acts 1974 and 2006. True or false?

9) George wants to borrow £20,000 in the form of a personal loan to install a new bathroom and kitchen in his house. This loan would be subject to consumer credit legislation. True or false?

10) An estate agent that makes misleading claims about the properties it is marketing is potentially in breach of:

a) Consumer Protection from Unfair Trading Regulations 2014.

b) The Consumer Protection (Amendment) Regulations 2014.

c) Consumer Credit Act 1974.

d) Consumer Credit Act 2006.

TOPIC 4

Principles of mortgage and property law

LEARNING OBJECTIVES

This topic looks at the laws underpinning mortgages and property ownership. An adviser is not expected to be a legal expert but understanding some basic principles and key issues can help you to spot pitfalls and provide a more helpful service to clients.

By the end of this topic, you should have an understanding of:

- important legislation relating to mortgages and property ownership;
- types of legal mortgage and the priority of legal charges;
- the ways in which property can be owned;
- land tenure;
- the provisions of the Commonhold and Leasehold Reform Act 2002.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about property law and mortgages.

For instance:

- What is the difference between freehold and leasehold?
- What does the term 'tenant' mean in relation to ownership of property?
- In what circumstances can the owner of a leasehold flat take over ownership of the freehold of the building?

You may have a good idea of the answers to these questions. If you do, that's great – we can build on that knowledge and introduce some of the finer detail. If not, don't despair – by the end of the topic you'll have a good grasp of the details.

4.1 Introduction

Mortgage law and practice has evolved over time, generally to the benefit of borrowers. This has arisen from changes to the law and, in recent years, as a result of social policy and improved consumer protection. For example, while borrowers were once unable to repay a mortgage loan early, they now have the right to do so at any time. Borrowers are also now far better protected if they cannot make a repayment when it is due.

KEY TERMS

CONVEYANCE

The transfer of rights in property is described as a conveyance.

MORTGAGEE AND MORTGAGOR

The borrower is described as the *mortgagor* and the lender as the *mortgagee*. It is not uncommon for people to get these two terms confused, so ensure that you memorise them correctly.

In Scotland, the borrower is the *debtor* and the lender is the *creditor*.

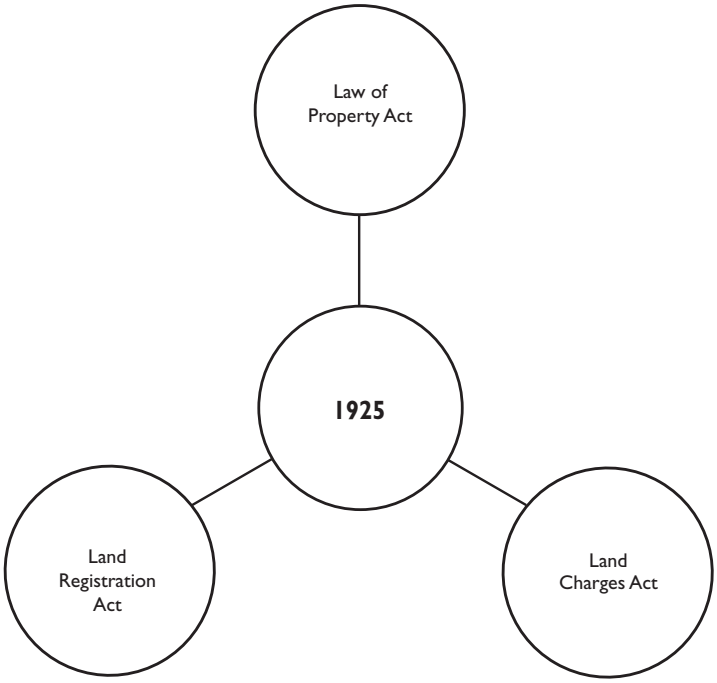
4.2 What is the basis of modern property law?

The year 1925 was a significant one for property ownership. Three pieces of legislation were passed, changing the way in which property could be owned, the registration of property and the way in which mortgages could be secured on land. We do not need to know the details of each piece of legislation, but it is important to understand the key changes the three Acts brought about.

COMMONHOLD

We will see in section 4.5.3 that a 2002 Act added a third form of ownership known as 'commonhold'. Do you know what this is?

FIGURE 4.1 WHAT ARE THE THREE SIGNIFICANT PROPERTY ACTS OF 1925?



Although the 1925 Acts have been updated by subsequent amendments and legislation, they still underpin the basis of land and mortgage law in England and Wales. They simplified the ways in which mortgages can be created, and the most common method now is through a legal charge.

One of the most significant changes was to reduce the ownership of land to two forms:

- estate in fee simple absolute in possession – more commonly known as 'freehold'; and
- estate for a term of years absolute – more commonly known as 'leasehold'.

KEY TERMS

FEE SIMPLE

The right for the property to be inherited on death.

ABSOLUTE

No limits on ownership.

KEY TERMS

IN POSSESSION

Immediate entitlement to occupation: nobody else has a prior claim.

TERM OF YEARS ABSOLUTE

Leasehold estate, which has a limited duration that must be fixed and certain.

The 1925 Acts introduced a system of land registration for all property (updated in later Acts). They also introduced legal remedies for the lender in the event of default or other breach of the terms of the mortgage by the borrower.

Other key provisions included the following:

- A minor (a person under the age of 18) cannot hold an interest in land.
- Where two or more loans are secured on a property, their priority is determined by the date of their registration.
- The borrower has a right to let the mortgaged property unless the mortgage deed states otherwise (in practice all lenders include a clause in their mortgage deed that specifically excludes this right).
- The lender is not liable for any loss made on the execution of its power of sale.
- The lender has the right to determine how the proceeds of any insurance claim relating to the mortgaged property are used.

CUIUS EST SOLUM, EIUS EST USQUE AD COELUM ET AD INFEROS

A principle of land ownership in the UK is that 'whoever owns the soil owns everything up to the heavens and down to the depths of the earth' (translated from Latin).

There are some exceptions to this principle. Court cases have established that the right to airspace above the land is limited to what is reasonable for the ordinary use and enjoyment of the land – so an individual could not take action for trespass against an aeroplane 30,000 feet above their property. The owner of land also owns the space below it and any minerals lying beneath it, apart from the rights of the Crown in relation to oil, coal, natural gas, gold and silver.

4.3 What are the types of mortgage?

Lenders will only usually lend for property purchases on the strength of a legal mortgage. Prior to the Law of Property Act 1925, there were a number of ways in which a legal mortgage could be created, but the 1925 legislation reduced these to two:

- **Mortgage by way of legal charge** – this type of mortgage is known as standard security in Scotland. The property is owned by the borrower from the outset (compare this with mortgage by demise below). The legal charge is a deed that states that the property has been charged with the debt (the loan) as security for the lender.

  The lender acquires certain rights that leave it in a very strong position should the borrower default. The charge is cancelled when the mortgage is fully repaid.

- **Mortgage by demise** – mortgage by demise is available in England and Wales only. The lender becomes the legal owner of the property when it is purchased, and legal ownership is transferred to the borrower when the mortgage is fully repaid.

  This arrangement was very rare, and was abolished in the Land Registration Act 2002 for new mortgages created for registered land. It can now only be arranged on unregistered property.

SCOTLAND

A mortgage is created slightly differently in Scotland. See the Scottish supplement, 'Securities over heritable property'.

4.3.1 What are second and subsequent mortgages?

As we saw in Topic 3, a second mortgage (or second charge) is where a borrower already has a mortgage (first charge), and then arranges more borrowing against the same property through a different lender.

REMEMBER

A second mortgage ranks behind the first mortgage in terms of priority for repayment.

The first-charge holder usually inserts a clause in the mortgage deed allowing it to make further advances as part of the first charge, rather than on a

second-charge basis. For this reason, a second charge is almost invariably with a different lender.

4.3.2 How is the priority of charges determined?

Registered land

The second charge will be registered with the relevant registry and the date order of registration generally determines which takes priority in the event of default, provided the earlier mortgagees followed proper procedures in registering their charges.

IN BRIEF

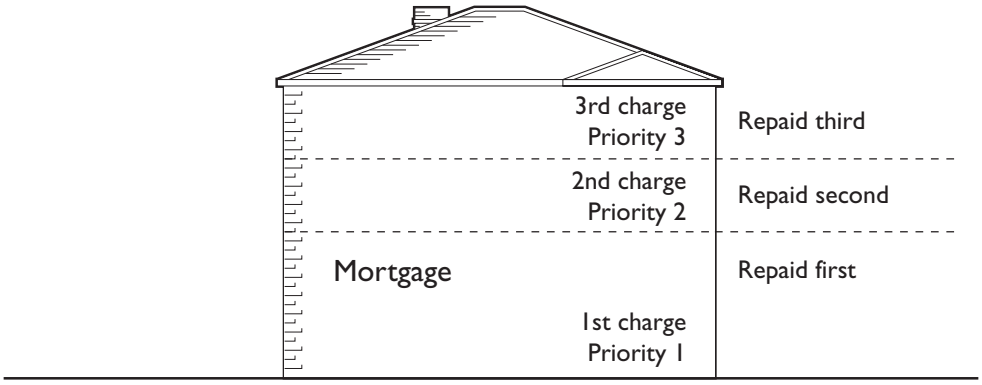
PRIORITY OF CHARGES

If the borrower defaults and the property is sold, the first mortgagee will benefit first from any sale proceeds before any surplus is available for the second, and so on; the earlier mortgage 'takes priority'. Subsequent mortgagees receive their share of any surplus in order of priority until each of their claims is satisfied, or until the sale proceeds run out. If there is anything left at the end, it must be repaid to the borrower.

Unregistered land

The lender that holds the title deeds as security will be regarded as the first-charge holder. Subsequent charges will be recorded in the Land Charges Registry, with their priority set in date order.

FIGURE 4.2 RANKING OF MORTGAGE CHARGES



If the first mortgagee fails to receive enough from the sale of the property to repay its loan, then subsequent mortgagees will get nothing. So, a lender will only accept a second or subsequent mortgage if it feels that there is sufficient

'equity' (value) in the mortgaged property to comfortably cover both earlier mortgages and its own.

Second mortgages present the lender with a higher risk and are likely to be offered at higher rates of interest or with higher tariffs of charges and fees; they are often provided by finance houses, which specialise in higher-risk secured lending.

4.4 What are the types of joint property ownership?

LEGAL AND EQUITABLE OWNERS

It is possible for up to four people to be registered as legal owners of a property. If there are more than four potential owners, four will be registered as the legal owners. Those who have a right to a share in the property but are not shown as legal owners at the Land Registry are referred to as equitable (or beneficial) owners.

TENANCY/TENANT

Legal terms used in the Law of Property Act 1925 to describe joint owners of property. This can be confusing, because we now tend to use these terms to describe people who *rent* a property.

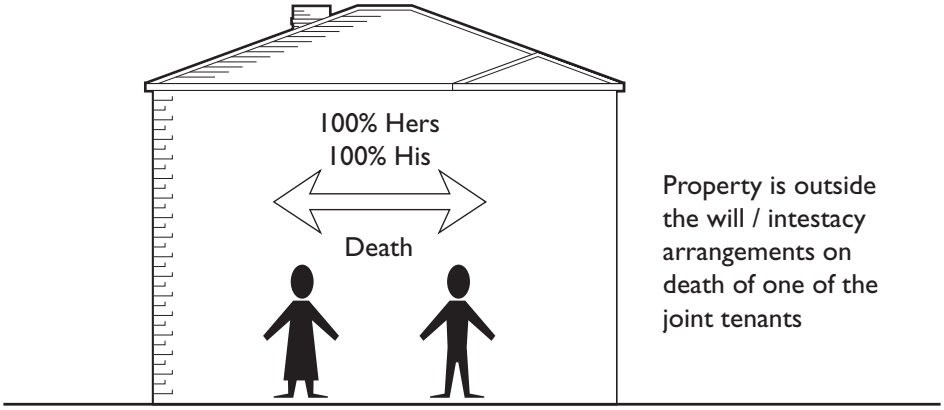
When a property is owned jointly, the Trusts of Land and Appointment of Trustees Act 1996 dictates that a trust of land is created automatically, with the legal owners as trustees. The legal owners are those who are the registered proprietors of a registered property or those whose names are shown in the latest conveyance for unregistered property. They have the power to transfer legal ownership of the land or to mortgage it as they wish, as long as they all agree. The legal owners hold the property on trust for each other and the equitable owners, and jointly owned property can usually only be sold if there are at least two legal owners. In most cases the legal and equitable owners are the same, although this is not always the case. Equitable owners do not have the right to transfer legal ownership.

4.4.1 Joint tenancy

Joint tenancy is the most common type of joint ownership – it is the default type. In simple terms it means that each joint owner owns 100 per cent of the property – there is no division of the property. On the death of any joint owner, the surviving joint owner(s) will take over legal ownership of the property. The transfer is automatic and cannot be overridden by any provisions made by a joint tenant in a will or through the laws of intestacy. For example, George

and Claudia own their property as joint tenants. If George died, Claudia would become the sole owner of the property, regardless of anything that George had stated in his will.

FIGURE 4.3 JOINT TENANCY

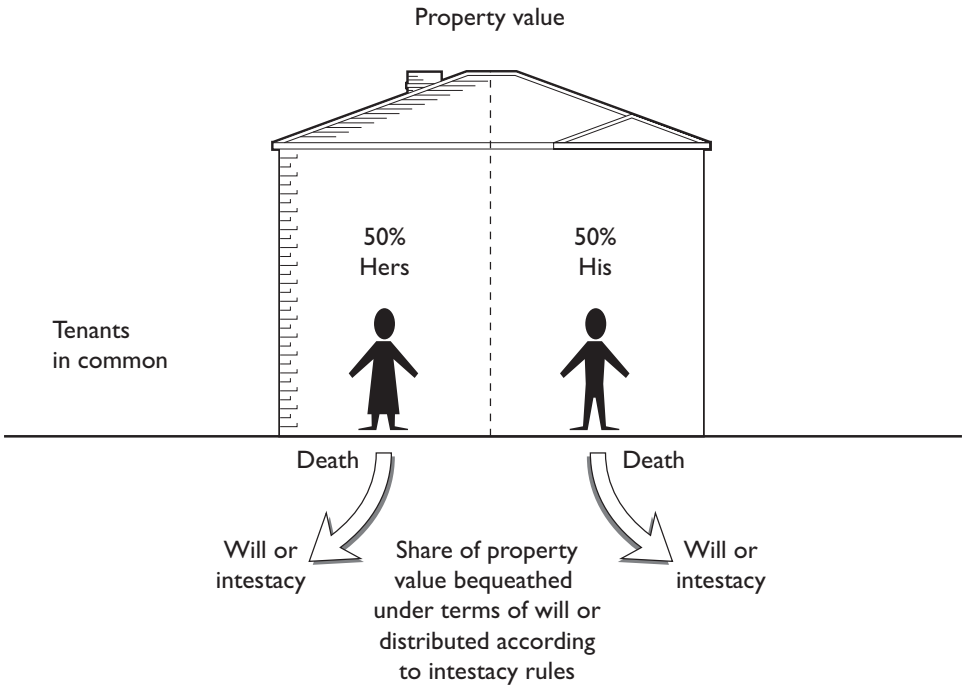


4.4.2 Tenancy in common

Tenancy in common is often described incorrectly. With tenancy in common, both legal and beneficial ownership feature.

The same basic principle applies to legal ownership – the joint legal owners are regarded as one single owner but are trustees of the land. However, each legal owner is also the beneficial (or equitable) owner of a defined interest (share) of the equity in the property, as agreed between them.

FIGURE 4.4 TENANTS IN COMMON



So, what does this all mean?

On the death of a joint tenant in common, legal title to the whole property passes to the survivor, who continues to hold it as a trustee in land. There is now one legal owner of the property. From a technical viewpoint, a property held jointly cannot be sold if there is only one surviving owner; there must be at least two legal owners for a sale to go ahead.

Each joint owner (or their heirs in the event of their death) is regarded as having a beneficial interest equal to their agreed share of the property. In simple terms this would equate to their share of the remaining equity in the property after any mortgage debts have been settled.

It is the beneficial interest (not legal ownership) that a joint tenant can leave to their chosen beneficiaries on their death.

The surviving legal owner, as trustee of the land, has a duty to look after the interests of a beneficial owner until a new joint legal owner can be appointed and the property is sold, if appropriate.

To set up a tenancy in common, a notice of severance (a written notice of the change) is served on the other owners. The original of the notice, or a certified copy, signed by all the owners, should be sent to the Land Registry together with a Form A restriction request on the property. The Form A restriction prevents either party selling the property or their share without agreement from the co-owner. The restriction will show up on conveyancing searches.

This means that the surviving legal owner cannot sell the property without following a legal process to appoint a new joint legal owner. Equally, because the beneficiaries are not the legal owners, they cannot force a sale.

The surviving owner, as a trustee, can (but is not obliged to) appoint someone to act as trustee for the deceased owner's share – usually their executor or personal representative. Once another trustee has been appointed, the property can be legally transferred into the joint names of the original owner and the new trustee as the new joint legal owner.

The new joint owners still have an obligation to look after the interests of the beneficial owners.

Once there are two legal owners again, the property can be sold and the proceeds distributed in accordance with the agreed shares.

!

OWNERSHIP *V* MORTGAGE

The situation described above refers to the ownership of the property itself and not the mortgage. The mortgage would be on a joint and several basis, so the survivor would take over responsibility for the debt, regardless of their eventual share of the property.

CASE STUDY: TENANCY IN COMMON

Dave and Sheila own their property, valued at £300,000 with no mortgage, as tenants in common on a 50:50 basis. Both have made wills, leaving their share of the property to their children; Dave's brother Jim is his executor.

On Dave's death, Sheila would become the sole legal owner of the property. However, Dave's £150,000 beneficial share of the equity in the property would pass to the beneficiaries of his will for the purposes of the distribution of the estate and inheritance tax.

Although Sheila would own legal title to the property, she would have to hold Dave's share on trust for his beneficiaries. On Dave's death, the restriction placed on the property at the Land Registry would mean that Sheila could not sell the property and would continue to hold the property as a trustee of land; nor could Dave's beneficiaries force Sheila to sell the property because she would be the sole legal owner at that stage.

Sheila could appoint Jim (or anyone else) to replace Dave as a trustee. Once that was done the property could be transferred into Sheila and Jim's names as joint owners. As joint owners Sheila and Jim could sell the property if they both agreed, but they must at all times protect the interest of the equitable owners – Dave's beneficiaries and Sheila. On Sheila's death, her executors and Dave's trustee must ensure that Dave's beneficiaries receive their rightful share of the property.

Tenancy in common can be useful if someone wants to leave their share of the property value to someone else rather than the joint owner. In most cases this would be part of an inheritance tax (IHT) mitigation plan, or perhaps to protect the inheritance of children from a first marriage in the case of a second marriage.

An example might be where two parents buy a holiday home on the coast. They have reasonable assets and would like to avoid IHT if possible. In the event that either of them were to die, it would be better to leave the children a share of the property rather than cash because the survivor would need the cash in order to live. In order to achieve this, the parents can arrange ownership on a tenants in common basis, each leaving 50 per cent to the children in their wills. On death, the children will own 50 per cent of the property value and the survivor the other 50 per cent. Most importantly, the share of the property value left to the children will form part of the deceased's nil-rate band and will enable the survivor to benefit from the cash left in the estate.

CHECK YOUR UNDERSTANDING

You learned about IHT in UK Financial Regulation – refer back to your study text if you need to refresh your memory.

A HIDDEN TRAP?

We established that, if a joint tenant dies, the surviving joint owner(s) become(s) the sole owner of the whole property, so 100 per cent of the property passes automatically to the survivor. However, IHT regulations regard jointly owned assets as being owned in equal shares by each owner, which means that the deceased owner's notional share of the equity in the property is treated as a transfer for IHT.

Where the owners are married or civil partners this is a technical issue because the spouse exemption means no tax would be payable. However, if the owners are not in that situation an IHT liability could arise.

For example, Joe and Glenda have lived together for 30 years but have never married. They own their house in London, worth £800,000, outright, having paid off the mortgage some time ago.

Joe dies. Glenda will become sole legal owner of their house, but £400,000 (50 per cent) of the house value will form part of Joe's estate for IHT purposes. This seems a bit of a contradiction, because Glenda would own the whole house, and nobody else would have a claim on any of its value.

Everything Joe owned above the nil-rate band would be subject to IHT. For example, if Joe died when the nil-rate band was £325,000 and IHT was 40 per cent, IHT would be payable at 40 per cent on the value of his estate above that amount. Even if he left nothing else, his share of the house would create a bill of £30,000. How would Glenda, or the family, find the funds to pay the bill? The additional residence nil-rate band would not apply because the property did not pass to a lineal descendant.

JOINT OWNERSHIP – SCOTLAND

Joint property is similar to a joint tenancy in England and Wales.

Common property is similar to a tenancy in common in England and Wales.

4.5 How does land tenure work?

Land tenure in Scotland is different from that in England and Wales. Students sitting the examination in Scotland will need to study the Scottish Appendix in addition to this topic.

TENURE

Denotes the way in which title to the property is held; it is taken from the French *tenir*, meaning 'to hold'.

We saw in section 4.2 that the 1925 legislation reduced the number of ways in which property (legal estates in land) could be held to two: freehold and leasehold. The Commonhold and Leasehold Reform Act 2002 introduced a third type of tenure – commonhold.

4.5.1 Freehold estate

The freehold estate is the best and highest form of ownership of land in England and Wales. However, although the owner of a freehold property owns it outright and with no restrictions, they are still not able to do totally as they might wish.

IN BRIEF

WHAT FACTORS MIGHT AFFECT FREEHOLDER RIGHTS?

- There is a requirement to meet local authority conditions, for example, those relating to property use and alterations.
- The owner is subject to local and national planning legislation, which may affect both the use of the property and the extent to which it can be altered.
- There may be covenants or easements that apply to the land.
- The title itself may contain restrictions imposed by an earlier owner.
- Former public utilities (now private companies providing water, electricity, gas, etc) have certain rights over the land; for example, the water companies own the rainwater that falls on the property.
- The owner has obligations to those who enter or pass by the property – for instance, if a tile falls off the roof and injures someone, the owner can be liable.

Freehold ownership does not always mean that the property is better security than leasehold property. Freehold land can provide defective title and have specific features that make it unsuitable from a lender's point of view. In particular, many lenders are reluctant to consider mortgages on freehold flats. The reason for this is that the buildings invariably have common areas for which there is no clear accountability. For example, the ceiling of one person's flat is another person's floor, so it is unclear who is responsible for damage. If the property is leasehold, there is a freeholder who determines who has responsibility.

IN BRIEF

FLYING FREEHOLD: A PROPERTY NIGHTMARE?

Flying freehold is the term used when part of a freehold property extends above or below another person's property but is not next to or touching the ground. Common examples include:

- a passage between two terraced houses (numbers 1 and 2), where the passage is on land owned by number 1 but part of a bedroom in number 2 is over the passage;
- a 'coach house' style property, where part of the property sits above an entrance to communal parking for the development;
- a cellar that extends under the neighbouring property;
- a balcony that extends over land owned by the property next door.

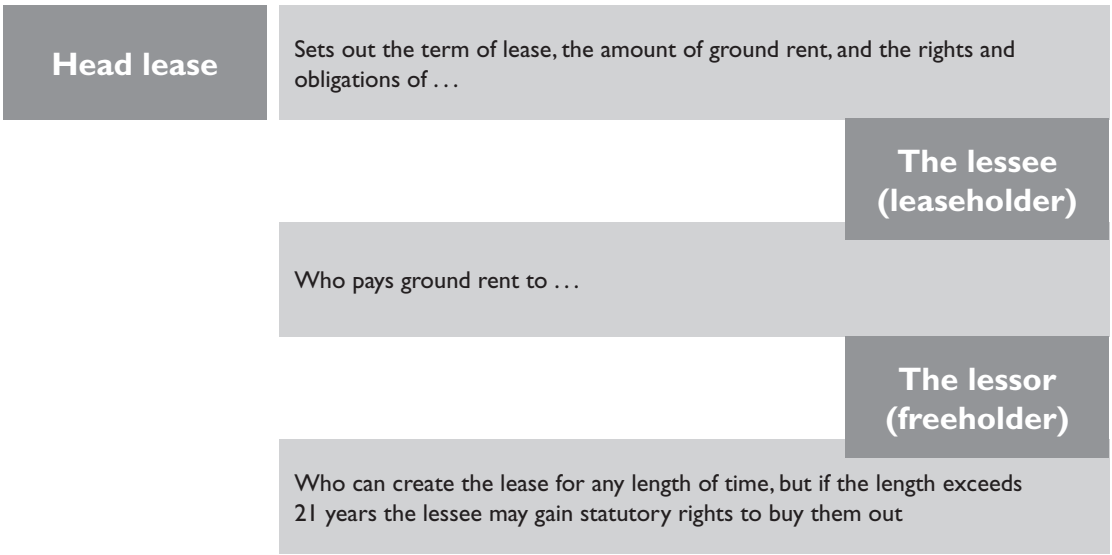
A flying freehold can be a major problem, because the owner of the land may fail to maintain their property, which could result in damage to the property with the flying freehold.

Lenders are usually reluctant to lend on property with a flying freehold, unless there is an enforceable right of support, shelter and repair, and appropriate rights of entry. In other words, there must be an enforceable requirement on the landowner to maintain the property to prevent damage, and to allow access to carry out any repairs to the property with the flying freehold.

4.5.2 Leasehold estate

Leasehold estate is a less permanent form of estate than freehold. It is a form of land tenure where a person has rights over the land for a specific period only. Referred to in the Law of Property Act 1925 as 'a term of years absolute', leasehold is a legal estate in land and occurs where the freeholder (the lessor) agrees to lease the land or property to another (the lessee). A typical lease may have an original term of 99 years, but it could be as long as 999 years.

FIGURE 4.5 HOW DOES LEASEHOLD OPERATE?



Ground rent on a leasehold property is usually relatively low, typically between £50 and £200 a year.

GROUND RENT AND LEASEHOLD HOUSES

Most leasehold properties are flats, and until recent years few houses were held on that basis. However, significant numbers of leasehold new-build houses have been sold, for example under the government's Help to Buy scheme, with a clause allowing ground rent to double after a specified time. Some developers also imposed unreasonable costs or obstacles on those who sought to buy the freehold (ie enfranchisement), or sold on the freehold to speculators who in turn increased the cost of enfranchisement.

In response to the growing controversy, in July 2019 the government banned the sale of leasehold houses under the Help to Buy scheme, with the promise of further legislation to address other issues.

Many leases contain a clause allowing a ground rent increase after perhaps ten years and then another after a further ten years, and so on. Even with an increase, the ground rent will be a relatively small amount.

It is possible for a leaseholder to create a lease to allow another person to use the property, known as a 'sub-lease', as long as the term is shorter than the original lease and the head lease does not prohibit it.

IN BRIEF

LEASEHOLDERS: RESTRICTIONS AND RESPONSIBILITIES

The freeholder of the leasehold property may be bound by any of the freehold conditions described above; these affect the leaseholder as well.

Leases may carry additional constraints such as:

- specific conditions relating to maintenance and repairs;
- constraints on use of the property;
- restrictions on alterations or enlargement;
- duties in respect of common areas – for example, where there is a block of leasehold flats, contributions may be required for the upkeep of spaces for communal use, such as landings and stairs, although the responsibility for the maintenance of the common areas lies with the freeholder;
- a requirement to insure through a specified company.

!

NOTE ON LEASEHOLD

When someone buys a leasehold property, they are actually buying the right to lease the property – it is the lease that has value and that is what the purchaser is buying. At no point does the leaseholder own the land or the bricks and mortar, unless they are able to buy the freehold as well. The purchase price of the lease will depend on a number of factors, including the type of property, the value of the property, the rent and the remaining term of the lease.

The lender must understand the nature of the lease when a leasehold property is considered for mortgage. If the lease is too restrictive it will affect the resale value of the property.

The unexpired term of a lease is very important. When a lease expires, the land and building reverts totally to the freeholder and, as a result, as the lease approaches expiry date, the value of the property will fall significantly. Most lenders are very wary of short leases, usually specifying that the lease must have a certain minimum number of years to run beyond the redemption date of the mortgage. A typical requirement would be 30–40 years more than the mortgage term.

LEASE TERM

A borrower buys a leasehold property for £100,000. The property is leasehold with 30 years to expiry. The purchase is funded by a 25-year mortgage.

Eight years later, the borrower defaults on the mortgage and the lender takes possession. By this time, the lease has only 22 years to run and, at the end of that period, it will revert to the freeholder. Anyone buying the property will only have use of it for 22 years and no rights at all after that. It is likely that the lender will find it almost impossible to sell the property for anything like its normal market value if it has to take possession.

BUYING AND SELLING PROPERTY WITH A SHORT LEASE

It is quite common at auction to see leasehold properties with very low estimated sale prices compared to similar properties – they appear to be real bargains. However, this usually means that the current lease has a very short period of time to run. The buyer will be taking a big risk because, as things stand, the lease has little value and will diminish rapidly in future, leaving them with no tangible asset when it expires.

However, if the buyer can secure a lease extension (see section 4.5.4.2), and is prepared to make the investment to do so, the value could soar and turn a risky investment into a profitable one. The main problem is that the buyer does not have an automatic right to extend the lease until they have owned it for two years, which means they have to take the risk of buying the lease first.

In many cases, it is in the vendor's interest to extend the lease before putting the property on the market, rather than attempting to sell with a short lease at a low price.

Failure to comply with a lease can result in its termination. This is called forfeiture and is a serious matter for the lender. In all instances, the rights of the freeholder take precedence over those of the lender. If the borrower fails to comply with the conditions of the lease and rights are forfeited, the lender

VENDOR

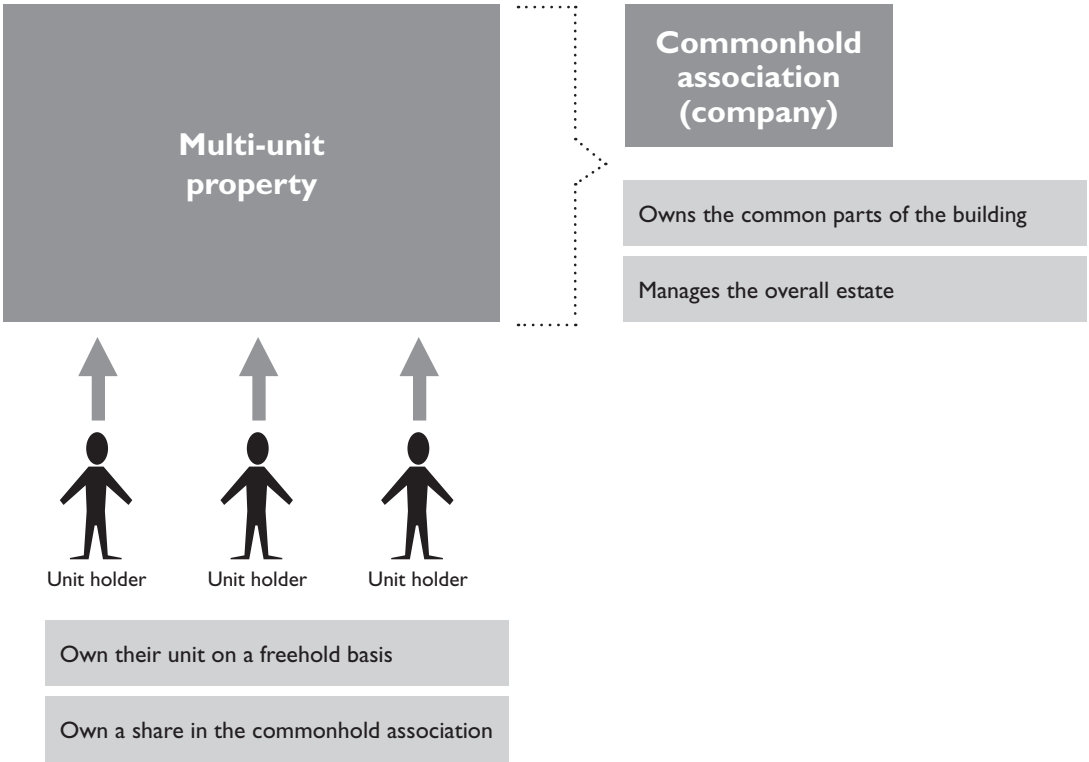
The seller of the property.

is left with no security. Consequently, all lenders include a clause in the legal charge, standard security or mortgage conditions that the conditions of the lease can be fulfilled by the lender if the borrower does not do so. In other words, the lender has the right to do the things a leaseholder should do if the leaseholder fails to comply. The lender will almost certainly add any expenses incurred to the mortgage account. As lenders will not always become aware of this happening, many have insurance policies in place to cover them against losses caused by forfeiture.

4.5.3 What is commonhold?

The Commonhold and Leasehold Reform Act 2002 brought about a change in the way in which property can be owned. Commonhold was introduced as a new type of tenure to provide flexibility for those who would previously have owned leasehold property within a larger development – a block of flats, for example. The larger development is called the multi-unit property and each individual property is called a unit.

FIGURE 4.6 HOW IS COMMONHOLD STRUCTURED?



Shares in the commonhold association may not be equal and may be based on the size of each unit. For example, the owner of a two-bedroom unit may be

allocated two shares, while the owner of a one-bedroom unit may be allocated just one share and the owner of a studio flat half a share.

In practice, commonhold is similar to a leasehold arrangement, but the maintenance of the building is the responsibility of a company owned by the unit owners (the commonhold association), rather than appointed by a freeholder. Only unit holders can be shareholders, although the association can appoint up to two directors who are not shareholders. As shareholders in the commonhold association, unit holders can vote at the annual general meeting. An important point is that, unlike leasehold, where the rights of the freeholder are superior to the leaseholder, with commonhold no individual has rights in the property that are superior to those of the unit holder.

- As a company, the association is required to establish a memorandum of association, articles of association and a commonhold community statement. The community statement includes the rights and obligations of individual unit holders, voting majorities and other essential rules for the community.
- The commonhold association would normally be expected to hold an annual general meeting where shareholders can vote on management issues and the running of the building, with voting on a simple majority basis.
- The commonhold association is able to set a commonhold assessment, which is an annual charge to unit holders to cover the expenses of running the association, and can also require unit holders to contribute to a reserve fund to cover the costs of maintenance and repairs to the common areas of the building. These charges are likely to vary depending on the size of each flat.
- The land/property must be registered with the Land Registry as an estate in commonhold land. This can only be done after the commonhold association has been formed. This means that a developer intending to build a block of flats on a commonhold basis must register a commonhold association with the Land Registry before the property can be registered. Once flats are sold, shares in the association can be transferred to the new unit holders who will take over control.
- The same rights and obligations that would exist between a freeholder and a leaseholder exist between the association and each unit holder. The association will collect a commonhold assessment, which replaces the management charge on leasehold property.

CONVERTING AN EXISTING MULTI-UNIT ESTATE TO COMMONHOLD

An existing multi-unit estate can be converted to commonhold only where all leaseholders, their lenders and the freeholder are in agreement. All leasehold obligations and agreements will terminate and be replaced by those of the commonhold association. It is not common for existing property to convert to commonhold in view of the difficulty in gaining agreement from all parties, and the costs of conversion.

4.5.3.1 Can commonhold replace leasehold?

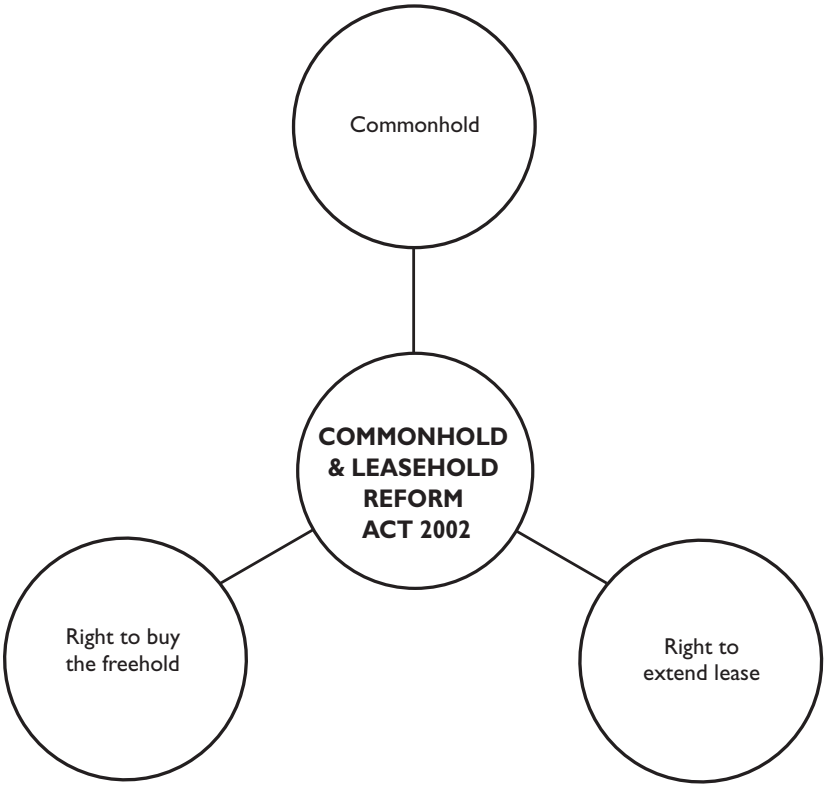
The majority of neutral experts agree that, in many ways, the leasehold system of tenure is out of date, potentially unfair and fraught with problems, and that commonhold is a realistic and progressive alternative. However, very few properties are owned on a commonhold basis. There are three significant factors in the apparent lack of appetite for commonhold.

- Few developers were prepared to take the risk of building flats on a commonhold basis as demand was unknown and the administration and costs involved in setting it up and transferring shares to buyers was seen as onerous. Developers understood leasehold tenure and many see it as a way to generate additional income through ground rents, management charges and other fees.
- Few lenders are prepared to provide mortgages on commonhold developments and it has become a niche market. This is partly due to concerns about the resale potential and future mortgageability of such property, given the public's lack of awareness about commonhold.
- The difficulty presented by the requirement for the freeholder and all leaseholders and lenders to agree to the change from leasehold to commonhold in an existing development.

In response to concerns over the fairness of leasehold tenure and general concerns about the housing market, the government issued a White Paper in February 2017, *Fixing our broken housing market*, which included a commitment to 'improve consumer choice and fairness in leasehold' and to consider 'whether and how to reinvigorate commonhold' (GOV.UK, 2017).

4.5.4 What else is in the Commonhold and Leasehold Reform Act 2002?

FIGURE 4.7 WHAT ARE THE MAIN PROVISIONS OF THE 2002 ACT?



The Commonhold and Leasehold Reform Act 2002 is designed to make it easier for leaseholders of flats to purchase the freehold of their building on a collective basis, or for individuals to extend their lease. It was felt that the previous provisions under the Leasehold Reform, Housing and Urban Development Act 1993 were too restrictive and prevented many leaseholders from being able to exercise the right of enfranchisement.

Those with long leases on houses had certain rights under the Leasehold Reform Act of 1967 to buy the freehold or extend the lease by a further 50 years, increased to 90 years by the Leasehold Reform Housing and Urban Development Act 1993. Subsequent legislation, including the 2002 Act, has extended this right so that most long-term leaseholders now have the right to buy their freehold. For the purposes of this text, we will focus on the more common purchase of leasehold flats.

ENFRANCHISEMENT

The right of the owners of leasehold properties in a building (eg a block of flats) to join together to buy the freehold of the building.

4.5.4.1 Buying the freehold of a flat

In order for leaseholders to be able to buy the freehold of a flat, they must be qualifying tenants, the main requirement for qualification being that the original lease on the flat was for a period of more than 21 years. Where the lease has changed ownership, the right passes to the new leaseholder, providing the original lease was for longer than 21 years. There is no need for the leaseholder to live in a flat, which means landlords can still qualify.

A qualifying tenant can purchase the freehold where the building meets the following criteria:

- The building must contain two or more flats.
- At least two-thirds of the flats must be held on a long lease – a lease that was originally granted for a term of more than 21 years.
- No more than 25 per cent of the internal floor area of the building (excluding common areas such as stairs and hallways) can be used for non-residential purposes.
- At least 50 per cent of the leaseholders in the block must agree to participate. For example, in a block of 12 flats, at least eight must be held on a long lease and at least six leaseholders must agree to participate in the purchase.

Leaseholders cannot be qualifying tenants where:

- the landlord is a charitable housing trust and provides the flat as part of its charitable work;
- the lease is for commercial purposes;
- the leaseholder owns qualifying leases of more than two flats in the building.

A leaseholder does not have to participate in the purchase of the leasehold. If they choose not to do so, they will lease their property from the new freeholders.

A further major restriction on leaseholders purchasing the freehold of their building is a situation where it is a converted property with four or fewer flats and the same person has held the freehold since before the conversion, and they (or an adult family member) have lived in one of the flats as their main residence during the previous 12 months. For ease of understanding we can call them a 'resident landlord'.

4.5.4.2 Extending the lease

As an alternative to buying the freehold, qualifying tenants who have held a long lease for more than two years have the right to buy a new lease, which will extend the existing lease by 90 years. This provision was included in the 1993 Act but improved by the 2002 legislation. For example, on a flat bought

three years ago with 40 years left on the lease, exercising the right to extend the lease would result in a new lease of 130 years.

As long as the applicant meets the qualifying criteria, the landlord cannot normally refuse the application. The payment made by the leaseholder to the landlord, known as the premium, must be a 'fair' value based on open market values. The value is based on the landlord's financial loss as a result of the extension, and generally includes:

- the reduction in the freeholder's financial interest caused by the extended lease;
- an element of the increase in value of the property as a result of the extension;
- compensation for the loss of ground rent.

The ground rent payable on the lease is cancelled and replaced by a 'peppercorn rent' from the point at which the lease is extended. The peppercorn rent is a nominal amount, and in most cases is zero.

In some cases, a leaseholder may qualify to extend their lease but may wish to sell the property before they have done so. If the property is on a short lease, this could significantly affect the sale price or even make a sale almost impossible. The vendor has two choices:

- **To extend the lease before sale**. This will take some time, which could delay any potential sale and may be an expense the vendor cannot afford.
- **To exercise their right to extend the lease and begin the process, but then assign the rights to the new purchaser**. The purchaser will be assured that they can extend the lease, even though they have not owned the lease for the minimum two years. The premium payable for extending the lease and any further costs will be the new owner's responsibility. This buyer will factor the cost of the lease extension into their offer, but the fact that the lease can be extended soon after purchase will result in a significantly higher price than selling with a short lease.

Where the leaseholder does not qualify to extend the lease under the legislation, they can negotiate an extension with the landlord, although the ground rent would not automatically be cancelled and the premium would be set by the landlord, who has the right to refuse an extension.

4.5.4.3 The Right to Manage (RTM)

One further change to leasehold law in the 2002 Act gave qualifying leaseholders the right to take over management of the building from the freeholder by setting up a Right to Manage (RTM) company.

The qualifying criteria for the leasehold property owners are as follows:

- The building or part of the building must contain at least two flats.
- At least two-thirds of the flats in the building must be owned by long leaseholders.
- Non-residential areas of the building cannot exceed 25 per cent of the building's total floor area.
- As with buying the freehold of a flat, if there are four or fewer flats and there is a resident landlord, the building will not qualify.
- At least 50 per cent of the qualifying leaseholders must agree to participate.

There is a set procedure to take over management of the building, as follows:

- Participating leaseholders must set up an RTM company with directors and standard articles of association.
- All those leaseholders who are not members of the company, or have not agreed to become members, must be served with a notice inviting them to participate.
- The freeholder must be sent a notice of claim within two weeks of the notice to non-members.
- The freeholder can respond with a counter-notice (challenge) within one month.
- If the freeholder does not challenge then the RTM company acquires the right to manage four months from the notice of claim. The freeholder can apply to be a member of the RTM.
- If the freeholder issues a counter notice, the RTM company can apply to the first-tier tribunal (England), or leasehold valuation tribunal (Wales) for a ruling about it.
- The RTM takes on all management functions for the building, although the freeholder must be consulted about any alterations or other matters relating to the building other than maintenance.
- The RTM has the right to enforce obligations under the lease, but cannot use the forfeiture procedures.

4.6 What should an adviser know when advising on property law?

A mortgage adviser is not expected to be an expert on matters of land law: it is a complex and specialised area, and one in which the solicitor will advise the borrower.

It is useful, however, for the adviser to be able to:

- understand factors applicable to tenure that affect the saleability of the property, especially those of which the owner might not be aware;
- outline the rights and obligations of the lender under the mortgage deed;
- (in England and Wales) distinguish between freehold, leasehold and commonhold, particularly to answer basic questions by the borrower;
- (in Scotland) understand the basis of land ownership and its implications for borrowers;
- understand the problems associated with lending on leasehold properties and freehold flats;
- understand the principles of leasehold reform and other recent legislation.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the key provisions of the 1925 property acts?
- explain the difference between mortgage by way of legal charge and mortgage by demise?
- explain the difference between joint tenancy and tenancy in common?
- outline the types of restriction that might be placed on the rights of a freeholder?
- describe the main aspects of commonhold?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

GOV.UK (2017) *Fixing our broken housing market* [online]. Available at: https://www.gov.uk/government/publications/fixing-our-broken-housing-market [Accessed: 5 November 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 4. Review the text if necessary.

Answers can be found at the end of this book.

1) The borrower is known as the 'mortgagor'. True or false?

2) Which of the following is the technical definition of 'freehold' land tenure?

   a) Estate in fee simple absolute in possession.

   b) Estate in fee simple for a term of years absolute.

   c) Estate in possession for fee simple absolute.

   d) Absolute term in possession for fee simple.

3) A legal charge is known in Scotland as a mortgage by demise. True or false?

4) A 'second mortgage' is a further loan from the original lender. True or false?

5) Where more than one charge is held over registered land, the order of priority for repayment in the event of default is determined by:

   a) which lender is owed the most money.

   b) the magistrates' court.

   c) the date order in which the charges were registered.

   d) the Financial Ombudsman Service.

6) Gary had a property subject to a legal charge with the Pleasant Building Society, registered 15 years ago on 1 May, securing a loan of £140,000, and a legal charge with the Consolidated Loans company, registered 10 years ago on 11 July, securing a loan of £30,000. Gary defaulted on his loans and the house was taken into possession and sold for £160,000 on 10 May this year. Who would get what from the proceeds of the sale?

   a) Consolidated Loans would receive £30,000 and Pleasant Building Society would receive £130,000.

   b) Pleasant Building Society would receive £140,000 and Consolidated Loans would receive £20,000.

c) Pleasant Building Society would receive £140,000, Gary would receive £20,000 and Consolidated Loans would receive nothing.

d) Pleasant Building Society and Consolidated Loans would require the court to decide how the proceeds should be divided between them.

7) 'Tenancy in common' means that when one joint owner dies their beneficiaries automatically become joint legal owners of the property. True or false?

8) Keith and Linda have just married. They have both been married before and each has two adult children. Each has a house of their own, but they have now decided to sell them and buy a home together. Which ownership arrangement would enable them each to leave their share of the property value to their children on their death?

a) Joint tenancy.

b) Joint and several tenancy.

c) Tenancy in common.

d) Ownership in one name with the partner as a beneficial owner.

9) Why might it be inadvisable for a leaseholder with 20 years remaining on their lease to put their flat on the market?

10) Iliana owns one of two flats in a converted house on a leasehold basis. She and her fellow leaseholder cannot buy the freehold of the property because it is too small to qualify under the commonhold legislation. True or false?

TOPIC 5

Practical aspects of property and mortgage law

LEARNING OBJECTIVES

In this topic we continue our focus on the legal aspects of property purchase and how they affect lending decisions.

By the end of the topic, you should have an understanding of:

- land registration;
- easements, covenants and other legal restrictions or obligations;
- title guarantees;
- legal obligations and guarantees in a mortgage contract;
- lenders' rights and borrowers' covenants.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about practical aspects of property and mortgage law. If you own your own home, or have been involved in the sale or purchase of a property:

- do you know what a 'title search' is and why it is important to the prospective buyer and the lender?
- do you know what a conveyancer does?
- have you encountered rules restricting what can be done with a property, for example, prohibiting the fencing off of the front garden?

5.1 What is the aim of land registration?

Land registration originates from 1897 and has been progressively implemented throughout England and Wales by successive statutes enacted throughout the twentieth century. The Land Registration Act 2002 and the Land Registration Rules 2003 made further changes with effect from October 2003.

CHECK YOUR UNDERSTANDING

As we saw in Topic 4, the main body of reforming legislation was passed in 1925. Which three significant Acts were passed in this year?

The aim of registration is to provide an accurate, up-to-date and continuing record of ownership of land, and registration enables the state to guarantee the validity of a title registered at the Land Registry. In view of this, the buyer's solicitor will carry out a detailed search of the relevant registers.

The registration process can also alert prospective buyers and lenders to a variety of rights that third parties may have over land, and obligations that owners may have in respect of land.

In Scotland, land registration is the responsibility of the registers of Scotland.

5.2 How is land registered in England and Wales?

Land registration has been compulsory for all transfers of land since 1990. This means that eventually every piece of land will be registered, but unregistered land remains unregistered until one of the events below occurs.

FIRST REGISTRATION OF TITLE

The compulsory registration of a previously unregistered property when it is transferred, has a lease exceeding seven years granted, or has a legal mortgage created upon it. The owner of unregistered land may also register it on a voluntary basis.

IN BRIEF

LAND REGISTRATION ACT 2002

The Land Registration Act 2002 replaced in its entirety the Land Registration Act 1925, although many of the principles have remained unchanged. The later Act is designed to encourage and facilitate electronic registration and conveyancing.

5.2.1 Registered land

For registered land, the Land Registry holds details on three registers.

TABLE 5.1 REGISTERS FOR REGISTERED LAND

The property register	The proprietorship register	The charges register
Details: ▪ the land ▪ its title number ▪ a plan of the property (easements that are beneficial to the property will be included here)	Gives: ▪ the name and address of the estate and owner ▪ the nature of the title ▪ date of registration ▪ any property restrictions on ownership Also sets out the class of the title	Records any charges over the property, such as: ▪ rights of any mortgagee ▪ a non-owning spouse's interests notifiable under the Family Law Act 1996 ▪ negative easements and restrictive covenants

The following sections set out the classes of title, in descending order of what might be seen as security or robustness.

Absolute

Where clear title is established. Absolute title is the most secure title there is and the most desirable. It may be either freehold with good title, or leasehold where the lease is for at least 21 years and both the freeholder and the leaseholder can demonstrate good title.

Good leasehold

- Can apply only in connection with leases of more than seven years. It means that the leasehold itself is good, but that the freehold title is in doubt or the freeholder has not produced evidence of ownership to the Land Registry.

  Absolute leasehold title cannot be given in this case because the Land Registry will not know if the landlord had the full and unrestricted power to grant the lease or if any restrictive covenants or other incumbrances affect the property.

Possessory

- Granted in situations where the applicant is unable to produce the title deeds or other proof of title when the property is first registered, and can apply equally to freehold and leasehold property.

- This could be because the deeds have been lost or destroyed – eg many title deeds were destroyed during World War II. If the owner does not have the deeds, they must apply for registration based on copy documents and statutory declarations explaining the basis of the application and the reason for any missing documents. If the Land Registry is satisfied with the validity of the claim, the applicant will be given possessory title.

- Possessory title means the owner is registered as the owner, but it does not provide protection from a claim from another person asserting that they owned the land before it was registered. As a result of the uncertainty over the future, lenders will be very careful when considering a mortgage on a property with possessory title, and the value of the property may be diminished. Most lenders will lend on such properties but insist on indemnity insurance to protect their interests. Indemnity insurance will cover against the costs of defending such a claim and any loss of value resulting in a successful counterclaim.

'Squatters' rights'

- Not a form of title, but can lead to the occupier gaining title to the land. It is more accurately referred to as 'adverse possession', and allows people who have intentionally occupied land (or part of it) as their own for a certain time to claim title.

  — Unregistered land: those who have been in intentional occupation of the land for 12 years with no objection from the legal owner may apply for possessory title. Once possessory title has been held for 12 years without counter claims, the Land Registry will usually allow the title to be upgraded to absolute title.

  — Registered land: if registered land has been intentionally occupied for 10 years without objection from the registered owner, the occupier can claim title to the land. When the application is made, the Land Registry will serve notice on the existing registered owner, and if no objection is received and they are otherwise satisfied that the application is in order, the applicant will be registered as the owner of the property with absolute title. If the registered owner opposes the application it will be refused unless the applicant can show that it would be unreasonable to deprive them of the property, or the applicant had a valid claim on the property (eg they had paid for the property but it was not registered in their name), or the applicant had occupied the property reasonably believing it to be theirs.

Qualified title

Very rare and occurs where there is some defect in the title as registered, and so absolute or good leasehold title cannot be guaranteed. The title is given, subject to any defect.

When land is registered it makes life easier for the conveyancer because a search of the Land Registry confirms beyond doubt the quality of title and any conditions attached to it.

Registration

Transfers of registered land should be registered within 30 days of completion. The 30 days is referred to as the priority period during which the new owner has priority over other claims and charges. Failure to register within 30 days could mean other interests may be registered and take higher priority.

CONVEYANCER

Person whose job is to manage the process of transferring legal ownership of property.

5.2.2 Unregistered land

Unregistered land is land that has not been legally transferred since the introduction of compulsory registration.

An application for registration must take place within two months of the transfer; failing to do so invalidates the legal transfer, which becomes void. In effect, the title reverts to the previous owner, who will hold it on trust for the new owner.

It is more difficult for a conveyancer to establish good title when unregistered land is sold. It is necessary to search back over at least a 15-year history of the property in order to discover anything that might affect the rights of the owner – this is known as the root of title.

Rights over unregistered land can be registered through the Land Charges Registry. There are six classes of land charge that can be registered but it is not necessary for the purposes of this text to detail all of these – they are conveyancing matters dealt with by the solicitors acting in a sale and purchase.

IN BRIEF

COMMON TYPES OF LAND CHARGE

The most common types of land charge registered are:

- Class C (I) land charges – legal mortgages not protected by deposit of title deeds (puisne mortgages), including second and subsequent charges. First charges are not recorded on the land charges register because the lender holds the title deeds as security.
- Class F land charges – notifications of spouses' interests from provisions of the Family Law Act 1996.

5.3 What rights and obligations are attached to land?

Certain rights and obligations may affect the title to a particular property – these are known as easements, positive covenants and restrictive covenants. Easements and restrictive covenants are said to 'run with the land'.

'RUNNING WITH THE LAND'

Rights and obligations relating to a property that are passed on to all subsequent purchasers, who remain subject to their conditions.

5.3.1 What are easements?

An easement is a right that one property has over the land of another. Examples include rights of way, rights to light or prospect (the view), rights to ventilation, or even rights to hang a sign on another person's house. The key points relating to easements are as follows.

- An easement must involve two properties.
- An easement attaches to, and is for the benefit of, the land, not the owner, and the two plots must be close to each other.
- The land that enjoys the right over another site is called the dominant tenement.
- The land over which the right is held is called the servient tenement. The dominant and servient tenements must be owned by different people.
- With one or two exceptions, the easement cannot impose a positive burden on the servient tenement – in other words, insist that the owner does

something. One major exception is that the easement can demand that the servient tenement fences the land.

- Easements can be positive or negative, depending on their nature.

In the *Phipps v Pears* case [1964], Lord Denning MR stated that: 'There are two kinds of easement known to the law: positive easements, such as a right of way, which gives the owner of land a right himself to do something on or to his neighbour's land, and negative easements, such as a right of light, which gives him a right to stop his neighbour doing something on his (the neighbour's) own land' (Swarb.co.uk, 2017).

Rights of way

You might need a right of way across someone else's land in order to gain access to your own property. In this case, the right of way is essential to the maintenance of the value of your property.

On the other hand, many prospective buyers would regard the existence of a right of way over their land as an invasion of privacy. This could make the land less desirable and reduce its value.

Rights of way can be removed by the courts but this is rare because they are normally created for good reason. Several walking and conservation groups have won cases confirming the rights of the general public to use rights of way that landowners have sought to deny.

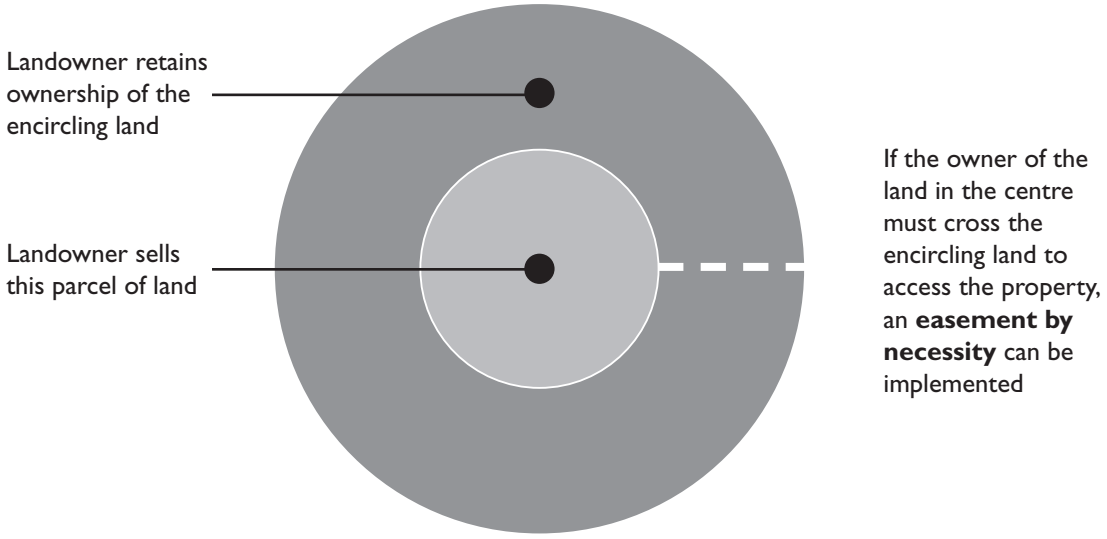
Right of light

A right of light is less commonly encountered, but can be established when one person wants to build a property adjacent to that of another. The occupant of the existing property can take action to secure their right of light, effectively forcing the developer to build a certain minimum distance away from the existing property – even if the land between is owned by the developer or by the developer's customer. It is a good example of a negative easement.

Easement by necessity

Another type of easement is that implied by necessity: in other words, it is assumed to be in place because it is necessary for the landowner in order to do something essential. A good example is 'encirclement' (Figure 5.1).

FIGURE 5.1 WHAT IS 'ENCIRCLEMENT'?



HOW CAN AN EASEMENT BE EXTINGUISHED (REMOVED)?

Easements are subject to a complex set of laws, and there are many potential ways in which an easement can be extinguished, either through agreement or by compulsion. It is beyond the scope of this text to consider all the potential legal implications, but we can consider the main ways in which an easement can be extinguished:

- The same person takes ownership of both the dominant and servient pieces of land.
- The easement reaches a formal expiration date.
- The owner of the dominant piece of land expressly terminates the easement by deed, usually as a result of negotiation with the other parties.

There is an implied release – for example, if the owner of the dominant land has not used the easement for more than 20 years.

5.3.2 What are covenants?

Covenants are essentially restrictions or conditions placed by a landowner on those who subsequently buy or lease the land. The person who established the covenant (or their heirs) is referred to as the 'beneficiary', because the covenant is intended to benefit them in some way. Unlike easements, covenants apply to a single property.

Positive and restrictive covenants

A positive covenant states what a subsequent owner-occupier *must* do. The most common positive covenant is an obligation to maintain boundaries. In a terrace of houses, for instance, a middle house will have boundaries with at least two neighbouring properties. There will in most cases be a covenant, specifying which boundary (eg in the form of a fence, wall or hedge) is the owner of the middle house's responsibility. This will be shown clearly in the title deeds.

A restrictive covenant states what a subsequent owner-occupier *must not* do. Some land has straightforward restrictions, such as prohibiting development on it, only permitting certain types of building, and so on. Other restrictive covenants are in place to protect the developer's position in a situation where the local authority could take action against the developer if a new owner contravened local planning rules. Even if no local authority restrictions apply, allowing certain activities (keeping caravans at the property, changing the nature of the building, etc) could create a poor impression of the development and have an adverse impact on the developer's reputation. Restrictive covenants 'run with the land', which means that they relate to the property rather than the owner and are passed on to the next owner when the property changes hands.

Positive covenants do not run with the land, and so do not automatically bind a new owner. However, the person who was first subject to the covenant may still be bound by it, and so will make a subsequent sale subject to the covenant, and insert a clause in the deed that makes any future sale conditional on the covenant being included. This position is usually protected by an entry at the Land Registry which prevents a future sale without the inclusion of the covenant.

Recent court cases have established the principle that if a positive covenant provides a benefit to someone it is reasonable that they should be subject to a 'burden' as a result. This is clearest in regard to a positive covenant that allows the use of a road to access the property in return for contributions to its upkeep. Judgements have confirmed that, in this case, the new owner cannot have the benefit of access without accepting the burden of making the contribution as required. So, the new owner could refuse the insertion of the covenant, but would then be unable to use the road.

KEY TERMS

EASEMENT

A right that one property has over another, eg rights of way, right of light.

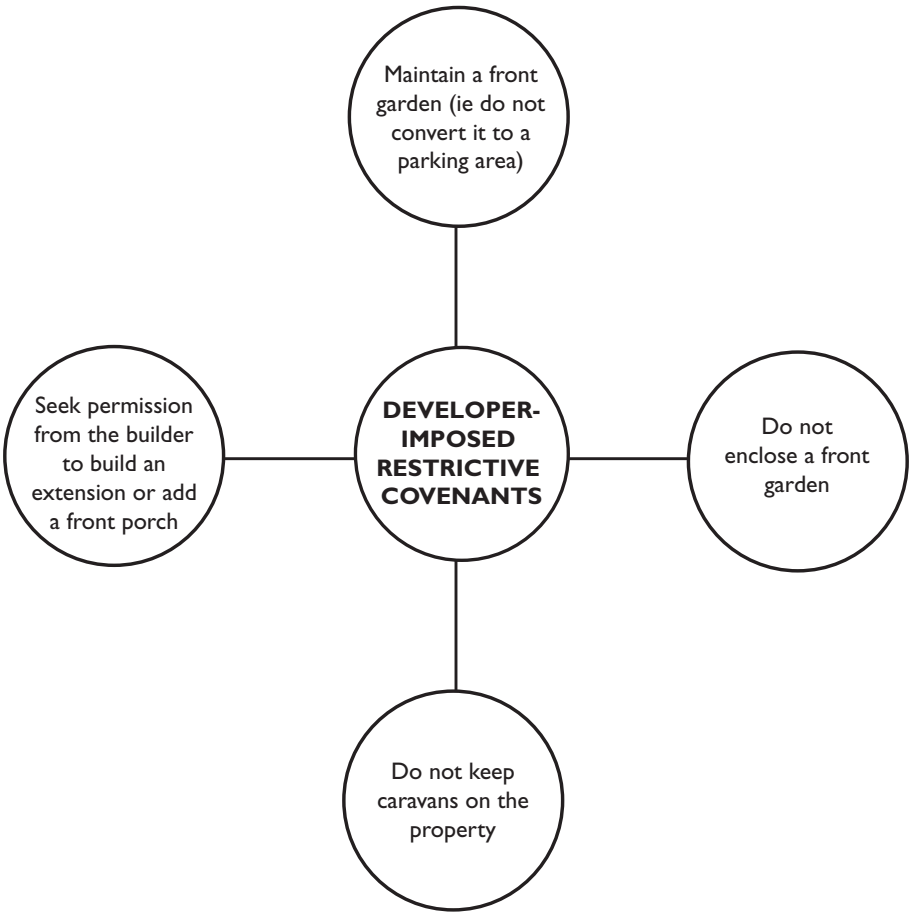
POSITIVE COVENANT

A condition of title imposed by an earlier owner stating what subsequent owner-occupiers must do.

RESTRICTIVE COVENANT

A condition of title imposed by an earlier owner specifying what an owner-occupier must not do.

FIGURE 5.2 WHAT SORTS OF RESTRICTIVE COVENANT PROTECT DEVELOPERS?



5.3.3 What is chancel repair liability?

Chancel repair liability is an obscure but important piece of land law that applies to certain types of property, although the majority of owners are not aware of it until a problem arises. It originates from the Middle Ages when rectors received tithes (levies) from the parish instead of a stipend (salary). Part of the rector's responsibility was to arrange and pay for repairs to the church's chancel (the area around the altar) from tithes received, while the parishioners were responsible for repairs to the rest of the church.

As land was sold by the Church, responsibility for chancel repairs was passed on with the land; the new owners were known as 'lay rectors', even though they had no religious role.

COURT DISASTER!

In 2003, Mr and Mrs Wallbank were asked to pay almost £100,000 to repair the parish church in Aston Cantlow as a result of their ownership of a property with chancel repair liability. The case went to court, but the couple lost their case and faced legal and repair costs totalling some £350,000.

Parochial church councils (PCCs) have the right to take court action if a lay rector fails in their duty to repair the chancel of the associated church, as in the case of Mr and Mrs Wallbank. The PCC can choose which, if any, affected landowners to pursue for the cost of repairs, and although the owner can take action to seek a contribution from others with a similar liability, this may not be easy.

It can be difficult to determine whether a property has chancel repair liability because it may not be noted on property deeds or be the subject of a standard search. Changes to the process from 13 October 2013 provided some clarity to the situation, although the liability has not been abolished (as many people thought).

- PCCs must register a notice of chancel repair liability on the Charges Register at the Land Registry in order for a registered property to be subject to a potential liability.
- If the property is unregistered, the PCC must enter a 'caution against first registration'. This means that the PCC will be informed when the property is sold and has to be registered, and will have the right for its interest to be noted on the Land Registry entry.
- Once a liability is registered, the existing owner and any subsequent purchasers will be subject to the liability.

- Registration or a caution will be shown during conveyancing searches, making the potential position much clearer.
- The PCC loses its right to register a notice if:
  - a registered property is sold without a notice having been registered by the PCC before the sale;
  - an unregistered property without a caution entered is registered for the first time.
- The PCC can register a notice or a caution until just before completion of a sale, which could cause problems very late in the transaction.
- If the property has not changed hands since 13 October 2013, the PCC can register a notice at any time, and the owner at the time of registration (and any future owner) would then have a potential liability.

Chancel repair liability insurance

The owner of a property may not know whether the PCC has the right to register a notice on the property. To address the risk of a potential liability, two types of insurance are available:

- to cover the cost of any repairs should it transpire that there is a liability that was not known at the time of purchase;
- to cover repairs where a notice has already been registered or a caution entered. This is obviously more expensive.

5.4 What is a title guarantee?

A contract for the sale of a property states whether the vendor is selling:

- with full title guarantee;
- with limited title guarantee;
- with no guarantee.

IN BRIEF

TITLE GUARANTEES

Title guarantees provide certain levels of comfort as to the robustness of the title being conveyed. For example, full title guarantee establishes that the property is free from charges and encumbrances (restrictions or limitations).

Limited title guarantee also gives some guarantees, but not the categorical guarantee available with a full title guarantee.

Under the Law of Property (Miscellaneous Provisions) Act 1994, certain covenants are implied, depending on the nature of the title being given. It is up to the vendor to decide what type of title guarantee they are giving, but a purchaser and a mortgage lender will be concerned about the type being offered. Many mortgage lenders insist on full title guarantee before they will proceed.

TABLE 5.2 WHAT IS THE VENDOR DEEMED TO COVENANT BY TITLE GUARANTEE?

Irrespective of whether a property is transferred with full or limited title guarantee	▪ That the vendor has the right to sell the property. ▪ That they will do all that can be done to give the purchaser the title they require, including assistance with any details required by the Land Registry.
If the vendor sells with full title guarantee	▪ They sell free from any charges and encumbrances, and free from any rights exercisable by third parties, other than those of which they could not reasonably be expected to know.
If the vendor sells with limited title guarantee	▪ Since they acquired the property, they have not created any charges or encumbrances that still subsist over it. ▪ As far as they know, no one else has done so either.

SCOTLAND

The process for registering land in Scotland is different. Students sitting the examination in Scotland will need to study the Scottish Appendix in addition to this topic.

5.5 Matrimonial interests

NOTE ON USAGE

For ease of reading, the term 'spouse' will be used throughout; in this context spouse means husband, wife or civil partner as defined under the Civil Partnership Act 2004.

Matrimonial interests are particularly important in regard to land registration. There are many properties where only one partner in the marriage is the registered owner. For older owners, this dates back to times when it was traditional for only the husband to be named as owner. There are also properties owned by an individual who met their spouse only after acquiring the property. The legislation recognises the rights of a non-owning spouse to register an interest in the property through a formal entry on the charges register at the Land Registry for registered land, or the land charges register for unregistered land. Effectively, this prevents the property from being sold or transferred until the spouse's notice is removed at the appropriate registry.

LEGISLATION

The law applicable to matrimonial interests in the UK is set out in the Family Law Act 1996 (England and Wales), updated to include the Civil Partnership Act 2004.

The legislation ensures that a non-owning spouse can continue in occupation of a property and provides a right of entry and occupation for those not already in occupation. The lender therefore has to satisfy itself at application stage as to who exactly will occupy the property, whether signatories to the mortgage deed or not.

Any non-owning spouse who will not become party to the mortgage can be asked to sign a 'consent to mortgage' form, waiving rights of residence (in

England and Wales) or renouncing occupancy rights (in Scotland). In the latter case, the non-entitled spouse swears before a notary public that the renunciation is made freely and without coercion.

A lender needs to exercise great care because it may later be bound by the occupational rights (ie the overriding interest) of a person who was not revealed at the time of application and who did not sign a consent to mortgage form. The vendor of the property may not be the only person who is in occupation, and rights of occupation are not limited to the vendor's spouse. The Family Law Act 1996 extended rights of occupation to include, for example, adult children. Cohabitants can apply for protection through the courts.

SCOTLAND

The law in Scotland is different. Students sitting the examination in Scotland will need to study the Scottish Appendix as well as this topic.

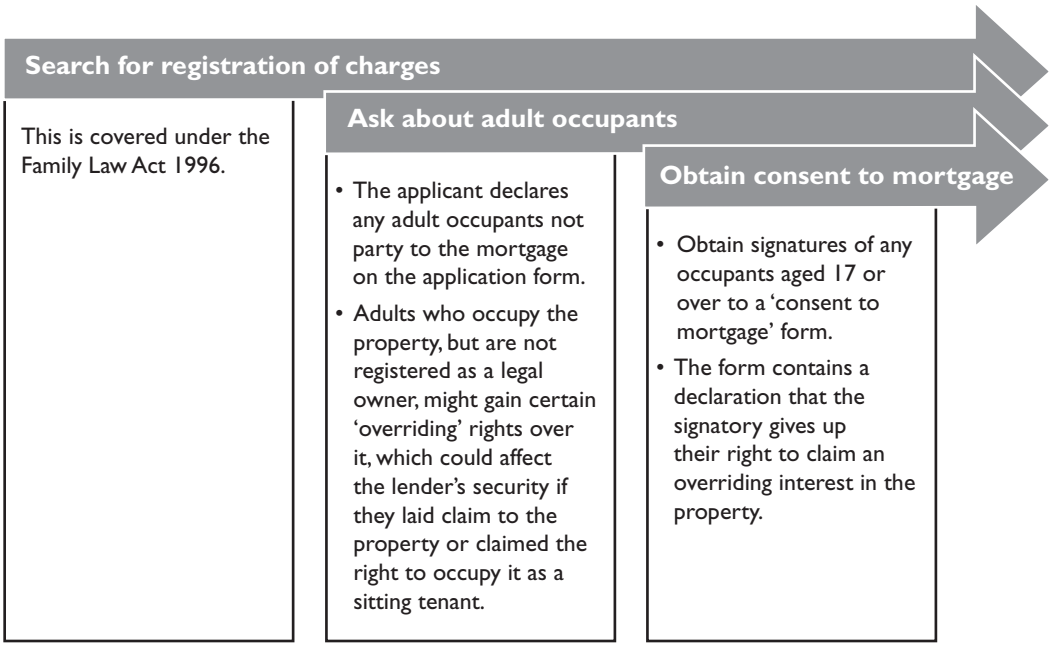
5.6 How should the lender respond to results of a title search?

We have seen that when land is sold, the type of title guarantee provided will determine the robustness of title offered. We also know that a solicitor's search of the relevant registers may identify a variety of third-party rights over land or certain obligations enforceable against the owner of that land. It is worth considering briefly the potential effect of this on the lending decision.

FIGURE 5.3 WHAT EFFECTS MIGHT A TITLE SEARCH HAVE ON THE LENDING DECISION?

Title guarantee	Some lenders will insist on full title guarantee and not lend against a property where the title conveyed is anything less.
Easements	• If the valuer of a property is aware of any easements, their effects will be reflected in the valuation figure. If, however, they only come to light later (eg during the legal work) then not only may this figure need to be reviewed for the purposes of any sale, but the lender may also decline to lend as much as they otherwise would – or to lend at all. • Easements are not always negative, however, and so may not be detrimental to the value of the land.
Restrictive covenants	These may have a significant effect on the value and saleability of the land, particularly if they severely restrict its use. Conversely, archaic and irrelevant restrictions are unlikely to affect the resale value of land that is now in use for very different purposes.
Matrimonial interests	These interests and the potential interests of others who may be occupying the property will require the lender's attention.

FIGURE 5.4 WHAT MUST A LENDER DO WHEN CONSIDERING MATRIMONIAL AND OTHER INTERESTS?



WHAT ARE THE LENDER'S OPTIONS AFTER A TITLE SEARCH?

There are a number of steps that a lender can take in each of the above circumstances.

- Taking the appropriate initial steps, including ensuring a search of relevant registers, requiring consent to mortgage forms, etc.
- Declining to lend at all.
- Insisting on a revaluation of the property, taking account of the issues affecting title.
- Taking out indemnity insurance against the possibility of defective title having an adverse impact on the lender's security. This will protect the insured (the lender and owner) from claims made by others who lay claim to the property. The fee for such a policy is likely to be around 0.10 per cent of the property value, subject to a specified minimum premium.

5.7 What rights and obligations are set out by a mortgage deed?

The mortgage deed sets out the terms and conditions of the mortgage. As part of the conditions, the deed stipulates the rights of the lender and the borrower's covenants – a number of things they promise to do, which the lender can enforce if they fail to do so.

FIGURE 5.5 LENDER'S RIGHTS UNDER THE MORTGAGE DEED

Levy charges

Charge capital, interest and any other fees

Call in the debt

Call in the whole debt in the event of the borrower's default or bankruptcy, or if a compulsory purchase order is made on the property

Insure the property

Insure the property, if the borrower fails to do so, and charge the premiums to the mortgage account (the lender will do this as a matter of course to make sure the insurance stays in force)

Meet statutory conditions

Meet any conditions imposed by statute, a local authority or title, if the borrower fails to do so

Let the property

Let the property after it has been taken into possession

Transfer the mortgage

Transfer the mortgage to another lender, subject to the borrower's consent

Make further advances

Make further advances without the need for a new mortgage deed

FIGURE 5.6 BORROWER'S COVENANTS UNDER THE MORTGAGE DEED

Make payments

To make payments in accordance with the mortgage deed

Insure the property

To insure the property in accordance with the lender's requirements

Comply with legislation

To comply fully with appropriate legislation, local authority byelaws and other regulations

Seek consent before letting

Not to let the property without the lender's prior consent

Repair and access

To keep the property in good repair and allow access to the lender for the purpose of inspection at any reasonable time

Title conditions

To comply fully with all conditions of title, eg positive covenants, restrictive covenants and easements

Leasehold property

In the case of a leasehold property, to comply fully with the terms of the lease

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the purpose of land registration?
- describe the different classes of title?
- explain what an easement is and how it can be removed?
- explain how a restrictive covenant runs with the land?
- explain why it is important to establish whether a property is subject to chancel repair liability?
- describe the different forms of title guarantee?
- outline the steps a lender should take at application stage to establish who has occupancy rights over a property?
- summarise the respective obligations of the lender and the borrower under the mortgage deed?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

Swarb.co.uk (2017) *Phipps v Pears and others: CA 10 Mar 1964* [online]. Available at: http://swarb.co.uk/phipps-v-pears-and-others-ca-10-mar-1964/ [Accessed: 5 November 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 5. Review the text if necessary.

Answers can be found at the end of this book.

1) Kevin and Janice married five years ago and lived in the house Kevin bought before their marriage; he is registered as the sole owner. The couple divorced last year, but under the Family Law Act 1996, there is a charge over the property to protect Janice's interests in the property. This charge would be shown in the:

   a) proprietorship register.

   b) property register.

   c) charges register.

   d) ownership register.

2) Karen has put her house on the market. She is registered as the owner at the Land Registry but at the time of registration she was unable to provide the title deeds or other proof of title. What form of title does Karen have?

   a) Qualified.

   b) Possessory.

   c) Absolute.

   d) Limited.

3) How long after taking possession of the land can a 'squatter' apply for ownership of registered land?

   a) 10 years.

   b) 12 years.

   c) 15 years.

   d) It is not possible in relation to registered land.

4) Rights over unregistered land are registered in the charges register. True or false?

5) What are the implications for the buyer of failing to register previously unregistered land within two months of purchase?

6) Javier's self-build property is encircled by land owned by the person who sold him the plot. An easement by necessity will give him a right of way to gain access to his house. True or false?

7) Don's deeds contain a clause forbidding him from having trees in excess of 2m in height on his boundary. This is an example of a:

   a) positive covenant.

   b) negative easement.

   c) easement by necessity.

   d) restrictive covenant.

8) Vendors are deemed to covenant that they have the right to sell the property. True or false?

9) If the owner of a property has chancel repair liability, they will be required to pay for all repairs to the local church where necessary. True or false?

10) In the event that the borrower fails to insure the property, what rights, if any, does the lender have under the mortgage deed?

   a) To call in the debt.

   b) To insure the property and debit the borrower's current account.

   c) To insure the property and charge the premiums to the mortgage account.

   d) The lender has no rights in relation to insuring the property.

Buying a property: an overview

LEARNING OBJECTIVES

This topic provides an overview of the property-buying process, mainly from the perspective of the buyer. It aims to help you to understand the stages involved, from finding the property to completion, with the focus on the stages up to receipt of a mortgage offer. In Topic 7 we will look more closely at the role of the solicitor and the conveyancing process and in Topic 8 at the regulatory requirements that govern the involvement of the lender.

By the end of this topic you should have an understanding of:

- contract law;
- the principles of agency;
- finding a property;
- the role of the estate agent;
- making an offer to buy;
- the mortgage offer;
- exchange and completion;
- buying at auction.

THINK . . .

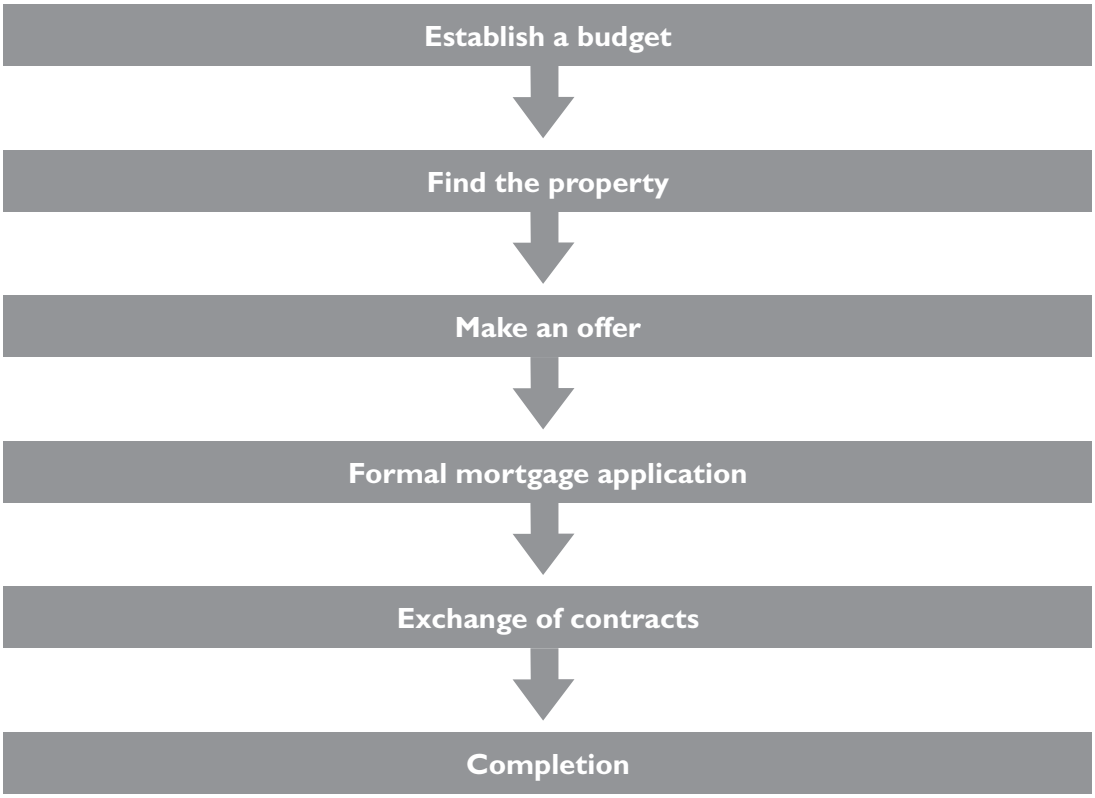
Before you start work on this topic, take a moment to think about what you already know about the property-buying process. You covered the basics of contract and agency law in UK Financial Regulation, so you should be familiar with the content revisited in this topic. If you have been involved in buying or selling a property, you might also know:

- at what stage in the process the mortgage should be arranged;
- the latest point at which either a buyer or a vendor can withdraw from the transaction without penalty.

6.1 Introduction

Figure 6.1 provides an overview of the property-buying process. Not all property purchases follow this neat process, but this topic outlines the typical stages.

FIGURE 6.1 WHAT IS A TYPICAL PROPERTY-BUYING PROCESS?



We will look at each stage in more detail. The sale of properties may be arranged by private treaty (private bargain in Scotland) or auction. The majority of sales are on a private treaty basis, although auction is suitable for certain types of property and more popular in some regions than others. We begin by looking at private treaty sales and then move on to buying at auction in section 6.9.

SCOTLAND

The process of buying property in Scotland differs from that in the rest of the UK. Students taking the examination in Scotland need to study the Scottish Appendix as well as this topic.

6.2 Law of contract and principles of agency

The laws applying to contracts and those acting as agents are important in the house-buying process, so we begin by exploring key principles and how they relate to property purchase. Buying a property involves a legally binding contract, as does taking out a life insurance policy to support a mortgage. Residential properties are usually bought and sold through an estate agent, and, on occasion, an agent may represent the buyer in the buying process.

CHECK YOUR UNDERSTANDING 1

You learned about contract law and the principles of agency in your studies for UK Financial Regulation. Before continuing with this topic, see if you can list the key requirements for a binding contract, and note down what the terms 'agent' and 'principal' mean.

6.2.1 Law of contract

FIGURE 6.2 WHAT ARE THE BASIC PRINCIPLES OF A CONTRACT?

Agreement
- An agreement between two or more people to enter into a legal arrangement

Offer and acceptance
- One party will make an offer and the other will accept
- Both offer and acceptance put legal obligations on both parties

Consideration
- A consideration must be given – in property terms the buyer usually gives a consideration (money) and the vendor gives a consideration (property)

Capacity
- All parties must have the capacity to enter a contract, being:
  - aged 18 or over (16 in Scotland)
  - legally able to sell or buy the property – acting either as principal or agent (with authority)
  - of sound mind

Intention
- It must be clear that both parties intended to enter into a legally binding contract

Bound by terms
- Once a contract has been agreed and put in place, both parties are bound by its terms
- If either party fails to comply with the contract terms they could be sued for breach of contract by the other party and ordered to comply, or to pay damages and / or compensation to the 'injured' party

Generally, there is no duty of disclosure between parties to a contract; most contracts are based on the principle of *caveat emptor* ('let the buyer beware').

This means that neither party is required to disclose information to the other unless asked to do so, in which case they must answer any questions honestly and to the best of their knowledge but do not have to volunteer information not requested. With property, this is particularly relevant to the vendor, as the buyer's solicitor will ask a number of questions about the property, the surroundings and any disputes. If the vendor does not answer honestly, they could face legal action.

IN BRIEF

UTMOST GOOD FAITH

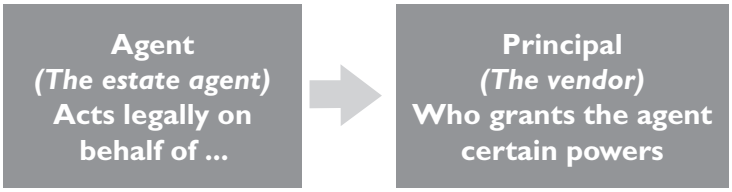
In contrast to *caveat emptor*, the principle of 'utmost good faith' (*uberrima fides*) requires disclosure of all material facts by both parties. In relation to property purchase this means that both parties must answer any questions that are asked of them accurately and honestly.

CHECK YOUR UNDERSTANDING 2

You covered the principle of utmost good faith and its application to insurance policies during your studies for UK Financial Regulation. Prior to April 2013, why did the Financial Ombudsman Service find in favour of many policyholders who felt an insurer had unreasonably rejected their claim on the grounds of a breach of utmost good faith?

6.2.2 Principles of agency

FIGURE 6.3 WHO ARE THE AGENT AND THE PRINCIPAL?



An agent should only act within the powers given to them by the principal, so it is crucial to set out the conditions of the agency in a written contract before the agent starts to act on the principal's behalf: this is commonly known as the *actual authority*. It includes what is expected from each party and the limits to the agent's remit.

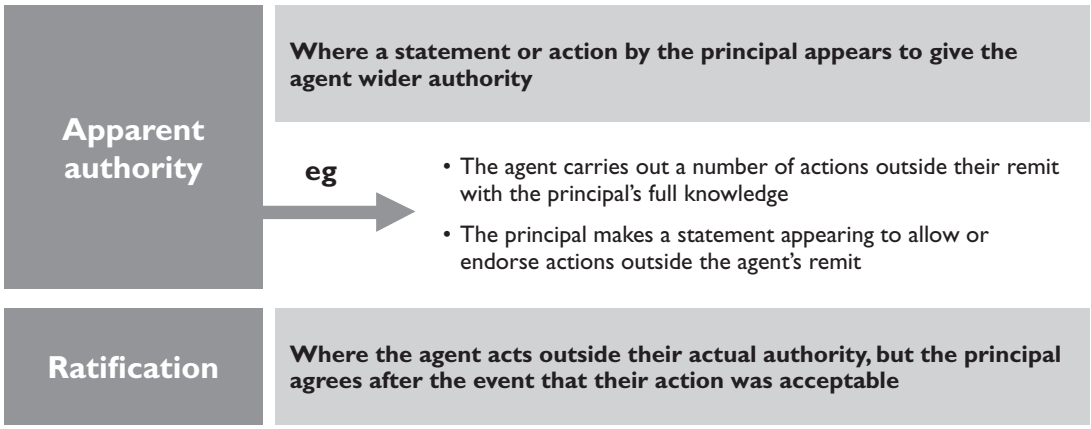
THE GENERAL PRINCIPLE OF AGENCY

The principal is liable for the agent's actions unless the agent acted outside their authority. In the latter case, the principal may be able to seek redress from the agent.

The terms of an estate agent's agency will usually state that they forward offers on the property to the vendor, who makes the decision whether to accept. This is in contrast to many other types of agency, where the agent is given authority to act on the principal's behalf.

There are two situations in which the agent may act outside their actual authority without necessarily making themselves liable for redress. These are outlined in Figure 6.4.

FIGURE 6.4 WHEN CAN AN AGENT ACT OUTSIDE THEIR ACTUAL AUTHORITY?



6.3 Establishing a budget

Having set out the principles of contract and agency, we can look in more detail at the steps in the property-buying process.

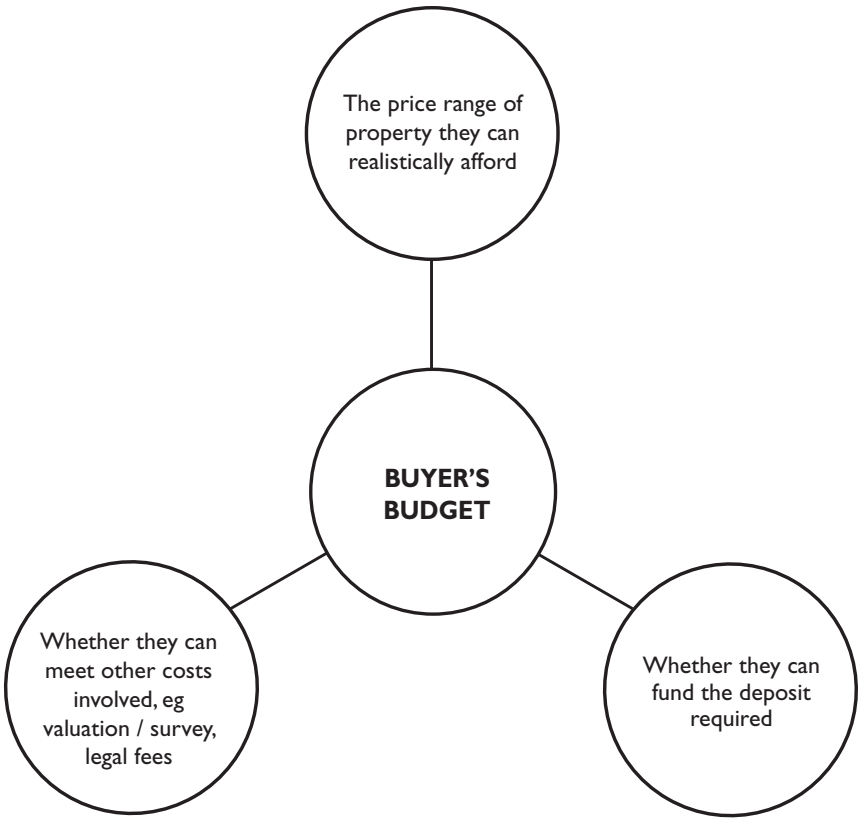
A sensible starting point for potential buyers is to consult mortgage intermediaries or lenders in their area to find out how much they can borrow.

If they are selling a property as well as looking to buy, they need to understand how much they are likely to realise from the sale, as this will affect the size of the loan they need. Being clear about what they can afford will prevent a situation whereby the buyer makes an offer on their ideal property, only to find that they cannot secure a large enough mortgage and the deal falls through, wasting everyone's time.

Most lenders will provide an indication of the maximum they would be prepared to lend based on the borrower's circumstances, although this will not be binding on the lender as they will have many other checks to do before they can confirm a mortgage offer. The intermediary or lender will also be able to advise on the types of mortgage available, the deposit required, and costs associated with particular mortgage products. The borrower also needs to take into account the costs associated with buying a property, such as stamp duty land tax, solicitors' fees, searches and so on.

Figure 6.5 summarises the key factors determined by the buyer's budget. Based on this information, the prospective buyer will now be in a position to start looking for property.

FIGURE 6.5 WHAT DOES A BUYER'S BUDGET DETERMINE?



CHECK YOUR UNDERSTANDING 3

We will look at stamp duty land tax (SDLT) in more detail in Topic 15, but from your studies for UK Financial Regulation can you recall:

a) who pays SDLT?

b) how it is levied?

c) what happens if a single transaction involves multiple properties?

6.4 Finding the property

Buyers have a wide choice of media to use when searching for property, including estate agents, auctioneers, property pages of newspapers, word-of-mouth and (in Scotland) solicitors. The internet is an essential tool in finding properties for sale, with most estate agents using property search websites such as Rightmove, Zoopla, OnTheMarket and PrimeLocation to show the properties they have available. This means that prospective buyers can go to one website and access properties from a number of agents.

Once the prospective buyer has found a number of potential properties, they can view them, decide which one meets the requirements and make an offer.

6.4.1 What is the estate agent's role?

The majority of vendors appoint an estate agent to act for them in the sale. The estate agent is an agent of the vendor not the buyer, although they may choose to advise both parties on areas where a conflict does not exist.

It is the estate agent's job to market the property and secure a sale at the best price possible. Traditionally, estate agents have had a physical presence in the high street. However, a number of internet estate agencies, such as Tepilo and Purple Bricks have emerged, with valuations carried out by a local valuer and advertising, communication, and arranging viewings all carried out online. Offering services in this way significantly reduces the cost to the vendor, although some people prefer to deal with a local agent with a visible presence. The online agencies now have a significant presence in the market.

When someone decides to sell their property, the process begins with a market valuation by the estate agent, who will estimate a realistic sale price and advise on any action the vendor could take to increase the potential price or improve the prospect of a sale. At this stage the agent and vendor will agree the price at which the property will be marketed (the asking price). The agent will prepare marketing material for distribution to potential buyers and posting on websites, including a description of the property, photographs and other relevant information. Estate agents must take great care not to mislead potential buyers.

CHECK YOUR UNDERSTANDING 4

From your studies in Topic 3, can you remember which regulations make selling agents liable for extravagant or fanciful sale particulars that are subsequently found to be misleading?

The estate agent usually markets the property through local (and sometimes national) press advertising, and on the internet through their own website or property search websites. Potential buyers contact the agent to establish further details and arrange a viewing, where they can look around the property to see if it meets their requirements, sometimes accompanied by a representative of the estate agent.

Generally, estate agents will guide the vendor on progress and interest shown in the property. If demand is greater than expected, the vendor will be more likely to obtain the asking price or even a higher price in some circumstances. If demand is 'flat', the estate agent might recommend a lower advertised price or even a sale by auction.

Once a provisional offer is made, the estate agent liaises with the vendor's solicitor to progress the formal sale.

The estate agent is usually paid on a commission basis, expressed as a percentage of the sale price (typically 1–3.5 per cent), with internet agents offering significantly lower fees. It is becoming more common for estate agents, particularly those who are internet based, to charge a fixed selling fee and separate fees for additional services.

Table 6.1 sets out a number of ways in which an estate agent can operate.

TABLE 6.1 HOW CAN AN ESTATE AGENT OPERATE?

Type of arrangement	What is it?	Notes
Sole selling rights	The agent has exclusive rights to sell the property and will receive the fee even if the vendor or a third party finds a buyer	Not a common arrangement
Sole agency	The agent has exclusive rights to sell the property, although they will not be entitled to a fee if the vendor finds a buyer	Most agents charge less if they are given sole agency
Joint sole agency	Two agents agree to market the property exclusively and split the commission when a sale is made	The commission is likely to be higher

Multiple agency	A number of agents market the property	The agent who sells the property will receive the fee In the past, fees for such arrangements tended to be higher than normal to reflect the agent's gamble; in today's competitive market, multiple agency fees tend to be similar to standard fees

Estate agents may offer a range of additional services including:

- auctioneering;
- property listings;
- property management and letting agency services;
- removals;
- arranging mortgages and the associated financial advice (some estate agents now have in-house independent financial advisers);
- insurance services;
- relocation services;
- survey and valuation services.

ENERGY PERFORMANCE CERTIFICATE

An energy performance certificate (EPC), detailing a building's energy efficiency, is required for a new build or when a property is marketed for sale or rent, and is valid for ten years. The estate agent cannot market a property unless an EPC has been commissioned, although marketing can start before the certificate is received. Failure to commission an EPC before marketing a property is an offence carrying a fixed penalty.

Buildings need an EPC if they have a roof and walls, and use energy to heat, cool or ventilate the building. If a building consists of separate units, each unit requires its own EPC.

An EPC is not required for certain buildings, such as places of worship, temporary buildings intended to be used for less than two years, and listed buildings that meet specific minimum energy performance standards.

The certificate rates the property from A (efficient) to G (very inefficient), in the same way that domestic electrical appliances are rated. It is now illegal to arrange new rentals or renew an existing rental agreement for a residential property with an EPC rating of F or G, unless a landlord has an exemption.

6.5 Making an offer to buy

In England and Wales, it is common to sell houses by private treaty. The house is marketed at a particular price and prospective buyers make offers through the agent (or directly if no agent is involved). The vendor is free to decide which offer to accept, but no offer is binding until exchange of contracts. It is very common for the asking price to be set at a level higher than the vendor is actually prepared to accept, and equally common for the initial offer to be below the asking price. In a rising market the property may sell for a price above the asking price, while in a falling or static market, the agreed price is likely to be below the asking price. In many cases several buyers may be involved in a bidding war for the same property.

An offer is usually made subject to contract, which means that neither vendor nor prospective buyer is legally committed until contracts have been exchanged. Either party may withdraw from the sale at any point up to exchange of contracts, with no penalty and no compensation to the other party.

GAZUMPING

Sometimes the vendor, having accepted an offer, accepts a better offer from another buyer later on. This is known as gazumping.

Although gazumping could be seen as unethical, it is legal because neither the vendor nor the buyer is bound by an offer until exchange of contracts.

Property law in Scotland means that gazumping cannot occur in Scotland unless the sale is based on a conditional offer.

6.6 Formal mortgage application

Once the buyer's offer has been accepted they need to make a formal application for a mortgage. While they might have had a decision in principle for a mortgage, it is likely to be based on a relatively superficial view of their finances and unlikely to be based on information about a specific property. We will look at the assessment of the borrower and the property as security for a mortgage in Unit 4.

If the lender is satisfied that the borrower's ability to repay and the security offered by the property are in order, the lender will issue an offer of advance.

6.7 Offer of advance

An offer of advance (or offer letter) is not the final legal contract – that comes later. The offer letter is an invitation to the applicant to enter into an agreement, rather than the agreement itself. The offer letter will, however, contain many of the details that will also eventually be reflected in the mortgage contract.

OFFER OF ADVANCE

The formal statement of the terms and conditions on which the lender is prepared to enter into a mortgage contract.

The lender's offer is binding on the lender, and can only be withdrawn in certain circumstances, which include:

- where the buyer knowingly provided false, inaccurate or incomplete information;
- material changes to the buyer's circumstances after the binding offer was made that would affect their ability to pay the mortgage;

- a material change affecting the condition or value of the property after the offer was made, or issues affecting the title to the property, such as defective title. Investigation of title is usually carried out after the mortgage offer is made, and so problems would not be identified until the investigation was completed.

The requirement for a binding offer does not prevent the lender from making a provisional offer, sometimes known as an 'offer in principle', subject to further clearly stated checks by the lender. Once these checks have been concluded to the lender's satisfaction and it is happy to lend, it must issue a final, binding offer.

The lender will generally send one copy of the final offer letter to the applicant and another to the applicant's solicitor. Offer letters are highly standardised and typically contain:

- general details confirming the applicant, property and loan (see Table 6.2);
- standard warranties and conditions, applicable to the vast majority of mortgages and not specific to the property or borrower (see Table 6.3);
- any specific conditions that might be applicable (see Table 6.4).

TABLE 6.2 GENERAL DETAILS COVERED IN THE OFFER LETTER

Information	Significance
Personal details:	
Name and address of applicant	Confirms details of the prospective borrower
Customer/account number, if an existing account-holder	
Details of property to be mortgaged:	
Address or plot number	Confirms details of the property to be mortgaged, its value for lending and insurance purposes
Brief description	
Tenure – freehold, leasehold or commonhold	This ensures that the value of the security and its resaleability is not prejudiced
Value for mortgage purposes	
Value for insurance purposes	
It will be a requirement that the property is subject to vacant possession	

Details of the loan being offered:	
Amount	Tells the applicant(s) unambiguously what the lender is prepared to lend and on what terms
Term	
Repayment method	
Interest rate and whether variable, fixed, etc	
Length of fixed/capped/discount rate period	
Monthly repayment and number of instalments	
Special conditions	
APR or APRC	
Higher lending charge	

TABLE 6.3 STANDARD WARRANTIES AND CONDITIONS IN THE OFFER LETTER

Statement	Significance
A disclaimer: the offer does not imply a warranty of the reasonableness of the purchase price or condition of the property	Limits the lender's liability in respect of the value and condition of the property
The fact that the offer is subject to certain conditions, including a satisfactory certificate of title	Confirms that the offer itself is not binding on the lender and that there are conditions to be met
Statement that the lender can withdraw the offer at any time if the conditions are not met, subject to the MCOB rules on binding offers	
Statement that the lender can vary the terms of the offer for legitimate reasons	
The period for which the offer letter remains valid	The offer will not remain open indefinitely and so the offer must be accepted within a certain period

TABLE 6.4 SPECIAL CONDITIONS IN THE OFFER LETTER

Specific conditions	Significance
Conditions relating to an additional security or guarantee, if any	Sets out the requirements for further security or the obligations of any guarantor
Requirements in relation to completion of roads and access	Important to maintain market value of property – relevant for new developments
Work that the applicant must carry out and by when	Relevant where the lender believes remedial work is necessary to protect the condition and value of the property
Right of the lender to inspect the property to check the work has been done	Protects the lender against the borrower's failing to carry out remedial work
Retention conditions, if applicable	Allows the lender to hold back part of the advance until remedial work is done
Requirement for 'consent to mortgage' form to be completed by non-owning occupants aged 17+	Prevents an occupant deriving an overriding interest in the property (preventing the lender from easily obtaining vacant possession of the property)
Requirement for the redemption of any existing mortgages or other borrowings on, or before, completion	Prevents the applicant becoming overstretched

The offer must include an illustration, together with a tariff of charges, and explain that there is a seven-day reflection (or cooling-off) period during which the applicant can change their mind. The applicant can also waive their right to the reflection period. (The reflection period is covered in detail in Topic 8, as are the details of the contents of the illustration.)

If, on receipt of the offer letter, the applicant wishes to proceed, they will sign the documentation to accept it and return it to the lender. At the same time, their solicitor will be liaising with the vendor's solicitor to agree terms for the sale.

Once the final binding offer has been accepted by the applicant, they know that the lender will make funds available to them. The next step is for contract terms to be agreed with the vendor and for the buyer's solicitor to carry out

all the relevant searches. Many buyers will start the process on the basis of an offer in principle from a lender, and may agree contract terms and start the legal process at that point. However, until the lender's formal offer is in hand the borrower is taking a risk that the funds may not be available.

6.8 Exchange of contracts and completion

If the vendor has accepted their offer, the mortgage offer is in place and everything is proceeding according to plan, the buyer can brief their solicitors to commence their work to transfer the property from vendor to buyer, a process known as 'conveyancing'.

IN BRIEF

CONVEYANCING

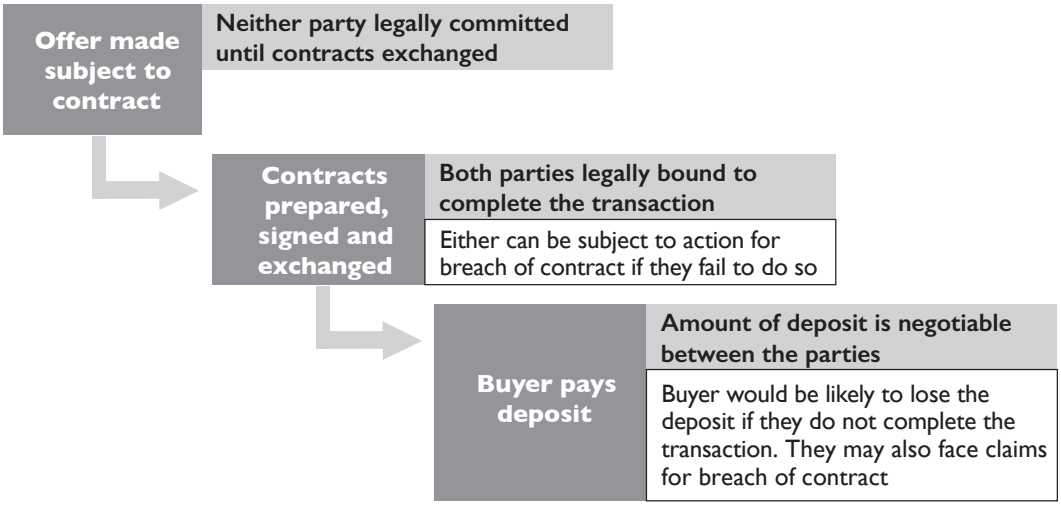
Conveyancing is covered in detail in Topic 7, but in essence it requires the solicitor or conveyancer to carry out a number of searches and enquiries to establish that:

- the property is what it is claimed to be;
- the vendor has the right to sell it; and
- there is nothing that will prevent the buyer from obtaining good title to it.

Most of the work is carried out by the buyer's solicitor and takes place before contracts are exchanged, because it is at that point that the buyer becomes committed to the purchase.

The vendor's solicitor will draw up a standard contract of sale and purchase and send it to the buyer's solicitor. Both parties should sign their copy in readiness. Once the solicitors are happy with the results of searches and other legal work, they will indicate to the buyer and vendor that they are ready to exchange contracts. If both parties are happy to go ahead they will instruct their solicitors to exchange contracts, and the buyer will normally pay a non-refundable deposit to the vendor's solicitor.

FIGURE 6.6 WHAT IS THE TYPICAL PROCESS OF OFFER AND CONTRACT EXCHANGE?



BUILDINGS INSURANCE

Once contracts have been exchanged, the buyer is technically responsible for any damage or loss to the building, even though they don't yet own it. For this reason it is important that they insure the building from the point of exchange of contracts. A sensible vendor will make sure they also maintain their insurance – just in case the buyer fails to arrange cover. We explore buildings insurance in section 18.3.1.

Between exchange of contracts and completion – the actual handover of the property – the lender will prepare the mortgage documentation.

When contracts are exchanged the solicitors will agree a 'completion' date for the sale, which is when the balance of the sale price is paid and keys are given to the buyer. It is typically around 28 days after exchange, to allow for final legal work to be completed. However, it is not uncommon for completion to be sooner, and there have been many cases of exchange of contracts and completion on the same day.

6.8.1 Conditional exchange

Sometimes there may be an issue that needs to be settled or confirmed before the transaction can be completed, but the two parties do not wish to delay exchange of contracts. In this case either party may choose to exchange contracts

conditional on a specified event, which means they can withdraw without penalty if the condition is not met. Figure 6.7 outlines examples of conditional exchange.

FIGURE 6.7 EXAMPLES OF CONDITIONAL EXCHANGE

Conditional on sale or purchase of another property, or completion of another transaction	Conditional subject to satisfactory search results	Conditional on a 'long-stop date'
• The buyer or vendor may rely on the sale of another property to provide the finance to proceed or to buy another property • Completion may be conditional on that sale or purchase taking place, and the contract could allow the party to withdraw without penalty if the transaction did not go ahead • Alternatively it could allow for completion to be delayed until the transaction has taken place	• Most searches are carried out before exchange of contracts, but the buyer may wish to speed up the process by agreeing to exchange subject to search results • This would allow them to withdraw should the searches show any problems	• When buying a new property, it is often difficult to set a definite completion date. The developer's standard contract may leave the buyer with no real idea of when they can move in • To counter this, it is possible to insert a 'long-stop' date into the contract. If the property is not ready by that date, the buyer can void the contract and abort the purchase without penalty

6.8.2 Completion

Completion is the point at which the sale is officially made and ownership transfers to the new owner. In Topic 7 we will look more closely at the process from exchange of contracts to completion with the focus on the work of the solicitor.

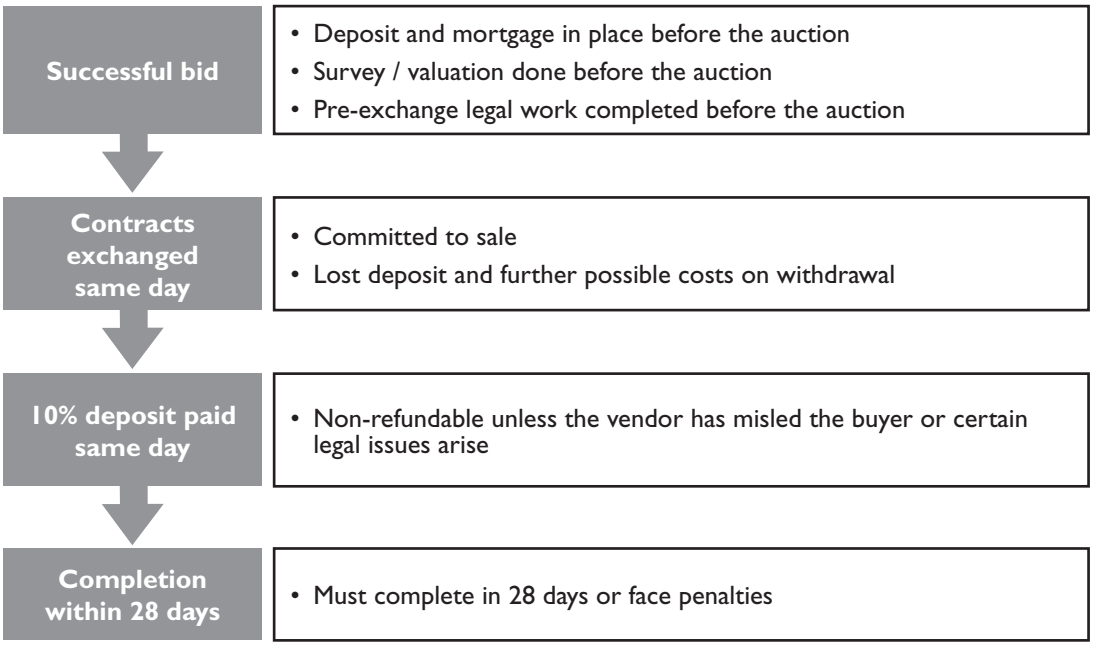
6.9 Buying at auction

We've talked so far about buying through private treaty, but an increasingly popular way to buy property is at auction. Bargains can often be found and the process is very quick.

Property for sale by auction can be found in local and national newspaper advertisements, through estate agents or auctioneers, and on the internet. It varies from repossessed property and redevelopment projects to standard residential property. An indicative (or guide) price will usually be given, although in many cases the final price is far in excess of expectations.

Most property has a reserve price – a minimum price that the vendor is prepared to accept. If the reserve price is not reached during bidding, the property will not be sold, although interested parties may be able to negotiate with the vendor after the auction, particularly where the bid was close to the reserve.

FIGURE 6.8 WHAT IS THE PROCESS FOR BUYING AT AUCTION?



6.9.1 Preparation required for a bid at auction

Once a winning bid is accepted, a 10 per cent deposit is paid and contracts are exchanged on the day of the auction, so the buyer must be in a position to go ahead at the auction.

The buyer will have to make sure financing is in place, which usually means the mortgage is agreed or cash is available. In view of this, before the auction the buyer will need to complete a survey, mortgage application and offer, and preliminary legal work, in order to exchange contracts on the day. It is now common for the vendor's solicitor to prepare a legal pack for potential bidders to inspect before the auction. Typical contents include:

- memorandum of sale;
- special conditions of sale;
- the local search (if and when available);
- Land Registry search;
- proof of title;
- a copy of any lease affecting the property.

However, the buyer may choose to commission their own legal checks rather than rely on the vendor's pack; such checks should be completed before the auction. Defects or issues identified after exchange of contracts will not release the buyer from their obligations unless the defects are the result of

deception or misdescription by the vendor, or there is a legal issue that could not reasonably have been identified prior to exchange.

IN BRIEF

WHAT HAPPENS IF THE BUYER RENEGES ON THE CONTRACT?

The vendor is entitled to keep the deposit and resell the property. If the resale results in a lower price, they can also claim the shortfall from the former buyer.

FIGURE 6.9 ISSUES TO CONSIDER IF PROPOSING TO BUY AT AUCTION

Substantial prior outlay

- Valuation and legal fees need to be paid before the auction, without any guarantee of a successful bid.
- While this eliminates frivolous bidding, it means potential buyers must have a realistic prospect of matching other bids.
- Buyers must also go to the auction with a realistic budget and be prepared to stick to it.

Habitable standard

- The property may need work to bring it to a habitable standard or to suit the buyer's needs.
- The buyer should investigate the extent and cost of such work and ensure that funds are available before the auction.

Deposit

- The 10 per cent deposit must be available on the day of the auction and will not be returned, in most circumstances, if the sale does not proceed.

Retention of funds

- The mortgage lender may place a retention on the funds if the property requires repair, particularly in the case of older property.
- The buyer must ensure that the necessary funds are available to carry out the work.

Speculation

- Even if the finances are in place, there is no guarantee the bid will be successful, and the money already spent may be wasted.

No backing out

- Once the bid has been accepted, there is no backing out, in normal circumstances, without loss of deposit – a big price to pay for making a mistake.

6.9.2 Modern method of auction

The modern method of auction is essentially a conditional auction carried out online. There are many similarities with auction websites such as eBay in that each property has a deadline by which bids must be made and bidders can track activity.

When a successful bid is made, the bidder is required to pay a non-refundable reservation fee on the day of up to 5 per cent of the purchase price to secure the property. The fee covers the auctioneer's costs and is not deducted from the purchase price. The buyer then has 28 days to exchange contracts and a further 28 days to complete. The reservation fee will be refundable if the sale cannot be completed due to a fault on the part of the vendor. Should the buyer withdraw before exchange of contracts, no recompense is due to the vendor, but the reservation fee will be lost.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the key requirements for a binding contract?
- describe the relationship between the agent and the principal?
- describe the role of the estate agent in the property-buying process?
- summarise the general details, standard conditions and warranties, and typical special conditions that are included in a lender's offer letter?
- explain what is meant by 'conditional exchange'?
- explain key differences between the process of buying at auction and buying via private treaty?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 6. Review the text if necessary.

Answers can be found at the end of this book.

1) In a contract to buy and sell property, both vendor and buyer give a consideration. True or false?

2) John is acting as agent for Donna. John carries out a transaction that appears to be outside his authorisation but Donna confirms that she is happy with what he did. The technical term for this is:

   a) apparent authority.

   b) additional authority.

   c) ratification.

   d) retrospective authority.

3) Fred and Eileen are about to put their house on the market and are considering whether to agree a sole agency arrangement with an estate agent or a joint sole agency in the hope of achieving a quicker sale. What would be the likely disadvantage to Fred and Eileen of the joint sole agency approach?

4) Who is liable to sanctions for a sales brochure that exaggerates the size of the main living room?

   a) The vendor.

   b) The estate agent.

   c) The vendor's solicitor.

5) An Energy Performance Certificate:

   a) must be received by the estate agent before a property can be marketed.

   b) is commissioned by the buyer's solicitor as part of the searches.

   c) must be commissioned before the property can be marketed.

   d) will cover all the flats in a block.

6) Once a lender has issued an offer of advance and the applicant has accepted it, the lender is bound to go ahead with the transaction. True or false?

7) Indira had exchanged contracts on the sale of her flat a week before her kitchen was badly damaged by a fire that caused structural damage. Who was responsible for insuring the property at the time the damage occurred?

   a) Indira as the vendor.

   b) The buyer's lender.

   c) Indira's solicitor.

   d) The buyer.

8) Either vendor or buyer can drop out of the sale/purchase of a property at any point up to the completion date. True or false?

9) Which of the following would not be a legitimate reason to arrange exchange of contracts on a conditional basis? Exchange is conditional subject to:

   a) sale of another property.

   b) satisfactory valuation of the property.

   c) satisfactory search results.

   d) a 'long-stop date'.

10) James has heard that bargains can be found by buying at property auctions. What cautionary advice would you give him?

TOPIC 7

The legal aspects of property purchase

LEARNING OBJECTIVES

Your studies in Topic 6 should have given you a clear overview of the stages involved in the property-buying process. In this topic the focus is on the role of the solicitor and the conveyancing process.

By the end of this topic, you should have an understanding of:

- the role of the solicitor or licensed conveyancer;
- investigation of title;
- the information that has to be provided by the vendor;
- key documents including the mortgage deed and contract of sale;
- the work carried out by the solicitor in relation to exchange of contracts and completion;
- work that is carried out post-completion.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about the legal side of property purchase. We have already looked at some of the work involved in investigation of title in Topic 5. Some of the processes in this topic will be familiar to you if you have been involved in purchasing a property.

For instance, do you know:

- what 'carrying out searches' means in the context of property purchase?
- what sort of information has to be provided on a seller's property information form?
- at which stage a buyer gets the keys to their new property?

7.1 What is the role of the solicitor?

It is not absolutely essential for a solicitor to act in a property purchase or sale but, in practice, no lender will consider a mortgage unless the legal formalities are carried out by a suitably qualified person. In the majority of cases a solicitor is appointed, although many buyers now use a licensed conveyancer to act for them.

WHAT IS A LICENSED CONVEYANCER?

A licensed conveyancer is a person who has met specific requirements relating to study, qualification and experience as required by a recognised conveyancing organisation.

Unlike a solicitor, who can deal in a number of legal matters, their qualifications limit them to property-related matters.

!

NOTE ON USAGE

For the purpose of consistency we will use the term 'solicitor' throughout this topic.

A vital role of the solicitor is to give advice throughout the process of house purchase and creation of the mortgage. Taking on a mortgage is a massive step, especially for a first-time buyer, so all sorts of questions may need to be addressed. Advice might relate to:

- the purchase/sale transaction;
- the mortgage itself and related matters, such as assignment of life assurances; or
- ensuring the property is covered by buildings and contents insurance.

Fees are incurred as the process progresses – we will look in detail at the costs involved in conveyancing in Unit 4. Apart from the solicitor's own fees, fees cannot be refunded once the service (title searches, for instance) has been provided. Some solicitors will reduce their fee if the purchase does not complete, depending on the stage that the process has reached. Aborting a purchase once the legal process has started is likely to be expensive.

7.1.1 Professional negligence

On rare occasions, a solicitor may make a mistake or overlook a significant fact during the process. If the solicitor is negligent, the implications can

be serious. Failure to identify a defect in the title, for example, can cause enormous problems for the owner of the property.

Solicitors, like other professionals, can be sued for negligence in the civil courts by those to whom they owe a duty of care. To establish negligence, the plaintiff must prove that a duty of care was both owed and breached, and that some loss, damage or inconvenience was caused.

In addition to legal redress, solicitors are bound by strict standards laid down by their professional body, The Law Society, which can take disciplinary action against those who fail to observe these standards.

All solicitors carry professional indemnity insurance against claims for negligence. This does not protect them entirely – if guilty of negligence, both their finances and future prospects of business can be severely damaged. Professional indemnity insurance does, however, ensure that the client will be paid in full if damages are awarded.

THE ROLE OF SOLICITORS IN SCOTLAND

In addition to carrying out the legal work associated with house purchase, some Scottish solicitors, particularly in eastern Scotland, act as selling agents for houses. This is attractive for vendors because combining the roles of selling agent and legal adviser in a single firm can result in cost savings and lower charges for the vendor.

Many solicitors have, collectively, established property centres that keep details of a large number of properties for sale, predominantly in their geographical areas. House buyers can visit these centres to look for potentially suitable homes. Several solicitors' property centres produce free newspapers or have websites containing details of properties for sale.

7.2 What is involved in investigation of title?

It is vital that the buyer becomes fully entitled to the property they buy. Investigation of title involves the solicitor making thorough enquiries to establish whether the property is what it is claimed to be and that it is free from restrictions that would inhibit the sale process. It also involves producing a certificate of title to confirm the findings. The certificate of title also confirms that the person who is selling is the legal owner, or their legal representative, and is entitled to sell the property.

Investigation of title requires the solicitor to make searches of various registers. Once these have been carried out satisfactorily, the solicitor can confirm good title.

These investigations are extremely important: any defect in title that is not uncovered at this stage could have very serious repercussions, at worst meaning that the buyer has not purchased what they thought they had.

The issue is equally important to the lender, since defects in the conveyance could mean it is unable to exercise some or all of its rights over the property, which would affect its security. For this reason the lender will insist on receiving a satisfactory certificate of title before it enters into a binding contract with a borrower.

The process of investigating title is becoming progressively more straightforward as land registration is now compulsory in England and Wales, as well as in many areas of Scotland. Registered details of the property, ownership and incumbrances affecting the property are guaranteed to be accurate.

If the title to the property is not free from defects, the solicitor must advise how these affect the security and/or how they may be overcome. For example, further legal work may be required to overcome the problem or, instead, insurance cover could be arranged to protect the lender.

The certificate of title will confirm the borrower's full name as it will be recorded in the legal documents, and show the outcome of the various searches on title that the solicitor has undertaken.

INSURANCE AGAINST DEFECTIVE TITLE

Insurance products have been developed to protect mortgage lenders against defective title. These policies can be specific, or they may be arranged on a block basis. They may be especially helpful where one lender is transferring a book of business to another, where a full investigation of each individual title would be very costly.

The extent of the cover can vary according to needs, but policies can provide cover against a solicitor's failure to identify a title defect, which could include covenants, different types of title, easements and so on. The policies can be arranged to protect only the lender, or the lender, the borrower and any subsequent purchasers.

FIGURE 7.1 WHAT SEARCHES ARE CARRIED OUT?

Land Registry search

Carried out if the land is registered and involves a search of the property, proprietorship and charges registers.

Land Charges Registry search

Carried out if the land is unregistered to check for puisne mortgages or spousal interests.

Local Land Charges Registry Search and Enquiries of the Local Authority

The Local Land Charges Register identifies details of obligations and restrictions attaching to the property. These records are being transferred to the Land Registry since 2018. Enquiries to the local authority identify road changes, town planning schemes and so on, which may affect the property and apply to the land (both registered and unregistered) rather than the individual.

Bankruptcy search

Carried out by the lender's solicitor to ensure that the applicant is not a bankrupt, and sometimes carried out on the vendor to confirm they have the right to receive the proceeds of the sale.

Commons registration search

Checks that the land being sold is not common land. Usually applies where the land is in the countryside and previously undeveloped; or belonged to the Lord of the Manor; or is designated a town or village green.

KEY TERMS

PUISNE MORTGAGE

A puisne mortgage is one where the lender on an unregistered property does not have the title deeds as security for the mortgage. For unregistered land, the lender holding the title deeds is considered to be the first-charge holder. A puisne mortgage holder is in the same position as a second or subsequent charge holder on registered land.

SPOUSAL INTEREST

Exists where a non-owning spouse has lodged an interest in the property under the Family Law Act 1996.

CAN A REMORTGAGE BE COMPLETED WITHOUT THESE SEARCHES?

It is quite common in remortgage cases for the lender to allow the borrower's solicitor to arrange search indemnity insurance rather than carry out the standard property searches usually required.

The cover protects the homeowner and the lender against any financial consequences that might have arisen as a result of the searches required, and allows the remortgage process to be completed more quickly than normal.

CHECK YOUR UNDERSTANDING 1

What can you remember about Land Registry searches and different types of title from your studies in Topic 5?

a) In which register would you find:

   i) a plan of the property?

   ii) details of restrictive covenants?

   iii) the class of title applying to the property?

b) What is the most desirable class of title from an owner's and lender's perspective?

7.3 What other work is carried out prior to exchange of contracts?

7.3.1 Information from the vendor about the contents of the sale

The buyer's solicitor confirms with the vendor exactly what is and is not included in the sale (such as fittings and temporary outbuildings, such as garden sheds). The vendor will also be required to complete a 'seller's property information form'. The vendor must answer questions honestly, because if false information is given the buyer could seek redress through the courts if they suffer as a result.

FIGURE 7.2 WHAT INFORMATION IS PROVIDED ON THE SELLER'S PROPERTY INFORMATION FORM?

Property boundaries

Disputes with neighbours

Notices affecting the property

Guarantees relating to the property

Services to the property
Water, electricity, gas, etc.

Sharing with neighbours
Any joint responsibilities to pay for maintenance of joint or common areas, or any need to go on to neighbour's property, or for neighbours to go on to the vendor's property, for maintenance purposes.

Arrangements and rights

Changes to the property

Planning and building control issues

Fittings included in the sale or fixtures that are to be removed

Other issues to do with the mechanics of the sale

IN BRIEF

WHAT ARE FIXTURES AND FITTINGS?

Fixtures are generally those items that are permanent additions to the fabric of the property – ie screwed in, nailed down, plumbed in and so on. Examples would be laminate flooring, fitted kitchen units and built-in appliances. It is normal, unless the agreement specifies otherwise, for fixtures to be included in the sale, whereas personal items (chattels) are not.

Fittings are items that it would be reasonable for a vendor to take with them, including curtains, carpets, freestanding furniture and so on.

Where fixtures are to be excluded from the sale or fittings included, this should be clearly specified in the contract to avoid problems at a later stage.

7.3.2 Preparation of mortgage deed

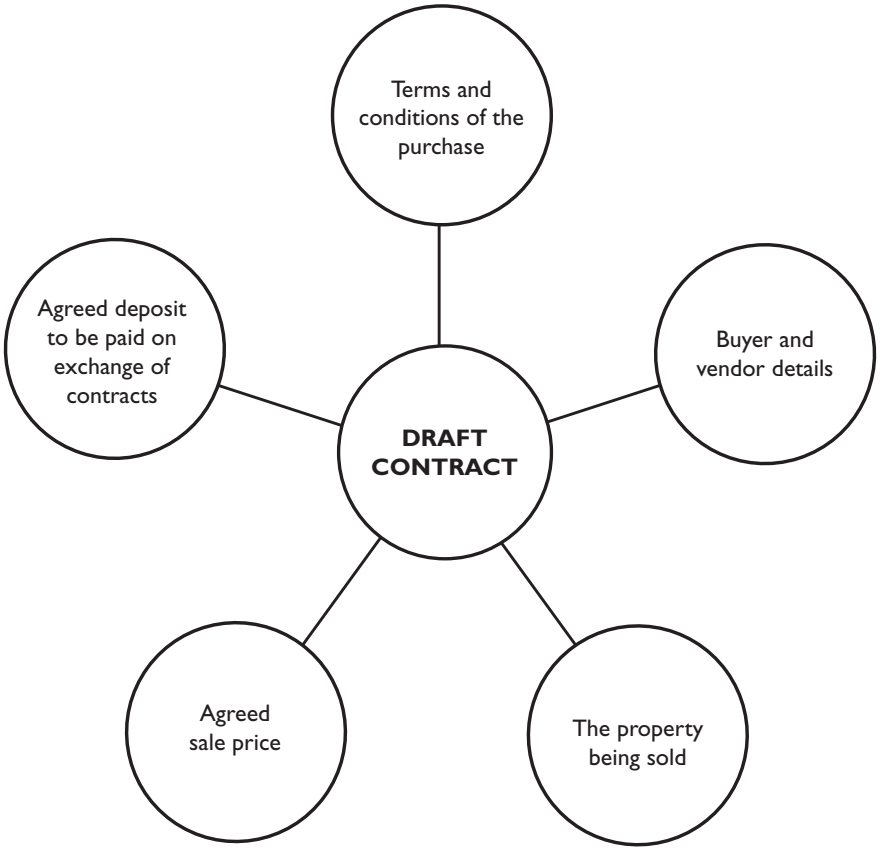
The mortgage deed forms the contract and the buyer's solicitor will carry out the work necessary on behalf of the lender to have the deed ready for completion. This involves liaison with the lender so that the mortgage funds can be transferred in time.

In addition to the mortgage, the solicitor may have to deal with deeds of assignment of life assurance policies, if this is the lender's policy, and other transactions related to the mortgage.

7.3.3 Preparation of draft sales contract

The vendor's solicitor prepares the draft sales contract. As with the seller's property information form, the vendor must be honest in the information they provide, because if false information is given the purchaser could seek redress through the courts if they suffer as a result.

FIGURE 7.3 WHAT DOES THE DRAFT CONTRACT SPECIFY?



7.4 What is involved in exchange of contracts?

Once all the searches have been completed, and the buyer's solicitor is satisfied with the results and has confirmation that a binding mortgage offer

is in place (if required), the signed contracts can be exchanged. The amount of the deposit paid at this stage is negotiable: it is customary for a deposit of 10 per cent of the purchase price to be paid by the buyer to the vendor's solicitor, but a lower deposit may be accepted – or even no deposit, in some circumstances.

Regardless of the deposit amount, the vendor can sue the buyer for breach of contract if they do not go through with the purchase having exchanged contracts.

CHECK YOUR UNDERSTANDING 2

Think back to your studies in Topic 6. Contract exchange is the point of no return – the vendor is obliged to sell and the purchaser is obliged to buy. Technically, either party can still withdraw from the transaction, but what consequences might this entail?

A completion date is agreed (in Scotland this is known as 'date of entry'). The vendor's solicitor will obtain a settlement figure to repay any outstanding mortgage the vendor has on the property when the sale is completed. If the buyer is selling a property to fund the new purchase, their solicitor will obtain a settlement figure to repay any outstanding mortgage on that property.

The buyer's solicitor will normally arrange for the buyer to sign the mortgage deed a day or two before the purchase is due to be completed, ready for execution on the day. The deed is a formal and binding contract between mortgagee (lender) and mortgagor (borrower). Its contents and those of any document 'linked' to it (such as the mortgage conditions) cannot be varied without the consent of both parties to the contract.

MCOB rules require lenders to make the conditions of a mortgage clear to borrowers. Usually, the solicitor will talk the borrowers through the transaction, telling them the significance of what they are signing.

The buyer's solicitor sends a draft transfer deed to the vendor's solicitor for the vendor to sign in readiness to be returned in time for completion. Soon after exchange, the buyer's solicitor will apply for release of any mortgage money needed to complete the sale, in time for completion.

SCOTLAND

In Scotland, the final acceptance of an offer to purchase (together, 'the missives'), which must be in writing, is legally binding – a solicitor also deals with this.

7.5 What happens at completion stage?

Completion day is when the property is finally transferred from vendor to buyer. The main event is the transfer of the balance of the purchase price from the buyer's solicitor to the vendor's solicitor via the Bacs or CHAPS system. The legal charge for the mortgage takes effect at completion because it is not until this point that ownership changes.

Once the money has cleared, the property belongs to the new owner, and they can move in.

7.6 What has to be done after completion?

Once the transaction has completed, the solicitor still has a few tasks to carry out:

- File a stamp duty land tax return within 14 days of the effective date of the transaction and pay the applicable tax. The effective date is usually completion.
- Apply for registration of the new owner at the Land Registry, and for any mortgage to be noted on the register.
- Send a bill to the buyer to cover conveyancing fees and disbursements. (In some cases the solicitor may ask the buyer to deposit a sum of money at the start of the process to cover some of the disbursements as they arise.)

DISBURSEMENTS

Expenses paid by the solicitor on the buyer's behalf, such as stamp duty land tax, registration fees, searches, etc.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain what searches are carried out as part of the investigation of title?
- list the contents of the 'seller's property information form'?
- explain the difference between a fixture and a fitting?
- summarise the content of the draft sale contract?
- outline the procedures that take place between exchange of contracts and completion?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

Use these questions to assess your learning for Topic 7. Review the text if necessary.

Answers can be found at the end of this book.

1) What type of insurance must a solicitor have in case of claims of negligence against them?

   a) Public liability insurance.

   b) Professional indemnity insurance.

   c) Partnership insurance.

   d) Law Society insurance.

2) Why is it important for the lender to be provided with certificate of title?

3) Town planning issues will be highlighted by a Local Land Charges Registry search. True or false?

4) Why might a bankruptcy search be carried out on a vendor?

5) Carmen and Joanna had had a long-running dispute with their neighbour over his poor maintenance of the boundary wall dividing their properties. On what document were the couple required to declare this issue when they sold their property?

6) Which of the following would usually be classified as a fitting?

   a) A built-in oven.

   b) A free-standing wardrobe.

   c) Laminate flooring.

   d) A bathroom vanity unit.

7) Which of the following would **not** be contained in a draft sale contract?

   a) Details of the buyer and vendor.

   b) The agreed deposit.

   c) The amount of the mortgage loan.

   d) Details of the property being sold.

8) Which of the following processes is **not** carried out between exchange of contracts and completion?

   a) The vendor's solicitor obtains a settlement figure to repay any outstanding mortgage on their property.

   b) The buyer signs the mortgage deed.

   c) The vendor completes a 'seller's property information form'.

   d) The buyer's solicitor applies for release of mortgage funds.

9) The legal charge for the mortgage takes effect:

   a) from the point where the solicitor registers the new owner at the Land Registry.

   b) from completion.

   c) when the lender issues its offer of advance.

   d) from the point where contracts are exchanged.

10) When a borrower is remortgaging, it is possible to minimise the conveyancing work involved by arranging search indemnity insurance. True or false?

TOPIC 8

Regulation and the buying process

LEARNING OBJECTIVES

In this topic we are focusing on the regulations with which the lender or intermediary must comply at key stages in the mortgage application process. You will then have considered the buying process from the perspective of the buyer, the solicitor and the lender, giving you a good picture of the interactions and responsibilities of the different participants.

By the end of this topic, you should have an understanding of:

- the key regulatory stages in the mortgage application process;
- real-time and non-real-time financial promotions and the rules that apply to each;
- the purpose and nature of initial disclosure requirements;
- the circumstances in which a mortgage may be sold on an execution-only basis;
- the information that must be provided at the pre-application and application stages;
- the information that must be provided at the start of the contract.

!

IMPORTANT

The focus of this topic will be on MCD regulated mortgages, which are entered into on or after 21 March 2016. Mortgages before that date are referred to as regulated mortgages and are subject to the original MCOB rules for servicing and variations.

However, firms have the flexibility to apply MCD disclosure requirements to pre-21 March 2016 mortgages in order to avoid running parallel processes. We will briefly cover the main rules applying to regulated (non-MCD) mortgages at the end of each section (where applicable).

THINK . . .

Before you begin work on this topic, think back to your studies on conduct of business requirements for UK Financial Regulation. You will find that you are already familiar with some of the information in this topic, which discusses regulation specifically in relation to the mortgage application process.

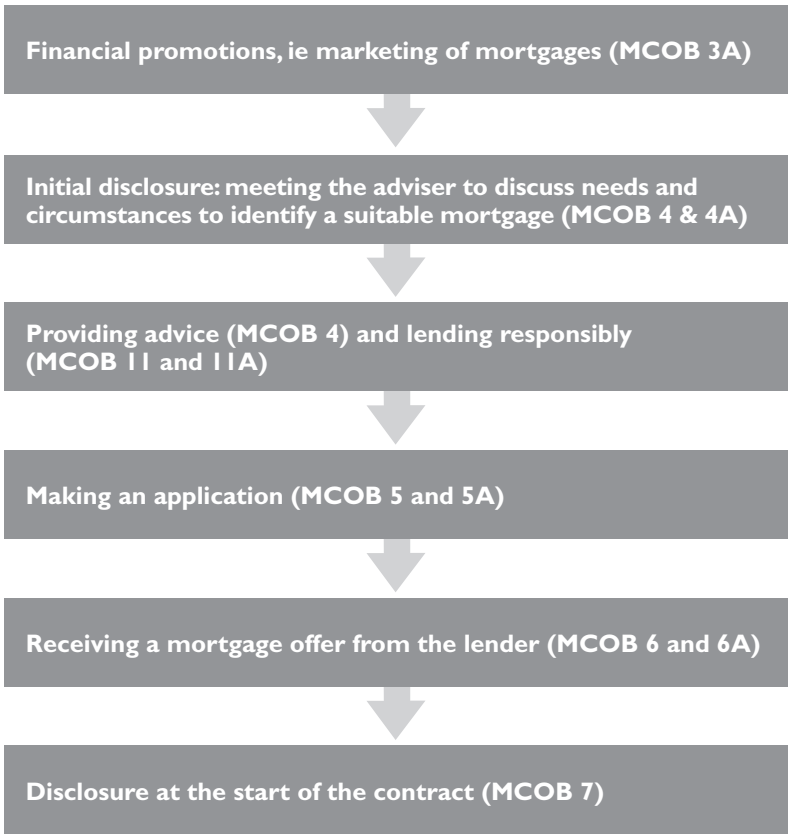
For instance:

- What different stages in the application process are identified in MCOB?
- What is a financial promotion?
- What does the acronym 'ESIS' stand for?

8.1 What are the key regulatory stages in the mortgage application process?

From a regulatory point of view there are key stages in the application process where regulatory requirements must be met, as outlined in Figure 8.1. We will work through these stages step by step.

FIGURE 8.1 KEY REGULATORY STAGES



8.2 Marketing of mortgages (MCOB 3A)

FINANCIAL PROMOTION

An invitation or inducement to engage in an investment activity, which includes mortgages.

The FCA MCOB rules refer to the marketing of mortgages as financial promotions, which can be solicited or unsolicited and take various forms, including telephone calls, mailshots, websites and newspaper or TV advertisements. The rules apply to financial promotions for qualifying credit (regulated mortgages) or home reversion plans.

CHECK YOUR UNDERSTANDING 1

What is the difference between solicited and unsolicited promotions to customers?

Financial promotions are not allowed unless they are carried out by an individual (or firm) authorised by the FCA, or the content has been approved by an individual (or firm) authorised by the FCA. In most cases an authorised firm would allocate responsibility for approving financial promotions to a specific team, such as marketing.

Some types of promotion are exempt from the rules. In the main, these are promotions that only contain general information about the firm and its main business, without offering any inducement to take up a particular mortgage or service. All financial promotions for qualifying credit or home reversion plans must be clear, fair and not misleading.

8.2.1 Non-real-time financial promotions

All non-real-time credit promotions must include the following:

- **Company details** – the company name and address, or a telephone number or email address where the full address is not available.
- **Terms of promotion** – a clear and prominent statement if the product being promoted is conditional on other products being purchased, eg house insurance.
- **Risk of repossession** – the statement: 'your home may be repossessed if you do not keep up repayments on your mortgage' or similar.

NON-REAL-TIME FINANCIAL PROMOTION

Any promotion that does not include interactive dialogue – SMS, email, faxes, letters, adverts, etc.

- **Annual percentage rate of charge (APRC)** – the APRC must be included if the promotion contains price information, and must be clearly distinguishable from any other rates shown. The APRC is designed to show the true cost of borrowing over the term and is expressed as an average annual interest rate. It takes into account the interest charged, plus any additional fees payable.
- **Interest rate** – the interest rate and whether it is variable or fixed, together with details of any charges included in the total cost of credit.
- **Credit** – the total amount of the credit.
- **Term** – the term of the mortgage, where applicable.
- **Instalments** – the amount and number of instalments, where applicable.
- **Total** – the total amount payable by the borrower.
- **Example** – a representative example to illustrate the points above. An example will only be regarded as 'representative' if the firm can reasonably expect that at least 51 per cent of people who respond to the promotion and those who enter into the contract advertised would actually be charged the APRC quoted (or a lower amount).

Competitor comparisons are only permitted on a like-for-like basis and must not disparage or discredit the competitor, or take unfair advantage of the competitor's reputation.

The firm must keep records of all non-real-time credit promotions for at least 12 months from the time they were last used.

8.2.2 Real-time financial promotions

REAL-TIME FINANCIAL PROMOTION

Any promotion made through a telephone or face-to-face conversation, or other interactive dialogue.

WHEN ARE UNSOLICITED CALLS ALLOWED?

Unsolicited calls ('cold calls') are only allowed where the recipient has an established existing customer relationship with the firm and the relationship is one where the customer can expect to receive such calls. It could be argued that these are not true cold calls at all.

The rules for real-time promotions, including those made by call centres, are as follows:

- **Hours** – they cannot be made at an unsocial hour unless previously agreed. FCA guidance states that an unsocial hour would usually be a Sunday or between 9pm and 9am on any other day. It also includes other days or times when the caller should know that the customer would not wish to take a call for personal reasons, such as religious beliefs or working patterns.
- **Contact** – contact cannot be made on an unlisted telephone number unless the customer has previously agreed.
- **Identification** – the caller must identify themselves and their firm.
- **Check** – the caller must check that the customer agrees to continue with the conversation if the time and method of communication has not been agreed earlier.
- **Terminate** – the caller must terminate the conversation if the customer does not wish to proceed.
- **Content** – the content of the conversation must be clear, fair and not misleading, and not make any untrue statements.

8.3 What is initial disclosure? (MCOB 4 and 4A)

When a prospective purchaser seeks a mortgage, the firm arranging the mortgage must provide the borrower with information about the firm and its status through 'initial disclosure'. As all new mortgages arranged are MCD regulated mortgages, we will focus on the rules applying to them.

The initial disclosure requirements apply to each of the 'relevant markets' in which the firm operates. Relevant markets are defined as:

- regulated mortgages that are not for business purposes; and
- those that are for business purposes.

If a firm is offering services to a customer in both the relevant markets, it must describe its services in each market and state, for each market, whether it offers first-charge mortgages, second-charge mortgages or both. Note that lifetime mortgages are not included under the MCOB 4 and 4A requirements because they have their own MCOB rules.

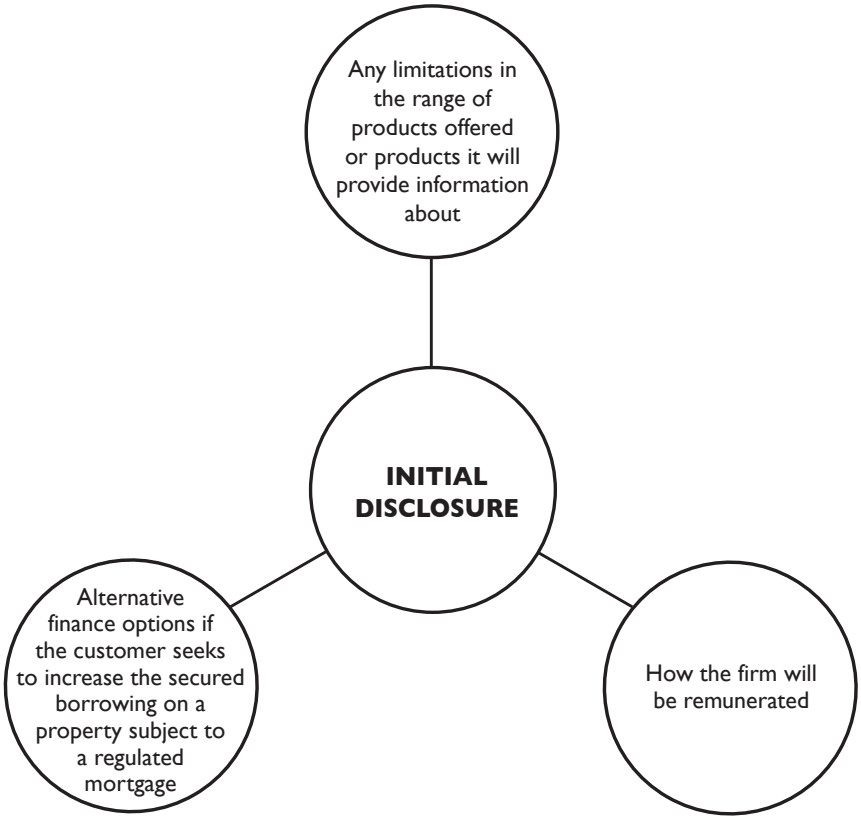
If the mortgage is to be arranged directly from the lender, it is the lender's job to provide the disclosure information. Where the mortgage is arranged through an intermediary, it is the intermediary who must provide the disclosure information.

Although the content is set out by the regulator (as shown in Figure 8.2), there is no prescribed format for the disclosure information and it can be designed

by the firm. The information must be presented in a durable medium for MCD regulated mortgages. Durable medium is defined in the FCA Handbook as: "paper; or any instrument which enables the recipient to store information addressed personally to the recipient in a way accessible for future reference and for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored" (FCA, no date).

The information must be provided before the firm carries out any mortgage arranging or advisory activity.

FIGURE 8.2 WHAT MUST INITIAL DISCLOSURE TELL THE CUSTOMER?



8.3.1 Range of products

In relation to the range of products offered, there are three types of service that the firm can offer to customers (see Figure 8.3); the service to be provided must be clearly indicated to the customer when first making contact.

FIGURE 8.3 THREE TYPES OF SERVICE

'Unlimited'	Firm selects and recommends from a range of products that represent the whole market
Limited range	Firm selects and recommends from a limited range of products, typically from a panel of lenders
Single lender	Firm selects and recommends only the products of a single lender

Note that 'unlimited' does not mean the firm has to select from every single product on the market – the key is that the products offered should be representative of the whole market.

If a firm does not offer an unlimited product range to its customers, it must list the names of all the lenders whose products it offers.

A firm that only offers products from one part of the relevant market cannot describe its service as unlimited. The FCA gives bridging finance as an example.

8.3.2 The firm's remuneration

The firm must inform the customer of:

- any fees the firm will charge them;
  - — there are rules covering the main ways in which fees can be calculated, such as hourly fees or fees calculated as a percentage of another figure, such as the mortgage amount;
  - — the principle is that the customer must be given the fee that will apply or, if that is not known at this stage, examples of how such fees work and the potential costs;
- when such fees will be payable (and when reimbursable, if appropriate);
- whether the firm will receive commission or a procuration fee from the lender or a third party; and
- the firm must state the amount of commission or, where the amount is not known at the time of disclosure, state that the actual amount will be disclosed at a later stage in the European Standardised Information Sheet (ESIS) that must be provided before an application is made.

If the firm will receive commission, it must disclose any arrangements for offsetting this against any fees charged to the customer, where applicable.

Fees should be shown as specific cash sums where possible. If the fee cannot be shown as a specific cash sum, in general terms the firm must provide the customer with an indication of the likely fees; the format for providing this information depends on the nature of the fee.

8.3.3 Alternative finance options

Where the borrower is looking to raise further funds on a property that is already subject to a regulated mortgage, the firm must inform them that alternative funding could be obtained through a further advance (unless it knows that the existing lender will not offer that facility), a second charge, a mortgage with another lender or unsecured borrowing. The firm does not have to ascertain the appropriateness of the alternatives.

Where a customer is considering a retirement interest-only mortgage, the firm must inform the customer, orally or in writing, that a lifetime mortgage may be available and more appropriate. There is no requirement to provide advice on the suitability of a lifetime mortgage.

8.3.4 Variations to pre-21 March 2016 contracts

The disclosure requirements for both regulated and MCD regulated mortgages contain a common core of information (MCOB 4), with MCD mortgages firms required to provide specified additional content (MCOB 4A). Should a firm need to provide initial disclosure documentation to a customer wishing to vary a mortgage taken out before 21 March 2016, firms may choose to avoid the potential problems caused by running two systems by providing the disclosure information in a format that meets the MCD requirements.

8.4 Providing advice (MCOB 4 and MCOB 4A)

A borrower seeking a regulated mortgage may:

- be given qualified advice; or
- proceed on an execution-only basis.

Firms can provide *information* (ie generic content that is not tailored to the specific borrower) at an early stage in the process but they are expected to provide advice whenever the sales process involves interactive dialogue. Advice must be given before a contract is arranged or the borrower enters into the contract.

Adequate explanation

When advising on an MCD regulated mortgage, the firm must provide an adequate explanation of the product being recommended. The explanation can be oral or in writing, and must cover:

- the information included in the ESIS – see section 8.6;

- the key characteristics of the product;
- the effect the product would have on the customer (including in the event of the customer defaulting on the repayments);
- the scope of service, fees payable and remuneration, if the advice is given by an intermediary.

RECORD-KEEPING

A firm must keep customer information records used to make a recommendation, as well as the reason why the advice is suitable and any customer decisions made about rolling up fees into the loan. Records must be kept for a minimum of three years from the date the advice was given.

EXECUTION-ONLY

A transaction executed upon a client's specific instruction, where the firm gives no advice and the rules on assessing appropriateness do not apply.

8.4.1 Execution-only business

Although firms are expected to provide advice in most cases, the FCA has made it easier for firms to provide options to consumers without it being deemed advice. This makes a firm's execution-only offering easier to use. In cases where a firm has provided customers with product information in line with MCOB requirements, it can carry out execution-only sales for those customers, as long as the information provided does not steer the customer towards execution only.

There are rules governing the situations in which customers may proceed on an execution-only basis at their own request, including those who wish to vary the terms of an existing contract.

Execution only is permitted when:

- there is **no interactive dialogue** between the firm and the customer during the sale, eg website and postal applications, as opposed to instant messaging and social media; or
- there is **interactive dialogue but the customer is in one of three categories** and has elected to proceed on an execution-only basis:
  - high-net-worth (HNW) customers;

— professional customers (who must select the product they wish to arrange);

— business customers; or

- there is **interactive dialogue but the firm's contribution is limited** to:

  — factual information about a regulated mortgage or application and administration processes;

  — the provision of an ESIS or a mortgage illustration;

  — an explanation that it has not assessed suitability and that the protection of an advised sale will be lost; or

- the **customer has rejected advice**, identified the product they wish to purchase and has elected to proceed on an execution-only basis.

When a firm accepts an execution-only sale it must keep a record of the sale, including the information provided, confirmation from the customer, and any rejected advice offered, for three years from the start of the contract.

High-net-worth customers

CHECK YOUR UNDERSTANDING 2

From your studies in Topic 2, can you remember the FCA criteria for a borrower to be classed as an HNW customer?

a) Minimum annual net income of £300,000, or minimum net assets of £3m.

b) Minimum annual net income of £3m, or minimum net assets of £300,000.

c) Minimum annual net income of £30,000, or minimum net assets of £3m.

Lenders may adopt a different approach to HNW customers from that used for most retail customers, based on three main factors:

- disclosure – lenders can use a tailored approach, which primarily focuses on the wording used;
- advice – interactive sales may be conducted on an execution-only basis;
- responsible lending – lenders can be a little more flexible in the assessment of affordability.

When lending to an HNW customer, the lender requires evidence that the customer has:

- rejected advice;
- identified the product they wish to purchase;
- positively chosen to proceed on an execution-only basis.

It also requires written confirmation from the customer that they understand the consequences of losing the protections of the rules on suitability.

Professional customers

CHECK YOUR UNDERSTANDING 3

From your studies in Topic 2, can you recall the criteria that define a professional customer?

a) For how long must they have worked recently in the home finance sector?

b) What must their professional position require?

c) Of what must the firm reasonably believe they are capable?

As long as the firm is satisfied that it has evidence that the customer meets the criteria for a professional customer, and that the customer has selected the product they require or rejected advice given, it can deal with the customer on an execution-only basis.

Regulated mortgages for business purposes

CHECK YOUR UNDERSTANDING 4

From your studies in Topic 2, can you recall the key difference that distinguishes a regulated mortgage for business purposes from a regulated mortgage for a personal borrower?

a) One of the purposes of the loan, remortgage or further advance is to raise additional money for the use of a small business.

b) The sole purpose of the loan, remortgage or further advance is to raise additional money for the use of a small business.

c) The sole purpose of the loan, remortgage or further advance is to raise additional money for the use of a large business.

Raising funds through a regulated mortgage to fund the purchase of, or work on, a buy-to-let property is not classed by the FCA as being for business purposes.

Customers who may not proceed on an execution-only basis

Apart from loans to HNW or professional customers, or mortgages solely for business purposes, a firm **cannot** arrange an execution-only sale if:

- the purpose of the loan is to exercise a statutory 'right to buy' a home; or
- the main purpose is to raise funds for debt consolidation; or
- the mortgage is a shared equity arrangement – shared equity being where one person buys a share in a property with a mortgage, and the remaining proportion is held by a third-party provider, who will receive a proportionate share of the proceeds when the buyer eventually sells the property. Shared equity is covered in Topic 25.

Customers in the situations listed above, together with those considered to be 'vulnerable customers' (see section 2.6.2), must receive advice. However, in the interests of freedom of choice, customers can choose to reject the advice offered and purchase a different product on an execution-only basis (MCOB 4.8A.12 – Exception: rejected advice).

Although execution only is not generally available to those exercising their statutory right to buy, or those wishing to consolidate debts, those customers can vary the terms of an existing arrangement on an execution-only basis if the new arrangement does not involve extra borrowing other than to cover product or arrangement fees.

VULNERABLE CUSTOMER

Someone who is especially susceptible to detriment as a result of their personal circumstances, particularly when a firm is not providing appropriate levels of care.

CHECK YOUR UNDERSTANDING 5

Based on the information provided, which of the following is most likely to be able to arrange a mortgage on an execution-only basis without receiving qualified advice?

a) Richard, who is an experienced mortgage adviser and wishes to arrange a further advance on his own property.

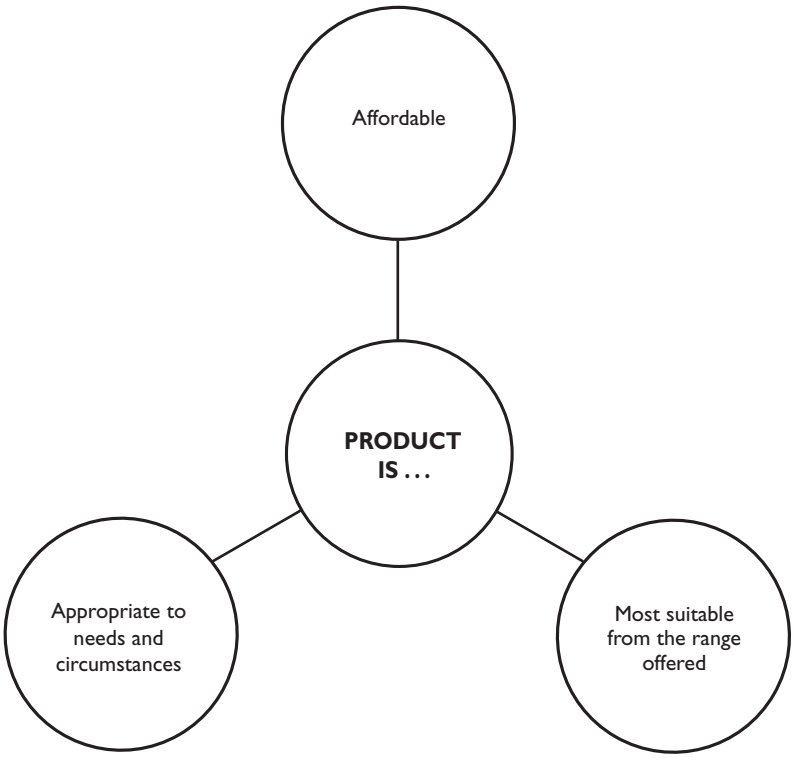
b) Shannon, who wants to buy her flat under a statutory right-to-buy scheme.

c) Niall, whose wife died last month and is seeking to relocate closer to his children.

8.4.2 What are the suitability requirements?

With advised sales, the firm must take reasonable steps to ensure that any personal recommendations are suitable for the client. This requires the adviser to gather information about the customer that will help them to assess which mortgage, if any, is suitable for the customer's needs and circumstances. The underlying requirements for a product to be deemed suitable are summarised in Figure 8.4.

FIGURE 8.4 SUITABILITY REQUIREMENTS



Where the firm offers more than one product that is appropriate to the borrower's needs and circumstances, and advises the borrower to take out a product other than the cheapest, it must explain why it is recommending the more expensive product. 'Cheaper' is defined as having a total amount payable that is lower than the other product.

RECORD OF THE RECOMMENDATION

A firm or adviser recommending an MCD regulated mortgage must provide the customer with a record of the recommendation made on paper or in another durable medium. This requirement can be met by providing an illustration or ESIS.

WHAT HAPPENS IF NO PRODUCT IS SUITABLE?

If there is no product within the range offered by the firm that is appropriate to the customer's needs and circumstances, no personal recommendation should be made. It is not acceptable to recommend a product from the range on the basis that it is the 'best fit' available.

RECORD-KEEPING

A firm must keep records demonstrating suitability, including information gathered relating to the customer's needs and circumstances, why the recommendation was suitable and any customer choices, such as adding fees to the loan.

The record must be kept for at least three years from the date of the advice.

8.5 What is responsible lending? (MCOB 11 & 11A)?

Lenders are required to meet the requirements of MCOB 11, which covers responsible lending. Before entering into the mortgage contract, or changing the terms of an existing contract that could affect affordability, the lender must be able to show that account has been taken of the borrower's ability to repay the mortgage. Examples of changing the terms of a mortgage include extending the term into retirement, changing from repayment to interest-only, or adding or removing a borrower.

A record must be kept of the information used by the lender in reaching a decision that complies with the responsible lending rules. The record will include the affordability assessment and, for interest-only mortgages, the reason for agreeing to the mortgage, the customer's repayment strategy and the result of the mid-term review required to check whether the repayment strategy is still on track and appropriate.

The record must be kept for the term of the mortgage. This contrasts with suitability records, which must be kept for three years.

The lender must establish and operate a written policy outlining the factors it will take into account in assessing the borrower's ability to repay the mortgage.

8.5.1 Income and expenditure

Lenders are required to obtain reliable evidence and verification to confirm that the income declared by the applicant is correct, and the lending decision should be based on that evidence. The rules specifically prohibit self-certification, where the applicant declares their own income and no evidence is sought to confirm their declaration. Instead, lenders must obtain evidence of income and it must be from a source independent of the customer, rather than from the customer themselves.

We will look in more detail at affordability in Unit 4.

8.6 Pre-application disclosure (MCOB 5 & 5A)

Pre-application disclosure is the information that must be provided before the customer completes an application for a regulated mortgage contract. The principle is that the customer should be in a position to make an informed decision. This means that they must be given sufficient information, specific to their case, to be able to make that decision. Illustrations and ESIS documents must only contain the information required by MCOBs and be separate from any other information given to the customer. The information must be specific to the customer's circumstances, the property and the required mortgage.

8.6.1 MCD regulated mortgages

The information provided must follow a prescribed format through an ESIS.

The following key information is required:

- The period for which the ESIS remains valid.
- The lender and contact details. Whether the firm has recommended a specific mortgage or provided information on a mortgage based on the customer's responses to questions so that they can make their own decision.
- The intermediary firm – name and contact details, where applicable. Whether the firm has recommended a specific mortgage or provided information on a mortgage based on the customer's responses to questions so that they can make their own decision.
- Main features of the loan, including:
  - the amount and currency of the loan;
  - if the loan is in a foreign currency and the value of the loan in the borrower's home currency, and the potential impact of a fall in the borrower's home currency;
  - loan duration, type, interest rate and the total amount to be repaid;
  - the amount to be repaid per pound (or other currency) borrowed;

— the amount owed at the end of the term, in the case of interest-only borrowing;

— the property value, the maximum loan to value available or the minimum property value required to support the borrowing.

- Interest rate and other costs – the APRC applicable and an explanation of the costs used in the calculation. Where an exact cost is not known, the firm must provide an indication of the amount if possible, or, if not, how the amount will be calculated and specify that the amount provided is only an indication.
- Frequency and number of payments.
- The amount of each instalment, with a warning that the borrower's income could change and they need to consider whether they could still afford the repayments. Also, where applicable:

  — interest-only mortgages – the need to make separate arrangements to repay the mortgage at the end of the term, and add the cost of the arrangements to the mortgage payments;

  — variable rate mortgages – a warning that the interest rate could change and payments may fluctuate, with an example of the cost of an increase;

  — foreign currency mortgages – a warning that payments could vary if the value of the home currency changes, with an example of a 20 per cent fall in the currency;

  — details of tied savings products or deferred interest loans.
- Illustrative repayment table (where applicable), showing the breakdown of interest, capital and other costs for each payment, and the outstanding capital after each payment.
- Additional obligations which the borrower must comply with as part of the mortgage conditions.
- Early repayment – the borrower's right to repay the loan (or part of it) early, the conditions that would apply, and any early repayment (exit) charge.
- Flexible features (where applicable) – whether the mortgage can be transferred (ported) to another property, or the mortgage can be transferred to another lender. Any other features offered as part of the arrangement that are not covered elsewhere in the document.
- Other rights of the borrower – the availability and length of the reflection period.
- In the case of a retirement interest-only mortgage to release capital, the firm must inform the customer that taking out the mortgage may affect their tax and state benefit position, provide information on restrictions

as to who may live in the property, and state that the customer should consider taking advice on the issues before applying. This information can be included in the illustration or as a separate document provided at the same time.

- Complaints – where to find the complaints procedure, and timescales for making a complaint. Reference to the Financial Ombudsman Service for unresolved complaints.
- Non-compliance with the commitments linked to the loan – the financial and/or legal consequences for the borrower. The need to contact the lender as soon as possible in the event of payment difficulty. A warning that the property may be repossessed on failure to maintain payments.
- Supervisor – the contact details of the FCA as the supervising authority.

If the advice is given by an intermediary, it is their responsibility to ensure that the information in the ESIS is accurate. The adviser must also explain to the customer the importance of reading and understanding the illustration. The lender cannot take any action to commit the borrower to the contract (application fees, etc) until the borrower has had time to consider the information.

FACTFIND

The detailed content of the ESIS is available in MCOB 5A Annex 1.

The ESIS must be provided to the customer as soon as possible after they have supplied the necessary information on their needs, financial situation and preferences, and in good time before they are committed to any mortgage offer or contract. In practical terms, this means before an application is made.

It must also be given if the customer requests the information (unless the firm is aware that the customer would not be able to obtain the mortgage), or in the case of an execution-only sale to indicate which contract the customer has chosen. If the terms of a proposed mortgage change materially between the provision of the ESIS, the firm must provide a revised ESIS before the application is made. The firm does not have to provide a revised ESIS if the change to the mortgage occurs after an application is made, but any changes must be reflected in the offer document.

If a recommendation is made over the telephone, the illustration must be sent to the customer within five business days.

8.6.2 Non-MCD regulated mortgages

When a customer with a regulated mortgage contract, pre-21 March 2016, wishes to vary the terms or arrange a further advance, the firm must provide them with an illustration that reflects the change. The document, referred to as a key features illustration (KFI) is broadly similar to the ESIS, but there are some differences. The main differences are:

- there is no reflection period;
- the offer is not subject to the MCD 'binding offer' requirement;
- the annual percentage rate (APR) is similar to the APRC but the calculation is slightly different.

As the MCD mortgage disclosure requirements contain broadly the same core information as that required for non-MCD mortgages, the lender may choose to adopt MCD processes to make administration simpler and avoid running two systems.

RECORD-KEEPING

The firm must keep a record of the ESIS or KFI for a period of one year from the date of the customer's application.

8.7 Disclosure at the offer stage (MCOB 6 and MCOB 6A)

Lenders are required to provide certain information to the borrower with the mortgage offer. The disclosure requirements apply only to lenders, although they affect advisers in that advisers need to be able to explain the details provided in the offer documents to their customers. The requirements for regulated mortgages and MCD regulated mortgages are broadly similar, but there some important differences.

8.7.1 MCD regulated mortgages

MCOB 6A details the rules applicable at the offer stage for an MCD regulated mortgage, either as a new mortgage contract or as a variation to an existing MCD mortgage contract.

Binding offer

The lender's final mortgage offer must be binding. This does not prevent a lender from making an offer that is conditional on the borrower meeting certain (lawful) requirements or the lender gathering further information. However, once all the requirements have been met to the lender's satisfaction and it is prepared to confirm the offer, that offer will be binding on the lender.

Note, however, that the requirement for a binding offer does not apply where the borrower is applying to vary an existing MCD contract.

WHAT CONDITIONS MIGHT A BINDING OFFER TYPICALLY INCLUDE?

- That there is no material change to the facts and circumstances on which the offer is based – the applicant's income or employment changing or the condition of the property deteriorating, etc.
- That the borrower has not knowingly provided inaccurate or false information or withheld information.

The lender may choose to provide an ESIS with the offer document, in which case the offer must reflect the details in the ESIS. If a binding offer contains conditions that differ from the ESIS provided at the application stage, a revised ESIS must be provided with the offer document.

Reflection period

When it has issued a binding offer, the lender must allow the borrower a reflection period of at least seven days, although the borrower can waive their rights to the full seven days and accept the offer at any time. During that period the offer remains binding on the lender. The principle of the reflection period is to give the borrower time to compare offers, consider their implications and arrive at an informed decision. Lenders and intermediaries are permitted to communicate with the borrower during the reflection period.

Note that where a borrower is applying to vary an existing MCD mortgage, the reflection period does not apply.

Content of the MCD offer document

There is no prescribed format for the MCD offer document, but the key information includes:

- the period for which the offer is valid;
- when the interest rate will change;
- the consequences of the customer not going through with the mortgage, including any fees already paid that will not be reimbursed;
- that there is no right of withdrawal once the mortgage is concluded;
- the customer's repayment strategy;

- where applicable, information about any retentions or reinspections that the lender may require;
- information about how to complain to the firm about its services relating to the mortgage, and whether or not such complaints can be referred to the FOS.

The following information must be provided either as an integral part of the offer document or as a separate document given with the offer document:

- A tariff of charges that could be incurred on the mortgage contract.
- Details of charges applicable to any current accounts, borrowing or deposit accounts linked to the mortgage.
- If the mortgage contract includes a credit card, the document must explain that the credit card will not provide the statutory rights associated with 'traditional credit cards'.

8.7.2 Regulated mortgages

MCOB 6 applies where the offer has been made to a customer with a view to:

- varying the terms of an existing regulated mortgage contract by:
  - adding or removing a party;
  - making a further advance;
  - switching some or all of the mortgage to a different interest rate option.

The offer document must contain a KFI (as described in section 8.6) and the offer must be based on the information contained in that illustration. The lender may choose not to provide a separate illustration, in which case the offer document must contain all the required information for an illustration. If the lender's final offer differs from the information included in the pre-application illustration, the illustration must be adapted to reflect the actual offer the lender is making.

Content of the offer document

The content of the offer document is broadly similar to the content of an MCD regulated mortgage, but must contain the statement: "You are not bound by the terms of this offer document until you have signed the legal charge and the funds are released for your mortgage". Note also that the lender's offer is not binding on the lender and can be withdrawn for a range of reasons.

As with other elements of disclosure, the core information applies to both regulated and MCD regulated mortgages. Lenders may choose to follow the requirements for MCD regulated mortgages in order to avoid having to run two systems.

RECORD-KEEPING

For both regulated and MCD regulated mortgages, a record of the offer document must be kept for one year from the date the offer was issued to the customer.

8.8 Disclosure at the start of the contract (MCOB 7)

MCOB 7 covers the disclosure requirements at the start of the contract and after it has started. In this section we will cover the requirements at the start of the contract. The ongoing requirements once the mortgage is in place are covered in Unit 6.

The lender is required to provide the following information before the first payment is made on a new mortgage, a further advance or a variation to the terms of a mortgage:

- amount and dates of the initial and ongoing mortgage payments;
- the method by which the payment will be collected;
- premiums and collection arrangements for any mortgage-linked investment/insurance contracts purchased through the firm;
- confirmation of whether the mortgage is interest-only, repayment or a combination;
- if the mortgage is interest-only, a reminder that the customer should check that any repayment vehicle is in place if it has not been provided by the firm;
- what the customer should do if they have payment difficulties or fall into arrears, and draw attention to the tariff of charges;
- confirmation of any linked borrowing and linked deposits; and
- whether the contract allows overpayments or underpayments.

MCOB 12 – Charges

MCOB 12 covers mortgage charges in general, and clarifies the requirements for disclosure of early repayment charges (ERC) in MCOB 5, 7 and 9. The lender is free to calculate the charge in a way that it chooses, but the charge must be a reasonable pre-estimate of the costs of ending the contract early and capable of being shown as a cash amount. In addition, when disclosing the ERC in accordance with MCOB 5, 7 and 9, the illustration must refer to such a charge as an early repayment charge and include:

- when an ERC would be payable;

- the basis of the calculation;
- the maximum ERC payable.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the sections of MCOB that apply to each stage of the mortgage application process?
- explain the difference between real-time and non-real-time financial promotions and the rules relating to each?
- summarise the purpose of the initial disclosure stage from the borrower's perspective?
- explain what is meant by 'execution-only business' and when customers are eligible to proceed on this basis?
- summarise the content of a KFI and explain how an ESIS differs from it?
- describe disclosure requirements at the start of the mortgage contract?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

FCA (no date) *Durable medium* [online]. Available at: https://www.handbook.fca.org.uk/handbook/glossary/G1286.html [Accessed: 5 November 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 8. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following is true in all circumstances in relation to unsolicited real-time financial promotions?

   a) They can only be made to existing customers.

   b) They cannot be made at an unsocial hour.

   c) Contact cannot be made on an unlisted telephone number.

   d) They can be made to any person who is on the company's mailing list.

2) Alex is his firm's marketing manager and he has just withdrawn a marketing mailshot, which will not be used again. For how long must his firm keep a copy of the mailshot?

   a) 6 months.

   b) 12 months.

   c) 36 months.

   d) 60 months.

3) For how long must a firm keep a record of an execution-only sale?

   a) One year.

   b) Two years.

   c) Three years.

   d) Five years.

4) An HNW customer can proceed on an execution-only basis if the firm has evidence that the customer meets the criteria, and has selected the product they require or has rejected advice given. True or false?

5) If there is no suitable product for a customer from within the range available, the adviser can recommend the closest fit from those available. True or false?

6) Examples of the APRC shown in a financial promotion must be 'representative'. This means that a specified percentage of those who respond to the promotion and those who enter into the contract advertised would be charged the quoted APRC. What is the percentage?

   a) 45 per cent.

   b) 51 per cent.

   c) 75 per cent.

7) If a recommendation is made over the telephone, an illustration must be sent to the customer within:

   a) five business days.

   b) seven business days.

   c) five calendar days.

   d) seven calendar days.

8) Lenders cannot make provisional offers to borrowers in relation to MCD regulated mortgages. True or false?

9) Chen has applied for a further advance on his MCD regulated mortgage. Once he receives an offer from the lender, how long will he have to think about whether to accept it, according to MCOB 6A?

10) The offer document must include details of the amount and dates of the initial and subsequent repayments due. True or false?

Appendix: Scottish supplement

This supplement contains information on Scottish law where it differs significantly from the law in the rest of the UK. It applies only to those students taking the Scottish version of the examination. Those students taking the examination in England, Wales and Northern Ireland will not be asked questions on Scottish law.

Topic 2: Types of borrower

Borrowers

In Scotland, the law of minority is quite different from the rest of the UK, although the principle that lenders should take great care when considering loans to young people is essentially the same. The Age of Legal Capacity (Scotland) Act 1991 states that children who are under 16 years of age are, with certain limited exceptions, unable to enter into transactions that have a legal effect. There are two main exceptions to this:

- those that are 'commonly entered into by persons of their age and circumstances';
- those that are entered into on 'terms which are reasonable'.

Both of these criteria are vague. It might be assumed that a minor buying sweets would be capable of contracting, while the same person looking for a loan may not.

A lender considering a loan to a young person might have the proposed contract ratified by the court. Under the 1991 Act, a guardian may contract on behalf of someone who is under 16 years old.

Individuals aged 16 and over are considered, under Scots law, to have full contractual powers. The 1991 Act, however, introduced a statutory challenge procedure to prejudicial transactions concerning those over 16 years of age but less than 18 years old. The transaction can be set aside by the court if it is considered that the transaction was one into which a reasonably prudent adult would not have entered and that the young adult has suffered loss as a consequence.

Topic 4: Principles of mortgage and property law

BACKGROUND

In the past, land in Scotland was held mainly on feudal principles. The word 'feudal' implies a hierarchy of rights that started with the monarch at the top and passed down to vassals or subordinates. Originally the monarch owned all the land, and rights to land were granted exclusively by the monarch, most often to the nobility. The nobles would then grant rights to land to 'lesser' citizens (known as vassals). The person who created the rights for the vassal was referred to as the 'superior' and could place restrictions and obligations on the land, including a requirement for the vassal to pay a periodic fee, known as feu duty. As with leaseholds in England and Wales, the vassal had to observe any conditions imposed by the superior.

Securities over heritable property (Scotland)

In Scottish law, heritable property consists of land, and things built on it and attached to it. It is divided into corporeal heritable property (including, for example, land, buildings, crops and growing timber) and incorporeal heritable property (including bonds or securities over land).

Mortgages in Scotland are created as a standard security, which consists of two main elements:

- a personal obligation from the debtor to the creditor to repay sums advanced by the bank;
- a grant by the debtor to the creditor of their interest in the heritable property.

The standard security must be recorded in the Land Register of Scotland. Until then, it will not be effective against third parties.

Abolition of Feudal Tenure etc (Scotland) Act 2000

The effect of the Abolition of Feudal Tenure etc (Scotland) Act 2000 is that, in the main, the rights of superiors in land held by vassals were ended on 28 November 2004. This means that rights of superiors, such as to collect feu duty and enforce title conditions (such as approve a change of use in the land or the erection of buildings) have been abolished. The owner of the land now has ownership rights that are similar to those of a freeholder in England.

Title Conditions (Scotland) Act 2003

Under the feudal system, when land was transferred to a vassal, the superior would typically insert a number of 'burdens' in the title to the land. The burdens would contain restrictions and obligations placed on the vassal, and are similar in effect to covenants in England (but often more onerous). As a result of the Title Conditions Act 2003, most feudal burdens have ceased to be enforceable by superiors. However, many existing burdens are non-feudal, in that they do not arise from the superior–vassal relationship, but were created by third parties or authorities. Examples include:

- community burdens, set by a developer for a whole estate;
- conservation burdens, enforceable by local authorities and the National Trust;
- economic development burdens, enforceable by a local authority;
- rural housing burdens, created and enforced by a rural housing authority.

Subject to certain conditions, non-feudal burdens can be created at any time in the ownership chain by inserting the relevant condition in the title deed when land is transferred. They are 'real' in the sense that they run with the land and are permanent obligations that require compliance on the part of all future owners.

Tenements (Scotland) Act 2004

The vast majority of flats in Scotland are owned on a freehold basis – leasehold ownership is not common. This presents a potential problem, in that no individual has responsibility for the common or shared parts of the building unless the title deeds make such provision. The Tenements (Scotland) Act 2004 introduced a statutory management scheme called the Tenement Management Scheme, which acts as a default management scheme for all tenements in Scotland (this is set out in the Schedule to the Act). It provides a structure for the maintenance and management of tenements, if this is not provided for in the title deeds. Where the title deeds do not contain a structure for decision-making, the Scheme allows a majority of the owners in a tenement to make decisions by majority vote.

The Tenement Management Scheme introduced the concept of scheme property, which refers to the main parts of the building that are so important to the building as a whole that they should be maintained by all owners. This does not, however, affect the ownership of the different parts of the building, which remains unchanged. The Tenement Management Scheme also contains default provisions on emergency repairs and apportionment of costs, which become effective if the relevant title deeds do not expressly deal with these issues.

Udal land

Udal land is an extremely old form of land tenure that exists in Orkney and Shetland. It is based on Norse law.

Topic 5: Practical aspects of property and mortgage law

Registering land in Scotland

Land registration principles are similar in Scotland to those applicable in England and Wales, though more recent in origin.

The Land Register of Scotland

The Land Register of Scotland is a map-based computerised system of land registration that was created by the Land Registration (Scotland) Act 1979 and subsequent revisions. Before the creation of the Land Register, property ownership and related charges were recorded in the Register of Sasines (discussed below). Compulsory land registration in the Land Register has been gradually extended through Scotland in a similar way to England, with most property recorded in the Land Register when it changed hands.

All new property purchases on or after 1 April 2016 are recorded in the Land Register of Scotland. Where the owner of a property that is still registered in the Register of Sasines wishes to remortgage or obtain other secured lending, they need to voluntarily register the property at the Land Register for the arrangement to go through.

Each property registered in the Land Register is detailed on a title sheet, which contains the following information:

- name of the person entitled to the property;
- heritable securities affecting the property;
- location of the property, based on the Ordnance Survey position;
- land obligations (or burdens) affecting the property.

The Register should be amended to reflect any changes in ownership or rights that affect the property. When a property is registered, the Keeper of the Land Register issues the owner with a land certificate, which is a copy of the title sheet. When a lender registers a security such as a mortgage, the Keeper issues a charge certificate that is retained by the lender and gives details of the security.

Registration does not guarantee a good title in every case. Those who wish to dispute ownership or rights can appeal to the Lands Tribunal for Scotland. There is also a right of appeal to the Court of Session. The Keeper is obliged to follow the directions of the Tribunal or court.

Many of the land records for Scotland are now held in digital form, although some property that has not changed hands for many years is still recorded in paper form.

The Register of Sasines

The Register of Sasines, introduced by the Registration Act 1617, provides a system of registration of deeds relating to land but was closed for the registration of new standard securities from the end of March 2016. It is a public register comprising mainly title deeds and records of charges, judgments and burdens over land, including conveyances (legal documents that transfer land from one party to another). Recording of a document in the Register of Sasines only guarantees protection of its contents; no title guarantee is provided.

Discharges of security, assignments, restrictions, variations and similar actions are not affected by the 2016 closure of the Register of Sasines and may be submitted for recording as normal.

Matrimonial interests

The law in Scotland relating to matrimonial interests is contained in the Matrimonial Homes (Family Protection) (Scotland) Act 1981 as amended. It is broadly similar to the law in England. The existence of matrimonial interests is not disclosed in the Register of Sasines, Land Register or Personal Register. In the case of a registered title, the title sheet may state that there are no subsisting occupational rights of spouses of previous owners if the Keeper of the Land Register is satisfied that this is the case. This statement is backed by a state indemnity but does not cover the current owner, so an enquiry is still necessary as to their position.

When title is in one name only, a lender should take an affidavit, or sworn statement, from the owner confirming that there is no 'non-entitled' spouse, or, where there is a non-entitled spouse, a renunciation of such rights should be obtained. This protects a third party (such as a lender) dealing with the entitled spouse against the risk of subsisting occupancy rights affecting the property.

The position in respect of occupancy rights must be checked each time a subsequent advance is granted.

Topic 6: Finding a property and making an offer

Making an offer

In Scotland, offers to purchase a property are generally made in a different way from those made in England and Wales (although there are exceptions, as outlined below). In Scotland it is common for the vendor to ask for offers above a base figure (the asking price) – the price advertised is usually the minimum that the vendors are prepared to accept, and in reality it is common

for the final agreed price to be 10–20 per cent or more above that level. The buyer makes an offer at a price they feel will be enough to secure the property, but, unlike the English system, they have just one chance and make a blind bid, with no idea of the level of other offers. The vendor's solicitor may set a final date for submission of offers, and the vendor does not make a decision until that date.

On the final date all submitted bids are assessed and the most suitable is accepted. This might not be the highest price – for example, someone who can complete the purchase more quickly with a cash sale might be preferred to a higher offer from a person who has yet to find a buyer for their present property. An unconditional offer will normally be preferred to a conditional offer.

Offers are sometimes made subject to survey, which means that the buyer reserves the right to withdraw should the survey reveal a material defect. This enables the potential buyer to delay surveying the property until it is clear that their offer has been accepted, and avoid the expense of wasted surveys on properties where their offer is not accepted. If the vendor agrees to this, they are likely to set a deadline for the survey to be completed, in order to prevent delays and time wasting. This type of conditional offer does not provide a basis for withdrawing just because the buyer has had second thoughts.

If the buyer is interested in a property but does not wish to make a formal offer at that point, they can ask the selling agent to note (or register) their interest, which means that the agent will inform them if any other offers are made so that they can make a competing offer and avoid missing the opportunity. The selling agent is not obliged to agree to note an interest, and if they are happy to do so may set a closing date for interest to be registered. The potential buyer runs the risk that another offer may be made and accepted before the closing date; it is now quite common for vendors to accept good offers before the closing date.

The practice of advertising at a fixed price has increased in popularity, and in these cases the vendor will usually accept the first suitable offer matching the price. Alternatively, property can be sold by private bargain, which is essentially the same as private treaty in the rest of the UK.

Missives

Once the offer is agreed, the contract is arranged by exchanging a series of formal letters known as 'missives', all of which are negotiated and signed by the two parties' solicitors as their agents. The missives cover the fine detail of the offer and form the basis of the final contract; each party discusses and agrees them with their solicitor. Once both parties are happy with the details, missives are said to be 'concluded' and the transfer of ownership will take place on an agreed date – known as the 'date of entry'. The conclusion of missives is broadly equivalent to exchange of contracts in England and Wales, and once they have been concluded there is a legally binding contract from

which neither party can withdraw without generally incurring a liability for damages to the other. Missives are concluded much earlier in the process than exchange of contracts in England and Wales.

If an offer is to be made, this has to be done very carefully. If made unconditionally and the vendor accepts it, an offer is legally binding under Scottish law. Consequently, it is common for an offer to be made conditionally, setting out precisely the conditions on which it is based. Once the offer has been accepted on all points through the conclusion of missives, the buyer has entered into a legally binding arrangement. Therefore, it is essential for the buyer to have the finances in place and be satisfied with the condition of the property before making an offer.

Date of entry

The date of entry can be any date agreed by the parties, and could be some time away. It is normal for the full purchase price to be paid on the date of entry, without the requirement to pay a deposit on conclusion of missives. Sometimes, however, particularly in the case of new property, a deposit may be required at conclusion of missives. Once missives have been concluded, the buyer is responsible for any damage to the property, so buildings insurance should be arranged at that point.

The buyer's solicitor will use the period between the conclusion of missives and the date of entry to carry out all the legal work needed to prepare the 'disposition', which is the document transferring ownership. The contract will contain a number of provisions allowing the buyer to withdraw without penalty if searches uncover problems with the title or other unexpected issues that could damage their position. In this case the buyer may be able to seek redress from the vendor as long as missives have been concluded.

Topic 15: Other factors that affect the lending decision

As a result of devolution, the Scottish government can make decisions about certain taxes. One such decision was to replace SDLT, as applies in England and Northern Ireland, with Land and Buildings Transaction Tax (LBTT). The tax's basis is similar to SDLT but the bands and rates are different. More detail can be found in section 15.9.4.

TOPIC 9

The role of the mortgage adviser

LEARNING OBJECTIVES

This short topic focuses on the role of the mortgage adviser with the emphasis on providing ethical advice. We will look in more detail at how the adviser assesses affordability and suitability in Topics 10 and 11.

By the end of this topic, you should have an understanding of:

- the key stages in the mortgage advice process;
- the principle of giving ethical advice;
- fair treatment of customers as an example of ethical advice in practice.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about the role of the mortgage adviser.

For instance:

- What are the main steps in the advice process?
- What kinds of issue need to be considered to ensure the fair treatment of customers?
- Can you recall the six fair treatment of customers outcomes from your studies for UK Financial Regulation?

9.1 Introduction

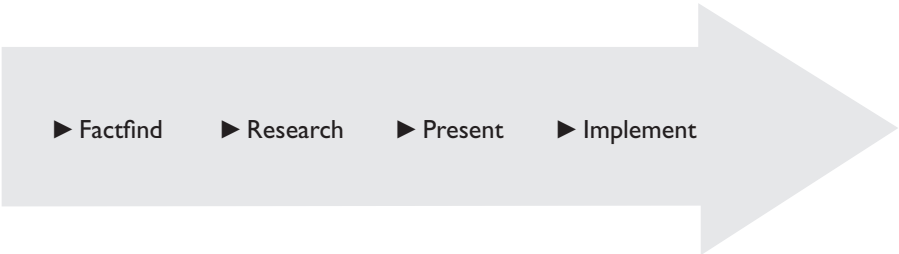
The mortgage market is often baffling for the average potential purchaser. Few people fully understand the complexities of the house-buying process, the mortgages available and the importance of choosing the most appropriate repayment method. This is where the mortgage adviser will play a pivotal part: they can inform and guide the customer towards the most suitable mortgage for their needs.

Advisers are expected to give ethical advice. This means asking appropriate questions to ascertain the customer's attitudes and needs, identifying the customer's full financial situation, verifying information where possible and offering advice and recommendations that best suit the customer. The customer's best interests should always be at the forefront of any advice or recommendations given.

We will look at the key elements of the adviser's role in the advice process and we will consider MCOB rules where they impact on that role. For consistency we will use the term 'adviser' to describe both a lender's adviser and an intermediary (mortgage broker).

The primary requirement of the advice process is that any recommendation should be suitable for the customer's needs. This is also essential for developing and maintaining the customer relationship and the adviser's reputation.

FIGURE 9.1 WHAT IS THE ADVICE PROCESS?



9.2 Compiling the factfind

The adviser should first interview the customer to find out as much relevant information as possible. In most cases, the adviser will need to explain terminology, products and procedures so that the customer can give reasoned and informed answers.

FIGURE 9.2 WHAT WILL THE FACTFIND INTERVIEW COVER?

Intentions
- The customer's intended purchase price and the type of property to be purchased

Income and outgoings
- The customer's income and outgoings to determine how much they can comfortably afford to borrow

Deposit and cash
- The amount of deposit available and other cash available to meet expenses

Employment
- The customer's current employment status and history
  - — Eg they might be on a career path that will lead to higher income, perhaps on passing exams or achieving benchmarks; this could help future affordability
  - — Or have there been any redundancies or cutbacks at work recently?

Management of finances
- How the customer manages their finances: if their bank account is usually in credit, this shows an ability to manage finances; if it is often overdrawn, it might suggest difficulty with financial management

Budget and rate rises
- The customer's budget and their ability to cope with potential rate rises in the future
  - — Particularly relevant where the customer is looking to borrow the maximum available, leaving them with little or no spare income; or where the customer is considering a fixed, capped or discount rate in the initial years because the payments may increase significantly at the end of the initial term
  - — Whether they need to start at the lowest possible cost via a discounted mortgage

Early repayment
- The potential/intention for the customer to make early repayments – partial or total

Term
- The customer's feelings about the term of the mortgage

Protection needs
- Protection needs that will arise when the mortgage is arranged – life cover, critical illness cover, mortgage payment protection and so on (assuming the adviser has the appropriate authorisation to advise on these products)

Attitude to risk
- The customer's attitude to risk in relation to mortgages
  - — Normally takes the form of a risk questionnaire resulting in a risk profile

The information gathered will establish two key factors:

- how much the potential borrower can afford each month; and
- the type of mortgage they would prefer.

Much of the information will be similar to that required on a mortgage application form, although it might not cover as much detail. The better the quality and accuracy of the information gathered at this stage, the greater the chances of a successful mortgage application. In many cases the adviser will approach a lender before submitting an application to establish whether a mortgage is likely to be agreed. If the initial information given to the lender proves to be inaccurate once a formal application is made, the final decision could be different. This would cause distress to the applicant and embarrassment to the adviser.

9.3 Researching the solution

The next stage is for the adviser to identify the most suitable product to meet the customer's needs, preferences and affordability, as identified through the factfind. The adviser must be able to show clearly how the product that is being recommended meets the client's precise needs and objectives. We will look at affordability and suitability in detail in Topics 10, 11 and 12.

CHECK YOUR UNDERSTANDING 1

From your studies in Topic 8, can you recall the three categories of service that a firm may offer to a customer when recommending a product?

9.4 Presenting the recommendation

Having decided on the most appropriate mortgage for the customer, the adviser presents their recommendation.

IN BRIEF

ESIS AND KFI

Remember: an ESIS must be provided for an MCD regulated mortgage, which will represent all new mortgages. A KFI must be provided for a regulated mortgage, which will apply to changes to mortgages originally taken out before 21 March 2016.

Ultimately, the decision to go ahead is the customer's responsibility, but this should be an informed decision, which means the adviser should ask the customer to read the information and then explain the key details, rather than leaving the customer to read it later. The explanations should be in language that the customer can easily understand, without unnecessary use of technical jargon. It is vital that the client fully understands why the product is being recommended and that they are encouraged to ask any questions or express any concerns so that these can be addressed properly.

Once the customer is clear on the technicalities, advantages and potential drawbacks of the mortgage, they can make a decision.

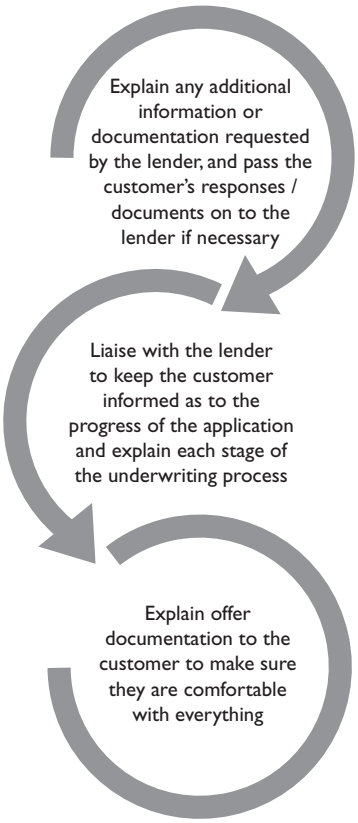
CHECK YOUR UNDERSTANDING 2

In Topic 8, we saw that for an MCD regulated mortgage, the adviser must provide adequate explanations of the recommended product. In addition to providing the ESIS, what does this entail?

9.5 Implementing the recommendation

Once the customer has made the decision, it is the adviser's responsibility to start the application process. Once the application has been completed and submitted to the lender, the lender will take responsibility for underwriting the application. However, the adviser will still have a role in liaising between the customer and the lender, and helping the customer through the process.

FIGURE 9.3 HOW DOES THE ADVISER CONTINUE TO LIAISE WITH THE CUSTOMER?



9.6 Principles of ethical advice

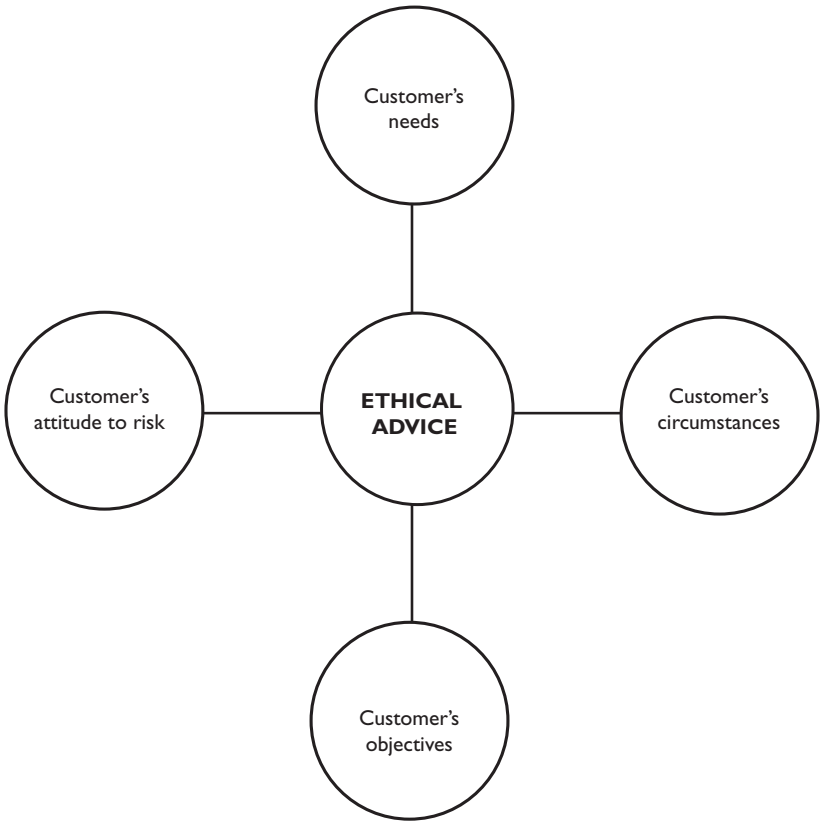
The mortgage adviser has a great deal of responsibility, as their advice will result in the client taking on a long-term commitment. Getting it wrong could cause major problems and distress for the customer, and lead to negative consequences for the adviser. Ethical advice is based on what is best for the customer in view of information known at the time, regardless of the needs of the adviser. For example, the adviser should not be influenced by commission or bonus payments that they might receive for selling certain products.

ETHICS

Conscious decisions taken by individuals and groups based on moral values; distinguishing right from wrong and choosing to do what we believe to be right.

The information the adviser needs to establish is summarised in Figure 9.4. Attitude to risk is an important consideration, as some mortgage products involve a greater element of risk than others. For instance, the uncertainty of how future interest rate movements will affect the monthly payments on a capped or discounted mortgage must be weighed against the certainty provided by a fixed-rate product.

FIGURE 9.4 WHAT DOES THE ADVISER NEED TO ESTABLISH?



It is almost impossible to impose ethical values through legislation and detailed rules; instead, the regulator provides guidelines as to what constitutes ethical behaviour and promotes examples of good practice. The principles of responsible lending are one example. The fair treatment of customers initiative that you studied in UK Financial Regulation is another, and we will revisit it here because it is central to the ethical provision of advice.

9.6.1 Fair treatment of customers

The FCA's fair treatment of customers initiative is a key element of one of its objectives: to secure an appropriate level of protection for consumers.

There are no specific rules relating to fair treatment of customers, although it is implicit in several conduct of business rules and the FCA's regulatory guidance includes The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD). Additionally, the FCA publishes its six outcomes for the fair treatment of customers, forming part of the regulator's core supervisory work with firms. The FCA assesses firms' ability to deliver the six outcomes.

IN BRIEF

FCA PRINCIPLES FOR BUSINESSES

In UK Financial Regulation you looked at the FCA's Principles for Businesses. Seven of the principles are especially relevant to the fair treatment of customers:

Principle 1: A firm must conduct its business with integrity.

Principle 2: A firm must conduct its business with due skill, care and diligence.

Principle 3: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management.

Principle 6: A firm must pay due regard to the interest of its customers, and treat them fairly.

Principle 7: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair and not misleading.

Principle 8: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

Principle 9: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.

CHECK YOUR UNDERSTANDING 3

Think back to your studies for UK Financial Regulation and see if you can remember the six fair treatment of customers outcomes.

Here are some hints:

a) Consumers should be confident of what?

b) Products and services marketed and sold in the retail market must be designed to do what?

c) Before, during and after the point of sale, consumers must be provided with what?

d) Where consumers receive advice, what criteria must be met?

e) How must products perform? What can consumers expect of the associated service?

f) What must firms ensure once a sale has been completed?

FACTFIND

If you would like more information on the regulatory guidance available, RPPDD is provided as part of the FCA Handbook at: https://www.handbook.fca.org.uk/handbook/document/rppd/RPPD_Full_20180103.pdf [Accessed: 5 November 2020].

Further information on the FCA's expectations in relation to fair treatment of customers is available at:

FCA (2018) *Fair treatment of customers* [online]. Available at: https://www.fca.org.uk/firms/fair-treatment-customers [Accessed: 5 November 2020].

9.6.2 What does fair treatment of customers mean practically?

In the process of gathering information and building a picture of the client's personal and financial circumstances, an adviser must bear in mind at all times that they must do what is best for the client.

This could mean that an adviser recommends a product that is entirely different from the one in which the client initially expressed an interest, or that the client thought would be suitable for their circumstances. It may occasionally mean that the adviser advises against a certain product, such as a flexible

or offset mortgage, because they do not feel that the client is sufficiently knowledgeable or sophisticated in financial matters to handle the account in a way that would best serve their needs.

With regard to certain specialist home finance products, such as Islamic home finance, the adviser needs to take into account the motives behind selecting such a product, for example the borrower's beliefs with regard to interest payments and their preferences concerning associated products such as insurance. This consideration must continue with any documentation or communications between the lender or adviser and their clients, taking care that they are consistent with the discussions that have taken place.

If the recommended mortgage is not the firm's cheapest appropriate contract, the firm must explain why the more expensive mortgage has been recommended.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the stages in the advice process?
- outline the areas that need to be discussed as part of the factfind?
- state the fundamental principle that underpins the provision of ethical advice?
- state the six outcomes for the fair treatment of customers?
- explain how fair treatment of customers applies in practice to the advice process?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 9. Review the text if necessary.

Answers can be found at the end of this book.

1) The primary requirement of the advice process is that:

   a) the product recommended should be the best fit to the customer's needs from the range available.

   b) the amount of time the adviser invests in the customer should be reflected in the commission earned.

   c) the customer should be sold the product they ask for.

   d) the recommendation should be suitable for the customer's needs.

2) If a mortgage adviser asks a customer about the age at which they expect to retire, this is most likely to be so that the adviser can:

   a) ascertain whether the type of property the customer is interested in buying is suitable for them.

   b) recommend an appropriate term for the mortgage.

   c) ensure that the customer can afford the repayments from their pension income.

   d) establish whether the customer is good at long-term planning.

3) Why might an adviser want to know about a customer's future career plans or expectations of promotion, as well as their current situation?

4) What are the four key pieces of information that an adviser needs from their customer in order to provide a recommendation that meets the customer's needs?

5) In what section of the FCA Handbook are the rules relating to fair treatment of customers set out?

6) Which of the FCA Principles for Businesses most closely reflects the FCA's objective of securing fair treatment for customers?

TOPIC 10

Assessing the applicant's financial status

LEARNING OBJECTIVES

In Topic 2 we introduced the 'three Ps' of assessing a mortgage application: person, property and purpose. In this topic we are going to look at how an adviser and lender assess the status of the person – in other words, the mortgage applicant.

By the end of this topic you should have an understanding of:

- the personal and financial information required by the lender;
- how income is assessed for employed and self-employed applicants, and for company directors;
- how income figures can be corroborated;
- assessing expenditure.

THINK ...

Before you start work on this topic, take a moment to think about what you already know about assessment of the mortgage customer's status.

For instance:

- What different categories of mortgage customer can you think of?
- What do you already know about responsible lending?
- Why does the lender need to know the number and ages of any dependants in the applicant's household?

10.1 Introduction

Although the principles of lending are common to all institutions, the procedures and documentation that each uses differ widely. The FCA MCOB rules are prescriptive on many aspects of the affordability assessment but lenders still have flexibility in how they interpret information and make decisions.

!

NORMAL MARKET CONDITIONS

A word of caution: much of the detail contained in this topic relates to 'normal' mortgage market conditions, and may at times differ from what actually happens. In times of upheaval each lender will adopt processes that suit their market and needs at the time, which might differ from those described.

The assessment of affordability is the responsibility of the lender or home finance provider, and is subject to the detailed requirements of MCOB 11. The lender must establish and operate a written policy outlining the factors it will take into account in assessing the borrower's ability to repay the mortgage.

However, in most cases it is the adviser who will help the applicant to complete the mortgage application and to provide supporting evidence. MCOB 11A requires an intermediary to submit accurate information obtained from the customer to the lender so that an assessment of affordability can be carried out.

10.2 Gathering information for the application

Once a prospective mortgage customer has decided to go ahead with an application, the next step is to complete the lender's application form. Although there are as many different application forms as lenders, the basic information required is common to all.

WHO COMPLETES THE APPLICATION FORM?

Whether the application form is completed by the applicant or by the mortgage adviser, the applicant should be encouraged to submit correct and unambiguous information that requires minimum effort to corroborate. If the adviser completes the form, the applicant must check it carefully for accuracy. Ultimately the accuracy of information is the applicant's responsibility.

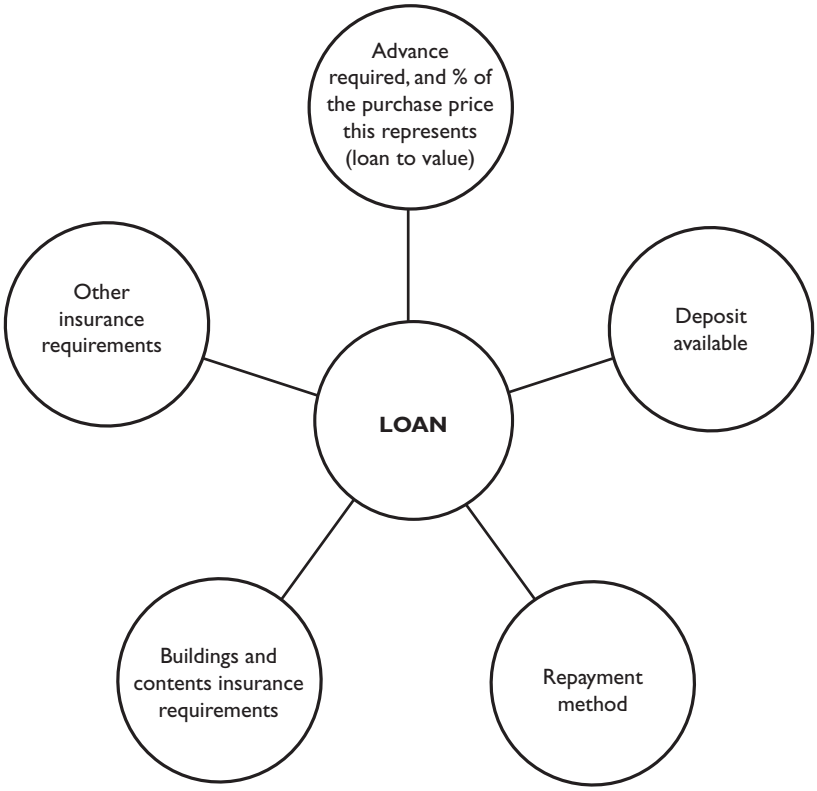
10.2.1 General information

- **Name(s) and address(es) of applicant(s)** – the lender is required by the Proceeds of Crime Act 2002 and money laundering regulations to check the applicant's identity. Generally, at least two pieces of identification are required. If the applicant's address has changed in the last three years, a previous address may also be required. The lender must also find out the

basis on which the applicant is living in their current property – are they renting or living with parents, for example?

- **Nationality and residential status** – it is illegal to discriminate on the grounds of nationality or race, but many lenders specify that mortgage business can only be accepted on normal terms if the borrower is resident in the UK. This is for control purposes – in the event of mortgage loss it can be difficult to sue a non-resident. Most lenders will consider loans to non-residents but with specific conditions attached.
- **Marital (civil) status and number and ages of dependants** – this gives the lender a view of the family unit. If any dependants are aged 17 or over and they are not to be party to the mortgage, they will usually be asked to obtain a 'consent to mortgage' form so that an overriding interest under s70 of the Land Registration Act 1925 is not created (England and Wales only). Overriding interests only apply to those aged 18 or over, but lenders generally collect details of people who are 17 or over to ensure they have details of everyone who will be 18 at the time of completion.
- **Occupation and nature of employment** – permanent, temporary, fixed term, etc.
- **Employer's name and address** – required to confirm income and employment details.
- **Length of time in current employment** – if the applicant has been employed by their current employer for less than (usually) three years, details of the previous employer are required.
- **Income** – the details provided here should separate basic earnings from other forms of income. A person earning £600 per week, for example, may be on a basic salary of one-third of that, with the difference made up of sales-related bonuses and commissions. If bonuses and commissions are to be considered, a conservative view should be taken. Many lenders take an average of non-guaranteed income over a stated number of years (for example, three years) to ensure that the mortgage payments remain affordable if income fluctuates.
- **All regular expenditure**.
- **Information on debts, bankruptcy and court judgments** – most lenders run applicant details through credit checks, and use a credit-scoring system in order to eliminate unsuitable applicants, as well as to indicate the likely degree of risk.

FIGURE 10.1 WHAT DOES THE LENDER NEED TO KNOW ABOUT THE LOAN REQUIRED?



The application form will also ask questions relating to the property to be mortgaged. We will look at this element of the mortgage process in Topic 13.

10.2.2 What is the declaration?

The declaration must be signed and dated by all applicants, and confirms that the information given is correct to the best of their knowledge. It also authorises the lender to make all necessary enquiries relevant to the application and warns the applicant that appropriate action will be taken, including referring the case to the police, if it is believed that information given has been used deliberately to defraud the lender. Although their role is to sell products, an adviser should nonetheless be prepared to make appropriate cautionary comments if they believe that applicants are being less than honest.

FRAUD SENTENCES

Owing to increases in fraud, the courts now take a serious view of offences in relation to loan applications. It is not unusual for prison sentences to be imposed, even for first offences.

10.3 How is borrowing capacity assessed?

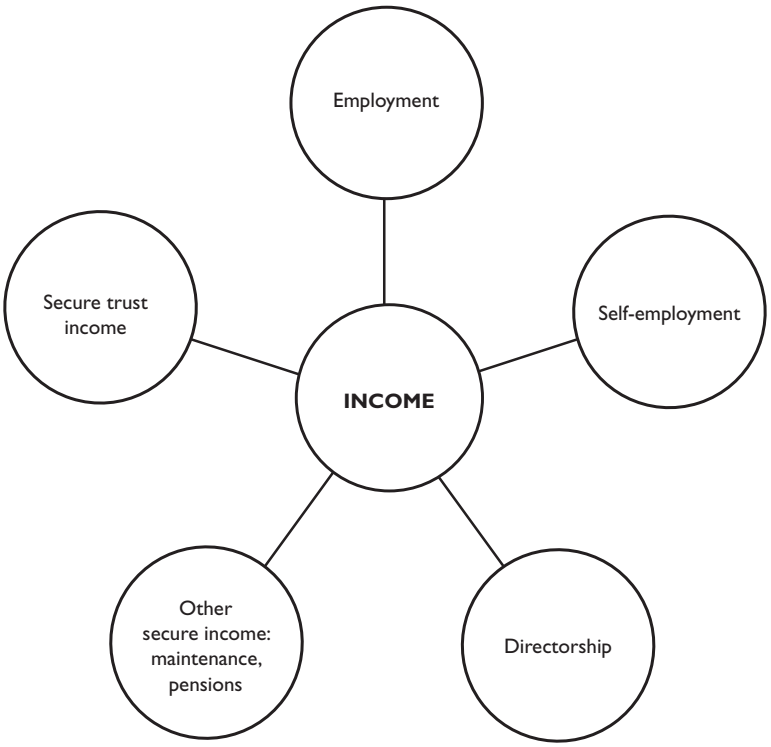
Until relatively recently, lenders normally used income multiples as a guide to the borrowing capacity of applicants, using a multiple of the gross annual income of the main borrower and a smaller multiple of a second borrower (for example, three to four times the income of the higher earner, plus the income or twice the income of the second earner), or a multiple of the borrowers' joint income (for example, three times their joint income).

The FCA has made it clear that, while income multiples may be used as a guide to the maximum borrowing potentially available, a full assessment of affordability should also be carried out as a matter of course. If the lender uses income multiples as an initial guide and the result suggests the proposed borrowing is affordable, it can investigate the applicant's ability to service the mortgage in more detail.

Lenders may be prepared to adopt a flexible approach in certain circumstances. For example, an applicant who is on a professional career path might be considered a good candidate for slightly higher borrowing, because their income is likely to rise in the relatively near future.

Figure 10.2 summarises the main types of income that are taken into account in assessing the applicant's capacity to borrow. In relation to maintenance and child maintenance payments, the lender needs to ensure that the payments are subject to a court order and have a suitable remaining term (such as five years). In sections 10.4–10.6 we will explore income from employment, self-employment and directorships in more detail.

FIGURE 10.2 WHAT TYPES OF INCOME ARE TAKEN INTO ACCOUNT?



10.4 How is income from employment assessed?

Employees receive a basic salary, which can be calculated on an hourly, weekly or monthly basis and, subject to continued employment, relied upon. Many employees also receive additional income, such as:

- car allowance;
- location allowance;
- mortgage subsidy;
- shift allowance;
- overtime;
- commission;
- other sales-related income.

The lender will evaluate the stability and lifespan of additional income and decide how much, if any, to take into account. For example, most lenders will take a percentage of guaranteed overtime into account, or include an element of additional income if it can be shown that it has been regular over a certain period of time.

MCOB rules require lenders to obtain reliable evidence and verification to confirm that the applicant's declared income is correct. Suitable documents for evidencing income include:

- basic salary and guaranteed allowances (as shown on the applicant's latest payslip);
- non-guaranteed income such as overtime and commission (sufficient past payslips to show a regular pattern, eg covering the last three months);
- quarterly bonuses – the lender may require sight of the last three quarterly payslips showing the bonus, or copies of award letters from the employer;
- a self-assessment taxation calculation.

If no suitable documents are available, an employer's reference may be acceptable. Such a reference must be:

- an original (not a photocopy) and written on the business's letterhead;
- dated recently;
- unambiguous in respect of permanence of employment and income.

As it is now easy to produce a reasonably high-quality false reference, lenders must exercise special care, following up to establish authenticity where appropriate. In addition, those who employ staff on a casual basis can

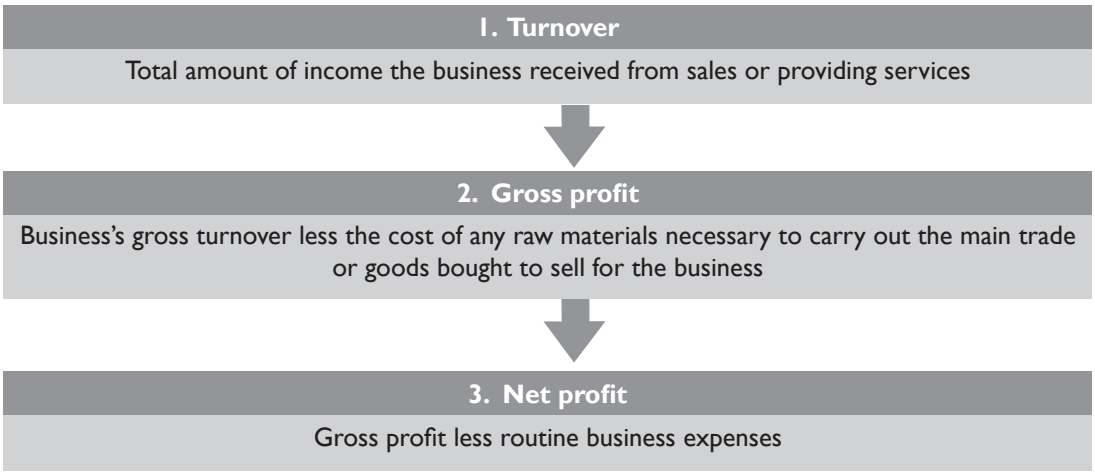
sometimes be encouraged to provide a reference that indicates the applicant's employment is on a more permanent basis than it actually is.

10.5 How is income from self-employment assessed?

The assessment of 'salary' for a sole trader is a little more difficult. Most lenders take the business's net profit as income when assessing affordability, and Figure 10.3 outlines how the net profit figure is arrived at. Lenders will usually want to see evidence of the business earnings for at least two to three years. Some will consider applications from sole traders with a shorter business history but may apply additional criteria.

In the case of self-employed partnerships, each partner is considered to receive an equal share of the business profit unless there is a partnership agreement dividing the profits in other proportions.

FIGURE 10.3 ASSESSING INCOME FROM SELF-EMPLOYMENT



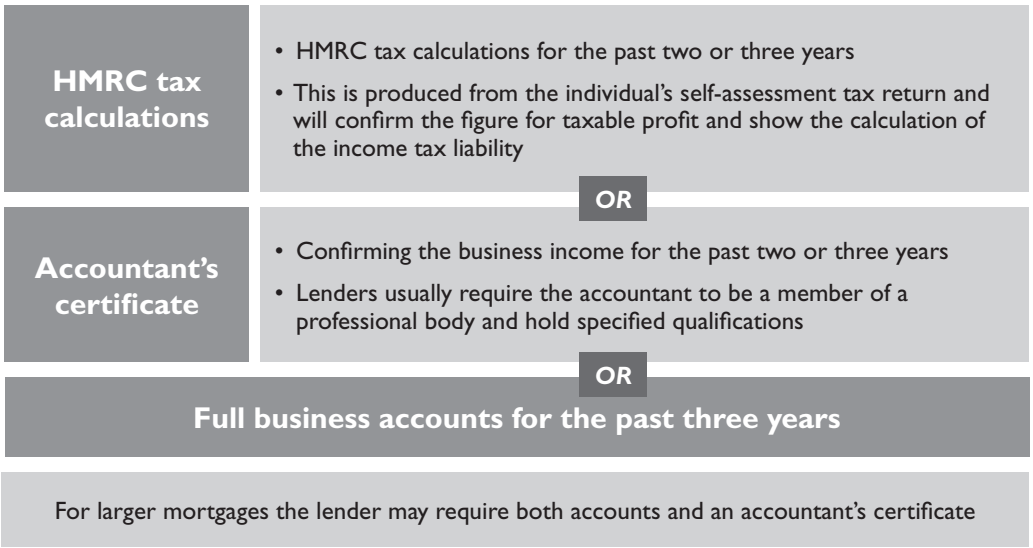
CHECK YOUR UNDERSTANDING 1

Al is a painter and decorator. What do you think would count as deductions to calculate his:

a) gross profit?

b) net profit?

FIGURE 10.4 HOW DO LENDERS CORROBORATE INCOME FROM SELF-EMPLOYMENT?



10.5.1 What information can be gathered from business accounts?

Businesses with turnover below the threshold for making a VAT return do not have to provide detailed accounts for tax purposes – they can complete a 'short' tax return, which requires only statements of total turnover, total allowable business expenses and net profit. Larger businesses are required to provide detailed accounts, itemising expenses in a number of categories.

A full set of accounts will normally comprise:

- a profit and loss account (also known as an income statement);
- a balance sheet (also known as a statement of financial position).

Profit and loss account

The profit and loss account is a record of the business income and expenditure for the trading year, showing figures for gross profit and net profit for that year.

REVIEWING THE PROFIT AND LOSS ACCOUNT

In looking at profit and loss accounts, it is important to identify any unusual items or substantial differences between the accounts for one year and another. For example, the profit and loss account for a particular year may show an expenditure item of £1,000 for bank interest. If the account for the previous year did not include a figure for bank interest, this indicates that a new bank loan has been arranged.

If the accounts were prepared by an accountant, an explanation of this item might have been provided in the form of notes to the accounts. If no such notes are included, the matter may need to be investigated to establish the size of the loan, the repayment term and the monthly repayment.

Balance sheet

While the profit and loss account covers the trading year, the balance sheet is a statement of the business's assets and liabilities at the end of the trading year on one particular day. Assets might include the business premises, vehicles, equipment, debtors and the bank balance. Liabilities include creditors and outstanding bank loans. The balance sheet also includes the balance of the capital account. This gives some indication of the underlying strength of the business.

WHAT IS THE CAPITAL ACCOUNT?

The capital account comprises:

- what remains of any capital that was used to establish the business;
- any further capital injected into the business since it was established;
- any surplus profits from previous trading years.

It also includes a figure for personal drawings: the amount withdrawn from the business during the trading year. Where drawings exceed net profit, comparative figures can be important. If personal drawings have only marginally exceeded net profit in one of, say, three years, there may be a satisfactory explanation. If personal drawings have regularly been much higher than net profit, the lender will need to proceed with caution.

If the applicant is running down the capital account, they will probably have to borrow elsewhere once the balance reaches zero. So, although the net profit for each of the past three years may look reasonable, these figures are misleading and the application may well be declined.

Having examined all this information, the lender must now decide whether to lend and, if so, how much. Although net profit is crucial, the figure for personal drawings is also important. If drawings are more than the net profit, the applicant may be living beyond their means by taking more out of the business than it is making by way of net profit.

10.6 Company directors

Directors of public companies are treated as employees for mortgage application purposes. Where a director of a smaller company owns more than a set percentage of the business shares (20–25 per cent is common), they are likely to be treated in the same way as a self-employed applicant (and in many cases they describe themselves as self-employed). As shareholders they own the company, can control how much they are paid and can decide how profits are distributed. Despite this, they can be (but don't have to be) 'employees' and will receive the same pay documentation as any other employee, such as a payslip and a P60.

One key difference between a sole trader and a director is that a sole trader pays income tax at their highest marginal rates on net profits, regardless of whether they take the money or leave it in the business. A company, on the other hand, pays corporation tax on profits after salaries have been paid to employees (directors).

FACTFIND

Find out the current rate of corporation tax here:

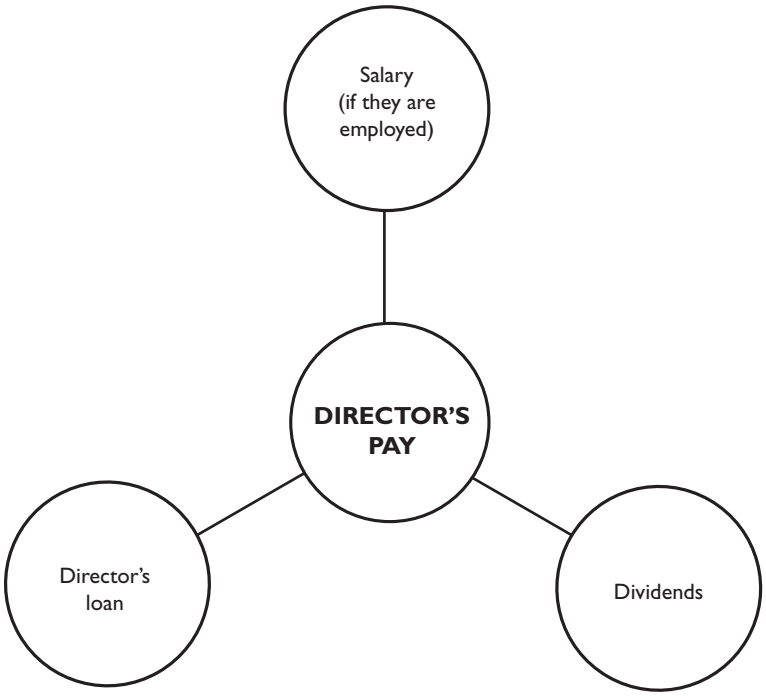
https://www.gov.uk/corporation-tax-rates/rates [Accessed: 5 November 2020].

Many directors arrange their pay so that they receive a small salary, typically just under the limit where they would have to pay National Insurance or income tax, and take a larger amount by way of dividends, typically paid quarterly. In this way a director can receive NIC credits towards the state pension but pay less income tax on their business earnings than a sole trader making the same profit. However, if dividends are paid monthly HMRC is likely to regard them as disguised salary and subject to tax and NIC in the normal way.

Because of how directors arrange their income, it can be more erratic than that of a regular employee and their low basic salary could cause problems substantiating a mortgage. In addition, the company's accounts may be constructed to minimise tax by showing the least amount of taxable net profit, thus not accurately reflecting the company's financial position.

Most lenders will accept salary and dividends as income for a director, and some will also accept the individual's share of retained profits as well.

FIGURE 10.5 WHAT COMPRISES A DIRECTOR'S PAY?



CHECK YOUR UNDERSTANDING 2

From your studies for UK Financial Regulation, can you remember what a dividend is and in what ways the tax treatment is different from that of earned income?

10.6.1 What is a director's capital account?

A director's capital account is a record of money owed to the company by participators and of money owed by the company to participators. This could include capital injected by directors to start the company, unpaid wages, the cost of business items supplied personally by a director, as well as straightforward loans between the company and directors.

10.6.2 What is a director's loan account?

A close company can lend money to or borrow money from a 'participator' in a company, and this is done through a director's loan account, which is part of the capital account.

KEY TERMS

PARTICIPATOR

A person with a share or interest in a company – usually a shareholder, who may also be a director. Also applies to any 'associate' – spouse or civil partner, or relative.

CLOSE COMPANY

A privately owned company controlled by five or fewer individuals; most small and family companies are close companies.

A director's loan account has two aspects:

- when the director is in **credit**, ie the company owes them money; and
- when the director is in **debit**, ie they have borrowed money from the company.

Figure 10.6 outlines the reasons why a participant might be in credit.

FIGURE 10.6 WHY MIGHT A PARTICIPANT BE IN CREDIT?

Injected capital	Property or equipment
When a company is set up, a participant is likely to inject capital into the business to help in the initial stages	When a business owner uses their own property or equipment for a business, they can charge a notional rent, which is added as a credit to the director's loan account
Eg: Gita is setting up her own limited company and has injected £20,000 of her own money	Eg: Gita uses a bedroom in her house as an office for the business, for which a notional rent of £400 a year is appropriate; this is added as a credit to her director's loan account

The benefit of a credit in the director's loan account is that the individual can withdraw the balance as and when they choose, providing the company has the assets to do so, and the withdrawal will be tax-free. Lenders will look favourably at a director's loan account with a high credit balance.

Conversely, a participant may borrow money from a director's loan account. In simple terms the company lends the individual an amount of money in return for repayment of the loan at the end of an agreed term or by a certain date.

If a director's loan is for more than £10,000 it will be treated as a taxable benefit in kind, unless the director is obliged to pay interest at a rate equal to, or above, the official rate for beneficial loan arrangements published by HMRC. The company will be subject to a tax charge on the loan if it is not repaid by the end of the company's accounting year. If it is repaid after that date, the tax will be refunded nine months after the end of the accounting period in which it is repaid.

Looking at the director's loan account when underwriting a mortgage application helps the lender to assess the company's financial position, which is a key factor in the director's ability to service the mortgage.

FACTFIND

If you wish to find out more about directors' loans or the latest official rate for beneficial loan arrangements, go to:

https://www.gov.uk/directors-loans [Accessed: 5 November 2020].

10.7 MCOB 11: Responsible lending

We have looked at the way in which different people earn their living, and how a lender will assess that income for mortgage purposes. It has always been the case that the lender will assess the applicant's ability to afford the mortgage from a business perspective. In the past this has been largely a decision based on the risk to the lender of the borrower not being able to make payments and defaulting. Increased concern about unaffordable levels of debt and the experiences of the first decade of the twenty-first century led the regulator to impose stricter controls on lending. In 2014, the FCA introduced revised rules on how affordability should be assessed, and it is important that we consider these rules and how they impact on the lending decision.

Before entering into the mortgage contract, the lender must be able to show that account has been taken of the borrower's ability to repay the mortgage. It must be able to demonstrate that the borrower (or any guarantor) can make the mortgage payments, and must not enter into the contract unless it can demonstrate affordability.

The information required from the customer must be proportionate and limited to what is needed to carry out the assessment. Equity in the property (loan to value) cannot be used as part of the affordability assessment, although it may form part of the overall mortgage assessment.

RECORD-KEEPING

For each customer, a lender must make an adequate record of the steps it takes to comply with the responsible lending rules. The lender's record should include the information used to make the assessment, in order to provide a rationale for the decision. The records must be in paper or electronic form and kept for the term of the mortgage.

10.7.1 Varying the terms of a regulated mortgage

There are circumstances in which a lender can agree to changes to a regulated mortgage without having to carry out an affordability assessment.

MCOB 11.6

The requirement to assess and prove affordability can be waived if the new arrangement is to vary the terms of, or replace, an existing mortgage with the same lender, either on the original property or a new property, providing that:

- the level of borrowing does not increase the amount outstanding on the mortgage, other than to cover product or arrangement fees for the new contract; and
- there is no change to the terms of the contract that is likely to affect affordability.

MCOB 11.7 Transitional arrangements

There are also transitional arrangements in MCOB 11.7 for borrowers who want to vary the terms of an existing mortgage or take out a new mortgage with the same lender. Although similar to the waiver facility in MCOB 11.6, the rules in MCOB 11.7 also allow an increase in borrowing in certain circumstances. The following must apply in that the:

1) mortgage must be a first charge mortgage in existence before 26 April 2014;
2) borrowing would not increase the amount outstanding on the mortgage other than to cover product or arrangement fees for the new contract;
3) arrangement would be in the customer's best interests;
4) customer has not increased the existing mortgage since 26 April 2014, other than to finance arrangement fees for the mortgage or to pay for the cost of essential repairs or maintenance to the mortgaged property.

The requirement in point 2 (increasing the mortgage) does not apply if all the following conditions are met. The:

- property value would be at risk if essential maintenance or repairs are not carried out;
- funds raised are to be spent on that work;
- lender has credible evidence that the additional borrowing is no more than the cost of the work; and
- mortgage is a non-MCD regulated mortgage contract.

MCOB 11.9 Remortgaging with the same or a different lender with no additional borrowing

In October 2019, the FCA made changes to MCOB 11 rules on the assessment of affordability to cover borrowers who wish to change their mortgage arrangement with their current lender, or to remortgage with another lender. In CP19/14, the FCA (2019):

> "set out [its] concerns that some consumers cannot switch to a more affordable mortgage despite being up to date with their mortgage payments. This includes those who can't switch because of changes to lending practices during and after the 2008 financial crisis and subsequent regulation that tightened lending standards – often called 'mortgage prisoners'."

The new rules enable a lender to apply a more proportionate affordability assessment for consumers who are up to date with their existing mortgage and want to switch to a more affordable mortgage without borrowing more.

- It is the lender's decision whether to implement the new process.
- To apply the relaxation, the lender must have established an internal switching policy that allows customers to move to more affordable arrangements.
- The borrower must have an existing regulated mortgage with the lender or a different lender, and must want to replace the mortgage with a new regulated mortgage on the same property.
- The new mortgage cannot exceed the outstanding amount of the existing mortgage, other than to finance related mortgage and adviser fees.
- There must not have been a payment shortfall at the time of the application or in the previous 12 months.
- The rule only applies where the new arrangement will be more affordable, which is defined as costing less each month than previously.
- The lender is not required to meet the income and expenditure requirements of MCOB 11 if the new arrangement is more affordable, and is not required to assess the effect of future interest rate increases. It is not required to consider the effect of future changes to the borrower's income and expenditure unless the mortgage term will run past their planned retirement date or state pension age.

In the remainder of this topic we will look at various aspects of the responsible lending requirements.

10.8 Income and expenditure

We know that lenders must obtain reliable evidence that the income declared is correct and base the lending decision on that evidence. The lender should also take any known future changes to the customer's income or expenditure into account. If the term of the mortgage will extend beyond the customer's expected retirement date (or state pension age if that date is unknown), the firm should take a prudent approach to assessing income beyond that date. For younger applicants it may simply involve checking that they have some pension provision, whereas for those near to retirement it could require sight of a pension statement to confirm the amount of income they expect to receive.

CHECK YOUR UNDERSTANDING 3

From your studies in Topic 8, can you remember what self-certification is and whether it is permitted?

10.8.1 What is free disposable income?

Affordability must be based on the applicant's free disposable income – the amount left each month after tax, National Insurance and normal expenses.

FIGURE 10.7 WHAT EXPENDITURE MUST BE DEDUCTED TO CALCULATE FREE DISPOSABLE INCOME?

Committed expenditure
Credit agreements and other contractual commitments that will continue after the new mortgage (or variation) is entered into

Basic essential expenditure
Spending to meet basic day-to-day needs, eg food and heating, and to meet non-reducible expenditure (eg council tax, utilities, insurance)

Basic quality-of-life expenditure
Clothing, household and personal items, basic recreation, childcare, etc

Lenders need the actual figures for committed expenditure, but for basic essential and basic quality-of-life expenditure they can use either the borrower's actual figures or statistical or modelled data from organisations such as the Office for National Statistics. Some lenders will use statistical information and then require the applicant to have a certain minimum amount of income left over after the mortgage payments. Other lenders will not allow mortgage payments to be more than a certain percentage of free disposable income – typically in the range of 80 to 85 per cent – based on actual expenses.

HOW MIGHT A LENDER CALCULATE THE FREE DISPOSABLE INCOME REQUIRED?

As an example, a lender might require a borrower to have enough income after the mortgage payments to cover the applicant's actual regular financial commitments such as loan repayments, etc (but not living costs, credit cards, childcare costs, and so on). The lender might then require the borrower to have a standard amount of income after the mortgage payments, based on modelled data about average household expenditure. Examples could be:

- £551 per month for a single applicant;
- £715 per month for two or more applicants;
- an additional £121 per month for each dependant.

So a couple with two children and regular commitments of £100 a month would need £1,057 left over after the mortgage payments.

Lenders have the flexibility to consider income other than earned income – for example, investment and pension income – and the evidence required will vary from customer to customer.

10.8.2 Future interest rate increases

Lenders must assess the impact of potential interest rate increases on the borrower's ability to maintain mortgage payments in the future. The process is known as a 'stress test', and the FCA sets out the requirements in MCOB 11.6.18 (R).

The basic requirements for the lender are as follows:

- Potential increases are based on the interest rate in place at the start of the mortgage and the effect an increase in the Bank of England (BoE) base rate would have on the lender's rate. Where the mortgage rate would increase to the lender's standard variable rate (or another rate), which is referred to as the 'reversion rate', at the end of the product term the lender must use the reversion rate in place when the mortgage starts when applying the interest rate stress test. For example, on a three-year fixed-rate term that reverts to the lender's standard variable rate (SVR) after three years, the lender must use the SVR as the starting point for the interest rate stress test, rather than the fixed rate.

- The lender must consider potential interest rate increases over a minimum period of five years from the start of the mortgage, unless the mortgage is on a fixed rate for at least five years or the mortgage term is less than five years.
- When deciding on the interest rate to use for the stress test, the lender must use an independent and recognised source of information, taking into account market expectations and the latest Financial Policy Committee (FPC) recommendations regarding the assumptions to use.
- The minimum interest rate increase to use is 1 per cent, even if the indicators above (including FPC guidance) suggest a rate below 1 per cent would be appropriate. For example, in the unlikely event that the FPC recommendation was to use an increase of 0.5 per cent, lenders must still use a rate of at least 1 per cent.

EXAMPLE OF THE AFFORDABILITY ASSESSMENT

%

The Academic Building Society is prepared to offer mortgages where the amount left over after mortgage repayments is at least the amount indicated by their statistical model. It assumes expenditure of £600 per month for a couple and £130 extra for each dependant, plus actual financial commitments. The mortgage is at a 3-year fixed rate of 3 per cent, reverting to the lender's SVR of 4.5 per cent at the end of the fixed term.

Grace and George have two children and want to buy a larger house to accommodate their family. Grace has a salary of £25,000, which gives her a net monthly income of £1,650; George earns £6,000 a year part-time, which works out at £500 per month. Their total net income is £2,150. Their assumed expenditure using the building society's model is £600 + £260 = £860 and they have regular financial commitments of £50 a month.

Their free disposable income is £2,150 – £910 = £1,240.

As the mortgage rate is fixed for less than five years, the lender must assume it will revert to the current SVR of 4.5 per cent after three years. It must also assume the SVR rate will increase by at least 3 per cent, giving a calculation rate of 7.5 per cent when assessing affordability. Every £1,000 borrowed at 7.5 per cent will cost £7.48, so we divide their free disposable income of £1,240 by £7.48; £1,240 ÷ £7.48 =165.77. They could borrow £165,770.

EXAMPLE (ASSUMING THE FPC PREVAILING RATE REMAINS AT 3 PER CENT)

John has applied for a 3 per cent fixed rate for three years, at which point the mortgage will revert to the lender's SVR of 4.5 per cent. Market indicators suggest rates will rise by 2 per cent. When applying the interest rate stress test, the lender must assume a rate of 7.5 per cent at the end of the three-year term (SVR of 4.5 per cent + 3 per cent FPC rate).

EXAMPLE (ASSUMING THE FPC PREVAILING RATE IS 0.5 PER CENT)

Jill has applied for a 3 per cent fixed rate for three years, at which point the mortgage will revert to the lender's SVR of 4.5 per cent. Market indicators suggest rates will rise by 0.5 per cent. When applying the interest rate stress test, the lender must assume a rate of 5.5 per cent at the end of the three-year term (SVR of 4.5 per cent + 1 per cent absolute minimum increase).

10.9 Debt consolidation

Where the mortgage is for debt consolidation, the firm must also take into account:

- the costs incurred by increasing the term of the debt repayment;
- whether it is appropriate to secure previously unsecured debts;
- if the customer is known to have payment difficulties, whether negotiating an arrangement with their creditors would be more appropriate than consolidating through a mortgage.

Where the purpose of the mortgage or further advance is to consolidate debts and the borrower is a credit-impaired customer, the lender must take extra care. If the increased mortgage would not be affordable unless the other debts were paid off, the lender must take 'reasonable steps' to ensure that the debts are repaid on completion of the mortgage transaction. 'Reasonable steps' could include the lender paying off the debt on behalf of the customer. Alternatively, the lender can assume the debts would not be paid off, and include ongoing payments as committed expenditure in the affordability assessment.

WHAT IS A CREDIT-IMPAIRED CUSTOMER?

A credit-impaired customer is one who:

- within the last two years has owed the equivalent of three months' payments on a mortgage or other loan, unless late payment was the result of errors by a bank or other third party; or
- within the last three years has had one or more county court judgments, totalling more than £500; or
- has had an individual voluntary arrangement or bankruptcy order in force within the last three years.

10.10 Interest-only mortgages

The Mortgage Market Review identified concerns that too many borrowers took out interest-only mortgages as a way of cutting monthly expenditure, without arranging adequate repayment vehicles. This can lead to problems repaying the capital at the end of the mortgage term. As a result, the MCOB rules address interest-only mortgages in two parts of the sourcebook. We will look at the requirements for interest-only mortgages in detail in Topic 12.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the general information required in a mortgage application?
- summarise the information the lender needs to know about the proposed loan?
- list the documents that may be acceptable as proof of an employee's income and explain what may be acceptable if such documents are not available?
- explain how a lender might be able to corroborate an applicant's income from self-employment?
- describe the elements of a director's income that might be considered as part of an application?
- list the expenditure that must be deducted in order to establish free disposable income?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

FCA (2019) *Changes to mortgage responsible lending rules and guidance – feedback on CP19/14 and final rules* [pdf]. Available at: https://www.fca.org.uk/publication/policy/ps19-27.pdf [Accessed: 5 November 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 10. Review the text if necessary.

Answers can be found at the end of this book.

1) Surinder and Kuldip are both applying for mortgages on houses in the UK. Surinder has just got a new job in Northampton and is moving there; Kuldip is buying a house there too for his family but he is working overseas on a long-term contract. The lender cannot treat Kuldip's application differently from Surinder's just because he is not currently living in the UK. True or false?

2) Last week Sam contacted her bank's mortgage adviser about applying for a mortgage, and the adviser told her that she and her partner could probably afford to borrow £180,000, which is three times their joint income. A friend who works in a building society has now told Sam that the bank is no longer allowed to assess her application on the basis of an income multiple. Should Sam be concerned about the way the bank dealt with her enquiry?

3) A lender may take account of sales-related income in assessing a borrower's ability to repay a loan. True or false?

4) All sole traders must provide a detailed breakdown of their business expenditure on their tax return. True or false?

5) Which of the following would **not** be an acceptable reason for a lender to waive affordability checks when varying the terms of a regulated mortgage started in 2013?

   a) A further advance is required for essential maintenance to the structure of the property.

   b) The borrower has requested a new 2.99 per cent fixed-rate loan on expiry of their current 3.30 per cent fixed-rate loan.

   c) A further advance is required for home improvements.

   d) Borrowing would be increased to cover the cost of the arrangement fee.

6) A water bill is an example of:

   a) committed expenditure.

   b) basic essential expenditure.

c) basic quality-of-life expenditure.

d) cost of living expenditure.

7) Karen is applying for a mortgage but is struggling to provide exact expenditure figures. For which of the following elements of Karen's expenditure could the lender **not** use figures from the Office for National Statistics instead?

a) Personal loan repayments.

b) Spending on food.

c) Spending on entertainment.

d) Electricity bill.

8) Andreas, who has been self-employed for 18 months, wants to buy a house but is concerned that his track record in self-employment is not long enough for him to be offered a mortgage. A friend has advised him to apply for a self-certified mortgage. Do you think this would be an appropriate solution for Andreas?

9) Rebecca and Rachel want to buy their first house. They have joint net income of £2,800 a month. They have committed expenditure of £400 a month, basic essential expenditure of £800 a month and basic quality-of-life expenditure of £600 a month. Their lender has calculated that their desired five-year fixed-rate mortgage product would cost £5.90 a month for each £1,000 borrowed. What is the maximum mortgage the lender is likely to offer?

10) To comply with MCOB 11, lenders must retain documents that provide a rationale for the decisions taken on mortgage applications:

a) in hard copy for five years after the mortgage application is granted.

b) in hard copy or electronic form for seven years after the mortgage application is granted.

c) in hard copy or electronic form for the length of the mortgage contract.

d) in electronic form indefinitely.

Checking the applicant's credit status

LEARNING OBJECTIVES

We looked in Topic 10 at the main ways that lenders can assess whether an applicant can afford the proposed mortgage, and the ways in which they can verify an applicant's income. Before making a mortgage offer, the lender will also need to be satisfied that the applicant is not hiding any debts or past credit problems that would affect their application. It is also important that the lender ensures, as far as possible, that the application is genuine and not an attempt at fraud or money laundering.

By the end of this topic, you should have an understanding of:

- how lenders assess an applicant's credit status;
- how and why lenders use credit searches;
- credit scoring;
- the role of guarantors;
- credit problems and their implications for borrowers and lenders;
- mortgage fraud and the measures lenders can take to combat it;
- references and the requirements of data protection legislation;
- anti-money-laundering requirements.

THINK . . .

Before you start work, take a moment to think about what you already know about the content of this topic.

For instance:

- What sorts of factor affect an applicant's credit score?
- How does being subject to a bankruptcy order or IVA affect an individual's access to credit?

- What information about themselves do individuals have the right to access under data protection legislation?
- What laws are in place to try to prevent money laundering?

11.1 What is credit assessment?

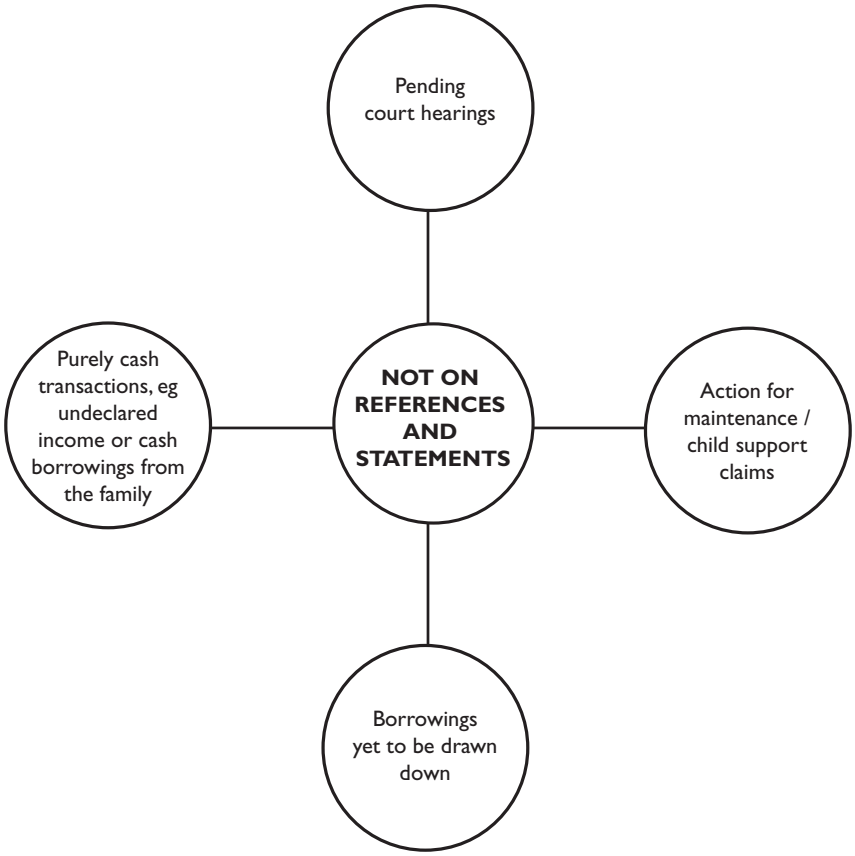
Although lenders can take references from a number of sources, including employers, lenders and landlords, financial statements are also useful as they can provide a good indication of track record and lifestyle.

Bank statements may appear to give a favourable impression of the applicant – but the adviser and lender should check that the applicant does not have bank accounts with other institutions that are being deliberately concealed. Figure 11.1 indicates some key points that the lender should look for, while Figure 11.2 highlights some important information that does not show up in financial statements.

FIGURE 11.1 WHAT SHOULD THE LENDER LOOK FOR IN FINANCIAL STATEMENTS?

Bottom line balance on bank statements	Whether there is a surplus or a deficit or there are fluctuations, and the reasons
Regular income	Compare this with information on the application form and employer's reference
Regular payments out	Compare this with information on the application form
Overdrafts	Amount, frequency and reasons
Fees and charges	Referral fees, etc
Returned cheques / failed direct debits	Frequency and amounts involved
Maintenance payments	Continuous or irregular
Mortgage statements	Regularity of payments, outstanding arrears, fees and charges and whether information is consistent with that on the mortgage application form

FIGURE 11.2 INFORMATION NOT REVEALED BY REFERENCES AND STATEMENTS



11.1.1 Credit searches

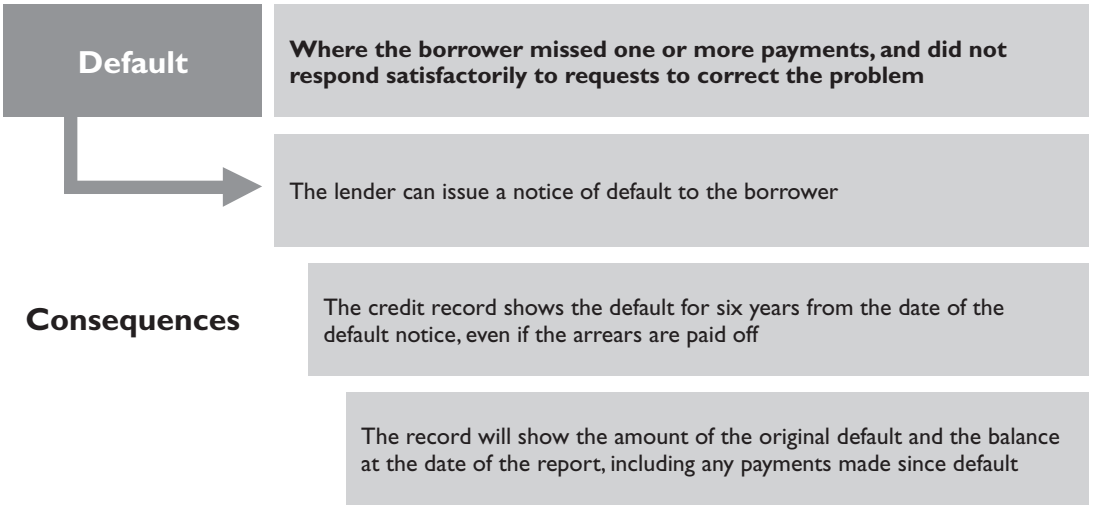
Credit searches are an integral part of the credit assessment process. The starting point is to establish whether the person applying for the mortgage is permanently resident at the address given in the application form. This can be confirmed by checking the electoral roll, although the roll is not totally up to date at all times. It tends to be amended once a year, using 1 October as a cut-off date. If a person has moved recently, the lender will cross-refer to the immediate previous address given on the application form. In a minority of cases, there will be no record on the electoral roll – for example, a family moving back to the UK after living and working abroad – and in this case the lender must simply use whatever evidence can be obtained.

CREDIT BUREAU

An organisation with a vast database of information on individuals, relating to previous bad debts and default, county/sheriff court judgments and insolvency.

Credit reference searches can be made through credit bureaux (ie credit reference agencies) such as Experian, Equifax and TransUnion, which store and maintain financial and public records of people who have received credit. Credit references provide an insight into the activities and credit problems of specific individuals based on historical information. A credit search could show a 'default' (see Figure 11.3).

FIGURE 11.3 WHAT IS DEFAULT?



Lenders will be wary of agreeing to provide a mortgage for someone who has defaulted and, if they do agree to an advance, may charge a higher interest rate. If the default happened some time ago, was satisfactorily resolved and the applicant has had a good track record since, the lender is likely to be more sympathetic and may agree to a mortgage on standard terms.

11.1.2 Payday loans

Current or previous payday loans may affect a lender's attitude towards agreeing to a mortgage. Using payday loans may be seen as an indication that the applicant is not able to manage their finances effectively, as they tend to be used as last-resort borrowing.

The lender may see the need to take out a payday loan as an indication that the applicant cannot budget effectively or may have a regular income shortfall.

PAYDAY LOAN

Short term, very high interest unsecured lending designed to be paid off on the borrower's next payday.

Due to the short duration of payday loans, they may not show up on all credit searches. However, lenders tend to use multiple data searches as part of the due diligence process for assessing the applicant, some of which may show payday loans taken out in the previous six years.

11.1.3 Credit scoring

Almost all lending institutions use credit scoring as an integral feature of the assessment process. Scores are given to certain aspects of the application, based on historical data relating to risk. In simple terms, a certain number of points are then allocated in each category so that, once the points for each category are added up, the total score reflects the credit score. Applications that receive more than a certain score (often known as the cut-off score) are accepted, while those that do not are declined.

The lender will consider specific factors such as:

- age;
- income;
- occupation;
- existing commitments;
- credit searches;
- conduct of any existing bank or loan accounts with the lender.

In addition, the credit score will consider more general factors that, from experience, are considered important in assessing risk (Figure 11.4).

FIGURE 11.4 WHAT GENERAL FACTORS DOES THE CREDIT SCORE CONSIDER?

Does the applicant have experience of managing credit?	Has the applicant shown poor debt management in the past?
Assuming an existing mortgage holder has had no problems, they tend to be scored higher than first-time buyers, who have no mortgage track record	If the applicant makes only minimum payments on a credit card balance, this could show problems with debt and could reduce the score
Applicants who have never applied for any form of credit before may receive a low score	If the applicant has applied for multiple credit cards or loans, this could indicate poor debt management

Critics of credit scoring suggest that it removes the 'human element' from lending but, although there is some truth in this, a good system is able to incorporate override features to enable discretion. Many lenders' systems will allow for scrutiny of 'borderline' applications – those that achieve a score

within a certain number of points of the cut-off point. Such applications can be referred to a supervisor or lending officer for review.

Credit-scoring models are not static: they have to change with the changing environment and lenders keep them under constant review to ensure they are robust. In addition, it is important to recognise the following points.

- There is no single scoring model. Different organisations have different lending policies and scoring systems – some will be happy to entertain a higher risk profile, compensating for the risk with higher interest rates. Others will have a policy of maintaining the lowest interest rates they can to keep their competitive edge, and will be keen to screen out all but the most creditworthy borrowers.
- Credit scoring is no more than a statistical tool. It cannot predict what will actually happen with an individual case – all it can do is highlight the probability that a particular proposition will do well or badly. As such, it can help lenders to screen out applicants where there is a high likelihood of default and thus manage their risk exposure.
- Credit scoring evolves over time as lenders learn from experience and refine their techniques. Some criteria can be shown to be consistently useful: for example, employment status and length of employment, income, credit history, home ownership status and length of time in current residence.

Credit scoring is best applied when:

- the institution has a well-developed database on its existing mortgage book;
- it is built into a mortgage processing system;
- dealing with high volumes of business, ie reasonable statistical sample size;
- lending policy is well defined.

Many advisers recommend that applicants check their credit score before making an application, using services provided by organisations such as Experian, Credit Karma and Equifax. Many people have accounts with such organisations that allow them to make regular checks on their own credit score.

11.2 What is the role of a guarantor?

Sometimes lenders feel that a borrower may be able to afford a slightly higher mortgage than they would normally offer, but are reluctant to lend the higher amount without additional security over and above the property. They require something more – and that something may be the support of a guarantor.

A guarantor makes a guarantee, which is defined under the Statute of Frauds Act 1677 as a written undertaking to answer for the debt, default or miscarriage of others. Typically, guarantees are taken from parents on behalf of their child's borrowing. Frequently, the directors of a company are asked to give personal guarantees to secure a loan made to the company because a loan made to a company is enforceable only against the company, not its shareholders and not normally against the directors. Undertaking to guarantee the loan ensures the support of the directors in making sure the company meets its obligations.

KEY TERMS

GUARANTEE

A formal agreement to accept legal responsibility for the repayment of a loan if the borrower cannot, or will not, repay it themselves.

GUARANTOR

An individual, a company or a partnership that provides a guarantee. Also known as a surety.

FIGURE 11.5 WHAT ARE THE TWO TYPES OF MORTGAGE GUARANTEE?

Full liability

- The guarantor is liable for the entire debt if the borrower defaults on the mortgage payments.
- The guarantor must usually be able to demonstrate that they can afford at least 100% of the mortgage, in addition to their own existing commitments.

Limited liability

- The liability is limited to the difference between the loan the lender would normally agree and the loan needed, with a possible additional percentage of perhaps 10%.
  - Eg: if the property was purchased for £200,000, the borrower had a £20,000 deposit and the lender would normally lend £150,000 based on the borrower's income, the guarantee would be for £30,000 plus 10% of the borrower's shortfall, totalling £33,000.
- The liability is shown as a percentage of the mortgage.

A lender must exercise great care in how it takes guarantees. On the one hand, it will want to be sure that it does all it legally can to ensure the guarantor pays; on the other, it must be careful to prevent the guarantor from being legitimately able to avoid their obligations.

A major risk to guard against is the guarantor arguing that the guarantee is invalid because they did not receive adequate explanation of the terms or that undue pressure made them sign it. Lenders should always advise prospective

guarantors to seek independent legal advice before agreeing to act as a guarantor.

Steps should be taken to ensure that prospective guarantors understand what they are taking on, including the amount they are guaranteeing. Unlimited guarantees are not permitted.

TABLE 11.1 WHAT ISSUES CAN RENDER A GUARANTEE INVALID?

Issue	Description
Lack of capacity to contract	Such as where the guarantor is a minor with no legal capacity to contract, or where the guarantor is a company with no powers to give guarantees
Undue influence	Where one party is dominant over another and can persuade them to do something they probably would not otherwise do This may simply be by virtue of the nature of the relationship between the guarantor and the borrower Examples of relationships where it might be possible to demonstrate undue influence include husband and wife, parent and child, doctor and patient, or solicitor and client
Misrepresentation	Where the terms of the guarantee were misrepresented to the prospective guarantor – whether because of negligence, fraud or accident
Misapprehension	Where the prospective guarantor is under an incorrect impression about the nature and effect of the guarantee and it is fundamentally different from what they had agreed If the lender becomes aware of this, it has a duty to correct the misapprehension or it may find itself liable for misrepresentation
Mistake	Where the guarantor can show that they have not understood the nature of the document being signed
Duress	Where the guarantor has been forced, perhaps by way of physical threats, to sign the guarantee document

KEY LEGAL CASES

In *Barclays Bank plc v O'Brien* [1994], the plaintiff, Mrs O'Brien, was able to prove that the guarantee she gave to support her husband's borrowing was invalid due to misrepresentation and undue influence, and that she had not been advised to seek truly independent advice.

It is now an established feature of lending practice that prospective guarantors are advised to seek independent legal advice before agreeing to act in that capacity.

In *Lloyds Bank v Waterhouse* [1991], the defendant, who was illiterate, signed a guarantee for his son, after first contacting the bank to check what he was being asked to sign. The bank told him he was signing a limited guarantee but it was in fact unlimited and left the defendant liable for all his son's debts. The bank's claim to enforce the guarantee was rejected by the court because the bank had given the defendant incorrect information when he sought to clarify the terms of the guarantee.

IN BRIEF

KEY FACTS ABOUT GUARANTEES

- The lender has the right to enforce the guarantee should the borrower default on repayment.
- The borrower has no duty to disclose information to the guarantor unless the guarantor asks for specific information.
- The guarantor does not have an interest in the property on which they are guaranteeing the mortgage and does not have the right to inspect mortgage documentation or be informed of mortgage payments missed. In many cases the first the guarantor will hear of a problem is when the lender demands payment.
- The guarantor must be informed if the mortgage holder requests a further advance or an extension of the term, and can refuse their consent.
- The guarantor can make a request to be released from the guarantee, but the lender will only usually agree to this if it is felt that the borrower will be able to manage the mortgage without danger to the lender. In many cases, the lender will simply refuse to release a guarantor.

The updated MCOB rules require lenders to assess whether the guarantor could afford to take on the payments should the guarantee be called upon. MCOB 11.6, which deals with responsible lending, states that "references to the customer must be read as referring also to any guarantor of the customer's obligations under the regulated mortgage contract, where the context permits". In essence, the lender must make the same checks on the guarantor as they would on the applicant.

As you will see in Unit 6 (Topic 24), several lenders now offer 'guarantor' mortgages, where a parent or other relative acts as guarantor for their relative's mortgage. With many of these mortgages, the guarantor is required to deposit a sum of money into a savings account with the lender. Although it earns interest, the money cannot be withdrawn until the end of an agreed period and can be used by the lender during that period to offset any losses if the borrower defaults.

JOINT BORROWER, SOLE PROPRIETOR

Some lenders offer a joint borrower, sole proprietor mortgage, where the property is purchased in the sole name of the buyer but a family member agrees to be a joint borrower, and their income (less commitments) is taken into account when assessing affordability. As joint borrower they are jointly and severally liable for the mortgage, but they have no rights over the property. This avoids two potential SDLT problems if a property-owning family member becomes joint owner and joint borrower:

- Becoming joint owner would result in the SDLT surcharge on the purchase.
- If one owner was already a property owner, the first-time buyer SDLT exemption would not apply to the purchase.

However, the joint borrower should fully understand the potential risks in being liable for the mortgage without any rights over the property.

11.3 Insolvency and debt problems

Most people manage to meet the terms of their credit agreements. However, some borrowers find themselves in a position where they default on credit, either through misfortune or through bad financial management. Insolvency occurs when:

- a person's liabilities exceed their assets; or

- they cannot meet their financial obligations when they fall due.

When it becomes clear that they will not be able to meet their obligations, there are a number of legal processes that can be used to address the problem.

11.3.1 County/sheriff court judgments

In England and Wales, when a person is unable to pay their creditor(s), the creditor(s) can bring a civil case to the county court. The court can make a county court judgment (CCJ) against the debtor, setting out how the debt should be repaid. This will normally be as a lump sum or by regular instalments. If the terms of the judgment are not met, the creditor can go back to court for further action, which may result in an 'attachment of earnings' order. This means that the individual's employer must deduct a certain amount from their pay and pass it on to the court for onward payment to the creditor. Attachment of earnings orders can only be made against employees.

CCJs are listed on the Register of Judgments, Orders and Fines for England and Wales. They stay on the register for six years, unless they are paid in full within a month of the judgment. If they are paid after one month, they are shown as satisfied on the register. CCJs that have not been paid are shown as 'unsatisfied' for the six-year period. The credit reports used by lenders take information from the register, so such reports will also show the CCJ for six years unless it was satisfied within a month.

SHERIFF COURT JUDGMENTS

Cases are brought to the sheriff court in Scotland, with the judgments held on a register of sheriff court judgments. Awards for debts are known as 'money decrees'. As with the process in England and Wales, the record is held for six years from the date of the judgment.

CONCEALMENT OF CCJS

A mortgage application form always requires details of CCJs or sheriff court judgments and it is a criminal offence to knowingly conceal them from a prospective lender.

Although CCJs do not rule out the ability to get a mortgage, they have to be considered within the context of the application as a whole. A person who has been unable or unprepared to meet obligations in the past may be regarded as less reliable in the future. However, some lenders are prepared to consider

'high risk' clients with a poor track record – several charge high rates of interest and impose onerous conditions for late payment.

11.3.2 Bankruptcy

Bankruptcy is a formal process for dealing with personal insolvency. Even if a potential borrower does not declare that they are or have been bankrupt, it will be revealed by credit searches.

CHECK YOUR UNDERSTANDING 1

We looked at bankruptcy in Topic 2. See what you can remember.

a) How much must a creditor be owed in order to petition for a debtor's bankruptcy?

b) For how long does a bankruptcy order remain in force?

c) What restrictions are there on a bankrupt individual's ability to borrow?

If the bankrupt is the sole owner of a property with at least £1,000 equity in it, the property will transfer to the trustee in bankruptcy, who becomes the legal owner and can sell it to settle debts. A bankruptcy restriction notice is entered at the Land Registry against a property. This shows that the bankrupt is no longer the legal owner of the property and cannot sell or deal with matters relating to the property; only the trustee can do so.

EQUITY

The difference between a property's sale price and any expenses such as the mortgage settlement figure and conveyancing fees.

Situations sometimes arise where a couple own a property, and one of them is bankrupt but the other is not. The following applies:

- The bankrupt's interest in the property does not pass to the trustee in bankruptcy.
- The trustee in bankruptcy can apply for a possession order and sell the property if the bankrupt's interest in the property (share of the equity) is £1,000 or more.
- The trustee enters a Form J restriction at the Land Registry. It records the trustee's interest in the property, and requires the Land Registry to notify the trustee of any dealings relating to the property. The restriction remains in place until the trustee's interest in the property has been settled. The restriction does not stop the bankrupt and the joint owner selling the property, but the restriction will not be lifted until the trustee has been paid.

- Where the bankrupt's interest exceeds £1,000, the forced sale of the mortgaged property can be delayed for at least one year to allow the family to make alternative arrangements.
- The joint owner can 'buy out' the bankrupt's interest in the property from the trustee in bankruptcy.
- If the property is the bankrupt's main residence, the trustee has three years from the date of the bankruptcy order to decide whether to sell the property to pay the debts. If no action has been taken by that deadline, the property reverts to the bankrupt. If the property is not the bankrupt's main residence, the trustee has no deadline by which to take action.

WHAT ARE THE DIFFERENCES BETWEEN BANKRUPTCY AND SEQUESTRATION?

The formal term for bankruptcy in Scotland is 'sequestration'. The differences are as follows:

- The debtor can apply to the court for a sequestration order for a minimum debt of £3,000.
- One or more creditors can apply for a sequestration order for a minimum debt of £3,000.

The debtor must be 'apparently insolvent' – or unable to pay their debts.

On the grant of a sequestration order, the debtor's assets are transferred to a trustee to be sold, with any money raised going to the creditors.

THE BANKRUPTCY (SCOTLAND) ACT

The Scottish government responded to concerns that the sequestration process in Scotland was complicated and confusing, with various pieces of legislation having built up over many years. The Bankruptcy (Scotland) Act came into force on 30 November 2016, and applies to all applications from that date. It is referred to as a 'consolidation' act because, although it does not make any significant changes to the basic bankruptcy law as such, it consolidates more than six previous pieces of legislation into one logically presented act, the purpose of which is to set out the process in one place and make it easier for those working in bankruptcy to follow the process for bankruptcy applications.

11.3.3 Individual voluntary arrangements

An individual voluntary arrangement (IVA) is an alternative to bankruptcy, supervised by an insolvency practitioner. If the arrangement is agreed, the creditors accept a reduced payment, for example 60p for every £1 owed.

CHECK YOUR UNDERSTANDING 2

Is an individual legally prevented from taking out a mortgage if they are subject to an IVA? Think back to your studies in Topic 2.

A creditors' meeting must be held for an IVA to be arranged, and creditors representing at least 75 per cent of the debt amount must agree to the IVA. For example, if the debt is £100,000, creditors owed at least £75,000 in total must agree to the IVA. Once the agreement is confirmed, interest and charges on the debts are frozen and the debtor makes fixed monthly payments towards the debts, as set out in the agreement.

Those subject to IVAs are considered by all lenders to be a poor credit risk, although in a minority of instances a mortgage may be a solution to the overall problem.

WHAT IS A PROTECTED TRUST DEED?

A protected trust deed in Scotland is similar to an IVA. The key points are as follows:

- The arrangement is made through an insolvency practitioner (known as the trustee).
- The debtor may be required to sell certain assets to help repay the debts.
- The debtor cannot take out any further credit during the term of the agreement.
- The arrangement lasts for four years, at which point the creditors write off the debts, assuming all the terms of the agreement have been met.
- The trustee must advertise the proposal in the *Edinburgh Gazette* and write to the creditors advising that the debtor wants to arrange a protected trust deed.
- Creditors have five weeks from publication of the notice to object.
- The trust deed takes automatic effect if no more than 33 per cent of creditors by value object.

11.3.4 Company voluntary arrangements

Company voluntary arrangements (CVAs) are the equivalent of IVAs for limited companies, and are subject to the same conditions as an IVA. A company or limited liability partnership can apply for a CVA if all the directors or partners agree.

11.3.5 Debt relief orders

Debt relief orders (DROs) are intended to help those living in England and Wales who are struggling to pay their debts, and who:

- owe a maximum of £20,000;
- have total gross assets not exceeding £1,000 plus a car worth less than £1,000;
- have disposable monthly income (after tax, NICs and normal household expenses) of no more than £50.

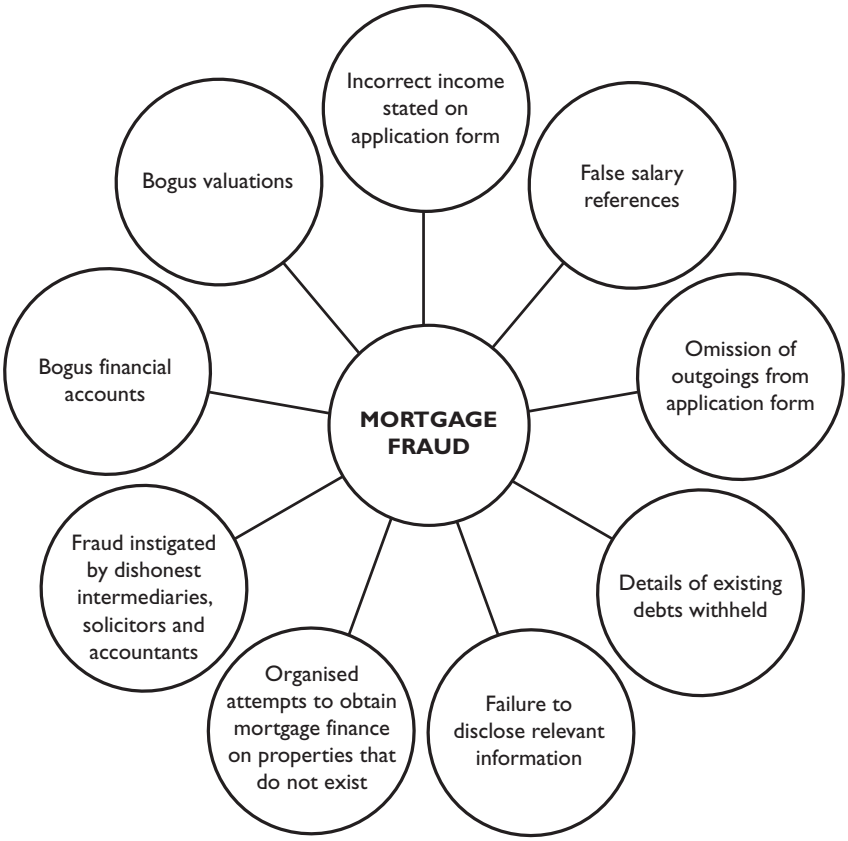
If a DRO is granted, the creditors listed in the order are subject to a 'moratorium' on debts owed to them, usually lasting for 12 months, during which they cannot seek repayment or enforcement of debts owed to them. At the end of the moratorium, assuming the debtor has met the terms of the DRO, the debts are written off and they are discharged.

An individual with a DRO is very unlikely to be in a financial position to take out a mortgage, and lenders would be reluctant to lend to such an individual.

11.4 Fraud

Fraud occurs when a person deliberately sets out to obtain funds from another person or organisation by dishonest means. In recent years, the incidence of mortgage fraud has increased significantly. The extent of the crime may vary from a simple overstatement of income to highly organised and systematic professional fraud attempts. Figure 11.6 provides some examples.

FIGURE 11.6 WHAT IS MORTGAGE FRAUD?



Advisers also have to be aware of fraud that can arise in respect of:

- money laundering;
- life assurance;
- household and other general insurance.

Fraud costs the financial sector millions of pounds each year. It is therefore a major area of concern to individual lenders and trade bodies such as UK Finance.

Measures that can be taken to combat fraud include:

- a rigorous approach to corroboration of income and outgoings, with written confirmation and telephone follow-up where necessary;
- special attention to applications from sole traders and partnerships to ensure that information supplied is signed off by a qualified and reputable accountant, where possible, and double-checking details with bodies such as HMRC where appropriate;
- lenders dealing only with reputable intermediaries;
- engaging in ongoing dialogue on fraud prevention measures with bodies such as the Building Societies Association, UK Finance, the Law Society of

England and Wales, the Law Society of Scotland and the main accountancy bodies;

- use of credit bureaux checks for all applications;
- use of other searches, such as the Companies Registry for corporate applications;
- only using solicitors, valuers and other professional advisers with a known track record;
- having proper systems of audit, control and inspection;
- adopting a strong approach to detection of fraud, referring cases to the police authorities as necessary;
- carrying out audits of adviser files to check consistency of information.

The Fraud Act 2006 includes the offences of false representation and failing to disclose information where there may be a legal duty to disclose the information, as in a mortgage application. Fraud occurs whether or not the mortgage is actually granted. The value of a mortgage gained in this way will be regarded as proceeds of crime under the Proceeds of Crime Act 2002, and the borrower will be regarded as having committed a money-laundering offence. Sentences depend on the severity of the offence, ranging from community service orders through to large fines and/or prison sentences.

11.5 Reference checks and data protection legislation

During the application process references may be taken on the individual applicant, on the partners in the case of a partnership, and on the directors where the applicant is a company.

Data protection legislation exists to protect the rights of individuals where information is held about them. The term 'data' includes both facts and expressions of opinion about people – so the statement 'we consider this individual to be creditworthy', in response to a credit reference request, would be covered under the legislation.

The Data Protection Act 2018 superseded the 1998 Act on 25 May 2018, enacting the EU General Data Protection Regulation (GDPR). The GDPR strengthened existing data protection rules and applies to firms offering goods or services to EU citizens.

CHECK YOUR UNDERSTANDING 3

You studied the requirements of data protection legislation in UK Financial Regulation. Refer back to your UK Financial Regulation study text if you would like to refresh your memory.

11.6 Anti-money-laundering regulations

Money laundering is covered by the Proceeds of Crime Act 2002 and the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, strengthened by 2019 amendments. Firms are able to structure their controls and procedures to reflect the specific risks they face, drawing guidance from the Joint Money Laundering Steering Group's guidance notes.

CHECK YOUR UNDERSTANDING 4

You studied money-laundering prevention in UK Financial Regulation. How much can you remember?

a) What are the three principal money-laundering offences?

b) Can you name two other offences in relation to money laundering that are particularly relevant to advisers?

c) What is the Joint Money Laundering Steering Group?

Taking out a mortgage may not appear the most obvious route for a money launderer: after all, lenders go to some lengths to confirm the identity of applicants for credit purposes. Money raised through a mortgage might be expected to remain tied up for a considerable length of time and there is a common perception that accounts used for laundering purposes are highly transactional in nature and have a large volume of turnover.

The anti-money-laundering provisions do, however, apply to mortgage business as much as they do to other financial products and services. As part of customer due diligence procedures, financial services providers must take specific initial steps to ensure that they obtain evidence of a client's identity. They also require evidence of the source of any funds deposited with them, which might include, for example, the deposit on a property being bought.

CUSTOMER DUE DILIGENCE

The regulatory term for the process of verifying a customer and their identity.

Firms must understand the purpose of the customer's relationship with them, and collect sufficient information to form a complete picture of the risk associated with the business relationship and provide a basis for subsequent monitoring.

The firm should also ensure that its staff are alert to any use of accounts that does not fit the expected pattern, and understand that they must report this to the lender's designated money laundering reporting officer. Not every unusual or unexpected transaction is evidence of crime: there may be a reasonable explanation arising out of a customer's changing circumstances. However, staff must remain alert to the possibility and take appropriate action whenever they have concerns.

The definition of satisfactory evidence of identity can be vague. It must be reasonably capable of establishing that the applicant is the person that they claim to be to the satisfaction of the person who obtains the evidence. Acceptable forms of identification include:

- current passport;
- driving licence with photograph;
- entry on electoral roll;
- recent utility bill or council tax bill in the customer's name;
- credit card statements accompanied by the credit card.

Documents such as mobile phone bills are not acceptable forms of ID.

WHEN CAN A LENDER ACCEPT AN ADVISER'S ASSURANCE OF CUSTOMER IDENTITY?

If a financial intermediary (such as a mortgage adviser) or other authorised firm introduces a customer to a lender, the lender can accept the introducer's written assurance that they have obtained sufficient evidence of identity.

11.6.1 Financial exclusion

Financial exclusion describes the situation in which people are unable to access financial services because they are unable to produce the type of identity document required (for example, people who do not have a passport or driving licence, or whose name does not appear on utility bills). In such circumstances, a firm may accept as evidence of identification a letter or statement from a person in a position of responsibility (such as a solicitor, doctor or minister of religion) who knows the client.

RECORD-KEEPING FOR MONEY-LAUNDERING PREVENTION

Institutions must keep appropriate records for use as evidence in any investigation into money laundering. This means that:

- evidence of identification must be retained until at least five years after the relationship with the customer has ended;
- supporting evidence of transactions (originals or copies admissible in court proceedings) must be retained until at least five years after the transaction was executed.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- list the issues that a lender should consider carefully when reviewing a prospective borrower's financial statements?
- explain some advantages and drawbacks of using credit scoring?
- describe the role of the guarantor and potential pitfalls that the lender needs to consider?
- explain the different ways in which an individual's insolvency might be addressed?
- outline examples of mortgage fraud and steps that can be taken to prevent fraud and money laundering?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 11. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following could not be identified by reviewing a prospective borrower's financial statements?

   a) Whether the borrower regularly exceeds their overdraft limit.

   b) Whether the borrower regularly receives income in cash.

   c) Whether the borrower's regular income is as stated on their mortgage application.

   d) The borrower's ability to manage their financial affairs soundly.

2) Which of the following is most likely to receive a good credit score?

   a) Ranbir, who has a personal loan and a mortgage and no record of missed payments.

   b) Joleena, who has never had a credit card, loan or mortgage.

   c) Barry, who has seven credit cards and has just applied for another one.

   d) Debbie, who has applied for payday loans twice in the past year.

3) An individual who assumes full liability as a guarantor for a mortgage loan must be in a position to repay 100 per cent of the outstanding loan if the borrower defaults. True or false?

4) Which of the following is most likely to invalidate a guarantee?

   a) The guarantor writing to the lender requesting to be released from the guarantee.

   b) The guarantor losing their job.

   c) The lender failing to advise the guarantor that the borrower had missed several repayments.

   d) The guarantor having experienced an episode of mental illness at the time of signing the guarantee.

5) A sole trader who fails to make payments under a CCJ may be issued with an attachment of earnings order. True or false?

6) What is the effect of a trustee in bankruptcy filing a 'Form J restriction' with the Land Registry in relation to a bankrupt's property?

   a) It prevents the owners from selling the property.

   b) It permits the trustee in bankruptcy to sell the property without recourse to the owners.

   c) It requires the Land Registry to note the trustee's interest in the property and notify the trustee of any dealings relating to it.

   d) It restricts the owner's right of entry to the property.

7) When completing a mortgage application, making false statements or providing false information is only a crime if the application leads to a mortgage being granted. True or false?

8) An expression of opinion as to an applicant's creditworthiness is not regarded as personal data under data protection legislation. True or false?

9) Which of the following would potentially be regarded as mortgage fraud?

   a) Omitting information from the mortgage application about repayments due on a loan from a friend.

   b) Including a variable annual bonus in the figure for regular income on the application.

   c) Stating a purchase price 10 per cent more than the agreed price.

   d) Submitting a mortgage application while under notice of redundancy without mentioning the fact.

10) In relation to anti-money-laundering requirements, for how long must evidence of a customer's identity be retained?

TOPIC 12

Suitability

LEARNING OBJECTIVES

In Topic 9 we looked at the factfind and the information that the adviser requires. The factfind helps the adviser to understand not only the client's financial position but also their needs and attitudes – for example, their attitude towards risk. Drawing on this information, the adviser can formulate a suitable recommendation.

By the end of this topic you should have an understanding of:

- the key issues that an adviser must consider in determining the suitability of a recommendation, including:
  - the mortgage term;
  - the approach to repayment;
  - the importance of the customer's attitude to risk;
- the factors to consider in relation to interest-only mortgages.

THINK ...

We have looked briefly at suitability requirements in earlier topics. Think about the following questions to focus your thoughts.

- What should the adviser do if there is no product in the range they offer that precisely meets the customer's needs?
- Should an adviser always provide the customer with the product they ask for?
- What information needs to be gathered at the factfind stage?

12.1 What does an adviser need to consider in assessing suitability?

With advised sales, a firm must take steps to ensure that any personal recommendations are suitable for the client. The adviser gathers information

about the customer that will help them to assess which mortgage, if any, is suitable for the customer's needs and circumstances. For each issue summarised in Table 12.1, the FCA requires firms to assess appropriateness for the customer.

TABLE 12.1 ASSESSING SUITABILITY OF A RECOMMENDATION

Does the customer ...	Considerations
Meet the lender's eligibility criteria?	Income, loan-to-value ratio, etc
Require a repayment or interest-only mortgage, or a combination of the two?	
Have a preference for a particular mortgage term?	
Have a preference or need for stability of monthly payments (fixed or capped)?	What are the customer's views on changes in interest rates – do they need certainty of payment amounts in order to budget? In some cases, the most suitable product in terms of stable payments might be subject to terms and conditions that discourage early repayment or switching to another lender – the customer needs to be aware of these
Have a preference or need for minimised initial payments?	Is a discount or low-start mortgage appropriate?
Intend to make early repayments?	Does the product allow early repayments without penalty? If there are penalties, the customer must be satisfied that they are outweighed by the benefits of the mortgage
Have a preference or need for any other mortgage features?	Are features such as payment holidays, overpayments, etc, an important consideration?
Have a credit record that suggests the mortgage is appropriate?	
Need to pay any fees or charges up front, rather than have them added to the mortgage?	

CHECK YOUR UNDERSTANDING 1

In Topic 10, you covered three points that the adviser should consider if the purpose of the mortgage is to consolidate debts. Can you recall what they are?

If there is no contract suitable for the customer's needs and circumstances within the range available to the firm, it should not make a recommendation. It is not acceptable to recommend the closest fit from those available. A good example is where the adviser is a sub-prime specialist, only offering mortgage products designed for those with poor credit records. If a customer with a good credit record asks for advice, the adviser must not recommend a sub-prime mortgage. The one exception is if the adviser can demonstrate that the costs, terms and conditions of the contract will not disadvantage the customer when compared with suitable standard mortgages.

12.2 What must be considered in relation to the mortgage term?

The mortgage term is an important part of the suitability assessment. In general terms, any mortgage should be arranged over the shortest feasible term that suits the borrower's needs. People generally dislike debt and would like to be mortgage-free at the earliest opportunity. Key considerations are as follows:

- The effect the payments will have on the borrower's monthly budget. For example, a short term may not leave the borrower much room in their monthly budget. They might prefer a slightly longer term that creates a bigger cushion between income and outgoings.
- The age at which the customer would like to have repaid the mortgage.
- Whether the customer feels there is a possibility of paying off the loan early – if there is, mortgages with early repayment penalties should be avoided.
- If the mortgage term takes the customer near or into retirement, will there be sufficient income to maintain the repayments?
- While settling the mortgage as early as possible is important, is the customer aware that shorter terms require higher monthly payments, either on a repayment basis or to the investment vehicle running alongside an interest-only loan? In many cases, a customer may want a shorter term, but a longer term will allow higher borrowing. For example, monthly repayments on a £100,000 repayment mortgage at 3.8 per cent would be £522 over 25 years and £602 over 20 years. To put it another way, using the same interest rate, someone with a monthly budget of £602 could increase their maximum borrowing to £115,000 by opting for a 25-year term. The number

of first-time buyers opting for terms in excess of 25 years has increased, mainly due to affordability issues.

CHECK YOUR UNDERSTANDING 2

Think back to Topic 10. If the term of the mortgage will extend beyond the customer's expected retirement date (or state pension age if that date is unknown), what should the adviser consider?

12.3 Why is considering risk important?

We don't usually associate mortgages with risk in the same way as investments. However, mortgage risk is a factor that must be taken seriously. In mortgage terms, risk encompasses a number of issues.

- **Risk to the home** – the home is at risk if the borrower fails to keep up repayments on the mortgage.
- **Negative equity** – borrowing a high percentage of the property's value presents the risk of negative equity if prices go down.
- **Repayment risk** – those who do not wish to run the risk of the mortgage not being repaid at, or by, the end of the term should be advised to select a repayment mortgage rather than interest-only.
- **Interest-rate risk** – rates can increase, making the repayments higher. Any increase in the size of the repayments may place pressure on the customer's ability to keep up repayments. Depending on their attitude to risk, a fixed or capped rate may suit them.
- **Fixed-rate risk** – if the customer takes out a fixed-rate mortgage, there is a risk that variable rates may fall below the fixed rate. This will mean the customer is paying more than someone on the variable rate; they must be aware of this risk and satisfied that the benefit of the fixed rate outweighs the risk.
- **Rate rises at the end of a fixed or discount term** – there is the risk that variable rates may have risen significantly by the end of a fixed rate or discount term. How would the customer cope in this situation?
- **Underperformance of investment vehicle** – there is a risk that an investment vehicle running alongside an interest-only mortgage may not perform to expectations. Is the customer aware of this risk and the consequences of such underperformance? Do they have other resources that might be used to repay the mortgage in that situation?

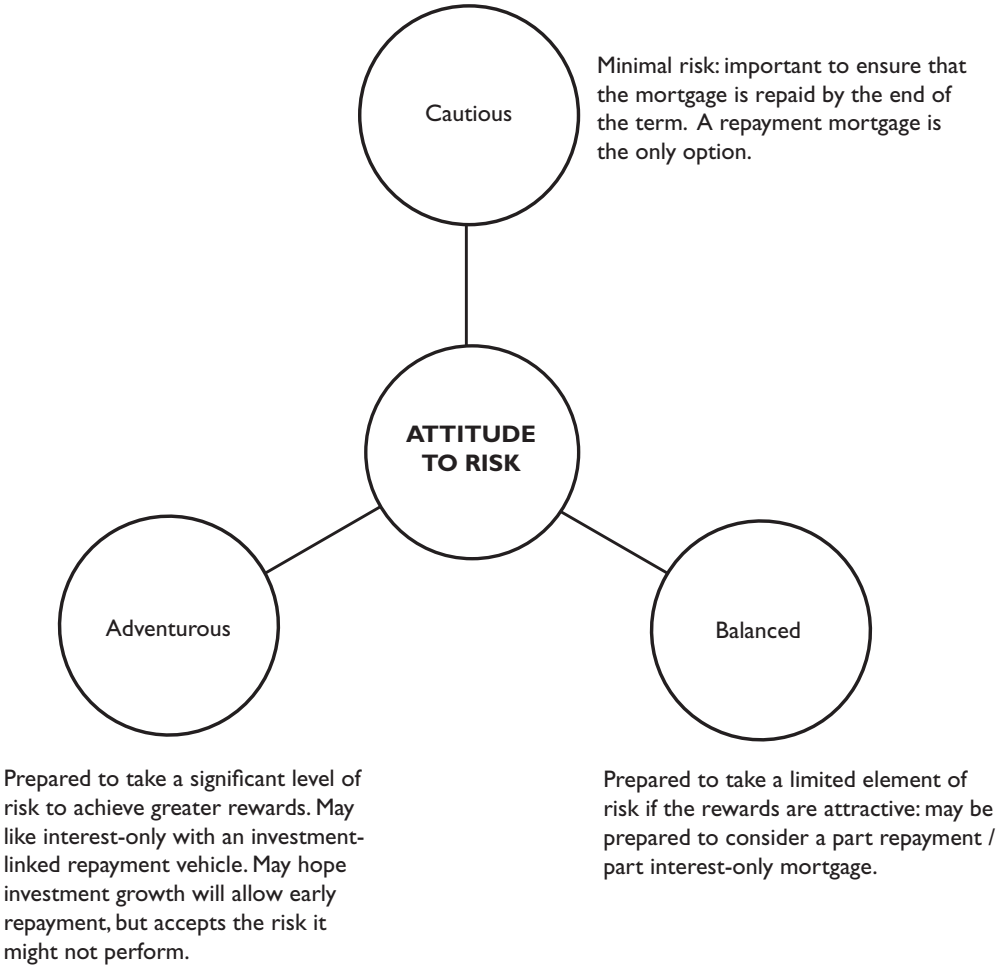
The two main issues to consider in this context are the customer's attitude to:

- the risk of not being able to repay the mortgage; and

- the risk posed by interest-rate changes.

Figure 12.1 illustrates an approach to categorising customers in terms of their attitude to repayment risk, but note that different lenders will categorise customers in different ways or may use more categories.

FIGURE 12.1 CUSTOMER RISK CATEGORIES FOR MORTGAGE REPAYMENT



In terms of interest rates, is the customer concerned about the impact an interest-rate rise would have on their payments? Do they wish to have certainty of payments for a specified period? Do they feel they have spare capacity to afford interest-rate increases? If they want to keep costs low initially (eg via a discount mortgage), how do they feel about the risk that their payments could go up significantly after a specified period?

The FCA has sought to limit the risk posed by interest-rate rises by establishing the interest-rate 'stress test', which lenders must use when assessing affordability, taking into account FCA rules and current Financial Policy Committee recommendations.

CHECK YOUR UNDERSTANDING 3

We looked at the interest rate stress test in Topic 10. Can you remember:

a) the minimum period over which lenders must consider the impact on affordability of potential interest-rate increases?

b) what the calculations of potential interest-rate increases are based on?

12.3.1 How is the customer's attitude to risk assessed?

There are many ways to assess a customer's attitude to risk, and each organisation will have its own procedures. Historically, advisers tended to conclude the process by asking the client to indicate their attitude to risk as a number on a scale. However, this is very subjective and reliant on the quality of the questions, the adviser's explanations and the client's understanding of the process and the questions.

Prompted by increasing concern from the FCA, most advisers now use a more formal approach involving a questionnaire. However, it is important that the adviser does not rely solely on the outcome of a questionnaire; they should ensure the client understands the questions and their implications, and then use the answers in conjunction with their own knowledge and experience in assessing risk, always ensuring that there are meaningful conversations with the client.

Some lenders use psychometric profiling, whereby the adviser uses software tools to assess the client's psychological attitude to risk in general. Psychometrics assesses the client's knowledge, experience, attitudes and personality rather than considering the risk they are prepared to take. The tests are validated statistically by using a large sample of the population. The questions will consider a number of aspects of the client's approach, including:

- their own feelings on their attitude to, and tolerance of, risk;
- past financial decisions they have made;
- how they would feel and react in a number of 'what if' financial scenarios containing positive and negative outcomes;
- how they would feel about a number of hypothetical events and outcomes in relation to their finances.

12.4 How do the suitability requirements affect interest-only mortgages?

IN BRIEF

WHY DID INTEREST-ONLY MORTGAGES BECOME A PROBLEM?

Many borrowers, particularly in the late 1980s through to the early 2000s, took out interest-only mortgages to cut monthly expenditure but did not arrange adequate repayment vehicles. Sometimes the problem was compounded because borrowers could use the interest-only approach to obtain a larger mortgage than they could afford with a repayment mortgage, but with little prospect of repaying it at the end of the term.

Many borrowers did not realise that this was a high-risk approach to mortgage repayment until they received warning letters explaining that their repayment vehicle was unlikely to produce enough to repay the mortgage; or until those who had no repayment vehicle found they had inadequate resources to repay the loan at the end of the term.

In response to the problems experienced by borrowers with interest-only mortgages, MCOB 4.7a and MCOB 11.6 require lenders to make sure the customer demonstrates that they have arranged a clearly understood and 'credible' repayment strategy, which the lender has assessed at the time as having the potential to repay the capital at the end of the term. The lender is not required to provide advice on that strategy, and MCOB is not prescriptive about what is meant by a 'credible' strategy (although MCOB 11.6 does provide some examples of strategies likely to be acceptable or unacceptable – see Table 12.2).

MCOB 11 requires the lender to assess affordability on a capital-and-interest basis unless there is a clearly understood and credible alternative source of capital repayment. In other words, an interest-only mortgage without a viable repayment vehicle is assessed in the same way as a repayment mortgage, and will not enable the borrower to obtain a larger mortgage. If there is a repayment vehicle to support the mortgage, its cost must be included in the affordability assessment as committed expenditure.

For interest-only mortgages other than lifetime mortgages, retirement interest-only mortgages and bridging loans, the lender must carry out a review at least once during the mortgage term (MCOB 11.6.49). The review checks that the customer's repayment strategy is still in place, and that it still has the potential to repay the mortgage at the end of the term. The review must be carried out at a stage in the mortgage term where there is still time for the customer to take remedial action if the strategy is shown to be failing. If the

review identifies a problem, the lender must take reasonable steps to discuss potential remedial action with the customer.

The FCA introduced a new regulatory category of interest-only mortgage with effect from 23 March 2018. The retirement interest-only mortgage is available to those over a certain age (not specified by the FCA) who wish (or need) to extend their mortgage into retirement, but are not seeking a lifetime mortgage. Interest payments are made in the same way as a standard interest-only mortgage, but the mortgage would only be repaid on the borrower's (or surviving borrower's) death, move into residential care or sale of the property. Normal affordability checks are required, including income in retirement, but the lender can assess the mortgage affordability on an interest-only basis without a repayment vehicle or strategy because, unlike a standard interest-only mortgage, sale of the property would be an acceptable repayment strategy.

TABLE 12.2 ACCEPTABLE AND UNACCEPTABLE REPAYMENT STRATEGIES

Potentially acceptable strategies	Strategies likely to contravene the rules
Regular deposits into a savings or investment product	Expectation that the value of the mortgaged property will increase sufficiently over the mortgage term to enable the customer to sell the property and repay the mortgage
Periodic repayment of capital from irregular sources of income (such as bonuses or some sources of self-employment income)	Intention to use an expected, but uncertain, inheritance to repay the mortgage
Sale of assets such as another property or other land owned by the customer	Sale of the mortgaged property, where it is the customer's main residence (unless the lender has considered whether it will have the potential to provide enough for the customer to repay the mortgage and allow them to buy another property to live in or execute another strategy)
The sale of the property for a shared equity or retirement interest-only mortgage	

RECORD-KEEPING: INTEREST-ONLY MORTGAGES

The lender must keep records of each interest-only mortgage for the term of the mortgage contract. The record should include:

- the reasons for the decision to offer an interest-only mortgage;
- evidence of the customer's repayment strategy and, where applicable, its cost;
- details of the firm's attempts to contact the customer for reviews;
- the outcome of each review.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the general considerations for an adviser when assessing suitability?
- list the key issues to consider in relation to the mortgage term?
- explain what the adviser should do if the borrower is nearing retirement age?
- outline the types of risk that relate to mortgage products?
- describe how a customer's attitude to risk could be assessed?
- give examples of potentially suitable repayment strategies for an interest-only mortgage?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 12. Review the text if necessary.

Answers can be found at the end of this book.

1) If there is no contract suitable for the customer's needs and circumstances within the range available to the firm, it should not make a recommendation. True or false?

2) John is 55 and is seeking a 20-year repayment mortgage. The lender's affordability assessment must only take into account his financial position at the time of the application. True or false?

3) Duncan is keen to accrue as little interest as possible on his mortgage and is pressing the adviser to arrange as short a term as possible. Of what should the adviser make him aware?

4) It is not necessary to establish the customer's attitude to risk when advising on mortgages because there is no investment exposure. True or false?

5) Which of the following would be most likely to be considered a credible repayment strategy for an interest-only mortgage?

   a) Planning to use a promised inheritance from a relative.

   b) Relying on the increase in value of the property to provide equity that can be released to pay off the loan.

   c) Using the proceeds from the sale of another property owned by the borrower.

   d) Using a pension commencement lump sum to pay off the loan.

6) For an interest-only mortgage, how often must the lender carry out a review of the borrower's repayment strategy?

   a) At least once during the term.

   b) Whenever the borrower requests it.

   c) At least once every five years.

   d) Halfway through the term.

TOPIC 13

Assessing the property

LEARNING OBJECTIVES

We've looked at how a lender assesses the status of the borrower in terms of their ability to maintain mortgage payments and repay the mortgage. This topic looks at the other side of a mortgage application – the assessment of the property as security for the mortgage.

As we saw in Unit 3, a legal charge (the mortgage) gives the lender certain rights over the property during the term of the mortgage. One of the main rights is the right to seek possession and sell the property to settle the balance of the mortgage if the borrower defaults. The lender will need to be confident that, in the event of repossession and sale, the proceeds will be sufficient to settle the debt.

By the end of this topic, you should have an understanding of:

- basic information about the property that the lender requires;
- issues that may affect the value of the property as security including:
  - title;
  - form of tenure;
  - location;
  - type, age, condition and construction;
  - insurance considerations;
- assessing yields on buy-to-let property.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know. What issues will the lender need to be aware of in order to assess the property's value as security?

For instance:

- what does the lender need to know about the legal ownership of the property (the 'title')?

- how might the existence of easements and covenants affect the value of the property?
- what are the different forms of tenure and what issues might arise in relation to these?

13.1 What basic information is required?

The lender will take a number of factors into consideration when assessing the property as security, and will also carry out or commission a valuation, during which the property details given on the application are checked. We will look at valuations and surveys in Topic 14.

Table 13.1 sets out the basic information about a property that the lender requires as part of the application process. This information should be available as part of the sales particulars from the estate agent, or from the vendor if no agent is involved.

TABLE 13.1 WHAT INFORMATION DOES THE LENDER REQUIRE?

Details required	Notes
Address or plot number and location	
Purchase price	
Type of property	House, bungalow, terraced/semi-detached/ detached, method of construction, etc
Tenure of property	Freehold, leasehold (and years unexpired) or commonhold
Number and type of rooms and accommodation	(Often recorded by 'ticking the box')
Whether vacant possession is available	Extremely important because the presence of tenants radically affects the market value (unless the proposition is buy to let)
Alterations proposed	Details, costs, how they will be funded
Proposed use of the property	Residential, business, mixed, etc

Name of the builder and whether the builder is a member of the National House Building Council (NHBC) or a similar protection scheme	Applies to new builds and those less than ten years old
Inspection arrangements for self-builds	Details of how the standards and quality of work will be confirmed at each stage if the builder is not an NHBC member. The following might be acceptable to the lender: ▪ appropriate structural warranty inspector ▪ suitably qualified building professional with appropriate insurance cover, eg architect, architectural technologist or structural engineer
Expected rental amount (for BTL property)	

WHAT HAPPENS IF THERE IS A SITTING TENANT?

With an assured shorthold tenancy (AST), the tenancy agreement sets out a fixed period for the tenancy, usually 12 months. A BTL landlord can regain possession at the end of the agreement, so most BTL lenders will offer mortgages where an AST is in place.

Although rare, some residential properties are sold with a sitting tenant: someone with a tenancy agreement that is not classed as an AST and is protected by law. In these cases it is more difficult to remove the tenant, who will devalue the property. Most buyers will want vacant possession, which means that they will have unrestricted use of the property and no sitting tenants. Few mortgage lenders will lend on properties with a protected sitting tenant because the occupant could gain an overriding interest in the property.

13.2 What are the legal title requirements?

The vendor must have title to the property in order to sell. If it is in dispute, or there are defects in the title, the property may be worth less – it may even be unsaleable.

CHECK YOUR UNDERSTANDING 1

We looked at the different classes of title in Topic 5. Try to **match** the classes of title to the descriptions given below.

Title class	Description
Absolute	Title subject to defect in registration. Very rare.
Good leasehold	Clear title is established – the most secure form.
Possessory	Applies in connection with leases longer than seven years. The leasehold is good but the right of the lessor (freeholder) themselves to grant title may not be guaranteed.
Adverse possession (unregistered land)	Applies if land has been occupied for 12 years without challenge from the legal owner – at this point the occupier may apply for possessory title.
Adverse possession (registered land)	The owner is registered as the owner but is not protected from a claim by another person that they owned the land before it was registered.
Qualified	Applies where the land has been occupied for 10 years without objection from the registered owner.

13.3 How might disputes affect the property's value?

As part of the due diligence process, the conveyancer will enquire about any disputes between the vendor and their neighbours or other parties connected (or claiming to be connected) to the property. Failure of the vendor to disclose a dispute could lead to legal action if the purchaser is later affected by it. In some circumstances the nature of the dispute could threaten the value of the property or lead to the transaction falling through. Examples would include disputes over:

- boundaries;
- trees or hedges;
- access;
- noise.

13.4 Are there any problems relating to freehold tenure?

Freehold tenure means that the owner is largely free from the restrictions and obligations that could apply to leasehold property. Thus this form of tenure will not usually have a negative impact on the property value. However, the value of freehold property might be affected by the existence of easements and covenants – for instance, a property with a right of way through its garden is likely to be valued lower than a similar property without such an easement. A flying freehold can also have an adverse impact on the value of a property.

Freehold flats present particular difficulties, as we saw in Topic 4. For example, there is no clear responsibility for certain areas in the building – damage to the ceiling of one flat may also involve the floor of the flat above it, but it may not be obvious who is responsible for repair. For this reason many lenders will not provide mortgages for freehold flats.

CHECK YOUR UNDERSTANDING 2

a) From your studies for Topic 5, can you recall the difference between an easement and a covenant?

b) From your studies for Topic 4, can you recall what a flying freehold is and why can it cause problems?

13.5 Are there any problems with leasehold tenure?

There are a number of issues that could affect the value of a leasehold property:

- The lease may contain restrictions or obligations that a buyer might find unreasonable.
- The length of the remaining lease term is crucial, and properties on long leases sell at significantly higher prices than those on short leases.
- Lenders are usually cautious about lending on former local authority flats, with typical concerns including the type of estate where the property is situated, the type of construction (particularly concrete), the height of the building (tower blocks), access and proposed developments, the proportion of flats that are now privately owned and maintenance of the building. Many lenders will not lend on former local authority flats in high-rise blocks.

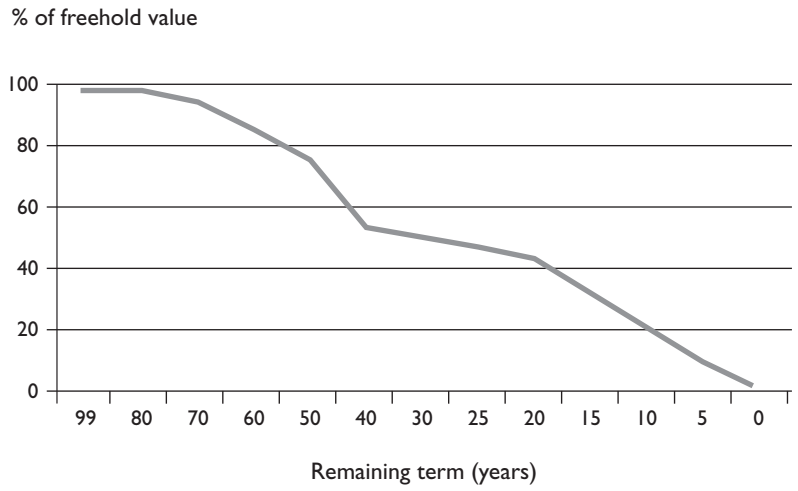
CHECK YOUR UNDERSTANDING 3

We looked at leasehold in Topic 4. When someone buys a leasehold property, what are they actually buying?

13.5.1 Is the term of the lease significant?

A lease has a defined term and is, therefore, a diminishing asset. A number of organisations produce 'graphs of relativity' relating to leasehold property. In simple terms, these show the value of a lease as a percentage of the freehold value of a flat as the lease term decreases. In 2009 the Royal Institution of Chartered Surveyors (RICS) used statistics from a number of organisations to show how the value of a leasehold flat reduced in relation to the value of the freehold over the term of a 99-year lease. Figure 13.1 indicates the reduction in value of a leasehold property in Greater London and England as calculated by one of the contributing organisations to the RICS research. (Note that this is the most authoritative and complete study carried out to date, and more recent, smaller studies do not show any marked change from the general pattern.)

FIGURE 13.1 REDUCTION IN VALUE OF LEASEHOLD PROPERTY IN GREATER LONDON AND ENGLAND



Source: RICS (2009)

The relative value of the lease decreases over time. Because the lease reverts to the freeholder at the end of the term, a lender could be left with no security if the lease expired during the term of a mortgage. Even if the lease expired some years after a mortgage was due to finish, the reduced value of the lease as it neared expiry would affect the lender's security.

In view of these risks, lenders generally insist that leasehold properties have a specified minimum unexpired period on the lease beyond the end of the mortgage term, typically of at least 30 to 40 years, with some requiring as much as 60 or even 80 years more than the mortgage term. If the remaining term was shorter, and the lender had to take possession after default, the shorter remaining term would significantly devalue the lease, and other lenders would almost certainly not consider a mortgage for a new buyer. This would restrict the potential market to cash-only buyers.

MARRIAGE VALUE

If a lease has less than 80 years to run, the leaseholder will have to pay a premium and an additional 'marriage value' to extend the lease. Some lenders will not lend on a lease with less than 80 years left to avoid potential problems.

In simple terms, the marriage value is the difference between the value of the property with the current lease and the value if the lease was extended by 90 years. As the term of the existing lease reduces, the value of the property decreases, and so the difference in the two prices increases. A property with 80 years or more left automatically has no marriage value. The freeholder has a right to 50 per cent of the marriage value.

A new owner must have owned the lease for two years before they have the statutory right to extend it. If a lender granted a mortgage on the basis that the buyer would apply to extend after the qualifying two years, they would risk the owner not keeping to their part of the bargain, particularly as the premium for extending increases as the term shortens.

Some lenders will consider a short lease, but will require an agreement that the current owner will apply to extend the lease by serving a statutory notice of claim on the landlord, and that the rights under the legislation will be transferred to the new owner at the same time as the lease (ie on completion). That means the new owner can then continue with the lease extension in their own name. In reality, a leaseholder considering selling a property with an unexpired lease term below 80 years should consider extending the lease before putting the property up for sale or, as a minimum, starting the extension process with a view to assigning the right to the new owner.

IN BRIEF

CALCULATING THE COST OF EXTENDING THE LEASE

The calculation in principle considers the diminution (loss) in the landlord's interest in the property as a result of the extension, and the marriage value. There are two elements to the diminution of interest.

- The landlord will not receive ground rent during the extended term, and so will be entitled to an amount to compensate.
- The lease will revert to the landlord 90 years later than on the original lease and they will need to be compensated for that.

The cost of lease extension will be the diminution value and 50 per cent of the marriage value.

13.6 How does location affect value?

Geographical location is of great importance in relation to property value. Generally, areas of economic prosperity attract population clusters that drive up demand, with London and the south-east of England being prime examples. This is not to say that property prices are inevitably low in sparsely populated areas – sometimes they have higher prices to reflect exclusivity.

Even within towns and cities, the very name or postcode of an area can affect property values positively or negatively. Think of your own area and you will easily come up with names of districts that are considered 'upmarket' and those that are less desirable.

13.7 How does type, age and condition affect a property's value?

The type of property will have an impact on its value. Generally, flats are less valuable than houses, and detached houses are more valuable than terraced and semi-detached houses. Bungalows are often more expensive than a house with a similar number of bedrooms, although bungalows do appeal to a more limited market. This may mean they are less sought after in areas where there are many bungalows.

WHAT IS THE VALUE TO THE LENDER IF THERE IS A LIMITED MARKET?

The design of a dwelling is a matter of personal taste: what is delightful to one person can be unappealing to another. Sometimes, a property can be so unusual that the lender will seriously doubt its potential for resale and, as well as looking at market value, a lender must consider value in a 'forced sale situation' where possession is taken due to default on the loan. If there is a limited market for the property, or even no possibility of a buyer, the land is almost worthless to the lender in the short term.

EXAMPLE

In recent years, a large market has developed for specialist 'retirement' apartments aimed at those aged 55 and over. The leasehold apartments are self-contained within a larger complex and offer communal facilities designed for older people. Many complexes employ full-time staff on site to provide 24-hour assistance. Prices vary, but are usually higher than comparable 'normal' apartments, and annual fees tend to be high. These retirement apartments are notoriously hard to sell when a resident dies, wants to move or goes into care; the combination of a limited market and high service fees tends to deter many potential buyers.

13.7.1 Age of the property

Period property with original fixtures and fittings can often be valued at a premium over its modern counterparts, provided it is in sound condition. The amount of similar property in an area will be a contributory factor – where there is a glut of older property, the premium may be reduced; where period property is rare, it can increase. Ultimately, the price achieved for a property, new or old, will depend on its appeal to the buyer, its condition and potential.

13.7.2 Condition of the property

Most buyers will be looking for a property in good condition that needs no work and can be occupied immediately. While many buyers are able to see past décor that might not suit their taste, most expect property to be well maintained and presented; the better the condition of the property, the higher the value and

the higher the chance of a successful sale. The valuer will take special note of necessary repairs and report these back, with recommendations, to the lender.

Buying a property that needs work can be an opportunity to add significant value, and a prospective purchaser might be willing to invest additional capital in a property to improve it. In that situation, the lender might be prepared to lend a higher amount than would otherwise be the case. The buyer would be prudent to investigate similar properties in the locality that may be in better condition and establish the prices asked for them. This would give a good indication of the potential value of the property after the improvements have been completed.

13.8 Why is it important to know about the property's construction?

The materials and methods used in construction can crucially affect the value and expected life of the dwelling – and this is very important to a lender with a 25-year loan secured on the property. On a house with a large area of flat, felt-covered roof, for example, the felt may need to be replaced regularly in order to maintain the integrity of the building and hence the property's value. Obtaining a mortgage on a property of traditional, or standard, construction is not generally a problem; non-standard buildings can be difficult to mortgage, as a result of which the value can be reduced.

Traditional construction is, generally speaking, bricks, mortar and tiled roof. For non-traditional construction, there may be inherent faults that reduce the potential lifetime of the property. As technology develops, more innovative methods of construction are used. Provided the methods are of proven solidity, lenders are likely to be prepared to lend on them. For new builds, lenders consider whether the builder participates in the Buildmark scheme or similar schemes. Lenders may not be willing to lend on non-traditional construction completed prior to the launch of these schemes.

PREFABRICATED HOUSING

Prefabrication became a significant construction method after the First World War to help solve the acute housing shortage as quickly and cheaply as possible. The pace of this development increased dramatically after the Second World War, resulting in more than 150,000 such houses between 1945 and 1951, when the programme ended. In some areas of the UK, local initiatives meant pre-fabrication continued until the early 1970s.

While the immediate post-war methods were invaluable in increasing housing stock, the methods were not conducive to durability or modern standards of insulation, with most expected to last around ten years. Houses built after the initial programme were intended to last for at least 60 years. Many of the buildings survive today but have been subject to remedial work, after which mortgage lenders would accept them as security.

MODERN CONSTRUCTION METHODS

Pressure to meet the demand for new property has led to innovation, in particular the development of pre-manufactured structures assembled on site. These structures are designed to meet modern standards and are backed by accreditation schemes.

The RICS valuation guide for new-build property provides guidelines on valuing modern methods of construction. It is also applicable to older properties.

Valuers should first check the lender's policy on the property's construction, and whether the lender accepts the building accreditation scheme. With a second-hand property subject to remedial work, this could amount to checking whether any insurance or warranty applies to the work. Valuation should be carried out based on evidence of comparable sales in the relevant local market.

13.9 What are the issues relating to multiple-use property?

Some buildings are designed for more than one use: a building containing a shop with a flat above, for example. The multiple-use aspect of a property can have a detrimental effect on the value of the flat compared with purpose-built flats, and some lenders may decline to lend.

Flats above shops are generally difficult to mortgage, because the buyer has little or no control over the commercial part of the building, and the flat's marketability could be affected by noise, smells and other problems. Location is a factor, so a flat above a small parade of shops closing at 5pm in a quiet residential area or village may be easier to mortgage than a flat above a shop in a busy high street. However, areas change, and a shop could easily become a restaurant or takeaway.

13.10 How might insurance issues affect value?

Insurability can affect the valuation of a property; some properties are uninsurable or, at best, difficult to insure. For example, insurance companies are reluctant to cover property in areas where subsidence has occurred, or properties with a history of subsidence that has not been professionally rectified with guarantees. The property value will be reduced in this situation and lenders may be reluctant to lend on affected properties.

Obtaining affordable insurance on properties on flood plains or near rivers where flooding is commonplace has become a significant issue in the UK since the early 2000s, with severe flooding becoming more frequent. A property's flood risk can be checked using the property's history and official flood maps, and insurers will assess flood risk as low, moderate or significant.

It is usually possible to insure properties exposed to flood risk, as a result of voluntary agreements between the government and members of the Association of British Insurers. However, until 2016 there were no measures to control the premiums payable by owners at risk of flooding. The 'Flood Re' scheme (a reinsurance scheme) came into force on 4 April 2016, and will continue for 25 years. It is designed to provide affordable home insurance for those properties at highest risk of flooding, and to increase the availability and choice of insurers. Although it is a company, Flood Re is a not-for-profit fund, owned and managed by the insurance industry. Details of the scheme are shown in Figure 13.2.

REINSURANCE

A process by which an insurer passes on some of the risk to another insurer or company in return for a premium.

FIGURE 13.2 WHAT ARE THE KEY FEATURES OF THE FLOOD RE SCHEME?

Annual levy

- The scheme is subsidised by an annual levy on all home insurers. The total annual levy is split between insurers based on their share of the home insurance market.

Premium and excess

- The insurer pays a capped insurance premium to Flood Re for each property insured under the scheme, based on the property's council tax band, and pays an excess for every claim.
- The premium is not affected by the property's level of flood risk, and is the same for all properties in the same council tax band. The premium will be lower than would normally apply to a high-risk property due to the subsidy.
- If the insurer can reinsure the flood risk elsewhere for a lower premium it is allowed to do so.

Increased competition

- Homeowners in a flood risk area can select their insurance in the normal way, and the intention is that more insurers will be prepared to offer insurance as a result of the scheme, which should increase competition.
- The insurer will assess the premium in the normal way, but may add the cost of their Flood Re premium to the homeowner's premium and increase the excess accordingly.

Claims and settlement

- Claims will be made to the insurer and settled in the normal way. Once the claim has been settled, the insurer will claim a settlement from Flood Re for any flood damage.

Eligibility

- To be eligible for Flood Re, property must be residential, have been built before 1 January 2009, be insured by the individual home owner and have a council tax band.

13.11 What are the issues to consider with buy to let?

When considering lending on buy-to-let property, the lender needs to be confident that the property is adequate security for the mortgage, just as for any other mortgage application. The lender also needs to make sure that the potential rental income is sufficient to enable the borrower to make mortgage repayments. This is important because the borrower's commitment to retaining ownership of the property will be different from their commitment to their own home.

The PRA introduced 'stress tests' for lenders to assess the affordability of mortgages for buy-to-let property falling outside the FCA's consumer buy-to-let regime. The requirements are detailed in section 24.6.2.

When an investor looks at property as a potential buy-to-let purchase, the main concern will be the yield achievable, although the prospect of making capital gains will also be a factor. The net yield is the more accurate figure for assessing the return on a property investment.

KEY TERMS

GROSS YIELD

Rent as a percentage of purchase price.

NET YIELD

Rent minus running costs as a percentage of purchase price.

%

GROSS AND NET YIELDS ON RENTAL PROPERTY

We can see from the example below how gross and net yields can be calculated.

Property price when purchased	£132,000
Annual rental income	£6,916
Annual running costs	£600
Net rental income	£6,316
Gross yield (6,916 ÷ 132,000 x 100)	5.24%
Net yield (6,916 – 600 ÷ 132,000 x 100)	4.78%

An investor can compare the yield on BTL investment with that on other investments such as deposits, shares and bonds.

Property investment does carry some risk, and so the investor would need the yield to be higher than less-risky investments, such as cash, to make it worth taking the risk. Additionally, while the yield as shown allows the investor to compare investments, it does not allow for the fact that there may be mortgage payments to make.

TOTAL RETURN ON RENTAL PROPERTY

Let's take the previous example and assume the investor uses an interest-only mortgage of £92,400 (70 per cent), with an interest rate of 3 per cent, giving annual costs of £2,772. We calculated earlier that the net rental income would be £6,316.

Net income after mortgage costs (£6,316 – £2,772)	£3,544
Total return (£3,544 ÷ £132,000 x 100)	2.68%

Thus the mortgage payments significantly reduce the net income and reduce the total return.

Of course, property prices tend to increase over the years, and adding the capital growth to rental income will increase the total return on investment, particularly in property hotspots This means that the prudent buy-to-let investor looks for areas that have relatively high rental yields and potential for capital growth.

FACTFIND

Lendinvest produces interesting statistics on the UK buy-to-let market, available at: https://www.lendinvest.com/media-centre/buy-to-let-index/ [Accessed: 5 November 2020].

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the basic information that the lender needs in order to assess the value of the property as security?
- explain the issues that might concern a lender in relation to freehold properties?
- explain why establishing the length of the lease is so important in relation to leasehold properties?
- explain why the location, type, age, construction method and material, and condition of the property might be important to the lender?
- outline how Flood Re works and why it provides reassurance to lenders as well as owners?
- explain how lenders and investors assess buy-to-let properties?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 13. Review the text if necessary.

Answers can be found at the end of this book.

1) Lenders tend to avoid lending on freehold flats because:

   a) there might be difficulties in renewing the freehold.

   b) there is a limited market for this type of property.

   c) it may be difficult to establish liability for commonly owned parts of the structure.

   d) the owner can only acquire possessory title.

2) Which of the following is true in relation to leasehold tenure?

   a) A marriage value only applies to extending leases with more than 75 years to run.

   b) Lenders will only consider lending on leasehold property with an unexpired lease of 40 years or more.

   c) Most lenders are happy to lend on former local authority high-rise flats.

   d) An owner must have held a lease for at least two years before they can apply for a lease extension.

3) The cost of extending a lease reduces as the unexpired term reduces. True or false?

4) Joe is considering buying one of four more or less identical flats in the same area, all of which are valued at £150,000, but each has a different remaining lease term. Which flat is most likely to have the highest marriage value?

   a) The flat with a current unexpired lease of 90 years.

   b) The flat with a current unexpired lease of 60 years.

   c) The flat with a current unexpired lease of 40 years.

   d) The flat with a current unexpired lease of 20 years.

5) Paula and Joe live in a converted water tower in a very rural area. The conversion was designed by an architect to their specific requirements. If they were to sell the property, why might a lender have concerns about offering a mortgage on it?

6) Apartments in a retirement complex are usually easier to sell than those in other purpose-built developments. True or false?

7) It is likely to be difficult to find a lender prepared to lend on a flat above a restaurant. True or false?

8) Which of the following properties is likely to be most attractive to a lender in terms of security?

   a) A brick-built, detached freehold Victorian property.

   b) A brick-built freehold bungalow on a road with a history of mining subsidence.

   c) A recently built leasehold flat in a purpose-built block.

9) Which of the following statements are true in relation to the Flood Re scheme?

   a) Insurers must reinsure flood risk through the Flood Re scheme.

   b) The premium the insurer pays to Flood Re on each property depends on how often the property has flooded in the past.

   c) Only properties built before 2009 are covered by the Flood Re scheme.

   d) The insurer may pass on the cost of its Flood Re premium in the premium it charges the property owner.

10) The net yield on a buy-to-let property always includes mortgage payments. True or false?

TOPIC 14

Valuations and surveys

LEARNING OBJECTIVES

In Topic 13 we looked at the information about the property that the lender requires as part of the mortgage application. Once the lender has this information, it will usually carry out a basic valuation. This indicates whether the value of the property, if repossessed and sold, would be sufficient to repay the mortgage loan. Buyers may also want reassurance as to the value and soundness of the property they are buying, and this topic outlines the different types they can arrange.

By the end of this topic, you should have an understanding of:

- the basic valuation and how the lender uses it;
- the different types of survey available to a borrower;
- property defects and their impact on the lending decision;
- warranties and guarantees for new properties.

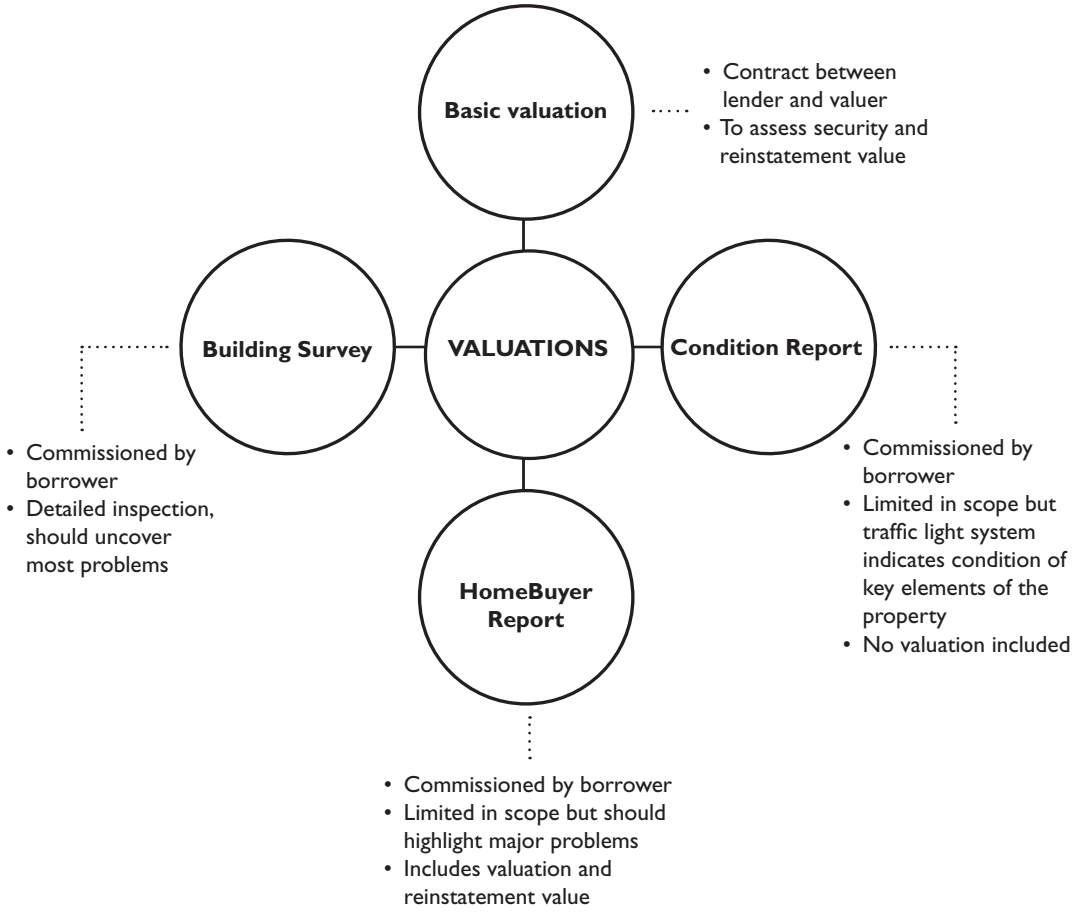
THINK . . .

Before you start work on this topic, take a moment to think about what you already know. For instance, if you have been involved in buying a property:

- what was covered in the lender's valuation report?
- did you decide to pay for an additional survey report, such as a Condition Report or HomeBuyer Report? How did you decide which type to have?
- did the lender require you to carry out repairs as a condition of the mortgage? We touched briefly on retentions in Topic 6 – can you remember what they are?

If you have copies of valuation reports and survey reports, you might find it useful to refer to them as you work through this topic.

FIGURE 14.1 WHAT VALUATIONS ARE AVAILABLE?



14.1 What is a basic valuation?

The Building Societies Act 1986, amended by the Building Societies Act 1997, requires a building society to make an assessment of the security offered for each mortgage secured on land. In the case of new mortgages, this requirement is satisfied through a valuation report. Other lenders have no statutory obligation to carry out an assessment, although the vast majority will do so as part of a prudent approach to lending.

The valuer may be an independent professional valuer or an employee of the lending institution. A basic valuation often takes as little as half an hour and is, by definition, a fairly superficial inspection.

!

RIGHTS OF THE APPLICANT

The contractual relationship for the basic valuation is between the lender and valuer, although the applicant pays any fee charged for the valuation. As they are not part of the contract, the applicant has few rights in relation to the valuation.

FIGURE 14.2 WHAT DOES A BASIC VALUATION INVOLVE?

Interior

- The valuer inspects the property, noting room sizes and the superficial appearance of the property
- Obvious defects or potential problems are noted, but no carpets are lifted, no furniture is moved and a loft is unlikely to be inspected

Exterior

- The valuer looks at the exterior of the property, again noting any obvious defects without close inspection

Comparison

- The valuer completes the valuation in the office by comparing prices of similar properties and calculating the reinstatement costs for insurance purposes

WHAT IS A DESKTOP VALUATION?

In certain circumstances the lender may arrange a desktop valuation, which is carried out in the office using computer software and does not require an inspection of the property. The valuer researches data on comparable properties and sales from a range of public data sources, and then selects a number of properties (perhaps three) that are the closest comparisons to the property being valued.

What are its limitations?

The desktop valuation helps the valuer to establish a market price, but it may not be very accurate because it uses historical data that may not reflect the situation in a rapidly rising or falling market; additionally, it does not take account of any risks posed by the property's condition that might be identified in a physical inspection.

When is it most suitable?

The desktop valuation is most suitable where the property has been inspected in the relatively recent past, perhaps where the application is for a remortgage. It may also be possible for a prospective buyer to arrange for a desktop valuation on a property they are thinking of buying to obtain an assessment of the market price.

The valuer sends the report to the lender, recommending whether the property is acceptable as security for the advance requested, stating the value of the property for lending purposes, the insurance reinstatement amount and any essential (and obvious) repairs that are needed. The valuation for lending purposes is not necessarily the same as the market value of the property, because the valuer has to consider the situation if the lender had to take possession and sell the property in the event of default. Properties sold in this situation are unlikely to achieve the best price, and may be sold at auction, where prices tend to be lower than on the open market.

RETENTION

A portion of the loan held back by the lender until the buyer provides evidence that specified repairs have been completed satisfactorily.

The lender will use the valuation to make the lending decision: whether to lend and, if so, how much. It will also decide whether to insist that the applicant undertakes to carry out specified repairs within a given period, or even to hold back some of the advance pending the repairs (known as a retention).

All lenders disclaim any responsibility for the condition of the property implied in the valuation report, and specifically state that they do not give any warranty as to the reasonableness of the purchase price.

The valuer's duty of care varies, depending on the type of borrower, and they could be sued by the borrower or the lender if it can be proved that negligence caused a financial loss. Courts have ruled that a valuation that errs by more than 5–10 per cent above or below the true value could be deemed negligent, although the exact figure will vary between types of property. A claim for negligence is only likely to succeed in two circumstances:

- the disclaimer was insufficiently prominent;
- the borrowers were inexperienced – this would typically apply to first-time buyers or those of modest means buying a home.

In relation to buy-to-let and commercial property, courts have made it clear that investors and business borrowers should be experienced enough to understand the limited nature of a valuation report and arrange their own inspection if they have any concerns.

CASE LAW: NEGLIGENT VALUATION

In *Smith v Bush* [1990] it was held that a valuer could not avoid liability for losses caused by his negligent valuation simply because he had included a disclaimer – despite the fact that it had appeared on both the mortgage application form and the copy of the valuation report sent to the buyer. A key factor was the Smiths' level of perceived experience in property matters: the courts found that the disclaimer was 'unreasonable' because the Smiths were 'first-time buyers at the lower end of the market'.

CASE LAW: NEGLIGENCE CLAIM REJECTED

In *Stevenson v Nationwide Building Society* [1984] the plaintiff's attempt to claim for losses caused by a negligent valuation (irrespective of the fact that there was a disclaimer) failed because:

- he was an estate agent, and could therefore be expected to have a good understanding of property matters; and
- he had signed a form that included the disclaimer in a prominent position.

14.1.1 What is the valuation report?

The valuation report forms the basis of the lending decision and will influence the following:

- whether to lend at all;
- the size of the advance;
- the percentage advance (loan-to-value ratio) that should be made available;
- reinstatement value (which is usually lower than the market value);
- the recommended conditions of the advance.

The list below outlines the typical structure of a valuation report, but reports will vary between lenders and valuers.

FIGURE 14.3 TYPICAL CONTENTS OF A VALUATION REPORT

- Details of the property to be mortgaged
- When the property was built
- Dimensions of the property
- Approximate floor area
- Tenure and, if leasehold, term unexpired
- Valuation for mortgage purposes
- Valuation for insurance purposes – main property and outbuildings
- Evidence of subsidence, heave or landslip affecting the property or the immediate neighbourhood
- Essential repairs*
- Minor repairs*
- Major defects*
- Recommendation for a specialist report**
- Recommendation for undertaking or retention
- Recommendation for reinspection
- A narrative report on the property in the valuer's own words
- A prominently placed disclaimer notice, stressing the limited nature of the valuation as a superficial inspection for assessing the security for mortgage purposes, rather than as a survey to evaluate the property's condition. It will also state that the lender is not making any comment upon the reasonableness of the purchase price, whether explicit or implied, in its decision whether to lend or not
- Comparable valuations of three similar properties
- Any detailed comments the valuer feels need to be included

*The report will only comment on those issues that can be identified from the superficial visual inspection

**If a valuer is in doubt about any features of the property, based on the relatively superficial inspection, they will recommend a further, more detailed report prior to a final decision. In particular, any evidence of subsidence or heave (where the ground is unsound beneath the property) will need to be investigated fully

FIGURE 14.4 ACTIONS THE VALUER CAN RECOMMEND TO A LENDER

Acceptance	The property is adequate security for the loan sought and there are no problems
Rejection	The property is not suitable security for a mortgage and should be declined
Conditional recommendations for acceptance	The valuer may make two types of conditional recommendation: • An undertaking to repair or make alterations is recommended when the property is good security but certain work needs to be done • A retention is more serious, where the lender holds back a sum of money from the advance, pending repairs being carried out to the lender's satisfaction
Lower valuation	The valuer may consider the property value to be lower than the purchase price, in which case the advance may be reduced. There are three potential outcomes: • The purchaser makes a reduced offer to the vendor • The purchaser continues on the basis of the agreed price but has to meet the funding shortfall from personal resources • The purchase and sale fall through altogether

Valuers sometimes recommend the involvement of specialists such as structural engineers, drainage experts or arboriculturists (tree experts). In mining areas they may recommend a coal-mining search to ascertain the existence of any past, current or proposed surface and underground coal-mining activity to affect a particular property or site.

WHAT IS REINSTATEMENT VALUE?

Although it does not directly impact on the value of the property, the reinstatement value is a vital part of the insurance cover. The reinstatement value is the valuer's estimate of the cost of rebuilding the property from scratch in the event of destruction by fire or another catastrophe. The value will be based on the size of the property and building costs for the area.

With properties of standard construction, the reinstatement value will be considerably less than the market value; in the main, this is due to the fact that the market value includes the price of the land, which is not a cost when rebuilding.

A property of unusual design and constructed of non-standard materials may have a reinstatement value that is approximately the same as, or even higher than, the valuation for mortgage purposes. This reflects the fact that the cost of rebuilding with non-standard materials is likely to be higher.

14.1.2 The lending decision

The lending decision should take full account of the recommendations in the valuation report, alongside the lender's own experience of similar mortgaged properties. All of these factors must be viewed alongside the assessment of the borrower's status and the affordability.

Once the lender has assessed the property as security, it will decide on the loan it is prepared to offer against the value of the property. As part of its underwriting policy, a lender will decide the maximum loan to value (LTV) it will offer. The LTV is based on the lower of the purchase price and the valuer's assessment of its value. For example, if a property has a purchase price of £200,000 and a valuation of £190,000, the offer will be based on £190,000.

14.2 What reports can the buyer commission?

We have established that the lender will carry out an assessment of the property as security for the proposed mortgage, and that any valuation commissioned will be limited and for the lender's benefit. Unless the property is a new build or covered by some form of building guarantee scheme, a sensible buyer should seriously consider commissioning their own, more detailed report that looks at the condition of the property.

The RICS has established three further types of service for mortgage applicants:

- the Condition Report;
- the HomeBuyer Report; and
- the Building Survey.

If a valuation or survey identifies a potential concern, further specialist reports may be required, for example a report on the state of the electrical wiring or a damp report. It is important to bear in mind that, if the sale does not go through, the costs of the survey or valuation are not refunded.

CAN ADVISERS RECOMMEND A SPECIFIC TYPE OF SURVEY?

Advisers must not recommend a specific type of survey (such as a HomeBuyer Report). For instance, if the adviser specifically recommends a HomeBuyer Report and something later comes to light that would have been picked up by a Building Survey, the adviser may be subject to a claim. However, if the surveyor misses something that should have been covered by the HomeBuyer Report, the adviser will not be liable.

14.3 What is a Condition Report?

The Condition Report (RICS Survey Level 1) was launched in mid-2011 as a cost-effective way for home buyers to check the basic condition of their prospective property. It is designed for relatively new, conventional properties that are in reasonable condition and built from standard building materials. Unlike a valuation report, it does not consider the market value of the property nor its value for insurance purposes, focusing instead on the overall condition of the property. It is designed for those buyers with limited budgets who might otherwise rely entirely on the lender's valuation report, which focuses on the property as security for the mortgage rather than on any defects or problems. The contract is between the buyer and the surveyor.

The Condition Report aims to comment on and/or identify the following areas, so that prospective buyers are aware of them before they commit to a purchase:

- the construction and condition of the property;
- issues that are serious or need urgent attention;
- issues that require further investigation to prevent further damage;
- issues that may be dangerous;
- advice for the buyers' solicitors with a summary of the key risks associated with purchasing the property – planning, guarantees, building controls, etc.

The report is presented using a 'traffic light' system, whereby each part of the building and its services is given a rating in relation to its condition.

!

LIMITED SCOPE

The Condition Report is limited in scope and is a 'snapshot' of the property's condition on the day, not a full survey. The surveyor will not look at hidden or covered areas and the report may not identify all defects. Neither will it make recommendations or give advice regarding how repairs or remedial action should be carried out.

Nonetheless, the report does give the buyer some legal recourse if the surveyor was negligent within the parameters of the report.

FIGURE 14.5 CONDITION REPORT TRAFFIC LIGHT RATINGS

Red	Indicates serious defects or problems that need urgent repair, replacement or further investigation
Amber	Indicates defects that need to be repaired or replaced, but are not considered serious and action is not urgent
Green	No defects are apparent and no repairs are required

14.4 What is a HomeBuyer Report?

The HomeBuyer Report (RICS Survey Level 2) is a compromise between a basic valuation and a Building Survey, offered by lenders as a moderately priced option, well within the budget of most prospective mortgagors. The commissioning of a HomeBuyer Report establishes a contract between the applicant and the surveyor.

There are two versions of the HomeBuyer Report.

HomeBuyer Report (survey and valuation)

The report identifies any relatively obvious problems: the valuer will inspect the property and identify any problems that are visible to them. They will not, however, lift carpets, or move heavy furniture to discover what problems may be hidden by them. The surveyor will carry out a visual inspection of services (gas, electricity, sewers, etc) as far as can be seen, but will not check safety aspects or carry out specialist tests.

The applicant has little comeback in the event that serious problems are encountered later. However, the report aims to identify major defects, allowing an opportunity to reject the property, make an amended offer or plan expenditure necessary to counter the problems.

IN BRIEF

WHAT ADDITIONAL ELEMENTS DOES THE HOMEBUYER REPORT CONTAIN?

The report contains all the elements of the Condition Report together with:

- a professional market valuation;
- an insurance reinstatement figure;
- a list of any problems or defects that may affect the property's value;
- advice on repairs and ongoing maintenance;
- information about the location, the local environment and the property's energy efficiency.

The surveyor will not carry out an energy efficiency assessment, but will include the details from an Energy Performance Certificate (EPC) if an assessment has been carried out on the property.

The report is presented using the same traffic light system as the Condition Report. Typical defects identified in the report would be:

- dry and wet rot where symptoms can be seen;
- problems relating to the condition and position of the damp-proof course;
- problems relating to the interior of the roof space – beams, rafters and the underside of the roof – although the scope of the survey may be limited by accessibility;
- defects in the pointing (ie mortar joints).

The report does not include estimates for the cost of repairs, a detailed description of the construction of the building or detailed advice on specific defects.

HomeBuyer Report (survey)

The HomeBuyer Report (survey) is a new type of report. It includes all the elements of the HomeBuyer Report (survey and valuation) apart from the valuation and reinstatement costs.

14.5 What is a Building Survey?

Previously known as a structural survey, a Building Survey (RICS Survey Level 3) is a thorough and detailed inspection of the property carried out by a qualified professional surveyor, engineer or architect. It is relatively expensive but worthwhile for many mortgage applicants. If the property is defective, this will almost certainly be discovered by a Building Survey. If it is not discovered, the borrower has some comeback against the surveyor, whose duty of care is only to the applicant.

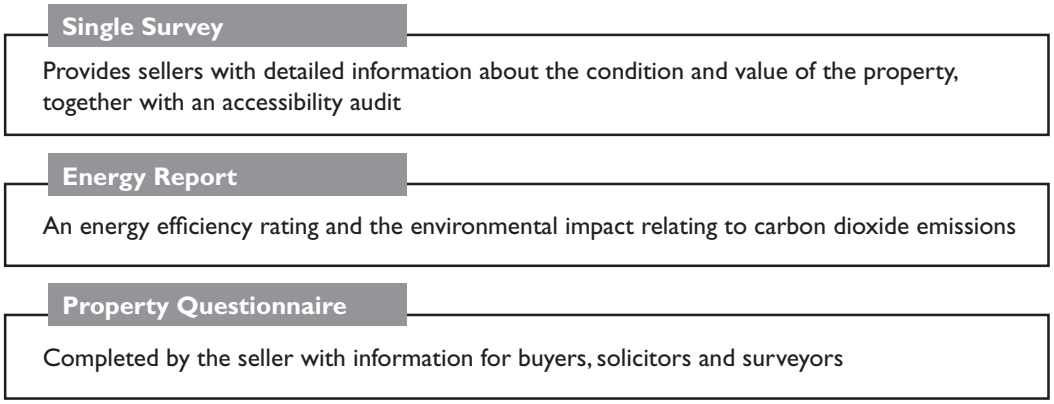
Such a survey will be more detailed than the HomeBuyer and Condition reports. It will involve a detailed inspection of the structure of the property and all the inspection elements of the HomeBuyer and Condition reports, as well as an inspection of the electrical system, drains, and other services that can be seen, but only insofar as their operation in daily use. The surveyor will lift carpets, inspect the roof space and generally probe a lot more than they would on HomeBuyer and Condition reports. The survey should be carried out to certain standards and so, in the event of later problems, the valuer may be liable for any losses as a result of negligence.

A Building Survey will include a valuation if the purchaser requests it. In some instances, the lender will not accept such a valuation as it has been commissioned by the buyer, and will insist on a valuation for its own use. This situation might arise if the surveyor is unknown to the lender and it would require considerable time or expense to validate the surveyor's credentials.

WHAT IS A HOME REPORT IN SCOTLAND?

Owners selling property in Scotland are required to arrange and have a Home Report in place before marketing the property. The report must be made available to prospective buyers on request.

FIGURE 14.6 WHAT DOES THE SCOTTISH HOME REPORT CONTAIN?



Prices vary, so Table 14.1 provides only an indication of costs involved. Valuation and survey fees are not refundable once completed. Many lenders offer free valuation as an incentive to attract customers and, where fees are charged, they vary widely depending on the value of the property.

TABLE 14.1 INDICATIVE COSTS OF VALUATIONS AND SURVEYS

Type of valuation/survey	Costs
Basic valuation	£175–£1,100 where charged
Condition Report	£250–£300
HomeBuyer Report	From £400, depending on property value, increasing to over £1,000
Building Survey	From around £600 up to £1,300 or more, depending on the size, structure and age of the property

14.6 What type of property defects affect the lending decision?

In surveying or valuing a property, surveyors or valuers may come across certain defects that affect the value of the property and which may affect the mortgage lender's decision to lend.

Structural movement is probably the most important defect. It can be related to walls, floors or the whole building, and can be caused by the property itself (such as by poor construction) or by the ground on which the property is built (such as subsidence). The surveyor will consider whether the movement is long-standing and non-progressive or recent and progressive.

Long-standing and non-progressive movement is the term used when the movement happened some years before and has not worsened, and this type of movement will not normally affect the decision to lend. If, however, the movement is recent and progressive, the surveyor will normally recommend that a structural engineer inspect the building and that further investigations be carried out. If the further investigations show that the movement cannot be remedied, the lender may decide to refuse the mortgage.

Two of the most common problems identified in surveys are subsidence and heave (see Figure 14.7).

- **Subsidence** occurs when land below the building drops unevenly, causing it to shift. Subsidence most commonly affects properties that are built on a clay soil and results from a drop in the water table after a long, dry spell of weather, most commonly due to tree roots drying out the soil. It can also

be the result of long-term leaking of drains or pipes, or settlement after excavation. The signs of subsidence include:

— new or expanding cracks in the plasterwork;

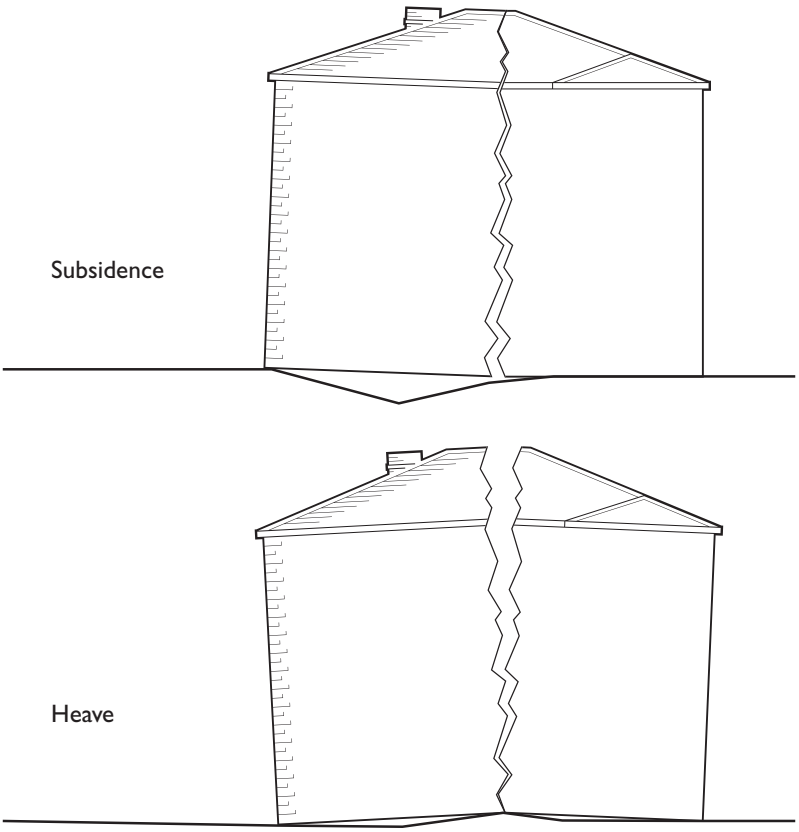
— new or expanding cracks in external brickwork;

— rippling wallpaper that is not caused by damp.

- **Heave** occurs when underground forces cause the land below the property to rise unevenly and put upward pressure on the building's foundations: the opposite of subsidence. It is usually caused by the removal of trees or shrubs near to the building, by clay soils expanding when wet or occasionally by a chemical reaction in the soil.

Both subsidence and heave can be serious and major expenditure may be required to correct the problem. In the UK, these problems tend to be localised and professional surveyors tend to know areas at risk. For example, some buildings close to the Thames basin in south-east England have been affected in the past due to the presence of shrinkable clays ('London clay').

FIGURE 14.7 SUBSIDENCE AND HEAVE



Further defects that may affect the decision to lend, or which may prompt the lender to require undertakings from the borrower, include untreated woodworm, severe damp, previous removal of chimney breasts, extensions

that do not conform to building regulations and the replacement of traditional roof coverings with concrete. This list is not exclusive and may vary from lender to lender.

Lenders may attach undertakings or a retention to the mortgage terms.

UNDERTAKING

A formal agreement that the buyer will undertake specific remedial work within a specific period of time after taking possession of the property.

14.6.1 Undertakings

The work required by an undertaking is not necessarily vital, but will either bring the dwelling up to the standard expected of an average property, or remove obvious defects. A typical undertaking might be to decorate internally or externally, or to tackle some localised dry rot.

The lender will reserve the right to inspect the property after a period of three to six months to see that the work has been done; some lenders telephone the borrower, others may wish to reinspect. Some do not check that the work has been completed.

In practice, there is little the lender can do to enforce an undertaking once a certain time has passed, although, theoretically, the borrower is in breach of the conditions of the mortgage if the undertaking is not fulfilled.

14.6.2 Retentions

Repairs required by a retention are more extensive and important than those where an undertaking may be acceptable. The lender will almost always inspect the work before releasing the retained funds. Examples of reasons for a retention are substantial repairs to a roof, or extensive dry or wet rot problems. If the valuer recommends a retention, the borrower will need to find temporary funds to cover the shortfall and complete the required work.

14.7 What are new-build guarantee schemes?

There are a number of guarantee schemes to provide buyers of new properties with protection against defects in the early years. Traditionally, lenders preferred builders to be members of the NHBC, which introduced the first guarantee scheme in 1965. The scheme was relaunched in 1988 as Buildmark, and serves as both a protection scheme and a warranty.

WHAT IS THE NHBC?

The National House Building Council provides warranties and insurance protection for new homes in the UK. It works with the building industry to raise standards and improve protection for consumers.

Other schemes are now available, all offering similar protection to the Buildmark scheme, and most lenders will lend on new property that is covered by one of the schemes. If the builder is not a member of the NHBC or a similar insurance scheme, the lender usually insists on a qualified supervising architect regularly inspecting the property under construction. There will be a requirement that the supervising architect meet certain minimum standards and has indemnity insurance cover of at least £1m in place.

14.7.1 NHBC Buildmark

To join the NHBC, builders must satisfy certain quality standards and, as part of the Buildmark scheme, must confirm that the property has been built to NHBC Building Code standards. In addition, NHBC personnel conduct site inspections to monitor standards.

The Buildmark scheme provides protection against defects and damage during the first two years, where it is caused by the builder's failure to meet NHBC standards. A claim is made to the builder for remedial action initially, but will go to the NHBC for arbitration in the event of a dispute. In the event that the builder fails to comply, the NHBC guarantee will cover the costs of remedial action.

For the balance of the first ten years the scheme provides insurance for the full costs of damage over a specified amount, known as the minimum claim value (MCV), caused by major defects in the building's structure. When a policy starts, it is subject to the MCV in place on 1 April before its start date. The MCV then increases each year. Claims are made direct to NHBC, and NHBC will arrange to have the remedial work done. The homeowner will have to arrange and pay for remedial work if the total claim is below the MCV. All claims are subject to an upper limit, which is reviewed regularly.

The scheme also provides cover from exchange of contracts to the completion date if the buyer loses their deposit or has to pay extra costs due to the builder becoming insolvent or committing fraud.

14.7.2 Premier Guarantee

Premier Guarantee is a UK home warranty provider set up for developers working on new building complexes and conversions; the cover is ultimately provided by a syndicate at Lloyd's of London.

Similar to the NHBC scheme, the insurance provides cover for ten years and the protection is more comprehensive for the first two years – covering snagging defects and arranging for remedial work to be completed if the builder fails to do so. The first two years is the 'defects insurance period' and, from year three to year ten, the 'structural insurance period' covers major structural defects that may compromise the structural integrity of the building. The level of cover is similar to the NHBC scheme and the property must have been built to NHBC Building Code standards.

14.7.3 LABC New Home Warranty

LABC New Home Warranty is a structural/latent defects warranty offered to the builders of speculatively built residential housing, social housing and completed properties. Speculatively built properties are those built by developers, in advance of receiving orders or finding buyers, in areas where they anticipate high demand. Conversely, 'custom-built' properties are built to a specific design on behalf of a buyer or buyers who place an order in advance.

The New Home Warranty is underwritten by the same Lloyd's syndicate, uses the same scheme administrator, offers almost identical terms and conditions as the Premier Guarantee warranty and the property must have been built to NHBC Building Code standards. The cover is split into three separate periods: the building period, the defects insurance period, and the structural insurance period.

WHAT IS LABC?

LABC is the member organisation representing local authority building control departments in England and Wales, promoting the design and construction of safe, accessible, environmentally efficient buildings that comply with building regulations.

14.7.4 Other warranties

Other warranties are offered by Evolution Building Warranties and Build-Zone.

14.7.5 Consumer Code for Home Builders

The Consumer Code for Home Builders is a code of practice developed by a consortium of key industry and trade bodies, including the various warranty providers listed above and UK Finance.

The purpose of the code is to ensure that homebuyers are better informed about their rights (both before and after the exchange of contracts); it seeks to reinforce the protection afforded to them by the existing home warranty schemes. The code aims to provide greater clarity and transparency in the documentation given to buyers of new properties, and includes an independent dispute resolution service.

The code requires that consumers:

- are treated fairly;
- know what service levels to expect from their builder;
- are given reliable information;
- know how to make a complaint if they are dissatisfied.

New house builders registered with NHBC, Premier Guarantee and LABC New Home Warranty must comply with the code.

CHECK YOUR UNDERSTANDING

Which type of survey is most likely to be suitable for the following buyers?

a) Cheryl and Dave, who are buying a semi-detached property dating from the early 20th century in south-east London?

b) Katya, who is buying a three-year-old house on a new development in Peterborough?

c) Dan and Greg, who are buying a thatched cottage in Dorset that is more than 200 years old.

d) Iqbal, who is buying his first home, a 12-year-old starter home, and is on a tight budget.

As an adviser, should you recommend a particular survey to any of these buyers?

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain who engages the valuer and who pays for the work to be carried out for each type of valuation or survey?
- explain the purpose of the basic valuation?
- describe the 'traffic light system' used in the Condition Report and HomeBuyer Report?
- explain the different types of inspection carried out for a Condition Report, HomeBuyer Report and Building Survey?
- explain the difference between an undertaking and a retention?
- outline the different types of warranty available on new build properties?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 14. Review the text if necessary.

Answers can be found at the end of this book.

1) A basic valuation is for the benefit of the lender and is paid for by the lender. True or false?

2) Which form of inspection gives the borrower the highest level of protection against negligence from the person carrying out the inspection?

   a) Valuation.

   b) Building Survey.

   c) HomeBuyer Report.

   d) Condition Report.

3) Lenders generally require valuers to specify both the value for lending purposes and the reinstatement value of a property. True or false?

4) Which of the following would be included in both a HomeBuyer Report and a Condition Report?

   a) A valuation.

   b) Issues that need urgent attention.

   c) Advice on how to deal with remedial work.

   d) A report on the property's energy efficiency.

5) A HomeBuyer Report is expected to report on the existence and condition of a damp proof course. True or false?

6) A lender will not proceed with a mortgage application if a survey report indicates that a property has suffered long-standing structural movement. True or false?

7) A survey shows significant work is required on a property's roof. The lender is likely to:

   a) require an undertaking.

   b) impose a retention.

   c) insist on additional buildings insurance.

   d) require a warranty.

8) Karen has applied for a mortgage on a property which, although structurally sound, is in need of external and internal redecoration. What action is the lender most likely to take?

   a) Impose a retention.

   b) Refuse to lend.

   c) Reduce the mortgage offered.

   d) Require an undertaking from Karen.

9) All new houses have a guarantee of either 10 or 15 years against major defects. True or false?

10) Ben bought a newly built house four years ago and it is covered by the Buildmark scheme. It now requires structural repair as a result of a defect in the construction materials. Ben is entitled to:

   a) require the builder to make good the property.

   b) claim under the Buildmark insurance scheme for the full cost of the repair.

   c) claim under the Buildmark insurance scheme if the cost of the work is above the minimum claim value.

   d) claim a percentage of the repair costs because the cover reduces for each year he has occupied the property.

TOPIC 15

Other factors that affect the lending decision

LEARNING OBJECTIVES

We looked in Topic 13 at what can affect a property's value, and in Topic 14 at the ways in which a lender and borrower can be satisfied that the property is adequate security for the loan sought. It is also important to be aware of other factors that could affect the lender's decision to lend, including planning consent, building regulations, listed building consent, and environmental issues. We explore these in this topic, and also investigate the costs that a borrower incurs when buying a property.

By the end of this topic you should have an understanding of:

- planning consent;
- building regulations;
- listed building consent;
- environmental issues;
- renewable energy generation;
- fees and charges involved in property purchase.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about the issues we are going to cover. We looked at the kind of searches that are carried out at conveyancing stage in Topic 7, and in Topic 14 we covered the different types of survey that can be carried out. In this topic we are exploring the costs involved in such work.

If you have been involved in buying a property or carrying out repairs and renovations, you might also know:

- when you need to get planning consent for such work;
- about the need to comply with building regulations.

You might also have explored the implications of installing solar panels, or setting up a wind turbine to generate electricity.

15.1 What is planning consent?

When a property is built or extended, or the owner wishes to undertake other building work on a property, they may be required to seek planning consent (often referred to as planning permission) or follow specific building regulations. Failure to do so could result in a compulsory order to reinstate the property to its original state; planning consent is rarely given retrospectively.

In terms of property values, failure to obtain the necessary consents will seriously devalue the property and is likely to result in lenders choosing not to lend.

Regulations were introduced to simplify and speed up the planning process. Known as 'permitted development', they allow certain development and changes of use to be carried out without the need for planning consent.

Permitted development rights are subject to conditions and limitations on size, scope and type to control the impact of the work on the local environment. Some permitted development rights (such as two-storey extensions) are excluded in areas of 'designated land'.

DESIGNATED LAND

Areas such as conservation areas, areas of outstanding natural beauty, national parks and World Heritage sites.

An owner can build an extension, conservatory or addition to a home without planning consent if it meets one of a number of conditions, including the following:

- The addition and previous additions, including outbuildings, do not cover more than half the area of land around the original house.
- The extension is within certain height and depth limits:
  - the front or side of the property will not be closer to a highway than before;
  - no part will be higher than the highest part of the existing roof;
  - two-storey extensions are no closer than 7m to a rear boundary;

— the depth of a two-storey extension is no more than 3m from the rear wall of the original house.

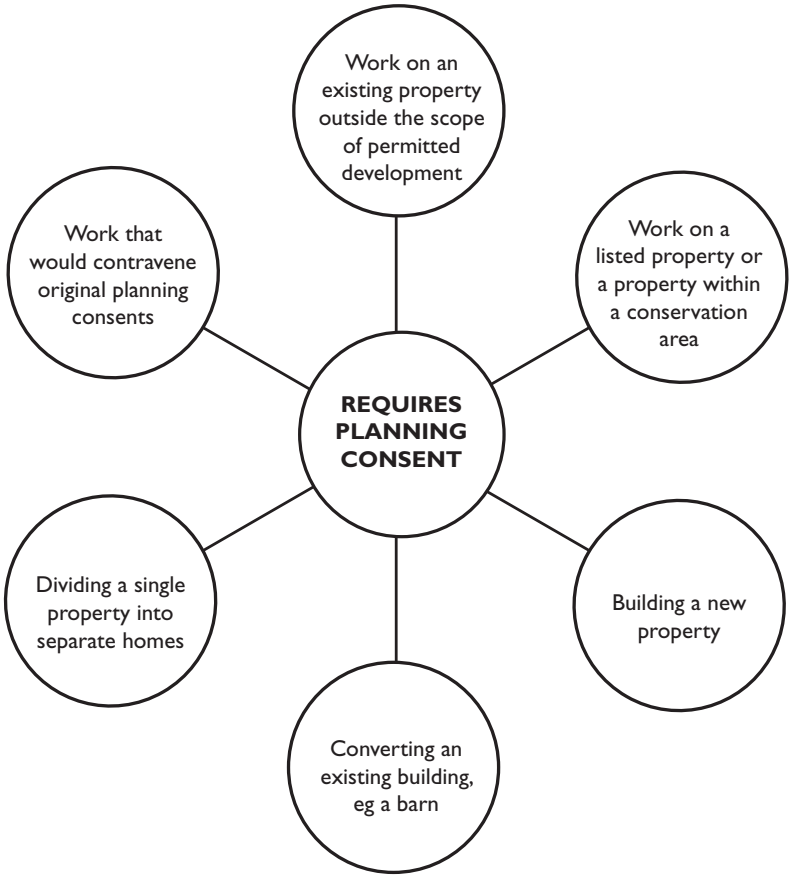
- Building materials match the existing building.
- Converting a garage internally does not add to the size of the building.
- A loft extension does not exceed $50m^3$ (detached house) or $40m^3$ (any other home).
- Erecting aerials or satellite dishes is permitted.
- A single-storey extension can project from the rear wall of the original house wall by up to 8m on a detached property and 6m on other property. Such work is subject to the neighbour consultation scheme, which requires owners to notify the local authority which, in turn, consults the adjoining neighbours. The local authority considers any issues raised before allowing the development to go ahead.

ORIGINAL HOUSE

The house as it was originally built or as it stood on 1 July 1948 (if built earlier).

The neighbour consultation scheme fast-tracks the process for non-controversial projects while protecting the reasonable interests of neighbours.

FIGURE 15.1 WHAT SORT OF WORK STILL REQUIRES PLANNING CONSENT?



It would be a serious problem if planning consent had not been granted on work on a property that was subject to a mortgage, as the local authority is unlikely to accept the work and may force the borrower to change the property back to its original condition. To make matters worse, if the borrower defaults in the meantime, the lender can be left with a property that is not saleable because it does not comply with planning laws and is subject to an enforcement order. This can result in heavy expenditure by the lender, which it may not be able to recoup from the borrower.

Unfortunately, the failure of a previous owner to gain planning consent or satisfy building regulations will not prevent the new owner from suffering the consequences. Where building work has been carried out on a property, lenders will usually ask for evidence of planning consent (or confirmation that permission was not required), before agreeing to lend.

IN BRIEF

HOW TO APPLY FOR PLANNING CONSENT

- Contact the local authority/council planning department and tell them the plan in outline.
- If they think planning consent might be needed, complete an application form.
- Submit an outline plan (known as a 'pre-application') or a detailed plan: an outline plan saves money and will enable the council to give an idea of acceptability; detailed plans are more costly. Although many local authorities now charge to consider a pre-application, it is still cheaper than producing full plans for initial discussions.
- The application is placed on the application register for public inspection. Notices will be posted on or near the site to inform neighbours.
- The planning committee makes the decision.

15.2 What are building regulations?

Building regulations relate to the structure of the development and the materials used. They are designed to set standards for the design and construction of buildings to:

- ensure the health and safety of people in or around the buildings; and
- maximise energy conservation.

The regulations are separate from planning consent, and so work may not require planning consent but will still be subject to building regulations.

The local authority has enforcement powers where the regulations are contravened, and has a general duty to enforce the building regulations in its area. The building control service can be provided by an approved inspector or the local authority.

Table 15.1 provides examples of the types of work that would be subject to or exempt from building regulations.

TABLE 15.1 WHAT BUILDING WORK IS COVERED BY AND EXEMPT FROM THE REGULATIONS?

Building work covered by the regulations	Building work exempt from the regulations*
▪ The erection of a new building ▪ The extension of an existing building ▪ Cavity wall insulation ▪ Adding or removing internal walls ▪ Loft conversion ▪ The underpinning of a building's foundations	▪ A carport extension, open on at least two sides and under 30 square metres in floor area ▪ A detached garage under 30 square metres in floor area and built at least one metre from the boundary of the property ▪ A new garden or boundary wall

*Exemptions listed above may not apply to listed buildings or those in conservation areas.

Air leakage (also called air tightness, air permeability or air pressure) tests must be carried out on a sample of new homes on all developments to ensure they meet the energy efficiency standards for new homes under Part L of the building regulations.

15.3 What is a listed building?

Listed buildings are properties that are of significant architectural or historical value. They are subject to restrictions on changes to the fabric of the building. This means that permission must be sought when changes are planned. This can affect the value of a property in two ways.

- The limitations placed on listed buildings mean that a new buyer may not be able to make changes to the exterior, or even the interior. Any 'material changes' to the fabric of the building, such as moving a kitchen or removing internal walls to change the character of the interior, will require consent. While this might preserve the heritage of the building and the area, it can be restrictive, and prospective buyers who see potential in a property may be put off by the requirements. Repairs may also be expensive, in that they have to be carried out according to strict rules and often have to use expensive original materials.
- If a listed building has been changed during a previous ownership, the potential buyer must ensure that any work carried out in the past has been the subject of relevant consent. If this is not the case, the property may need to be reinstated or the work carried out again, on the same basis that applies to planning consent.

Listed building consent is required where the owner wants to demolish a listed building or change or extend it in a way that will affect its character as a building of special architectural or historical interest. The procedure is similar to obtaining planning consent. The listing applies to the building and anything attached to it, and any buildings in its grounds. Some of the requirements may be very detailed.

Ultimate responsibility for listing buildings lies with the relevant government minister, although applications for listed building consent are made to the local authority. The local authority may consult with one of a number of government agencies in certain situations, usually where a change is proposed to a Grade I or Grade II* building (or the equivalent). The agencies are:

- England – English Heritage;
- Wales – CADW;
- Scotland – Historic Environment Scotland;
- Northern Ireland – The Northern Ireland Environment Agency.

FIGURE 15.2 WHAT ARE THE CATEGORIES OF LISTED BUILDING IN ENGLAND AND WALES?

Grade I	• Buildings of exceptional interest • Represent 2.5% of all listed buildings
Grade II*	• Buildings of particular importance • Represent 5.5% of all listed buildings
Grade II	• Buildings of special interest • Represent 92% of all listed buildings

Scotland – listed buildings fall into three categories: A, B and C(S), broadly equivalent to I, II* and II in England.

Northern Ireland – listed building categories are A, B+, B, B1 and B2.

Conservation areas are areas (rather than individual buildings) of architectural or historical significance. Local authorities, bodies such as Historic England, and the Secretary of State for Communities and Local Government all have varying powers to designate or influence the designation of conservation areas. Owners of properties in such areas may have to seek permission to carry out alterations, and will need permission to demolish the property. They may also need permission to prune or cut down trees in the designated area (note that trees with historical significance in any area may be subject to

'tree preservation orders', which means they cannot be cut or pruned without local authority consent). As with listed buildings, prospective purchasers of property in conservation areas need to be aware of any potential issues and restrictions before going ahead.

15.4 What environmental factors may cause concern?

Increasingly, the environment in which a property is located has a major effect on its desirability and, therefore, its value. There have been two comparatively recent developments that have had a serious effect on owners of certain houses.

- **Radon gas** is radioactive and is present in high concentrations in certain parts of the UK. It is believed to be highly carcinogenic and tends to work its way through cracks and cavities. To remove its effects, the owner of the property must install fans and pipes in the property to blow the gas around the house and into the atmosphere. Where practicable, particularly in new houses and extensions, a radon barrier could be laid on the floor before final screed. Similar material and cavity trays can be used to act as cavity barriers.
- **Contaminated land**: some buildings are built on land previously used for industrial purposes, leaving contaminates in the earth. Properties built on such land may be seen as posing risks to occupiers' health. Possible contamination is a consideration in property transactions based on the Environmental Protection Act 1990, and it can affect valuation due to negative perception. Many conveyancers carry out environmental searches to identify potential contamination.
- **Overhead electrical power lines** are also thought by some to cause cancer, though there is little conclusive evidence. The controversy is sufficient to make some lenders reluctant to accept mortgage business on properties with cables above them or where an electricity substation is in the vicinity.

Road-widening and infrastructure schemes are both common and controversial. In the early 1990s, some householders in Luton had a portion of their gardens compulsorily purchased in order for the M1 motorway to be widened. The compensation offered was at then-current values that were lower than had been the case only two years earlier due to the property slump. Lending institutions must be aware of such developments and their likely effects on neighbourhoods.

Another, more recent, example is the proposed High Speed railway project (HS2), planned to run from London to link eight of Britain's ten largest cities. The project required the ongoing compulsory purchase of land and buildings close to the route, and those whose property value will be affected by the line may be able to sell their property to the government at market value. However, many owners are concerned that their properties will reduce in value but not

qualify for compensation as they are not considered to be close enough to the line.

15.4.1 Geology

In addition to the above, surveyors will take into account the geology of the land: homes built on 'London clay', for example, can be prone to slippage and subsidence, as described in section 14.6.

Subsidence can also be caused by mining works, and has occurred in many of the UK's mining areas. The Coal Mining Subsidence Act 1991 sets out a framework for owners of damaged property to be able to claim for repairs or compensation. It is the responsibility of the mine owner to put right (or pay for putting right) any problems or pay compensation if repairs are not possible or not practical.

Although subsidence can usually be rectified, it may be that a property with a history of subsidence cannot be insured and will not be considered suitable security for a mortgage. Any evidence of past or present subsidence will be highlighted by a basic valuation but the valuer is likely to recommend that a specialist report be obtained before the mortgage application is approved and an offer of advance issued. Even if such a property is insurable as a result of past subsidence having been remedied, the proposed purchaser may well decide to withdraw and look for another 'safer' property.

Other environmental factors include proximity to flood plains, busy roads, mobile phone masts and substations. These factors are unlikely to affect the lending decision. However, they may affect the future marketability of the property and, therefore, the value of the lender's security.

15.5 How does renewable energy generation affect the sale of a property?

Various government initiatives aimed at reducing the UK's emissions and generally improving the environment have allowed homeowners to benefit from schemes such as the feed-in tariff (FIT). This scheme encourages homeowners to install electricity-generating technology based on renewable or low-carbon sources, such as solar panels or wind turbines. The scheme means that the owner is paid for the electricity they generate from the installation in two ways:

- one rate is paid for electricity that they generate, regardless of whether they use it or export it to the National Grid;
- an additional rate is paid for electricity that is exported to the National Grid – in other words the electricity that is generated but not used by the homeowner.

The Energy Saving Trust estimates an average installation would cost over £6,000. It has also estimated the approximate savings available to owners of a typical property. The amount varies depending on geographical location and the amount of time the property is occupied. (Energy Saving Trust, 2018).

While solar panels offer potential energy cost savings over the longer term, there could still be potential issues:

- The installations can be intrusive and may reduce the 'kerb appeal' of the property for prospective owners.
- Maintenance and repairs are the responsibility of the owner. Solar panels can put additional strain on the roof structure so this needs to be checked regularly.
- While there are immediate savings on energy costs, it will typically take between nine and ten years to recoup the cost of the panels.

A few companies offer 'rent-a-roof' schemes, where they lease the property's roof for a period of 20–25 years in return for installing solar panels on it. The company pays for installation and ongoing maintenance of the panels. There are a number of ways the schemes work, but a typical scheme would allow the homeowner to use any electricity generated for free (or in some cases at a significantly discounted rate), with any excess exported to the National Grid. The company would receive all the income from the electricity generated, which is how it makes its profit. Although initially viable for the provider, reductions in government tariffs and the cost for homeowners of buying their own panels mean that the potential profit has reduced and the number of companies offering the rent-a-roof scheme has fallen in recent years.

The arrangement saves the owner the cost of buying and installing the equipment, and also offers free electricity, but there are a number of issues to consider:

- The company will have a legal lease to use the roof for 20–25 years. The lease stays with the property, which means that if the owner sells the property the new owner will be obliged to continue with the arrangement until the end of the lease (unless the company agrees to terminate the lease, which is unlikely).
- Under the terms of the arrangement, the owner is likely to need the company's permission to make any alterations to the property that could affect the roof or the panels, such as a loft conversion. There may also be a clause that requires the company's permission to sell the property.
- If the owner needs to carry out repairs or work that requires the panels to be removed for a period, the company is likely to be entitled to compensation for lost income.

- Although most mortgage lenders will consider mortgages on a property with a rent-a-roof lease, additional work will be required to check the arrangement and grant approval.
- A minority of lenders may not be prepared to offer mortgages on properties with rent-a-roof agreements, because such agreements could be perceived as likely to reduce the number of potential buyers and so affect the security offered.

15.6 What issues arise in relation to agricultural holdings?

Agricultural properties bring with them some special issues for consideration. Not only is farming a far from trouble-free industry, but there is specific legislation that may mean expert advice should be taken. The Agricultural Holdings Act 1948 gave tenants of agricultural land a high degree of security of tenure (ie they could be very hard, if not impossible, to evict). Further, where there was evidence of poor land management, the Act allowed land to be taken out of the owner's control under a supervision order. Subsequent legislation updated the situation to an extent, but loans against the security of farmland and other agricultural land should still be approached with care, and advice should be taken where necessary.

As a consequence of the difficulties and uncertainty that this legislation presents to lenders, in terms of their ability to exercise their security promptly and effectively, some do not lend against land classed as agricultural land at all. Even the question of what is classified as 'agricultural land' for the purposes of the Act can demand fairly fine detail regarding the use of the land. Applicants for a mortgage on this type of property may need to seek out lenders with expertise who are comfortable lending on such security.

15.7 What additional security might a lender require?

WHAT IS LOAN TO VALUE?

The mortgage as a proportion of the property value is known as the loan-to-value (LTV) ratio. For example, if a house is valued at £200,000 and the mortgage is £160,000, the LTV would be 80 per cent. The LTV is based on the property valuation rather than the purchase price.

We looked in section 11.2 at the role of guarantors where the lender requires additional security due to the status of the borrower. Lenders are conservative in their underwriting, and need to make sure that, if the borrower defaulted on their mortgage and the lender took possession to sell the property, the sale

proceeds would comfortably cover the mortgage and additional costs. Most lenders do this by setting a maximum LTV threshold they would consider without some additional security – typically between 75 and 80 per cent LTV, although some lenders set a higher LTV threshold and some do not ask for additional security.

WHAT HAPPENS IF BORROWERS REQUIRE A HIGHER LTV THAN THE LENDER'S THRESHOLD?

Lenders will generally consider a higher LTV, providing the borrower pays for additional security. This additional requirement is not due to concerns about the borrower's financial position but is related to the security offered by the property. So, even if the borrower can comfortably afford the mortgage repayments, further security may be required if the mortgage exceeds 75–80 per cent LTV.

15.7.1 Higher lending charges

Where the LTV exceeds a certain level, the lender may charge a higher lending charge via a single payment that in many cases can be added to the loan.

HIGHER LENDING CHARGES

A mortgage applicant is hoping to borrow £144,000 to purchase a property priced at £168,000 but valued at £160,000. The lender requires a higher lending charge if the LTV exceeds 80 per cent.

The higher lending charge threshold is:

£160,000 x 80% = £128,000

The amount of the advance to be covered by the charge is therefore:

£144,000 – £128,000 = £16,000

If the higher lending charge rate is 4.5%, the premium will be:

£16,000 x 4.5% = £720

Some lenders take the higher lending charge as a way of offsetting the potential risk. However, although the lender is required under MCOB rules to explain the charge as a 'higher lending charge', it may use the charge to buy a mortgage indemnity guarantee (MIG) policy.

A MIG is an insurance policy that protects the lender if the borrower defaults on the mortgage and the sale of the property does not provide enough money to repay the mortgage. It will pay the lender the difference between the sale price and the outstanding mortgage, less an excess (usually 20 per cent of the amount claimed).

Although the premium is paid by the borrower, the mortgage indemnity guarantee does not actually benefit them, except in the sense that, without it, they would not be able to borrow such a large amount. The MIG contract is between the lender and the insurer. The charge is not refundable if the borrower moves or pays off the mortgage, and cannot be taken to another property or mortgage.

A MIG insurer is entitled to exercise its right of subrogation within six years of settling the claim (five years in Scotland). In simple terms, subrogation is the process by which one 'person' can stand in the place of another who has suffered damage, loss or injury. In a mortgage context, subrogation is the process by which the insurer can sue the borrower for recovery of the amount paid to the lender (the 'insured person'). The insurer is able to insist that the lender exercises prudent underwriting methods and can refuse a claim if not satisfied that that was the case.

If the lender makes a claim on a MIG policy, an excess will be deducted from the insurance payment. The lender has the right to claim the excess from the borrower, as long as they inform the borrower of the intention to do so within six years of the property being sold (five years in Scotland). Such a claim would be made in the lender's own right, so would not be made through subrogation.

WHAT IS SUBROGATION?

Subrogation is the right of an insurer to pursue a third party that caused an insurance loss to the insured person. For example, if a person has a car accident caused by another driver, their insurer will meet their claim and then claim the amount it paid out from the person who caused the accident (or that person's insurer).

How does this work in relation to mortgage lending?

If a lender sells a repossessed property for £120,000 but the total owed by the former borrower is £130,000, the claim made by the lender on any MIG would be for £10,000, less the £2,000 excess (ie 20 per cent of the claim).

The insurer will probably sue the borrower under its right of subrogation for the £8,000 that it has paid to the lender. The lender could also sue the former borrower (not through the right of subrogation) for the £2,000 excess, which is the loss it has suffered.

15.8 What professional fees might a buyer incur?

As we have seen, buying a house involves the payment of fees for the services of experts. The next section looks at the typical fees involved and whether they are refundable if the purchase fails to complete.

15.8.1 Estate agents

Estate agent fees are paid by the vendor once the sale has been completed and can vary between 1 and 3.5 per cent of the sale price, depending on whether the agent has sole selling rights or joint/multiple agency. Some agents charge a fixed fee, unrelated to the sale price. Most agents have a no sale, no fee agreement.

The development of online estate agents offering lower and often fixed fees has led to more competitive fees from high street agents. Fees tend to increase during buoyant markets and decrease slightly in poor markets.

15.8.2 Mortgage fees

FIGURE 15.3 WHAT MORTGAGE FEES MAY BE PAYABLE?

Product fee

- Payable when the borrower wishes to take advantage of a special deal – eg a fixed-rate mortgage
- May be a flat rate or a percentage of the mortgage, and may be refundable if the mortgage does not go ahead due to circumstances beyond the reasonable control of borrower or lender
- Can usually be added to the loan if required

Application fee

- Charged by some lenders on some or all of their mortgages to cover assessing and processing the application
- The fee can be as low as £50 and as high as £2,000 or more. In many cases, the arrangement fee includes a basic property valuation

Higher lending charge

- Where the LTV exceeds a certain level (see section 15.7.1)

Lender's reference fee

- Typically around £50 may be charged by an existing lender to supply the new lender with a reference in relation to the conduct of the existing account
- They are less common now because online central databases contain information about mortgage accounts

Adviser fee

- May be charged by an intermediary (broker) to arrange the mortgage
- Must be stated clearly in the intermediary's initial disclosure information
- Most commonly a fixed charge, although some intermediaries charge a small percentage of the mortgage advance, especially for non-standard cases
- In addition, the intermediary may receive a procuration (finder's) fee from the lender; advisers employed by the lender are not required to disclose this information

Mortgage packager fees

- Mortgage packagers (see Topic 1) charge fees ranging from a percentage of the mortgage to a flat fee of £300 upwards

MORTGAGE EXIT FEES

MCOB rules require the lender to state the amount of any fees to be paid on redemption of the mortgage, although it is acceptable for the lender to state the current fee (ie it may change over the life of the mortgage). The FCA's guidance for lenders is based on principles of fairness outlined in the Consumer Rights Act 2015.

The FCA considers the following to be acceptable components of the lender's costs of redeeming a mortgage:

- deed release fees;
- Land Registry charges;
- staff processing cost;
- a reasonable proportion of general overheads.

Where a borrower considers a mortgage exit fee to be unfair, they have the right to refer the case to the Financial Ombudsman Service, where the case will be considered on the basis of fairness.

An increase in a mortgage exit fee from the amount originally stated is likely to be reasonable if the contract contains a valid reason for an increase. The most likely valid reason would be increases in the lender's administration costs between the start of the contract and redemption. Any increases must represent the true increase in the lender's costs, and the right to vary the costs should be explained clearly in the contract.

15.8.3 Valuation and surveys

We looked at the different types of valuation and survey available and the likely costs of each in Topic 14.

15.8.4 Legal fees

The solicitor or conveyancer will charge a fee to cover the legal work carried out during the purchase process; it is payable on completion of the purchase. If the sale does not complete, some solicitors will reduce their charge, particularly if they are asked to carry out another purchase. Many solicitors now charge a flat fee, regardless of the property value.

In addition to the conveyancing fees, there are a number of additional fees and disbursements incurred by the conveyancer, as shown in Table 15.2.

TABLE 15.2 WHAT TYPICAL ACTIVITIES GENERATE CHARGES?

Activity	Description
Local Land Charges Registry (Local authority searches)	Before exchange of contract and not refundable once completed. The Local Land Charges Registry searches identify any obligations or restrictions attaching to the property. Enquiries of the local authority identify plans for new roads and developments that may affect the property.
Land Registry search	Pre-exchange and not refundable once completed. The fees are charged per register and depend on whether the search is conducted online, by post or in person, with online searches being less costly. Unregistered property may require a search of more than one register.
Environmental searches	Pre-exchange and not refundable once completed. They check for a history of flooding, mining subsidence, radon gas and so on.
Drainage search	Searches the water authority's records to check whether the property is connected to mains drainage and water supply, and if so the location of sewers and drainage pipes. Fees are not refundable once the search is completed.
Bankruptcy searches	Pre-exchange and not refundable once completed. These are carried out to ensure that the buyer is not an undischarged bankrupt. A bankruptcy search may also be conducted on the vendor if there is suspicion that they may not be entitled to receive the proceeds due to bankruptcy.

Land Registration fees	Payable to the Land Registry after completion of the sale to register the property in the new owner's name. The fees range from £40 for a property sold for £80,000 or less, to £910 for a property sold for more than £1m where application is made by post. Fees are reduced by 50 per cent when using the government online portal. The fee varies from £40 to £250 where a new mortgage is registered on a property but ownership does not change.
Indemnity fees	Title indemnity is required where the title cannot be fully guaranteed. The fee is typically 0.10 per cent of the property value, paid before completion. The policies can be arranged to protect only the lender, or the lender, the borrower and any subsequent purchasers. It is also possible to arrange indemnity insurance to protect the buyer against other potential problems. This might be appropriate in cases where an extension has been built and no evidence of planning consent is available. Indemnity insurance would cover the buyer against financial losses caused by retrospective local authority action, but not in relation to the quality of construction.

15.9 Property transaction taxes

Property transaction taxes are levied on the physical transfer of the property (or a lease) from the vendor to the purchaser.

The tax is applied progressively on each band of the property's value. As a result of devolution, the governments of Scotland and Wales have certain tax setting powers. Both governments have used these powers to introduce their own forms of property transaction tax – Land and Buildings Transaction Tax in Scotland and Land Transaction Tax in Wales. These are covered in sections 15.9.4–5.

15.9.1 Stamp duty land tax (England and Northern Ireland)

Stamp duty land tax (SDLT) applied throughout the UK until 2015, when the Scottish government replaced it in Scotland with Land and Buildings Transaction Tax (LBTT). The Welsh government replaced it from 1 April 2018 with Land Transaction Tax (LTT). SDLT now applies only to England and Northern Ireland.

Temporary reduced SDLT residential rates were applied during the 2020/21 tax year due to the Covid-19 pandemic. Since 1 April 2021, non-UK residents purchasing property in England and Northern Ireland are subject to an SDLT surcharge.

For certain 'non-natural persons', such as corporate bodies, SDLT is charged at a higher rate where the price is more than £500,000. This may be reduced by the application of a number of reliefs available in certain situations.

Since 1 March 2019, SDLT is payable by the purchaser through their solicitor within 14 days of completion.

Leasehold property

When someone buys a leasehold property, they buy the lease for a premium from the current owner and must also pay ground rent to the freeholder. If the property is subject to an existing lease, the SDLT is calculated on the premium in the same way as on the purchase price for a freehold property. SDLT is not payable on the ground rent.

When the lease is new (such as for a new-build flat), the premium may be subject to SDLT depending on the premium amount. If the ground rent is more than nominal, SDLT may be payable on the lease as well.

The value of the rent is the net present value, which is the total amount of rent payable over the term of the lease as calculated using a prescribed formula. Where annual rent is high enough to exceed the SDLT threshold, there could be SDLT to pay on the rent as well as on the premium. However, no SDLT will be payable on the rent if the buyer qualifies for the first-time buyer exemption.

First-time buyer exemption

The Chancellor introduced a first-time buyer SDLT exemption in the November 2017 Budget, which became effective on purchases completing from 22 November 2017 and is now a permanent part of the SDLT regime.

- First-time buyers are exempt from SDLT on residential properties valued at £300,000 or lower.
- On residential properties valued between £300,000 and £500,000, first-time buyers are exempt from SDLT on the first £300,000 and pay SDLT at the normal rate of 5 per cent on the balance.
- The first-time buyer exemption does not apply to residential properties with a purchase price exceeding £500,000.

In order to qualify for the first-time buyer exemption, the buyer and property must meet certain criteria as follows.

- **First-time buyer** – a buyer who does not own or has not previously owned, anywhere in the world, a major interest in a dwelling* or an equivalent interest in land. A 'major' interest means that they are the person for whom the property is intended to be of benefit. So, a trustee would be named as the legal owner of property bought to provide a home for the absolute beneficiary of the trust but, as they are not the person intended to benefit, they would not be deemed to have a major interest. Conversely, although

the trust beneficiary would not be the legal owner, they would have a major interest because they are the person intended to benefit from the property.

Ownership of non-residential or mixed-use property does not count as long as it does not include a dwelling.

*If the buyer owned a property, but on a lease with less than 21 years to run, they would still be deemed a first-time buyer and would be eligible for the exemption.

- **Joint buyers** – in order to benefit from the first-time buyer exemption, both joint owners must meet the definition of a first-time buyer. This means that if one of the joint owners owns, or previously owned, property then the exemption will not apply.
- **Main residence** – to benefit from the exemption, the buyer must intend to occupy the property as their only or main residence. There is no requirement for the buyer to occupy the dwelling immediately after purchase, but there must be a clear intention to occupy it as a main residence in the future. This allows for circumstances where it is not possible or practical for the buyer to move in immediately.
- **Definition of dwelling** – in simple terms, a dwelling is a building, or part of a building, where people will live or a building where they will be able to live once adaptation or construction has been carried out. The exemption applies only to the purchase of a single dwelling. For example, if a house has a self-contained 'granny annexe' where the annexe has separate access and facilities enabling the occupier to live independently from those in the main house, the building would count as two dwellings and the exemption would not apply.
- **Shared ownership** – if the buyer is purchasing a property on a shared ownership scheme, the first-time buyer exemption is available. The buyer can choose to apply SDLT to the market value of the property or to the share purchased. For example:
  - Property market value £300,000 or lower – opt to pay SDLT on the market value, although no SDLT would be payable as the full first-time buyer exemption (under £300,000) applies, regardless of the cost of the share purchased.
  - Property market value £350,000, share purchased £250,000 – the buyer has two choices, to opt to pay SDLT on the:
    - full market value, which would be 5 per cent of the £50,000 above £300,000 (£2,500); or the
    - share purchased – £250,000 is within the SDLT exemption of £300,000, so no SDLT would be payable when purchasing the initial share.

  However, if the market value exceeds £300,000 and the buyer opts to pay SDLT only on the share purchased, there could be SDLT when further shares in the house are purchased. Further details are in section 25.1, but in simple

terms, once the owner buys a further share or shares taking their total share above 80 per cent of the property's value, SDLT is payable on all additional shares bought since the first share was purchased, based on the total price paid to that trigger point.The first-time buyer exemption does not apply to the further shares purchased.

SDLT: EXAMPLES

The following scenarios use example SDLT rates.

Carrie buys a flat for £200,000. Assume the nil-rate threshold is £125,000 and the band from £125,001 to £250,000 attracts 2% SDLT. She pays:

Purchase price	Rate	Amount
First £125,000	Nil	Nil
£125,001–£200,000	2%	£1,500
Total		£1,500

If Carrie was a first-time buyer she could claim the first-time buyer exemption and would not pay SDLT.

Alan and Adrian buy a house for £450,000. Assume the band from £250,001 to £925,000 attracts 5% SDLT. They would pay:

Purchase price	Rate	Amount
First £125,000	Nil	Nil
£125,001–£250,000	2%	£2,500
£250,001–£450,000	5%	£10,000
Total SDLT		£12,500

If Alan and Adrian were both first-time buyers they would pay:

Purchase price	Rate	Amount
First £300,000	Nil	Nil
£300,001–£450,000	5%	£7,500
Total SDLT		£7,500

Andy and Clare buy a house for £650,000. They pay:

Purchase price	Rate	Amount
First £125,000	Nil	Nil
£125,001–£250,000	2%	£2,500
£250,001–£650,000	5%	£20,000
Total		£22,500

Andy and Clare would have to pay the full SDLT, even if they were first-time buyers.

Cerys and Gareth buy a house for £1.4m. Assume the band from £925,001 to £1.5m attracts 10% SDLT. They pay:

Purchase price	Rate	Amount
First £125,000	Nil	Nil
£125,001–£250,000	2%	£2,500
£250,000–£925,000	5%	£33,750
£925,001–£1.4m	10%	£47,500
Total		£83,750

15.9.2 Buy-to-let property and second homes

Buy-to-let and second home purchases for £40,000 or more are subject to an additional 3 per cent SDLT over and above the standard rate applying to the purchase price. The surcharge applies if the purchaser of a property owns a major interest in a property and then buys another property that is not to replace their existing main residence. A major interest is where the individual owns, or jointly owns another residential property anywhere in the world, and their share is worth more than £40,000.

EXAMPLE: MAJOR INTEREST THRESHOLD

If a married couple own a flat worth £75,000 on a joint basis, they would each be deemed to have an interest worth £37,500. As this is below the £40,000 threshold, neither would be required to pay the surcharge when buying another property.

The rules are complex, so we will consider just the main points. For the sake of simplicity, we will call the second purchase the 'new property'.

- The surcharge will not apply if the new property is purchased to replace the buyer's main residence. This means that if the individual already owns the family home and a holiday home, they can sell or gift the family home and buy a new one with the intention that it will be their new home. This would not incur the surcharge, even though they would own two properties.
- The surcharge applies if no other person has a lease on the new property that has more than 21 years to run.
- The surcharge applies if the chargeable consideration (price paid) for the new property is £40,000 or more. The £40,000 threshold applies to the total consideration rather than each joint owner.

General

Investors are required to declare that the property will not be used as their main residence – effectively they are required to 'opt in' to the SDLT surcharge. In the case of joint borrowers, the surcharge applies if just one of the buyers owns another property. If a home-owning parent agrees to help their child to buy a home, and as part of the agreement is registered as joint owner, the surcharge will apply, because the parent already owns their home. The surcharge also applies where someone owns a property abroad, even for holiday use, and buys a property in the UK for the first time.

It is also important to understand that, from an SDLT perspective, HMRC considers married couples and civil partners to be one 'unit' for property ownership. This means that as long as they are living together, property owned in the sole name of one partner will be regarded as being jointly-owned for the purposes of SDLT. So, if the property is registered in the sole name of the husband and the wife decides to buy her own property, her purchase will be subject to the second home surcharge, even though it is her only property. Living together is defined as married or in a civil partnership, and not divorced or legally separated.

There are special rules for two situations where someone might buy a second home:

- If the disposal of the existing main residence takes place before the land transaction return for the new residence is due, no additional SDLT will be due. If the individual(s) buy(s) a property intended for use as their main residence before selling their existing home, they can claim a refund of SDLT if they dispose of their original property within 36 months of buying the new home.
- If they sell their main home, keep an existing buy-to-let property, and then buy a new main home, no SDLT will be payable if they buy the new family home within 36 months.

There is what may be seen as an anomaly regarding SDLT. If two people buy a property together and one of them already owns a property, the purchase will be subject to the 3 per cent surcharge. This applies even if one of the buyers is a first-time buyer. There are two particular situations where it appears to have unintended consequences.

- A parent wishes to help their son or daughter to buy their first property but wants to be registered as an owner, either to give them some security over the property or to obtain a mortgage that the child could not otherwise afford. In a joint borrower, sole proprietor scheme, whereby a parent or relative is a joint borrower as a way to provide security, the property is registered in the single name of the person they are helping. As the 'helper' is not registered as a legal owner, their situation is not taken into account for either the first-time buyer exemption or the second property SDLT surcharge.
- Two people who each own property decide to move in together, buy a joint property and one or both parties decide to keep their original property. This could be as an investment, as security in case the relationship breaks down or simply because they cannot sell. It may be possible to claim a refund if the original property is sold within 36 months, although this will not help to alleviate the initial expense.

Married couples and civil partners

We looked at the position for 'normal' situations regarding married couples and civil partners. There are certain circumstances in which the surcharge will not apply.

- If a court orders, as part of a divorce settlement, that one party may remain in the former marital home until a specified event, such as remarriage or sale, but both parties can remain as joint owners. The surcharge will not apply if the person who left the property buys another main residence.
- In circumstances where a separation is likely to be permanent, SDLT will not be payable if one party buys a new home before the family home has been sold or transferred. This 'relief' is not automatic, and each case is considered in light of the circumstances, but there must either be a Court Order, a separation agreement or a permanent desire to separate.
- In situations where a spouse or civil partner transfers or sells their interest in a property to their spouse/civil partner, as long as there is only one buyer and seller, and they are married and living together on the date of the transfer.

15.9.3 Multiple property purchase

If the purchaser buys more than one residential property from the same vendor at the same time in a single transaction, or as part of a series of linked

transactions, the amount of SDLT chargeable will be determined by the average value of each property.

SDLT ON MULTIPLE PROPERTY PURCHASES

If an individual bought four properties at a total cost of £800,000, SDLT would be charged as if each property was sold for £200,000, and then the result multiplied by the total number of properties. The SDLT is the result of that calculation or 1 per cent of the combined purchase price, whichever is higher.

Assume the first £125,000 attracts 3% SDLT, and the band from £125,000 to £250,000 attracts 5% SDLT. An average purchase price of £200,000 would result in SDLT of:

£125,000 @ 3% = £3,750

£75,000 @ 5% = £3,750

Total for each property: £7,500

£7,500 x 4 = £30,000 total bill for the four properties.

If the purchase is for six or more properties, the buyer can opt to apply commercial property SDLT rates to the total value of the purchases but cannot use multiple property relief as well.

15.9.4 Land and Buildings Transaction Tax (LBTT)

In Scotland, LBTT replaced SDLT from 1 April 2015, reflecting the Scottish Parliament's right to establish certain tax legislation. Although essentially the same as SDLT in how it works as a progressive tax, the rates and thresholds for LBTT are different. LBTT is collected by Revenue Scotland, rather than by HMRC.

Buy-to-let and second properties purchased for £40,000 or more are subject to a 4 per cent LBTT surcharge, applied in the same way as SDLT in the rest of the UK.

First-time buyers are exempt from LBTT on the first £175,000 of the purchase price of a property, with no upper limit on the purchase price.

15.9.5 Land Transaction Tax – Wales

SDLT was replaced by Land Transaction Tax (LTT) in Wales from 1 April 2018. The Welsh government has set LTT rates progressively.

A surcharge on each band applies to second properties and buy-to-let properties with a purchase price above £40,000.

The Welsh government confirmed that there is not a first-time buyer exemption from LTT. Instead it raised the nil-rate threshold with the idea that at least 45 per cent of purchases will not be subject to LTT and the average first-time buyer will not have to pay it.

FACTFIND

To find the current SDLT rates, go to: https://www.gov.uk/stamp-duty-land-tax

To find the current LBTT rates, go to: https://www.revenue.scot/land-buildings-transaction-tax

To find the current LTT rates, go to: https://gov.wales/welsh-taxes

[All accessed: 26 October 2020].

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the types of building project that fall within the scope of 'permitted developments'?
- explain the implications for lenders and borrowers if building work is carried out without the necessary planning consent?
- explain why some lenders are not willing to grant mortgages for agricultural property?
- explain the implications for the borrower if the lender imposes a higher lending charge?
- list the mortgage fees that a borrower may have to pay?
- describe how SDLT is calculated on multiple property purchases?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

Energy Saving Trust (2018) *Solar panels* [online]. Available at: http://www.energysavingtrust.org.uk/renewable-energy/electricity/solar-panels [Accessed: 26 October 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 15. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following would not be deemed a 'permitted development'?

   a) A loft extension of $40m^3$.

   b) Internal conversion of a garage.

   c) A two-storey extension 2m deep.

   d) A barn conversion.

2) Which of the following would be exempt from building regulations?

   a) A $25m^3$ extension.

   b) Cavity wall insulation.

   c) A detached garage with a floor area of $20m^3$.

   d) A loft conversion.

3) Local authorities generally give retrospective planning consent if all their requirements have been met. True or false?

4) Converting an attached garage internally to create a living room of the same size would not usually require planning consent. True or false?

5) A rent-a-roof scheme contract for solar panels is automatically terminated if the property is sold. True or false?

6) Local authority searches generate a non-refundable charge before exchange of contracts. True or false?

7) Glen owns a third share in a buy-to-let flat, valued at £100,000, which he intends to keep. He is now buying a house for his family. Glen would not have to pay 3 per cent stamp duty land tax surplus on his new purchase. True or false?

8) Vicky's property purchase fell through just before exchange of contracts. She had already incurred a number of fees and charges. Which of the following fees could be carried forward to a new property purchase?

   a) Solicitor's fees.

   b) Local authority search.

   c) Environmental search.

   d) Land Registry search.

9) Clive owns a family home in Brighton. Would he have to pay SDLT on a buy-to-let purchase of £180,000?

10) Joe is buying seven buy-to-let flats in one transaction. He can choose to pay SDLT at commercial property rate. True or false?

TOPIC 16

Financial protection and planning

LEARNING OBJECTIVES

By the end of this topic, you should have an understanding of:

- people's income and capital protection needs;
- reasons for and consequences of underinsurance;
- differing protection priorities depending on circumstances;
- considerations in prioritising protection needs.

THINK ...

Before you start work on this topic, take a moment to think about what you already know about financial protection.

For instance:

- What societal factors make it crucial for people to protect themselves?
- Why do some people have little or no financial protection?
- Consider the situation of your close friends and family. How might their lives be affected financially if they suffered a death, disability or serious illness?
- Are there differences in the potential implications among people you know? If so, why?

16.1 Income and capital protection needs

A death or serious illness in a family can have many consequences, not all of which can be alleviated by financial means. No amount of money can bring back a loved one who has died or ease the feelings of a family member caring for someone who is seriously ill. However, the effects of a death or serious illness can be worsened by financial difficulties that arrive when those affected feel least able to cope with them.

CHECK YOUR UNDERSTANDING

Think back to when you looked at protection products in your UKFR studies.

a) What type of life insurance product is usually best to support a mortgage?

b) Why would we not normally use the other type of life insurance to protect a mortgage?

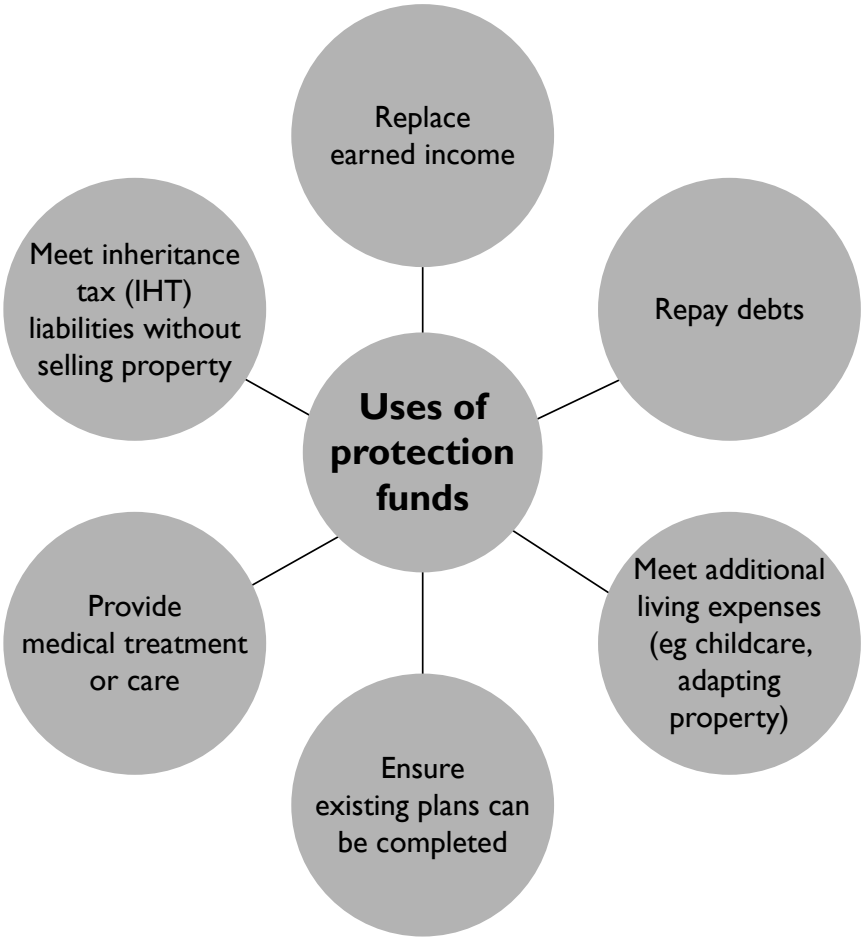
Check your answers against those in the back of the book before continuing with this topic.

There are almost always financial consequences for the family if a person dies or suffers a serious illness.

- This is most evident when that person e**arns an income on which the household depends**. A serious illness can also prevent further earnings or reduce earning capacity, while increasing outgoings due to treatment costs and the expenditure of visiting the loved one.
- A person who does not earn an income is likely to make a **key contribution to looking after children or the home**. If they die or become seriously ill, it may be necessary to employ someone else to do that work.
- People may also require **additional capital**, ie a lump sum, to cover costs beyond income such as mortgages, loans or other debts, or funeral costs.

By making adequate financial provision through various protection policies, people can mitigate the adverse financial consequences arising from death, sickness or disability (see Figure 16.1).

FIGURE 16.1 USES OF FUNDS FROM A PROTECTION POLICY



IN BRIEF

PROTECTION FOR MORTGAGE PAYMENTS

There is a vital need to protect repayment of outstanding interest and capital on a mortgage (ie property loan) in the event of death, illness, accident or redundancy. A person's loss of earnings might arise from any of these causes and the effect can be devastating for the family, who may have to sell their property and move elsewhere.

Unemployment and redundancy are, alongside divorce and separation, the major causes of arrears and subsequent repossession of mortgaged properties.

Certain situations would lead to immediate difficulties in the event of death or illness:

- little or no savings;
- inability to replace earned income;
- unprotected debts;
- financial dependants (often, but not exclusively, a young family).

If one or more of these criteria apply, there will likely be a need to protect against the financial effects of death and long-term inability to generate income.

CONSIDERATIONS: FINANCIAL PROTECTION FOR ILLNESS OR DISABILITY

In some ways, the need to provide adequate protection against the financial effects of illness or disability is greater than protecting against the effects of premature death.

- On the **death** of an individual, those left behind have to cope with a changed situation. Death may bring many adverse financial outcomes but the need for large financial outlay is unlikely to be one of them. On death, replacement income is likely to be required, as well as funeral costs and possibly replacement of employer-provided benefits.
- In the event of **illness or disability**, the consequences may be more acute: not only is there the possibility that an income earner can no longer work or that a homemaker can no longer do household jobs; they may also need medical care, personal care and adaptations to the home. In lots of cases, the care may not be funded.

Defining the amount of cover required

There is no universal rule for calculating the amount of cover required but it is usually based on quantifying the shortfall in income that dependants would suffer.

The shortfall can be expressed as the difference between the:

- amount of protection that **would be needed** if the risk event happened; and
- amount of protection that the client **currently has**.

An amount of protection may already be in place from savings or investments, existing protection policies, or state provision.

16.1.1 Underinsurance and its consequences

There is a considerable amount of underinsurance for life cover and illness or accident protection in the UK. The main reasons are as follows.

- **'It won't happen to me'**: some people perceive that the chances of them needing protection are low, but in reality many people of working age die or fall ill every day.
- **Misapprehension of needs**: many do not fully appreciate the magnitude of their protection needs and may believe they have sufficient cover. It is the adviser's responsibility to help the client recognise the nature and size of their need, so they can understand the potential financial impact.
- **Affordability perception**: many clients believe they cannot afford to provide full protection, not realising how affordable protection policies can be, especially if taken out when relatively young. The adviser's responsibility is to help the client prioritise their needs and to allocate resources accordingly.
- **State provision**: other clients may feel confident in the provision of state benefits. However, state benefits are unlikely to support more than a threshold standard of living.
- **Unhappy subject**: the topic is not pleasant; who would want to discuss death, illness and the potential financial consequences of either?
- **Consumer trust and product complexity**: consumer trust in the insurance sector is the lowest in financial services, and price is customers' main driver. Complexity of products is also an issue, with "almost half of income protection customers [finding] policies hard to understand" (FCA, 2020). More than half of customers without life assurance say they would be encouraged to take out "simple, low-cost cover" (FCA, 2020).

EXAMPLE: CONSEQUENCES OF INADEQUATE PROTECTION

Rebecca and Leo are young parents who earn £19,000 and £17,000 gross (ie before deductions) respectively in trainee roles. They currently have no financial protection in place except buildings insurance for their home.

- If Rebecca could no longer work due to accident, illness, disability or death, Leo would have a monthly shortfall of about £1,400.
- If Leo could no longer work or died, Rebecca would have a monthly shortfall of about £1,300.

The couple budget to use most of their earnings on essential spending with a modest amount saved each month, so a shortfall would cause immediate problems. If the healthy or surviving partner could not make up the shortfall, such as through a loan from family, they would struggle to make ends meet.

There would be additional considerations and expenses depending on the event that occurred.

16.1.2 How do mortgages affect consumer attitudes?

Many people first take out a protection policy when they take on a mortgage. The mortgage debt tends to focus their minds on the problems that would arise if the debt were not repaid on death, or if serious illness led to a reduction in earning capacity.

The death of a property owner is traumatic enough for family and friends, but if the property is mortgaged there could be additional problems.

- If the property was **registered in the deceased's sole name**, those who will benefit from the estate will need to pay off the outstanding mortgage.
- If the property was r**egistered as a joint tenancy**, the survivor will still have an outstanding mortgage on the property, even though they become the sole owner. This could cause problems with mortgage repayments, because only one party is contributing to the mortgage whereas both likely contributed in the past.
- If the property was **registered as tenants in common**, the deceased's share will pass according to their will. The survivor will be jointly and severally liable for the mortgage, so could end up with the whole mortgage but effectively only own half the value of the property.

Protecting the mortgage is relatively simple, with the type of product dependent on the type of mortgage. However, although the mortgage offer may recommend life cover, it is up to the mortgagor to arrange it. Lenders assume that the property would provide them with security in the event of a mortgagor's death.

People tend to grasp how inadequate protection may affect their ability to continue paying a mortgage. They may find it harder to understand the broader impact of death or serious illness on the household, even though this represents by far the greater need.

Other life events can also spur people to consider the adequacy of their financial protection, such as the birth of a child or the death/illness of a parent or close friend.

16.1.3 Risk and underwriting in insurance

Once the decision to purchase a protection plan is made, an application must be completed according to legal processes. The application then goes through a process of underwriting – a different process than for mortgage underwriting – to assess the risk involved in insuring the applicant.

The insurance underwriter considers relevant factors related to the health, lifestyle, occupation and environment of the person being insured. If the underwriter is wildly wrong in their predictions, the company will suffer a serious loss.

Insurance companies average out the uncertainties by spreading the risk over a large number of clients, while also considering risk probability. The underwriters then decide for each client whether the premium (ie monthly or yearly amount paid) should differ from the standard rate and by how much.

IN BRIEF

RISK PROBABILITY IN INSURANCE

The premium paid for an insurance policy depends on a risk estimate carried out by actuaries, who use past statistics to assess the probability of the risk occurring. The greater the probability of the risk occurring in a particular case, the higher the premium.

16.2 Protection priorities

Consumer priorities differ depending on a person's circumstances. Let's outline typical client characteristics that may indicate a need for protection at various generic life stages. These generalisations are only a guide; every client is different and their exact needs should be understood.

Young, single person

Protection is primarily intended to protect against the consequences of financial loss. For a young, single person, there may be no adverse financial consequences in the event of their death, even if they have a mortgage or other loans.

Any outstanding mortgage or debts might be repaid from the sale of the property and by the use of savings. So, financial protection through life assurance is unlikely to be a priority.

- Protection in the event of **illness or accident** is, however, likely to be important to maintain standards of living if the person is unable to work.
- Protection against the financial effects of **critical illness or unemployment** is also likely to be significant.

Younger couple without children

For a married couple, civil partners or partners who live together, the needs are likely to be more diverse. The guiding factor remains the extent of potential financial loss in various situations.

EXAMPLE: STRAIGHTFORWARD PROTECTION NEEDS

Farida and Niraj both work. They have no joint liabilities and no dependants.

Their main need is income protection in the event of an inability to work, and protection against the additional costs resulting from one of the parties suffering a serious illness.

A joint mortgage or unsecured debts may require protecting to the extent that each partner would be unable to afford repayments in the event of death or illness of the other.

A young couple may also have an interest in private medical insurance (PMI). Planning for long-term care is another area of need but, psychologically, may be too far away to worry about at this life stage.

The need to plan for IHT in expectation of receiving future legacies is a possibility, depending on the situation.

IN BRIEF

PRIVATE MEDICAL INSURANCE

PMI provides cover for medical expenses and allows an individual access to private medical treatment, so they are not entirely reliant on the NHS and can avoid NHS waiting lists. PMI is aimed at covering acute conditions, which develop rapidly and respond to treatment.

Younger couple with children

The situation of a young couple with children is similar to that of those without, but their needs are magnified. If both parents work, with children in paid childcare or being looked after by other family members, the couple is likely to rely on both incomes. So, protection in the event of death and illness is crucial.

If one of the parents looks after the children full-time, the protection needs are not likely to be much diminished. Someone would probably need to be employed to carry out that role if the parent were to fall ill or die.

Middle-aged couple, children have left home

Many of the protection needs from earlier in life may have disappeared by middle age.

As children leave home and become financially independent, the need for financial protection in the event of death and illness decreases, although it is unlikely to disappear.

Mortgages and other debts may be reduced, or perhaps paid off, and this will reduce the need in some areas of protection.

However, other needs may come to the fore:

- ensuring that the costs of medical treatment are protected through PMI;
- planning to fund long-term care needs;
- IHT planning, depending on the size of the couple's estate and their plans for its future distribution.

Retirement

Reliance on earned income will have ceased by retirement. This reduces the need for protection in the event of death or illness, because the individual no longer relies on their ability to work to generate income. However, the nature of needs may change.

Benefits from pension plans will continue to be paid if the pension holder becomes ill. However, if the member dies, benefits are likely to be reduced and may even be wiped out.

EXAMPLE: ANNUITIES

If the scheme member has bought an annuity (which pays an income in retirement), this will cease on death unless there is annuity protection or a guarantee period.

A scheme pension may cease or pay only reduced dependants' benefits on the member's death. Ensuring that a spouse/partner and dependants are adequately protected may be a major area for planning at this stage in life. Other priorities are likely to be IHT mitigation and care provision.

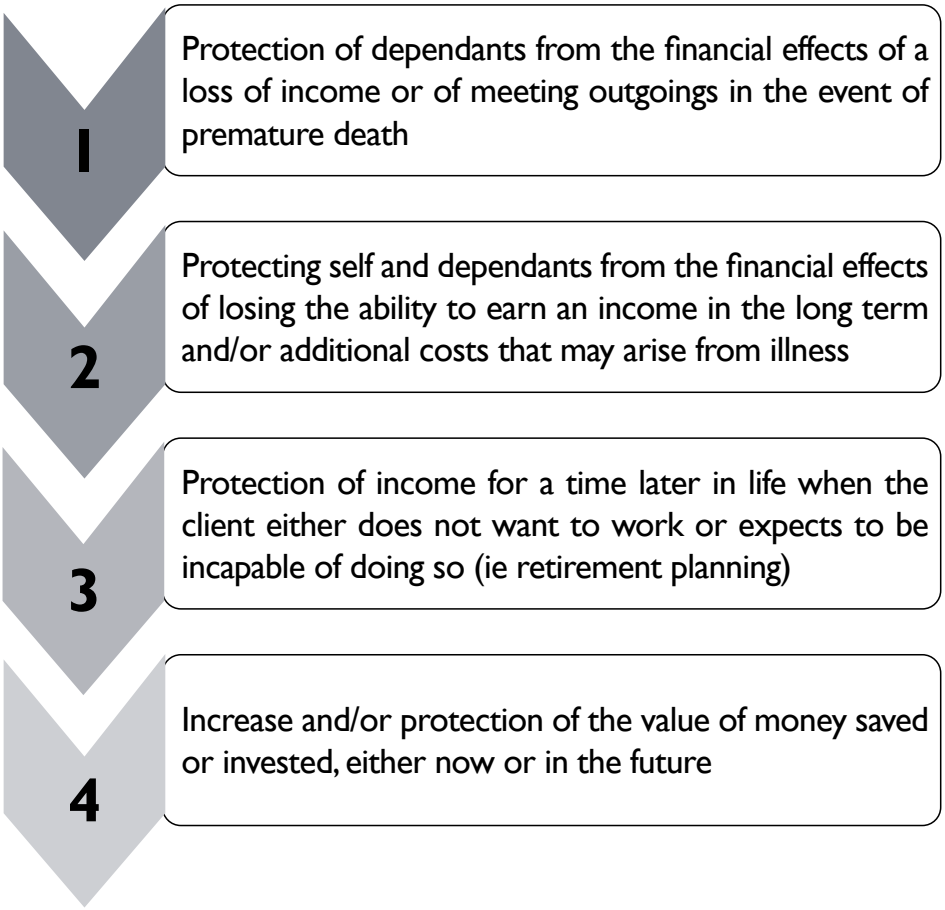
16.2.1 Prioritisation of needs

The need to protect against the effect of illness or accident does not sit in isolation: there is a strong connection to protection needs in the event of death. Some of the policies that protect against the event of death have options that allow a degree of protection against the effects of illness.

With such a diverse range of possible needs, budget is likely to be a major constraining factor in protecting against the consequences of illness. It is crucial that the adviser agrees the client's protection priorities.

A good starting point is to think about where a client's protection needs sit in comparison with their other financial needs. Protection of current and future income levels is often assumed to be the highest priority. One method of ranking individual financial needs is to order them as in Figure 16.2.

FIGURE 16.2 RANKING FINANCIAL NEEDS



The overriding consideration is to ensure adequate protection of what the client currently has before looking to improve things for the future.

However, it is difficult, and perhaps inappropriate, to generalise about how various protection needs should be prioritised because much depends on each client's situation and objectives.

Issues to consider include the following.

- The amount and duration of sick pay provided by an employer may be an important factor in prioritising income protection needs.
- Family medical history may be a factor in determining the priority of cover such as critical illness cover (CIC).
- Support from family or friends may mitigate the costs associated with illness, disability or premature death.
- The need for long-term care can be addressed later in life if finances do not permit immediate action.

- Life cover is likely to be less important for someone who is single with no dependants than it is for a client with a family.
- Where a client lacks practical or financial support, income protection insurance (IPI) and CIC are likely to be particularly important.
- For a family, protection needs are likely to exist across several areas.

CLIENT AWARENESS VERSUS ABILITY TO ACT

Even if a client accepts that they need financial protection and understands the extent of the need, they may not commit to taking all or any of the recommendations. Often, this is a result of budgetary factors and competing financial demands.

Where cost is an issue, there needs to be a degree of compromise, and the client must be aware of the best options for them. Part of this process may involve developing a portfolio of protection policies with different plans over different terms that aim to meet each of the client's needs.

FACTFIND

Visit the websites of some life and illness protection companies and make notes on what guidance they give on:

- the factors to take into account in setting an amount of cover;
- which areas of financial protection should be seen as priorities; and
- other areas of financial planning that link to financial protection.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the need for financial protection at various life stages?
- list reasons why people may be underinsured?
- discuss how taking out a mortgage affects people's attitude towards protection?
- outline how a person's circumstances can affect their protection priorities?
- summarise factors to consider in prioritising protection needs?

Test your knowledge before moving on to the next topic.

References

FCA (2020) *Sector views* [pdf]. Available at: https://www.fca.org.uk/publication/corporate/sector-views-2020.pdf [Accessed: 3 November 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 16. Review the text if necessary.

Answers can be found at the end of this book.

1) Protection for dependants in the event of death or illness is likely to be most crucial at which life stage?

   a) Young, single person.

   b) Younger couple with children.

   c) Middle-aged couple, children have left home.

2) PMI may become a priority at which life stage?

   a) Young, single person.

   b) Younger couple with children.

   c) Middle-aged couple, children have left home.

3) Financial protection through life assurance is unlikely to be a priority for which of the following?

   a) Young, single person.

   b) Younger couple with children.

   c) Middle-aged couple, children have left home.

4) "I find income protection policies hard to understand." This customer is voicing which reason for underinsurance?

   a) It won't happen to me.

   b) Product complexity.

   c) State provision.

5) If a mortgaged property owner dies, the survivor might end up with the whole mortgage while owning only half the value of the property if it was registered:

   a) as tenants in common.

   b) as a joint tenancy.

   c) in the deceased's sole name.

6) If a person has an amount of protection already in place, they are likely to have no shortfall. True or false?

7) Protection funds may be used to meet what liabilities without selling property?

8) The shortfall in protection cover can be expressed as the difference between the amount of protection that would be needed if the risk event happened, and the:

   a) amount of protection the client desires.

   b) amount of protection the client currently has.

   c) amount of protection the client will have in five years' time.

9) The mortgagee will both recommend and arrange life cover. True or false?

10) Which of the following protection needs is generally prioritised highest?

   a) Protection of dependants from the effects of loss of income in the event of premature death.

   b) Protection of income for a time later in life when the client does not want to work.

   c) Protecting self and dependants from the effects of losing the ability to earn an income in the long term.

TOPIC 17

Types of financial protection I

LEARNING OBJECTIVES

By the end of this topic you should have an understanding of:

- the role of state benefits in financial protection;
- the range of state benefits available to provide financial protection;
- mortgage repayment support;
- life assurance including term assurance and whole-of-life assurance;
- critical illness cover (CIC);
- income protection insurance (IPI).

THINK ...

Before you start work on this topic, take a moment to think about what you already know about types of financial protection.

For instance:

- How can eligibility for benefits affect a household's protection needs?
- What is a means-tested benefit?
- What are the possible consequences of people having to live with impaired earning capacity for months or even years?
- Which core conditions does CIC always cover, regardless of provider?
- In which situations is whole-of-life assurance appropriate?

17.1 State protection

In the UK, the state provides numerous benefits for a degree of financial protection against the adverse financial consequences of illness,

unemployment, death, retirement, and the inability to pay a mortgage. However, the level of provision is minimal compared to the reality of most people's overall protection needs.

Partly to constrain benefit claims and to ensure that benefits are paid out only to those whose situation merits payment, each benefit typically has eligibility criteria attached.

KEY TERMS

ELIGIBILITY CRITERIA

Factors determining the circumstances in which someone is able to claim a particular benefit.

MEANS-TESTED BENEFIT

Eligibility depends not only on the claimant suffering from a certain condition or experiencing a certain life event, but also on the claimant's financial circumstances – in particular, how much income and/or savings they have.

Sometimes the only criterion applying to a benefit is that the claimant has suffered a certain condition or life event. For some benefits specific additional criteria apply, such as:

- National Insurance contribution (NIC) record;
- age; and
- means testing of savings and/or income.

There is also a benefit cap that limits the amount of overall state benefit claimed by each household.

With means testing, if savings and/or income exceed certain thresholds then either:

- the scale of benefits is reduced below the maximum available level; or
- no benefits are payable at all (even if others in a similar situation, but with lower levels of income or savings, may be able to claim).

FACTFIND

Browse the UK government website to supplement what you learn in this topic and to find current benefit rates:

https://www.gov.uk/browse/benefits [Accessed: 3 November 2020].

The main benefits that are means tested on income are:

- Universal Credit, which is replacing various other benefits;
- income-based Jobseeker's Allowance (JSA), being replaced by Universal Credit;
- income-based ESA, being replaced by Universal Credit;
- Income Support, being replaced by Universal Credit;
- the savings element of Pension Credit (only available to those who reached state pension age before 6 April 2016);
- Housing Benefit, being replaced by Universal Credit; and
- Council Tax Reduction.

A calculation is carried out to determine whether the claimant is eligible and, if so, what scale of benefit is payable.

In assessing income, the amount taken into account is usually that which the claimant – and their partner, if appropriate – has left each week after paying specified outgoings such as taxes and rent or mortgage. Eligibility may also be tested, additionally or alternatively, against savings.

!

KEEPING UP TO DATE

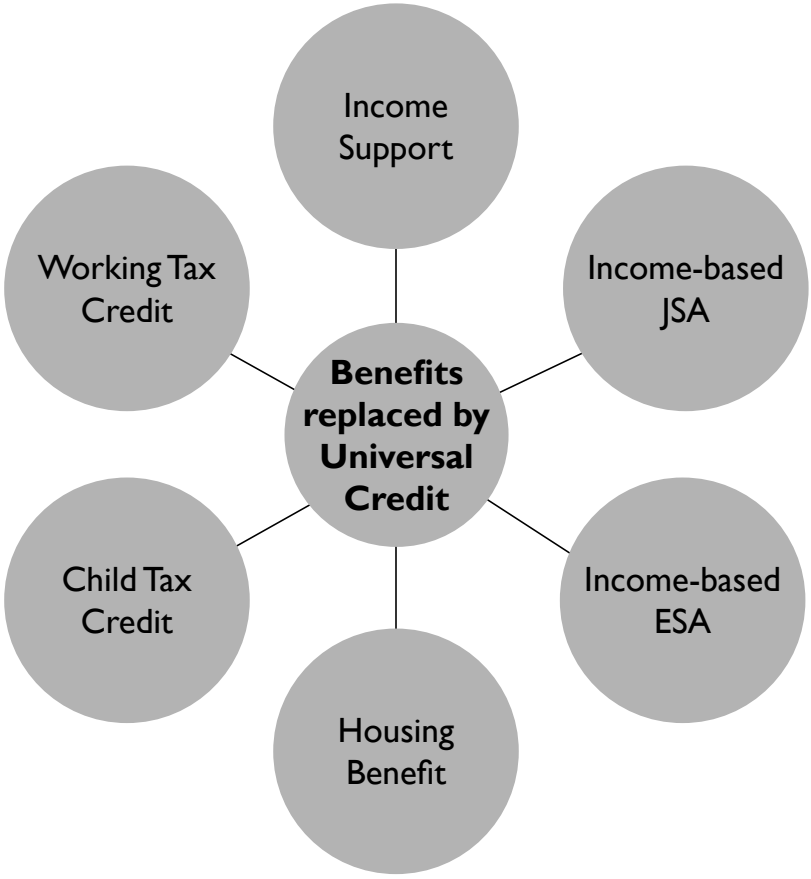
Rules relating to eligibility and rates of state benefits change regularly. We provide an overview of the principles here, but when advising clients it is important to check that you have current information.

17.1.1 What is Universal Credit?

Since 2013, the UK system of working-age benefits and tax credits for people looking for work, or in work but on a low income, has undergone a gradual

process of simplification. Universal Credit is an integrated means-tested benefit not limited to people who are in or out of work, thus aiming to improve the transition between the two.

FIGURE 17.1 WHICH BENEFITS DOES UNIVERSAL CREDIT REPLACE?



Claims for Universal Credit are made on a per-household, rather than per-individual, basis. The amount payable depends on the income and circumstances of all household members.

Transition phase

Large-scale change is required to facilitate the introduction of Universal Credit, so the approach is phased. Rollout of Universal Credit has made progress but has been beset by controversies and delays, with full rollout not expected until the mid-2020s.

Eligibility

UK claimants may be eligible for Universal Credit if they:

- are aged 18 or over (with some exceptions for 16- and 17-year-olds);

- are on a low income or out of work;
- are, or have a partner who is, under state pension age;
- have less than £16,000 in household savings.

A claimant's number of children may affect their level of benefit.

FACTFIND

Read the detailed eligibility criteria, including for those studying full-time:

https://www.gov.uk/universal-credit/eligibility [Accessed: 3 November 2020].

IN BRIEF

AMOUNT AND PAYMENT OF UNIVERSAL CREDIT

Universal Credit consists of a basic allowance with different rates payable for single people/couples and younger people.

There are additional payments for claimants who have:

- responsibilities as a carer;
- children or disabled children;
- housing costs;
- childcare costs;
- limited capability for work.

A single payment is made on a monthly basis. If a claimant is working, the payment depends on their earnings and reduces as they earn more.

17.1.2 Support for people who are ill or disabled

This section summarises the main benefits for people who are sick, injured or disabled, or who need constant care.

Statutory Sick Pay (SSP)

SSP is paid by employers to employees who are off work owing to sickness or disability for four consecutive days or longer. (Employers pay the benefit on behalf of the Department for Work and Pensions and reclaim the amounts paid.)

- SSP is paid for up to a maximum of 28 weeks in any spell of sickness. Spells of sickness with less than eight weeks between them count as a single spell.
- SSP is payable to employees with earnings above the lower earnings limit (LEL).
- SSP is not means tested.
- Amounts paid as SSP are subject to tax and to NICs, just as normal earnings would be. People who are still sick after 28 weeks may be able to claim short-term Incapacity Benefit.

LEL

The amount above which an individual is entitled to NIC-dependent benefits. For earnings in the LEL band, the person does not pay NICs but gets the benefits of paying.

Incapacity Benefit and Income Support

Incapacity Benefit is for people who are unable to work owing to illness or incapacity for at least four days in a row, but it is being replaced by ESA and no new claims are allowed. Existing claimants are reassessed for eligibility for ESA or capability of working. If deemed fit for work, a claimant may be moved to JSA.

Income Support paid on the grounds of illness or disability has also been replaced by Universal Credit.

Attendance Allowance

Attendance Allowance is a tax-free benefit for people who have reached state pension age and need help with personal care as a result of sickness or disability. It is neither means tested nor dependent on NICs.

There are two levels of benefit:

- a lower rate for people who need help with personal care **by day or at night**; and
- a higher rate for those who need help both **by day and at night**.

Personal Independence Payment (PIP)

PIP helps people with the additional costs arising from illness or disability, usually where the person:

- has had difficulties with daily living or mobility for **three months**; and
- expects their difficulties to continue for **at least another nine months**.

The amount of benefit paid depends on how a person's illness or disability impacts on them.

PIP is made up of two elements. A person may be entitled to one element or both.

- The **daily living component** is paid if a person needs help participating in daily life. Assessment focuses on the ability to perform ten daily living activities.
- The **mobility component** is assessed by reference to two mobility activities.

17.1.3 State assistance with mortgage payments

Support for Mortgage Interest (SMI) is paid as a loan – not as a benefit – to people who are having problems meeting their mortgage payments if they are in receipt of:

- Universal Credit;
- Income Support;
- income-based JSA;
- income-based ESA; or
- Pension Credit.

Following a claim, the waiting period that must elapse before payment commences is 9 consecutive Universal Credit payments, or 39 weeks after claiming for another qualifying benefit, but pensioners receiving Pension Credit have no waiting period.

SMI is paid to cover interest (not capital) on the first £200,000 of a mortgage, but claimants receiving Pension Credit are generally only covered for interest on the first £100,000.

Main features of SMI

- Claims can be made for the original mortgage amount. Claims may also be accepted for specific loans taken out to cover essential repairs or improvements necessary to maintain the home's fitness for habitation, or to buy an ex-partner's share in the home on separation.

- Payment is made directly to the lender to ensure the money is used for the purpose intended.
- Payments are calculated using a standard rate of interest, rather than the borrower's actual pay rate.
- Interest charged on the loan is usually lower than market interest rates and is reviewed every six months.

FACTFIND

Find out the current interest rate used to calculate SMI payments, and the current interest rate added to the loan:

https://www.gov.uk/support-for-mortgage-interest/what-youll-get [Accessed: 3 November 2020].

- The SMI loan is secured by a second charge on the claimant's property, ie if the borrower misses mortgage repayments, the second charge is repaid after the original mortgage, which is the first charge. All legal owners must consent to the loan.
- The SMI loan must be repaid when the property is sold or transferred, or the owner dies, or when it can be repaid voluntarily if the claimant returns to work, with a minimum repayment of £100. If there is insufficient equity in a claimant's property to repay the whole SMI loan on one of these events, the balance will be written off.
- The loan is not repayable where the property is transferred to the claimant's partner on death and they remain in the property, or where the property is transferred based on court orders or a maintenance agreement.
- Payments continue indefinitely until the claimant no longer qualifies. The claimant can opt to stop receiving payments at any time.
- Endowment premiums, buildings and contents insurance premiums, and certain arrears are not covered by the scheme.
- Where the claimant has been receiving SMI for at least 26 weeks but they are about to start a job that will make them ineligible, they can claim mortgage interest run-on. This pays the benefits for a further four weeks, and straight to the claimant rather than to the lender.

IN BRIEF

THE 52-WEEK LINKING RULE

Under the 52-week linking rule, a borrower who has already served the waiting period for SMI and then ceases to claim payments for up to 52 weeks will not have to serve a further waiting period at the start of the second claim. This means that those who claim SMI can accept offers of short-term or seasonal work without losing their entitlement to further SMI payments.

17.2 What is life assurance?

The life assurance industry offers a diverse range of policies to meet a diverse range of protection needs. Some cover can be in the form of a paid-up policy, meaning all premiums have been paid and the policy remains in force until death or policy termination.

Mortgage lenders may insist on the assignment of life policies to make sure the mortgage is paid off if the borrower dies, or to ensure an endowment policy is used to repay an interest-only mortgage. Assignment involves the policyholder signing over the benefits of the policy to the lender for the term of the mortgage. It gives the lender certain rights, including the right to surrender the policy if the borrower fails to make mortgage payments. The insurance company pays any policy proceeds to the lender when the policy matures or there is a death claim.

Assignment used to be normal practice among lenders, but it has become increasingly less common. An alternative is for the borrower to deposit the life assurance policy document with the lender. Although the lender has no legal rights over the policy, the fact that the lender has been given the policy creates an 'equitable right' for the lender over the policy.

EQUITABLE RIGHT

Governed by the practice of equity, or fairness; indicates an agreement between the two parties that the policy has been given as a form of security.

The two main types of life assurance policy are term and whole-of-life assurance. Under these broad headings, a wide variety of policies meet different needs.

17.2.1 Term assurance

All types of term assurance (or temporary assurance) share a common characteristic: the sum assured is payable only if the death of the life assured occurs within a specified period – the term.

KEY TERMS

LIFE ASSURED

The person covered by a life assurance policy.

SUM ASSURED

The monetary amount of cover provided by a life assurance policy.

Term assurance is the most basic form of life assurance: it is pure protection (see section 19.1) for a limited period with no element of investment. For this reason, it is also the cheapest. Term assurance can be used for personal and family protection, and also for many business situations. Business use includes protecting against a loss of profits resulting from the death of an important employee (ie key person insurance), and share protection schemes for business owners.

- The term can be anything from a few months to 40 years or more.
- If the life assured survives the term, the cover ceases and there is no return of premiums.
- There is normally no cash value or surrender value at any time.
- If premiums are not paid within a certain period after the due date (normally 30 days), cover ceases and the policy lapses with no value. Most companies allow reinstatement within 12 months, provided that all outstanding premiums are paid and evidence of continued good health is provided.
- Premiums are normally paid monthly or annually, although single premiums (ie one payment to cover the whole term) are allowed.
- Premiums are normally level (ie the same amount each month or year), even if the sum assured varies from year to year.

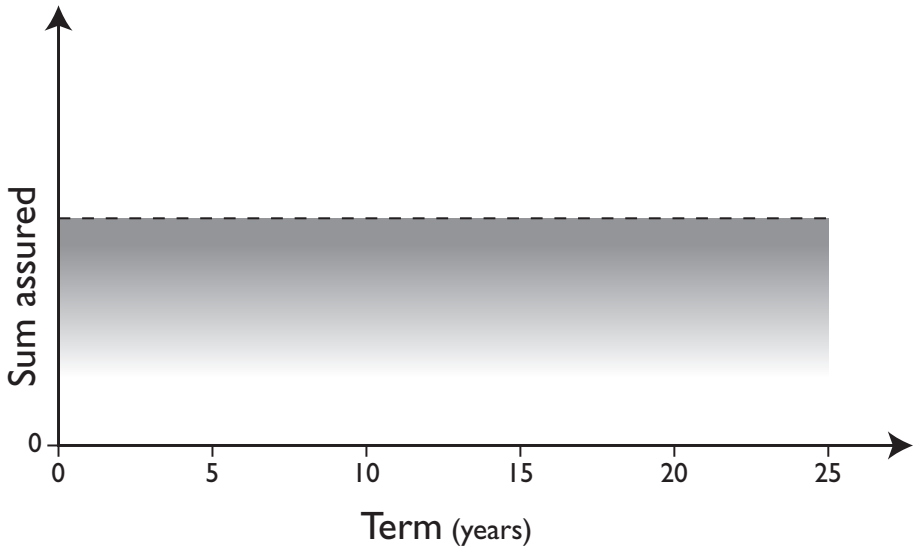
SURRENDER VALUE

An amount paid when cashing in an investment-linked policy early. This ends the policy and typically incurs high charges.

Level term assurance

With level term assurance, the sum assured remains constant throughout the term. The sum assured will be paid out on death during the term. The policy ceases at the end of the term or on earlier death.

FIGURE 17.2 LEVEL TERM ASSURANCE



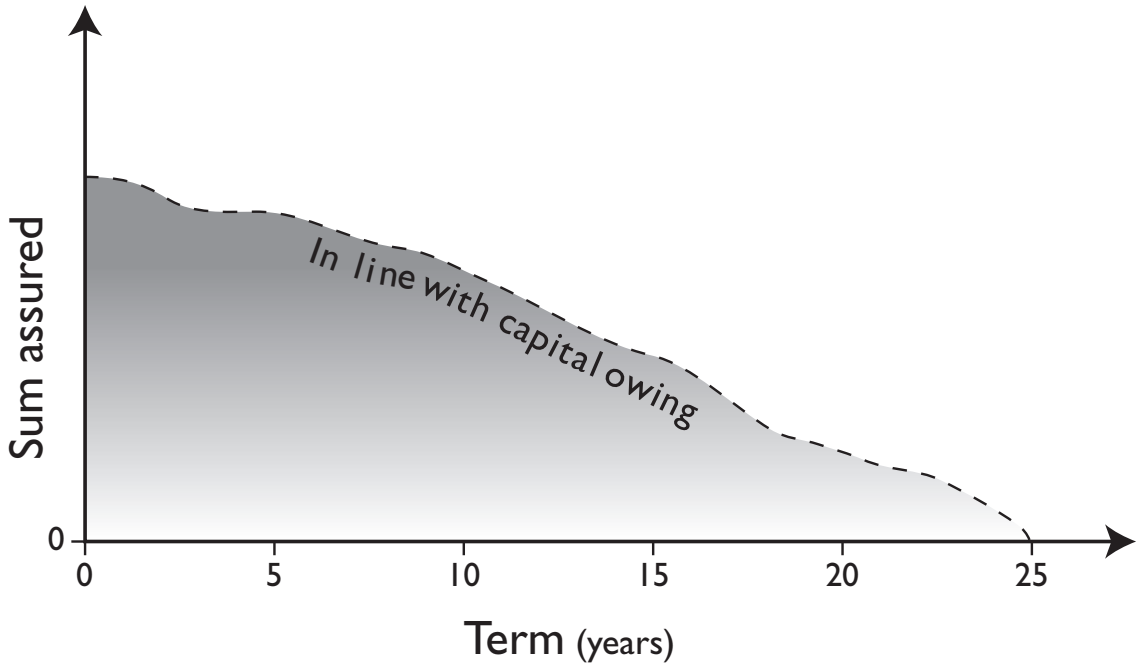
Level term assurance is often used when a fixed amount would be needed on death to repay a constant fixed-term debt, such as an interest-only mortgage.

It can also be used to provide family cover, for example until children leave home. If it is used for that purpose, the policyholder should bear in mind that the amount of cover in real terms will be eroded by the effect of inflation.

Decreasing term assurance

With decreasing term assurance, the sum assured reduces to nothing over the term of the policy, usually by equal annual amounts. Premiums are normally payable throughout the term and remain unchanged.

FIGURE 17.3 DECREASING TERM ASSURANCE



Decreasing term assurance may be used to cover the outstanding capital on a debt that reduces by a fixed amount each year.

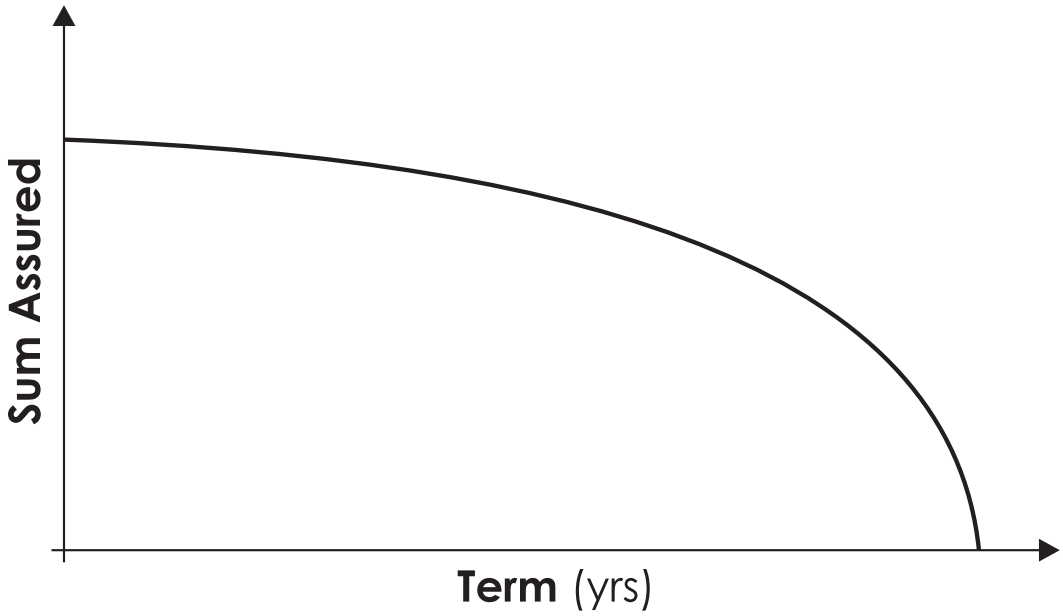
EXAMPLE: DECREASING TERM ASSURANCE

Fabio took out a ten-year personal loan to renovate his house. The monthly repayments are fixed and he now has eight years left on the loan. He arranges decreasing term assurance to cover the outstanding debt if he dies.

The most common use of decreasing term assurance is to cover the amount outstanding on a repayment mortgage, via mortgage protection assurance. The sum assured is calculated so that, as long as premiums are maintained, it is always equal to the amount outstanding on a repayment mortgage of the same term, based on a specified interest rate.

The sum assured, like the mortgage, decreases by lesser monthly amounts near the start and by larger amounts towards the end of the term.

FIGURE 17.4 MORTGAGE PROTECTION ASSURANCE



Convertible term assurance

Convertible term assurance includes an option to convert the policy into a whole-of-life or endowment assurance without further evidence of health or additional underwriting. Underwriting only takes place at the policy's outset.

This guaranteed insurability means that the conversion is carried out at normal premium rates applying to the person when they elect to convert the plan, whatever their state of health at that time.

Generally, such a policy costs 10–15 per cent more than the premium for an equivalent policy without the conversion option. The option is normally included only on level term assurance policies, but there is no technical reason why it should not be included on others.

CONVERSION RULES AND RESTRICTIONS

- The conversion is normally carried out through cancellation of the term assurance, in part or in whole, and the issue of a new whole-of-life or endowment policy. A new endowment can extend beyond the end date of the original convertible term policy.
- The option can only be exercised while the convertible term assurance is in force.
- The sum assured on the new policy cannot exceed the original sum assured.
- The premium for the new policy is the current standard premium for the new term and for the life assured's age at the conversion date.

Personal pension term insurance

Until 2006 it was possible to arrange level term insurance as part of a personal pension arrangement and receive tax relief on the contributions.

Pension term insurance cannot extend beyond the individual's seventy-fifth birthday, and the policy cannot be held in joint names or assigned to a lender. People who have such cover in place should think carefully before cancelling due to the tax advantages.

17.2.2 Whole-of-life assurance

Whole-of-life assurance covers the life assured for their whole lifetime and pays out the sum assured in the event of death, whenever it occurs, provided that the policy remains in force (ie that the premiums have been paid). Whole-of-life policies are commonly used to provide financial protection for self and dependants, and to protect the value of the estate on death from IHT.

A whole-of-life policy combines life cover with investment, and the client needs to understand that their payouts will depend on the investment's performance.

Uses and benefits

Whole-of-life policies are appropriate when the need is for a sum of money to be paid on an individual's death, whenever that may occur. Like all protection policies, an overriding benefit is providing peace of mind.

Whole-of-life policies can be used in personal and business situations, and for certain tax purposes. These uses include to:

- protect dependants against loss of financial support in the event of an income earner's death;
- provide a lump sum on death;
- fund additional expenses on death; and
- provide funds for the payment of IHT.

Different types of whole-of-life contract may be appropriate in different circumstances.

- **Non-profit** is suitable where an absolute fixed amount, no more and no less, is needed on death. In practice, such situations are rare.
- **With-profit** is suitable where a cautious approach to the provision of lifetime cover is required, but where an increasing benefit is also needed (eg to allow for inflation).
- **Unit-linked** is suitable where both lifetime cover and an increasing benefit are required. Some of the money is used to buy the life assurance while the rest is invested. However, whole-of-life is primarily a protection policy, so more speculative funds should generally be avoided.
- **Universal whole-of-life** is suitable if the client has needs similar to those fulfilled by a basic unit-linked policy, but they want the flexibility of a variable mix of protection types.

17.2.3 Typical exclusions

Life policies, whether term or whole of life, may include exclusions that nullify cover in particular situations, or that prevent certain people from arranging cover.

Exclusions from cover

An applicant for life cover will not be accepted if they present what the insurer considers too great a risk. This could be because the applicant:

- **works in a high-risk job**, such as a builder or a member of the armed forces;
- **has risky hobbies**, such as motorcycling or mountaineering;
- **has a history of serious health issues**, such as cancer or diabetes; or
- **has a lifestyle that presents a high risk**, such as long-term smoking.

However, insurers have different attitudes to risk and about what they will and will not cover.

IN BRIEF

EXCLUDED CIRCUMSTANCES

Some life policies may not pay out if the insured dies:

- due to alcohol or drug misuse;
- as a result of war or terrorism;
- from suicide or self-inflicted injuries;
- due to a reckless act, eg gross negligence.

CHECK YOUR UNDERSTANDING

Fill in the table below, which considers life insurance policies that can be used with mortgages. Tick the relevant columns where features apply to the product, and fill in the last row using numbers.

Feature	Convertible term	Whole-of-life	Level term	Decreasing term
Limited term				
Can be investment-linked				
Conversion to whole-of-life or endowment				
Level sum assured				
Sum assured decreases in line with mortgage				
Order of cost (*lowest first – rank from 1 to 4*)				

17.3 What is critical illness cover?

As new protection needs have arisen, product providers have introduced a range of policies to meet them. CIC provides a lump-sum payment on diagnosis of one of a specified range of life-threatening or debilitating illnesses or medical

conditions. Some providers also offer policies that can pay an income, though this actually means paying the lump sum in instalments.

CIC is available in different forms and is typically used for:

- the provision of long-term care, either in hospital or at home;
- alterations to living accommodation;
- the purchase of specialised medical equipment, such as a kidney dialysis machine;
- mortgage/debt repayment;
- protecting lump sum investments to avoid the need to draw on them in the event of illness;
- improving the quality of life of a terminally ill person.

The death of the life assured is not a requirement for payment of the sum assured. To receive payment, the life assured must survive for a specified period after an insured event, typically 14 to 28 days (known as the survival period). The life assured may recover, possibly as a result of treatment paid for by the lump sum. However, the policy ceases on payment of the sum assured – it is not possible to claim more than once on the same CIC policy.

Core conditions and their definitions

The illnesses and conditions covered vary among providers, but all CIC covers the following, which comprise the majority of CIC claims:

- most forms of cancer, excluding less advanced cases;
- heart attack of specified severity;
- stroke resulting in permanent symptoms.

In the past, many companies covered the same core conditions but applied very different methods to assess the conditions in the event of a claim. To help deal with this problem, the Association of British Insurers (ABI) developed model definitions of each core condition and issued several statements of best practice on CIC.

FACTFIND

Look through the ABI minimum standards for CIC:

https://www.abi.org.uk/globalassets/files/publications/public/protection/new-abi-guide-to-minimum-standards-for-critical-illness-cover.pdf [Accessed: 3 November 2020].

Where a CIC provider is a member of the ABI, the minimum standards must be met. Providers may offer more generous definitions of the core conditions if they wish. Many other conditions are often covered too.

FIGURE 17.5 OTHER CONDITIONS CIC COMMONLY COVERS

Alzheimer's disease before a certain age	Aorta graft surgery	Benign brain tumour	Blindness	Coma
Coronary artery bypass	Deafness	Heart valve replacement or repair	Kidney failure	Loss or paralysis of limb
Major organ transplant	Motor neurone disease	Multiple sclerosis	Parkinson's disease before a certain age	Permanent loss of speech
	Third-degree burns	Total and permanent disability	Traumatic brain injury	

As the range and definition of insured conditions vary by company, it is vital to check the exact terms and conditions of the policy when comparing providers. An adviser has a key role to play in ensuring the client understands the scope of coverage and definitions of insured conditions.

IN BRIEF

TOTAL AND PERMANENT DISABILITY

Many policies include a total and permanent disability feature that allows for payment of the sum assured in that event. However, ABI guidelines provide four options of model wording to define total and permanent disability. Customers and advisers should check which definition a provider is using.

Level, decreasing and increasing cover

CIC can be arranged on the basis of level, decreasing or increasing cover.

- **Level cover**: the cover and premium amounts stay fixed throughout the term.

- **Decreasing cover**: the cover amount decreases each month, generally in line with a repayment loan such as a mortgage, while applying a fixed interest rate chosen at the start.
- **Increasing cover**: indexed cover that is suitable where the plan is purely used to cover medical or care costs that typically increase year on year. Cover increases yearly within agreed limits, without the need for further underwriting. Premiums also increase.

Addition to a term assurance

CIC may be added to a term assurance policy, whether decreasing or level. This ensures protection benefits are provided in the event of the policyholder:

- dying; or
- suffering one of the defined critical illnesses.

Where the plan is an additional element of a term assurance, cover can be set up in different ways:

- **Add CIC to the term assurance so that benefits are paid whichever event occurs first**, after which the plan ceases.
- **Set up a plan that potentially pays out on both events**: diagnosis of a critical illness and on subsequent death during the term.

Adding CIC to a term assurance in either of these ways increases the cost of the plan compared with term assurance offering death benefits only.

IN BRIEF

COMBINED-NEEDS PLANS

When CIC is arranged through a plan that also offers life cover, death does not have to arise from a critical illness for death benefits to be paid.

When a combined-needs plan is established on a first-claim basis, life cover will cease once a CIC claim is paid. This can be a problem for the life assured, as life cover will be difficult to obtain if they have suffered a critical illness. Some providers offer a buyback option, enabling those who have made a CIC claim to arrange a limited amount of life cover without medical underwriting.

17.3.1 Premium structure

One of the main factors in underwriting a critical illness plan is the risk of morbidity. When CIC was introduced, it was common for providers to offer

fixed premiums for the term of the contract; this was especially common on CIC plans arranged as part of term assurances.

Fixed premiums

Fixed premiums have an obvious advantage when budgeting, but many providers find fixed premiums inappropriate. One reason is the limited experience of critical illness claims, because CIC is a relatively new product. As a result, the data on which premiums are based is incomplete and claims have sometimes been higher than expected.

Advances in medical science have also contributed; some conditions are now identifiable very early, where previously they remained undiagnosed for years before proving terminal shortly after diagnosis. Early diagnosis has improved the chances of recovery and seen CIC claims increase dramatically.

Reviewable premiums

Many companies' investment returns on CIC premiums have also fallen, which is another factor contributing to many providers no longer offering fixed CIC premiums on new plans.

Increasingly, companies instead offer reviewable premiums. A typical review structure might be after every five years of the plan. If, at review, certain factors are as expected, the premium can be maintained until the next review. The factors are the insurer's:

- claims experience;
- investment returns; and
- expenses.

Although fixed premiums are attractive, reviewable premiums might occasionally be reduced on review. This should not be used as a sales pitch for reviewable premiums, but it shows that it is incorrect to perceive fixed premiums as 'good' and reviewable premiums as 'bad'.

17.4 What is income protection insurance?

IPI is designed to provide replacement income in the event of an individual being unable to work owing to illness, disability or accident.

IPI is permanent, so the insurer cannot cancel the cover simply on the grounds of poor claims experience. This distinguishes IPI from short-term cover such as sickness and accident insurance, which is typically reviewed annually. However, although the plan cannot be cancelled by the insurer, it is common for plans to have a reviewable premium structure. Typically, reviews take place every five years, allowing the provider to compare general claims experience with that anticipated.

IN BRIEF

FORMS OF IPI

Income protection is available as a standalone policy, either:

- as a **pure protection plan**; or
- on a **unit-linked basis**.

IPI can also be available as an option on a universal whole-of-life plan. Where the unit-linked option is selected, an investment value may accrue that enables the plan to acquire a surrender value.

The insurer can cancel the policy if the client fails to maintain the premium payments. The client can also cancel the policy.

IPI is generally perceived to protect working people whose earned income needs to be replaced owing to illness or accident, but there is one major exception to this rule. Most providers also offer cover for dependent spouses or partners, because there is a clear need to provide income to pay someone else to do a dependent partner's ordinary work.

DEFINING SICKNESS/DISABILITY

Different companies have different definitions of what constitutes inability to work owing to sickness or disability. They may refer to an inability to carry out:

- the insured's own occupation; or
- any occupation for which the insured is suited by training, skill and experience.

For a dependent spouse or partner, the definition may be written in terms of 'being confined to bed' or 'an inability to leave the house'.

17.4.1 Benefit structure

To prevent prolonged IPI claims, life companies insist on a maximum benefit that can be paid out.

Traditionally, companies offer benefits set as a proportion of earnings (typically 50–80 per cent, though higher levels are available). Different companies offer different benefit levels:

- some offer a lower maximum percentage but do not take state benefits into account;
- others offer 50–60 per cent on the first band of earnings but a lower percentage on higher earnings.

MAXIMUM BENEFIT APPLIES TO ALL IPI POLICIES

The maximum benefit applies to all IPI policies a client may have. To enforce this rule, clients are asked, both on the proposal form and in the event of a claim, whether they have any other policies or other sources of income. Care must be taken to fairly represent any information provided to the insurer; if a misrepresentation is made, the insurer may refuse to pay a claim.

Many policies have a proportionate benefit clause under which, if a client returns to work but at a lower salary than previously, a proportion of the benefit will be paid.

It is also possible to index benefits. The rate of increase may be a fixed rate or in line with the Retail Prices Index (RPI). As IPI is income replacement and most people get an annual pay rise at work, it makes sense to have indexed benefits. Without indexation, what started off as a realistic level of IPI can soon lose its value owing to the effects of inflation.

KEY TERMS

INDEXATION

Linking the sum assured to an index figure, such as an inflation measure, so that the sum assured rises year on year in line with the index.

RPI

A UK inflation measure of the change in the cost of representative retail goods and services, including housing costs.

Term of income protection

Clients can generally choose any policy term as long as the policy does not run beyond their normal retirement date and is in line with the provider's rules. However, some providers have minimum terms, for example 5 years, and maximum terms, such as 40 years.

Benefits, when they become payable, are paid at regular intervals (usually monthly) until recovery and end of policy term, death or retirement, whichever occurs first.

17.4.2 Deferred period

Benefits are payable after the expiry of a deferred period, which for IPI tends to be at least four weeks. An effect of the deferred period is automatically excluding claims for short-term illnesses such as colds and flu, which would be expensive to cover and make premiums very high. A limited number of providers offer 'back to day one' cover, with benefit entitlement commencing on the first day of illness once the insured has been off work for three days.

Clients can choose from a range of deferred periods, the usual options being 4 weeks, 13 weeks, 26 weeks or 52 weeks. Two factors influence the choice of deferred period.

- **An employee's sick pay benefits**: if, for instance, a client's employer pays full salary for 6 months, the sensible choice would be a 26-week deferred period.
- **Cost**: the longer the deferred period, the less likely it is that periods of illness will be sufficiently long to result in a claim. Lower premiums can thus be charged for longer deferred periods.

Self-employed people tend to choose the shortest deferred period they can afford, as any inability to work will have an almost immediate effect on their lifestyle.

IN BRIEF

LIMITED-PERIOD BENEFITS

Some companies offer IPI that provides benefits for a limited period. For instance, if benefits are limited to 24 months, the cover runs for the rest of the agreed term but would only pay out for a total of 24 months over that period. This provides a degree of security for the policyholder while reducing the premiums.

17.5 CIC and IPI comparison

Although there are similarities between CIC and IPI, notably in that both plans aim to protect against the financial implications of illness, they have key differences.

- CIC is primarily aimed at meeting the additional costs associated with an illness. It will pay out a lump sum or possibly an income **if one of a range of specified illnesses is contracted**.

- IPI is designed to replace income when the insured suffers an illness or accident that **prevents the insured from working**. Although the lump sum from CIC can be invested to provide an income, IPI is much more suited to meet this need.

Payouts

A payout from a CIC plan may be triggered even if the insured has to take little, or no, time off work. For a payment to be triggered under IPI, the illness or condition must prevent the insured from working for longer than the deferred period agreed at the outset.

Benefits from IPI can continue until retirement, if the insured is out of work for that long, whereas CIC will only pay a single lump sum. Even if the sum paid under CIC proves insufficient to meet the insured's costs, there will be no more than that payout. Similarly, a CIC plan will cease once a claim has been made, whereas IPI plans keep running as long as premiums are paid, meaning multiple claims can be made in the event of successive illnesses.

17.5.1 What are the typical exclusions?

It is usual for CIC and IPI policies to include general exclusions that set out the conditions under which payment will not be made in the event of a claim, even if the claimant suffers an insured condition.

Typical general exclusions

Typical exclusions for both policy types include any illness, accident or injury either resulting from or aggravated by:

- self-inflicted injury;
- alcohol or recreational drug use;
- taking part in a criminal act;
- participation in certain high-risk sports/pastimes;
- war, invasion or terrorism;
- flying (other than as a fare-paying passenger);
- unreasonable failure to follow medical advice;
- any condition that the insured failed to declare at the time of application; and
- any condition that leads to the death of the insured within a specified period following diagnosis.

A claim may also be excluded if the insured has lived abroad for more than 13 consecutive weeks in the last 12 months.

FACTFIND

In 2018, the ABI removed discriminatory wording about people living with HIV from its CIC minimum standards. Traditionally, an HIV claim was only allowable when HIV resulted from a blood transfusion, a physical assault or an accident at work. Insurers are encouraged to review HIV-related exclusions in their policies. Read more:

https://www.nat.org.uk/press-release/hiv-discrimination-removed-new-insurance-policy-guidance [Accessed: 3 November 2020].

Personal exclusions

The underwriting process that assesses the risk of a claim, and that determines the premium rate, may result in some additional exclusions relating to the individual applicant's circumstances.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the main features of SMI and how the loan is secured?
- discuss the varieties of term assurance and their uses?
- list the main uses of whole-of-life policies?
- outline the conditions that CIC commonly covers?
- explain how the IPI maximum benefit rule works?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

Use these questions to assess your learning for Topic 17. Review the text if necessary.

Answers can be found at the end of this book.

1) Which UK state benefit is replacing various others?

2) Housing Benefit is means tested. True or false?

3) SMI is paid as a:

   a) benefit.

   b) loan.

   c) gift.

4) Mortgage protection assurance is the most common use of which type of term assurance?

   a) Level term assurance.

   b) Decreasing term assurance.

   c) Convertible term assurance.

5) When exercising the convert option on convertible term assurance, the new sum assured:

   a) cannot exceed the original sum assured.

   b) must be equal to the original sum assured.

   c) can exceed the original sum assured.

6) Which core conditions are generally always covered by a CIC policy? Select all that apply.

   a) All forms of cancer.

   b) Heart attack of any severity.

   c) Stroke resulting in permanent symptoms.

   d) Heart attack of specified severity.

   e) Most forms of cancer.

7) When deciding whether to change a reviewable CIC or IPI premium, the insurer cannot consider claims experience. True or false?

8) For which of the following traditional exclusions did the ABI revise its CIC guidance in 2018?

   a) Self-inflicted injury.

   b) Participation in certain high-risk pastimes.

   c) HIV not resulting from a blood transfusion, an assault or a work accident.

9) A payout from a CIC plan can only be triggered if the insured takes a specified minimum amount of time off work. True or false?

10) IPI benefits cease on the earliest of recovery and end of policy term, death or what else?

TOPIC 18

Types of financial protection II

LEARNING OBJECTIVES

By the end of this topic, you should have an understanding of:

- additional policy options, ie rider benefits, to increase the level of cover;
- protection schemes offered by employers;
- buildings and contents insurance, including standard coverage and exclusions;
- self-build insurance and landlord's insurance;
- other types of protection policies related to accident, unemployment and mortgages.

THINK ...

Before you start work on this topic, take a moment to think about what you already know about other types of financial protection.

For instance:

- Why do mortgage lenders insist that borrowers take out buildings insurance?
- What additional liabilities do landlords have over regular homeowners?
- What kinds of loss or damage does contents insurance cover?
- What kinds of specialist protection need may not be covered by CIC or IPI?
- Do employers always pay the costs of an employee group scheme?

18.1 What are rider benefits?

Providers offer various rider benefits for a customer to increase their level of cover on life assurance, CIC or IPI plans. Sometimes they are automatic features, but usually they are additional charged options. This means it may be more appropriate to amend a client's existing policy when circumstances change than to start a new one. Common optional benefits that offer increased cover include the following.

Waiver of premium (WoP)

Providers often offer WoP as an option or automatic feature on most types of protection policy. WoP is designed to ensure that policy payments are maintained and benefits preserved if the insured is unable to work owing to accident, illness or disability.

If a person is unable to work, their income may fall and they may cut back on insurance, perhaps just at the time when they need the plan most.

With WoP, the provider waives the policy's premiums to ensure that the protection benefits remain in place.

- WoP typically raises premiums by 4–6 per cent.
- If the underlying plan is arranged on a joint-life basis (ie to cover two lives), WoP may only be available to one of the lives insured.
- In the event of a claim, there is normally a deferred period that must elapse between the insured event happening and the commencement of WoP.
- WoP appeals to the self-employed, whose income may be quickly affected if they cannot work. It can also be of value to the employed because sickness benefits will only be payable for a limited period, replacing a percentage of total remuneration.

EXAMPLE: WOP

Yana falls seriously ill and has to stop working as a teacher. She hopes this will be temporary, and her employer has a company sick pay scheme that maintains full pay for eight weeks of sickness.

However, Yana has now been ill for ten weeks and has gone down to half pay. She would be tempted to cancel her life assurance to make ends meet, but because she chose WoP the premiums are covered for her.

Terminal illness cover

Terminal illness cover can allow an accelerated payment of death benefit on a life or IPI policy where the life assured has a short life expectancy, typically under 12 months.

Accidental death benefit

Accidental death benefit typically pays a multiple of the sum assured if death occurs as a result of an accident.

Total and permanent disability cover

In a similar way to terminal illness cover, total and permanent disability cover enables an accelerated payment of the death benefit should the insured become permanently incapacitated and unable to work (as defined by the provider).

CHECK YOUR UNDERSTANDING 1

How many forms of model wording does the ABI provide for defining a total and permanent disability?

Guaranteed insurability options

Guaranteed insurability options enable the sum assured to be increased without the need for medical underwriting. Such an option may arise:

- at a set point in the plan's term; or
- when specified events occur, such as marriage, taking out or increasing a mortgage, or the birth of a child.

Life changes benefit

If the customer experiences a significant life event for which they have evidence, they can increase a life policy's sum assured without providing further underwriting information. Eligible life changes include:

- divorce, civil partnership dissolution, or separation;
- buying a first home;
- moving house;
- having or adopting a child;
- a child starting higher education;
- a substantial salary increase.

The amount by which the client can increase the sum assured varies by provider, but it may be up to 100 per cent. The benefit can be used whenever the client's circumstances change before they reach a specified age.

Replacement benefit

For a joint life policy, the policy ends in the event of one of the policyholders dying. With a replacement benefit, the remaining policyholder can start a new single policy without further underwriting.

Separation benefit

A separation benefit effectively splits a joint life or CIC policy into two single policies if a couple separates. The separation must be evidenced and the new policies will be subject to the terms and conditions applicable at the time they are taken out.

18.2 What is employee protection?

All UK employers must provide, and pay into, a workplace pension through auto enrolment. Smaller businesses may also offer group benefits in addition to life assurance, such as CIC or IPI. This provides income above the statutory minimum if an employee cannot work due to ill health. A firm may also offer protection in the event of death.

- A **death-in-service benefit** is a traditional group scheme that pays out a multiplier of an employee's salary to their family if they die while employed.
- A **relevant life policy** offers a variant on this benefit but with tax efficiencies for the employer.

Group cover should be tailored to the business's needs. Potential advantages for the business include:

- reducing long-term absences through effective intervention;
- promoting wellbeing in the workplace;
- the premiums generally qualifying as an allowable business expense that can be offset against the business's tax bill.

What are group schemes?

Employers can arrange IPI, CIC or accident and sickness schemes for employees on a group basis. The employer may cover the costs of NI and pension contributions. Medical underwriting may not be required, and the policies are flexible to allow businesses to choose the right type of cover for them, such as:

- how much cover to offer;
- which employees to cover; and

- different levels of benefits for different employees.

IN BRIEF

WELLBEING SUPPORT

Additional benefits may include workplace wellbeing services, such as webinars, health promotion days, and return-to-work support.

Training courses and workshops may also be available, including on mental health, mindfulness, physiotherapy, and stress management.

18.3 What is home insurance?

Varieties of home insurance are key to ensure a building and its contents are adequately protected against risk events.

18.3.1 Buildings insurance

Lenders insist that a mortgaged property is adequately insured against damage or destruction. The protection policy must meets the lender's standards because the property is the main security for the loan, and any damage could reduce its value. It is also important from the owner's perspective that a property is insured.

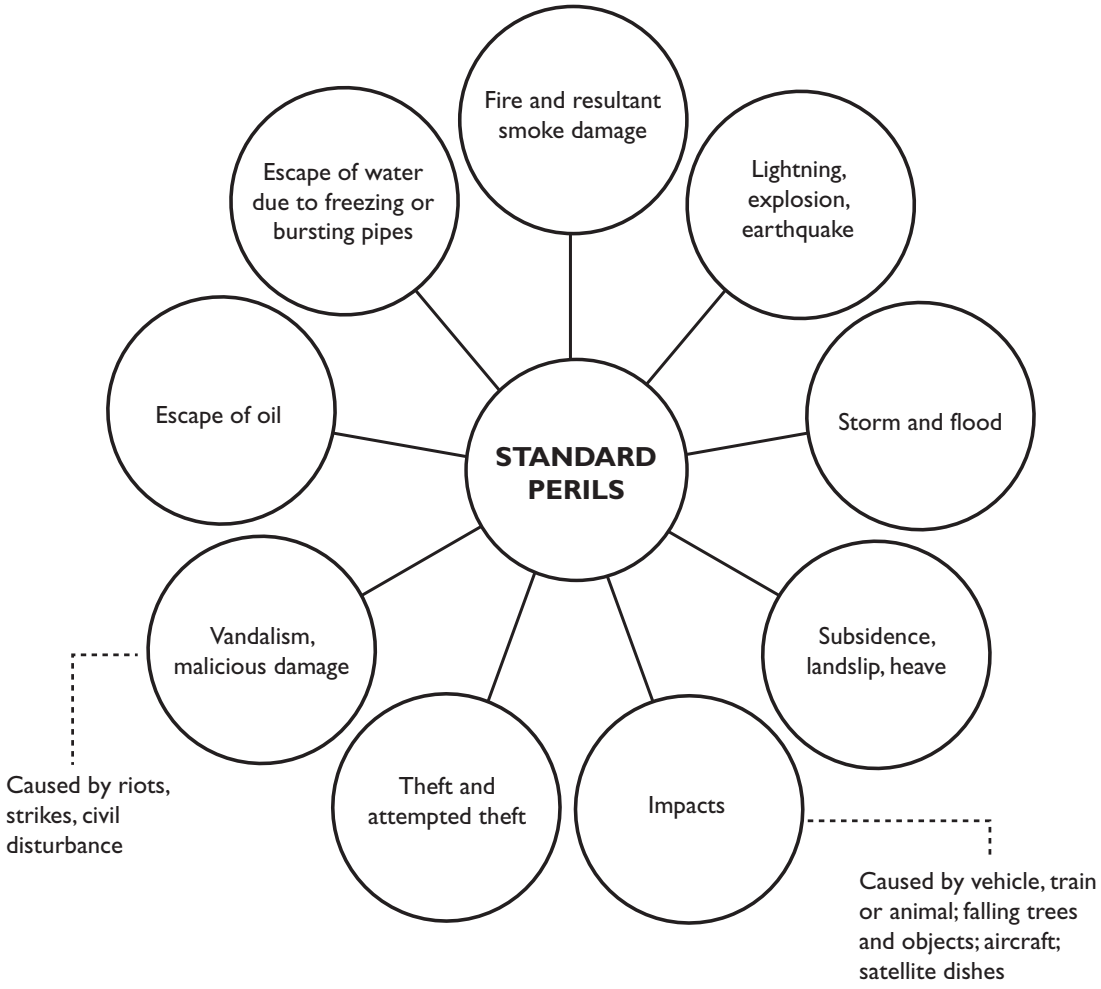
CHECK YOUR UNDERSTANDING 2

From your studies in Topic 6, can you remember at what point in the buying process the buyer should arrange for buildings cover to start?

Buildings insurance covers the building and fixtures, usually defined as items physically attached to the property, such as fitted kitchen units, fixed wardrobes, window glass, sanitary ware and so on. In broad terms, the policy will pay for repairs, reinstatement or replacement needed as a result of damage, theft or attempted theft. Policies are usually renewed annually.

Each policy lists the perils (which cause a financial loss) or hazards (which make perils more likely) covered, in most cases including the perils in Figure 18.1.

FIGURE 18.1 STANDARD PERILS COVERED BY MOST BUILDINGS INSURANCE POLICIES



If major repairs are required, the property may not be habitable for a period, and so significant professional fees may be incurred in arranging the repairs. Most policies cover the cost of alternative accommodation while the property is unfit for occupation, and architects' and surveyors' fees incurred.

To keep premiums as low as possible, and to reduce the number of minor or frivolous claims, many of the standard perils carry an excess. The excess typically ranges from £50 for damage claims to £1,000 or more for subsidence claims.

Most insurers offer cover for accidental damage to buildings for an additional premium. This covers accidents such as putting a foot through the ceiling while in the loft, or cracking a bath by dropping a heavy object.

STANDARD EXCLUSIONS

A number of events are excluded from claims as a matter of course, including:

- damage caused by escape of water or oil when the property is unfurnished;
- damage to gates, fences and hedges caused by falling trees and branches;
- theft or attempted theft if the property was left unoccupied and windows and doors were not fully secured;
- damage to a heating system caused by rusting, corrosion or wear and tear.

On occasion there may be other exclusions specific to the property and circumstances.

Public liability insurance

Public liability insurance up to about £5m tends to be included as standard, covering the owner's legal liability to others, although the extent varies by insurer. Typical cover extends to the owner and their family, or their personal representatives if a claim arises after their death.

Standard level of cover

It is common for insurers to set a standard upper level of cover for buildings policies rather than a specific level for each property. For example, the policy might provide maximum cover of £500,000, regardless of the cost of reinstatement. However, the insurer will set specific sums assured for higher-value or unusual properties.

If the sum insured does not reflect a property's true reinstatement cost, the property is underinsured. In this case, the insurer is unlikely to meet a claim in full, and will reduce the payment in proportion to the level of underinsurance, known as averaging.

CHECK YOUR UNDERSTANDING 3

We introduced the concept of averaging in Unit 1 of UKFR. Can you recall how it works? Try to complete this calculation to check your understanding.

A property has an insurance reinstatement valuation of £180,000 but it is actually insured for £150,000. If a claim for £15,000 is submitted and a standard excess clause of £500 applies, how much will the insurer pay?

The borrower does not have to arrange insurance with their lender; they have the right to choose their own insurer from the wider marketplace. However, the lender has the right to insist that the borrower's proposed policy meets its minimum requirements and is with a reputable insurer. As a minimum, this will mean the insurer should be an ABI member.

Lender's rights

The lender has certain rights to ensure cover is maintained, as contained in the mortgage deed.

The lender has the right to:

- insist that a mortgaged property is **insured continuously** in accordance with its requirements;
- have its **interest noted on the policy** by the insurer (or even to have the policy written in the joint names of lender and borrower);
- secure a **right over the proceeds of any claim** made by the borrower and insist that they are used either to repair any damage, or to reduce the mortgage debt.

If the borrower chooses their own provider, the lender has the right to be informed if premiums are not paid before any action is taken to cancel the policy. The lender may choose to pay the outstanding premiums and add the payments to the mortgage loan.

18.3.2 Self-build insurance

Specialist buildings insurance policies are available for those undertaking a self-build project, because standard policies would not cover many of the specific risks. Self-build policies include the following elements.

- **Site insurance**: covers liability exposure on a project during development, from the time when the insured assumes responsibility on a plot or property that is to be redeveloped or demolished. The policy continues while they are planning and then covers the works in progress and the materials.

- **Ten-year structural warranty**: covers the cost of rebuilding or rectifying work to the housing unit after work is complete, up to a specified amount, if there is major damage attributable to a defect in the design, workmanship or materials, provided the insurer's liability does not exceed the reasonable cost of rebuilding to the original specification. The warranty also covers:
  - making good defects in the design, workmanship or materials of a newly constructed drainage system;
  - repairs or replacements owing to water damaged caused by a defect in design, workmanship, materials or waterproofing elements;
  - repairing or making good defects in chimneys and flues that cause an imminent danger to occupants (Self-Build Zone, no date).
- **Liability cover**: insures against risks to the public and any contractors while the work is going on, typically up to £5m and £10m respectively, including claims due to negligence.
- **Employer's liability insurance**: both compulsory and desirable, as the property owner or developer has a duty of care to the project's workers and could be subject to compensation claims if workers are injured.

18.3.3 Contents insurance

Property owners should insure the home's contents against theft and damage. Unfortunately, a significant amount of owners fail to do so, and a lender will not insist on this protection because its security is not affected by damage to contents.

Contents insurance compensates the insured for loss or damage to personal effects, money, and household fittings and furniture, as a result of a number of perils.

The basic structure and principles are similar to buildings insurance, and the plan covers loss or damage to contents from similar causes (see section 18.3.1).

Contents insurance also covers:

- the insured's money being stolen from another building following a forced entry;
- damage to computers, TVs and other appliances;
- replacement of locks and keys required as a result of any of the standard perils.

IN BRIEF

ADDITIONAL CONTENTS COVER

Most policies offer additional cover for an additional premium:

- accidental damage;
- cover for food in freezers lost as a result of breakdown or contamination;
- theft or damage of money, credit cards or other possessions that are temporarily away from the home (with limits for each item), known as 'all risks' cover;
- contents taken by a family member to university, up to a specified limit.

As with buildings cover, each claim is subject to an excess; the amount depends on the peril and the insurer.

18.3.4 Landlord's insurance

Most standard home policies do not offer cover for buildings, contents or the landlord's third-party liabilities while a property is being let out. So owners of buy-to-let property face additional risks compared to residential homeowners.

- If damage to the property makes it uninhabitable, the landlord will either lose rent or be required to cover temporary accommodation for the tenants.
- Tenants may default on their rental payments.
- There is a risk of damage to third parties or their property while in or around the property.
- Tenants may cause damage to the property or its contents.

Landlord's buildings insurance

Landlord's buildings insurance provides cover against financial loss for those renting out property, on a single- or multi-property basis. It normally covers the standard perils, together with a range of additional options such as accidental damage, terrorism, legal protection, alternative accommodation costs, rent guarantee insurance, and liability insurance to cover the landlord against tenants' claims for losses.

It insures the same elements as standard policies, but also covers fixtures and fittings such as carpets, laminate flooring, kitchens, bathrooms, white goods, light fittings and curtains.

Theft is generally only covered in the case of forcible or violent entry or exit. This is designed to preclude claims where a tenant or a friend steals a landlord's items.

Landlord's contents insurance

A landlord can insure the contents of the property where it is completely or partly furnished. This will only cover contents owned by the landlord. The tenant needs to insure any personal furniture or valuables.

Tenants' liability

Tenants taking out contents insurance may be covered, or take out additional cover, for their liability for damage to fixtures in the landlord's property, and for claims for accidental injury to domestic employees.

18.4 Other forms of protection

A number of protection policies are available to cover other protection needs.

18.4.1 Accident, sickness and unemployment (ASU) insurance

ASU is a type of general insurance that may be considered as an alternative to, or to work in conjunction with, IPI. It is relatively inexpensive compared to IPI, because it is not underwritten on a personal basis and will pay income benefits for a shorter period (typically 12 months but can be up to 2 years). Under the umbrella of ASU is a wide range of contracts from different providers.

Unlike life assurance contracts, ASU deals with probabilities, not certainties. With life assurance, the insured will either live or die, and will eventually die. The risks covered under accident, sickness and unemployment, however, may arise once, on several occasions, or never.

ASU policies are annually renewable at the discretion of the insurer. This means the insurer can increase premiums in light of poor claims experience, or even withdraw cover that was previously available.

CHECK YOUR UNDERSTANDING 4

Think back to Topic 17. Can an insurer withdraw IPI cover based on claims experience?

A regular income benefit can be provided if the insured is unable to work owing to accident, illness or unemployment via redundancy.

DISMISSAL AND VOLUNTARY RESIGNATION

Although these policies are known as ASU, a more accurate description would be accident, sickness and redundancy,because policies will not cover unemployment where the insured is dismissed or has voluntarily resigned.

Income benefits are payable after a deferred period, typically one month, for a maximum specified period, typically one or two years.

Some providers only offer accident and sickness cover because they consider the unemployment element too risky. A limited number of providers offer unemployment cover as a standalone product.

Insurers may offer different levels of ASU at different levels of premium to suit customers' needs. Protection for the self-employed may be offered for if they permanently cease to trade.

Exclusions and restrictions

A number of restrictions are normally applied to ASU policies, as follows.

- The applicant must have been actively and continuously employed for a specified period before arranging the policy.
- Any redundancy that the applicant had reason to believe was imminent when they took out the policy will be excluded.
- No benefit is payable if redundancy occurs within a specified period of the cover starting.
- Unemployment tends not to be covered if the policyholder is self-employed.
- No benefit is payable if sickness is owing to a pre-existing condition.
- There is a maximum benefit payable, which may be a monetary limit or a percentage of the insured's salary, whichever is the lower.
- There will be a deferred period following unemployment or incapacity during which no benefit is payable.

Any event giving rise to a claim must fall within the precise terms set out in the policy document.

IN BRIEF

PERSONAL ACCIDENT INSURANCE

As opposed to the income benefits of ASU, personal accident insurance policies offer lump-sum payments in the event of specified conditions arising due to an accident. This can include accidental death and accidental personal injury for personal or family cover. Group accident and sickness schemes can be established in the same way as group IPI.

18.4.2 Payment protection insurance (PPI)

PPI is designed to protect repayments to service a loan or debt. It is commonly arranged in conjunction with a mortgage, a personal loan or an overdraft. Where a mortgage is arranged on a joint basis, it is possible to protect one borrower or both, the latter at twice the premium.

The level of assistance provided by the state if someone is struggling to make their mortgage repayments is limited. It is partly to avoid the need for people to rely on state provision that many mortgage providers offer PPI.

Clients taking out mortgages or loans often depend on their continuing income to maintain repayments. In all cases, clients should be encouraged to protect the loan in the event of death, ill health or redundancy.

All PPI benefit payments are tax-free. The policy is annually renewable, which means the insurer can decline to renew it.

Exclusions and restrictions

The exclusions applied to PPI are similar to those for ASU. Typical exclusions and restrictions include the following.

- Pre-existing medical conditions are not usually covered.
- Claims resulting from self-inflicted injury (other than accidents), alcohol or substance abuse, pregnancy or involvement in criminal acts are not generally covered.
- Permanent and total disability claims must meet the insurer's criteria.
- The self-employed and small business owners (directors) may only be able to claim benefits if they play no part in running the business while making the claim. This makes it difficult for many such claims to succeed.

For unemployment cover:

- the applicant must have been continuously employed for a specified period;

- any redundancy that the insured could reasonably have anticipated when the policy was taken out will be excluded;
- no benefit is likely to be paid if the policyholder is made redundant within a specified period of the policy's start date;
- no benefit is payable if the policyholder becomes unemployed as a result of disciplinary action or voluntary redundancy.

IN BRIEF

PPI AVAILABILITY

PPI gained a bad reputation due to a prolonged mis-selling scandal involving hefty customer compensation, but it is still useful and available to those borrowers who need it.

Levels of cover

Cover is normally provided at a fixed cost per £100 of benefit. Basic cover can be arranged to cover mortgage repayments as well as other essential household bills, but the higher the level of benefit required, the higher the premium.

Payment will commence after a deferred period (typically between 30 and 60 days). Cover can be usually arranged for a benefit period of up to 12 months but some providers may provide benefit for up to 24 months. As with higher benefit levels, the cost of the policy will also be higher the longer the payment period selected.

18.4.3 Mortgage payment protection insurance (MPPI)

An MPPI policy covers the borrower's mortgage payments for up to two years if they are unable to work due to accident or sickness. The policyholder usually has the option to include redundancy cover as well. Although usually called MPPI, the policy is an ASU policy marketed as mortgage protection. The exclusions and restrictions are broadly the same.

An MPPI policy does not provide life cover and usually allows more than one claim to be made, provided that premiums are maintained. It has the following key features.

- Cover is usually available to those aged 18–65.
- Most insurers do not require a medical questionnaire.
- Benefit is payable after a deferred period, usually 28–30 days, and for a maximum period of up to 2 years, depending on the policy terms.

- The level of benefit is usually sufficient to cover the monthly mortgage payment and any associated insurance premiums. It may be increased to include an allowance for some essential living expenses.
- All benefit payments are tax-free.
- The policy is annually renewable, which means the insurer can decline to renew it.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- list standard perils covered by both buildings and contents insurance?
- explain what events contents insurance can cover for an additional fee?
- discuss a lender's rights to ensure buildings cover is maintained?
- outline the typical restrictions applied to ASU policies?
- describe the key features of MPPI?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

Self-Build Zone (no date) *Structural warranty* [online]. Available at: https://www.nhbcselfbuildzone.com/structural-warranty [Accessed: 3 November 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 18. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following standard perils are specific to contents insurance?

   a) Damage by storm and flood.

   b) Damage or losses caused by theft and attempted theft.

   c) Damage to computers and TVs.

   d) Damage caused due to frozen or burst pipes.

   e) Damage caused by impact from falling trees.

   f) Replacement of locks and keys.

   g) Theft of the insured's money from another building.

   h) Subsidence, landslip and heave.

2) Damage caused by escape of water or oil is excluded from buildings insurance when the property is:

   a) furnished.

   b) unfurnished.

   c) self-build.

3) If a mortgage borrower fails to maintain their buildings insurance premiums, the lender may:

   a) repossess the mortgaged property.

   b) choose to pay the outstanding premiums and add the payments to the mortgage loan.

   c) choose to pay the outstanding premiums and charge the borrower a specified interest rate.

4) Landlord's contents insurance will cover:

   a) the landlord's contents only.

   b) both the landlord's and the tenant's contents.

   c) the tenant's contents only.

5) ASU can work in conjunction with IPI. True or false?

6) An ASU redundancy claim is likely to be excluded if the applicant had:

   a) no reason to expect the redundancy when they took out the policy.

   b) previously been made redundant from a job unrelated to the claim.

   c) reason to believe the redundancy was imminent when they took out the policy.

7) If PPI is arranged on a joint basis to protect both mortgage borrowers, the premium will be:

   a) the same as that quoted to protect one borrower.

   b) double the amount quoted to protect one borrower.

   c) variable depending on the second borrower's health.

8) When using WoP, if the underlying plan is on a joint-life basis the WoP is always available to both of the lives assured. True or false?

9) Which rider benefit splits a joint life or CIC policy into two single policies if the need is evidenced?

   a) Separation benefit.

   b) Replacement benefit.

   c) Life changes benefit.

10) MPPI usually allows:

   a) one claim to be made.

   b) more than one claim to be made.

TOPIC 19

Protection advice

LEARNING OBJECTIVES

By the end of this topic, you should have an understanding of the following:

- framing protection recommendations;
- identifying budgetary and other considerations;
- the importance of regular reviews;
- selecting a suitable protection provider.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about the provision of protection advice.

For instance:

- What is a pure protection product?
- What is an honest and reasonable misrepresentation by a customer?
- How can an adviser assess a client's capital and income needs?
- Why is flexibility crucial in a package of recommendations?
- What aspects of good service can a customer expect from a protection provider?

19.1 Providing advice

The following insurance products are 'pure' protection products and the rules for providing advice and sales are contained in the Insurance: Conduct of Business sourcebook (ICOBS):

- term insurance;
- income protection insurance (IPI);

- critical illness cover (CIC);
- accident, sickness and unemployment (ASU);
- mortgage payment protection insurance (MPPI).

In simple terms, a pure protection product provides protection against one or more perils but does not contain an investment element. So, term insurance is a pure protection product but most whole-of-life plans are not because they are investment linked. Buildings and contents insurance policies are also regulated under ICOBS.

Firms and advisers operating under Mortgages and Home Finance: Conduct of Business sourcebook (MCOBS) rules are subject to ICOBS rules for any advice given relating to pure protection products. We consider aspects of ICOBS in this topic.

IN BRIEF

INTRODUCTION TO ICOBS

- **Authorisation**: to offer advice on insurance products, the firm must be authorised by the FCA.
- **Training or qualifications**: the FCA stipulates that all those involved in the distribution of insurance products possess appropriate knowledge and ability to perform their duties. As part of this, individuals complete a certain amount of relevant continuing professional development (CPD) per year.
- **Suitability**: the adviser/firm must take reasonable care to ensure that advice given is suitable for the customer, based on their identified demands and needs and other relevant information, including details of existing cover.

Advice can provide a vital service to customers considering financial protection. It helps them to understand the extent of their protection needs and what products are available to meet them.

CONSUMER CHOICES

Consumers have access to insurance cover through a variety of providers and should seek valuable information in making their decision.

Comparison sites collect data from multiple providers to find insurance quotes based on information the customer inputs. Each site works with specific insurers rather than comparing the whole market. Comparison sites offer a useful general overview of the coverage available but there is no advice element, so customers must be confident in what they are looking for.

Protection advice is available from free and impartial sources, such as Citizens Advice and the Money and Pensions Service. General written information is also available from these sources and others. Consumers can also seek advice from an adviser (or broker or planner), such as through Unbiased.co.uk, the Chartered Institute for Securities & Investment, or an advice finder site. Advice may be particularly helpful for clients in unique or complex circumstances.

19.2 Pre- and post-contract disclosure

Disclosure of relevant facts is crucial to all parties entering into an insurance contract. Policy documentation helps with the fact-gathering process, and disclosure of the right information is also key when considering cancelling a policy.

19.2.1 Disclosure requirements

The Consumer Insurance (Disclosure and Representations) Act 2012 came into force on 6 April 2013, making changes to the existing duty of disclosure applying to consumers entering into, or renewing, an insurance contract. The Act:

- provides **better protection** for consumers, who can no longer have claims rejected by insurers if the insurer didn't ask the consumer for all required information;
- removed the requirement for **utmost good faith** in relation to applicable insurance contracts;

- replaced the duty for consumers to disclose all material facts with a duty to **take reasonable care** not to make a misrepresentation, known as fair representation;
- enables the insurer to **take a range of actions (ie remedies)** if a consumer makes a misrepresentation.

IN BRIEF

UTMOST GOOD FAITH IN INSURANCE

Utmost good faith required both applicant and insurer to disclose accurately, honestly and completely any information (ie material facts) that might influence the other party's decision to enter into the contract. This put too much onus on the consumer to disclose factors they may not have realised were relevant.

The Act reflects what was already seen as good industry practice. In effect, consumers are protected unless they deliberately mislead or are careless when providing information to an insurer. The consumer must sign a declaration that the information they have supplied is true to the best of their knowledge and belief, ie it is a fair representation.

The Act applies to personal insurance contracts, including primarily personal contracts with a business element. Life assurance, IPI, health insurance and CIC all fall under the Act's provisions. The Insurance Act 2015, effective from 12 August 2016, made similar changes for non-consumer insurance contracts, including business protection.

Misrepresentation

If a consumer makes a pre-contractual misrepresentation dishonestly, ie during application, it is a breach of their duty to take reasonable care. The insurer is then able to apply a remedy, the nature of which depends on the nature of the misrepresentation. Distinctions are made between:

- **honest and reasonable** misrepresentation;
- deliberate or reckless misrepresentation:
  - **deliberate** misrepresentation if the consumer knows they should disclose information but does not;
  - **reckless** misrepresentation if the consumer acts without care or regard for the truth of an answer;
- **careless** misrepresentation, where the consumer makes a statement they believe to be true but without sufficient care to check the facts.

Remedies can be applied in event of deliberate, reckless or careless misrepresentation.

TABLE 19.1 REMEDIES AVAILABLE TO THE INSURER

Deliberate or reckless misrepresentation	Treat the contract as if it never existed	Refuse all claims	Retain all premiums paid, unless this would be unfair
Careless misrepresentation	If the insurer would not have entered into the contract if it knew the information, all claims can be refused but premiums must be returned	If the insurer would have entered into the contract on different terms (eg at a lower level of cover) the different terms are taken as applying to the contract	If a higher premium would have been charged, the insurer can make a proportionate reduction to the amount of any claim
Honest and reasonable misrepresentation	None: the insurer must pay any claim		

19.2.2 Policy documentation

Several pieces of documentation are issued to the customer when setting up a protection plan.

- **Key features document (KFD)**: also known as an illustration, normally issued when the recommendations are presented to the customer. It sets out the key features of the specific plan and may be in the form of a brochure. For a pure protection contract, a policy summary can be used instead to serve a similar purpose.
- **Acceptance letter**: issued after the application is underwritten, confirming the exact terms and conditions under which the insurance is offered. These terms may differ from those specified on the KFD, eg if health issues are discovered during the underwriting process that lead to an increased premium.
- **Cancellation notice**: sent to the customer around the same time as the acceptance letter. It sets out their rights should they decide to cancel the plan.
- **Policy document**: also known as an illustration, confirming the details of the plan, the cover provided and the terms under which the cover is

provided. It serves as a certificate of insurance and the client should keep it safe.

FACTFIND

For most insurance contracts, under ICOBS 7: Cancellation there is a short cooling-off period during which the customer can cancel without penalty. This is generally 30 days for life assurance, CIC or IPI, and 14 days for home insurance. The period starts when the policy begins or when the customer receives their policy documents, whichever is later. Find out more about cancellation rights:

https://www.citizensadvice.org.uk/consumer/insurance/insurance/cancelling-an-insurance-policy/ [Accessed: 3 November 2020].

ICOBS 5: Statement of demands and needs

ICOBS 5 states that before an insurance contract is put in place, the insurer must specify the customer's demands and needs based on information from the customer (FCA, no date).

- Information can be gathered face to face, through a questionnaire and/or through the proposal form.
- The details must be communicated to the customer in writing via a clear and accurate statement of demands and needs, which cannot be generic.
- For sales involving advice, the firm must take reasonable care to ensure its advice is suitable for the customer.
- Any insurance offered must be consistent with the customer's demands and needs.

ICOBS 6: Product information

ICOBS 6 states that a firm must take reasonable steps to ensure a customer is given appropriate information about a policy so that they can make an informed choice about the arrangements proposed. Information that must be provided pre-contract includes the term, the definition of each benefit and option, means of payment and duration of premiums, tax arrangements of benefits, cancellation information, and complaints-handling procedures.

Other information given varies depending on factors such as:

- knowledge and experience of a typical customer for the policy;

- policy terms, benefits, exclusions and duration;
- policy complexity;
- whether the policy is purchased in connection with other products or services (FCA, no date).

For insurance that is not payable on death or in the event of injury, sickness or infirmity, the firm must provide an Insurance Product Information Document to the client in a durable medium.

FACTFIND

A durable medium allows the customer to store the information for future reference and to reproduce the information. For example, paper, email and PDF file format all meet this definition. The FCA provided clarifying information for firms:

https://www.fca.org.uk/firms/durable-medium [Accessed: 3 November 2020].

19.2.3 Cancelling or replacing protection contracts

There are occasions when it may be appropriate to cancel an existing protection policy. These could include the cover no longer being needed, the availability of a lower-cost alternative, the benefit or term no longer being sufficient, or the type of plan no longer meeting the customer's needs.

TABLE 19.2 WHAT FACTORS REQUIRE CONSIDERATION BEFORE CANCELLATION?

Is the new policy on a like-for-like basis?	If replacing a policy for cost reasons, consider that a cheaper plan might not have the same range of cover, or the definitions of illnesses or disability might be inferior. This is particularly relevant to IPI and CIC policies
Is the replacement cover in force?	Existing cover should never be cancelled until the replacement cover is in force – to cancel before confirmation could expose the customer to risk. They would potentially be uninsured for a period and may not be offered cover by the new insurer

19.3 Identifying suitable products

A customer's protection needs depend on their circumstances, and priorities will differ based on, for example, life stage, finances and family situation (as discussed in section 16.2.1). A person may have a large reserve fund or investment vehicle that helps to meet some of their needs, while another may only have state benefits to fall back on if a risk event occurs.

An adviser must evaluate the client's existing provision when assessing how much protection is needed – ie the size of the protection gap – and what products are suitable.

19.3.1 Assessing current and possible future needs

Assessing a client's protection needs may involve considering a number of issues.

FIGURE 19.1 ISSUES TO CONSIDER IN ASSESSING PROTECTION NEEDS

Set alongside this complex picture is a wide range of products, each designed to meet distinct protection needs. So it is essential to conduct a thorough factfind with the client to establish a full picture of current and likely future circumstances and needs.

Once needs are fully understood, a package of protection recommendations can be devised that best meets the client's requirements. After the solutions are in place, it is necessary to conduct regular reviews to ensure the recommendations continue to meet the client's needs.

19.3.2 Capital and income needs in the event of death

Protection needs on death are often based on the insured earner's debts and current income, which will be lost if death occurs. Strictly speaking, it may be more effective to base needs on any dependants' projected expenditure, with relevant consideration made for any additional expenditure required on death. This is a more accurate reflection of protection need.

A single person with no dependants has different protection needs than a couple with children. Their concerns are likely to include protecting against the effects of illness, accident or unemployment rather than providing for others in the event of their death. Single people also need to cover their debts, but on death these may be covered by savings and/or sale of a property.

Quantifying the need

Let's consider the provision of financial protection in the event of death by means of new policies. Clients may have both income and capital needs in the event of death. The adviser should establish the total cover needed, while being mindful that the two elements may require different cover types and/or different terms.

FACTFIND

Look at an example life cover calculator to see the costs typically considered for covering income and capital needs:

https://www.aviva.co.uk/insurance/life-products/life-insurance/life-insurance-calculator/ [Accessed: 3 November 2020].

The total recommendation should be for an amount of cover that meets current needs but also anticipated future needs; these requirements will change over time.

Assessing the income need

It is helpful to start by understanding the required replacement income to arrive at the most effective income solution.

Protection can be provided by:

- taking out a policy that would pay out a **regular income** equal to the shortfall, in monthly or quarterly instalments over the required period; or
- calculating a **lump sum** sufficient to generate an income equal to the shortfall for an appropriate period.

These solutions can be used in combination. If a lump sum is required, there are several calculation methods that can be used.

- A common older method is to take a **multiple** of either the insured earner's annual income or the projected income shortfall. Some advisers have used five times income or ten times income, but these figures can be arbitrary and may not reflect the client's needs.
- Another method is to multiply the additional annual income required by a **factor** that takes into account for how long the income will be required. A typical factor might be the number of years until the youngest child reaches the age of 18 or 21, or even until the life assured's planned retirement date.

When seeking to provide income in the event of death, note that an earner's income would probably have increased each year (at the least to offset the effects of inflation). Similarly, the cost of childcare and housekeeping will rise year on year, and this should be taken into account when calculating the level of cover needed for a dependent partner.

Assessing the capital need

People may also require additional capital, ie a lump sum, to cover costs beyond income.

- It is normal practice to address the capital need, such as a mortgage or a loan, with a policy to match the amount and term.
- The capital calculation is thus different than using a factor to determine the income need, and the client may end up with two (or more) different policies.
- A combined policy may be an option, but the suitability of the options can only be determined after discussion with the client.

IN BRIEF

THE REQUIRED TERMS

Once the amount and form (lump sum, income or both) of cover has been agreed, the term or terms must be decided. The discussion of cover is likely to involve a range of protection needs and may be based on different terms.

- Where the aim is protecting a dependent spouse and child in the event of an earner's death, capital needs are likely to be matched to the term of the debt.
- In respect of protecting a main earner's income, a certain level of cover may be required until dependent children are expected to have completed education.
- The level of cover may then reduce to a level required until retirement.
- At this time, needs change again as the individual becomes eligible for pension payments.

Selecting the appropriate term for cover is a complex issue, and the recommendation may well be for a portfolio of plans with different terms to meet different needs.

19.3.3 Capital and income needs in the event of illness or disability

Many of the factors that support the need for protection against the adverse financial consequences of death apply equally to protection against illness. However, the arguments for protection against this eventuality may be even stronger because:

- the financial consequences of a long-term illness can often be more severe than those that affect the family in the event of death;
- there is a greater chance of a person of working age suffering a long-term illness or disability than there is of them dying.

Yet, despite the fact that long-term illness is more likely to strike than premature death, relatively few people take out policies to protect against it.

Critical illness and income protection needs

The needs arising from illness and/or disability are potentially more complex than those arising on death. If death occurs, those left need to cope without the deceased's ongoing contribution, but there are more considerations for illness or disability.

In the event of a critical illness, it is possible that the insured may have to:

- give up work permanently as a result of the condition;
- give up work temporarily to undergo treatment;
- move house as a result of the condition; or
- pay for medical treatment or adaptations to the home.

An individual might suffer a critical illness, receive treatment and return to their job within a short period. Equally, they might suffer an illness that requires lengthy and costly medical treatment, as well as changes to their home, and that prevents them from performing any type of work in the future.

IN BRIEF

CIC AND IPI FUNDS

CIC will, on diagnosis of a specified insurable condition, provide funds to:

- allow debt repayment;
- provide for the costs of medical treatment, rehabilitation, etc; and
- maintain an acceptable standard of living.

In the event of a specified illness or disability preventing the insured from working, IPI will provide a replacement income after a deferred period. This income may be used to:

- service debt;
- maintain an acceptable standard of living; and
- allow recuperation without the added stress of financial worries.

Quantifying the need

The process for identifying the current shortfall in financial provision in the event of illness or disability is, in essence, the same as that for calculating the shortfall in the event of death.

The question of how much would be needed is subjective; the answer can only be based on the client's expectations of the future.

The amount needed to provide cover for illness or disability can be based on many of the same factors relevant to cover in the event of death. Again, it is sensible to base the calculation on projected expenditure rather than lost

income, with due consideration given to any additional expenditure required. An adviser should bear in mind that policies, such as IPI, have a maximum benefit payable, based on the applicant's income.

Anticipated changes in outgoings are worthy of particular consideration. Illness or disability are likely to bring increased outgoings, as a result of the costs of medical treatment or of being at home more than normal (increased use of utilities, for example).

However, assessing the level of cover that might be needed in the event of illness or disability involves a degree of speculation since it depends on the severity of any condition: for how long will someone be off work? How much will medical treatment cost? Until the event actually happens, these questions cannot easily be answered.

19.3.4 Budgetary considerations

In assessing affordability, an adviser must ask the client for a budget they feel is realistic, affordable and sustainable. Clients might find it difficult to commit to a budget if they have little idea of the cost of protection policies.

- **A proper factfind involves a detailed discussion of current income and outgoings.** Not only will this information help to establish protection needs, but it will also help when agreeing a budget. The factfind indicates the client's level of disposable income (net income minus current outgoings), to be used as a starting point for budget discussions.
- **Only a proportion of current disposable income should be viewed as a maximum budget for protection** (eg 50 per cent as a maximum), because overcommitting the client may mean policies are later cancelled. There must be room for flexibility in the client's spending pattern and in the event of unexpected expenditure.

If cost or the willingness or ability to take action are issues, some options allow compromise.

- A joint-life plan is cheaper than two single-life plans.
- Protection is cheaper the shorter the term of the plan.
- Mortgage-related plans can be kept separate from other plans to minimise cost (and can be arranged on a joint-life basis and to correspond to the mortgage term).
- Decreasing term assurance is cheaper than level term assurance.
- CIC can be arranged as an added benefit within a term assurance – there will be a single payout on a death or diagnosis of an insured illness, but this is appropriate if the objective is protection of debts.

- CIC can also be arranged on a joint-life basis. Again, the plan will cease on the first payout but premiums are likely to be lower than those for two single-life plans.
- Universal whole-of-life plans meet a variety of protection needs within one plan. They are flexible enough to be adjusted in the future.
- Since cost will increase the longer the term, it may be worth considering a portfolio of plans with varying terms, rather than one plan with cover to the maximum term.
- Most types of PMI scheme offer a range of cover types. Affordability can be addressed by selecting a lower-benefit scheme.

19.3.5 What are some other planning considerations?

Discussion of a client's protection needs is likely to identify other issues linked to financial protection, including the following.

TABLE 19.3 OTHER PLANNING CONSIDERATIONS

Savings/investments	If existing savings and investments form part of the agreed protection solution, the client may wish to make additional provision, such as to ensure original savings goals can still be achieved if some savings are reallocated to meet costs arising on death or illness
Relationship breakdown	The effect of divorce, dissolution or relationship breakdown on current protection planning may be particularly profound ▪ Joint-life plans may need to be re-evaluated and even replaced with single-life plans. The two parties may still have some joint financial interests, notably in ensuring the protection of children. Conversely, they may want a complete break, with the severance of all financial ties ▪ The nature of protection needs may change depending on the arrangements made between the two parties, eg if one party takes sole responsibility for any children

Relationship breakdown, continued	▪ Where protection was provided through one party's pension plan or where their employer provided sick pay, income protection or medical expenses cover, the gap created by the loss of this cover may need to be filled by additional personal arrangements ▪ If maintenance payments are agreed, the party in receipt of the payments has an insurable interest in the life of the paying partner and they may wish to ensure their payments are protected in the event of death or illness
Cancelling plans	While it is permitted to advise a client to cancel an existing protection plan and replace it with a new plan, eg at a cheaper cost, this is an area where the utmost care must be exercised. The new plan must offer cover that is at least equivalent to the plan being cancelled. This is crucial when considering replacing a CIC plan because the: ▪ range of illnesses covered on the new plan may not be as wide; ▪ definitions of illness on the new plan may be more restrictive in the event of a claim; ▪ definition of total and permanent disability on the plans may be different; ▪ new plan may only offer reviewable premiums, compared with fixed premiums on the original plan; ▪ rider benefits available on the current plan may not be available on the new plan; ▪ client may have a pre-existing condition that is covered by the current plan but that would be excluded under a new plan

19.4 Recommendations

A key consideration for an adviser is to put together a package of suitable recommendations flexible enough to cope with changes in the future.

EXAMPLE: CONSIDERING CHANGING INCOME

Keshia wants to protect her dependants financially, but her current income levels make it impractical to implement a full set of recommendations.

Keshia expects her disposable income to rise in the future through promotion at work. Her adviser recommends maximising protection at a low cost in the short term, then taking a more comprehensive set of actions as her income rises.

WoP is an important feature to ensure that financial protection continues in times of need. If the client is eligible and the cost is affordable, WoP should be recommended whenever it is available.

CHECK YOUR UNDERSTANDING 1

What must normally elapse between the insured event happening and the commencement of WoP?

Suitability

Product suitability must be at the forefront of an adviser's discussions and thinking process. ICOBS 5 states that firms must take reasonable steps to ensure the suitability of advice to any customer who is entitled to rely on their judgement. Such advice must inform the customer of any needs that are not met, and it must take account of:

- level of cover;
- cost;
- relevant exclusions;
- excesses, limitations and conditions (FCA, no date).

Under ICOBS 5, firms must:

- take reasonable steps to ensure that a customer only buys a policy from which they are **eligible to claim benefits**;
- inform the customer if they find that **parts of the cover do not apply**, so the customer can make an informed choice (FCA, no date).

The adviser can help to ensure suitability by clearly summarising a recommended product's features and disadvantages.

CHECK YOUR UNDERSTANDING 2

The duty to give a customer appropriate information to make an informed choice about a policy is covered in which part of ICOBS?

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- list examples of protection products covered by ICOBS?
- explain what factors to consider when forming a protection recommendation?
- outline how to ensure a recommendation is flexible enough to meet future needs?
- describe the key pieces of protection policy documentation?
- discuss the importance of product suitability when making a recommendation?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

FCA (no date) *ICOBS* [online]. Available at: https://www.handbook.fca.org.uk/handbook/ICOBS/ [Accessed: 3 November 2020].

Test your knowledge

Use these questions to assess your learning for Topic 19. Review the text if necessary.

Answers can be found at the end of this book.

1) Whole-of-life assurance is a pure protection product. True or false?

2) When determining a person's budget for protection, the adviser should use as a maximum:

   a) a proportion of the person's current disposable income.

   b) a proportion of the person's future disposable income.

   c) all of the person's current disposable income.

3) Which whole-of-life plans meet a variety of protection needs within one plan?

   a) Joint life.

   b) Mortgage-related.

   c) Universal.

4) If a couple separates and the parties want to sever all financial ties, a joint-life policy is still appropriate. True or false?

5) Under ICOBS 5 suitability requirements, a firm must inform the customer if it finds that:

   a) they have made a misrepresentation.

   b) documents have been provided in a durable medium.

   c) parts of the cover do not apply.

6) Which remedy may be available to the insurer if a customer makes a careless misrepresentation?

   a) Refuse all claims but return the premiums.

   b) None: the insurer must pay any claim.

   c) Treat the contract as if it never existed.

7) Consumers' main duty of disclosure when entering into, or renewing, an insurance contract is:

   a) utmost good faith.

   b) fair representation.

   c) disclosure of all material facts.

8) Which section of ICOBS states that firms must take reasonable steps to ensure the suitability of advice to any customer who is entitled to rely on their judgement?

9) If some savings are reallocated to meet costs arising on death or illness, the client may wish to make additional protection provision. True or false?

10) Which piece of documentation is normally issued when the recommendations are presented to the customer?

   a) Acceptance letter.

   b) KFD.

   c) Cancellation notice.

Mortgage repayment methods

LEARNING OBJECTIVES

In this topic we are going to look at the two basic ways to arrange a mortgage – repayment and interest-only – and the different ways a lender can calculate interest.

By the end of this topic, you should have an understanding of:

- capital repayment mortgages;
- interest-only mortgages;
- methods of calculating mortgage interest, including the APRC.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about the two mortgage repayment methods. We introduced these in UK Financial Regulation and if you have been involved in buying a property you will be familiar with them. What are the key differences between the two repayment methods?

We also looked at interest-only mortgages when we covered suitability in Topic 12. Can you recall:

- why this type of mortgage can appear attractive to people on tight budgets?
- the concerns about the risks posed by this type of mortgage?
- the rules set out in MCOB designed to address those risks?

!

REPAYMENT METHODS *V* MORTGAGE PRODUCTS

Although there are many mortgage products available, there are only two mortgage repayment methods: capital repayment (or capital and interest) and interest-only. It is important not to confuse mortgage products, such as fixed-rate and discounted, with repayment methods.

20.1 How does a capital repayment mortgage work?

Until the mid-1970s, the capital repayment mortgage (usually shortened to 'repayment mortgage') was the conventional method of arranging a mortgage. Interest-only loans then became prevalent, but, following well-publicised problems that emerged with interest-only mortgages in the 1990s and early 2000s, the capital repayment method became popular again.

With a repayment mortgage, each monthly payment consists of two parts:

- a capital element, which repays the outstanding capital over the term of the mortgage; and
- an interest element, which represents the interest charged on the outstanding capital.

If the borrower makes all monthly payments when they fall due, the loan is guaranteed to be fully repaid at the end of the mortgage term. It does take several years before there is any noticeable reduction in the amount of capital owed because initially much of the borrower's monthly payment is allocated to repaying the interest due (as explained in the In Brief panel); this can cause concern to some borrowers, who may feel that their loan will never be repaid.

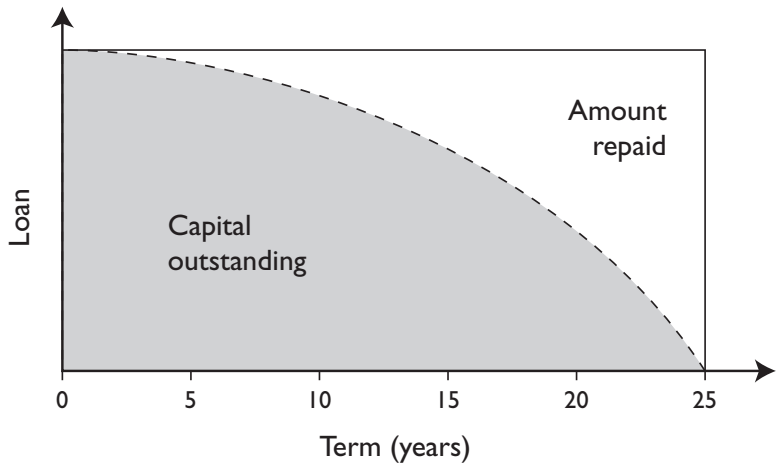
IN BRIEF

HOW A CAPITAL REPAYMENT MORTGAGE WORKS

- At the start of the mortgage, the lender calculates how much will need to be paid each month to repay the capital by the end of the term and pay the monthly interest due. The lender then assumes that the payment will remain the same throughout the term.
- Part of each monthly payment reduces the capital outstanding and, as the capital reduces, less interest is charged on the reducing balance.

- At the beginning of the mortgage term, the monthly payment consists largely of interest. This means that the repayment of capital is slow in the early years.
- As the term progresses, the balance begins to change, and more of each monthly payment is used to repay the capital, because a lower capital balance means less interest is charged each month.
- If the lender's interest rate changes, the lender recalculates the monthly payment needed to ensure the mortgage is repaid by the end of the term. This could mean the monthly payment increases if rates increase, or decrease if rates decrease.

FIGURE 20.1 CAPITAL REPAYMENT MORTGAGE



CAPITAL AND INTEREST PAYMENTS ON A CAPITAL REPAYMENT MORTGAGE

The monthly payment on a new capital repayment loan of £60,000, spread over 25 years, at an interest rate of 5 per cent is £354.78. This is taken from standard repayment tables available online.

Assuming that the interest rate remains unchanged for the whole of the first year, the amount of interest payable in that year is:

60,000 ÷ 100 x 5 = £3,000

The interest element of each monthly payment in the first year is:

3,000 ÷ 12 = £250

The amount of capital repaid in the first year is therefore:

(£354.78 – £250.00) x 12 = £1,257.36

If the interest rate were 10 per cent, the monthly payment on £60,000 over 25 years would be £550.86.

The amount of interest payable in the first year is:

60,000 ÷ 100 x 10 = £6,000

The interest element of each monthly payment in the first year is:

6,000 ÷ 12 = £500

The amount of capital repaid in the first year is therefore:

(£550.86 – £500) x 12 = £610.32

The examples illustrate that the higher the interest rate charged, the smaller the amount of capital that is repaid during the early part of the mortgage term.

The capital repayment method has inbuilt flexibility:

- If interest rates decrease, lenders generally allow borrowers the option of maintaining their payments at the level required prior to the decrease. This will shorten the mortgage term because each overpayment will reduce the capital outstanding, assuming it is applied to the account immediately.
- The change to the term is likely to be quite short-lived, because the next rate change may alter the required payment again.
- Many lenders allow borrowers to increase their monthly payment, irrespective of any change in interest rates. This is known as 'overpayment', and can help to reduce the mortgage term as described above. This is a popular option for those who receive a pay rise or otherwise find they have more disposable income and wish to pay off the mortgage earlier than scheduled. Should their situation change, they can always revert to the original payment.
- Many lenders also allow one-off partial capital repayments, which again would reduce the term of the mortgage.
- If a borrower is struggling to meet the monthly payments on a short-term basis, the lender might agree to reduce the monthly payments for an agreed period. As less capital is repaid each month than scheduled, the mortgage term would be extended.

CASE STUDY

John has a repayment mortgage with a term of 19 years remaining. His lender's rate decreases by 0.5 per cent, reducing John's required payment by £42 a month. John decides to maintain his existing payments, which means he will overpay by £42 each month, reducing the capital more quickly and reducing the interest charged. The lender calculates that if this overpayment continues for the rest of the mortgage term, the mortgage will be repaid two years early.

Six months later, the lender's rate increases to the original level and John decides to maintain his existing payment. He will have paid off a very small amount of additional capital by overpaying for a short period, but not enough to make a significant difference. As a result, the lender's recalculation will show that, if this payment continues for the rest of the mortgage term, the mortgage is now likely to be repaid only a month or so before the original end date, now 18 years and six months away.

Table 20.1 shows the capital outstanding at points in the term of a 25-year £100,000 repayment mortgage. The figures assume interest rates will not change over the term.

TABLE 20.1 DEBT REDUCTION TABLE

		Capital outstanding (£) at years into the term				
Interest %	**£ monthly**	**5**	**10**	**15**	**20**	**22**
3	479	85,400	68,600	49,000	26,300	16,200
5	591	88,400	73,600	54,800	30,700	19,300
7	715	90,900	78,200	60,300	35,200	22,500
9	848	92,900	82,100	65,300	39,600	25,800
11	990	94,600	85,400	69,900	43,900	29,000

20.1.1 Repayment mortgage advantages and disadvantages

The main advantages are as follows.

- **Debt reduction** – many borrowers find comfort in the knowledge that they are reducing their mortgage debt over time.
- **Guaranteed repayment** – the repayment method guarantees that the loan will be repaid by the end of the term, as long as the required payments are made on time.
- **No investment link** – the mortgage repayment is not dependent on the performance of an investment vehicle.

The main disadvantage of capital repayment is that there is no built-in life cover. This must be arranged separately, although decreasing term assurance cover is generally inexpensive and will pay off the mortgage if a borrower dies before the end of the term.

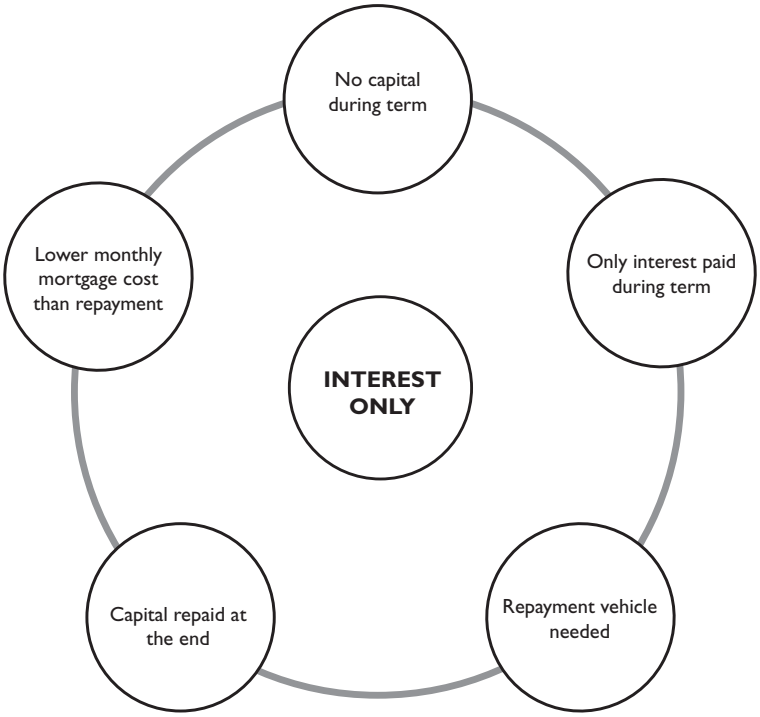
CHECK YOUR UNDERSTANDING 1

You learned about decreasing term assurance in Topic 17 and in UK Financial Regulation. Can you remember how it works?

20.2 How does an interest-only mortgage work?

With an interest-only mortgage, the borrower makes monthly mortgage payments consisting of interest only. The full capital amount remains outstanding during the mortgage term and is repaid in one lump sum at the end of the term. This means that the mortgage payments each month are lower than those for a repayment mortgage for a similar amount. Figure 20.2 summarises the key features of this type of mortgage repayment method.

FIGURE 20.2 INTEREST-ONLY MORTGAGE: KEY FEATURES



Monthly interest payments are easily calculated. The capital is multiplied by the interest rate and then divided by 12. For example, a £150,000 interest-only mortgage with an interest rate of 5 per cent would be: £150,000 x 5% = £7,500 ÷ 12 = £625 per month.

The borrower usually arranges a repayment vehicle (usually an investment) to build up the capital needed to repay the mortgage at the end of the term. The repayment vehicle runs alongside the mortgage but is separate from it, although the cost should be taken into account when calculating the overall costs of the mortgage arrangement. In many cases, once the cost of the repayment vehicle has been added to the mortgage payment, the overall cost of an interest-only mortgage may be little different from a repayment mortgage.

The repayment vehicle is totally separate from the mortgage, and the borrower can only be advised on it by a suitably qualified financial adviser. The repayment vehicle does not have to be arranged by the lender, and in some cases the lender will not offer advice on it.

As we will see in Topic 21, the vast majority of investments that can be used to support an interest-only mortgage do not offer any guarantee that the investment performance will be sufficient to repay the debt in full. Until relatively recently, the most common repayment vehicles were low-cost with-profit and unit-linked endowment policies, but most new interest-only mortgages are supported by stocks and shares ISAs.

CHECK YOUR UNDERSTANDING 2

You learned about low-cost with-profit and unit-linked endowment policies in UK Financial Regulation. Can you recall:

a) how a low-cost with-profit endowment is structured?

b) how a unit-linked endowment works?

Many endowment policies taken out in the past appear increasingly unlikely to produce enough to repay the associated mortgage in full. For this reason, interest-only loans have become unpopular with borrowers, although some lenders allow interest-only loans to be taken out without any supporting repayment vehicle in place, subject to the MCOB rules on responsible lending outlined in section 10.7. This effectively puts the responsibility on the borrower to ensure that they have the means to repay the loan in full at the end of the mortgage term.

20.2.1 MCOB rules on interest-only mortgages

Interest-only mortgages were scrutinised as part of the Mortgage Market Review (MMR) that was carried out by the Financial Services Authority, and implemented by its successor, the FCA, in April 2014. There was concern that too many borrowers took out interest-only mortgages as a way of cutting monthly expenditure, without arranging adequate repayment vehicles. This led, or could lead, to problems repaying the capital at the end of the mortgage term. Strengthening of the rules relating to interest-only mortgages was an important element of the changes brought in following the MMR.

- **MCOB 4.7a** requires a firm to make sure that the customer demonstrates that they have arranged a clearly understood and 'credible' repayment strategy that the lender has assessed at the time to have the potential to repay the capital at the end of the term. The lender is not required to provide advice on that strategy and the regulator is not prescriptive about what is meant by a 'credible' strategy.

  Acceptable repayment methods could include regular payments into a savings or investment product, the allocation of regular bonus payments to pay down the capital or the sale of another property. Speculative strategies such as relying on house price inflation, potential inheritance, windfalls or ad-hoc investments are not considered to be acceptable approaches.

- **MCOB 11.6.4.9** requires lenders to carry out at least one review during the term of the mortgage, where the borrower is contacted to check that the repayment strategy is still in place, and that it still has the potential to repay the capital borrowed. The review must be carried out at a point where there would still be sufficient time for the customer to remedy any problems before the end of the mortgage term.

WHAT IS A 'PURE' INTEREST-ONLY MORTGAGE?

In a very limited number of situations it may be appropriate for the lender to arrange an interest-only mortgage with no repayment vehicle. Known as 'pure' interest-only, this applies where there is a degree of certainty that the mortgage can be paid off without relying on speculative sources. An example is the eventual sale of the mortgaged property as the repayment method, but only where the value of the property should be sufficient to repay the mortgage. The lender cannot allow for house price inflation as part of the calculation, so the LTV of such a loan would be relatively low.

Pure interest-only is an accepted method of arranging a business buy-to-let mortgage. Consumer buy-to-let mortgages are subject to the same rules on affordability and suitability as standard residential mortgages, although nothing in the rules prevents such a mortgage being arranged on a pure interest-only basis.

As we saw in Topic 13, the FCA introduced a new category of interest-only mortgage into retirement, whereby borrowers over a certain age can take out a pure interest-only mortgage repayable on their death or move into residential care. This is separate from lifetime mortgages, so the lender needs to do affordability checks, including income in retirement, but is not required to carry out a review of the borrower's repayment during the term.

Changing contracts

MCOB rules recognise that some customers with an existing interest-only mortgage may not be able to vary their existing mortgage terms if the rules are applied strictly. In order to make sure these customers are not disadvantaged, lenders can allow them to vary the terms of an interest-only mortgage, as long as the borrowing is not increased by more than the costs of changing the mortgage.

High-net-worth customers

MCOB rules also allow more flexible treatment for interest-only applications from high-net-worth customers, as outlined in Topic 8.

20.2.2 Advantages and disadvantages of interest-only mortgages

Table 20.2 summarises the advantages and disadvantages of interest-only mortgages.

TABLE 20.2 ADVANTAGES AND DISADVANTAGES OF INTEREST-ONLY MORTGAGES

Advantages	Disadvantages
A wide variety of investment products can be used as repayment vehicles to build up the capital	No capital is paid off during the term, which means the debt does not reduce
If the repayment vehicle performs better than expected, it may be possible to repay the mortgage early	There is a significant risk that the chosen repayment vehicle will not produce sufficient capital to repay the whole mortgage at the end of the term, so interest-only mortgages are not suitable for the risk averse
	The total interest payable over the term is much higher than a repayment mortgage

20.3 How is mortgage interest calculated and charged?

The way in which mortgage interest is charged can be calculated on an annual basis, or on a monthly or daily basis. The technical term used for the frequency of calculation is 'rest', so we have daily rest, monthly rest and annual rest calculations.

Note that the method of calculating interest makes no difference to the interest-only borrower unless additional payments are made to reduce the outstanding debt.

FIGURE 20.3 HOW IS MORTGAGE INTEREST CALCULATED?

Annual rest	• Interest calculated annually at year start • Payments credited as paid but deducted from the balance at the year's end • Most interest paid over the term: slowest debt reduction
Monthly rest	• Interest calculated monthly at month start • Payments credited and deducted from the balance monthly • Less interest over the term
Daily rest	• Interest calculated daily • Payments credited and deducted from the balance immediately • Potentially least interest over the term and quickest debt reduction

20.3.1 Annual rest basis

Until relatively recently, lenders calculated mortgage interest on an annual basis, the actual calculation date normally being 1 January, which is the date we'll assume for the rest of this explanation. This means that interest for a particular year is calculated using the balance outstanding on 1 January of that year, and assumes the balance will remain the same throughout the year, ignoring any repayments made during it. The calculation for the following year is then based on the revised balance outstanding on 1 January of that year.

The annual rest method is easy to operate and benefits the lender because, on a capital repayment mortgage, interest is charged on the balance outstanding at the beginning of the year and no adjustments are made for the capital that is paid off in the next 12 months. The borrower is disadvantaged because they are paying interest on money they no longer owe. It also means the debt is repaid more slowly than with monthly and daily calculations.

Annual rest is also of no benefit to a borrower who wants to pay off part of the mortgage with a single lump sum, because the repayment will not have any effect until 1 January of the following year. In this case the borrower would be better off putting the lump sum into a deposit account to earn interest and then use it to pay off some of the mortgage in late December, just in time to affect the next calculation.

While few, if any, lenders use the annual rest basis for new mortgages, older mortgages may still be calculated on that basis. Many lenders will allow an existing mortgage to be switched to a daily rest basis on request.

20.3.2 Monthly rest basis

With the monthly rest basis, interest is calculated on the outstanding balance on a specified day each month. It benefits the borrower because the interest charged more accurately reflects the actual amount owed.

For example, the monthly payment made in March partly comprises capital that reduces the outstanding debt. This reduced figure is used to calculate the interest to be charged for April. Over the whole mortgage term the borrower pays considerably less interest than would be the case on the annual calculation basis. Any overpayments that are not subject to an interest penalty will reduce the amount of interest charged to the account from the start of the following month.

20.3.3 Daily rest basis

The calculation of interest on a daily basis became quite common with the introduction of flexible mortgages in the UK. The interest charged is based on the outstanding balance at the start of each day.

The daily rest basis benefits borrowers who want to make ad hoc single payments or overpayments to reduce their mortgage because the additional payment will reduce the balance immediately, whereas those on a monthly basis will have to wait until the monthly calculation date to see a reduction. This encourages borrowers to make additional payments whenever possible to reduce the term of their mortgage considerably.

There is no benefit for borrowers who make regular monthly payments, because the outstanding balance on each day will be the same as the balance at the end of the month. Those who pay their mortgage late will not benefit either.

20.3.4 Annual review schemes

An annual review scheme enables the borrower to fix their monthly payment for a 12-month period based on the interest rate being charged at the start of the period. This is particularly beneficial to borrowers on a tight budget.

If interest rates change during the 12-month period, the borrower will either have underpaid or overpaid interest in some months. At the end of the 12-month period, overpayment is deducted from the capital balance or underpayments are added to the capital balance. The payments for the next 12-month period are fixed based on the capital balance and the interest rate at the time.

Annual review schemes are only normally available on repayment mortgages. Interest-only borrowers must usually amend their monthly payments in line with interest-rate changes.

The advantage of being able to fix the monthly repayment for 12 months is offset to some extent because either:

- the monthly repayment cannot be reduced immediately following an interest-rate reduction; or
- if the interest rate has increased substantially, this will mean an equally substantial increase in the revised monthly payment, due not only to the new higher rate but also to the increase in the capital balance.

As with annual rest interest calculations, annual review schemes are rare in the modern market. Borrowers with older mortgages, based on an annual review basis, may be able to remove this feature on request.

20.4 The annual percentage rate of charge

The implementation of the Mortgage Credit Directive in 2016 resulted in mortgages being calculated in a slightly different way from the annual percentage rate (APR). This calculation is referred to as the annual percentage rate of charge (APRC). It enables a prospective borrower to compare the true cost of borrowing from different lenders. The APRC is regarded as a rate of charge because it takes into account some, but not all, of the costs involved in

setting up and administering a loan. In simple terms, the interest payable over the term, and the additional costs, are totalled and calculated as an annual percentage rate on the mortgage amount. As a result, the APRC is usually higher than the advertised (ie 'flat') rate, which represents the nominal interest rate charged on the mortgage amount alone.

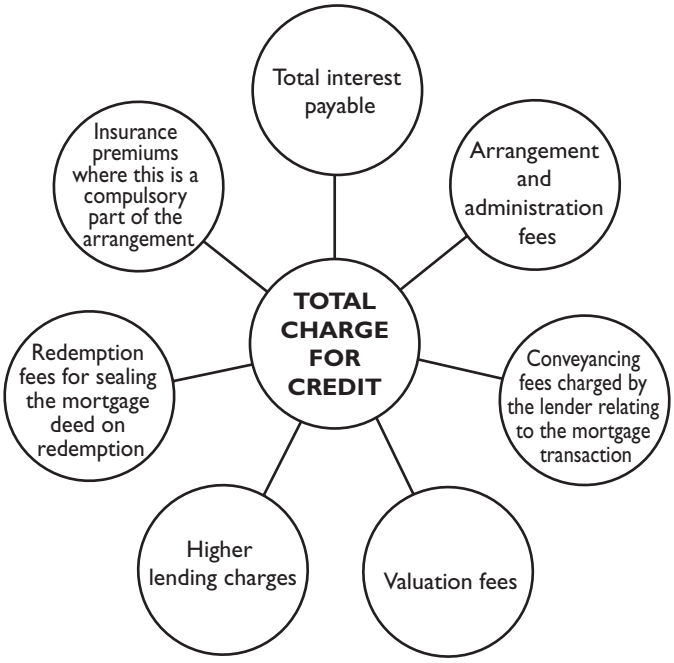
The calculation of the APRC requires the application of a complex mathematical formula, which is beyond the scope of CeMAP®. Regulated mortgages and MCD regulated mortgages use slightly different assumptions but the result is very similar. Figure 20.4 sets out the broad principles that apply to all contracts.

FIGURE 20.4 WHAT ASSUMPTIONS MUST THE LENDER MAKE IN CALCULATING THE APRC?

- £ The interest rate at the start of the contract will apply throughout the entire period of the loan
- £ The borrower will make all payments on the due dates
- £ No life assurance premiums are included in the monthly payment
- £ The loan will not be redeemed early, ie it will run for its full term

The true cost of borrowing is arrived at by calculating a total charge for credit (TCC), which is then converted into the APRC.

FIGURE 20.5 COSTS AND CHARGES INCLUDED IN THE TCC CALCULATION



The following costs and charges are excluded from the TCC calculation:

- early repayment charges;
- endowment and other life assurance premiums;
- charges levied in respect of any default by the borrower.

WHAT IS THE SECOND APRC?

For MCD regulated mortgages there is an additional requirement. Where the rate of interest or charges applied to the mortgage are variable, the lender must include a second APRC figure in the ESIS or as part of the KFI top-up. The calculation provides a warning about the possibility of an increase in interest rates or charges and the effect they may have.

FIGURE 20.6 WHAT ARE THE RULES FOR THE SECOND APRC?

- £ Where the interest rate is capped, the second APRC must assume the rate rises to the capped limit at the earliest point
- £ Where the mortgage is on an uncapped variable-rate basis, the second APRC must use the product's highest borrowing rate over the previous 20 years
- £ Where the interest rate is linked to an external index or benchmark (eg base rate trackers) the APRC must use the highest rate for that index or benchmark in the past 20 years
- £ Where a lender does not use an external reference rate, it must use the highest value of a benchmark rate specified by the FCA, another competent authority or the European Banking Authority

The usefulness of the APRC has been questioned by many experts, particularly with the growth in the number of fixed-rate mortgages. In addition, the requirement for a second APRC for MCD regulated mortgages may result in further confusion among borrowers.

An advertisement that gives the 'flat' rate of interest for a mortgage must also show the equivalent APRC, and show it more prominently than the flat rate. A general advertisement that does not include a flat interest rate does not need to show an APRC.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe how a capital repayment mortgage works?
- explain the advantages and disadvantages of this repayment method?
- describe how an interest-only mortgage works?
- explain the risks associated with this type of mortgage?
- outline the different ways of charging interest and the advantages and disadvantages to the borrower of each?
- explain what is meant by the 'APRC'?
- list the costs and charges included in the TCC?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 20. Review the text if necessary.

Answers can be found at the end of this book.

1) In the first year of a capital repayment mortgage, repayments are mainly interest. True or false?

2) Capital repayment mortgages offer borrowers the possibility of a capital surplus at the end of the term. True or false?

3) Cathy has a capital repayment mortgage of £150,000 over a 25-year term. The interest rate is 3 per cent on an annual rest basis and her monthly repayment is £711 (to the nearest whole pound). Calculate how much of the capital she will repay in the first year.

4) Greg has a capital repayment mortgage on which the interest rate has just increased. Greg's lender has agreed that he can maintain his monthly repayments at the level prior to the rate increase. What effect will this have?

   a) The mortgage term will decrease.

   b) The mortgage term will increase.

   c) The mortgage term will not be affected.

   d) Greg's lender will require him to make overpayments later in the term.

5) One advantage of an interest-only mortgage is that the capital is guaranteed to be repaid at the end of the term. True or false?

6) Gordon wishes to arrange an interest-only mortgage to buy his new property. Which of the following repayment strategies would be **most unlikely** to be acceptable to the lender?

   a) An ISA funded monthly.

   b) Allocating his quarterly bonus payments to reduce the capital balance.

   c) A potential inheritance as the beneficiary of his 65-year-old aunt's will.

   d) A unit-linked endowment policy.

7) Retirement interest-only mortgages require the lender to review the repayment vehicle at least once during the mortgage term. True or false?

8) The daily rest basis of calculating interest is advantageous to people who are often late with their mortgage repayments. True or false?

9) Jenny's mortgage is on an annual review basis, and the last review was held on 31 December a year ago, when the interest rate was 4 per cent. What would be the consequences if interest rates then rose from 4 per cent to 5 per cent from July to December?

   a) The capital owed would have reduced on 1 January this year.

   b) The capital owed would have increased on 1 January this year.

   c) There would be no difference in the capital owed.

   d) Jenny's mortgage payments would reduce from 1 January this year.

10) Which of the following is excluded from the APRC calculation?

   a) Valuation fees.

   b) Higher lending charges.

   c) Redemption charges for sealing the mortgage deed.

   d) Early repayment charges.

TOPIC 21

Using endowment policies for mortgage repayment

LEARNING OBJECTIVES

In this topic and Topic 22 we are going to explore the different repayment vehicles that can be used for interest-only mortgages. We begin by looking at the use of endowment policies.

By the end of this topic you should have an understanding of:

- with-profits endowment policies;
- the differences between full with-profits and low-cost with-profits policies;
- unit-linked endowment policies;
- unitised with-profit policies;
- rules affecting endowment policies as qualifying life policies;
- regulatory review requirements and the traffic light system for endowment shortfalls.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know. We introduced endowment policies in UK Financial Regulation. Can you recall, for instance:

- what an endowment policy is?
- different types that are available?
- the benefits of a life policy being a 'qualifying' policy for tax purposes?

21.1 What is an endowment policy?

An endowment policy, whether with-profit or unit-linked, comprises two elements:

- **Life assurance** – guarantees to pay the sum assured if the borrower dies during the policy term. This means that, as long as the policy sum assured is the same as the mortgage and all policy premiums are paid, the mortgage will be repaid on death.
- **An investment element** – targeted to provide a maturity value sufficient to repay the loan in full at the end of the mortgage term and possibly provide a surplus for the borrower.

Personal pension plans and ISAs, on the other hand, provide investment but do not include built-in life cover. This must be purchased separately, usually as level-term assurance.

Mortgages that used endowments as their repayment vehicle were the most common type chosen by borrowers until the late 1990s. However, as you will see in section 21.6, many endowments fell short, or were projected to fall short, of the returns expected, many had been mis-sold and they rapidly became unpopular, to the extent that endowment mortgages are very rare in today's market.

!

PROVISION OF ADVICE

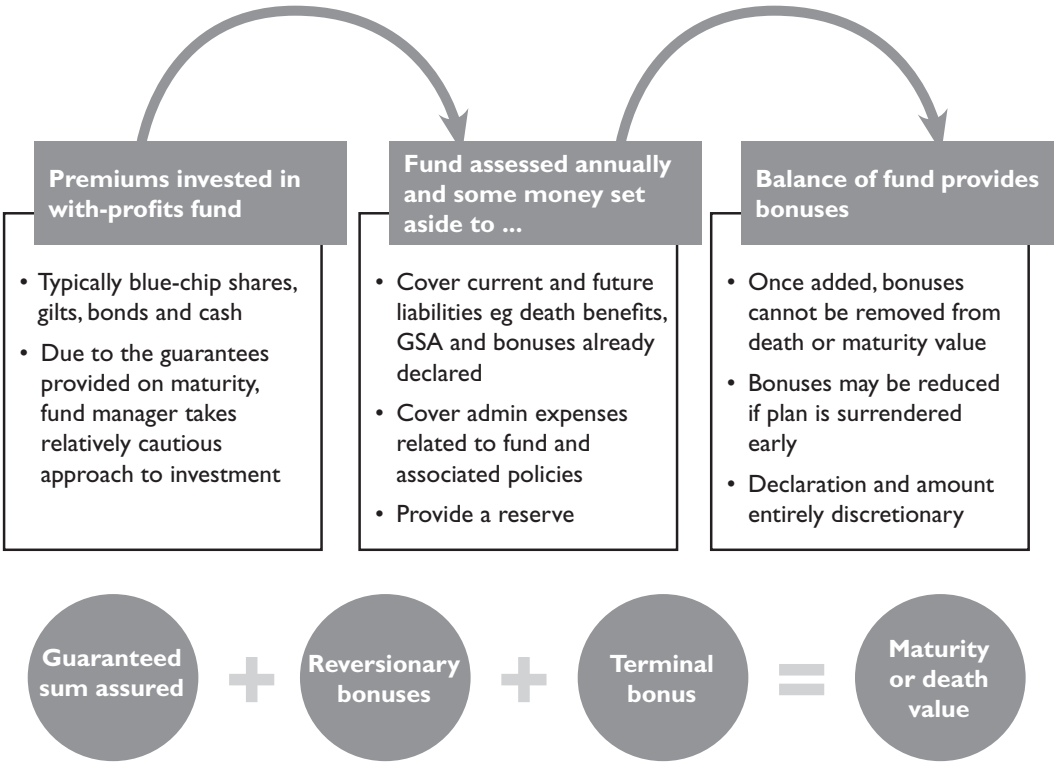
While information on these investment-backed products can be given by mortgage advisers, only those who have approved-person status in a customer function and have appropriate qualifications can give advice and make a recommendation regarding investment products.

21.2 What is a with-profits endowment policy?

With-profits endowments offer policyholders a degree of guarantee with the potential for capital growth. There are two forms of with-profits endowment – the full with-profits version and the low-cost with-profits version (see sections 21.2.5 and 21.2.6).

The basic way in which both types of with-profits endowment work is outlined here.

FIGURE 21.1 HOW A WITH-PROFITS ENDOWMENT WORKS



The reserve allows the company to maintain bonuses in years when the fund performance would not normally justify such payments. This means that the policyholder will see smoother performance from their plan – hence the term 'smoothing'. If the fund were to return growth of 11 per cent in a year, the company might only pass on the equivalent of 6 per cent. The rest will be held in reserve. If the fund achieves no growth, or even a loss, in the following year, the company may still be able to pass on a bonus by using these reserves. The problem in recent years has been that fund growth has been poor and reserves have been run down. Many companies have added small bonuses, or no bonuses at all.

WHAT HAPPENS IF THE PLAN IS SURRENDERED BEFORE THE END OF THE TERM?

If the plan is surrendered before the end of the term, actuaries will calculate the surrender value. This is unlikely to represent the full value of the plan at the time of surrender, and may result in a significant loss for the policyholder, although there are FCA rules designed to ensure the calculations are fair to all parties. The guaranteed death benefit and reversionary bonuses are not guaranteed in the event of early surrender.

While the company will seek to declare bonuses, there is no guarantee that they *will* be declared or that a certain amount will be paid, and neither will the bonuses necessarily represent the full growth of the fund. There are two types of bonus – reversionary and terminal.

KEY TERMS

GSA

Guaranteed sum assured, the amount that will be paid on maturity (or death if this occurs earlier), assuming premiums are paid as required.

SMOOTHING

Creating a reserve in years of good fund growth rather than paying all the growth out in bonuses, so that in poorer years it may still be possible to pay a bonus.

SINGLE LIFE AND JOINT LIFE FIRST DEATH

Endowments can be held on a **single life** basis, where the policy is owned by one person who is the life assured. The policy will pay out on maturity or their earlier death. With a **joint life first death** policy, two people are joint owners and lives assured. The policy pays out on maturity or when the first of the lives assured dies during the term.

21.2.1 Reversionary bonuses

Reversionary (or annual) bonuses are usually added to the policy each year as a percentage of the plan's GSA. Once added, the reversionary bonus is guaranteed to be paid on maturity, providing the plan remains in force and premiums are paid. Reversionary bonuses can be calculated in a number of ways.

21.2.2 Terminal bonuses

Terminal bonuses are usually added at maturity, or sometimes on earlier death. They can represent a large proportion of the final policy value, perhaps as much as 40 per cent. They are designed to reward longstanding policyholders. As with reversionary bonuses, terminal bonuses are at the discretion of the company and can vary from year to year. Although insurers strive to pay a terminal bonus, it is entirely possible that in years of poor performance they could decide not to do so. During times of volatile investment performance, the level of most terminal bonuses reduces significantly, which in turn reduces maturity values.

21.2.3 Charges

You will see later that the majority of charges for unit-linked endowments are clearly stated as part of the policy terms. With-profits policy charges are not so transparent.

- Usually, a stated monthly policy fee, often in the region of £2–£3 a month, is taken from the premium to cover some of the administration of the policy.
- The costs of managing the investment fund, providing the life cover and general administration are taken from the investment fund, as noted in Figure 21.1, and are not specifically detailed in the policy terms.

If the policyholder cashes in the plan early, the policy might incur a market value adjuster (MVA) where the company will reduce the value of units transferred to protect the interests of other investors. This is usually invoked in times of poor fund performance when the value of the underlying with-profits fund assets is lower than the value of the plan built up, although some insurers apply some form of MVA in most encashment situations.

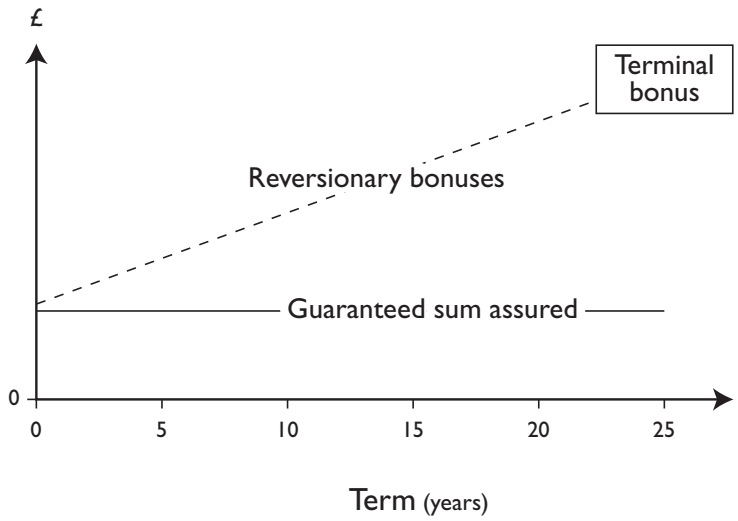
21.2.4 Paid-up policies

If a with-profit policyholder wishes to discontinue their policy, but not actually surrender it, then they can make it paid up. This means that no further premiums are paid and the policy has a reduced GSA and death benefit. Reversionary bonuses added to date are unaffected and remain attached to the policy. The value of the policy will continue to grow, although at a much lower rate, because no further premiums will be paid.

21.2.5 Full with-profits endowment

The full with-profits endowment is the original product designed to support interest-only mortgages. The GSA is equal to the mortgage amount, which means that the mortgage is guaranteed to be paid off by the GSA. Any bonuses added provide a cash surplus over and above the mortgage. The premium is calculated based on the need to pay the GSA at the end of the term. This makes the full endowment much more expensive than the low-cost versions.

FIGURE 21.2 WITH-PROFITS ENDOWMENT



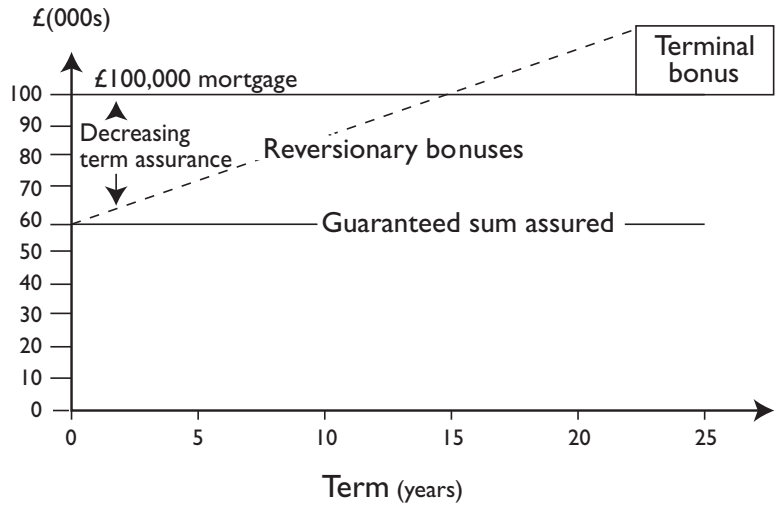
21.2.6 Low-cost with-profits endowment

The low-cost with-profits endowment policy was developed in the 1970s as a more affordable alternative to the full with-profits policy. Over the next two decades it became a very popular mortgage repayment vehicle. The low-cost with-profits policy operates on a similar principle to the full endowment, but there are some significant differences.

- The GSA is typically 50–60 per cent of the mortgage amount. As with the full endowment, the GSA is payable on the earlier of maturity or death during the term. However, unlike the full endowment, the low-cost with-profits endowment plan does not guarantee to repay the mortgage at the end of the term.
- The premium is worked out by assuming that the guaranteed sum assured plus a percentage of the anticipated reversionary bonuses (typically 80 per cent) will provide sufficient capital on maturity to repay the loan. If these assumptions prove to be wrong and the terminal bonus is not sufficient to plug the gap, the maturity proceeds will not repay the loan; the final sum is not guaranteed.
- In the event of death during the term, the GSA plus accumulated reversionary bonuses and a potential terminal bonus will be paid. A form of decreasing term assurance is built in to plug the gap between the value of the guaranteed sum insured plus accrued bonuses and the mortgage. This ensures that the mortgage can be repaid on death before the end of the term.

A low-cost, low-start endowment works on similar lines but the premiums in the first five years are lower. The premiums increase by 20 per cent in each of the first five years, leading to a doubling of the premium by that stage. From then onwards the policyholder is paying a higher premium than would be the case with a standard low-cost endowment.

FIGURE 21.3 LOW-COST WITH-PROFITS ENDOWMENT



CASE STUDY

Will has a mortgage of £75,000 and has arranged a low-cost endowment policy to support it. The policy is targeted to provide £75,000 at maturity, with a GSA of £40,000 and a guaranteed death benefit of £75,000.

1) Assume Will dies after ten years, reversionary bonuses accrued to that point equal £8,000 and a terminal bonus of £14,000 has been declared. This will give the plan a value of £62,000. The death benefit will comprise £62,000 from the accrued GSA plus £13,000 from the decreasing term element.

2) Assume the policyholder dies after 20 years, reversionary bonuses accrued to that point equal £15,000 and a terminal bonus of £25,000 has been declared. This will give the plan a value of £80,000. The death benefit will be the full value of the policy – £80,000 – but no decreasing term assurance would be included.

TABLE 21.1 ADVANTAGES AND DISADVANTAGES OF LOW-COST WITH-PROFITS ENDOWMENTS

Advantages	Disadvantages
▪ GSA will be paid on maturity, providing premiums are paid and plan remains in force. This means there is at least a partial guarantee of the final value	▪ Final value not guaranteed to pay off mortgage. Bonuses are not guaranteed and if they are below the assumed rate, the final value will be less than predicted
▪ Combines investment and life cover. In the event of death during the term, GSA will be paid, which together with a decreasing term assurance enables mortgage to be paid off	▪ As a result of market volatility and poor investment returns, majority of low-cost with-profit endowments maturing in recent past have failed to reach their target
▪ Provided policy remains in force to maturity, any gains made are locked in and cannot be lost	▪ Often difficult to identify product charges
▪ Possibility of a surplus over the mortgage amount	▪ Inflexible policies: term cannot be extended and increasing premiums may not be possible
▪ No tax payable on maturity value, assuming the plan remains qualifying	▪ Poor recent past performance and availability of more flexible investment products has resulted in fewer providers offering the product and limited consumer choice

21.3 Unit-linked endowment policies

Unit-linked endowment policies were introduced as an alternative to with-profit policies in the 1980s. Although they carry a greater risk, they also provide the potential for higher returns than with-profit policies.

The unit-linked endowment is designed to accumulate capital by the end of a set term, but differs from the with-profits endowment in the way that the fund is built up. The policy value is linked directly to the performance of the policyholder's chosen investment funds, which can result in higher returns if the funds perform well, but there is no 'bottom line' guarantee such as the GSA provided by a with-profits policy. The only guarantee is that the policy will pay a guaranteed death benefit equal to the mortgage amount if the insured dies during the term.

Premiums buy units in one or more of a range of unit-linked funds. On a monthly basis, enough units are encashed by the company to cover the cost of the mortality risk (life cover), administration and other benefits selected; the remaining units remain invested to build up the fund value. The value of units is directly related to the performance of the fund, so there is no smoothing effect because growth (or loss) is directly reflected in unit prices.

The value of the plan is simply the number of units held in the plan, multiplied by the current fund price. There are no bonuses.

At the start of the plan, the company sets out assumptions about annual fund growth (typically 6 per cent), the cost of running the plan, the cost of providing the death benefit and any other benefits selected. The premium for the target maturity amount (the mortgage) is then calculated based on those assumptions. If the investment funds grow at the assumed rate and all other assumptions prove correct, the target maturity value will be achieved. If fund growth is lower than estimated, or the costs of running the plan or providing the death benefit prove higher than anticipated, the maturity value is likely to be lower than the target. Unit prices can, and do, fluctuate.

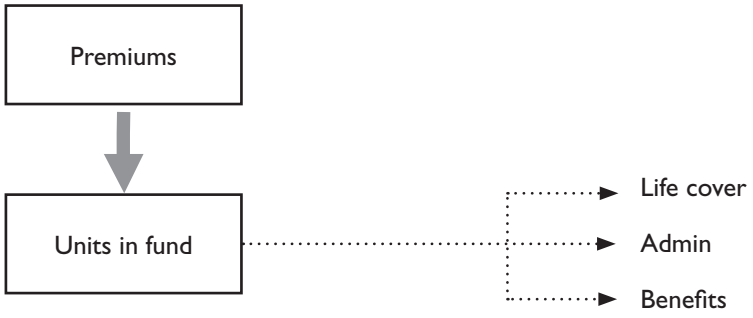
One potential advantage of a unit-linked endowment is that, if growth exceeds expectations, the plan could hit its target earlier than the end of the term. In this case, the planholder could cash in the plan and there may be enough in the plan to repay the mortgage early and save interest charges. As explained in section 21.3.3, early surrender may be subject to charges that need to be taken into account.

HOW IS THE GUARANTEED DEATH BENEFIT PROVIDED?

The guaranteed death benefit is provided through a combination of the plan's value and variable term assurance. On death, the plan's investment value is topped up to the guaranteed death benefit by the term assurance. The amount of that life assurance will vary from month to month as the value of the fund varies, and units are cancelled from the fund each month to pay for the cost of the life cover (a mortality charge), which will always be the difference between the sum assured and the fund value.

For example, Roisin's plan has been in force for ten years, has a death benefit of £75,000 and a current unit value of £25,000. If Roisin dies, the death benefit will comprise a return of the fund (£25,000) plus a payment of £50,000 from the variable term assurance, giving a benefit of £75,000.

FIGURE 21.4 UNIT-LINKED ENDOWMENT



Units have two prices:

- the **offer price** – the price at which the policyholder buys units;
- the **bid price** – the price at which units are bought back by the fund: the maturity or surrender value.

The bid price is lower than the offer price because the initial charge is deducted from the offer price and there are other relatively small charges involved in buying the units. The bid–offer spread is not a charge, but reflects the difference in price between the bid and offer prices. A typical bid–offer spread would be between 5 and 6 per cent.

21.3.1 Flexibility and fund choice

We mentioned earlier that the plan will be taken out with a set term and a premium calculated to achieve the target maturity amount. Unlike with-profits policies, unit-linked policies are flexible, and it may be possible to increase or decrease the premiums or sum assured, or to extend the term, subject to the insurer's rules and qualifying rules.

When a policy is taken out the investor can choose how much of each premium is invested in each of the available individual funds. The range of funds offered will include high-, medium- and low-risk investments, and the policyholder can base their selection on their overall attitude to risk. This represents an advantage over a with-profits policy where the policyholder has no say over how premiums are invested: they are invested in the company's with-profit fund.

TABLE 21.2 EXAMPLES OF UNIT-LINKED FUNDS

Type	Invested in . . .	Advantages/notes	Disadvantages
Cash	Money markets and deposit accounts	Very low risk Provide virtually 100% guarantee that all money invested will be returned	Earn relatively low rates of interest – seldom used for mortgage purposes. Can be useful in last few years of a policy when growth has been good and investor wants to consolidate gains made
Fixed interest	Gilts and corporate bonds	Relatively low risk	Do not offer significant growth – rarely used for mortgage purposes
Managed (or balanced) fund	Mostly blue-chip equities and gilts	The choice of most mortgage investors. Fund mandate is to produce reasonable capital growth without taking excessive risks Manager adjusts balance and selection of assets as appropriate	
UK equities	Shares of blue-chip companies that trade on London Stock Exchange	Medium to long term, expected to produce reasonable level of dividend income for the fund as well as capital growth	Medium risk in short term
Property	Commercial property	Normally provide steady returns in medium to long term	Can be volatile in short term

Specialist and international equities	Shares of companies that operate in a specific sector, eg technology, pharmaceuticals, or in companies across the world	More risky than UK equities

IN BRIEF

CHARGES ON A UNIT-LINKED PLAN

The charges on a unit-linked plan are clearly laid out in the policy document. Typically, they include:

- an initial charge – an amount taken from the value of the units when they are purchased (typically 5 per cent);
- a monthly management or policy fee – deducted from the premium before investment;
- an annual fund management charge – this is taken from the fund and typical charges range from 0.5–1.5 per cent of the fund value;
- an early surrender charge – charged on surrender in the first ten years;
- charges deducted by cancelling units – to cover the cost of the death benefit and other costs.

21.3.2 Policy reviews

Borrowers need reassurance that their policy is on track to achieve the target maturity amount; if it is not on track, they need to be aware that action is required.

Mortgage-related unit-linked endowments are subject to policy reviews, where the insurer checks the plan's progress in relation to the maturity target. Where the plan is not on track, the insurer is likely to recommend an increase in premiums. On a typical 25-year policy, reviews would take place after 10, 15 and 20 years, becoming annual after that.

21.3.3 Early surrender

Most unit-linked endowments impose some sort of charge for cashing in the plan before the end of the term, usually within the first ten years of the plan.

The most common method is to deduct a certain percentage of the units on encashment, with the percentage reducing each year during the penalty period.

TABLE 21.3 ADVANTAGES AND DISADVANTAGES OF UNIT-LINKED ENDOWMENTS

Advantages	Disadvantages
▪ Flexible policy: premiums can be increased or decreased, depending on policy conditions and qualifying rules; may be possible to extend term, subject to policy conditions and qualifying rules	▪ Final value not guaranteed, and unit values can go down at any time as well as up
▪ Wide range of funds to choose from	▪ In times of poor investment returns or market volatility, many unit-linked endowments have failed to meet targets
▪ Charges clearly stated and policy is simple to value	▪ High charges on some policies can reduce growth made
▪ Combines investment and life cover	
▪ No tax payable on maturity value	

21.4 Unitised with-profits endowment

Unitised with-profits endowment policies combine the security of a with-profits policy with the greater growth potential of a unit-linked policy. There are a number of ways in which this type of policy can work, so we will look at the basic principles rather than every potential variation. Each premium buys units in the with-profits fund at a set price, perhaps with a value of £1. Once invested, the price is the minimum that is guaranteed to be paid at maturity.

There are two types of units in a unitised with-profits fund, which is a sub-division of the firm's main with-profits fund and is invested in exactly the same way.

- **'Variable' units** – the value of each unit is set when it is purchased, based on the performance of the with-profits fund at the time. As bonuses are declared, the value of each unit will increase proportionately and cannot be reduced in future.
- **'Fixed' units** – the value of each unit is fixed when it is purchased and does not increase. Bonuses are added by crediting more units to the policy at the current price

Most unitised with-profits policies allow the investor to switch into and out of other unit-linked funds. If the policyholder switches out of the unitised with-profits fund or cashes in the plan early, the policy might incur a market

value adjuster (MVA). As with other unit-linked policies, the plan's performance will be subject to regular reviews.

21.5 Endowments as qualifying life policies

One traditional advantage of endowment policies is their 'qualifying' life policy status. However, in 2012 measures were introduced to limit the premiums payable on qualifying endowments issued on or after 21 March 2012.

CHECK YOUR UNDERSTANDING 1

From your studies in UK Financial Regulation, can you recall:

a) what is meant by a 'qualifying' life policy and the advantages it offers over non-qualifying policies?

b) the criteria a life policy must meet in order to be a qualifying policy?

POLICIES ISSUED BEFORE 21 MARCH 2012

Policies issued before 21 March 2012 and taken out to repay a mortgage are not affected by the change to the rules, even if the premium is increased as a result of a review in order to ensure the mortgage amount is achieved.

Under the updated rules, premiums to qualifying policies are limited to £3,600 per year. The limit applies to all policies held by the same individual, not per policy. In the case of joint owners, each is limited to £3,600 per year.

Policies taken out from 6 April 2013 are totally non-qualifying if the premium exceeds £3,600 at the start, or if the premium increases above £3,600 at any point during the term, regardless of the reason.

Policies issued between 21 March 2012 and 5 April 2013 are known as 'restricted relief' policies. The £3,600 limit applies to premiums paid from 6 April 2013 and, if premiums exceed the £3,600 limit, the part of any gain attributable to the excess premiums will be treated as a non-qualifying policy and may be subject to income tax. If the premiums are subsequently increased to more than £3,600, the whole policy will become non-qualifying.

21.6 Endowment shortfalls

The performance of many low-cost with-profits and unit-linked plans has been very poor since the mid-1990s for the following reasons:

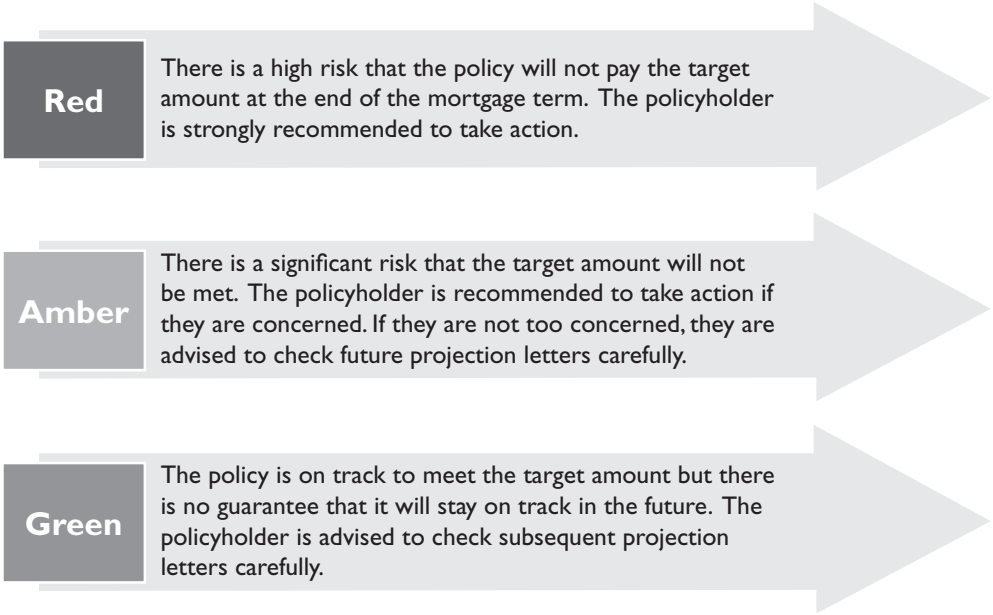
- Assumptions about future investment performance proved to be overly optimistic.
- Inflation and interest rates over this period have been much lower than anticipated – most life insurers invest heavily in gilt-edged securities, the returns from which have steadily fallen in line with long-term interest rates.
- In the early 2000s, the situation was made worse by falling share prices, not only in the UK but also across the world.

While not all interest-only borrowers with a repayment shortfall are relying on endowments to repay their mortgage, a significant number are.

21.6.1 Review requirements

From 1999 the Financial Services Authority instructed endowment providers to review the performance of all endowment plans that were being used as mortgage repayment vehicles. The reviews are required at least every two years, and the provider must use assumed future growth rates set by the regulator (now the FCA). The firm is required to write to the policyholder, indicating the result of the review using a traffic light system.

FIGURE 21.5 TRAFFIC LIGHT SYSTEM FOR ENDOWMENT POLICY REVIEW LETTERS



Provider letters must be accompanied by an FCA Factsheet, which outlines the action a policyholder can take:

- Switch the amount of the projected shortfall from interest-only to capital repayment. This will guarantee that the projected shortfall figure will be repaid if all future monthly payments are made on time.

- Repay some, or all, of the mortgage early, either by means of a lump sum or by making additional payments each month.
- Convert the whole mortgage to a capital repayment basis. This will guarantee that the loan will be repaid by the end of the mortgage term, but the monthly payment will increase considerably, particularly if the remaining term is 20 years or less.
- Use compensation received as a result of a complaint (see section 21.6.2) to repay part of the mortgage.
- Accumulate savings and use these to reduce the mortgage debt.
- Extend the term of the endowment policy and the mortgage. This will require permission from the endowment provider and the lender, and is only possible on a unit-linked policy. Extending the term of the policy may have tax implications if it ceases to be classed as a qualifying policy and will still not guarantee that its maturity value will be sufficient to fully repay the loan. The lender does not have to agree to the extension, and in any case will need to assess the affordability of the new arrangement. Extending the term of the mortgage and the policy will also result in additional interest and premiums being paid.
- Increase the endowment premiums. It may be possible to increase premiums into the endowment in order to boost the maturity value. If this facility is available, charges may be levied for varying the policy and there may also be tax implications. The additional premiums will still not guarantee that the policy will fully repay the loan at the end of the term, and it may not be seen as a sensible approach, given the plan's performance to date.

If the policyholder decides to switch the whole mortgage to a repayment basis, the endowment may become superfluous. It can then either be maintained as a general savings plan or surrendered. The surrender value can be used to reduce the mortgage balance and total outgoings will probably be much the same as, or even less than, before. It is important that the borrower obtains advice from a qualified financial adviser before taking this course of action.

If the endowment policy is surrendered, alternative life assurance cover may need to be arranged. An early repayment charge may also be payable on any capital reduction made with the surrender proceeds.

The option chosen depends on the individual policyholder. The guidance issued by the FCA in its Factsheet gives a clear indication of the relative merits of each option and explains the risks involved. It strongly recommends the policyholder take action sooner rather than later if a shortfall looks likely.

CHECK YOUR UNDERSTANDING 2

If the policyholder requires advice about the endowment itself, can they seek advice from any mortgage adviser?

21.6.2 Complaints

There has also been much concern over the standard of advice given by some financial advisers, with the risks associated with investment plans not being adequately explained to clients. The FCA Factsheet recommends that immediate action must be taken if it is felt that there are grounds for a valid complaint.

The grounds for a complaint are if:

- the adviser did not explain that an endowment policy would not necessarily mature with sufficient funds to repay the mortgage in full, and the policyholder would not have accepted this risk if they had known about it;
- the maturity date of the endowment policy is after the agreed redemption date of the mortgage;
- the maturity date of the endowment policy is after the policyholder's selected retirement date and the adviser did not specifically check that the premiums would be affordable after retirement;
- the adviser recommended that an existing endowment policy be surrendered and replaced with a new one.

Complaints will not succeed if they are based purely on the fact that the endowment will not provide the expected sum at maturity. Customers have recourse to the Financial Ombudsman Service if they are not satisfied with the provider's response.

WHAT IS THE TIME LIMIT FOR COMPLAINTS?

Complaints are subject to a time limit. The complaint must be made:

- within six years of the alleged mis-sale – usually when the endowment started; or
- if it gives the customer more time, within three years of the date when the consumer became aware (or should reasonably have become aware) that they had cause for complaint. This period would usually start when they receive a red letter.

The Financial Ombudsman will only consider complaints if the original complaint was made within the above time limits and within six months of the date on which the company sent the complainant its final response, compensation or summary resolution communication.

In reality, the majority of policyholders with an endowments shortfall were sent a red letter ten or more years ago; the time limit for complaints means that there are very few new ones.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the basic structure of a with-profits endowment policy?
- explain when terminal bonuses are usually added?
- outline the advantages and disadvantages of a full with-profits and a low-cost with-profits policy?
- describe how a unit-linked endowment policy works?
- explain one key advantage and one potential disadvantage compared with a with-profits policy?
- explain what the red, amber and green categories of the traffic light system for endowment review letters mean?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 21. Review the text if necessary.

Answers can be found at the end of this book.

1) Once added to the GSA, reversionary bonuses:

   a) cannot be removed but may be reduced if the policy is surrendered early.

   b) cannot be removed but may be reduced if the policyholder dies before the policy reaches maturity.

   c) may be removed if the policy is made paid up.

   d) cannot be removed or reduced in any circumstances.

2) What is meant by 'smoothing'?

3) A low-cost with-profits endowment guarantees to repay the mortgage on the death of the borrower. True or false?

4) The low-cost with-profits endowment has reduced premiums for the first five years. True or false?

5) In what ways does a unit-linked endowment differ from a with-profits endowment?

6) Unit-linked endowments can usually be extended to a longer term if there is a shortfall in the amount needed for repayment. True or false?

7) Which of the following types of unit-linked fund is **most commonly** used for investment for mortgage repayment purposes?

   a) Fixed interest.

   b) UK equities.

   c) Managed.

   d) Property.

8) If a borrower's endowment policy seems likely to result in a shortfall, the mortgage can be converted to the repayment method with the agreement of the lender. True or false?

TOPIC 22

Other repayment vehicles for interest-only mortgages

LEARNING OBJECTIVES

As we noted in Topic 21, although endowment policies were once a very popular way to build up a fund to repay an interest-only mortgage, they are rarely used now. This topic looks at other investment products that are used to support interest-only mortgages.

By the end of this topic, you should have an understanding of the following investment products and their role in supporting mortgages:

- individual savings accounts, including Help to Buy and Lifetime ISAs;
- unit trusts and open-ended investment companies;
- pension plans.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know. You have already studied ISAs, unit trusts, OEICs and pension plans in UK Financial Regulation, and our aim in this topic is to refresh your memory and explain their use in relation to mortgages.

Can you recall:

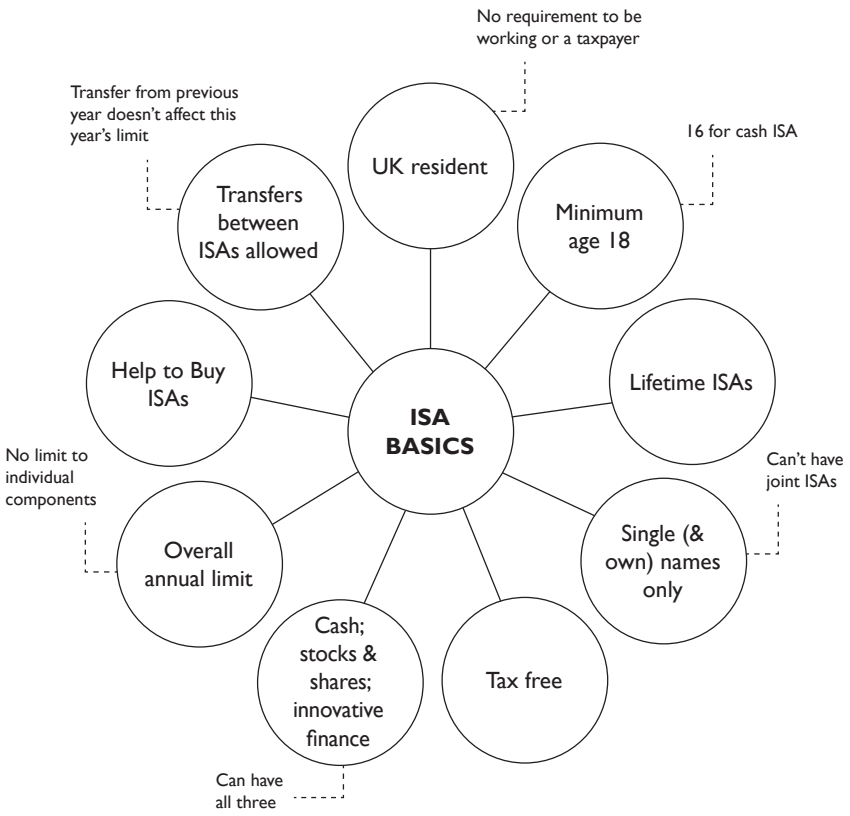
- the key features of an ISA?
- how unit trusts and OEICs work?
- the different ways in which people can access their pension funds at retirement?

22.1 How is an ISA used as a mortgage repayment vehicle?

CHECK YOUR UNDERSTANDING 1

You should be familiar with ISAs from your studies for UK Financial Regulation. Refer back to your study text if you need to refresh your memory. Figure 22.1 provides a summary of the basics.

FIGURE 22.1 BASIC FEATURES OF ISAS



FACTFIND

Find the latest information on ISAs at:

https://www.gov.uk/individual-savings-accounts [Accessed: 26 October 2020].

The characteristics of an ISA mortgage are that:

- only the interest due on the loan is paid to the lender during the term – the entire capital remains outstanding throughout the term;
- investment is made into an ISA on a regular basis;
- separate life cover is needed to repay the loan should the borrower die before the end of the term. The sum assured should be the same as the initial mortgage because the value of the ISA could fluctuate during the term;
- at the end of the mortgage term the ISA fund is used to repay the capital;
- ISAs can be cashed in at any time without penalty, which means that the planholder can increase payments to reduce the mortgage term, reduce payments to suit their cash flow or cash in the plan early if growth is better than expected.

It is important to realise that the underlying investment risk depends on the underlying product and fund.

TECHNICAL NOTE

Unlike endowments, it is not possible to assign ISAs, and the lender can gain no legal or equitable rights over them.

In terms of investment, there are three categories of ISA:

- **cash** – deposit based, very similar to a standard savings account;
- **stocks and shares** – invested in shares, collective investments and corporate bonds;
- **innovative finance** – investment in peer-to-peer lending platforms.

Given the need for capital growth, and the time span for a mortgage, stocks and shares ISAs are the only realistic option for ISA mortgages, and so we will focus on them.

There are four types of ISA that can be used to hold the investments summarised above:

- Standard ISA;
- Junior ISA – available to those under the age of 18, so not applicable here;
- Help to Buy ISA;
- Lifetime ISA.

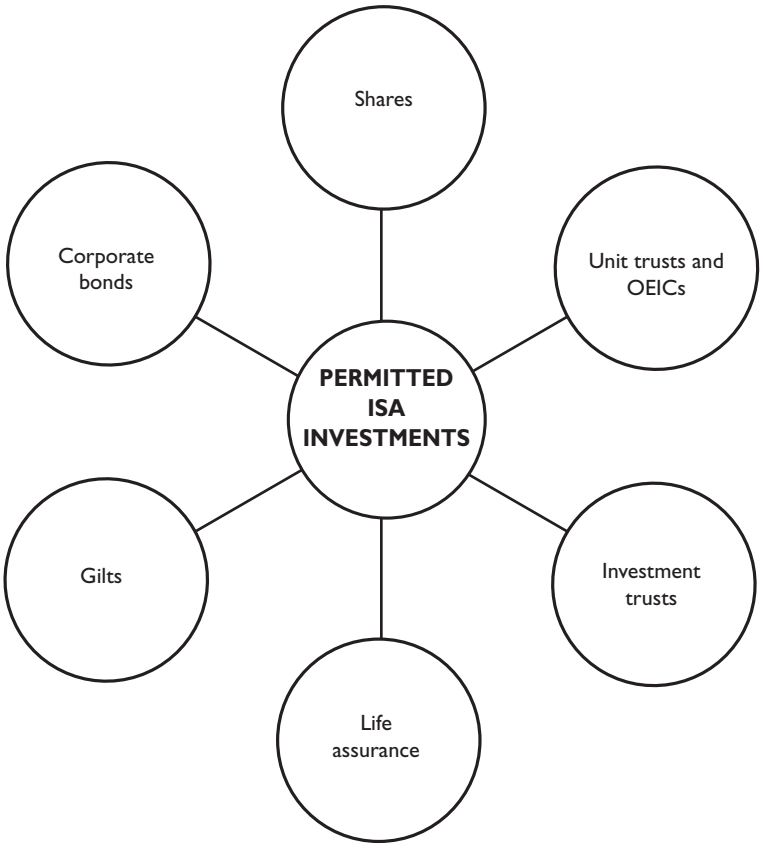
22.1.1 Standard ISA

The standard ISA is available to those who meet the minimum age requirement.

Stocks and shares ISAs

Stocks and shares ISAs are available to UK residents aged 18 or over. They carry the same level of risk as the underlying shares, unit trusts, OEICs or investment trusts. Figure 22.2 summarises the types of investment that can be included in an ISA.

FIGURE 22.2 PERMITTED INVESTMENTS



The annual limit applies to total investment made in a tax year. Unless the product is categorised as a flexible ISA, as explained below, the ISA holder cannot withdraw money from the ISA and then 'replace' it later in the tax year unless they have sufficient unused ISA subscription available.

Cash ISA

The cash ISA is available to those aged 16 or older. It involves investment in savings accounts, fixed interest or cash unit trusts, and open-ended investment companies, including some NS&I products. Other than relatively short-term saving for a deposit, the cash ISA is of limited value in relation to mortgages, given that capital growth is limited by the nature of the underlying assets.

Flexibility

Changes to ISA rules in 2016 allow providers to offer 'flexible' ISAs, although they are not obliged to do so. The key elements of a flexible ISA are:

- They can be cash, stocks and shares or innovative finance ISAs. Help to Buy and Lifetime ISAs cannot be flexible ISAs, and some ISAs, such as those offering fixed rates or bonuses, are likely to have penalties for withdrawal and will not be flexible.
- The flexibility only applies to cash held in the ISA. In the case of stocks and shares ISAs, this means cash held in the account, dividends received and the proceeds of selling investments.
- The ISA holder can withdraw cash held in the account and then re-invest it in the same tax year without the re-investment counting as part of that tax year's ISA contribution allowance. Cash withdrawn can be from investments made in previous tax years.
- Re-investment must be into the same account and must be made in the same tax year as the withdrawal.

22.1.2 What is the Help to Buy ISA?

The Help to Buy ISA is designed to help first-time property buyers accumulate money for their purchase, with the help of a government incentive. Applications for the Help to Buy ISA could be made from 1 December 2015 to 30 November 2019. Anyone who opened an account within those dates will be able to fund it until they buy a house. Existing Help to Buy ISAs can continue to receive contributions until November 2029. Holders then have until 1 December 2030 to buy a property and claim the bonus.

- **Providers** – the accounts are cash accounts available through participating banks and building societies, with the interest rate set by the provider. Once started, a Help to Buy ISA can be transferred to another provider.
- **Other ISAs** – each individual can only have one Help to Buy ISA. The Help to Buy ISA is a form of cash ISA, and so, in principle, it is not possible to contribute to a Help to Buy ISA and a cash ISA in the same tax year. However, if an ISA provider offers a 'portfolio' ISA, it is possible to hold a range of cash-based investments within a cash ISA. In this case, it may be possible to contribute to both a cash ISA and a Help to Buy ISA in the same tax year, subject to the overall cash and Help to Buy ISA limits.
- **Tax treatment** – interest and the government bonus is tax-free.
- **Property price** – the account can be used to save a deposit for property purchases up to £450,000 in London and £250,000 elsewhere.

- **Monthly limits** – savers can deposit up to £1,200 in the first month (it does not have to be in one payment) and then between £1 and £200 a month after that.
- **Withdrawals** – money can be withdrawn at any time without penalty, but the bonus is only payable if the money is used to buy a property.
- **Government bonus** – the government will add a bonus equal to 25 per cent of the total amount saved, plus interest earned, with a maximum bonus of £3,000 per person.
- **Bonus threshold** – the minimum government bonus that can be paid is £400 per person, which means that the account holder must have at least £1,600 saved in order to receive a bonus.
- **Purchase deadline** – the government bonus is paid to the buyer's conveyancer ready for completion, subject to a deadline of 1 December 2030. This contrasts with the Lifetime ISA, where the bonus can be paid at exchange of contracts to form part of the deposit.
- **Death of the ISA holder** – if the Help to Buy ISA holder dies, the account will close and no bonus is payable. A surviving spouse could claim the additional permitted subscription (refer to the box in section 22.1.3 on what happens when an ISA holder dies).

22.1.3 What is the Lifetime ISA?

The Lifetime ISA became available from 6 April 2017 and is designed to help those saving for retirement or to purchase their first property. Like the Help to Buy ISA, it forms part of the overall annual ISA allowance and can run alongside a Help to Buy ISA.

- **Eligibility** – UK resident individuals (not joint accounts) aged between 18 and 39 when the account is opened. Contributions can be made up to the day before the investor's fiftieth birthday.
- **Limits** – up to £4,000 can be paid in each tax year and invested in the full range of permitted ISA investments. The Lifetime ISA contributions are part of the overall ISA limit, which means that the saver could pay the balance of their ISA allowance into other ISAs, including a stocks and shares ISA.
- **Government bonus** – the government credits a 25 per cent bonus on the annual contributions (not the fund value) each year on a monthly basis, up to a maximum £1,000 per annum.
- **Access to fund at age 60** – the ISA is designed to run until the saver reaches the age of 60 (or buys their first property), at which point money can be withdrawn without penalty. If funds are withdrawn before the age of 60 for any reason other than serious ill-health or buying a first property, a 25 per cent penalty will apply to the amount withdrawn, including growth.

20 per cent of the penalty represents a return of the bonuses to date (plus any growth or minus any loss), with a further 5 per cent as a penalty.

EXAMPLE

Assuming no investment growth, a £4,000 contribution would attract a £1,000 bonus, giving a fund value of £5,000. If the ISA holder withdrew the funds early, a penalty of £1,250 (25 per cent of the funds withdrawn) would apply. This equates to the original bonus of £1,000 plus a further £250 (5 per cent of the withdrawal) – effectively a penalty for early withdrawal. Clearly, if the fund had grown, the penalty would have been higher.

- **Access for property purchase** – once the ISA has run for 12 months, the saver can access the fund (including bonuses) before the age of 60 to buy their first property. The property must be a first home in the UK worth up to £450,000 and, unlike the Help to Buy ISA, the fund can be released to provide a deposit at exchange of contracts. If the sale falls through, the money can be repaid to the account without affecting the year's contribution limit.
- **Death of the ISA holder** – if the investor dies before withdrawing the fund, the ISA wrapper is removed and the fund becomes part of their estate. No withdrawal penalty would be applied, and a surviving spouse could claim the additional permitted subscription (please refer to the upcoming box on what happens when an ISA holder dies).
- **Interaction with the Help to Buy ISA** – It is possible to transfer a Help to Buy ISA to a Lifetime ISA, counting towards the year's Lifetime ISA limit. Alternatively, the planholder can continue to pay into the Help to Buy ISA, or contribute to both a Lifetime ISA and their Help to Buy ISA. If contributions are made to both, only the bonuses from one plan can be used to buy a property. If the Help to Buy bonus is claimed to buy a property, the Lifetime ISA bonus can be claimed when the investor reaches the age of 60.

WHAT HAPPENS WHEN AN ISA HOLDER DIES?

ISA funds continue to retain tax advantages until the earlier of completion of administration of the deceased's estate, closure of the ISA or three years from the date of death, although the ISA forms part of the estate for inheritance tax purposes. During this period, the ISA is referred to as a 'continuing account of a deceased investor', often abbreviated to a 'continuing ISA'.

The surviving spouse or civil partner can claim an 'additional permitted subscription' (APS). This allows their own ISA allowance to be increased by the higher of the value of the deceased's ISA fund at the time of their death or its value when the allowance is claimed. The APS allowance must be claimed by the surviving spouse and is available until the later of three years after the date of death or 180 days after administration of the estate is complete. As a result of a successful claim, their own ISA allowance for the relevant tax year will be increased by the APS.

The APS applies even if the original ISA holder left their ISA assets to someone else.

If someone other than the spouse or civil partner inherits the assets, the ISA tax wrapper is removed from their legacy and the assets become subject to income and capital gains taxes as with any other investment. The additional allowance applies only to a spouse or civil partner.

EXAMPLE: DEATH OF AN ISA HOLDER

Nadira died leaving an ISA fund of £50,000 to her grandchildren. Nadira's wife Lori would be able to claim an APS of £50,000, even though she did not inherit the money.

The ISA would remain tax free until the earlier of:

- completion of administration of Nadira's estate;
- closure of the ISA; or
- three years from Nadira's death.

When the ISA is passed to her grandchildren, the tax 'wrapper' will be removed, and any future income or gains will be taxable in their hands.

TABLE 22.1 ADVANTAGES AND DISADVANTAGES OF ISA MORTGAGES

Advantages	Disadvantages
▪ No liability to income tax or capital gains – final value will be higher than same investment outside an ISA	▪ No guarantee fund will be sufficient to fully repay mortgage
▪ A number of investment products can be held in an ISA	▪ No life cover included – must be arranged separately
▪ Flexibility – no contractual term, so contributions can be regular or single, can be varied and no penalties for early closure or encashment	▪ ISAs are as risky as the underlying investments
▪ ISA benefits from all the advantages of the underlying investment	▪ Investment limits might not be sufficient for very large or short-term mortgages
▪ Withdrawals can be made at any time – no impact on the tax-free status	▪ Could affect eligibility for means-tested benefits
▪ If the investment performs well, there could be a chance of paying off the mortgage early	
▪ No limit on total value of ISA holdings	

22.2 How are unit trusts and open-ended investment companies used for mortgage repayment?

It is possible to use unit trusts and open-ended investment companies (OEICs) as mortgage repayment vehicles. However, since both these vehicles can be held within an ISA, it is more tax efficient, and more common, for them to be used as part of an ISA repayment 'package' as a stocks and shares ISA permitted investment.

CHECK YOUR UNDERSTANDING 2

Again, you should be familiar with unit trusts and OEICs from your studies for UK Financial Regulation, so we will refresh the basics and then look at them in relation to mortgages. Refer back to your earlier studies if necessary.

22.2.1 Unit trusts and OEICs – the basics

Unit trusts and OEICs are pooled (or collective) investments, with investments made via regular payments or single lump sums. Both types of investment fund are open-ended, which means that there is no limit on the number of units or shares that can be issued. Unit trust funds are managed by a fund manager and an OEIC fund is managed by the authorised corporate director (ACD). The manager/ACD can create them to meet demand and must buy back units or shares from investors who want to cash in their investment.

Unit trusts sell units to investors and OEICs sell shares, although there is little practical difference between the two methodologies. In simple terms, the fund value is divided by the number of units or shares to calculate the value of each individual unit or share. For example, if the fund is worth £1m and there are £1m units or shares, each is worth £1 at that time. Funds, and therefore units or shares, are valued daily and, as with any investment, prices can fluctuate.

There are technical differences between unit trusts and OEICs, but in practical terms they operate in much the same way, so much so that the Investment Association puts the 3,000 plus unit trust and OEIC funds available in the UK into the same categories and performance tables.

The funds in both arrangements are held by a third party to protect investors' interests, and both are subject to regulation by the PRA and the FCA to provide investor protection.

Unit trusts and OEICs can be actively managed, where the manager reviews, assesses and changes the fund investments on a regular basis, or passively managed (trackers), where the fund tracks a benchmark, such as the FTSE 100. The manager of a tracker fund ensures that the fund's assets are representative of the benchmark in terms of its constituents and weightings, but does not make day to day investment decisions.

Unit trust and OEICs are subject to charges, the principal of these being the initial charge and the annual management charge.

Taxation of unit trusts and OEICs depends on the nature of the underlying investments. If the fund is share based, income may be paid out as dividends, which will be subject to the income tax regime for dividends, including the availability of the annual dividend allowance.

If the fund has more than 60 per cent of its money in cash and fixed interest investments, income paid out is regarded as interest and is paid without tax deducted at source. Distributions are taxed under the savings regime as interest, including the availability of the personal savings allowance.

The fund itself is exempt from capital gains tax, but the investor's gains on disposal are subject to capital gains tax.

22.3 How can a pension be used as a mortgage repayment vehicle?

Historically, a pension mortgage was a mortgage arranged on an interest-only basis, with the tax-free lump sum from the pension providing the capital to repay the mortgage and the balance of the fund used to provide an income for life. New pension freedoms have given planholders more flexibility in the way they can take their benefits and the amount of cash they can take, which may make a pension an attractive repayment proposition in certain circumstances. However, as we will see, there are many points to consider before making such a decision.

You should be familiar with pensions from your studies for UK Financial Regulation. We will refresh the basics and then look in more detail at those factors that are important for pension mortgages. Refer back to your earlier studies if necessary.

Personal pensions, stakeholder pensions and Self Invested Personal Pensions (SIPPs) are 'defined-contribution' pension schemes. For the purposes of this text we will use the term 'personal pension' in reference to these schemes. It is also possible to use benefits from an employer's defined-benefit pension scheme, also known as a 'final salary' or career average scheme. A pension plan can be arranged by, or for, any person under the age of 75 who is resident in the UK.

CHECK YOUR UNDERSTANDING 3

From your studies for UK Financial Regulation, can you recall the key difference between a defined-benefit and a defined-contribution scheme?

22.3.1 Contributions, tax relief and allowances

TABLE 22.2 CONTRIBUTION LIMITS AND TAX RELIEF

Contribution limit	Subject to earnings, annual and lifetime allowances
Tax relief limit on personal contributions	£3,600 or the individual's earned income for the year
Annual allowance (ie maximum for tax relief)	£40,000
Tax treatment of contributions	Paid net of basic-rate tax Higher- and additional-rate taxpayers can claim further 20%/25% of gross payment as tax relief via self-assessment

PENSION TAX RELIEF IN SCOTLAND

The Scottish government has devolved powers to set the rate of income tax applicable to earned income (not savings or dividend income) for Scottish tax residents. This means that the rate of pension income tax relief may be different for some Scottish taxpayers, depending on the rate of income tax they pay.

Although the rates are set by the Scottish government, tax is collected by HMRC with relevant amounts then paid to the Scottish government, which has resulted in complications. The UK government announced a system that applied for the 2018/19 tax year, and stated it would hold consultations with relevant stakeholders to establish a permanent system. At the time of writing (November 2020) no announcement had been made.

Scottish taxpayers continue to receive tax relief at the UK basic rate, even if they pay the lower starter rate. Where the individual pays more than the basic rate of income tax, they can claim the difference between the rate paid and the basic rate via self-assessment (GOV.UK, 2018).

An individual's employer can pay into an employee's pension and receive tax relief by claiming it as a business expense. If the combined payment from

employer and employee is more than the annual allowance, the employee will have to pay tax at their highest income tax rate on the excess above £40,000. In effect, the excess over £40,000 will be treated as additional income and taxed accordingly.

Contributions to an occupational pension scheme are paid through the 'net pay' arrangement. Contributions are deducted from gross pay before tax. Contributions from an employer are paid gross, and the employer can set the contribution against the business's income as a business expense.

It may also be possible to carry forward unused allowances from the previous three tax years to use in the current year.

Tapered annual allowance

A tapered annual allowance applies to someone who has both:

- **threshold income** exceeding a certain limit – threshold income is total income less personal gross contributions to registered pension schemes; and
- **adjusted income** exceeding a certain limit – adjusted income is total income plus any employer contributions to a registered pension scheme.

The taper reduces the annual allowance by £1 for every £2 of adjustable income above the threshold income limit, subject to a specified minimum annual allowance.

Money purchase annual allowance

Once a pension planholder starts to take benefits using flexi-access drawdown or uncrystallised pension fund lump sum arrangements (see section 22.3.2 below), the money purchase annual allowance applies. This means that, for tax relief purposes, they can contribute no more than £4,000 into a defined-contribution (eg personal pension) scheme each year without a tax charge. However, the balance of the £40,000 annual allowance can still be used to fund an occupational pension scheme if they are a member.

IN BRIEF

WHAT IS THE LIFETIME ALLOWANCE?

- The lifetime allowance (LTA) is the maximum amount that can be held in pension funds by an individual at the point when they take benefits.
- It is index-linked each year.
- If the fund exceeds the LTA on taking the benefits, there is a 55 per cent tax charge on the excess if taken as a lump sum, or 25 per cent if it is taken as income.
- A higher LTA is possible for those who had pension funds above the LTA when it was reduced. This is available through various LTA protection schemes.

22.3.2 Pension benefits

It is not necessary to retire in order to start taking benefits from a personal pension. A planholder aged 55 or older can take benefits and continue working if they wish. The state pension age will increase to 67 by 2028, and then increase in line with life expectancy. When benefits are drawn, the scheme member can usually take up to 25 per cent of the fund as a tax-free cash sum, known as a pension commencement lump sum (PCLS).

Modern pension plans allow parts of the fund to be crystallised separately. This means that, subject to the provider's systems functionality, each of the benefit options outlined below can be used with part of the fund, allowing the benefits to be phased in over time, or all three options can be applied to the whole fund.

There are three options for those wishing to take benefits:

- uncrystallised funds pension lump sum;
- flexi-access drawdown;
- annuity.

Uncrystallised funds pension lump sum (UFPLS)

The planholder can take the entire fund as a single lump sum or a series of smaller lump sums. Twenty-five per cent of each lump sum is tax-free, with the remainder added to the planholder's income for that tax year and subject to income tax.

This may be tempting for those who wish to pay off a mortgage, but only 25 per cent of the amount withdrawn will be tax free; 75 per cent will be taxed as income in the same way as earned income. So, if 75 per cent of the withdrawal

kept the planholder in the basic-rate tax band when added to their existing income, they would pay 20 per cent on it. If 75 per cent of the withdrawal took them above the higher-rate threshold, they would pay 20 per cent on the amount within the basic-rate band, 40 per cent on the part above the higher-rate threshold and 45 per cent above £150,000.

In terms of mortgage repayment, this is unlikely to be the most efficient way to provide the required lump sum, because only 25 per cent of each lump sum taken is tax-free. We will see the effect of this in the calculation below.

Flexi-access drawdown (FAD)

The planholder can take 25 per cent of the fund as a tax-free lump sum and then take an income (known as 'drawdown') from the balance of the fund. The income is taxable in the same way as earned income. The income can be stopped and started as required and there is no minimum or maximum amount required. The income is taken directly from the fund, which remains invested. It is also possible to take the full 25 per cent tax-free cash at the start and delay taking the income until a later date.

In terms of mortgage repayment, this is likely to be the most efficient method of providing the required lump sum, as we will see in the calculation below.

Annuity

The planholder can take the tax-free cash and then use the balance of the fund to purchase an annuity. The annuity will provide an income for life, and can be:

- fixed; or
- escalating by a set percentage each year or with inflation; or
- investment-linked (with-profits and unit-linked).

It is also possible to arrange an annuity that provides a reducing income (designed for those who need extra income earlier in retirement), or one that runs for a defined term rather than for life.

Joint-life annuities continue to pay a spouse or dependant an income on the death of the annuity holder, typically between 50 and 100 per cent of the original annuitant's income for the rest of their life.

22.3.3 Death benefits

Death before age 75

If a planholder dies before the age of 75, the remaining fund can pass to their chosen beneficiaries (who do not have to be dependants). Beneficiaries can then take the fund as a lump sum, take income withdrawals or buy an annuity – all tax-free.

Income from joint life and guaranteed annuities that started payment on or after 6 April 2015 will be tax-free when paid to the survivor or a beneficiary. However, those that were in payment before 6 April 2015 will be taxed as the beneficiary's income.

Death at or after age 75

If the individual dies after reaching the age of 75, beneficiaries can take the fund as a lump sum, take income withdrawals or buy an annuity – all of these will be taxed at the beneficiary's marginal tax rate. Income from joint life and guaranteed annuities will be taxed at the survivor or beneficiary's marginal rate.

TABLE 22.3 ADVANTAGES AND DISADVANTAGES OF A PENSION MORTGAGE

Advantages	Disadvantages
▪ Tax relief on contributions, tax-free lump sum, tax-free fund growth	▪ Limits on contributions for tax relief
▪ Wide fund choice	▪ No guarantee of final fund value
▪ Choice in how benefits are taken	▪ Taking funds to repay the mortgage will result in a lower pension being received
▪ Flexible income options	▪ Funds are locked in until at least age 55* – this may result in a term longer than 25 years for younger borrowers. *57 from 2028
▪ Fund is free from inheritance tax and can be passed to beneficiaries tax-free on death before age 75 or at the beneficiaries' marginal rate on death at or after age 75	▪ Taking more than 25 per cent of the fund will result in an increased tax bill
	▪ The lifetime allowance limits pension funds to a certain amount. A charge applies to funds above this amount on taking benefits

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the key features of the Help to Buy ISA and the Lifetime ISA?
- summarise the advantages and disadvantages of using an ISA for mortgage repayment?
- explain the main similarities and differences between unit trusts and OEICs?
- explain how a pension fund can be used to repay a mortgage?
- discuss the methods of the different approaches to pension drawdown?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

GOV.UK (2018) *Pension schemes relief at source for Scottish income tax newsletter – February 2018* [online]. Available at: https://www.gov.uk/government/publications/pension-schemes-relief-at-source-for-scottish-income-tax-newsletter-february-2018/pension-schemes-relief-at-source-for-scottish-income-tax-newsletter-february-2018 [Accessed: 6 November 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 22. Review the text if necessary.

Answers can be found at the end of this book.

1) A couple wishing to arrange an interest-only mortgage can arrange a joint ISA as the repayment vehicle. True or false?

2) An individual cannot contribute to both a cash ISA and a Help to Buy ISA in a tax year. True or false?

3) A Help to Buy ISA saver will need a minimum of £1,600 in the account to earn a bonus. True or false?

4) Jason starts to contribute to a Help to Buy ISA, paying in £1,000 as an initial deposit and £100 every month. He plans to buy a property three years later, when his grandparents have promised him a lump sum to help with the deposit. Assuming he maintains his contributions for three years, and ignoring any interest earned, how much bonus will his Help to Buy ISA give him towards his deposit?

   a) £900.

   b) £1,150.

   c) £1,500.

   d) £3,000.

5) Which of the following is true in relation to personal pensions?

   a) Individuals can pay in to a defined-benefit pension or a defined-contribution pension, but not both.

   b) An individual using flexi-access drawdown must take the available tax-free cash in instalments.

   c) It is possible to take the maximum tax-free cash and delay taking an income until later.

6) Tanya earns £27,500 a year from her job as a contracts manager. The maximum that can be paid into her pension annually is £27,500. True or false?

7) Jane, aged 28, wishes to arrange an interest-only mortgage, which she intends to pay off by the age of 53, although she would like to do so earlier if she has sufficient funds. She will be able to make regular contributions to a repayment vehicle but also intends to make additional payments from her quarterly bonus scheme when she feels able to do so. Other than a savings account for her deposit, she has no other investments. Which product from those below would best meet her needs as a repayment vehicle?

   a) A stocks and shares ISA.

   b) A with-profits endowment.

   c) A personal pension.

   d) A unit trust.

8) Kevin is a basic-rate tax payer and has a pension fund of £500,000 and an interest-only mortgage of £150,000. What is the maximum amount of cash he could take from his pension without potentially incurring a tax bill?

   a) £125,000.

   b) £150,000.

   c) £200,000.

   d) £500,000.

TOPIC 23

Interest-rate options

LEARNING OBJECTIVES

In Topic 20, we emphasised that there are only two methods of repaying a mortgage: capital repayment or interest-only. However, there are a wide variety of mortgage products available that offer different interest-rate options. The variety of products means a prospective borrower should be able to find at least one that matches their needs. The wide choice can be confusing, so good advice is important.

By the end of this topic, you should have an understanding of the following:

- standard variable-rate products;
- discounted-rate products;
- tracker products;
- fixed-rate products;
- capped-rate products;
- flexible and offset products;
- product incentives.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about these different interest-rate options. We introduced some of them in UK Financial Regulation and if you have been involved in buying a property you have probably had to decide which option to choose.

For instance, can you recall:

- the difference between a discounted-rate and a tracker mortgage?
- the main benefit of a fixed-rate mortgage?

- two types of flexible mortgage?

From your studies in Topic 20, can you remember the three different ways in which interest can be applied to an account?

!

PRODUCT AVAILABILITY

This topic covers the most common schemes available in a normal mortgage market. Some mortgage products may be withdrawn for a period, the popularity of products is influenced by prevailing interest rates, and new products may be introduced. Regard this topic as a guide to the main schemes, not an exhaustive list.

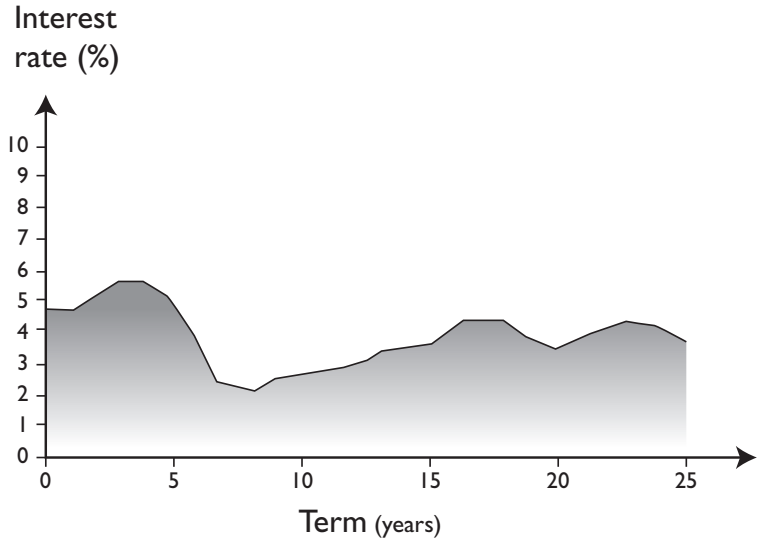
23.1 What is a standard variable-rate mortgage?

For many years the standard variable-rate (SVR) mortgage was the most common mortgage available. The development of the mortgage market has led to a wide range of products that may be more attractive to borrowers, and many lenders no longer even offer an SVR mortgage, preferring instead to offer discount or tracker mortgages. Many borrowers who have had SVR mortgages for many years with the same lender have remortgaged to take advantage of the benefits offered by new products.

The SVR mortgage does exactly what its title suggests – the interest rate varies with market rates in general. For example, an increase in Bank rate as a result of a Monetary Policy Committee decision will usually lead to lenders increasing their own standard variable rate, which in turn means that borrowers with a variable-rate mortgage will see their payments increase. If the SVR is reduced, the borrower's payments will decrease.

While there is a link between Bank rate and a lender's SVR, it is up to the lender whether to increase or reduce the SVR when Bank rate changes. Lenders have often been criticised for increasing the SVR quickly when Bank rate rises, but taking too long to reduce it when Bank rate is reduced.

FIGURE 23.1 THE SVR MORTGAGE



Someone who does not want to be locked into early repayment charges may still opt for this product, whether on a capital repayment or interest-only basis. No protection is offered against steep interest-rate increases and, generally, the monthly payment must be amended in line with each change in the interest rate charged. At times of economic volatility, the interest rate might change frequently and this uncertainty can make it difficult to plan household budgets.

Variable-rate mortgages tend to have lower product fees than fixed-rate or capped-rate mortgages and do not usually carry early repayment charges.

When interest rates are low, few lenders tend to offer standard variable-rate mortgages, preferring instead to offer discounted or tracker mortgages, although they do show a standard variable rate for comparison and to illustrate the rate that could apply at the end of the discount/tracker term.

Variable-rate mortgages do not usually offer a portability option.

23.2 What is a discounted-rate mortgage?

The discounted-rate mortgage is a popular variation on the SVR mortgage. It simply offers a discount from the lender's standard variable rate for a given period and is designed to attract new mortgage business, in the same way as a fixed-rate product.

So, if the lender's SVR is 4 per cent and the discount offered is 1 per cent for two years, the borrower will pay 3 per cent initially. If the lender's SVR increases or decreases during the discount term, the borrower will still pay 1 per cent below the SVR. The discount is genuine in that the interest saved is not added to the loan.

Some discounted mortgage products offer what is known as a stepped discount: the discount may be 1.0 per cent in the first year, 1.25 per cent in the second year and 1.5 per cent in the third year, while some lenders reduce the discount over each of the first few years.

FIGURE 23.2 DISCOUNTED-RATE MORTGAGE: KEY CONSIDERATIONS

Product fee

If an arrangement fee applies, it is typically between £100 and £500, and generally non-refundable.

Interest-rate 'floor'

The minimum interest rate that would apply – this is a relatively recent development as a result of the prevailing low interest rates.

Early repayment charge

Designed to deter part or full redemption of the loan during the discounted period. May be calculated as:

- a fixed percentage of the amount redeemed; or
- so many months' interest on the amount redeemed; or
- the actual amount of discount received by the borrower up to the date of the part or full redemption.

Additional purchases required

Loan may be subject to compulsory purchase of an associated product, eg buildings and contents insurance, buildings insurance only or mortgage payment protection insurance, thus providing the lender with commission income. This is not common in today's market.

Increases in SVR

No protection against increases in the lender's SVR – the interest rate payable is discounted from whatever the SVR is. However, borrower does have assurance that, for a given period, they will be paying less than the lender's SVR.

23.3 What is a tracker mortgage?

Tracker mortgages are variable-rate mortgages that follow (or track) a stated interest-rate benchmark.

23.3.1 Base-rate tracker

A base-rate tracker follows the Bank of England (BoE) base rate (Bank rate) for a given period – typically up to five years, although some lenders offer lifetime trackers. During that period, the interest rate on the mortgage is set at a percentage rate above or below the base rate. For example, a base-rate tracker set at 2 per cent above base rate will follow the base rate but will always be 2 per cent above it. A base-rate tracker set at 1 per cent below base rate will follow the base rate but will be 1 per cent below it. The Bank's Monetary Policy

Committee meets eight times a year to review and set the BoE base rate, and any changes to the interest rate are applied to the tracker mortgage. At the end of the tracker term, the mortgage will automatically revert to the lender's standard variable rate, although most lenders will allow the borrower to move to another product if one is available.

The interest rate charged is usually lower than the lender's SVR because the Bank of England base rate is usually lower than the average lender's SVR.

There may be occasions when a lender will make a small reduction in its SVR even though the Bank of England base rate has not been reduced. In these circumstances, borrowers with a base-rate tracker mortgage with that lender are unlikely to have their rate reduced.

WHAT HAPPENS TO TRACKER RATES WHEN INTEREST RATES ARE VERY LOW?

A potential problem with tracker mortgages came to light in early 2009 when the base rate fell to 1 per cent. Many borrowers had trackers set at 1 per cent or even 2 per cent *below* the base rate, which could, in theory, have led to the lender paying the borrower because the tracker rate could be minus 1 per cent.

Most lenders responded by invoking (or trying to invoke) a minimum rate (or 'collar'), ie a rate below which the tracker rate was not permitted to fall. Given that the base rate then fell to 0.5 per cent, stayed at that level for seven years and was then cut even more, it is a safe assumption that all new trackers will have a minimum interest rate (collar) to ensure the problem does not arise in future.

As with a discounted-rate mortgage, a number of charges and conditions may apply:

- **Product fee** – typically between £500 and £999.
- **Application fee** – to cover the lender's application processing costs.
- **Early repayment charge** – on full or part redemption within a specified period.
- **Compulsory purchase of associated products** – eg buildings, contents and/or mortgage payment protection insurance. This is not common in today's market.

Most arrangements allow the borrower to make overpayments or lump sum payments within specified limits – typically up to 10 per cent of the initial mortgage per year.

23.3.2 Libor tracker

A Libor tracker (or Libor-linked) mortgage follows the three-month London interbank offered rate, which is the traditional rate at which banks lend to each other; it is usually around 0.1 to 0.2 per cent above Bank rate. The lender's rate is reviewed every quarter, in line with Libor. As with the base-rate tracker, the interest rate is set at Libor plus or minus a stated percentage, and the lender cannot change the rate other than as a result of a change in Libor.

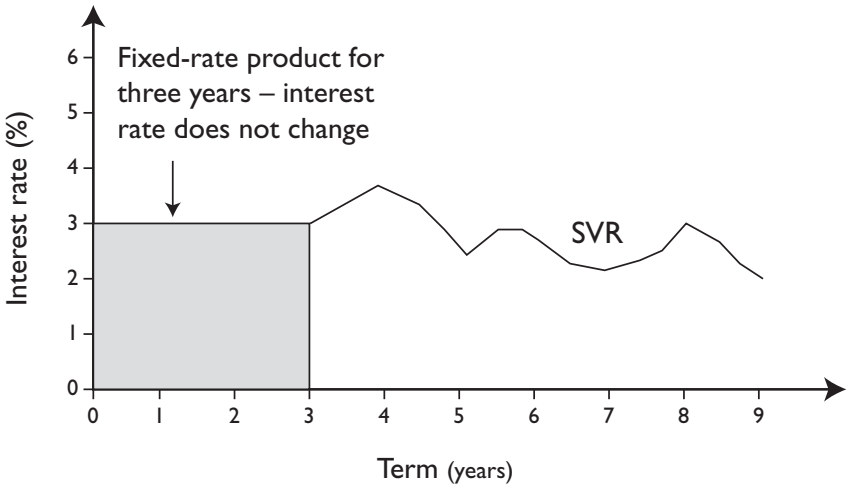
In today's market, Libor trackers are uncommon for standard residential mortgages but may still be offered by sub-prime lenders, which specialise in lending to those with an impaired credit rating, and by commercial mortgage lenders. Libor tracker mortgages usually charge a product fee and impose an early repayment charge on full or part redemption within a specified period.

As explained in section 1.5.1, Sonia replaces Libor as a benchmark from the end of 2021, with Libor mortgages transitioning to Sonia. The Sonia rate will generally be a little lower than Libor, so it will be permissible for lenders to charge a small, fair premium to compensate.

23.4 What is a fixed-rate mortgage?

With a fixed-rate mortgage, the rate of interest (and so the monthly payment) is fixed for an agreed period, typically between one and five years, but sometimes as long as ten years. At the end of the fixed-rate term, the rate normally moves to the lender's standard variable rate (SVR), known as the 'reversion' rate. The market for fixed-rate mortgages is highly competitive, and with the Bank of England base rate and general interest rates low, fixed interest rates are very low when compared to the past.

FIGURE 23.3 THE FIXED-RATE MORTGAGE



HOW DOES THE LENDER RAISE FUNDS FOR FIXED-RATE MORTGAGES?

The rate at which interest is charged is linked to the rate paid by the lender on a tranche of funds raised on the wholesale money markets. If a lender raises £100m from the market at a fixed rate of 1.5 per cent over a five-year period, then this amount may be made available to new borrowers in the form of a five-year fixed-rate mortgage at a rate of between 2.5 per cent and 3 per cent. Once the £100m has been lent, the product will be withdrawn, and possibly replaced with a new product at an interest rate linked to the prevailing money market rates at that time.

The main benefit of a fixed-rate mortgage to the borrower is that it helps them to budget. They know exactly what their monthly payment is for a given period of time and they are protected against interest-rate increases during that period. The borrower may also be permitted to make overpayments or one-off additional repayments each year within specified limits without incurring charges. The typical limit is 10 per cent, although some lenders set higher limits, and one or two set no limit. The lender's terms will specify whether the 10 per cent is based on the original mortgage or the amount outstanding at the time of the repayment. There are, however, other matters that the borrower needs to consider:

- **Interest rates** – they cannot take advantage of any reductions in the lender's standard variable rate during the fixed-rate period. They must also bear in mind the possibility that interest rates will rise during the fixed-rate period, resulting in a substantial increase in monthly repayments when the fixed-rate period ends.
- **Fees**
  - An application fee may be payable at the time the application is made – this may be as low as £100 or as high as £2,000 or more, or it may be a set percentage of the advance.
  - There may also be a product fee to ensure the product remains profitable for the lender. The fees are not usually refundable if the application is subsequently cancelled by the borrower.
- **Early repayment charges** – an early repayment charge will almost certainly be applied if the loan is fully or partly redeemed during the fixed-rate period. This penalty may be calculated either as:
  - a fixed percentage of the amount redeemed; or
  - a number of months' interest on the amount redeemed.

At one time it was quite common for the early repayment charge to apply beyond the end of the fixed-rate period. These 'overhang' penalties are now rarely found, although they are not banned.

- **Associated purchases** – although it is uncommon in the current market, due to regulatory constraints, some lenders may insist on the purchase of associated products such as buildings insurance, contents insurance or mortgage payment protection insurance as part of the arrangement.

PORTABILITY OPTION

Many fixed-rate and 'special deal' mortgages feature a portability option. This allows the borrower to take the existing arrangement to a new property without incurring an early repayment charge. The existing rate can be transferred to a new property for the same amount and the same remaining term as on the previous property. If the borrower needs a larger mortgage, the excess will be on whatever product the lender offers at that point and, if the borrower requires a smaller mortgage, there is likely to be an early repayment charge on the difference between the old and new amount. The lender also needs to ensure the new arrangement is affordable and meets its current lending policy.

WHY DO LENDERS IMPOSE EARLY REPAYMENT CHARGES?

The early repayment charge is to allow the lender to recover some of its losses on cancelling the fixed-rate deal. The funds would have to be lent to another borrower, possibly at a lower rate of interest, and the lender's profit margin would be reduced.

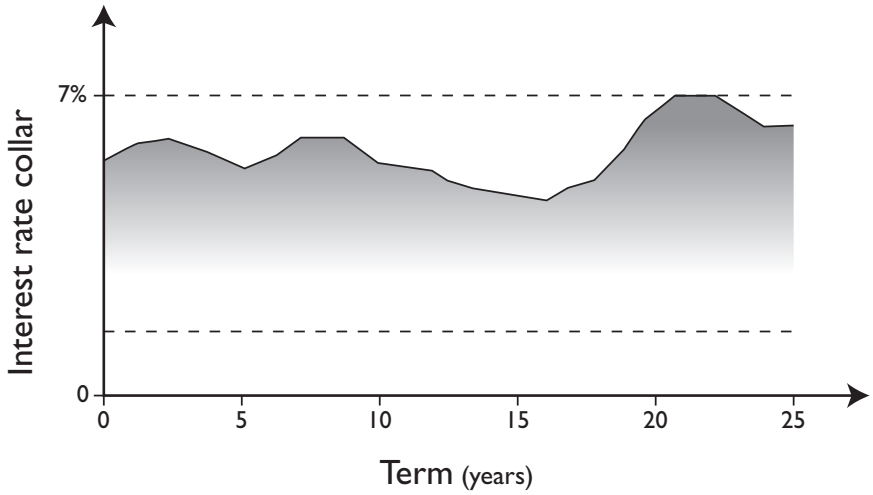
23.5 What is a capped-rate mortgage?

The capped-rate mortgage varies with the lender's SVR, up to a preset cap (or maximum). If the SVR is reduced, the rate the borrower pays is reduced. If the SVR moves above the cap, the borrower pays the capped rate. In other words, there is a limit (cap) on the rate the borrower pays. They can take advantage of reductions in the lender's SVR while at the same time knowing the maximum that they will pay. The rate payable below the cap may include a small premium over the lender's standard variable rate (SVR) – it might, for example, be the SVR plus 0.25 per cent.

A capped-rate mortgage is suitable for somebody who feels that interest rates are about to rise and wants the security of knowing the maximum they will have to pay each month, but would like to benefit if rates drop. Other points to consider are as follows:

- There is likely to be an application and/or product fee.
- There will probably be an early repayment charge on redemption during the capped period.
- As with fixed-rate mortgages, lender may allow charge-free overpayments or single repayments within specified limits.
- Most capped-rate mortgages offer a portability option.

FIGURE 23.4 THE CAPPED-RATE MORTGAGE



When fixed-rate mortgage rates are low, capped-rate mortgages are not particularly attractive and many lenders withdraw them until rates increase.

With Bank rate at an all-time low, lenders have not offered capped-rate mortgages for some time, but if mortgage rates in general start to increase they could become available again.

WHAT IS AN INTEREST-RATE COLLAR?

In the same way that the cap represents the maximum rate that the borrower will pay, the 'collar' represents the minimum interest rate payable during the term. Thus the lender sets an upper and lower limit to the interest payable: a mortgage with a 5.5 per cent cap and a 2.5 per cent collar will allow the rate to vary within those limits, but if rates were to go above 5.5 per cent, the borrower would pay 5.5 per cent, and if they were to drop below 2.5 per cent, they would pay 2.5 per cent.

23.6 How does a flexible mortgage work?

There is no specific definition of a 'flexible mortgage' as such, but it is generally accepted that it will have the following basic features:

- daily interest calculation;
- the facility to make overpayments, within specified limits, at any time without incurring a penalty;
- the facility to underpay (lower than normal monthly payments) if the borrower's circumstances warrant it;
- the facility to take a payment holiday, again if circumstances warrant it;
- the mortgage arrangement can be transferred to another property without penalties;
- most flexible mortgages offer an offset facility.

Underpayments and payment holidays are usually subject to the account holder having overpaid at some point to build a 'credit' above the amount that would normally have been paid off at that point through normal payments. Some flexible mortgages also offer a 'payback' facility, where the borrower can take back any overpayments they have made in the past.

CHECK YOUR UNDERSTANDING 1

Think back to the work you did in Topic 20. What is the advantage of calculating interest on a 'daily rest' basis and in what circumstances does it provide real benefit to the borrower?

Flexible mortgages may offer more than the basic features described above. The lender might offer a 'drawdown' facility, where:

- a maximum borrowing amount is agreed at the start, typically 75 per cent of the initial property value;
- the borrower takes initial borrowing below the maximum limit;
- the borrower can drawdown additional funds from the account as and when they wish, providing total borrowing doesn't exceed the agreed limit. This also allows the borrower to 'borrow back' money they repaid from the original loan amount.

When the drawdown concept was originally introduced, the maximum borrowing was underwritten at the start of the contract, and withdrawals were not subject to further affordability checks: a simple request form would allow cash to be released. This involved less administration than a further advance, and the wording of the mortgage deed used for this type of product is such that all further advances automatically take priority over any other charges registered against the property; the need for a subsequent mortgagee to postpone its charge in favour of the further advance is eliminated.

However, with the introduction of more stringent affordability checks as a regulatory requirement, lenders undertake a further affordability assessment before releasing more funds.

23.7 How does an offset mortgage work?

An offset mortgage is similar in most ways to a flexible mortgage. The main difference is that the account holder's mortgage and savings are held in linked accounts. The savings held in the linked savings account are offset against the mortgage account, which means that mortgage interest is only charged on the balance. The savings are not tied into the mortgage account and can be taken out at any time without notice or penalties.

Some offset mortgages allow the borrower to link the mortgage to a current account as well, which means that a positive balance will be added to savings to be offset against the mortgage.

Mortgage payments are based on the amount borrowed at the start, which means that a healthy savings balance will result in lower interest each month and a payment surplus because the interest charged is lower than expected. In relation to the surplus, the borrower is likely to have the choice of either reducing the payments or maintaining them and reducing the mortgage term.

%

USING AN OFFSET ARRANGEMENT TO REDUCE INTEREST PAYMENTS

Monique has a £100,000 interest-only mortgage (this is simpler to illustrate than a repayment mortgage). She has savings of £25,000. Interest rates are 5 per cent on the mortgage and 2 per cent on a 'normal' savings account.

If Monique were to pay interest on the full £100,000 mortgage, the monthly interest would be £417. She would receive £500 interest on her savings account over the year.

In an offset arrangement, her savings of £25,000 would be offset against the mortgage of £100,000, leaving a balance of £75,000 on which interest would be charged. With this arrangement, her monthly interest payment would be £312.50 per month.

She would not receive any interest on her £25,000 savings, but she would reduce the amount of mortgage interest she has to pay by £104.50 each month.

Although offsetting would mean lower interest charges each month, Monique could choose to reduce her monthly payment or maintain the payments and reduce the term. Assuming interest rates did not change, maintaining the payments would result in an overpayment of £104.50 in the first month to reduce the capital outstanding. In month 2 she would pay interest on £74,895.50, which would be £312.06 – resulting in an overpayment of £104.94, and reducing the capital to £74,790.56, and so on.

Assuming the savings remained linked to the mortgage and interest rates stayed the same, at the end of the first year offsetting would have reduced the mortgage outstanding by approximately £1,400 compared with a conventional mortgage. The longer the savings remain linked to the mortgage, the more the outstanding mortgage would be reduced, allowing Monique to repay the mortgage over a shorter term.

If Monique were to decide to keep her mortgage and savings in separate arrangements, she would receive £500 in interest, but if she opted for the offsetting arrangement she would reduce her mortgage by £1,400. It could be said that offsetting the savings means they would be working harder for her.

While an offset mortgage sounds like a good idea, it is really only of value to those who will be able to maintain a significant and consistent level of savings in the arrangement. In the example given, if Monique were to reduce

her savings to £10,000, she would only achieve a reduction in the mortgage of around £560 – not so impressive but still worth considering.

More sophisticated and complex offset mortgages are now becoming available. These enable a borrower to offset interest payable on various savings accounts against the interest charged on their mortgage and other secured and unsecured loans held with the same lender.

The flexibility afforded by these mortgages often comes at a price: the interest rate charged may be slightly higher than the lender's SVR. It is, however, becoming increasingly common for lenders to offer flexible mortgages with a fixed, discounted, tracker or capped rate for an initial period. Early repayment charges may apply and some products may incorporate a product fee and/or the requirement to purchase an insurance product from the lender.

Although the number of people arranging flexible mortgages is increasing rapidly, lenders tend to regard these products as being more suitable for those who are perhaps at the higher end of the market in terms of financial awareness. At this stage in the development of flexible and offset mortgages, it is probably true to say that they are not appropriate for all borrowers.

23.8 What product incentives might be offered?

From time to time, lenders offer additional incentives to prospective borrowers, and these may be added to any of the products previously described. Examples of such incentives include the following:

- No valuation fee payable by the applicant (although sometimes a fee is charged when the application is made and then refunded in full on completion of the mortgage).
- All legal fees paid by the lender.
- Free insurance cover for a given period, normally 12 months – this usually applies to mortgage payment protection insurance, income protection insurance or critical illness insurance.
- A cashback facility – a tax-free lump sum paid to the borrower when the mortgage is completed. The cash could either be a fixed amount or a percentage of the amount borrowed. The cash is a gift and not added to the debt, but could be clawed back if the borrower redeems the mortgage within a set period. Some years ago it was possible to receive a significant sum from a cashback mortgage, but in the current market sums of £200 to £500 are likely to be the limit.
- Portability on fixed-rate, discounted-rate and capped-rate products.

CHECK YOUR UNDERSTANDING 2

The table below lists features of the main product types that borrowers need to consider. However, the description in the right column might not be opposite the correct product. Try to match the description to the product type to check you have assimilated the information in this topic – there are a lot of product features to remember!

Product	Considerations for borrowers
Standard variable rate	Can be a good option for a borrower with significant savings and no plans to withdraw them
Discounted rate	Simple structure but exposes borrower to risk of interest-rate rises, making budgeting difficult
Tracker	Allows borrower to make overpayments, or take a repayment holiday or make underpayments if they have previously made overpayments and thus are ahead of the anticipated repayment schedule
Fixed rate	Suits borrowers who want to make sure their payments will not exceed a certain level but also want to benefit from reductions in interest rates
Capped rate	Gives borrower certainty in terms of monthly repayment required but means they cannot benefit from reductions in interest rates until the end of the agreed period
Flexible	Interest rate moves up/down in line with Bank rate or 3-month Libor
Offset	Borrower pays less than SVR for a given period but interest rate can still fluctuate

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the advantages and disadvantages of an SVR mortgage?
- explain the difference between a discounted-rate mortgage and a tracker mortgage?
- explain why a lender might impose an early repayment charge on some mortgage products?
- explain how the drawdown facility works on a flexible mortgage?
- describe how an offset mortgage works?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 23. Review the text if necessary.

Answers can be found at the end of this book.

1) Discounted-mortgage interest rates are guaranteed not to change for a defined period. True or false?

2) Discounted-rate mortgages usually have an early repayment charge. True or false?

3) Which of the following is true in relation to a base-rate tracker mortgage?

   a) The rate is linked to the lender's standard variable rate.

   b) Any change to the interest rate is at the lender's discretion.

   c) The initial rate is likely to be higher than the lender's standard variable rate.

   d) There may be application and early repayment fees.

4) Which of the following is a feature of a typical capped-rate mortgage but **not** a typical fixed-rate mortgage?

   a) An application fee.

   b) Early repayment charge.

   c) Variable monthly costs.

   d) Overpayment facility.

5) One feature of flexible mortgages is that interest is calculated on a daily basis. True or false?

6) The Prudent Building Society is offering a flexible mortgage with a maximum loan-to-value lending limit of 80 per cent. Will and Grace are looking to borrow an initial £130,000 on a property valued at £220,000; this figure is well within their assessed affordability. One of the attractions of this mortgage is that Will and Grace can draw down further funds to finance a holiday home later on with minimal administration. How much can they draw down, assuming they passed the lender's affordability assessment when drawing down the funds?

7) Bob and Luka have an offset mortgage with an outstanding balance of £120,000 and a current interest rate of 4 per cent. They have no savings linked to the mortgage at the moment

but they do have £20,000 in an investment account with a local building society, earning 2 per cent gross. Their financial adviser has suggested that they move their savings into a linked offset account. Comment on this advice, giving facts and figures to support your position.

8) A fixed-rate mortgage will automatically switch to the latest fixed-rate deal at the end of the term. True or false?

9) A capped-rate mortgage will always have a collar. True or false?

10) Ellen is considering a mortgage that offers a cashback facility. Which of the following is true? The cashback received:

    a) will be subject to income tax.

    b) may be clawed back if the mortgage is redeemed early.

    c) will always be based on a percentage of the mortgage.

TOPIC 24

Other mortgage products

LEARNING OBJECTIVES

In Topic 23 we looked at the most common mortgage products. The products we are going to outline in this topic are less widely used but it is important for an adviser to be aware of them – they may be precisely the products that a customer needs.

By the end of this topic, you should have an understanding of:

- foreign currency mortgages;
- sub-prime mortgages and mortgages for credit impaired borrowers;
- guarantee (guarantor) mortgages;
- Islamic home finance;
- mortgages for people who are building their own property (self-build);
- buy-to-let mortgages including the use of SPVs.

THINK . . .

The mortgage products in this topic may well be unfamiliar to you, even if you are currently working for a mortgage provider or have experience of buying your own home. We introduced the use of guarantees in Topic 11 and looked at buy-to-let mortgages from various perspectives (eg in Topics 2 and 3). In Topic 1 we outlined the role of sub-prime mortgages in triggering the 2007–09 financial crisis.

To focus your thoughts on some of the other areas in this topic:

- what impact do you think the rules on affordability and suitability might have had on the sub-prime lending sector?
- if you were lending to an individual who was building their own home, what precautions might you want to take?

24.1 How does a foreign currency mortgage work?

In simple terms, a foreign currency mortgage is one where the borrower's income is in a different currency from that applying to the mortgage. So, if an individual has a UK property with a sterling mortgage, but is paid in euros or US dollars, that mortgage would be a foreign currency mortgage. A Spanish mortgage used to fund a UK resident's holiday home in Spain would also be a foreign currency mortgage, unless the owner had sufficient income in euros to pay the mortgage.

Our focus in this study text will be on the use of foreign currency mortgages to buy UK property, which is very much a niche market.

Foreign currency mortgages secured on UK property were never mainstream products; a combination of high minimum loans, low loan-to-value limits, set-up costs and the potential risks meant they were only of interest to high-net-worth individuals with very large mortgages.

They were introduced when UK interest rates were very high compared with other countries, and were of potential benefit to those with very large mortgages who wanted the potential to reduce the monthly payments in return for taking a significant element of risk. Borrowers arranged mortgages in currencies allied to countries with much lower interest rates than the UK – most commonly Japan (yen) and Switzerland (Swiss franc). Now that rates in the UK, Europe, the USA and Japan are more closely aligned, such products are less attractive because, for most people, the savings may not be enough to justify the risks.

The key points relating to a foreign currency mortgage are as follows:

- The mortgage is arranged in a foreign currency and secured on a UK property.
- The capital owed is denoted in that currency.
- Each repayment is made in that currency – which means converting from sterling.
- The interest rate is determined by the rates applicable to that currency in the country in which it is used (eg if the currency is the yen, Japanese interest rates apply).
- There is usually a very high minimum loan – at least £250,000 in most cases.
- Loans are usually available on a repayment or interest-only basis.

CALCULATING REPAYMENTS ON A FOREIGN CURRENCY MORTGAGE

To illustrate how a foreign currency mortgage works, we will look at an example denominated in Swiss francs (CHF). Note that it is a purely hypothetical example, because interest rates are currently low in most of the developed world.

Oscar borrows £250,000 in Swiss francs (CHF) on a repayment basis at an exchange rate of CHF1.45 to the pound.

The interest rate charged is 4 per cent; UK interest rates are 6.5 per cent.

This gives a debt of CHF362,500 (£250,000 x CHF1.45) and a monthly repayment of CHF1,932. This equates to £1,319 per month. A sterling mortgage for the same amount would cost £1,688 per month.

If the Swiss franc were to strengthen against the pound to CHF1.30, the debt owing would increase to £278,846 (CHF362,500 ÷ 1.30); the monthly sterling payment would rise to £1,486.

If the Swiss franc were to strengthen to CHF1.15, the monthly sterling payment would increase to £1,680 and the debt to £315,217.

Movement in the exchange rates has increased both the debt and the repayments, and the benefit of the lower interest rate has been eroded.

It is possible to insure against currency fluctuations, but this is expensive and will reduce savings. Some companies offer managed currency loans, where the debt is switched between currencies to gain advantage of better rates. These are still risky and cost a lot to run, again reducing the savings.

24.1.1 MCD requirements relating to foreign currency mortgages

The Mortgage Credit Directive includes requirements for foreign currency mortgages, which it defines as mortgages that are in a currency other than the borrower's income or a currency different from that in the country where the borrower lives. Examples:

- A borrower lives in the UK and has a UK mortgage but is paid by his German firm in euros.
- A British expatriate lives and works in Spain but has a mortgage on a UK property.

In such cases, the lender must include in the ESIS additional warnings about the potential impact of fluctuations in the exchange rate, particularly those that would have an adverse effect. Lenders are also required to put in place systems that provide consumer protection against such risks, such as allowing the borrower to convert the mortgage into another currency if the fluctuation exceeds a specified percentage, or capping the amount by which the consumer would be affected by the movement.

24.2 What is a sub-prime mortgage?

The mortgage market includes a number of specialist businesses that have created a niche in lending to, or arranging loans for, people who might not fit neatly into standard lending criteria, either because they do not have a track record of using credit or because they have suffered financial difficulty in the past. Those who have suffered credit problems in the past are referred to by the FCA as 'credit impaired' borrowers. The mortgages offered by sub-prime lenders reflect the increased risk taken, and interest rates are usually higher than those that apply to standard mortgages.

As lenders develop more expertise in underwriting sub-prime mortgages, the products have evolved to the extent that it is now possible to select from a range similar in structure to those in the general market. For example, it is possible to arrange sub-prime mortgages on a variable, tracker, fixed, capped or discount basis. The essential difference lies in the rate charged and the underwriting process. It may even be possible for borrowers with severe credit problems to arrange a sub-prime mortgage – at a price.

Many lenders and brokers now prefer to use the term 'near-prime' rather than sub-prime; MCOB requirements for more comprehensive assessment of affordability and a more responsible approach mean that they are more cautious in their approach to lending in this sector of the market.

The essential features that differentiate sub-prime mortgages from the mainstream are as follows:

- Borrowers with previous bad credit (credit impaired borrowers) can be accommodated. On occasion, those within weeks of having their home taken into possession have been able to arrange remortgages, although in the current market lenders are more cautious.
- Some lenders will include certain state benefits as part of assessable income.
- Interest rates are higher than those for prime borrowers. Many lenders set interest rates in broad bands depending on the credit history of the borrowers. For example, for those with one or two county court judgments (CCJs) against them, the rate might be 1–2 per cent higher than the prime rate; borrowers with more CCJs might be offered rates 2–3 per cent higher.

It is not unknown for fixed rates as high as 11 per cent to be offered to those with a very poor credit history.

- Maximum loan-to-value ratios may be lower than those for prime borrowers.
- Product fees tend to be higher than those for equivalent prime products. Early repayment charges can be considerably higher than on conventional mortgages and overhanging penalties are not unusual.

There may be rare occasions where a sub-prime mortgage could be suitable for a customer with a good credit record. MCOB rules allow this as long as the customer is not disadvantaged and the arrangement can be shown to be suitable and in their best interests.

24.3 What is a guarantor mortgage?

As property prices escalate, first-time buyers find it increasingly difficult to raise mortgages large enough to purchase a property. Typically they cannot raise a large enough deposit, or their income will not stretch to meet the repayments using the lender's standard affordability criteria. Many lenders have recognised this dilemma and have introduced 'guarantor mortgages'. A guarantor mortgage operates on the same principle as any other mortgage supported by a guarantee but the difference is that it is formally marketed as a specific product.

CHECK YOUR UNDERSTANDING 1

We looked at guarantors in Topic 11. Can you recall:

a) what a guarantor is?

b) the two bases on which a guarantee can be provided?

In most aspects the mortgage is the same as any other mortgage product: it may offer fixed or variable rates in line with standard products, and repayment or interest-only options. The key details are as follows:

- The product will allow higher lending than a standard mortgage.
- The applicants are responsible for the debt in the first instance, but if they fail to meet the interest or capital payments as required, the guarantor becomes responsible for some or all of the debt, depending on whether the guarantee is on a full or limited liability basis.
- The lender will need evidence that the guarantor can afford their own commitments as well as the payments on the guarantor mortgage. Some lenders will take a charge over the guarantor's property to secure the lending.
- Lenders are unlikely to consider guarantors over the age of 65.

- As with all loan guarantees, the lender will require the guarantor to seek independent legal advice to ensure they understand the implications of what they are taking on.

Guarantor mortgages tend to be short-term arrangements, and the lender would be looking for evidence that the borrower(s) would be able to maintain the mortgage independently in the relatively near future, perhaps within three to four years.

PROVIDING ADDITIONAL SECURITY VIA ASSIGNED SAVINGS

Rather than take a conventional guarantee, some lenders offer a different approach to prospective guarantors who perhaps do not want to take too much of a risk. A number of lenders, including Halifax, Barclays and the Family Building Society, have launched schemes designed to allow family members to provide security – outside of the legal definition of a guarantor – to help others secure a larger mortgage than they could otherwise. The general principles are as follows.

- Family members usually provide security by placing cash equal to a set percentage of the purchase price (typically 10 per cent) in a savings account with, and assigned to, the lender.
- The borrower can then arrange a repayment mortgage of between 95 and 100 per cent of the purchase price, depending on whether they are able to provide a deposit.
- The savings account is locked to the lender for a minimum period – typically three to five years – and earns interest.
- As long as the mortgage account has been conducted satisfactorily, the savings are released at the end of the agreed period, the guarantee is cancelled and the mortgage continues as normal.
- If there are problems with the mortgage account during the initial period, the lender has the security to make up any deficit or can extend the lock-in period.
- By the end of the lock-in period, the borrower will have repaid enough of the mortgage to bring the loan closer to (or within) the lender's normal limits, and the lending risk will have reduced to acceptable levels.

Another offering from some lenders is the joint borrower, sole proprietor scheme, as covered in section 11.2.

TECHNICAL TERM

Where a third party's savings are assigned to guarantee a loan, this is known as a surety.

24.4 What is Islamic home finance?

Muslims wishing to buy property are faced with a religious dilemma because Sharia principles and law forbids the payment or receipt of interest. This is because one party would gain at the expense of another without regard to the value of the goods traded – a concept that conflicts with the Islamic principle of equality. Islamic law does allow the sharing of risk and profit.

Islamic home finance (sometimes inaccurately called Sharia or Islamic mortgages) is based on Islamic finance principles and has been developed to allow Muslims to raise the finance to buy property without compromising religious principles.

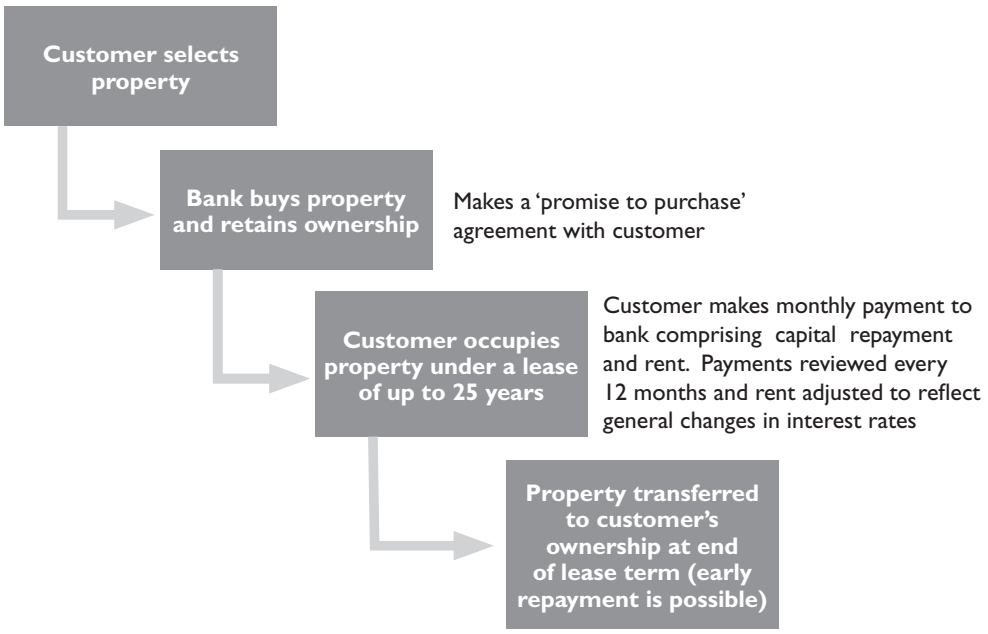
There are two types of arrangement available:

- *Ijara* – which follows the acceptable principle of leasing;
- *Murabaha* – which follows the acceptable principle of co-ownership.

24.4.1 *Ijara* method

The *Ijara* (lease to own) method is a type of home purchase plan whereby the bank buys the client's selected property. The method is summarised in Figure 24.1.

FIGURE 24.1 *IJARA* METHOD OF HOME PURCHASE

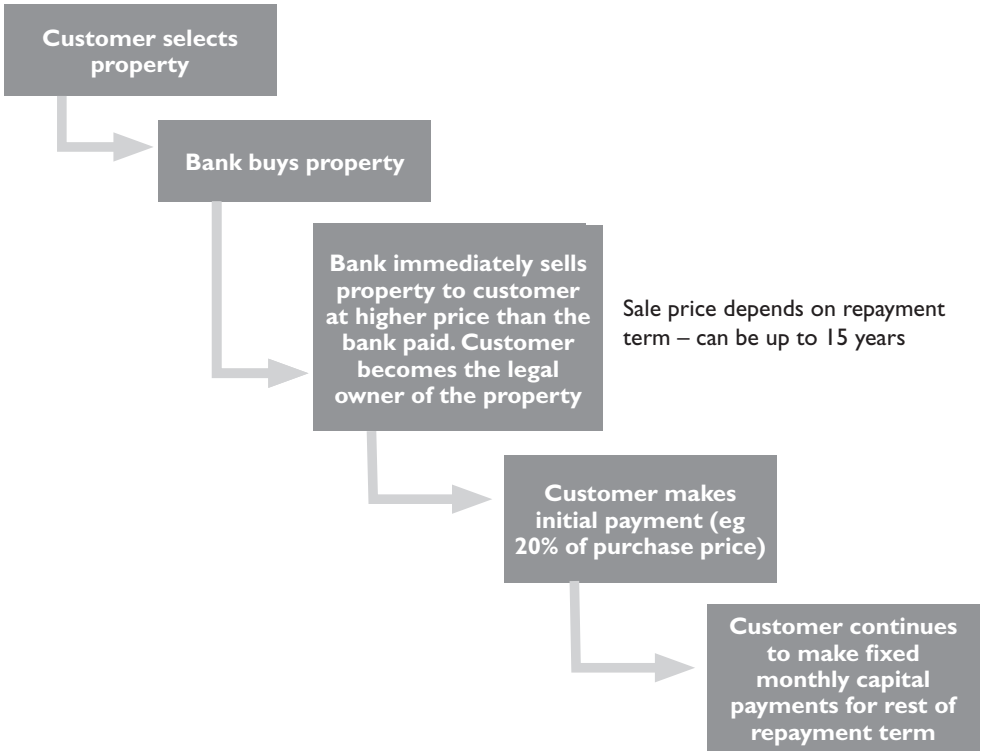


Under Sharia principles, the rent is seen as a fair price for using the property and so there is no conflict of principle. The bank makes its profit from the rent paid over the term. In comparison with a conventional mortgage, the *Ijara* method is more expensive – the monthly payments tend to be higher.

24.4.2 *Murabaha* method

The *Murabaha* method is outlined in Figure 24.2. The *Murabaha* arrangement is less popular than the *Ijara* approach as it is more expensive overall and less flexible in terms of early repayment. Note that properties purchased under 'Right-to-Buy' schemes cannot qualify.

FIGURE 24.2 *MURABAHA* METHOD OF HOME PURCHASE



SDLT AND ISLAMIC HOME FINANCE

With both the *Ijara* and *Murabaha* methods, stamp duty land tax is paid once, when the property is initially purchased by the lender.

24.5 How does a mortgage for a self-build project differ from a standard mortgage?

A limited number of lenders provide finance for people wishing to build or supervise the building of a property, generically termed self-build mortgages. The self-build mortgage allows the borrower to purchase the land and finance the construction as well, with funds released at key completion stages of the build process, ie stage payments in arrears. Lenders generally release the initial funding on purchase of the land (see Figure 24.3). They usually require an inspection to confirm that each stage has been completed satisfactorily.

FIGURE 24.3 TYPICAL COMPLETION STAGES TRIGGERING RELEASE OF FUNDS

A typical arrangement would offer self-build finance for up to 70–75 per cent of the initial land costs. Further advances would then be available at the completion of each stage, up to between 65 and 90 per cent of the total build costs. Arrears stage payments require the self-builder to have the resources to pay for the work first before receiving the mortgage funds later.

Some lenders consider advancing funds at the start of each significant phase, known as advance stage payments. This is better for those on a tight budget, but the risk to the lender is higher than for stage payments in arrears, so higher interest rates tend to be standard.

24.6 What is a buy-to-let mortgage?

A buy-to-let mortgage is designed to enable an individual to finance a property for letting rather than for owner occupation. Consequently, most buy-to-let (BTL) mortgages are not regulated by the FCA and are outside the scope of MCOB. The exception is when it meets the criteria for a regulated consumer buy-to-let (CBTL) mortgage, a new category of BTL mortgage, which was described in Topic 2.

24.6.1 Consumer buy-to-let mortgages

Consumer buy to let (CBTL) mortgages are expected to represent a very small part of the overall BTL market. Lenders are required to treat CBTL borrowers in the same way as those arranging a mortgage to buy a home for themselves. This means that the lender must carry out affordability checks and follow all the Mortgage Credit Directive Order application and documentation requirements. In theory, lenders have the discretion to include potential rent as part of the affordability assessment.

KNOWLEDGE REFRESHER

A CBTL mortgage contract is one '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' (Mortgage Credit Directive Order, 2015). Borrowers in this category are sometimes described as 'accidental landlords' – in other words, they are people who need to let out a property because of personal circumstances, rather than because they have made a conscious choice to buy a property for rental. Such circumstances might include those who inherit a property, or people who need to move quickly because they have a new job and do not have time to sell their family home before moving.

It is possible, in certain situations, for CBTL borrowers to waive their regulatory protection and opt for a loan on business BTL terms. The business BTL contract states that the property cannot, at any time, be occupied by the borrower or a family member, and the borrower declares that the BTL is for business purposes and they understand that they are waiving their right to protection under mortgage legislation.

Only new mortgages taken out in these circumstances would be CBTL mortgages. If the owner already has a residential mortgage on the property, the mortgage will keep its original status, unless the owner remortgages.

24.6.2 Business buy-to-let mortgages

The bulk of BTL mortgage lending is for those looking to use property as an investment. It is possible to arrange business BTL mortgages from a similar range of interest options as conventional mortgages, and they can be on an interest-only or repayment basis. These products usually incorporate an application and/or product fee and an early repayment charge.

The range of products and the approach to BTL lending varies between lenders; this text will consider the typical products and approach rather than provide details of specific products.

IN BRIEF

BUSINESS BTL

- Lenders usually limit BTL lending to 75–80 per cent of the property valuation, and set a minimum property value.
- They usually insist that a BTL borrower already owns their main residence, or sometimes at least one other property.
- Most lenders require a minimum gross income, typically £20,000–25,000 for single applicants. Where there are joint applicants, one of them typically must have an income of at least £20,000–£25,000. Some lenders will consider joint applicants where neither meets the minimum income requirement but the joint income is above a higher minimum – typically £30,000 or more.
- Most lenders set a minimum and maximum age range – typically between 18 and 25 years old as a minimum, with the mortgage typically ending by age 75. The borrower must usually be employed, self-employed or retired with a pension.
- There are now many buy-to-let mortgages available on a fixed-rate or discounted-rate basis. These products usually incorporate an application fee or a product fee and an early repayment charge.

Although the PRA requires a rental cover ratio of at least 125 per cent, that, and changes to the tax relief available on buy-to-let mortgages, has led to many lenders setting a minimum ratio of 145 per cent as a cautionary measure. So, if the net rent is £800 a month, the maximum mortgage payment will be £552 (800 ÷ 145%) and the maximum mortgage will be whatever that level of repayment would provide.

RENTAL COVER RATIO

The proportion of the mortgage payment covered by the anticipated rental income.

Prudential Regulation Authority (PRA) regulatory intervention

If a buy-to-let mortgage is not regulated under the FCA's MCOB regime or the Mortgage Credit Directive Order 2015, the lender and its lending activities are regulated by the PRA.

The Prudential Regulation Authority issued a supervisory statement (SS13/16) in September 2016, entitled *Underwriting standards for buy-to-let mortgage*

contracts. The PRA took action in response to concerns about potential issues with the affordability of buy-to-let mortgages that were not regulated under the FCA's consumer buy-to-let regime. The statement details minimum expectations for the standards to be applied by firms underwriting non-FCA regulated buy-to-let mortgages, which are those taken out for business or investment purposes.

The PRA defines a buy-to-let mortgage as one which is secured by a mortgage on land in the UK in pounds sterling, and:

- at least 40 per cent of the land is used, or is intended to be used, as or in connection with a dwelling; and
- the land subject to the 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 – for the purpose of the statement, an agreement to rent a property for less than one month is not a 'rental agreement'.

The following are excluded from the requirements:

- Corporate lending.
- An application from an existing borrower for consent-to-let, although existing consent-to-let exposures should be taken into account when assessing affordability for a new buy-to-let mortgage contract.
- A buy-to-let mortgage contract with a term of 12 months or less.

The new requirements do not apply where an existing buy-to-let customer remortgages and does not borrow more than the outstanding balance of the existing mortgage, plus associated remortgaging costs.

The PRA buy-to-let regime requires lenders to assess the affordability of a buy-to-let mortgage contract using an approach that includes whether the income from the property is sufficient to cover the monthly mortgage cost and, if the borrower's personal income is used to support the mortgage, whether that income is sufficient for this purpose. There are three main elements to the requirements – the interest coverage ratio, the income affordability test and the interest rate affordability stress test.

Interest coverage ratio (ICR)

The ICR is the ratio of rental income to mortgage payments and associated costs and tax, and can be set by each lender. The ICR factors in assumptions for tax and other costs, and so is applied to the actual rent received. The PRA requires the lender to set an ICR based on rental demand and typical rent levels in the area, with expected rental income verified by an independent, qualified surveyor, the use of automated valuation models or an existing rental agreement. The assessment must allow for property running costs for which the owner is responsible, together with tax liabilities. The statement quotes the existing industry minimum standard as 125 per cent, and makes it clear

that it does not see ICRs reducing; if anything, they are expected to increase. Due to changes to tax relief on mortgage interest, many lenders require a higher ICR for higher-rate taxpayers because higher-rate tax will reduce their net rental profit.

Income affordability test

If the borrower intends to use personal income to supplement rental income to support the mortgage, the lender must carry out a detailed affordability assessment.

Income could be income from all rental properties, employment, pensions, savings and investment after deductions for tax and National Insurance, and taking into account any likely changes to the income in the future, such as retirement. The lender can take into account the overall wealth of a high-net-worth customer, as defined in MCOBS, as part of the affordability assessment.

Expenditure is calculated using the same methodology as a FCA regulated mortgage.

Interest rate affordability stress test

As with an FCA regulated mortgage, the lender is required to consider the effect of interest rate increases on the borrower's ability to service the mortgage. The basic requirements for the lender are as follows:

- The lender must consider potential interest rate increases over a minimum period of five years from the start of the mortgage, unless the mortgage is on a fixed or capped rate for at least five years or the mortgage term is 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.
- When deciding on the interest rate to use for the stress test, the lender must take into account market expectations and the latest Financial Policy Committee (FPC) recommendations regarding the assumptions to use. It must be able to justify the decision based on those factors.
- The minimum increase to use is 2 per cent, and the minimum future rate to use is 5.5 per cent, even if the indicators suggest the rates will not reach that level. So, if current rates are 3 per cent, the minimum rate to use would be 5.5 per cent, because adding 2 per cent to the current rate would not equate to the minimum 5.5 per cent future rate. However, if current rates are 4 per cent, the minimum future rate to use would be 6 per cent.
- The lender can allow for inflation-linked rent increases where they will mitigate some of the effect of interest rate rises, but only in line with increases in the CPI, maximum 2 per cent a year.

Where an individual has four or more buy-to-let properties, the lender is also required to consider the borrower's general experience as a landlord, their

existing portfolio, overall wealth and other financial factors specific to their business.

Why does a BTL mortgage represent a greater risk to a lender?

A BTL mortgage presents a greater risk to the lender because:

- there is no guarantee that the property will be permanently tenanted – lengthy periods during which no rental income is received may affect the borrower's ability to maintain monthly repayments;
- the borrower may treat the financial commitment less seriously than if the property were their own home;
- the value and saleability of the property may be adversely affected if it is badly treated by tenants and not adequately maintained by the borrower.

Initially, lenders countered this increased risk by charging a higher rate of interest than for conventional mortgages; as the demand for these schemes has grown, interest rates have fallen.

Before deciding to proceed with a BTL application, the prospective borrower should assess the proposition carefully by checking information on the local rental market and appointing a reputable letting agent to manage the tenancy.

The lender will want to ensure that a suitable form of tenancy agreement is used so that it is not prevented from obtaining a possession order in the event of default. It is usual for an assured shorthold tenancy agreement to be drawn up because this also gives the landlord the right to take possession of the property when the lease expires.

The rapid growth in the BTL market has caused concern for some time. In some areas of the country, it is felt that BTL purchasers have been pushing first-time buyers out of the market. They are often competing for the same relatively lower-priced properties, which has driven up prices and reduced the stock available for those wishing to put a foot on the property ladder. The Chancellor's decision to cut tax relief on BTL mortgage interest from April 2017, together with the SDLT surcharge (see section 15.9.1), was an attempt to redress the balance. However, many experts feel that the changes will result in rent increases and some landlords deciding the investment is not viable. Their withdrawal from the market could reduce the supply of rental property available for those who either wish to rent rather than buy or cannot afford to buy.

24.6.3 Taxation of individually held buy-to-let property

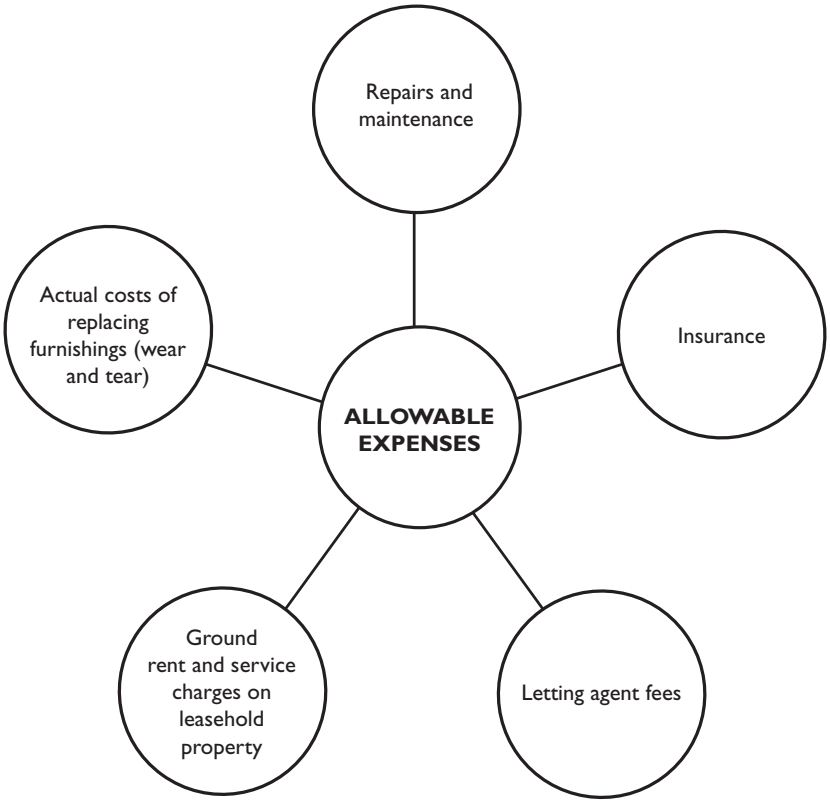
Taxation of rental income

Rental income, after the deduction of certain expenses, is taxed as non-earned income at the rate applicable to the owner's tax band.

The income is taxable in the tax year it is received, regardless of whether the owner takes the income or leaves it in the business account.

Expenses that can be deducted from rental income are summarised in Figure 24.4.

FIGURE 24.4 EXPENSES DEDUCTIBLE FROM RENTAL INCOME



CHANGES TO TAX RELIEF ON BTL MORTGAGE INTEREST

Since 6 April 2020, tax relief is not available on mortgage interest. Instead, a tax credit is given equal to 20 per cent of the mortgage interest paid.

A higher-rate taxpayer paying £5,000 mortgage interest a year would receive a tax credit of £1,000 against the mortgage interest. This compares with £2,000 tax relief at 40 per cent before April 2017.

The rules also apply to property partnerships and members of limited liability partnerships, based on a fair and reasonable apportionment of profits/liabilities between members.

Capital gains tax

Personally owned BTL property is subject to capital gains tax (CGT) on sale, levied at different rates for basic-rate taxpayers and for higher-rate taxpayers on gains above the annual exemption. SDLT can be claimed as a purchase expense against capital gains tax. CGT is payable within 30 days of the transaction.

24.6.4 Using a special purpose vehicle (SPV)

CHECK YOUR UNDERSTANDING 2

We introduced SPVs as a way of owning property in Topic 2. Can you recall:

a) what kind of legal entity an SPV is?

b) who owns the property held in an SPV?

TABLE 24.1 OWNING BTL PROPERTY VIA AN SPV

Advantages	Disadvantages
▪ Changing ownership is relatively simple, as SPV shares can be sold to a new owner without the property being transferred. Advice should be taken regarding potential CGT and IHT issues ▪ If the property itself were transferred to a new owner, SDLT would be payable. If the property remains in SPV ownership, and ownership of the company changes hands, only stamp duty of 0.5 per cent of the value of the shares transferred is payable, if the SPV is UK-based ▪ Companies are able to claim expenses not available to individual landlords ▪ The SPV can be used to hold a number of properties as and when they are purchased ▪ Directors are not liable for the debts of the SPV unless they have given personal guarantees	▪ Number of lenders who will consider lending to a BTL SPV is limited – restricts range of mortgages available ▪ Lack of competition and level of work involved means SPV mortgages tend to be more expensive to arrange than loans to individuals ▪ Accounting and administrative requirements for limited companies are more onerous than those for an individual ▪ Most lenders require personal guarantees from directors to support the mortgage

Experts accurately predicted that changes to the taxation of BTL property (outlined in section 24.6.3) were likely to lead to an increase in the number of property-letting SPVs.

An SPV can claim the same running expenses as an individual landlord, but in addition, an SPV can claim mortgage interest in full as a business expense (although many experts anticipate that this may change in the future).

- **Corporation tax** – as companies, SPVs pay corporation tax on rental income received (after expenses) at a specified rate.

  Expenses include the costs of running the property and the company, and salaries paid to directors and employees. Unlike salary payments, dividends do not qualify as a business expense, so cannot be deducted from profits.

The income is only subject to corporation tax once, when it is received; leaving it in the account will not result in further tax in future years, other than on any interest received on it.

- **Income tax on salary and dividends** – it is up to the board of directors to decide whether to distribute some or all of the income to shareholders as salary and/or dividends. The company is not obliged to pay a salary or a dividend to directors; it can retain the income (less corporation tax) in its bank account. This means that the directors can decide if and when to pay dividends, allowing them to control the amount of income tax they pay. Salary and dividends are added to the individual's taxable income for the tax year.
- **Capital gains** – capital gains made by an SPV are treated as trading receipts and subject to corporation tax. SPVs are not able to claim the annual CGT exemption available to individuals. SDLT paid on purchase can be claimed as an acquisition cost to be set against the gain. The individual shareholder would have a potential CGT liability if they decided to sell their shares in the SPV, although the annual CGT exemption would be available.
- **Stamp duty land tax** – if a company buys a property to let out as part of a rental business, the SDLT surcharge of 3 per cent applies.

24.6.5 Transferring property from individual ownership to an SPV

While SPVs may seem to offer tax benefits for owners, they should be approached with caution. The position is relatively straightforward if an SPV is set up to purchase a property. SDLT is paid on purchase, and from then on company taxation rules apply. If a property held in the SPV is sold, it is usually achieved by selling shares in the SPV rather than selling the property itself – the company is the legal owner of the property. This means that no SDLT is payable by the new shareholder.

If an individual is looking to transfer an existing buy-to-let property into an SPV, the transfer is treated as a disposal for CGT purposes: the individual will have a CGT liability on the notional gain made between original purchase and transfer.

The SPV will have to pay SDLT on the property value because ownership of the property will change.

24.7 What is a second charge?

We look at second charges in detail in Topic 26 but mention them briefly here as they are a different type of mortgage loan.

CHECK YOUR UNDERSTANDING 3

From your studies in Topics 2 and 3, can you recall what a second charge is and the rules under which it is regulated?

Second charges are ranked after first charges for repayment, which means that the lender is taking a higher level of risk than with a conventional mortgage, and will charge a higher rate of interest to reflect that risk.

24.8 What is bridging finance?

Bridging finance is secured lending designed to enable a home owner to bridge the funding gap when they have to complete on the purchase of a property before they have received the funds from the sale of their existing property.

CASE STUDY

Alan has agreed a completion date of 30 October for the purchase of a family home, but delays mean that the sale of his existing family home will not be completed until 21 November, leaving him temporarily £80,000 short of the finance needed to complete his purchase. A conventional mortgage lender would not allow him to have mortgages on both properties at once, unless he was able to prove he could afford repayments on both, which would be unlikely. Bridging finance for £80,000 for three weeks, secured on his existing property, would solve his problem. The loan would usually be on an interest-only basis, and Alan might be able to defer paying the interest until the loan is repaid.

We will look at bridging finance in more detail in Topic 26.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain how a foreign currency mortgage works?
- explain how a sub-prime mortgage product differs from a standard mortgage?
- describe two methods by which an individual can support someone else (eg a relative) to take out a larger mortgage than would be permitted under normal affordability criteria?
- describe the two methods of arranging Islamic home finance?

- summarise the advantages and disadvantages of using an SPV for buy-to-let property?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 24. Review the text if necessary.

Answers can be found at the end of this book.

1) Foreign currency mortgages can be secured on UK properties. True or false?

2) Which of the following is true of a typical sub-prime mortgage compared with a standard mortgage?

   a) Interest rates are usually slightly lower.

   b) Arrangement fees tend to be higher.

   c) Maximum loan to value tends to be higher.

   d) The range of interest-rate options is very limited.

3) Which of the following is true in relation to a guarantor mortgage?

   a) The guarantor must agree to guarantee the whole mortgage.

   b) The guarantor must be able to afford their own commitments as well as the guarantor mortgage.

   c) Most lenders will consider guarantors up to the age of 75, as long as they prove sufficient income in retirement.

   d) The guarantee usually lasts for the term of the mortgage unless the lender is satisfied it is no longer needed.

4) Islamic home purchase plans reflect the principle that Muslims must not enter into transactions where interest is paid. True or false?

5) Which of the following is true of both *Ijara* and *Murabaha* methods of Islamic home finance?

   a) The bank buys the property initially.

   b) The term can be up to 25 years.

   c) They require the payment of rent.

   d) Monthly payments are fixed for the term.

6) Self-build mortgages usually provide funds for up to 90 per cent of the cost of the land. True or false?

7) Which, if any, of the following is **not** an allowable expense for a BTL landlord?

   a) Buildings and contents insurance.

   b) Repairs to a broken window.

   c) Replastering the kitchen ceiling following a water leak.

   d) An allowance for damage caused by wear and tear to furnishings.

8) Joe is planning to invest in a buy-to-let property when he gains access to his pension fund in August this year and is unsure whether to use an SPV or buy a property in his own name. Which of the following would be an important consideration for him?

   a) The SPV will pay higher stamp duty land tax.

   b) The SPV will be able to claim mortgage interest as a business expense in full.

   c) Holding the property in his own name will enable him to avoid paying income tax on rental income he does not withdraw from the business.

   d) Joe would lose control of the property if he bought it through a SPV.

9) If Joe were to go ahead and set up the SPV and later sell his shares in it, the buyer of the shares would be liable for stamp duty. True or false?

10) Capital gains made on sale of a property by an SPV are subject to:

   a) corporation tax.

   b) capital gains tax.

   c) income tax.

   d) stamp duty land tax.

TOPIC 25

Schemes for specific groups of borrower

LEARNING OBJECTIVES

The mortgages we have considered so far have been available to most property buyers and serve a wide range of buyers. This topic looks at schemes designed to help specific types of purchaser to secure a home, or to gain access to the equity built up in an existing property. Some of the schemes discussed are not mortgages as such, but allow individuals who meet particular criteria to buy a property on special terms with a mortgage product from a lender involved in that market.

By the end of this topic, you should have an understanding of the following home finance products and schemes:

- shared ownership;
- equity share;
- government initiatives to help people to buy a home;
- right to buy;
- lifetime mortgages;
- home reversion schemes.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about the schemes and products we are going to cover. We have looked at some of them in a different context.

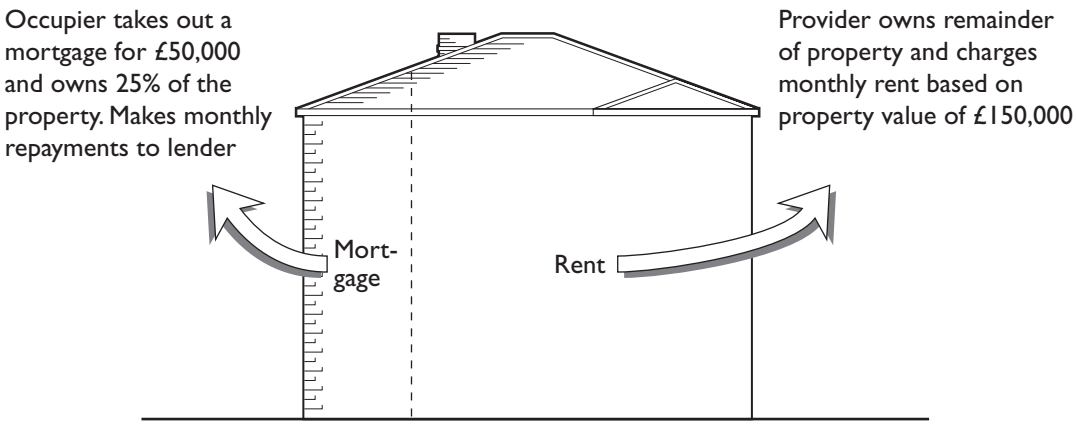
For instance, we touched briefly on equity-release products in Topic 3. In Topic 8, we covered the particular requirements relating to advice for customers applying for a mortgage under statutory right to buy or for an equity share arrangement.

You might also have personal experience of buying a property using one of the schemes explored in this topic.

25.1 What is shared ownership?

Shared ownership is not a mortgage scheme as such, although many lenders offer mortgages to shared-ownership buyers. Shared-ownership schemes offer a way for first-time buyers to get on the housing ladder, and were first developed in the late 1970s, as a result of co-operation between housing associations, local authorities and mortgage lenders.

FIGURE 25.1 SHARED OWNERSHIP ON £200,000 PROPERTY



IN BRIEF

HOW DOES SHARED OWNERSHIP WORK?

- The provider (eg a housing association) assesses the applicant to ensure that they fulfil all the relevant criteria to be allocated a property under the shared-ownership scheme. In some instances, a local authority may put forward applicants who have been on the housing waiting list for more than a specified period.
- The buyer purchases a share in a property (typically 25–50 per cent), with the provider retaining ownership of the rest of the property. The maximum initial share is 75 per cent. The property will be leasehold and is valued at its open market value.
- The buyer arranges a conventional mortgage via the scheme provider's partner lender to buy their share. The lender assesses the application for that share in the usual way.
- The buyer pays rent to the provider; the amount is based on the value of the part retained by the provider (the maximum is 3 per cent).

- Their total outgoings are lower than if they had to take out a mortgage to buy the whole property.
- When the buyer has a lump sum available, or they can afford a larger mortgage, they can buy further shares in the property through a process called staircasing. Some schemes will eventually allow the property to be purchased outright through staircasing, while others may impose a limit of 75 per cent on the share that can be owned.
- The borrower is responsible for maintenance of the property, in the same way as an outright owner of the property.

STAIRCASING

Buying further shares (usually a minimum of 10 per cent each time) in a shared-ownership property based on its market value at the time of the additional purchase.

WHAT HAPPENS WHEN A SHARED-OWNERSHIP PROPERTY IS SOLD?

When the property is eventually sold, the equity is split between the vendor and the housing association or local authority, according to the share of the property that is owned and the proportion that is rented. If the property is not owned outright by the vendor, then they may be required to offer it back to the housing association or local authority, which will then find a suitable purchaser from its own list. In many instances, however, the vendor may be allowed to sell the property on the open market.

The lease

A shared ownership lease is different from a standard long lease. The lease holder of a shared ownership flat will only qualify for the statutory right to extend the lease once they own 100 per cent of the flat, although some landlords may allow an extension voluntarily.

Most shared ownership leases are in a format approved by the Homes and Communities Agency (HCA), which will contain a number of core clauses common to all such leases, in addition to elements of a standard lease. These core clauses are:

- Restrictions on sales, which could include maximum staircasing allowed, pre-emption period (see below), period between staircasing to 100 per cent and selling.
- Subletting is not permitted.
- Landlord's pre-emption rights if the leaseholder has not staircased to 100 per cent. The owner must first offer the flat to the landlord, or a buyer nominated by the landlord, at a price set by an independent valuer appointed by the landlord. If the right is not exercised within eight weeks, the leaseholder can sell in the open market.
- The right of the landlord to take court action to gain possession in the event of rent arrears. The leaseholder would have no right to receive compensation to reflect any increase in the value of their share.
- The requirement to pay a service charge based on the full value of the property.

25.1.1 SDLT on shared-ownership property

SDLT on shared-ownership property is quite complex. The explanation that follows covers the basic principles but is not the entire picture, which is beyond the scope of this qualification.

IMPORTANT NOTE

The first-time buyer exemption is available on shared ownership property if the buyer is purchasing on a shared ownership basis and meets the eligibility criteria.

If the property is purchased from an approved qualifying body, the purchaser has two options for the payment of SDLT. Approved qualifying bodies are:

- a local housing authority;
- a housing association;
- a housing action trust;
- the Northern Ireland Housing Executive;
- the Commission for the New Towns;
- a development corporation.

Option 1 – pay SDLT on the market value of 100 per cent of the property at the time of purchase. For example, assuming temporary reduced rates due to Covid-19 do not apply:

- First-time buyer – property market value £300,000 or lower: no SDLT as the full FTB exemption (under £300,000) applies, regardless of the cost of the share purchased.
- First-time buyer – property market value £300,000 to £500,000: no SDLT on the first £300,000, 5 per cent SDLT on the balance.
- Second-time buyer – standard SDLT rates on property purchased for more than the nil-rate threshold. Let's assume it is £125,000 for this explanation.

Option 2 – pay SDLT initially only on the value of the share purchased. For example, on a property with a market value of £350,000 and a purchased share of £250,000:

- First-time buyer – opts to pay SDLT on the £250,000 share purchased – £250,000 is within the SDLT exemption of £300,000, so no SDLT is payable. However, the FTB exemption only applies to the purchase of the initial share.
- Second-time buyer – no SDLT on the first £125,000 and then 2 per cent on the next £125,000 (£2,500), saving 5 per cent SDLT (£5,000) on the full market value.

However, while paying SDLT on the share purchased might seem attractive, there is a catch. In simple terms, once the owner buys a further share (staircasing) that takes their total share above 80 per cent, SDLT is payable on all additional shares bought since the first share was purchased, based on the total price paid up to that trigger point.

The process

- The purchase of the initial portion must be reported to HMRC, regardless of the price.
- Staircasing up to 80 per cent of the property's market value does not incur SDLT at the time.
- Staircasing that takes the proportion owned above 80 per cent must be reported to HMRC and SDLT becomes chargeable.

Once the occupier owns more than 80 per cent of a shared ownership property, SDLT is calculated in the following way:

- The amount of SDLT is first calculated based on the total paid for the property to date.
- The payment that takes ownership above 80 per cent is calculated as a proportion of the total price paid.

- SDLT is payable in the same proportion. So if the payment that takes ownership over 80 per cent is 20 per cent of the total paid to date, 20 per cent of the SDLT based on the total price is payable.

Although opting to pay SDLT on a stage payment basis can provide initial cost savings, it may be a gamble. If it takes the buyer some years to exceed the 80 per cent threshold and property prices have increased significantly, the total SDLT cost may be more than paying SDLT on the full market value. Conversely, if the buyer exceeds the 80 per cent relatively quickly, or if prices do not rise significantly, a significant SDLT saving could be made overall. If the buyer has little intention of exceeding the threshold, the stage method is the better option.

25.2 Equity share

An equity-share scheme enables the borrower to buy a property they might otherwise not be able to afford. The borrower will be the legal owner of the whole property and will pay a deposit and arrange a conventional first-charge mortgage on an agreed proportion of the property. The scheme provider will take an equity stake in the balance of the property price through a second charge. Ownership can be on a freehold or leasehold basis, depending on the type of property and the nature of the arrangement.

A number of different schemes have been introduced during past decades but a typical scheme might involve the borrower financing 80 per cent of the purchase price through a deposit and a repayment mortgage, and the provider taking a second charge over the other 20 per cent. The second charge is repayable on the earlier of the property being sold or the end of an agreed term, which would usually coincide with the first-charge term. The provider's stake is usually based on a straightforward equity arrangement, which means that no interest is charged on their 'share', but if the property was sold at some point, the provider would receive that percentage of the sale proceeds.

Less commonly, some providers charge a low rate of interest or charge a fee on their share while still taking their part of the proceeds on sale.

Some providers only offer equity share schemes on a leasehold basis.

Equity share appeals mainly to first-time buyers who may be borrowing at the maximum and who wish to keep their monthly payments to a minimum, or who may not be able to arrange a mortgage large enough to purchase in the conventional way.

There are drawbacks: if the original loan-to-value ratio was high and property price inflation has remained low for some time since the purchase was completed, it may make it difficult for the borrower to trade up in the property market because the already limited equity will be further reduced when the lender takes its share. If the property was later sold for less than the original

purchase price, the provider would receive their share of the lower price, which means they would also share in any downside.

25.3 What government schemes are available to help people to purchase property?

In England, there have been a number of government initiatives to help those who could not otherwise afford to buy a property to do so. These are offered under the banner of 'Help to Buy' through Help to Buy agents appointed by the government.

!

CHANGES TO SCHEMES

New initiatives are announced relatively frequently, and existing schemes are changed or withdrawn. This text will provide an overview of the main types of arrangement currently available. You can find details of current schemes at: https://www.gov.uk/affordable-home-ownership-schemes [Accessed: 28 October 2020].

25.3.1 Help to Buy shared ownership (England)

The Help to Buy shared-ownership scheme operates as described in section 25.1 above. Applications cannot be accepted from those with combined income above £80,000 (£90,000 in London), and priority may be given to armed forces personnel where available housing is limited. Where a local authority provides shared ownership property, it may establish other priority groups based on local needs. There are no other restrictions on who may apply for help and applicants may be first-time buyers, those who previously owned a property but cannot afford to buy one now or those who wish to move from an existing shared ownership property.

Subject to availability of housing, applicants can buy between 25 and 75 per cent of the property on a leasehold basis, using a conventional repayment mortgage to buy their share. The remaining share is held by the provider, with the buyer paying rent of up to 3 per cent of the value of that portion of the property.

Shared ownership (Wales)

A similar scheme was launched in Wales in February 2018. The basic principles are the same as the English scheme, but there are some differences:

- The maximum combined household income is £60,000 a year.

- The applicant must be a first-time buyer, a newly-forming household (eg someone starting again after a relationship break-up) or relocating for work to an area where property prices would otherwise prevent the purchase of a home suitable for the size of the family.

Rent to Own (Wales)

Also launched in February 2018, the Rent to Own scheme in Wales is a five-year rental agreement that allows buyers to rent new-build homes from housing associations, and then purchase them between the end of the second year and the end of the rental period. On purchasing the property, the tenant will receive a sum towards their deposit equal to 25 per cent of the rent paid and 50 per cent of any increase in the property value at the time of purchase.

The scheme is open to applicants who do not own another home, are in work with a maximum combined income of £60,000 a year, and who are unable to afford a suitable home on the open market or through other home ownership initiatives.

25.3.2 Help to Buy Equity Loans (England)

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UPDATED SCHEME

The equity loan scheme runs under new rules from April 2021 to March 2023. Those wishing to buy under the pre-2021 scheme must have completed their purchase by 31 March 2025.

Under the Help to Buy Equity Loan scheme in England, applicants with a minimum 5 per cent deposit can buy a new-build property up to a specified purchase price over a 25-year term. The scheme is open to first-time buyers and existing homeowners wishing to move up the property ladder. The government will provide a further equity loan to help with the purchase, with the scheme remaining in place for new applicants until March 2023, at which point the Help to Buy equity loan scheme initiative will end. There are two schemes – one for London and one for the rest of England.

Rest of England

- The borrower must not own any other property, and properties bought under the scheme cannot be let out. Before they exchange contracts on the new property, those who currently own property and wish to use the scheme to move up the property ladder must provide evidence from their solicitor or conveyancer that they are selling their current property.
- The government loan can be for between a minimum of 10 per cent and a maximum of 20 per cent of the full purchase price. It will be secured by a

second charge on the property. The maximum government loan would be £120,000.

- The buyer must provide a minimum of 80 per cent of the purchase price, with a deposit of at least 5 per cent and a conventional repayment mortgage for between 25 and 75 per cent of the purchase price. Interest-only mortgages cannot be used with the scheme.
- In most cases the buyer will put down a 5 per cent deposit, borrow 20 per cent through an equity loan and arrange a mortgage for 75 per cent.
- A monthly fee of £1 is charged from the start of the arrangement until it ends.
- No interest is charged on the equity loan for the first five years, after which a charge of 1.75 per cent of the equity loan is made from the start of year six, and the charge will increase in line with the RPI plus 1 per cent in each subsequent year.
- The buyer can later repay some of the equity loan at any time, subject to a minimum repayment of 10 per cent of the property's market value at the time. The equity loan must be repaid at the end of the 25-year term.
- If no repayments are made and the property is sold before the end of the 25-year term, the equity loan is repayable as a percentage of the property's market value. For example, if the property was purchased for £200,000 with a 20 per cent equity loan of £40,000 and was sold for £250,000, the owner would have to repay 20 per cent of the sale price (£50,000), assuming it was the same as the market value.

London Help to Buy scheme

The London Help to Buy scheme is similar to the scheme for the rest of London, with one difference.

- The available government loan is increased to 40 per cent of the full purchase price, giving a maximum government loan of £240,000. The purchaser must arrange a conventional mortgage up to 55 per cent of the full purchase price which, together with the minimum 5 per cent cash deposit, means the purchaser must be able to fund at least 60 per cent of the purchase.

Since the start of 2016, a number of lenders have reintroduced 95 per cent mortgages aimed at first-time buyers. These products are not tied into the Help to Buy scheme and may offer better value for the prospective buyer.

IN BRIEF

CHANGES FROM APRIL 2021

Since April 2021, Help to Buy equity loans in England are only available to first-time buyers, and the maximum price of properties eligible for the scheme changes. From that date, the maximum price is based on 1.5 times the average first-time buyer price for the region in which a property is sited, plus 50 per cent. The maximum price depends on the part of the country. The ground rent on a leasehold property bought through the Help to Buy scheme is nil.

Wales

A similar scheme is operated by the Welsh government. The only differences from the English scheme are that the maximum property value is £300,000 and the applicant must show that they can fund at least 80 per cent of the purchase price with a mortgage and a minimum deposit of 5 per cent. The government announced in 2016 that the scheme would continue until 2021.

Northern Ireland

There is no Help to Buy scheme available in Northern Ireland.

Scottish schemes are detailed in section 25.4.

25.3.3 First Homes initiative

The Queen's speech of December 2019 started consultations on a scheme to enable first-time buyers and key workers in England to purchase a new-build house with a 30 per cent discount, funded by developers.

The 30 per cent discount would remain in perpetuity, so it would apply to the sale price whenever a home purchased through the scheme was sold to another buyer.

25.4 What schemes operate in Scotland?

There are a number of schemes available in Scotland through partnerships between the Scottish government, social landlords, and participating builders and lenders. The Scottish government establishes available funding for the schemes each year, and once the funding has been exhausted no further help is available until the next year.

25.4.1 Help to Buy (Scotland)

Two Help to Buy schemes became available in Scotland from 1 January 2016 for new-build properties offered by participating builders. The scheme is administered through local agents appointed by the Scottish government.

- Help to Buy (Scotland) Affordable New Build Scheme – available from large housebuilders;
- Help to Buy (Scotland) Smaller Developers New Build Scheme – available from smaller housebuilders.

The rules for the two schemes are the same, and the administering agents decide which scheme will apply to each applicant. From the applicant's perspective, it makes no difference which scheme applies.

- **Availability** – the schemes are available on new-build property from participating builders. Applicants must be first-time buyers or existing home owners who could not afford to buy without the scheme's help. It is not available to single applicants needing a mortgage of more than 4.5 times their income or couples needing a mortgage of more than 3.5 times their joint income. If an applicant already owns their home, it must be sold before the new home is purchased.
- **Purchase price** – the maximum purchase price (the threshold price) was £200,000 until April 2021.
- **Deposit and mortgage** – the buyer must be able to provide 85 per cent of the purchase price through a combination of deposit and normal mortgage. The minimum deposit is usually 5 per cent. The mortgage must be on a repayment basis, and must be for at least 25 per cent of the purchase price.
- **Equity loan** – the Scottish government provides a 15 per cent equity loan for the balance of the property value. No interest is paid on the equity loan and it can be repaid at any time. The repayment is based on the property value at the time of the repayment.

25.4.2 Open Market Shared Equity Scheme (Scotland)

The Open Market Shared Equity Scheme is designed to help people on low to moderate incomes to buy 'starter' homes on sale in the open market. In simple terms these are homes with one more room (referred to as an 'apartment') than the people who will be living in the property need, not including kitchens, utility rooms, hallways, box rooms and bathrooms. For example, a couple would be able to buy a property with three 'apartments' (two bedrooms and a lounge, or one bedroom and two reception rooms).

- The scheme is available to:
  - first-time buyers;

— those aged over 60;

— those who rent from a local authority or housing association;

— people with disabilities;

— members of the armed forces;

— veterans of the armed forces who have left service within the past two years;

— spouses and partners of service personnel who were killed within the past two years while serving in the armed services.

- The buyer must buy between 60 and 90 per cent of the property, and will be expected to provide a 'modest' deposit. If the buyer has savings, they can keep £5,000 to pay for the costs of moving or as an emergency fund, but must use at least 90 per cent of the balance towards the purchase.
- The balance of the purchase price (10–40 per cent) is provided by the Scottish government, which takes a share of the equity. The government's share is secured on the property and will be repaid when the property is sold.
- The scheme is administered, and applications assessed, by registered social landlords on behalf of the government.
- There are limits on the value of property eligible for the scheme. The threshold depends on the town/city where the property is located.
- Once the initial share has been purchased, the owner can 'tranche up' (the same as 'staircasing'), to eventually own all the property.
- In certain areas where there is a shortage of eligible property, the government will retain a 10 per cent share, known as the 'golden share', which means the buyer can only ever own 90 per cent outright.

25.4.3 New Supply Shared Equity Scheme

Under this scheme the Scottish government provides grants to registered social landlords to build new homes for sale.

It operates on a similar equity share basis to the Open Market scheme, but buyers can buy an initial stake of between 60 and 80 per cent of the property. In exceptional cases the buyer may be allowed to buy an initial stake below 60 per cent. An example would be where their existing property is subject to a demolition programme and they wish to buy a replacement property in the same area.

25.4.4 First Home Fund scheme

Launched in December 2019, Scotland's First Home Fund scheme provides first-time buyers with up to £25,000 towards the purchase of a new or existing property as their sole residence.

- The scheme contribution is an equity stake in the property, repayable on eventual sale. No payment is required during ownership, but on sale the percentage repayable will be based on the sale price, eg if the original scheme contribution is 20 per cent of the purchase price, repayment will be 20 per cent of the sale price.
- The buyer owns 100 per cent of the property, with the fund holding an equity share.
- There is no maximum property value.
- A minimum deposit of 5 per cent is required.
- A minimum mortgage of 25 per cent of the purchase price is required on a capital repayment basis.
- The maximum scheme contribution is 49 per cent of the lower of the property valuation or purchase price, up to £25,000 per property, not per applicant.
- The owner's share can be increased up to 100 per cent, by repayments of at least 5 per cent each time. Repayment will be based on the market valuation at the time.
- For joint applications, only one applicant needs to be a first-time buyer.

25.5 What is right to buy?

Right to buy is not a mortgage scheme, but gives the tenants of social landlords in England and Northern Ireland (the House Sales Scheme) the right to buy the property they are renting.

Right-to-buy legislation was included in the Housing Act 1985 and revised in the Housing Act 2004. It enables a secure tenant of a local authority, district council, London borough council or certain registered social landlords to purchase their property at a discounted price. The basic rules are shown in Table 25.1.

The right to buy was abolished in Wales by the Abolition of the Right to Buy and Associated Rights (Wales) Act, which received royal assent on 24 January 2018. No applications to exercise the right to buy could be made after 6 January 2019.

RIGHT TO BUY IN SCOTLAND

In Scotland, the Housing Act (2014) ended right to buy with effect from 1 August 2016.

TABLE 25.1 RIGHT TO BUY: BASIC RULES

	England	Northern Ireland*
Minimum period as secure tenant to acquire right to buy	3 years	5 years
Discount available for houses	35% (after 3–5 years' tenancy)	20%
Discount available for flats	50% (after 3–5 years' tenancy)	20%
Additional discount on houses for tenancies held over 5 years	1% per year	2% per year
Additional discount on flats for tenancies held over 5 years	2% per year	2% per year
Maximum % discount**	70%	60%

*The purchase of certain types of home particularly suitable for disabled people may not be eligible for the scheme in Northern Ireland due to a shortage of similar stock to meet the region's needs.

** There is also a maximum monetary discount that increases annually by the CPI.

WHAT IS A 'PRESERVED RIGHT TO BUY'?

Where a tenant had a secured tenancy with a local authority and ownership of the property was transferred to a housing association while they were a tenant, the tenant will have a 'preserved right to buy', which means they have the right to buy based on their combined tenancy.

25.5.1 Discounts

In addition to the percentage maximum discount, the government imposes a monetary limit on the actual amount of discount that can be given by the landlord. The limit in England is increased by the CPI in April each year. Limits in Northern Ireland are not index-linked.

FACTFIND

For further information and to check the current monetary limits on right-to-buy discounts, go to:

https://www.gov.uk/right-to-buy-buying-your-council-home [Accessed: 28 October 2020].

Subsequent sale of a property bought under right to buy

If the tenant sells the property within a certain period, some, or all, of the discount may be repayable (see Table 25.2).

TABLE 25.2 DISCOUNT REPAYABLE ON SALE AFTER EXERCISING RIGHT TO BUY

Property sold during . . .	Discount repayable
Year 1	100%
Year 2	80%
Year 3	60%
Year 4	40%
Year 5	20%
Year 6 onwards	No repayment required

The 'discount' to be repaid will be calculated as a percentage of the sale price. For example, if the buyer received a discount of £20,000 on a £100,000 house, the discount will be 20 per cent of the price. On sale after three years, the discount repayable would be 20 per cent of the sale price multiplied by 40 per cent.

Additionally, those who exercised the right on, or after, 18 January 2005 who wish to sell within ten years of exercising the right must offer it first to their former landlord or another social landlord at full market price.

DISCOUNT REPAYABLE ON SALE OF PROPERTY AFTER EXERCISING RIGHT TO BUY

Purchase price	£100,000
Discount (20%)	£20,000
Subsequent sale price in year 4	£150,000
Discount to be repaid (20% of sale price x 40% – ie discount repayable in year 4)	£150,000 x 20% = £30,000 £30,000 x 40% = £12,000

25.5.2 Mortgages on right-to-buy property

Most lenders will consider mortgage applications from tenants wishing to purchase under the right-to-buy legislation. Lenders' attitudes vary – some will lend based on the market value of the property, while others will base lending on the discounted price.

The valuer will also look carefully at how the location of the property might affect its resale value. An owner-occupied property that is situated in a road or area where almost all other properties are still tenanted may have limited appeal, and very few lenders will lend on flats in tower blocks.

25.6 What is the 'right to acquire'?

The 'right to acquire' gives tenants of housing associations broadly similar rights to those who have the right to buy. They may acquire (ie buy) their housing association property after three years of tenancy. The main difference is that right-to-acquire discounts are based on a flat rate monetary amount, varying with the location of the property. The length of tenancy does not affect the discount, and the landlord does not have to sell the specific property the tenant lives in – they could choose to offer an alternative property to the tenant.

In some cases local authority properties were sold to housing associations, and existing tenants became housing association tenants. Those tenants may also have a 'preserved right to buy' under the same terms as a local authority tenant.

In 2016 the government put in place measures to extend the right to buy to all housing association tenants at some point in the future; this scheme is referred to as 'voluntary right to buy' (because housing associations came to an agreement with the government to implement the necessary measures on a voluntary rather than statutory basis). A two-year pilot scheme involving a small number of housing associations was established in 2016. Eligibility and discount levels were the same as those of the standard right-to-buy scheme.

Source: GOV.UK (no date)

25.7 What is equity release?

Equity-release plans are designed to enable homeowners who do not have a mortgage on their property to release some of the equity in order to provide capital or supplement their retirement income. Most of the schemes are available only to property owners aged at least 55, and some have a minimum age of 70. While aimed at those who do not have a mortgage, these schemes are also available to those with small mortgages, although the prior mortgage would have to be paid off as part of the arrangement.

Some of these schemes involve mortgages – known as lifetime mortgages – and some involve the sale of the property to a provider in exchange for a benefit: the latter are known as home reversion plans.

25.8 Lifetime mortgages

The FCA defines lifetime mortgages as regulated mortgage contracts that are available only to older borrowers over a certain age and where the lender cannot seek full repayment until one of the following events occurs:

- the borrower's death;
- the borrower moves to live elsewhere without the reasonable expectation of returning – into residential care or sheltered accommodation, for example;
- the borrower moves to another 'main residence';
- the borrower sells the property;
- the lender exercises its legal right to take possession under the mortgage contract.

CHECK YOUR UNDERSTANDING

What is a regulated mortgage contract?

While the borrower occupies the property as a main residence, the definition of a regulated lifetime mortgage allows a number of ways in which the arrangement can operate, as outlined in Figure 25.2.

FIGURE 25.2 LIFETIME MORTGAGE OPTIONS

No regular payments of capital or interest required. Interest accrued can be 'rolled up' to be paid at end of mortgage	Payment of interest required but capital not repaid until end of mortgage
LIFETIME MORTGAGE OPTIONS	
Payment of interest and partial repayment of capital may be required, but full repayment of capital not required until end of mortgage	Payment of interest required, but borrower has option to convert to 'roll-up' basis in future (hybrid scheme)

WHAT ARE THE RISKS RELATING TO INTEREST ROLL-UP?

Where interest is rolled up, the debt is likely to double approximately every 11 years at 6.5 per cent interest, around 14 years at 5 per cent and around 18 years at 4 per cent. Lenders are cautious – they limit roll-up mortgages to relatively low loan-to-value ratios and only consider borrowers with a minimum age between 55 and 60, for the following reasons:

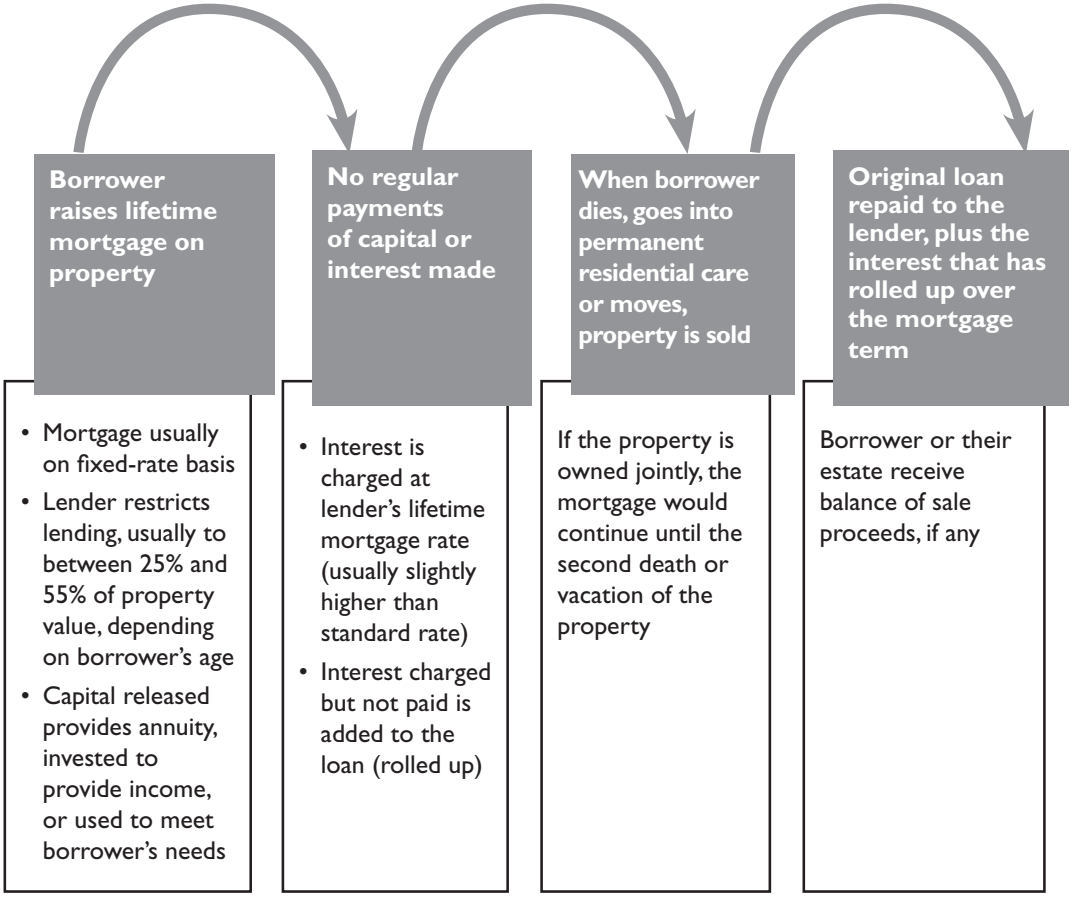
- Increases in life expectancy mean a mortgage could run for several decades.
- Property prices are not guaranteed to rise, and could even fall over time.
- In the worst case, a combination of these two factors could see some borrowers with debts approaching (or even exceeding) the value of their property. This would be a concern for lenders because their security would be threatened, and for borrowers, who might have hoped to be able to leave some of the value in their property to their heirs.
- Most schemes impose early repayment charges if the mortgage is repaid before the borrower dies/vacates the property. Such charges typically apply for at least five to ten years, and some may apply for the life of the plan.

Despite the risks involved in interest roll-up, the majority of lifetime mortgages are arranged on this basis. Most lenders provide a no-negative-equity promise, which means that the borrower cannot owe more than the value of the property when the loan is due to be repaid.

Capital repayments

Many modern lifetime mortgages allow the borrower to make penalty-free lump-sum payments during the life of the mortgage. A typical scheme would allow up to 10 per cent of the initial mortgage to be repaid each year. This allows those with sufficient resources to either repay some of the lending or, at least, pay sums to reduce the effect of interest roll-up.

FIGURE 25.3 HOW DOES A LIFETIME MORTGAGE WORK?



25.8.1 Hybrid schemes

Hybrid lifetime mortgage schemes are lifetime mortgages initially arranged on an interest-only basis, with the borrower making regular interest payments. However, the contract gives the borrower the right at any time to switch to an interest roll-up basis and stop making interest payments.

Hybrid schemes are helpful for borrowers who are a few years below the lender's minimum age for an interest roll-up scheme, but intend to take advantage of roll-up as they get older. Examples would be people who are working now, need to raise some capital and can afford to make interest payments now, but would prefer not to do so when they retire. They may also be helpful to many of those approaching retirement who have an interest-only mortgage but no way of repaying the capital or affording a normal mortgage in retirement.

In the case of hybrid arrangements, the lender is not required to carry out an affordability assessment when the mortgage is arranged, because the borrower can switch to an interest roll-up basis if, and when, they choose.

25.8.2 Drawdown

A lifetime mortgage can be arranged on a drawdown basis. The lender agrees a maximum lending limit and the borrower can draw down lump sums as they wish, subject to a minimum withdrawal, typically £2,000 to £5,000. Interest is charged on the amount outstanding, but is rolled up rather than paid each month.

The benefit of this type of loan over a standard lifetime mortgage is that interest only accrues on the amount actually borrowed, so the borrower has a degree of control and the debt will not increase as rapidly. It will allow the borrower to provide an annual income by drawing down capital, while maintaining control over the speed at which the debt builds up.

WHAT IS A HOME INCOME PLAN?

Home income plans (HIPs) were launched in the 1980s when annuity rates were much higher than today and mortgage interest relief was available. The minimum age was at least 70 and the homeowner took out a mortgage, with the interest rate fixed for life. The provider allowed the borrower to take some cash, typically 10 per cent of the money released, and bought a lifetime annuity for the borrower with the balance.

The annuity income was used to pay the monthly interest charge with the balance paid as income to the borrower.

Until 1999, mortgages received tax relief on interest payments at 23 per cent for the first £30,000 of the mortgage, known as mortgage interest relief at source (MIRAS). For example, this reduced the real interest rate from 7 to 5.39 per cent on the first £30,000. Annuity rates were much higher in the early 1990s than now, which meant that the borrower had a significant additional income from the arrangement, even after interest was paid.

Unfortunately, the combination of decreasing annuity rates, higher interest rates and the withdrawal of MIRAS meant that home income plans are viable only for the very elderly, and even then the benefits are unlikely to be particularly attractive; few, if any plans are sold today. Those who arranged a plan before the abolition of MIRAS will still receive 23 per cent tax relief and will, of course, be locked into a much higher annuity rate than they would receive today. The major benefit of the HIP arrangement was the ability to provide an increased income without rolling up interest and reducing the equity further.

Retirement interest-only mortgage

As a result of demand due to the number of borrowers unable to repay, or finding difficulty in repaying, interest-only mortgages at the end of the term, the FCA introduced a new regulatory category of interest-only mortgage from March 2018. Known as the retirement interest-only mortgage, lenders are permitted to arrange mortgages on an interest-only basis, with no specified term, for borrowers above an age specified by the lender. Affordability can be assessed on an interest-only basis, with no requirement to account for a repayment vehicle.

The retirement interest-only mortgage is defined in MCOB as:

"An interest-only mortgage:

1) which is not an interest roll-up mortgage;

2) entry into which is restricted to older customers above a specified age; and

3) under which the lender is not entitled to seek full repayment of the loan until the occurrence of one or more of the specified life events, unless the customer breaches their contractual obligations (including any obligation to pay interest during the term) in a way which allows the lender to terminate the agreement."

Although we have included the retirement interest-only mortgage in the lifetime mortgage section of this text, it is a separate regulatory category and is not subject to lifetime mortgage rules.

25.9 What is a home reversion scheme?

Home reversion schemes are an alternative to lifetime mortgages. The homeowner sells all or part of their property to the lender in return for a capital sum, an income or both. The original owner then enters into a lifetime lease agreement with the provider, usually at a nominal annual rent, typically between £1 and £12 a year, which guarantees them lifetime occupation.

Home reversion plans are defined in the following way:

- a person (the reversion provider) buys all or part of a qualifying interest in land from an individual or trustees;
- the reversion occupier (the previous owner) or a trust beneficiary (or a related person) is entitled under the arrangement to occupy at least 40 per cent of the land as, or in connection with, a dwelling.

The arrangement specifies that the right to occupy the property will end:

- when the occupier moves into residential care on a permanent basis;
- on the death of the occupier;
- after a specified period of at least 20 years from the date of the arrangement.

Home reversion plans that comply with the Equity Release Council's Code of Conduct (see below) must allow the planholder to move to a different property, subject to certain conditions.

Other key points relating to home reversion plans are as follows:

- **Legal ownership** – the arrangement involves the transfer of legal ownership to the provider. In the case of partial reversion, where only part of the property is entered into the plan, the provider usually takes full legal title to the property, but the previous owner becomes the beneficial owner of the part they retain. The tenant is responsible for basic maintenance of the property. Although they are protected by a legally binding lifetime lease, many people feel uncomfortable living as tenants in their former home.
- **Funds released** – home reversion plans usually allow the homeowner to release more capital than they could by taking out a lifetime mortgage at the same age. The amount the provider gives the homeowner in return for the property (or share) is based on estimates of the borrower's life expectancy, and always represents a substantial discount on its true market value. For example, on a house worth £200,000, £70,000 to £100,000 might be released, depending on the borrower's age. If the homeowner sets up a home reversion plan on half the property, the homeowner might receive £35,000 to £50,000. The large discounts on the market value are to allow for the fact that the lender does not receive any interest payments on this type of arrangement and has to wait for the death of the borrower(s) to receive most of the profit.

- **Minimum age** – the minimum age for a home reversion plan is higher than that for a lifetime mortgage – typically 65 to 70.
- **Taxation** – the capital can be used as the homeowner wishes and, because it comes from the sale of a main residence, is not subject to tax. As an alternative, some schemes use the cash released to buy an annuity, thereby increasing the individual's income. Note, however, that annuity income is potentially subject to income tax (depending on the recipient's overall income).
- **Drawdown** – many providers allow the owner to enter a minimum amount of the property value initially, and draw down further amounts later, subject to minimum and maximum amounts.
- **Sale of the property** – when the tenant dies or moves into residential care, the provider sells the property and retains all the proceeds from the percentage of the property it owns. Where only part of the property is held in the plan, the provider will retain that percentage of the property value when it is sold. For example, if 50 per cent of the property is sold to the provider, 50 per cent of the final proceeds will be retained by the provider and 50 per cent passed on to the estate.

In general, home reversion plans provide more cash when compared to lifetime mortgages. This is because the mortgage lender must take a conservative approach to excessive interest charges eroding the equity, whereas the reversion provider owns the property from the outset and knows that only unexpectedly poor property growth can affect its position.

THE LENDER'S RISK – A COMPARISON

Let's consider a property valued at £150,000 today, owned by a single man aged 70. We'll assume that property prices increase by 2 per cent per annum over the next 15 years, at which point the owner dies and the property is worth £202,000. To make things simple, we will not consider the cost to the provider of funding the arrangement or any other costs the provider might face. The examples below illustrate why lifetime mortgages provide lower amounts.

Home reversion

A reversion provider might advance as much as 50 per cent of the property value, giving a sum of £75,000 today. On sale of the property 15 years from now, this would result in a simple profit of £127,000 for the provider (ie £202,000 – £75,000). The provider would only face the prospect of losing money if property prices had fallen by the sale date.

Lifetime mortgage

If the mortgage provider lent 50 per cent of today's value and charged a fixed interest rate of 7.5 per cent, the debt plus accrued interest in 15 years would be £222,000, ie £20,000 more than the value of the property. If the lender limited the original loan to 35 per cent (£52,500), the debt would be £155,000 in 15 years' time, thus allowing the lender to receive all the money it was owed.

25.9.1 What is the Equity Release Council?

Some years ago, before equity release plans were regulated, the main providers of equity plans joined together and formed a trade association called Safe Home Income Plans (SHIP). SHIP established a Code of Practice, the principles of which are still in force today, designed to safeguard the interests of borrowers. SHIP is now known as the Equity Release Council (ERC). Members of the ERC are required, as a condition of membership, to adhere to the Council's statement of principles, rules and guidance and product standards, which replace the previous Code of Practice. The main safeguards the ERC offers are summarised in Figure 25.4. Although not a regulator, the ERC standards work in tandem with FCA standards, and in the areas listed below include requirements not covered by regulation.

Although equity release plans are now regulated, the ERC remains a strong force in the market.

FIGURE 25.4 MAIN SAFEGUARDS PROVIDED BY THE ERC RULES AND GUIDANCE

Legal advice

Applicant must be encouraged to seek independent legal advice to ensure they fully understand risks involved and fact that any children and other beneficiaries will receive a reduced inheritance

No negative equity guarantee

Provider gives a 'no negative equity' guarantee, ie the amount that has to be repaid will not be more than the price obtained when property is sold

Right to remain in home

Borrower is entitled to remain in their home for rest of their life – in case of joint borrowers this applies to each of them

Portability

Borrower must be allowed to transfer loan to another property, although part of it may have to be repaid if the value of the new property is insufficient to cover it

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain how shared ownership works?
- describe the two different ways in which SDLT can be paid on a shared-ownership property?
- explain how equity share schemes differ from shared-ownership schemes?
- give an overview of government schemes that are available to help people to purchase a home?
- summarise the criteria for right to buy in England, Wales and Northern Ireland?
- explain how a lifetime mortgage works?
- explain how a home reversion scheme works?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

GOV.UK (no date) *Right to Acquire: buying your housing association home* [online]. Available at: https://www.gov.uk/right-to-acquire-buying-housing-association-home [Accessed: 28 October 2020].

Test your knowledge

Use these questions to assess your learning for Topic 25. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following is **untrue** in relation to shared ownership?

   a) The property is bought on a freehold basis.

   b) It involves paying rent to the provider.

   c) The maximum initial share is 75 per cent.

   d) The property is valued at its open market value.

2) A shared-ownership mortgage is one on which part of the loan attracts zero or very low rate of interest. True or false?

3) In an equity-share mortgage arrangement, the borrower pays rent for a portion of the property while owning the remainder. True or false?

4) With the Help to Buy equity loan scheme (England):

   a) the maximum government loan is 25 per cent of the full purchase price.

   b) the buyer must provide a deposit of at least 5 per cent of the full purchase price.

   c) no interest is charged on the equity loan for three years.

   d) on sale, the equity loan is repaid as a percentage of the original purchase price.

5) Jay and Emma are buying a 50 per cent share in their new home. What type of government scheme are they using?

6) Under the right-to-buy scheme, in England the maximum discount on a flat is 60 per cent. True or false?

7) Gary and Ayesha are buying their local authority flat in Leeds under the right-to-buy scheme, having been tenants for six years. What is the maximum discount they could claim?

8) Moira and Ken (both aged 67) are considering an equity release scheme because they would like to improve their standard of living. Their three daughters are all in favour, although Moira and Ken are concerned that the scheme would prevent them leaving as much of their estate as they would like to their daughters and grandchildren. Why would an adviser suggest a drawdown roll-up lifetime mortgage might be best for them?

9) The minimum age for a home reversion plan is usually lower than for a lifetime mortgage. True or false?

10) Home reversion plans generally allow more capital to be released than lifetime mortgages. True or false?

TOPIC 26

Raising additional funds from property

LEARNING OBJECTIVES

A property is a valuable commodity, and those who have built up equity in property might be able to use it to release funds, to spend on improving the property or on other things. This is achieved by securing further borrowing on the property, either by increasing the existing mortgage or by taking out a second charge. This topic looks at the ways in which a property owner can use their property to raise additional funds.

By the end of this topic you should have an understanding of the following:

- further advances and drawdown facilities;
- second charges;
- bridging loans;
- equity release.

THINK . . .

We have already introduced many of the products and concepts covered in this topic so you may find that the most challenging aspect is remembering the differences between the different methods of releasing funds.

You will find it easier to understand this topic if you have a good understanding of first- and second-charge lending and the order of priority for repayment – look back to Topics 3 and 4 if you need a reminder. We have covered equity release products too, so look back to Topic 25 to make sure you understand what equity release is and how it works.

26.1 What is a further advance?

A further advance is a 'top-up' to an existing mortgage, usually over the remaining term of the existing loan. It is generally the most cost-effective way to

raise additional funds and involves considerably less legal and administrative work than remortgages and second-charge loans. However, in some cases a remortgage may offer the owner a better deal overall, and second mortgages can often be used to avoid potential problems involved in further advances.

DISCLOSURE OF ALTERNATIVES

As the FCA expects customers to be able to make informed decisions about their financial affairs, MCOB rules require lenders to inform customers seeking to raise additional funds from their property that there are alternative options.

The lender must inform customers that a second-charge loan or a remortgage could be a suitable alternative to a further advance, although further advice on the alternatives or their suitability is not required. A similar requirement to outline the alternatives applies to those advising on second charges or remortgages.

IN BRIEF

FURTHER ADVANCES – KEY FACTS

Each lender has its own approach to the terms and conditions of further advances. The details below are typical.

- Further advances usually run for the remainder of the term of the original mortgage, although it may be possible to arrange the advance over a shorter term. Some lenders set a minimum term between five and ten years.
- Lenders may consider further advances taking the total mortgage to between 80 and 90 per cent LTV, although some set a lower maximum LTV.
- Lenders may set a lower LTV limit if the further advance is not for home improvements or repairs, and some may not consider advances that are not for property-related purposes.
- The lender may set a minimum property value for considering further advances.
- Lenders generally require the existing mortgage to have been in force for at least six months.

- Many lenders will only consider further advances on a repayment basis.
- The advance will be based on interest rates and options available at the time, which are likely to differ from the original loan. Many lenders have specific further advance products.
- Application and product fees are generally lower than for a regular mortgage.
- Early repayment penalties may apply to the further advance if it is on a special rate.
- Many lenders will allow overpayments up to a specified percentage of the original advance.

The lending market is highly competitive; there is no guarantee that the original mortgage lender will be an automatic choice for additional finance. All lenders actively pursue this type of business where their records identify high-quality lending opportunities.

An application for a further advance follows the same principles as a new mortgage application. Because the lender has information about the applicant's track record and the property, and there is no conveyancing, the process is usually faster and less costly.

26.2 What information does the lender need for a further advance?

As with a mortgage, gathering information is the first stage in the further advance process. There are two aspects:

- assessment of the ability to repay – the borrower's status and track record;
- adequacy of the property as security for the further lending.

Stringent checks must be in place to confirm the information submitted in support of the application.

26.2.1 Assessing ability to repay

- Affordability is assessed in the same way as for a new mortgage application (see Topic 10).

- **Regular and irregular expenditure** – comprehensive details must be obtained, as defined in MCOB 11.4. Particular scrutiny will be given to other borrowings and normal household expenditure.

- **Family/household circumstances** – the lender will assess the overall family circumstances. For example, the number of dependants will often affect ability to repay the loan.

  Since the original advance was made, one party to the mortgage might have left the home or others might have moved in. If the former applies, the person who has left will be unlikely to take on additional debt burden with no benefit. In the latter case, the lender will require the person who is not a party to the mortgage to sign a 'consent to mortgage' form, to waive rights of residence. This also applies to children aged 17 at the time of application who intend to live in the property as their main home.

  The lender can also permit a new occupant to become a party to the mortgage, subject to status, and hence become jointly and severally responsible for the debt – this requires a variation of the mortgage deed.

- **Conduct of existing account** – the lender will review the account history to find out whether the applicant has a track record of meeting their repayments. Many lenders insist that arrears be cleared before a further advance is considered. If a borrower has had problems in the past but has maintained the account well for a number of years, it is unlikely to adversely affect the lender's decision.

26.2.2 Assessing the security

- **Reassessment of the property as security** – as we saw in Topic 14, building societies must conduct a formal assessment of the property. The assessment does not have to involve a formal valuation; it could be made by comparing the property with similar properties that have sold recently or by checking sales data as part of a desktop valuation. Other lenders have no similar statutory duties – they can assess the security in any way that meets their lending practices.

- **Property value** – this constrains the size of the loan. Since the original loan was granted, the property may have increased or decreased in value. Even if work has been done to improve the property, there is no guarantee of an enhanced value. Many lenders will not require a valuation if the property has been valued in the previous 12 months, unless there has been significant work that might have increased its value.

- **Loan to value** – if the original LTV was high, a new valuation may be needed to determine whether the property offers sufficient security for the higher borrowing commitment. The LTV is the most crucial factor, and the lender must be confident that total new borrowing will be in line with its lending criteria.

- **Advance for home improvements** – if this is the purpose of the advance, the lender may be prepared to consider the enhanced value of the property once the work is completed. Plans and estimates will be required, and evidence of planning permission in some cases. Work may be subject to final inspection by a valuer.
- **Local authority/legislation conditions** – if the loan is for improvements or repairs, these must be consistent with conditions imposed by local authorities or national town and country planning legislation, such as planning consent, listed building consent and building regulations. Failure to take sufficient account of these factors can result in the local authority imposing an enforcement order to undo work after it has been done, thus leaving the borrower with a higher mortgage on a property with a lower value, and a bill for the reinstatement work. The lender would be left with a property that might not offer adequate security for the increased loan. Planning consent and building regulations were covered in detail in sections 15.1 and 15.2. Check back to refresh your memory.
- **Location and neighbourhood** – a long-term perspective is taken. Is the area new or well-established, improving or declining? Are there any plans to develop infrastructure and local amenities? Are there any plans to build roads or housing estates that might affect the value?

26.3 What else must a lender consider in relation to a further advance?

26.3.1 Postponement of second charges

You learned in Topic 4 that a second charge ranks after a first-charge mortgage for repayment: the Law of Property Act 1925 states that the priority is determined by the date of registration at the Land Registry. In the case of unregistered land, the lender holding the title deeds is regarded as the first-charge holder, and subsequent charges will be prioritised by the date their interest was recorded in the Land Charges Registry. The law relating to further advances and existing second-charge holders is complex. The following information covers the basic principles, and may not apply to all situations.

SECOND CHARGES AND FURTHER ADVANCES

If Lender A secures a mortgage of £90,000 on a property worth £130,000 and Lender B provides a second charge on the same property for £10,000 the following year, Lender A's mortgage has priority over that of Lender B. In the event of default, A will be repaid first and so incurs less risk.

If Lender A makes a further advance of £5,000 two years after the original mortgage, however, this £5,000 will rank third (ie behind the original two loans) in priority for repayment. This means that the third loan represents a higher risk to Lender A.

Lender A may not be prepared to take its place in a line of mortgagees because of the higher risk involved in being last in the queue for repayment. In some instances, Lender A might ask Lender B to postpone its prior charge in favour of the new one. If Lender B does not agree, Lender A may offer a remortgage to consolidate both debts, and Lender B will lose out altogether.

To set aside a second charge, a deed of postponement must usually be executed. The process of adding a subsequent mortgage to an original one after postponing an intervening second charge is called 'tacking' – the further advance is 'tacked' on to the original mortgage.

DEED OF POSTPONEMENT

Effectively allows a new loan from the original mortgage lender to 'jump the queue' and become part of the first charge.

There are three situations where a deed of postponement is not required:

- if the first charge holder had no notice of the other charge at the time when the further advance was made;
- if the mortgage deed obliged the first-charge holder to make further advance, the obligation was registered at the Land Registry, and at the time the lender entered into the obligation, it had not received any notice from a second-charge lender. Any obligation can be subject to appropriate assessment and acceptance at the time of application;
- the lender agreed a maximum lending limit with the borrower, with a facility for the borrower to take some of the borrowing now and take the rest at some future date. An example would be a drawdown mortgage that allowed the borrower to draw down further amounts up to a predetermined limit.

In these circumstances, the original mortgagee takes priority and the new advance becomes part of the first charge.

If none of the factors above apply, the lender will need to seek a deed of postponement in its favour.

CASE STUDY: DEED OF POSTPONEMENT NOT REQUIRED

Lynette obtains a mortgage from the Academic Bank: £100,000 towards purchase of the property, which is worth £200,000. The mortgage deed contains an option that allows Lynette to take total borrowing up to 75 per cent of the original LTV, subject to specified conditions.

As the mortgage deed commits the lender at the outset to subsequent advances, all such advances are first mortgages and the Academic Bank will have priority over any second-charge holders.

RANKING OF SECURITIES IN SCOTLAND

The ranking of securities in Scotland is governed by the Conveyancing and Feudal Reform (Scotland) Act 1970. The holder of a first security receives notice of a second or subsequent (postponed) security. The previous ranking of the prior lender is then restricted to cover its existing advances, interest and expenses. The provisions of the Act may, however, be varied between the debtor and creditor by a ranking agreement.

26.3.2 Higher lending charge

Many lenders require a higher lending charge where the LTV exceeds a particular threshold, typically 75–80 per cent. This applies where the further advance takes the lending above the threshold – or even higher above the threshold, if the original mortgage already exceeded the threshold. The borrower pays an additional amount (or it is debited to the mortgage account).

26.3.3 Listed buildings

As we saw in Topic 15, listed building consent is required where the owner wants to demolish a listed building or change it in a way that would affect its character as a building of special architectural or historic interest. As with planning consent, any changes made without listed building consent may result in the local authority requiring reinstatement to the previous position.

26.3.4 Architect's certificates

If the advance is to fund building work and is not being carried out by an NHBC member, the lender may require work to be signed off by a professionally qualified architect. This confirms that the job has been done to a required standard. Typically, either an architect or a surveyor will be appointed to oversee the work, regardless of whether it is carried out by an NHBC member.

The architect's costs can be substantial and are the borrower's responsibility. A typical fee is 12.5 per cent of build cost; this can increase as the level of supervision increases.

26.4 What are the MCOB rules in relation to further advances?

MCOB 7, 7A and 7B detail the rules that govern how lenders must deal with mortgages that are already in place, including further advances.

Before the customer submits an application for a further advance, the lender must supply information that meets the pre-application disclosure requirements in MCOB 5 and 7.6. The requirements differ depending on whether the advance is on a regulated mortgage (taken out before 21 March 2016) or an MCD regulated mortgage (taken out from 21 March 2016).

For an MCD regulated mortgage that requires the lender to approve further advances, MCOB 7B.1 requires the lender to provide an ESIS that meets the requirements for pre-application disclosure in MCOB 5A, unless one has already been provided. The ESIS and the APRC must be based on the further advance only.

For a regulated mortgage, the lender must provide an illustration or ESIS that meets the pre-application disclosure requirements in MCOB 5 or 5A, unless one has already been provided or the lender is applying the tailored provisions for a loan to a high-net-worth borrower, or the loan is for business purposes.

The illustration or ESIS must be based on the amount of the further advance only and include a section that shows the total amount of borrowing and the new total payment.

26.5 What is a drawdown facility?

Modern flexible and offset mortgages usually offer a 'drawdown' facility, which allows the borrower to take further advances without a formal application. When the original mortgage is arranged, the borrower is given a maximum amount of borrowing, typically 75 per cent LTV. Assuming that they have not taken the maximum at the start, they can then draw down further funds as they require in future, up to the agreed limit. The further advances usually

require a short application form and a small application fee, although the lender must check that the advance is affordable.

!

AFFORDABILITY RULES

Changes to MCOB affordability rules from 26 April 2014 resulted in lenders carrying out affordability checks before allowing drawdown of further funds.

As the facility is clearly stated as a term of the mortgage in the mortgage deed, any further funds released will form part of the first charge, and will not require a deed of postponement over any second or subsequent charges.

26.6 What is second-charge lending?

We recapped in section 26.3.1 how second charges are ranked behind first charges in priority for repayment. This means the lender takes a higher level of risk than with a conventional mortgage and thus charges a higher rate of interest.

TAKING A SECOND MORTGAGE TO AVOID AN HLC

Jaysharan and Marie have a property valued at £200,000 and a mortgage of £145,000. They wish to borrow a further £20,000 to build a conservatory. Their existing lender applies a higher lending charge (HLC) on loans over 75 per cent LTV; this means a higher lending charge on £15,000 of the proposed loan.

Taking a second mortgage might incur a higher interest rate but the couple will avoid the higher lending charge, so it might work out as a better deal.

The use of second charges was common in the 1970s, often to increase initial borrowing to buy a property. The majority of mortgage lending was done by building societies and restricted to 75 per cent LTV, so, to increase borrowing to buy a property, it was common for second charges (often from an insurance company) to be arranged at the same time as a mortgage. Second charges can still be of value today where a further advance would take the borrower above the lender's HLC threshold, and would allow the borrower to avoid an HLC.

There is no requirement under general property law for the first charge lender to agree to a second charge because its own position will not generally be affected. However, a first charge lender has the right to include a clause in the mortgage deed (which most major lenders do) allowing them to place a restriction on title at the Land Registry. This means that the Land Registry cannot register any further charges without the first-charge holder's agreement.

In the case of unregistered land, the lender holding the title deeds will be regarded as the first-charge holder. A second-charge lender's interest would be recorded by an entry in the Land Charges Registry.

The length of a second charge would not usually run past the end of the first charge, although the lender could agree to a longer term if it felt it was appropriate. The existence of a second charge can be an early warning sign of problems, especially if the borrower has already been turned down for a further advance by the first lender. Finance houses tend to charge higher rates of interest in line with the higher risk, so a borrower choosing to use a finance house may indicate a need to secure a lump sum urgently.

CHECK YOUR UNDERSTANDING 1

If a mortgage is in default, the lender will eventually proceed to possession and exercise its power of sale to recover the debt. The holder of the first charge takes what is legally due to it from the proceeds, then passes the balance of the sale money (if any) to the second lender, who takes what is due to it. When all secured lenders have been satisfied, what happens to the balance, if any?

26.7 What are the regulatory requirements for second-charge lending?

Since 21 March 2016, second charges have essentially been subject to the same MCOB rules on advising and selling standards as first-charge mortgages, and are subject to the same definition – ie 40 per cent of the land to be used as a dwelling, etc. This aims to ensure that people use second-charge loans only when they are suitable and affordable, and that the lender will treat them fairly, particularly if they go into arrears. The rules apply retrospectively to second-charge loans in place before 21 March 2016 – known as 'back book loans'.

IN BRIEF

REGULATORY REQUIREMENTS

When arranging a second charge, the lender must:

- meet the Initial Disclosure requirements, including an outline of the firm's scope of service and its remuneration;
- provide an ESIS for product disclosure;
- provide an 'adequate explanation' of the product, its key features and how they will impact on the customer, including what happens if the customer defaults;
- confirm key details when the contract starts;
- follow the same post-sale procedures as for first-charge mortgages.

!

BUSINESS LOANS EXEMPTION

MCOB rules only apply to second charges taken out for business purposes if the loan is for £25,000 or less.

The rules relating to advising and selling are the same as those for first-charge mortgages, including execution-only sales. This means the lender must assess affordability, including the stress test for future interest rates.

Second charges are often used for debt consolidation purposes and, historically, second charges show higher levels of payment problems than first charges. For this reason, MCOB requires second-charge lenders either to:

- take reasonable steps to ensure the consolidated debts are repaid when the new loan starts; or
- include the existing debts in the affordability assessment.

Lenders can only roll up interest and charges into the loan if the borrower decides to do so. The lender cannot do so automatically. Some second-charge lenders offer interest-only loans where the interest rolls up and is repaid with the original loan at the end of the term, typically between two and five years. Some bridging loans can also be arranged on the same basis over a shorter term of between one and two years.

26.8 What is bridging finance?

CHECK YOUR UNDERSTANDING 2

We introduced bridging finance in Topic 2. Can you recall when bridging finance might be required?

There are two types of bridging finance:

- **Closed bridging** – the borrower has a confirmed 'exit strategy' (ie feasible plan) for repaying the loan within an agreed timescale. Typically, this is through the sale of the existing property and it requires the borrower to have exchanged contracts with a buyer. Closed bridging usually starts at or just after exchange of contracts or conclusion of missives. This is less risky than lending to someone who has no buyer. In other, less typical cases, the borrower might have funds secured, but they will not be available before purchase of the second property.
- **Open bridging** – the borrower needs finance to buy the new property but does not have a firm buyer for their existing property. This can represent a high risk for lender and borrower because there is no guarantee that the property will be sold within a reasonable period of time. Borrowers should be advised to think very seriously before committing to this arrangement. Open bridging interest rates are higher than those for closed bridging, due to the increased risk.

Bridging finance is offered by banks, some of the largest building societies, and specialist bridging lenders. Lenders are much more willing to lend for closed bridging than open bridging. The availability of funds and lenders' attitudes may also depend on the economic conditions at the time. Note that the practice of many developers of taking properties in part exchange has reduced the need for bridging finance to some extent.

Let's consider some typical standard requirements:

- The lender usually requires details of the new property and sight of the mortgage offer on it. It may also ask for evidence that the current property is being marketed actively.
- The lender requires details of the borrower's exit strategy.
- The lender sets a minimum loan amount, typically around £30,000.
- Lending on residential property is typically available at up to 70–75 per cent LTV for first-charge loans, and slightly less for second-charge loans.
- Lending is usually arranged on an interest-only basis, because it will be repaid relatively quickly.

- Terms can range from hours to years, although most lenders limit open bridging to 12 months. They might be prepared to review the loan at that point and extend it if the borrower has met all the payments and the property market has not deteriorated.
- Once the decision has been made, the funds can often be made available within days.
- Some lenders may lend on an interest roll-up basis, with the interest paid with the capital when the property is sold. The main consideration is the value of the property offered as security, because the loan is for a fixed term, the amount of interest can be calculated, and the lender can ensure the total loan represents a 'safe' LTV. As a result, the lender is unlikely to be concerned with the borrower's income or credit history.

Bridging finance is more expensive than a conventional mortgage, with typical charges including a valuation fee, legal fees, an application fee or a completion fee, loan interest, and an exit fee.

26.9 What regulatory requirements apply to bridging finance?

MCOB defines a bridging loan as an MCD-exempt bridging loan or a regulated mortgage with a term of 12 months or less. Second-charge bridging loans of over £25,000 for business purposes, and some types of second-charge bridging loans with four or fewer repayments, are exempt from the MCOB requirements.

MCD-EXEMPT BRIDGING LOAN

A regulated mortgage contract or an article 3(1)(b) credit agreement either of no fixed duration or which is due to be repaid within 12 months, used by the consumer as a temporary financing solution while transitioning to another financial arrangement for an immovable property (FCA, no date).

If a loan meets the definition of a bridging loan, it will not be subject to the full requirements of MCOB but the lender will still need to ensure it is suitable and that the borrower can afford it. If the loan does not meet the definition, it will be a normal regulated or MCD regulated mortgage and subject to the full MCOB requirements.

If the loan has an original term of more than 12 months, or is extended beyond 12 months, it is (or will become) an MCD regulated mortgage and is subject to MCOB. At the point that bridging finance becomes regulated under MCOB, the client must be issued with the ESIS. If the extension does not reflect the original ESIS, the lender may have to treat the extension as new borrowing and go through the assessment process again.

26.9.1 Provisions of MCOB 4.7

MCOB 4.7 (advice) requires the firm to assess whether a bridging loan would be appropriate to the customer's needs and circumstances in broadly the same way as a normal mortgage. Additionally, the lender must consider whether it is appropriate for the customer to make regular payments and to gain access to finance quickly. Part of the assessment requires the firm to consider whether a 'normal' regulated mortgage would be more appropriate than a bridging loan.

The rules also require that, where bridging finance is appropriate, the firm must make the customer aware that they will have to demonstrate they have a credible repayment strategy in place.

26.9.2 Provisions of MCOB 11

MCOB 11 (responsible lending) requires the lender to assess the affordability of the bridging loan. This requirement does not apply when the bridging loan is on an interest roll-up basis, although the borrower must be made aware of the impact of rolling up the interest on the remaining equity in the property. Where the borrower intends to use the sale of their existing property to repay the bridging finance, guidance (not rules) in MCOB 11 suggests that the lender should ask for an independent survey of the property in order to satisfy itself that the property represents a valid repayment strategy.

Another potential repayment strategy is for the borrower to take out a mainstream regulated mortgage at the end of the bridging period, assuming they can afford the payments. MCOB 11 guidance suggests that the lender should seek evidence that there is a guaranteed offer or an offer in principle for the replacement mortgage. If no such offer exists, the lender should assess the borrower's income and expenditure to establish whether such an offer is likely. If there is no offer, and the bridging finance is provided on the basis that the borrower's financial position might improve in the future and allow them to arrange a standard mortgage, the lender will be in contravention of the rules.

There is no requirement for the lender to carry out a review of the repayment strategy during the term of an interest-only bridging arrangement.

EXTENDING THE TERM OF BRIDGING FINANCE

A lender cannot agree to an extension of the bridging loan unless the borrower makes a positive choice to extend it. Unless the finance is a secured overdraft for business purposes or for a high-net-worth customer, an extension to a bridging loan must be treated as a new loan and subject to an affordability assessment.

> If the extension is on an interest roll-up basis, the affordability assessment is not required, but the lender must consider with the borrower the impact of the extension on the remaining equity in the property.

26.10 Equity release

We looked at equity release products in Topic 25. This topic will consider the uses of equity release.

Homeowners in, or nearing, retirement often have a requirement for additional cash or income, whether to improve the home, pay unsecured debts, take a holiday or clear a mortgage. They have equity in their property, which will normally allow them to raise additional finance by a conventional remortgage or a further advance. This route is likely to pose problems because:

- any additional income produced by investing the cash raised will be eroded by the increased mortgage payments;
- they may not have sufficient income to validate the extra borrowing;
- to make payments affordable they may have to extend the mortgage term past retirement age, or they may already be in retirement.

There are alternatives in this situation:

- **Lifetime mortgage** – the mortgage is on an interest-only basis, with no defined term. The interest payable is usually rolled up rather than paid when due.
- **Home reversion plan** – the property is sold in return for a lump sum or an income, together with a guaranteed tenancy for life.
- **Retirement interest-only mortgage** – as only interest is payable on the mortgage, the monthly cost will be lower than a conventional repayment mortgage. However, affordability may still be a problem.

CHECK YOUR UNDERSTANDING 3

We covered both lifetime mortgages and home reversion plans in Topic 25. Make sure you understand the key features of these products and the differences between them. Revisit your studies for Topic 25 if necessary. In this topic we are going to consider the advantages and disadvantages of each type of product.

A potential disadvantage of both types of equity release is that increases in income or capital resulting from the scheme may affect eligibility for means-tested benefits, such as Income Support, Pension Credit and Council Tax Reduction.

TABLE 26.1 USING LIFETIME MORTGAGES

Advantages	Disadvantages
With an interest roll-up plan, no monthly payments are required. This means that all the cash or income raised can be used as the borrower wishes.	Interest may roll up quickly, depending on the rate charged.
Most lifetime mortgages offer a no-negative-equity guarantee, so the debt will never exceed the value of the property, although this is not a regulatory requirement. It is a requirement of the Equity Release Council's statement of principles, rules and guidance and product standards.	'Younger' borrowers are likely to live for many years, allowing the debt to increase significantly.
The borrower can benefit from the additional finance without having to move house.	The borrower has little control over the increasing debt and may see their children's legacy significantly reduced. Many products now offer the facility to repay up to 10% of the initial borrowing each year, which does offer some control to those who can afford to make such payments.
The borrower retains ownership of the property.	It may not be possible to move house, because repaying the mortgage plus rolled-up interest may leave insufficient capital to buy another property.
If the property increases in value at a higher rate than the interest accrues, the borrower's estate will benefit.	
A hybrid scheme starts with regular interest payments, but allows the borrower to switch to interest roll-up whenever they wish. This allows them to reduce and control the effect of interest roll-up.	

TABLE 26.2 USING HOME REVERSION PLANS

Advantages	Disadvantages
No interest is payable or rolled up. This means that the planholder does not have to worry about repayment.	The cash or income provided will be at a discount to the value of the property given up.
The scheme will probably provide more cash for a given age than a mortgage-based scheme.	The owner loses all rights to the increase in value of the part of the property given up.
Although losing ownership, the planholder is guaranteed tenancy for life.	If the planholder dies relatively shortly after starting the arrangement, it will have been a very costly way of raising the cash or income.
Part-reversion is available, allowing the planholder to retain an interest in some of the equity in the property.	Schemes are quite inflexible and moving may be a problem.
	Any improvements made to the property will not benefit the planholder, as the provider owns it.

26.10.1 Retirement interest-only mortgages

The relatively new regulatory category recognises the needs of some borrowers who either have an interest-only mortgage that they will not be able to repay at the end of the term, or those who wish to release capital from the equity in their property in retirement. These borrowers do not want the perceived expense of rolling up interest over the longer term, as happens with a roll-up interest lifetime mortgage.

As the category will be treated as a standard interest-only mortgage, the lender must assess affordability in the usual way, which may prevent some borrowers from taking this option.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the key features of a further advance?
- explain why a first-charge holder might seek a deed of postponement for a further advance?

- summarise the regulatory requirements that apply to second-charge lending?
- explain the difference between closed and open bridging finance?
- outline the advantages and disadvantages to a borrower of a lifetime mortgage?
- outline the advantages and disadvantages to a borrower of a home reversion plan?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

FCA (no date) *Glossary terms* [online]. Available at: https://www.handbook.fca.org.uk/handbook/glossary/ [Accessed: 29 October 2020].

Test your knowledge

?

Use these questions to assess your learning for Topic 26. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following is true of a further advance?

   a) It must finish at the same time as the original mortgage.

   b) The same loan-to-value limit will apply, regardless of the purpose of the further advance.

   c) The existing mortgage must usually have been in place for at least six months.

   d) The lender will not need to reassess the property as security, as it would have been valued for the original mortgage.

2) Karen has requested a further advance but her personal circumstances have changed since she obtained the original mortgage. Her partner has now moved into the property and her son has returned to live at home since graduating from university. Assuming Karen meets all the other criteria for a further advance, what action would the lender need to take in relation to the change in occupants?

3) The value of the security should be reassessed if a further advance is requested. True or false?

4) In relation to a further advance on an existing MCD regulated mortgage, in order to comply with MCOB, the lender must provide the borrower with:

   a) an illustration based on the further advance only.

   b) an ESIS based on the further advance only.

   c) an ESIS based on the total borrowing.

   d) an illustration based on the total borrowing.

5) The order of priority for legal charges on registered property is established by:

   a) the date of the charge's registration at the Land Registry.

   b) the date the loan came into force.

c) the date the solicitor received confirmation of the charge from the lender.

d) the size of the loan.

6) A deed of postponement is required for all second charges. True or false?

7) Which of the following is **untrue** in relation to MCOB rules and second charges?

a) MCOB rules apply to new and existing second-charge loans, regardless of when they started.

b) When arranging a new second-charge loan, the lender must provide the borrower with a KFI and an ESIS.

c) The lender must provide a suitability report to give an adequate explanation of the product.

d) A second-charge loan of £30,000 secured on the borrower's home for business purposes would not be subject to MCOB.

8) When a second mortgage is taken, the new lender informs the original lender of the situation. True or false?

9) Dmitri has accepted a new job in Manchester and bought a house there, but the sale of his previous home in Derby fell through and he has not yet found a new buyer. He needs bridging finance – which type is most likely to be appropriate?

10) An advantage of a lifetime mortgage is that the planholder is guaranteed a tenancy for life. True or false?

TOPIC 27

Transferring mortgages

LEARNING OBJECTIVES

A mortgage is a long-term commitment, often lasting twenty years or more. Inevitably, over such a long period, most people want or need to make changes to their borrowing arrangements – to secure a better deal, to facilitate a property move or to reflect changes in their personal circumstances. This topic explores the different ways in which these needs can be met.

By the end of this topic, you should have an understanding of the considerations and processes involved in:

- converting to a different mortgage with the same lender;
- remortgages;
- property moves;
- transferring equity – removing a party from or adding a party to a mortgage and the SDLT implications of doing so;
- redeeming a mortgage early;
- making capital repayments during the term.

THINK . . .

You should now have a good understanding of the different processes involved in buying a property and securing a mortgage. To help you to prepare for this topic, think about the following questions:

- What do you think the advantages and disadvantages might be of staying with an existing lender rather than switching to a new one? (Think about the MCOB affordability requirements, for instance.)
- What costs might be involved in a property move, in addition to the cost of the property itself?
- If a couple splits up and one of the mortgagors asks to be released from the mortgage, why might a lender refuse such a request?

27.1 Changing the mortgage

The mortgage market is a very competitive environment, and lenders are always looking to increase their share of quality customers by offering tempting deals to potential new customers. If a borrower wishes to reduce the cost of their mortgage or take out a different type of arrangement, or is reaching the end of a special rate, it is an opportunity to review mortgage arrangements and look at offers available from other lenders, as well as finding out what their existing lender can offer.

The decision as to whether to remain with an existing lender or move the mortgage to another lender is not always easy. Reductions in monthly repayments achieved by remortgaging could be outweighed by fees charged on the new arrangement by the new lender. In addition, some lenders offer loyalty deals to encourage borrowers to stay with them.

CHECK YOUR UNDERSTANDING

In Topic 10, we considered the situation where an existing borrower wishes to vary the terms of, or replace, an existing mortgage with the same lender, either on the original property or a new property. Does a lender have to carry out an affordability assessment for an existing customer in these circumstances?

CONSIDERATIONS FOR SWITCHING TO A NEW ARRANGEMENT WITH THE EXISTING LENDER

- Application and/or product fees for the new deal.
- Early repayment charges might apply to the original arrangement, although lenders might waive the charge if a new offer is taken up.
- Switching with the original lender does not involve substantial legal costs, and no formal valuation will be required unless a significant increase in borrowing is proposed. This contrasts with a remortgage, where there will be legal costs and a valuation fee, unless the new lender pays them as part of the remortgage package.
- The process should be much quicker than switching to a new lender, once approval has been given.

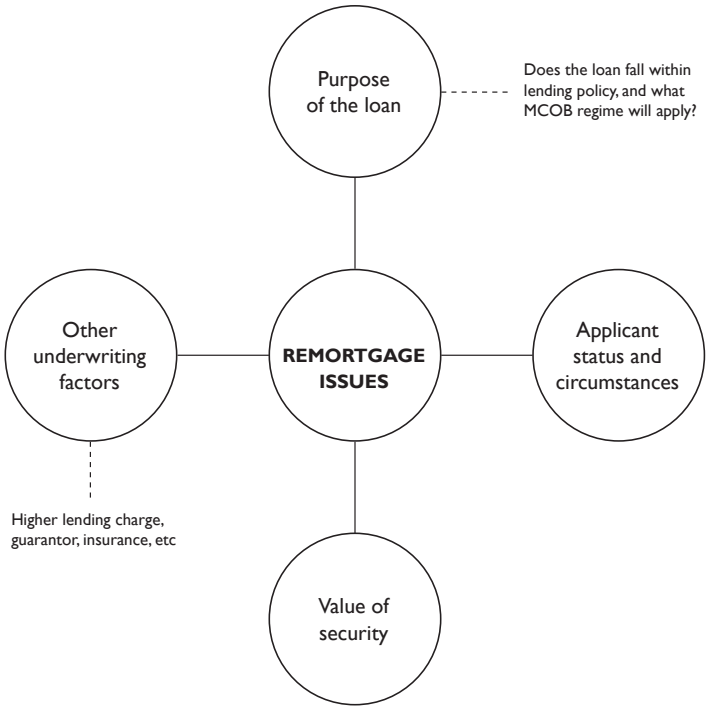
- We saw in Topic 10 that a lender can waive the normal affordability checks in favour of a proportionate affordability assessment for consumers who are up to date with their existing mortgage and want to switch to a more affordable one (with their existing lender or a new one) without borrowing more. There are also transitional arrangements for borrowers who took out a mortgage before 26 April 2014 (non-MCD regulated) and wish to change their mortgage without borrowing more. In this case, the lender is not required to carry out an affordability assessment.

27.2 What is involved in remortgaging?

A remortgage is a replacement loan for one already in force. The replacement loan may be with the original lender or with a different lender, although the need for a remortgage from the original lender is rare. Nearly all mortgage deeds have clauses allowing a further advance to be made without having to draw up a new deed, and most lenders will allow an existing borrower to move to a new mortgage product without the need for a remortgage.

From a regulatory perspective, a remortgage is an entirely new arrangement, and the new lender must apply MCOB rules to the application. As the arrangement starts after 21 March 2016, it will be an MCD regulated mortgage, which must be suitable and affordable. This means that the normal checks, including affordability, must be carried out, unless the remortgage is for the same amount, in which case the lender can apply a proportionate affordability assessment (covered in section 10.7.1). Regardless of the MCOB requirements, the lender will need to be satisfied that the borrower can maintain the mortgage repayments and that the property is adequate security for the mortgage.

FIGURE 27.1 WHAT FACTORS WILL THE REMORTGAGE LENDER CONSIDER?



27.2.1 What is involved in the remortgaging process?

The procedure for remortgaging is relatively straightforward and mirrors in many ways the normal mortgage application procedure, including the rules on advice and execution-only. It is also important to remember that a remortgage will now be an MCD regulated mortgage.

As mentioned above, the necessary status and security information has to be gathered. In particular, details of the existing mortgage have to be confirmed – the lender should obtain details of the existing mortgage, together with statements going back over a reasonable period of time.

The lender should check whether the information given at application stage is consistent with evidence presented by the existing lender. For example, the borrower might state that the switch is to get a lower rate of interest, but evidence might suggest that the existing lender is at an advanced stage of action for recovery.

The borrower should obtain a redemption statement in order to establish accurate borrowing requirements – otherwise there may be a shortfall that cannot be met from personal resources.

Once the lender has assessed the application as acceptable, a formal offer of advance will be issued. Assuming the borrower is happy with this, the conveyancing work can start.

The solicitor acting for the borrower will arrange to pay off the existing mortgage from the proceeds of the advance cheque, alongside any other costs, fees, or expenses involved.

27.2.2 What issues does the borrower need to consider?

Remortgaging can be a painless way of raising extra money, and the costs can be reduced by taking a deal that offers free valuations and legal services. However, the borrower should be aware of the following issues before remortgaging.

- **Terms and conditions** – replacing a mortgage without raising additional capital can be a good way to reduce the interest paid, or to take advantage of special offers. The borrower should make sure they understand the terms and conditions that apply to the proposed new arrangement – often there are tie-in conditions with financial penalties for early redemption, or other conditions that may not be immediately obvious.

- **Fees and other costs** – there are likely to be fees and costs associated with remortgaging, unless the lender offers free valuations and legal services. Costs would include application and/or product fees with the new lender, valuation and conveyancing fees, and potential redemption penalties from the existing lender. Many legal processes would have to be repeated, including local authority searches, although SDLT will not be charged again. In view of this, the borrower should consider the impact of the costs on the overall arrangement. For example, if the fees on a three-year fixed-rate deal amount to £500 and the borrower pays them from their own resources, they will need to save at least £14 a month in order to make it viable. If they choose to add the costs to the amount borrowed, they should consider the impact of paying interest on it for the term of the mortgage.

- **Debt consolidation** – replacing an existing mortgage with an increased loan to consolidate other debts can be a money saver in the short term, as mortgage rates are lower than other forms of borrowing. However, the following considerations need to be taken into account:

  — The borrower will be paying interest on the consolidated debt until the end of the mortgage term, which will usually be longer than the original loan it replaced. Over the full term of the mortgage, the costs will be higher.

  — If the borrower is classed as a 'credit impaired customer', MCOB rules require the lender to take reasonable steps to ensure the consolidated loan is repaid on completion of the mortgage where the borrower would not be able to afford the increased mortgage if it remained in place, or add the existing debt repayments as a committed expense in the affordability calculation.

  — Moving unsecured loans to secured status can be risky for two reasons:

- The borrower's equity in the property will be reduced, which could reduce their options if they wanted to move in future.
- If the borrower has difficulty meeting monthly costs and defaults on a mortgage, the lender might commence possession proceedings, whereas this would not happen with an unsecured loan.

- **Financing non-property purchases** – using a remortgage to raise additional money for other purposes (car purchase, holidays, etc) can be attractive at the time, as mortgage rates are generally lower than other forms of borrowing. However, the borrower will be repaying the increased borrowing to the end of the mortgage term; this could mean the car is financed for upwards of 20 years, even though it will lose value rapidly.
- **Higher lending charge** – increasing the level of borrowing may result in an LTV in excess of the new lender's threshold for an HLC. In this situation, the HLC should be taken into account when calculating the overall benefit of the new arrangement. HLCs already paid to the current lender will not be refunded or transferable to the new mortgage.
  - Any second charges will either need to be settled on completion of the remortgage, or the second charge holder will need to agree to postpone their charge to allow the new lender to establish a first charge on the property. If this was not done, the new loan would become a second charge itself, due to registration after the existing second charge. There may be a fee to settle the second charge.

ISSUES TO CONSIDER IN RELATION TO THE EXISTING MORTGAGE

- **Early repayment charges on the existing mortgage** – if the existing mortgage is based on a special deal (eg a fixed rate), the borrower might be charged by the lender for transferring to another lender during the term of the special deal. Typically, such a charge would apply until the end of the fixed-rate term but some deals are subject to an 'overhang', where the penalty continues beyond the term.
- **Administration fees** – most lenders charge a fee to close a mortgage account. In some cases, this can be as high as £295.
- **Loyalty offerings** – some lenders offer borrowers special loyalty bonuses after a specified period. For example, the borrower might be given a 0.5 per cent discount from the standard variable rate once they have held the mortgage for five years. A borrower close to becoming eligible for such a discount might find it more cost-effective over the longer term to remain with their existing lender.

- **Relationships** – many borrowers develop a positive relationship with their lender and feel a degree of loyalty. In some cases the relationship has enabled them to overcome repayment problems, or to arrange lending outside the lender's normal criteria.

27.3 Property moves

Moving home is an opportunity for the borrower to reassess existing arrangements and decide whether better terms can be secured elsewhere. Factors that could influence the decision include:

- the existing lender's service standards;
- the existing lender's interest rates compared with the market;
- special deals available elsewhere and the existing lender's efforts to retain the borrower;
- the comparative costs and attractiveness of offerings from new and existing lenders.

Many lenders offer a portability option. For example, a borrower with a £75,000 five-year fixed-rate deal would be allowed to move without penalty within the five-year term, providing that £75,000 of their new mortgage was on the same deal. Effectively, they would be transferring that mortgage to the new property, although from a technical standpoint the original mortgage would be redeemed and then another mortgage arranged. Any increase in borrowing would be on a deal offered at the time. If the borrower wished to reduce the amount ported, any early repayment charge applicable to the mortgage would usually be applied to the reduction. Other companies offer portability on the basis that the new mortgage must be for at least the same amount but may be on different terms. This could save a significant amount in early repayment charges compared with arranging the new mortgage with a new lender.

PORTABILITY

The facility to transfer an existing mortgage to a new property during the term of a special deal without penalty.

When porting a mortgage, the borrower will have to submit a new application and the lender will be required to carry out an affordability assessment, although MCOB 11.6 does allow the lender to waive affordability checks if there is no increase in borrowing and the change will not impact on affordability. It is possible that the application could be declined if there have been problems

with the account or the borrower fails to meet the affordability requirements for increased borrowing.

Some lenders insert a condition requiring the borrower to pay the standard early repayment charge when the original mortgage is redeemed, and will then refund it when the new loan is completed. In most cases, the lender will only impose the condition if there is a time lapse between sale and purchase, but as a potential charge that may affect cash flow during the purchase process, it is important to check the exact terms and conditions of the portability facility.

27.3.1 Considering whether to move

Moving home is an expensive process, and the owner should weigh up the benefits of moving compared with the costs. Depending on the reasons for their wish to move and the degree of flexibility they have, an owner might be fortunate enough to move to an area where house prices are lower, in which case they might be able to reduce borrowing or choose a larger house. Conversely, they might be forced to move to an area where prices are higher, resulting in a much larger mortgage or a smaller property for their money.

Common reasons for moving include the following:

- **Relocating as a result of a change of job** – in this case, a buyer should be sure that they have researched the proposed area, assessed property available within the budget, and ensured family needs can be met by local facilities such as schools, shops, medical facilities and so on. Proximity to work might also be a consideration: a non-driver who works locally might need to be on a bus route; and a commuter might like to live within walking distance of a railway station.

- **Family circumstances** – a growing family or a need to provide a home for dependent elderly relatives may require a bigger property in the same area; a separation may result in the sale of the family home and downsizing into smaller properties.

- **Personal preferences** – an owner might decide to move because they want to, rather than from necessity. For instance, they might want to move from an urban area to a rural area, or to a more attractive or larger home. This is more likely to be the case with buyers who have yet to start a family, or whose family members are independent.

27.4 What is involved in transfers of equity?

IN BRIEF

TRANSFER OF EQUITY

A transfer of equity arises when:

- a joint owner transfers their 'share' of the property into the other owner's sole name;
- a sole owner wishes to add another person as joint owner.

There are many reasons for such a move, but the most common are:

- the property is to be transferred to one party as part of a divorce settlement or relationship break up;
- an existing owner is marrying and wishes their new spouse to become joint owner.

From a legal perspective, a transfer of equity must be agreed by all the owners, who can then arrange for a solicitor to register the transfer at the Land Registry. However, a mortgage must replicate ownership of the property, so if the transfer will involve removing a joint mortgagor or adding a new mortgagor, the lender will have to agree to the transfer of equity as well. The legal charge, or standard security, is made between the parties specified in the original contract, and the contract can only be varied with the agreement of those parties.

If there is any threat to the security of the mortgage, the lender is unlikely to agree and the transfer cannot go ahead. Often, this has led to a situation where divorced couples are still joint mortgagors and, to compound their problem, are unable to arrange a mortgage on a new property because the existing mortgage affects their affordability assessment.

A transfer of equity request is often made at the same time as a request for a further advance – for example, the remaining borrower needing to raise finance to buy out the borrower who is leaving the property. It is normally the borrower who originates the request.

Similarly, a person may wish to be added to the mortgage when a relationship is formed and that person moves in with the existing borrower. This makes little difference to the occupant's rights if the two people legally marry – under the Family Law Act 1996, an occupying spouse has certain rights whether named on the mortgage deed or not. The Civil Partnership Act 2004 extends the same rights to civil partners.

MORTGAGE RELEASE TO ESCAPE CREDITORS?

A less common reason for a request to release a borrower from the mortgage contract is where that party is seeking to escape creditors. It is a common fallacy that a person faced with bankruptcy can protect assets by transferring them to a partner or spouse; as we saw in Topic 11, in practice the trustee in bankruptcy can seize those assets anyway.

27.4.1 The purpose of the request

The purpose of the request may be straightforward or concealed. The lender will investigate the request in order to understand the borrower's motives for the approach.

A request to transfer equity can result in additional business arising from unfortunate circumstances. Often when two people split up, additional mortgage finance is required by one person to buy out the other, and for the person leaving to buy a new home. There are other related product needs that a revised factfind for both parties would reveal.

27.4.2 Status

If a person is to be removed from the mortgage, the lender will examine the remaining borrower's financial circumstances in order to establish whether their income and expenditure will enable them to support the outstanding mortgage on their own. This may involve taking references and/or examining statements, as well as carrying out a credit search for details of any other bad debts. Although this process will have been carried out when the original mortgage was arranged, circumstances might have changed in the interim. For example, the remaining party might not have been the main earner when the original assessment was carried out, or their income might have changed significantly.

If the transfer request is due to separation or divorce, the lender should be aware that the remaining borrower might have to make maintenance payments, or, conversely, might expect to receive such payments. Maintenance arrangements might not be finalised at the time of application, but they can substantially affect the borrower's ability to repay the loan.

27.4.3 Value of the property

The borrower's ability to repay must be considered alongside the current LTV ratio on the mortgage. Only by looking at these two factors will the lender better identify the risk. A revaluation of the property may be necessary.

27.4.4 New occupier

If a person is moving in, it must be established whether they intend to become a party to the mortgage contract. If so, the lender will carry out normal status and affordability checks before agreeing to the transfer.

If another person aged 17 is already living in the property at the time of transfer, or will be moving in once the transfer is complete, and does not intend to become a joint owner and mortgagor, they will be required to complete a 'consent to mortgage' form, waiving rights of residence should the lender have to seek possession. Failure to do this can result in the occupier enjoying a right of residence that overrides the mortgage under section 70 of the Land Registration Act 1925 (England and Wales only). In effect, the lender will not be able to obtain vacant possession following litigation for possession unless the consent to mortgage has been obtained.

27.4.5 Track record

The track record of the account to date is important, but the lender also needs to make sure that the individual who is to remain in the property is fully aware of the consequences of releasing the other party to the mortgage.

If the borrowers have a longstanding relationship with the institution, it may be possible to learn quite a lot from examining the past conduct of the account, as well as (sometimes) the adviser's knowledge of the individuals concerned. Less can be learned from looking at the track record if the loan is relatively new.

27.4.6 Guarantee

If the loan is supported by a guarantee, any proposed changes in the terms and conditions of the guaranteed mortgage must be agreed by the guarantor(s).

27.4.7 Life assurance policies

If the mortgage is interest-only, there may be a joint life assurance policy in existence to repay the loan at the end of the term.

If the policy is assigned to the lender as security, the lender must be involved in any variation of the policy terms. If the policy is not assigned, it should be transferred or assigned to one or other of the policyholders, usually as part of any settlement. Where a party is to be added to the mortgage, they should consider the way in which the mortgage will be repaid. For example, if both original parties had ISAs to repay the loan, there will be a shortfall as the person 'leaving' the mortgage takes their ISA with them. The new party to the mortgage will need to consider how to address the shortfall.

27.4.8 The transfer process and costs

The lender will charge a fee for the transfer of equity, which will be borne by the borrower. It is normal to take legal advice and arrange for a solicitor to act,

and the transfer will be arranged by a deed of transfer (or a deed of variation in Scotland).

27.4.9 Stamp duty land tax (SDLT)

A transfer of equity may create a liability to SDLT in some situations, regardless of whether it was paid on the original purchase of the property. The rules are relatively complex, but the key points can be explained relatively simply. In the following scenarios, assume the SDLT nil-rate threshold is £125,000.

SDLT: ADDING A JOINT OWNER

Where a sole owner is getting married, entering a civil partnership or setting up home with someone, and they want to transfer ownership into joint names, there may be a charge to SDLT. However, if the transfer took place after they married, and they were living together, the surcharge would not apply to the transfer.

The charge arises where the transfer is agreed in exchange for a consideration, which includes a cash payment and/or an assumption of liability to pay a mortgage.

For example, Alison owns her house, which is worth £400,000 with a mortgage of £180,000. She will marry Brian in the near future and would like to transfer the house into their joint names. Brian has agreed to pay Alison a cash sum equal to half the equity in the house, to be added to the mortgage.

For SDLT purposes, there is a cash sum of £110,000 (50 per cent of the equity), plus a mortgage of £90,000 (50 per cent of the mortgage). As the total of £200,000 is above the threshold for SDLT, tax of £1,500 (2 per cent above £125,000) will be payable.

In our example, if Brian did not pay a cash sum but was purely added to the mortgage, there would be no liability as the consideration would only be £90,000 (50 per cent of the mortgage). However, this might not be fair to Alison or any potential heirs, who are, in effect, giving away a large sum of money to Brian.

The rules also mean that if Brian already owned another property, the 3 per cent SDLT second home surcharge would apply to his 'consideration'.

SDLT: REMOVING A JOINT OWNER

A charge may also arise where joint owners separate and the property is transferred into one name. In the case of a court order or agreement between the partners in a divorce, judicial separation or dissolution of a civil partnership, the transfer will be exempt from SDLT. In all other situations a liability may be created. The charge will be based on the consideration given in exchange for the transfer.

For example, Jeff and Dave are good friends who bought a flat jointly to get on the housing ladder. Dave has accepted a job 200 miles away and would like to buy his own flat near to work. The flat he and Jeff currently own is worth £180,000, with a joint mortgage of £140,000.

Jeff has agreed to pay Dave £20,000 to buy out his share of the flat's equity and will take over the mortgage in his sole name.

For SDLT purposes, the consideration is a cash sum of £20,000 (50 per cent of the equity), plus a mortgage of £70,000 (50 per cent of the mortgage). As the total of £90,000 is below the threshold for SDLT, no tax will be payable. Had the total consideration been above the threshold, Jeff would have to pay the appropriate rate of tax.

27.4.10 Regulatory considerations (MCOB 7.6)

When a party is added to a mortgage contract, the lender must provide them with an ESIS for the whole loan. When a party is removed from a mortgage contract, the remaining borrower must be provided with an ESIS for the whole loan.

In each case the ESIS must meet the requirement for pre-application disclosure in MCOB 5. However, the lender can make changes to the wording and add, remove or alter information to ensure the content reflects the context of the change and avoids misleading information.

Where the removal of a party is due to death, the lender does not have to provide a new ESIS.

27.5 What is involved in early redemption?

It is the right of any borrower to redeem a mortgage at any time. The law prohibits lenders from obstructing this right, although they are allowed to make a reasonable charge to cover their lost income.

When a mortgage is created, the deed will contain a legal date of redemption, which is usually six months after the mortgage is created. Either party to the mortgage has the right to ask for early redemption after that date has passed, although the lender will usually only do so if the borrower has breached the conditions of the mortgage.

WHEN MIGHT A MORTGAGE BE REDEEMED EARLY?

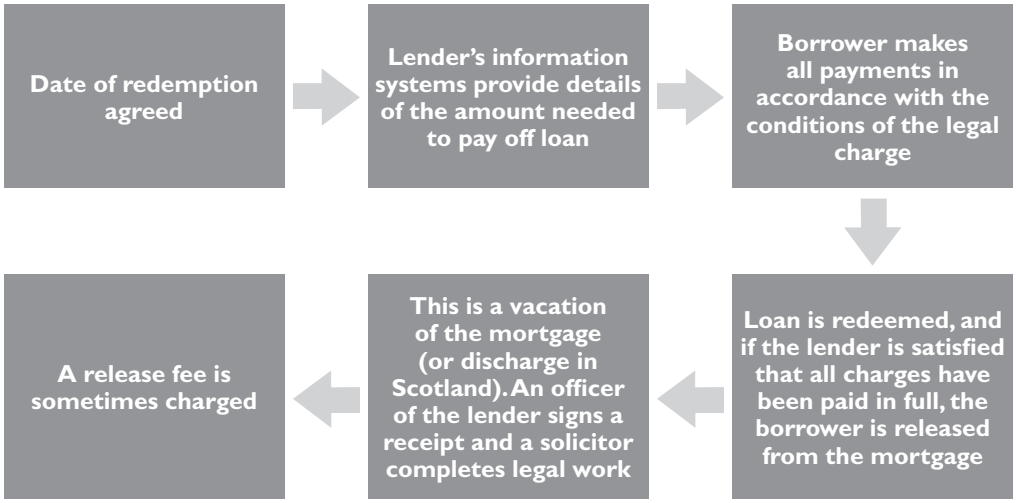
When the borrower:

- receives a legacy;
- wants to move and take a new mortgage;
- has funds to clear the mortgage and feels it will be of benefit to do so.

Early redemption may not always be the best course of action for the borrower. The borrower should be encouraged to take an overall view of their financial circumstances to decide whether there are more efficient ways of using the funds.

27.5.1 The process for early redemption

FIGURE 27.2 REDEEMING A MORTGAGE EARLY



27.5.2 Early repayment charges

Many lenders impose an early repayment charge to offset loss of anticipated interest from special deals. Details of such a charge are included in the mortgage deed or conditions at the time the mortgage is completed, are detailed in the annual mortgage statement, and can be obtained from the lender on request. These fees are usually expressed in terms of so many months' interest or a percentage of the loan. The amount can be significant and must be taken into consideration in the overall calculation. It is over and above the relatively small mortgage exit administration fee imposed to complete the account closure and any associated administration work.

Mortgage exit fee

The mortgage exit fee is often charged by the lender to cover its costs in closing the account and carrying out the required procedures when the borrower redeems a mortgage.

The fee used to be relatively low, often around £50, though many lenders increased the fees for existing customers, often to amounts as high as £500, which led to controversy, complaints and some refunds or reductions.

MCOB rules require the lender to state the amount of any fees to be paid on redemption of the mortgage, although it is acceptable for the lender to state the current fee (ie it may change over the life of the mortgage). The FCA's guidance for lenders is based on principles of fairness outlined in the Consumer Rights Act 2015.

The FCA considers the following to be acceptable components of the lender's costs of redeeming a mortgage:

- deed release fees;
- Land Registry charges;
- staff processing cost;
- a reasonable proportion of general overheads.

Where a borrower considers a mortgage exit fee to be unfair, they have the right to refer the case to the Financial Ombudsman Service where the case will be considered on the basis of fairness.

An increase in a mortgage exit fee from the amount originally stated is likely to be reasonable if the contract contains a valid reason for an increase. The most likely valid reason would be increases in the lender's administration costs between the start of the contract and redemption. Any increases must represent the true costs to the lender and the right to vary the costs should be explained clearly in the contract.

CLOG ON THE EQUITY OF REDEMPTION

In rare circumstances, a court can decide that an early repayment charge is a 'clog on the equity of redemption'. This means that the court feels an unreasonable condition has been imposed deliberately to prevent or discourage a borrower from paying back the loan. In such cases, the court can set aside the clause in the mortgage, thereby allowing the borrower to make early redemption.

For example, in the 1990s, Northern Rock imposed a relatively high early repayment charge in the first seven years of its variable-rate mortgages. A court ruled this was an unreasonable charge and ordered the lender to remove it.

We discuss 'equity of redemption' in Topic 29.

27.5.3 Part-redemption

Sometimes a borrower may wish to pay a lump sum to reduce the mortgage balance. This is called a part-redemption.

Most lenders set down a minimum capital repayment, mainly to enable completion of the transaction as a capital reduction rather than an earlier-than-scheduled monthly repayment. As more lenders move towards calculating interest on a 'daily rest' basis, the need to differentiate between capital reductions and other payments becomes less important.

The borrower needs to know the lender's attitude towards part-repayment. Some lenders will not apply the money to the account until the end of the year, which means it will have no effect until then. Many lenders will accept part-repayment but need to be told to use it immediately to reduce the capital – otherwise it will sit in a separate account until the year end. Where the part-repayment represents part of a special-deal mortgage, a proportional penalty may apply.

WHAT ARE THE BORROWER'S OPTIONS AFTER PART-REDEMPTION?

When a part-redemption is made, subject to the agreement of the lender, the borrower with a repayment mortgage can either:

- continue repayments at the same amount and reduce the mortgage term; or
- reduce the amount of monthly payments and keep the same term.

In the absence of a request from the borrower, the lender normally reduces the monthly mortgage payment.

27.5.4 Early repayment disclosure (MCOB 7A.3)

If a customer wishes to repay the mortgage before the end of the term, the lender must provide them with the necessary information to allow them to make that decision. The information must:

- be provided without delay;
- quantify the implications of early repayment;
- clearly set out the assumptions used when calculating charges. The assumptions must be 'reasonable and justifiable'.

27.6 Changing the mortgage term

It is possible for a repayment mortgage term to be reduced or extended.

To reduce the term, the borrower can make larger monthly repayments than those set out in the mortgage contract. More than the scheduled capital is repaid each month, which reduces the interest charged and the capital outstanding. Some borrowers choose to leave their monthly repayments unchanged when interest rates are falling, on the basis that they have been able to make the payments up to now and can continue to do so. This reduces the mortgage term.

The term of the mortgage can also be extended, with the agreement of the lender; this is sometimes an option for borrowers who have run into financial difficulties. It has the effect of reducing the monthly repayment and so makes the mortgage more affordable.

Lenders will only agree to extend the term if it represents a genuine solution to the borrower's problems. If the lender feels that it will not improve the borrower's ability to repay the loan, an extension of the term will not be granted.

No money will be saved directly by extending the term of an interest-only mortgage; it may be of benefit in that it gives the associated investment vehicle more time to grow.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the issues a borrower needs to consider when deciding whether to opt for a new arrangement with their existing lender or a remortgage?
- explain what is meant by a 'transfer of equity'?
- outline the issues a lender would need to consider before agreeing to remove a borrower from a joint mortgage?
- outline the steps a lender would need to take before adding a borrower to an existing mortgage?
- describe the regulatory requirements that apply to the lender if a borrower asks to redeem a mortgage early?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 27. Review the text if necessary.

Answers can be found at the end of this book.

1) Nicola has not made any changes to her current mortgage, which started in 2012, and is now considering whether to switch to a different arrangement with her current provider. In what circumstances would her lender not be able to apply the transitional arrangements in MCOB 11.7 regarding an affordability assessment? Where Nicola wants to:

   a) increase the borrowing to pay for the mortgage arrangement fee.

   b) increase the borrowing to fund essential repairs.

   c) increase the borrowing to build an extension.

   d) reduce her mortgage with a small capital payment.

2) The facility to transfer a mortgage product to a new property during the term of a special deal, without incurring charges, is called:

   a) transfer of equity.

   b) redemption.

   c) portability.

   d) remortgaging.

3) A transfer of equity occurs when a mortgage or block of mortgages is sold by one lender to another. True or false?

4) The terms and conditions of a mortgage contract can be changed by the lender without the borrower's agreement. True or false?

5) Removing a borrower from a mortgage deed cannot be done without the lender's permission. True or false?

6) Alan and Ann are divorcing and Ann is going to take over their interest-only mortgage. What would be an appropriate course of action in relation to their joint endowment policy?

7) Jack and Tom have a joint mortgage on their flat, with Jack's mother as guarantor. The couple have split up and Tom wants

to be released from the mortgage. Does Jack's mother have to be informed of Tom's request?

8) SDLT is always payable if a new owner is added to the property and the mortgage. True or false?

9) Releasing a borrower from their mortgage obligations when the mortgage is repaid is known in England and Wales as:

   a) discharge.

   b) redemption.

   c) completion.

   d) vacation.

10) What is meant by the term 'a clog on the equity of redemption'?

TOPIC 28

Arrears and debt management

LEARNING OBJECTIVES

We have looked so far at the positive side of buying a house and arranging a mortgage – the excitement of buying a property, the technicalities of the buying process and the types of mortgage that can be used. While the majority of property owners manage to meet their mortgage commitments, even if money is tight at times, a small minority of borrowers cannot repay. This topic looks at the options available to lenders and borrowers in this situation.

By the end of this topic, you should have an understanding of the following:

- MCOB rules for the treatment of borrowers with a payment shortfall;
- possible courses of action to help borrowers with a mortgage payment shortfall;
- sources of advice for borrowers;
- government and other schemes to help borrowers with a payment shortfall;
- the principles of using mortgages for debt consolidation.

THINK . . .

In your studies so far we have placed a lot of emphasis on the need to assess affordability. In theory, a careful assessment of affordability should minimise the numbers of people who have difficulty paying their mortgage but changes in personal circumstances cannot always be foreseen.

To focus your thoughts before starting work on this topic, think about the different circumstances that might leave people unable to afford their mortgage repayments. Perhaps this is a situation that has happened to you, or to people you know. If so, what options were available to help you/them resolve the situation?

28.1 What are the MCOB rules on borrowers with a payment shortfall?

Before looking at the possible courses of action to help borrowers facing a payment shortfall, we need to understand the regulatory position. The two overarching principles are that a lender:

- must treat those in difficulty fairly; and
- must not take advantage of their vulnerable position.

The detailed rules are set out in MCOB 13.

28.1.1 Dealing fairly with customers

MCOB 13 requires that a borrower who has arrears or a mortgage debt shortfall must be dealt with fairly by the lender. The lender is required to put in place written policy and operational procedures for dealing with such cases, which should include the provisions outlined in Figure 28.1.

FIGURE 28.1 LENDERS' RESPONSIBILITIES IN DEALING WITH CUSTOMERS WITH MORTGAGE DEBT OR ARREARS

Seek agreement
Use reasonable efforts to reach agreement with the borrower over the method of repaying the arrears or shortfall.

Liaise
Liaise with a third-party source of advice regarding the arrears or shortfall.

Allow time
Adopt a reasonable approach to the time over which the arrears or shortfall should be repaid, taking into account the borrower's circumstances.

Permit changes
Allow the borrower to change the mortgage payment date or repayment method, unless the lender has good reason not to do so.

Consider options
Where no reasonable payment arrangement can be made, consider allowing the borrower to remain in the property until a sale is made.

Take possession as a last resort
Take possession of the property only when all other reasonable attempts at resolution have failed.

The FCA considers that a 'reasonable period' for repayment of arrears or a shortfall will depend on the borrower's circumstances. In some cases, it can mean spreading the payments over the remaining mortgage term.

A firm must also establish and implement clear, effective and appropriate policies and procedures to ensure the fair treatment of customers whom the firm understands, or reasonably suspects, to be particularly vulnerable.

IN BRIEF

WHAT MUST THE LENDER DO IF A BORROWER HAS A PAYMENT SHORTFALL?

- Where a borrower has a payment shortfall, the lender must not attempt to process more than two direct debit requests in any one calendar month.
- If the borrower's bank has refused to pay the lender's direct debit at least once in each of two consecutive months due to insufficient funds, the firm must:
  - consider whether the payment method is still suitable for the borrower;
  - make reasonable efforts to contact the borrower to discuss whether the payment method is still suitable;
  - not pass on any costs arising from the failed direct debits.

If a borrower is in arrears, the lender must consider whether one or more of the following actions would be suitable to help resolve the problem:

- extend the mortgage term;
- change the mortgage type;
- defer payment of interest due on the mortgage or sums due under a home purchase plan;
- treat the payment shortfall as if it was part of the original amount – known as 'capitalisation' and effectively adding the shortfall to the capital owing;
- make use of any government forbearance schemes to help borrowers with problems.

Note that the firm must not automatically capitalise a payment shortfall where the impact would be 'material'. MCOB defines capitalisation as 'material' if, on its own or taken together with previous automatic capitalisations, it increases the interest payable over the mortgage term by £50 or more or the contractual monthly repayment amount by £1 or more.

The firm must give customers sufficient information to help them to understand the implications of any proposed arrangement.

RECORD-KEEPING

The lender must keep records of its dealings with borrowers who are in arrears or have a shortfall debt. The records must be kept for three years from the date of such dealings.

28.1.2 Information provision

Under MCOB 13, the lender must write to the borrower within 15 business days of becoming aware that the account is in arrears. The letter must contain:

- the information sheet 'Problems paying your mortgage', available from the Money Advice Service, now part of the Money and Pensions Service;
- a list of payments missed or partly paid;
- the total of the arrears;
- the charges likely to be incurred as a result of the arrears;
- the total outstanding debt, excluding charges that may be made on redemption;
- the nature and level of charges that will be incurred unless the arrears are cleared.

28.1.3 Procedure before taking possession

One action a lender can take if all attempts to rectify the problem have failed is to seek a possession order, to give the lender the right to take possession of the property and sell it to pay off the mortgage. We shall look at that option in more detail in Topic 29, but MCOB 13 requires that, before taking action for possession, the lender must:

- provide a written update of the arrears and charges (see section 28.1.2);
- ensure the borrower is informed of the need to contact the local authority to establish their eligibility for rehousing after the lender takes possession;
- clearly state the possession procedure.

CONTACTING THE BORROWER

The lender must not put pressure on the borrower through excessive telephone calls or correspondence, or by contact at an unreasonable hour. A reasonable hour is generally considered to be between 8am and 9pm, but must take into account the borrower's known work patterns and religious observance.

28.1.4 Marketing a possessed property

Once a property has been taken into possession, the lender must take steps to:

- market the property for sale as soon as possible;
- take reasonable care to obtain the best price that might be reasonably achieved, taking into account market conditions and the increasing debt. The lender has a duty of care, though it cannot 'nurse' the property, which is the term used when the lender delays accepting reasonable offers in the hope of achieving a 'target' price.

If the proceeds of the sale are less than the debt, the lender must advise the customer as soon as possible after sale of:

- the mortgage shortfall;
- whether another firm – mortgage indemnity insurer, etc – may pursue the debt.

If a lender decides to recover a shortfall, it must notify the borrower of its intention within six years of sale (five years in Scotland). If the proceeds of the sale are more than the debt, the lender must take reasonable steps to inform the borrower and pay the surplus to them, subject to the rights of any subsequent mortgagees.

28.2 What role can the lender play?

The MCOB rules define the minimum requirements for a lender, which leaves the lender with a range of possible courses of action over and above those described in the rules, providing they are fair to the customer.

Lenders should encourage borrowers to contact them as early as possible in cases of difficulty and must do all they can to help borrowers to bring their mortgage accounts to order. The assistance that can be provided can take the form of short-, medium- or long-term measures (see Figure 28.2).

If it appears that the arrears situation can be remedied, the lender has many options. The decision will also be influenced by the lender's perception of the risk posed. For example, if the current LTV is relatively low, the lender's security is under less threat and it might be prepared to consider a wider range of options.

FIGURE 28.2 MEASURES TO DEAL WITH MORTGAGE ARREARS

Short-term measures	Taken prior to litigation, usually when the account is between one and three months in arrears.
Medium-term measures	Introduced once litigation has commenced and may be applicable for cases with up to 12 months' repayment arrears.
Long-term measures	Attempts to restructure or reschedule the loan over a longer term.

28.2.1 Payment of arrears over a given period

The borrower may agree to clear the arrears by paying more than the monthly instalment for an agreed period, known as rescheduling. This may be possible, for example, when a period of unemployment is followed by the borrower taking a job at a salary level that can sustain the increased monthly payments.

Most lenders want to help borrowers but cannot do so indefinitely. It is, therefore, vitally important to:

- permit increased repayments only where they can genuinely be met and there is a real desire on the part of the borrower to address the problem;
- agree the increased payments to bring the account up to date within a reasonable period, based on what the borrower can afford. The FCA requires the situation to be reviewed every three to six months.

The lender can help the borrower to put their mortgage account back into order by working through their household income and outgoings in a thorough and logical way. Many experienced debt counsellors find that borrowers get into financial problems because they are unable or unwilling to take time to plan their budgets and they prioritise payments due to others first. Some lenders have budget factfind aids for use by debt counsellors, while others use outside specialists who are either independent and experienced practitioners or established firms working in this field.

If a plan to pay arrears over a given period is agreed, it should be fully documented for internal records and confirmed to the borrower in writing. If the arrangement is not maintained and court action is required, such documentation will be essential.

28.2.2 Full or partial suspension of monthly payments

Full or partial suspension of monthly payments is used mainly where:

- the mortgage is on a capital repayment basis, although it could be a viable short term measure for interest-only mortgages;
- there is already a reasonable amount of equity (and therefore security) in the property; and
- the lender believes that the borrower's personal and financial circumstances merit it.

It is essentially a short-term measure: the lender grants a payment 'holiday' or partial suspension of monthly payments. Arrears build up over the period of the 'holiday' or suspension, and the borrower must clear them within a set time after the end of the concessionary period.

The lender will need to be confident of the borrower's ability to service not only the normal monthly payments but also the future additional payments necessary to clear the backlog. If they have already fallen behind with the standard monthly payment, what changes to their income or spending habits need to be put in place to enable them to manage the additional payments at a later stage? If the reason for their having fallen behind relates to one-off circumstances beyond their control, which are not expected to recur, the lender may be inclined to be sympathetic – and more optimistic for the success of this option.

28.2.3 Accepting interest-only payments

If the loan is a capital and interest mortgage, the lender may be prepared to accept interest-only payments for a specified period. However, one problem with interest-only payments is that, in the early years of a capital and interest mortgage, most of the monthly repayment is made up of interest. The concession of removing the capital element might be worth very little.

A lender will need to weigh the benefits and drawbacks of this course of action: will the borrower gain any real benefit on a monthly basis if the capital element of the loan at this stage is only small? What are the prospects for making up the deferred capital payments at a later stage?

28.2.4 Extending the term

A repayment mortgage account can be put back on course by extending the term on a short-term or long-term basis. In the latter case, a customer with a ten-year mortgage term could extend it to 15 years to reduce the payments. This option is used with great care by lenders. The borrower must be genuinely committed to keeping the account on course, because it cannot be repeated time after time.

The term of an interest-only mortgage can be extended, but it will only result in additional interest over the term, as no capital is repaid. It is only of benefit if the repayment vehicle term can also be extended to reduce the monthly investment costs. With-profits endowment mortgages cannot usually have their term extended because they mature on a particular date. Other repayment vehicles, such as unit-linked endowments and ISAs, are more flexible and more likely to allow the holder to change payments or the term.

28.2.5 Capitalising the arrears

A lender may also agree to capitalise the arrears: a mortgage of £50,000 with £2,000 arrears (balance outstanding £52,000) might have the arrears effectively built into the loan, making it a loan of £52,000 with no arrears. However, they will be paying interest on the capitalised arrears for a long period, potentially the rest of the mortgage term.

Most lenders will regard capitalisation of arrears as a 'one-off' remedy, not usually to be repeated.

28.2.6 Surrendering a supporting investment and changing to a repayment mortgage

If the borrower's arrears are serious, and the mortgage is supported by an endowment policy that has been assigned to the lender, then the lender has the right to surrender and may well do so as a matter of course. If the policy has not been assigned, it cannot be surrendered unless the borrower is in agreement. Also, the assurance policy may have lapsed already if the borrower is in financial difficulties.

It is not good investment practice to surrender an endowment policy very early. Nearly all policies are geared to long-term capital growth and perform badly over short periods. Early surrender is a way of obtaining capital in a hurry – but in such cases, financial advice should always be sought.

A disadvantage of surrendering the policy is that the loan is converted to a capital repayment mortgage. Payments will increase and alternative life cover should be arranged because the life cover provided by the endowment will end.

Some life assurance companies prefer to allow borrowing against the surrender value of the policy rather than see the policy surrendered. Another option can be to sell the endowment policy in the secondary market. This option is limited to with-profits policies but is usually a better option financially than surrendering the policy. A number of specialist intermediaries can arrange the sale of second-hand endowment policies (or 'traded endowment policies'). The insurer must inform the policyholder about the availability of the second-hand market when an enquiry is made about surrendering a policy. The borrower should be encouraged to seek financial advice on this issue.

If an interest-only mortgage is supported by an ISA, the borrower has more flexibility, and the borrower could choose to take a lump sum from the ISA without penalty. Bear in mind that the lender has no legal or equitable rights over ISAs, and so cannot force the borrower to use them to pay off the arrears. If the ISA is used in this way, the borrower will need to either increase their future ISA investment to rebuild the capital, or switch to a repayment mortgage.

PENSION FREEDOM

'Pension freedom' now allows personal pension planholders to take as much cash as they want from their pension fund from the age of 55. This can be an attractive option for those in mortgage difficulty, but there are two key factors to consider:

- Only 25 per cent of the fund can be taken tax free, with any excess added to income for the year. This could result in a large (and unexpected) tax liability, which, in turn, could lead to less cash than expected.
- The planholder's income in retirement could be significantly reduced as a result of using the pension fund in this way. In addition, because they cannot take cash from their fund before the age of 55, they will have only limited time to rebuild their pension fund for retirement.

28.2.7 Trading down

If the borrower cannot manage the mortgage payments, another option may be to trade down to a cheaper property, assuming they have reasonable equity in their current property. Trading down will release equity to settle (or reduce) any arrears, and may also provide a deposit for a smaller property. Often, the lender will suspend litigation proceedings if there is a genuine attempt to sell the property with a view to buying a cheaper one.

28.2.8 Other issues

Before any of these options can be considered, the lender must encourage the borrower to take early action to discuss the specific problems relating to the mortgage. A lender might also consider allowing a customer to rent out a room in their home to generate more income, but care must be taken to ensure that a tenancy with rights of occupation is not created.

28.3 Implications of not repaying a mortgage at the end of the term

A mortgage is agreed on the basis that the borrower will repay the debt at, or by the end of, the agreed mortgage term. In the case of a repayment mortgage, as long as the borrower makes the required monthly payments on time, the mortgage will be repaid by the end of the term. With an interest-only mortgage this could be more problematic because an associated investment vehicle may not have produced the expected return, or the borrower may have adopted another repayment strategy that did not provide the expected capital, leaving them with a shortfall.

In the event of the borrower being unable to repay an interest-only mortgage at the end of the term, the lender has the legal right to demand repayment and seek possession. This is a drastic step and, in most cases, the lender will be prepared to discuss alternatives. The introduction of retirement interest-only mortgages (see section 26.10.1) should reduce the number of borrowers in this position. Those with sufficient income and equity will either be able to switch to a retirement interest-only mortgage with their existing lender or, if the lender does not offer such mortgages, they should be able to remortgage with another lender.

If there is a shortfall at the end of the term, there are a number of potential approaches, as outlined below.

28.3.1 Using other capital

If the borrower has savings or access to other capital, such as a pension scheme lump sum, the simplest solution would be to use the other capital to repay the mortgage. This does, of course, depend on what the other capital was intended to be used for and the full implications of diverting it.

28.3.2 Moving house

On the face of it, selling the property and moving to a cheaper property could be a simple and effective solution, and should result in the shortfall being settled relatively quickly. However, as we saw earlier, there are many reasons why moving or downsizing may not be desirable.

28.3.3 Extending the term

The lender may agree to extend the term of a repayment mortgage with the borrower continuing to make the same monthly payments as before, or perhaps increasing the payment to repay the mortgage as quickly as possible.

In the case of an interest-only mortgage, the lender may agree to extend the term on a repayment basis, with monthly payments calculated to repay the shortfall over an agreed term.

In both cases, it is important for the lender to ensure that the mortgage payments are affordable. If the extended term would take the borrower into retirement, it is important to check that their anticipated retirement income would be enough to support the mortgage.

The introduction of the retirement interest-only mortgage as a separate category of mortgage will present a realistic alternative for those struggling to repay an interest-only mortgage. Although intended to help borrowers in or near retirement, the retirement interest-only mortgage is categorised as an interest-only mortgage rather than a lifetime mortgage, with the addition of the sale of the property on the occurrence of certain specified life events to the list of acceptable repayment strategies.

This type of mortgage will meet the needs of some borrowers who may struggle to find the capital to repay their mortgage but do not want the perceived expense of rolling up interest over the longer term, as happens with a roll-up interest lifetime mortgage. As a retirement interest-only mortgage will be treated as a standard interest-only mortgage, the lender must assess affordability in the usual way, which may prevent some borrowers from taking this option.

28.3.4 Equity release

If the borrower is over 55, equity release may be a solution. Subject to the property value and the age of the borrower(s), it could be possible to clear the deficit through an equity release scheme, either taking the maximum available or through drawdown. Affordability would not be an issue because a standard equity release scheme would not require monthly repayments. However, as we saw in section 26.10, there are pros and cons to equity release, which would need to be considered along with the need to repay the original mortgage.

Hybrid lifetime mortgage schemes are helpful for borrowers who are close to the lender's minimum age for an interest roll-up scheme, but may wish to take advantage of roll up as they get older. The borrower makes interest-only payments initially but can switch to interest roll-up at any point after a specified age, perhaps 55. As the borrower has the right to switch to interest roll up in the future, the lender is not required to carry out an affordability assessment. Making interest payments obviously means the hybrid mortgage debt will not increase, and so it could buy the borrower time to accumulate money to settle the debt at some point. Alternatively, they could switch to an interest roll-up basis at some future point.

28.4 What state assistance is available to borrowers in arrears?

The government has for some years provided support through SMI for borrowers who have problems paying their mortgage and qualify for certain

state benefits. SMI was paid as a benefit to qualifying claimants until 5 April 2018.

SMI then changed to a system where payments are made in the form of a loan that must be repaid. We discussed SMI in depth in section 17.1.3.

CHECK YOUR UNDERSTANDING 1

What is the 52-week linking rule for SMI claims?

28.5 What sources of advice are available?

A range of bodies provide advice to those who run into difficulties with their mortgages. Citizens Advice, for instance, is available in most major towns and cities and can provide guidance to those who need help when they experience difficulties in paying their mortgage. The advice is free and advisers can usually explain the various options available. Citizens Advice is not able to provide financial 'advice', as defined by the FCA in relation to regulated products. It is standard practice for the borrower to be advised to contact the lender as early as possible before the problems escalate. In addition to providing guidance on short-, medium- and long-term arrears problems, Citizens Advice produces information packs on insolvency and bankruptcy.

TABLE 28.1 OTHER SOURCES OF ADVICE*

Name	Description
Money advice centres	Many local authorities provide free debt and benefit advice through money advice centres.
StepChange Debt Charity	A registered charity whose purpose is to assist people in financial difficulty by providing free, independent and realistic advice from trained advisers. The advice is offered through its free telephone advice line and eight centres in the UK.
Financial advisers	Although not free, the services of a good financial adviser can be of great assistance in sorting out debt problems.
Money and Pensions Service	A government-sponsored organisation that offers free and impartial money advice.

*As with Citizens Advice, charities and money advice centres are not authorised to give financial advice as defined by the FCA.

There are several other sources of assistance for borrowers in difficulty. Often, the local office of the Department for Work and Pensions should be the first contact point. Sometimes borrowers are not aware of the benefits they can claim or with whom they should consult.

Some local housing associations are also involved in schemes to assist those in financial difficulties. Several have introduced innovative measures, including schemes offered as mortgage rescue packages.

28.6 How do mortgage rescue schemes work?

Mortgage rescue schemes usually operate in one of two ways:

- An organisation buys the property from the borrower and then rents it back to them, allowing the borrower to remain in their home as a tenant.
- The borrower sells part of the property, leaving them in a shared ownership situation.

Some schemes allow the former owner to repurchase the property if their situation improves.

Schemes are sometimes run by private companies, on a profit-making basis. These schemes are seen as risky because the provider's main motive is profit, which may result in less sympathetic treatment for the borrower. Where the arrangement involves the company buying the property from the borrower and renting it back to them, there have been examples of such schemes increasing tenants' rents to unreasonable levels.

MORTGAGE RESCUE SCHEMES IN SCOTLAND

Mortgage-to-rent scheme

The Scottish Executive introduced the mortgage-to-rent scheme in 2003. Managed by Communities Scotland, the scheme protects homeowners by allowing them to switch tenure from ownership to Scottish secure tenancy. Owner-occupiers in mortgage difficulties can arrange for a social landlord – housing association or local authority, etc – to buy the home and can continue to live there as a tenant.

Mortgage-to-shared-equity scheme

The mortgage-to-shared-equity scheme is for Scottish homeowners who face increasing mortgage and general living costs that affect their ability to pay the mortgage, but who can still make some payment towards the mortgage.

The owner sells up to 30 per cent of the property to the government. The owner can buy the share back at a later date, or share the proceeds with the government when the property is sold. To be eligible for the scheme:

- the property must be the applicant's main home, and they must have at least 20 per cent equity in the property, based on a capital and repayment mortgage;
- the borrower must be at least three months in arrears and have tried, but not succeeded, to reach a repayment arrangement with the lender;
- the borrower cannot have more than £2,000 in savings (£4,000 for those over 60);
- the property must have a minimum value, which will be established by the local authorities, and meet a certain minimum standard of repair (ie be habitable);
- the borrower must seek advice from an independent money advice service and have agreement from the lender to go ahead with the arrangement.

28.7 What are the issues relating to use of a mortgage for debt consolidation?

Mortgages can provide viable options for those who have mounting debt problems. Consolidating debts into a mortgage has advantages, particularly because mortgage interest rates are generally well below those for other types of borrowing.

As we saw in section 8.4.1, borrowers who wish to consolidate debts into a mortgage cannot opt initially to proceed on an execution-only basis. They must be given suitable advice, but they can reject the advice given and then select a product on an execution-only basis.

CONSOLIDATING MORTGAGE AND DEBT

Ricardo and Tina have a mortgage of £80,000 on their house worth £150,000; the mortgage interest rate is 4.5 per cent and the mortgage has 15 years to run. They have debts of £10,000 on credit cards, with an interest rate of 16.9 per cent. The credit cards are costing them £140 a month in interest (this will reduce each month as some of the capital is repaid) and they have to pay

at least £200 a month (2 per cent of the balance); this is affecting their cash flow.

If they add the credit card debt to their mortgage by taking a further advance or remortgage, they will pay £37.50 a month on an interest-only basis, or £76 on a repayment basis, for the additional borrowing over the remainder of their existing mortgage term. This will save them a significant amount each month and ease their cash flow problem.

Consolidating debts in this way can seem an attractive proposition, but there are a number of points to consider.

- The debt being consolidated will now run for the rest of the mortgage term, rather than for around six or seven years, as would be the case if a borrower kept things as they are.
- The extended term is likely to mean paying more interest overall than would be paid by keeping the existing arrangements – a borrower needs to check comparative costs.
- The new mortgage will have to meet the lender's normal affordability and LTV criteria.
- A remortgage is likely to involve costs – potentially up to £500. These will have to be offset against potential savings in order to decide if the consolidation is viable.
- Moving to a new fixed rate or discount rate might save even more money. The borrower will have to assess whether any redemption penalties will impact on the strategy.
- Consolidating the debt will reduce the equity in the property – an important consideration if planning to move in future.
- The borrower might be well advised either to overpay the mortgage to clear the consolidated debt more quickly or to set aside some of the savings with a view to paying off some of the new debt early.
- Securing previously unsecured debts will reduce the equity in the property and increase the risk of repossession if the borrower defaults on the mortgage.
- Having consolidated the debt, a borrower must maintain discipline to avoid putting themselves in the same position a few years later.

If a customer has a mortgage with a drawdown facility, it may be possible to draw down the required funds, although, as a result of the tightening of MCOB rules on assessing affordability, the ability to draw down may be more restricted than before. Alternatively, if the customer has a flexible mortgage,

it may be possible to take a payment holiday and accumulate the money in this way, subject to meeting the criteria for such action.

28.7.1 Seeking advice

As we have seen in this topic, consolidating debt into a mortgage can be a viable option for many people. However, borrowers should think carefully before consolidating and, in most cases, should seek advice before making the decision.

In many cases, a borrower will consider consolidation to reduce their monthly outgoings. They may not have too many problems servicing their unsecured debts but may wish to increase their disposable income. In this case, an adviser should point out the potential disadvantages of consolidation and help the borrower to make an informed decision.

In some cases, the borrower may have significant debts that they are struggling to service, and may be considering an individual voluntary arrangement (IVA), whereby some of their debt is written off by their creditors. It is possible for a homeowner to enter into an IVA, but the IVA is likely to contain specific conditions regarding the property, referred to as an 'equity clause'. This requires the debtor to agree to remortgage their property at a specific point in the IVA, usually during the last year, to make a payment towards their unsettled debt. There are conditions for such an arrangement:

- On the date when the clause is about to take effect, the debtor's share of the equity in the property must be more than £5,000 (after remortgage costs) at the time of the remortgage, so on a jointly-owned property the equity must be at least £10,000. The clause cannot be activated if the equity share is £5,000 or less. If both owners are subject to the IVA then the clause will treat them as one borrower and the £5,000 equity threshold will apply.
- The required remortgage cannot be for more than 85 per cent of the property value.
- The difference between the original mortgage and the remortgage amount (less remortgaging costs) will be used to pay off some or all of the debt. The amount of equity required to be released will not exceed the unsettled debt.
- The increased mortgage cost must be affordable, cannot exceed 50 per cent of the 'normal' IVA payment and any increase in mortgage payments can be deducted from the monthly IVA payment.
- The costs of remortgaging can be deducted from the available amount.
- The remortgage term cannot extend beyond the later of state retirement age or the existing mortgage term.

If the borrower is unable to remortgage as required, the IVA supervisor has the discretion to:

- accept a third-party sum equivalent to what would have been received through a remortgage;
- extend the term of the IVA so that 12 additional monthly contributions are made, with the total amount paid limited to what has been received through a remortgage.

Clearly, the decision whether to enter into an IVA or voluntarily remortgage to clear debts is not simple. Borrowers would be advised to seek professional advice from a debt counsellor, a financial adviser offering debt counselling or charities such as Citizens Advice.

CHECK YOUR UNDERSTANDING 2

Earlier in your studies (Topics 2 and 10) we looked at the rules surrounding the treatment of vulnerable customers. Can you recall:

a) whether a customer seeking a mortgage to consolidate debts can opt for an execution-only sale?

b) the definition of a 'credit-impaired customer'?

DEBT CONSOLIDATION AND CREDIT-IMPAIRED CUSTOMERS

Where the purpose of the mortgage or further advance is to consolidate debts and the borrower is a 'credit-impaired' customer (see section 10.9), the lender must take extra care. If the increased mortgage would not be affordable unless the other debts were paid off, the lender must take 'reasonable steps' to ensure that the debts are repaid on completion of the mortgage transaction. Reasonable steps could include the lender paying off the debt on behalf of the customer. Alternatively, the lender can assume the debts would not be paid off and include ongoing payments as committed expenditure in the affordability assessment.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the responsibilities of the lender when dealing with customers in arrears?
- state what a lender must *not* do in such situations?
- outline the different options that a lender might consider to help the borrower get their account back in order?
- discuss the purpose of an IVA?
- explain what a borrower might need to consider before deciding to consolidate debt into a mortgage?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 28. Review the text if necessary.

Answers can be found at the end of this book.

1) Lenders are under no obligation to contact borrowers about mortgage arrears. True or false?

2) What must a lender do if it becomes clear that a borrower's mortgage account is in arrears?

3) For how long must a lender keep a record of its dealings with a borrower who is in arrears?

   a) One year from the date of the dealings.

   b) Three years from the date of the dealings.

   c) Five years from the date of the dealings.

   d) Until the end of the mortgage term.

4) Accepting interest-only payments is a way of helping capital repayment mortgage borrowers with a payment shortfall. True or false?

5) Gavin lost his job a few months ago and is now in arrears with his capital repayment mortgage payments. Although he is trying hard, he sees no prospect of finding a job in the foreseeable future. His lender has turned down his request to capitalise his arrears. Explain the lender's reason for turning down his request.

6) Extending the term in order to reduce mortgage repayments is not appropriate for low-cost endowment mortgages. True or false?

7) When George defaulted on his mortgage, the lender took possession of his flat and sold it to pay his outstanding mortgage, but the proceeds did not repay the whole debt. Within what period of time must the lender inform George of its intention to pursue him for the remaining shortfall?

   a) One year from the sale.

   b) Three years from the sale.

   c) Five years from the sale.

   d) Six years from the sale.

8) The costs of remortgaging during an IVA can be deducted from the available amount. True or false?

9) In mortgage and debt consolidation, the new mortgage does not have to meet the lender's normal affordability and LTV criteria. True or false?

10) Which of the following statements is true of mortgage rescue schemes?

    a) Schemes never allow the former owner to repurchase the property if their situation improves.

    b) Some schemes allow the former owner to repurchase the property if their situation improves.

    c) All schemes allow the former owner to repurchase the property if their situation improves.

Lenders' legal rights and remedies

LEARNING OBJECTIVES

In Topic 28 we looked at the responsibilities placed upon the lender when a borrower is in arrears; we emphasised that taking a property into possession must be a last resort. In this topic we look at the legal rights and remedies of lenders and insurers once efforts to address arrears have been exhausted. The legal code in England and Wales differs from that in Scotland.

By the end of this topic, you should have an understanding of the following:

- the lender's legal rights and the legal remedies available;
- procedures for taking possession;
- procedures for selling a property that has been taken into possession;
- the rights of the lender and the insurer where a mortgage indemnity guarantee is in place.

THINK . . .

It is likely that most of the content of this topic will be unfamiliar to you, although we did look at mortgage indemnity guarantees in Topic 15. Before you begin studying this topic, think about:

- what a lender might need to do once it has decided to take a property into possession;
- what it might need to consider in relation to selling the property.

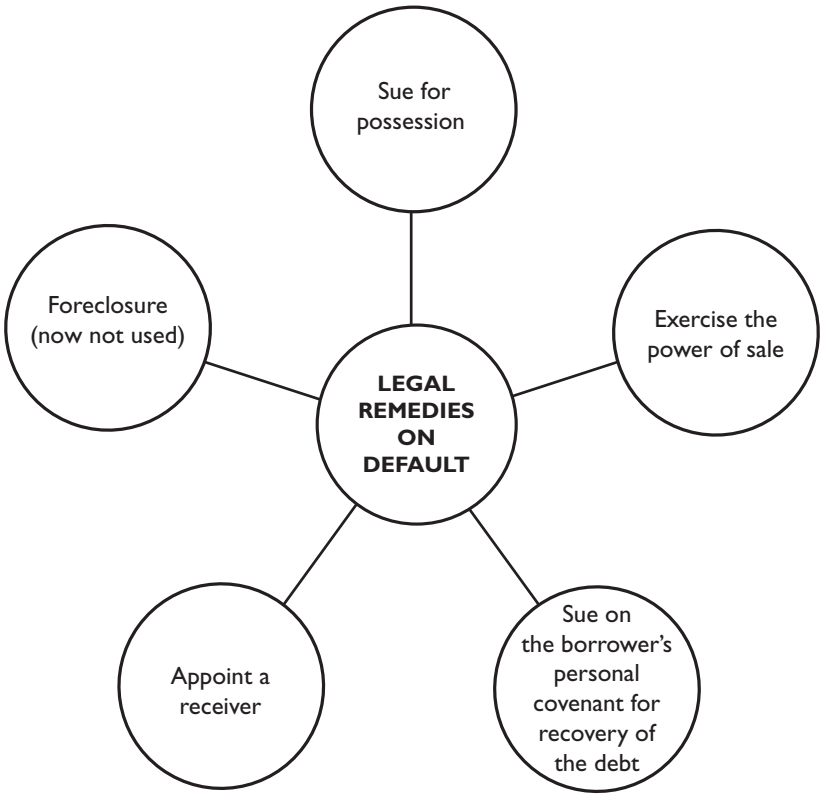
29.1 What legal remedies are available on default in England and Wales?

In England and Wales, legal remedies are laid down by the Law of Property Act 1925. Northern Ireland is not subject to the Law of Property Act, although it has adopted many of the concepts.

LEGAL REMEDIES

Actions laid down in law that a lender can take against a borrower in default.

FIGURE 29.1 WHAT ARE THE FIVE LEGAL REMEDIES?



29.1.1 The right to sue for possession and exercise the power of sale

The most commonly used legal remedies are where the lender sues the borrower for possession of the property and then sells the property in order to recover the debt.

To take possession, the lender must petition the county court for a possession order. Before the county court will consider granting such an order, it has to be satisfied that every other option has been explored by lender and borrower, and that possession is a very last resort. The county court has discretion to take one of three courses of action:

- Grant an **outright possession order**, enabling the lender to take possession, usually within 28 days.

- Grant a **suspended possession order**, imposing on the borrower an obligation to make payment in accordance with the court's decision. The suspended possession order becomes enforceable if the borrower fails to keep up the repayments. The court will have to grant a final possession order in this situation.
- **Adjourn or suspend the case** until a future date.

The lender must be well prepared for the court hearing, because it must present to the court full and itemised details of transactions including credits, debits and transfers. In addition, the lender must be seen to have done everything possible to help the borrower bring the account to order. If the lender is unable to demonstrate this, the court is likely to adjourn the case, or even dismiss it.

Once a possession order has been granted, the lender can proceed to take possession. The court will give a date on which this order is enforceable and, in the majority of cases, the borrower will vacate the property prior to the date of possession. If necessary, however, a court bailiff can enforce the possession order, usually accompanied by a representative of the lender. Even after the date of possession, the lender still owes a duty of care to the borrower and the borrower can still settle the full mortgage account, which includes the capital plus arrears, until the point at which the lender exchanges contracts with a new buyer.

Once the lender has sold the property it must pass on any surplus after the mortgage debt and any costs or fees incurred during the repossession and sale process.

29.1.2 The right to exercise the power of sale

The section of the Law of Property Act on exercising the power of sale has been under review for some years. While it allows lenders to sell a property in specified circumstances, it is rarely, if ever, used for residential property. It theoretically allows the lenders to sell the property in one of the following circumstances:

- the mortgage has not been repaid within three months of the lender serving notice to the borrower requiring full repayment of the loan;
- the borrower is more than two months in arrears;
- the borrower breaches another non-financial mortgage covenant.

If the lender exercises the power of sale, it must obtain a 'proper' price for the property, and must pay the borrower the balance of the proceeds after the outstanding mortgage, interest and arrears, sale costs and other secured loans have been settled.

29.1.3 The right to sue on the borrower's covenant

The right of the lender to sue the borrower on their personal covenant to repay the debt arises from the contractual obligations in the legal charge. Taking this action is often futile because, even if the court makes an award to the lender, the borrower may not have the resources to pay it. In the event of mortgage loss, the lender may take further action for recovery if it believes the borrower does have the financial means to make good the loss.

29.1.4 The right to appoint a receiver

The right to appoint a Law of Property Act (LPA) receiver is exercised when there is an income from the property. This happens, for example, when the property has tenants who are paying rent. The LPA receiver collects the rent and any other income from the property on behalf of the lender, and this money is applied to the mortgage account to reduce the overall debt.

An LPA receiver is deemed an agent of the borrower, and acts on their behalf in respect of disbursement of money received and duties of accountability. However, the lender appoints the receiver who, with a few exceptions, can be anybody, including the lender's employees.

If there is an unauthorised tenancy at the property, the lender must do nothing that could be considered as formally recognising that tenancy – this could unwittingly create an overriding interest for the tenant.

29.1.5 Foreclosure

The remedy of foreclosure is of historical importance only. Despite the word being used generically to mean pursuing recovery of a debt, a foreclosure order is never used in the UK today. A foreclosure order results in the borrower forfeiting all rights to the property. The lender is theoretically able to take possession, sell the security and retain any surplus. The borrower loses the right to redeem the mortgage after possession – this is now regarded as unfair.

The foreclosure procedure is extremely complicated: the petition must be made to the Chancery Division of the High Court of Justice and, in the case of joint borrowers, separate foreclosure orders must be sought.

29.2 What legal remedies are available in Scotland?

Under Scottish law, there are three legal remedies available to a lender when a borrower fails to maintain a mortgage. The lender's solicitor will serve the borrower with one of the following:

- a **calling-up notice**, which requires the whole debt to be repaid;

- a **notice of default**, which requires that the arrears be brought up to date or another breach of the mortgage conditions remedied (eg a failure to repair the property);
- a **court warrant** – the lender can apply to court to be given the right to exercise any available remedies, including carrying out necessary maintenance and selling the property to settle the debt.

These remedies are available under the Conveyancing and Feudal Reform (Scotland) Act 1970.

Failure by a borrower to comply with a calling-up notice or a notice of default enables the lending institution to proceed to possession and ultimate sale. If the borrower does not leave the property of their own accord, the lender must take court action to seek their ejection. The principles of possession and sale are similar to those applicable in England and Wales.

MORTGAGE RIGHTS (SCOTLAND) ACT 2001

This Act, which came into force on 3 December 2001, is also relevant. It provides increased protection to debtors and their families from lenders exercising remedies on default. The Act gives the debtor (and certain other parties including a cohabitee) the right to apply to the court for suspension of enforcement proceedings.

A suspension order may be granted in relation to enforcement proceedings where it is considered reasonable in the circumstances, with particular regard to:

- the nature of and reasons for the default;
- the applicant's ability to remedy the default within a reasonable period;
- any action taken by the creditor to assist the debtor to remedy the default; and
- the ability of the applicant and those residing with them to secure reasonable alternative accommodation.

The Act also provides for a notice to be issued to an occupier of the property. This allows a tenant the opportunity to give reasons for suspension of enforcement proceedings.

29.3 Possession procedures – England, Wales and Northern Ireland

Possession procedures are described in Figure 29.2. In the majority of cases, the property is vacated voluntarily – eviction is comparatively rare and a last resort. When it does occur, it sometimes attracts media coverage, which may be unfavourable to the lender.

Once vacant possession has been obtained, it is important to ensure that the borrower cannot regain entry to the property. Arrangements should be made immediately with a locksmith to change the locks of the property and secure all points of entry.

Before starting formal possession proceedings, the lender must follow the Ministry of Justice's Pre-Action Protocol for Possession Claims based on Mortgage or Home Purchase Plan Arrears in Respect of Residential Property. The protocol aims to:

- ensure the lender and borrower act fairly and reasonably in resolving any arrears-related matters;
- encourage greater pre-action contact to reach an agreement out of court, or, when an agreement cannot be reached, to enable efficient use of the court's time and resources;
- encourage lenders to check who occupies the property before starting possession proceedings.

The protocol applies to first- and second-charge residential mortgages, but not to buy-to-let mortgages, and a repossession claim should be the lender's last resort. When a borrower falls into arrears, the lender must provide them with specified information, including the total amount of arrears and sources of independent debt advice. It must complete a number of actions, including discussing with the borrower any proposals for settling the arrears.

If, after all reasonable attempts to resolve the problem have failed, the lender wishes to repossess the property, it must give 15 days' notice in writing of its intention.

The lender cannot instigate the possession process if the borrower can demonstrate that:

- a claim has been submitted for an SMI loan, for Universal Credit, for an MPPI policy or for help from a mortgage rescue scheme;
- there is a reasonable expectation of a payment from the DWP, an insurance policy, a local authority or a charity;
- they have financial or specific personal difficulties affecting affordability and so need time to seek independent debt advice;

- their financial circumstances should improve in the foreseeable future;
- they have made a legitimate complaint about the possession claim to the FOS; or
- they are taking active steps to market the property at an appropriate price and have given the lender specified information.

FIGURE 29.2 POSSESSION PROCEDURES – ENGLAND, WALES AND NORTHERN IRELAND

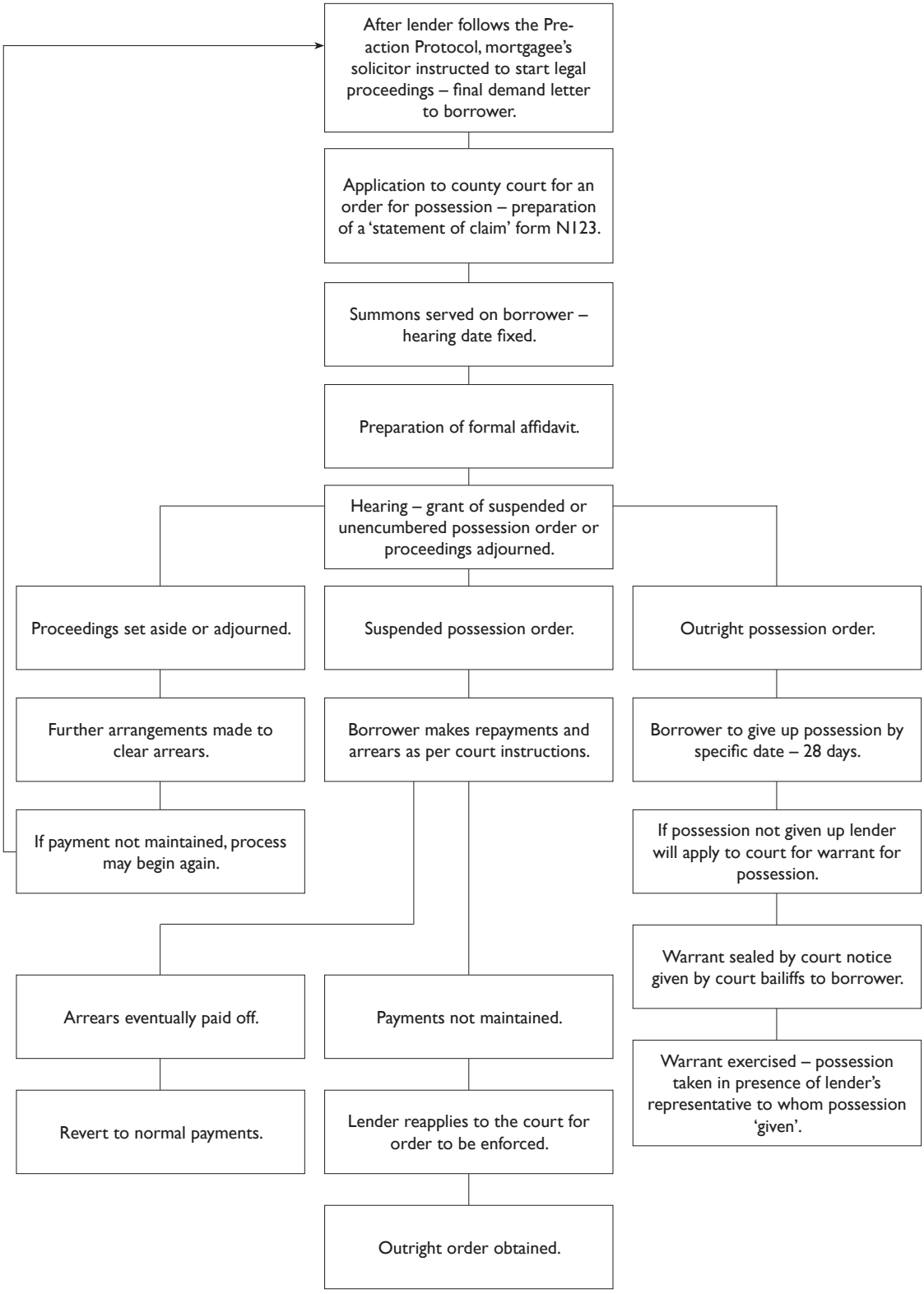


FIGURE 29.3 POSSESSION PROCEDURE – SCOTLAND

1. Calling up	• Service of calling-up notice requiring repayment of whole debt within two months • If repayment is not made, power of sale arises automatically
2. Notice of default	• Service of notice of default requires borrower to cease to be in default within one month • If not, the power of sale arises
3. Section 24 application	Application by creditor to court, stating that borrower is in default and seeking permission to sell. This is usually used when the borrower is insolvent.

OTHER CONSIDERATIONS WHEN TAKING POSSESSION

- Utilities such as water, gas, electricity and telephone must be disconnected, and gas and electricity meters must be read. The local water and sewerage authorities should be advised that the property is empty. The borrower is responsible for payment of services used before the readings were taken.
- Fixtures pass to the lender but any fittings left behind by the borrower are held in trust on their behalf. If the borrower reclaims them, the lender must take care not to readmit them to the property, or a new possession order may be required. The lender should list the items involved and document how it has dealt with them, eg by arranging removal and storage. A mortgagee in possession can be held liable if it can be established that it has been negligent towards the borrower's belongings.
- If the borrower's fittings are not claimed by a specified time, they may be disposed of, with any proceeds credited to the mortgage account.

29.4 Sale procedure and mortgagee obligations

Once a property has been taken into possession, the lender seeks to dispose of it as quickly as possible in order to repay the mortgage, so a valuation is necessary to set an appropriate selling price. Some lenders use asset management companies that specialise in managing and marketing repossessed properties. Other lenders rely on their internal resources.

In dealing with properties in possession, lenders have obligations to their former borrower. Legally, the borrower retains an 'equity of redemption' until the lender exchanges contracts with a new buyer. In addition, the lender has a duty of care to obtain the best price reasonably obtainable, although it does not have to look after and maintain the property indefinitely to obtain a higher price. In order to establish that this obligation has been fulfilled, many lenders in England and Wales will, having obtained an acceptable offer for the property, place an advertisement in a local newspaper seeking best and final offers by a particular date. The lender must have regard for the borrower and balance achieving the best price reasonably possible with the impact of delay on the borrower's position.

EQUITY OF REDEMPTION

The borrower's right to settle the mortgage debt in full at any time up to the point of sale. 'In full' means the settlement must include any arrears.

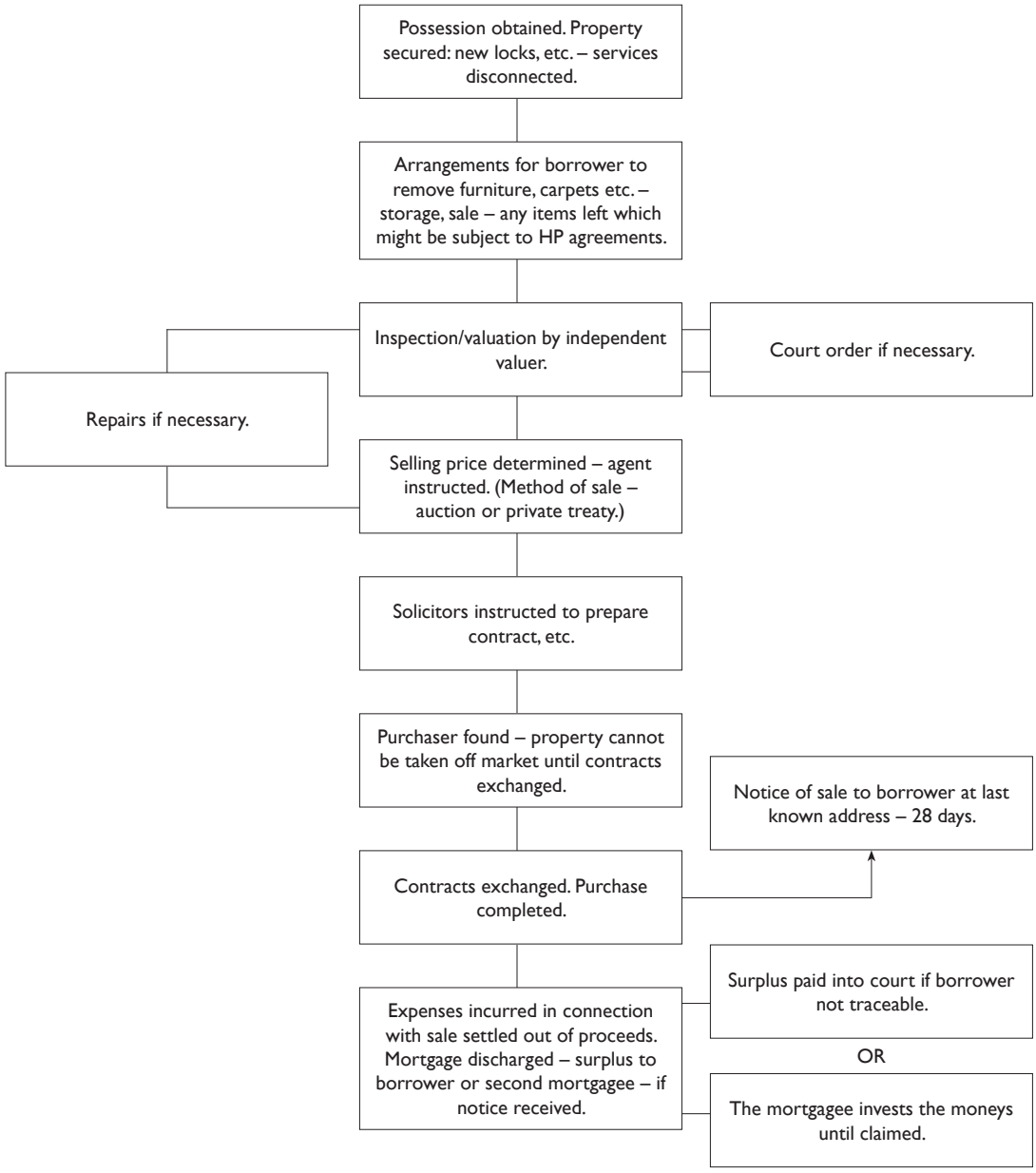
CASE LAW: MORTGAGEE OBLIGATIONS

In the 1944 court case of *Reliance Permanent Building Society v Harwood-Stamper*, it was held that the lender, while having an obligation to get the best price reasonably obtainable, cannot 'nurse the security' indefinitely. In the 1991 Scottish case of *Dick v Clydesdale Bank*, it was held that a lender, being in the position of a quasi-trustee for the seller when exercising a power of sale, is required to take account of the potential 'development value' of land when conducting the sale.

'NURSING' A PROPERTY

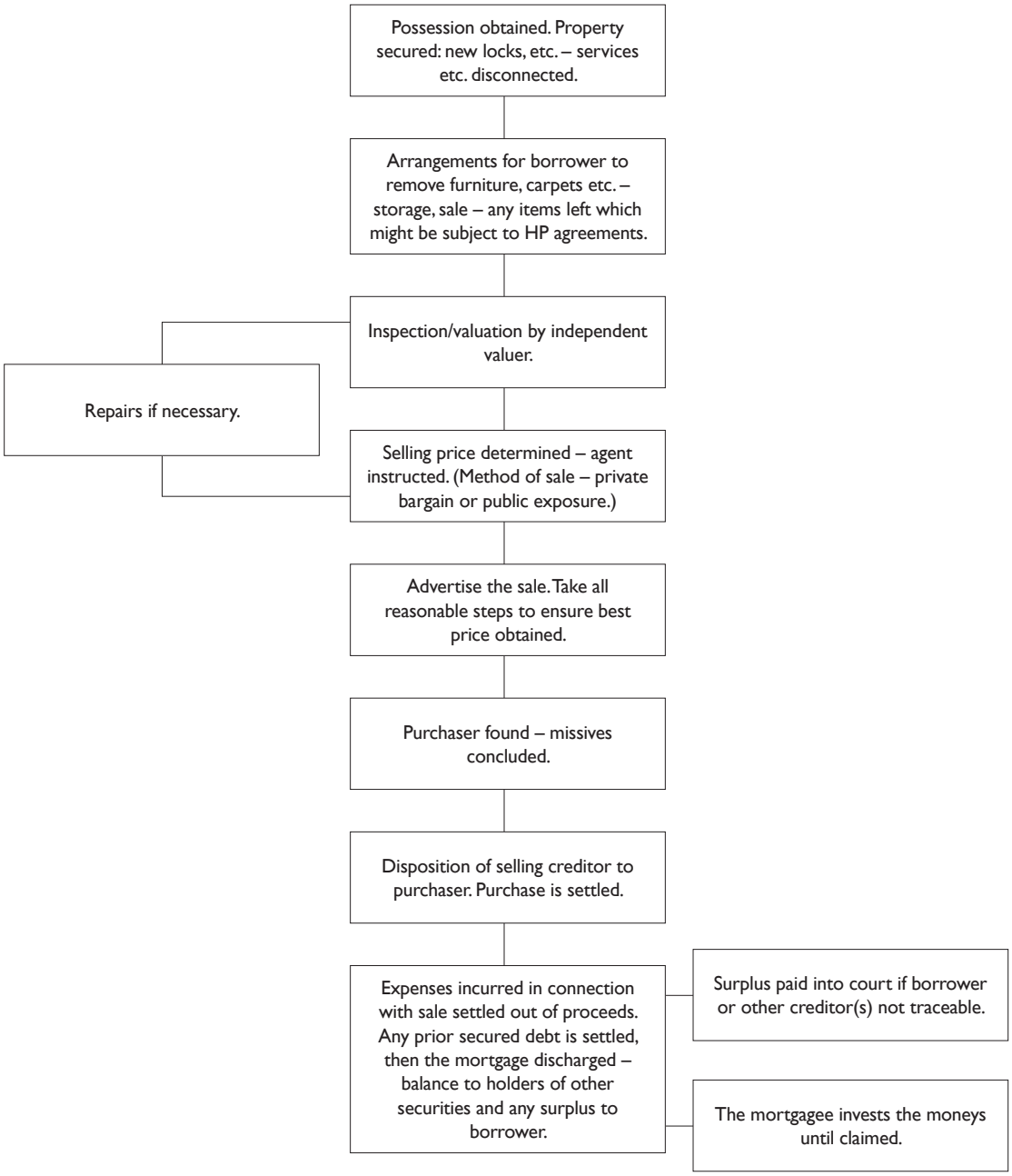
Setting a sale price and then not selling the property until an offer at or very near that price is received, regardless of the time taken to achieve it.

FIGURE 29.4 SALE PROCEDURE – ENGLAND, WALES AND NORTHERN IRELAND



If the sale proceeds are not enough to pay off the mortgage, the lender must inform the borrower of any shortfall in a durable medium. If it intends to pursue the borrower for payment of any shortfall, the lender has six years from the date of sale to notify the borrower of that intention.

FIGURE 29.5 SALE PROCEDURE – SCOTLAND



CONSIDERATIONS IN SCOTLAND

In Scotland, the debtor may redeem the mortgage at any time up to conclusion of missives of sale. In respect of disposal of the mortgaged property, the Conveyancing and Feudal Reform (Scotland) Act 1970 imposes a duty on the lender to advertise the property and to meet a specified minimum standard of advertising.

If the sale proceeds are not enough to pay off the mortgage, the lender must inform the borrower of any shortfall in a durable medium. If it intends to pursue the borrower for payment of any shortfall, the lender has five years from the date of sale to notify the borrower of that intention.

LENDER BEWARE!

Some lenders consider auction as well as private treaty to ensure that the highest price possible is obtained for the property. If a lender sells a property and fails to obtain an appropriate selling price due to error or omission from the sale particulars, it can be sued for damages by the former borrower.

In a 1971 case, one lender had to pay in excess of £10,000 damages to the former borrower because the sale particulars omitted any reference to the existence of planning permission for the property, which would have substantially increased the potential selling price.

Recent court cases have emphasised the need for lenders to take great care in this area. In one case, a county court judged that a higher potential purchase price could be obtained by allowing the borrowers to remain in the property, provided that there was a serious effort to bring the property to market and eventual sale. In another case, a borrower was able to establish in court that the lender was taking too long bringing the property to market and that the mortgage debt was accumulating faster than necessary.

29.5 What is the procedure on default where a MIG is in place?

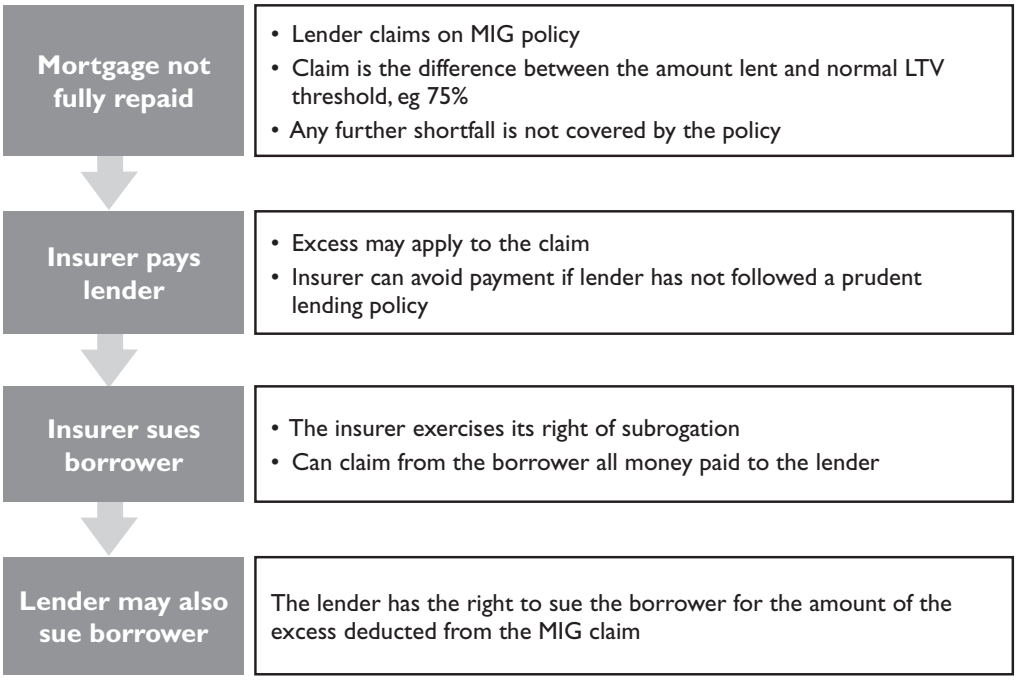
CHECK YOUR UNDERSTANDING

We looked at subrogation earlier, but it would be useful to refresh your memory here. Can you recall:

a) what is meant by the term 'subrogation'?

b) the type of fee that is often used by a lender to purchase a mortgage indemnity guarantee (MIG)?

FIGURE 29.6 PROCEDURE ON DEFAULT WHERE A MIG IS IN PLACE



MCOB 13 covers the situation where the proceeds of sale are less than the amount due under the mortgage contract or home purchase plan. The borrower must be provided with certain information as soon as possible after the sale in a durable medium. They must be informed of the shortfall and whether another company, such as a mortgage indemnity guarantee insurer, may pursue them for the shortfall.

If the lender, insurer or another party decides to pursue the borrower for the shortfall, it must notify the borrower within six years (five years in Scotland).

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the legal remedies available on default?
- outline the stages in the possession procedure prior to the court hearing, and the range of different potential outcomes?
- outline the sale process once a property has been taken into possession?
- explain how the borrower might be affected if they default on a loan on which the lender has taken out a mortgage indemnity guarantee?

Go back over any points you don't understand and make notes to help you revise. Then test your knowledge.

Test your knowledge

?

Use these questions to assess your learning for Topic 29. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following legal remedies is **not** used in the UK today?

   a) Exercising the power of sale.

   b) Suing on the borrower's personal covenant.

   c) Appointing a receiver.

   d) Foreclosure.

2) Appointing an LPA receiver is a legal remedy available where a property is let to tenants. True or false?

3) Once a possession order has been granted, the lender can usually take possession within:

   a) 7 days.

   b) 14 days.

   c) 28 days.

   d) 60 days.

4) Once a property has been taken into possession, the borrower has the right to regain possession by:

   a) paying off the arrears, up to the point at which the lender exchanges contracts with a new buyer.

   b) paying off the full mortgage debt, up to the point at which the lender markets the property for sale.

   c) paying off the full mortgage debt, up to the point at which the lender exchanges contracts with a new buyer.

   d) paying off the full mortgage debt, up to the point of completion of the sale to a new buyer.

5) A suspended possession order automatically becomes an outright possession order if the borrower fails to keep up the agreed repayments. True or false?

6) Lenders have a legal obligation to sell a property taken into possession for at least the amount of the mortgage. True or false?

7) Once a lender has taken possession of a property, it can delay a sale until it feels it will get the highest possible price. True or false?

8) The right of subrogation enables insurers to sue borrowers for any amount paid out on a mortgage indemnity guarantee policy. True or false?

Answers to knowledge and understanding questions

Topic 1

✓ CHECK YOUR UNDERSTANDING

1) Liquidity is the ease and speed at which an asset can be converted to cash without a significant loss of value.

2) The Monetary Policy Committee (MPC) of the Bank of England sets Bank rate at a level that the Committee believes will enable the government's inflation target to be met.

3) Capital adequacy requirements are designed to ensure that a business holds sufficient reserves of capital to be sustainable. Regulations broadly state that, should a business run into difficulties, the business must have sufficient capital to make it very unlikely that deposits will be placed at risk. Capital in this context is often referred to as the own funds of a business, ie those obtained from shareholders and related sources, as distinct from funds deposited by customers.

? TEST YOUR KNOWLEDGE

1) Recession; reluctance of sellers to put properties on the market or buyers to commit to purchases at a time of falling or static property prices; financial institutions concentrating on building up reserves rather than lending; tighter affordability criteria making it more difficult for people to obtain mortgages.

2) A combination of more stringent affordability criteria, a requirement for larger deposits and rising property prices.

3) They are likely to increase: people feel confident that they can afford to borrow more, which drives demand and, in turn, leads to rising prices.

4) Three-month Libor.

5) False: the level of government borrowing does have an influence on interest rates. When government borrowing increases, interest rates generally increase.

6) False: inflation usually increases when interest rates are reduced.

7) c) Building societies must devote a minimum of 75 per cent of their total lending activities to residential mortgages.

8) Securitised lending involves bundling together a number of mortgage loans and selling them to another business. The seller receives a capital sum that they can use to offer further mortgage loans. The buyer receives the regular income stream from borrowers' repayments on the bundled mortgages.

9) True: sub-prime lending is lending to those with poor credit histories.

10) False. A sub-prime customer is not necessarily a customer who cannot afford a mortgage loan or a bad risk for the lender. Additional assessment is needed to confirm affordability and the interest rate can be set at a level that reflects any additional risk to the lender.

Topic 2

✓ CHECK YOUR UNDERSTANDING

1) c) Elena and Rita are both jointly and severally liable for the whole amount of the loan, not just their 'share' of it.

2) A limited company is a separate legal entity (or body) from its directors and shareholders, and is able to borrow in its own right. Shareholders receive income in the form of dividends, so in terms of taxation they are entitled to the dividend allowance as well as the personal allowance. Neither directors nor shareholders are directly responsible for the company's debts. If the company were to be wound up and could not settle its debts, a shareholder could lose any money they had invested in shares but they could not be pursued for more.

? TEST YOUR KNOWLEDGE

1) b) Helena and Cath initially, but ultimately Cath for the whole amount because they have joint and several liability for the loan.

2) To purchase a family home, to arrange additional finance on a second-charge basis or to provide bridging finance.

3) That the trustees have authority to borrow for the proposed transaction under the terms of the trust deed.

4) False. A partnership is not a separate legal entity. Assets and liabilities are jointly owned by the partners.

5) Yes. Even though the further advance is for business purposes it would be secured on the family home, so it would be regulated, as long as at least 40 per cent of the land is used as the main residence.

6) No – the properties are regulated under the Mortgage Credit Directive Order 2015.

7) False – an undischarged bankrupt can own property, although the trustee in bankruptcy may take it to pay their debts. An undischarged bankrupt cannot acquire an interest in property, which means they cannot buy property while undischarged.

8) a) 5 May next year – his bankruptcy lasts for 12 months from the date he was declared bankrupt.

9) True.

10) Only if the EPA is registered with the Office of the Public Guardian; an EPA must be registered when the donor loses mental capacity.

Topic 3

✓ CHECK YOUR UNDERSTANDING

1) The holder of a second charge is likely to apply a higher rate of interest than the holder of a first charge. Although the loan is secured against the asset, in the event of default they will only be repaid if there is any money left over once the holder of the first charge has been repaid in full. Therefore they are running a greater risk and will expect a higher return.

2) As the MCD is an EU Directive, it is binding in terms of the outcome that must be achieved and the date for implementation but member states have discretion to determine for themselves the most appropriate way to achieve the outcome. A regulation, on the other hand, is applied in all member states, exactly as it is laid down – there is no scope for flexibility.

3) Refer back to section 2.2.2.

4) A corporate mortgage is a loan to a limited company, whether secured on residential or commercial premises.

5) In both cases the owners would be regarded as 'accidental landlords', and any new mortgage they arranged on the property would be regulated as a CBTL mortgage.

? TEST YOUR KNOWLEDGE

1) Yes. Second-charge mortgages that would have been subject to MCOB had they been taken out after 21 March 2016 fall within the MCOB regime.

2) No. The mortgage would not be regulated, because less than 40 per cent of the land is to be used as a dwelling.

3) Second-charge lending.

4) False, for two reasons: a) the CBTL regime applies only to mortgages arranged on or after 21 March 2016; b) a mortgage is only a CBTL mortgage if the borrower is an 'accidental landlord', ie is not involved in a property-letting business.

5) c) A lifetime mortgage.

6) £150,000 would form part of Andy's estate. He entered 50 per cent of the property into the plan, which means the provider would be entitled to 50 per cent of the proceeds of the sale, regardless of how much Andy received when the plan started.

7) b) Training and competence.

8) False. Regulated mortgages are regulated under MCOB, not the consumer credit legislation.

9) True. George wants to use a personal loan, rather than a further advance on his mortgage, to fund his home improvements, so the loan is subject to consumer credit legislation rather than MCOB. There is no upper limit on the amount of the loan covered by the legislation as the loan is not for business purposes.

10) b) The Consumer Protection (Amendment) Regulations 2014.

Topic 4

✓ CHECK YOUR UNDERSTANDING

1) Refer back to UK Financial Regulation if necessary.

? TEST YOUR KNOWLEDGE

1) True: the borrower is known as the mortgagor, the lender is the mortgagee.

2) a) Estate in fee simple absolute in possession.

3) False: a legal charge is known in Scotland as a standard security.

4) False. A further loan from the original lender is known as a 'further advance'.

5) c) The order of priority for repayment reflects the date order in which the charges were registered, with the earliest-dated charge repaid first.

6) b) Pleasant Building Society as holder of the first charge registered would receive £140,000 but Consolidated Loans would only receive £20,000, this being the amount left over from the proceeds of the sale once Pleasant Building Society has been repaid in full.

7) False: the survivor becomes the sole legal owner, but must hold their deceased co-owner's part in trust for the deceased's beneficiaries.

8) c) Tenancy in common would allow each of them to leave the value of their share to their children.

9) A flat with only 20 years remaining on the lease might have to be sold far below the going market rate for similar properties; it would be preferable to negotiate an extension to the lease before trying to sell the flat.

10) False. A building need only contain a minimum of two flats in order for the leaseholders to have the right to buy the freehold.

Topic 5

✓ CHECK YOUR UNDERSTANDING

1) Land Registration Act, Land Charges Act, Law of Property Act.

? TEST YOUR KNOWLEDGE

1) c) Charges register.

2) b) Possessory – Karen is the registered owner, but because she did not have the title deeds or other proof of title, there is a possibility that someone else has a claim on the property. Therefore she cannot be granted absolute title.

3) a) Ten years.

4) False: rights over unregistered land are registered with the Land Charges Registry.

5) The legal transfer becomes void. Title reverts to the previous owner, who holds it on trust for the new owner.

6) True.

7) d) Restrictive covenant.

8) True: vendors are deemed to covenant their right to sell whether or not they sell with full title guarantee.

9) False: the owner will have a liability for repairs to the chancel, which is a specific part of the church. The liability may be shared with other property owners.

10) c) To insure the property and charge the premiums to the mortgage account.

Topic 6

✓ CHECK YOUR UNDERSTANDING

1) Requirements for a binding contract are: there must be offer and acceptance; there must be consideration; parties must have capacity to contract and the intention to create a legal relationship; contract terms must be certain, complete and free from doubt; it cannot be made for illegal and immoral purposes; there must be no misrepresentation, duress or undue influence involved.

   The principal is the body that instructs the agent to act on their behalf.

2) There were many cases of insurance companies declining seemingly valid claims because the policyholder failed to disclose information about previous illnesses or medical consultations, even though the 'fact' would have had no bearing on the reason for the claim, and the majority of application forms relied on the applicant to determine, remember and list all such relevant information. This was made worse by the fact that many insurers reduced the level of pre-application underwriting and effectively asked medical underwriting questions when a claim was made, at which point problems could arise.

3) a) SDLT is paid by the buyer.

   b) It is levied in bands, with different portions of the purchase price being taxed at different rates.

   c) For multiple properties purchased in a single transaction, SDLT is charged on the average value of each property, rather than on the overall total.

4) The Consumer Protection (Amendment) Regulations 2014.

? TEST YOUR KNOWLEDGE

1) True: the buyer's consideration is the money for the purchase; the vendor's is the property to be purchased.

2) c) Ratification.

3) The commission each agent charges is likely to be higher than if they had sole agency.

4) b) The estate agent is liable for exaggerated claims about a property contained in the estate agent's particulars.

5) c) The EPC must be commissioned, but not necessarily received, before the property is marketed. It is the responsibility of the vendor to ensure this is done.

6) False. There are a number of situations in which the lender may withdraw the mortgage offer, including dishonesty on the part of the applicant, a material change in their circumstances such that the lender is not satisfied that the mortgage is still affordable for them, material defects in the condition of the property or defects in the title.

7) d) The buyer was responsible for arranging buildings insurance from the point at which contracts were exchanged.

8) True. Technically, either party can drop out from a purchase prior to the completion date, but the buyer would lose their deposit if they were to withdraw after exchanging contracts and either party might be sued by the other for breach of contract.

9) b) The valuation would have taken place in order to arrange a mortgage, which should be agreed before exchange of contracts.

10) A successful bid is binding; 10 per cent deposit is paid at the auction and contracts are exchanged the same day. There is no time to change your mind. Finance – mortgage or cash – must be in place prior to the bid. The survey and preliminary legal work must be completed before the auction. This can all be money wasted if the bid is not successful. If the bid is successful and James pulls out later, the vendor can keep the deposit and claim any shortfall from James if a subsequent sale achieves a lower price.

Topic 7

✓ CHECK YOUR UNDERSTANDING

1) a) i) The property register.

   ii) The charges register.

   iii) The proprietorship register.

   b) Absolute title.

2) Such action would be a breach of contract and would lead to loss of the deposit and possible court action against either party for breach of contract.

? TEST YOUR KNOWLEDGE

1) b) Professional indemnity insurance.

2) If the title is defective in any way the lender might not be able to exercise its rights over the property and thus the mortgage loan might not be fully secured.

3) False. They would be shown in enquiries of the local authority.

4) A vendor who is an undischarged bankrupt would not be entitled to receive the proceeds of the sale, as their assets are controlled by an insolvency practitioner.

5) The seller's property information form.

6) b) A wardrobe would be classified as a fitting if it was a free-standing one (but not if it was built in).

7) c) The amount of the mortgage loan is a matter only for the buyer so would not be included in the sale contract.

8) c) The vendor completes a 'seller's property information form' before exchange of contracts.

9) b) From completion as this is the point where the ownership of the property changes hands.

10) True.

Topic 8

✓ CHECK YOUR UNDERSTANDING

1) Solicited contact is made by the firm at the request of the customer. Unsolicited contact is initiated by the firm; unsolicited telephone contact is known as a 'cold call'.

2) a) The FCA defines an HNW customer as one with a minimum annual net income of £300,000, or minimum net assets of £3m.

3) a) At least a year. b) Knowledge of the product or service to be arranged. c) Understanding the risks involved in the proposed arrangements.

4) b) The sole purpose of the loan, remortgage or further advance is to raise additional money for the use of a small business.

5) a) Richard because he would be classified as a professional customer. Shannon must be given advice because she is exercising a statutory right to buy. Niall is potentially a vulnerable customer as a result of his recent bereavement and the adviser would need to assess Niall's circumstances sensitively.

? TEST YOUR KNOWLEDGE

1) a) is correct. b) is untrue, in that calls can be made at an unsocial hour if the customer had previously agreed, c) is untrue, in that a call can be made on an unlisted number if the customer has agreed beforehand, d) is untrue, in that being on a mailing list is not the same as being an existing customer.

2) b) 12 months.

3) c) Three years.

4) True.

5) False. The adviser must not recommend any product if there are none in the range offered that meet the client's needs and circumstances.

6) b) 51 per cent.

7) a) Five business days.

8) False. An offer of advance can be provisional, but once all due diligence has been completed the final offer for an MCD regulated mortgage is binding.

9) MCOB 6A sets out a requirement for a seven-day reflection period once a binding offer is made for an MCD regulated mortgage but as Chen is applying to vary the terms of an existing MCD regulated mortgage, neither the requirement for a binding offer nor the seven-day reflection period apply.

10) False. This information must be provided before the first payment is made on a new mortgage, a further advance or a variation to the terms of a mortgage.

Topic 9

✓ CHECK YOUR UNDERSTANDING

1) Unlimited, limited range or single lender. If no suitable product is available from the range available to the adviser, no recommendation should be made.

2) The key characteristics of the product; the effect the product would have on the customer; the scope of service, fees payable and remuneration if the advice is given by an intermediary.

3) a) Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.

   b) Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.

   c) Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.

   d) Where consumers receive advice, the advice is suitable and takes account of their circumstances.

e) Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.

f) Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

? TEST YOUR KNOWLEDGE

1) d) the recommendation should be suitable for the customer's needs.

2) b) The adviser is most likely to ask about retirement plans to help them suggest an appropriate term for the mortgage, since many lenders are reluctant to agree to borrowing that will not be repaid before the customer retires.

3) Information about future expectations of earnings might influence the type of product that the adviser would recommend (for example, a low-start mortgage might be suitable for a trainee in a job with a recognised career path and expectation of a higher salary on qualification).

4) The adviser needs to know the customer's needs, circumstance, objectives and attitude to risk.

5) There are no rules relating to fair treatment of customers. However, guidance is provided in the regulatory guide The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD) and in the 'six outcomes' for consumers.

6) Principle 6: a firm must pay due regard to the interest of its customers, and treat them fairly.

Topic 10

✓ CHECK YOUR UNDERSTANDING

1) a) Gross profit is turnover minus the cost of basic materials to enable him to work on a day-to-day basis – paint, filler, wallpaper, brushes, etc.

b) Net profit is the gross profit minus routine business expenses, such as motor expenses (petrol, repairs and insurance); postage and stationery; telephone charges, etc.

2) A dividend is a portion of the profits of the company, paid to its shareholders. The level of dividend received depends on the amount of profit made by the company. In the case of small company where directors own the majority of shares, they can decide what dividends to pay. Dividends are paid without deduction of income tax at source and UK taxpayers have a

dividend allowance on which no income tax is payable. If dividend income in excess of the allowance is received, the tax is calculated after calculating the tax due on earned income and savings interest.

3) Self-certification involved the applicant declaring their own income and no evidence was sought to verify their claim. The rules now prohibit this and insist that evidence of income must be obtained from a source independent of the customer.

? TEST YOUR KNOWLEDGE

1) False. A lender cannot discriminate on grounds of race or nationality but it can impose different terms on a borrower who is living outside the UK, or decide not to lend at all, because of the increased difficulty of pursing the borrower in the event that they default on the repayments.

2) No – lenders are allowed to give initial assessments based on income multiples. If Sam were to go ahead and make a mortgage application the lender would be required to carry out a full and detailed assessment of her income and that of her partner.

3) True: variable sales-related income is usually averaged over three or five years.

4) False. All businesses must maintain accurate accounts but a detailed breakdown of expenditure is only required on a tax return if the business turnover is above the VAT registration threshold.

5) c) Affordability checks cannot be waived for additional borrowing unless it is for essential repairs or maintenance.

6) b) A water bill is basic essential expenditure.

7) a) Personal loan repayments are committed expenditure and the lender needs to use Karen's actual figures rather than representative data.

8) No, this suggestion would not help Andreas, as self-certified mortgages are no longer available.

9) Rebecca and Rachel would have free disposable income of £1,000 per month. Their chosen product is fixed for five years, which means the lender does not have to consider the impact of future interest rate rises.

   £1,000 ÷ £5.90 = £169.49, so £1,000 would support a mortgage of £169,490.

10) c) Documents that evidence the rationale for decisions should be retained in either hard copy or electronic format for the length of the mortgage contract.

Topic 11

✓ CHECK YOUR UNDERSTANDING

1) a) A creditor must be owed a minimum of £5,000 to petition for bankruptcy against an individual in England, Wales and Northern Ireland.

   b) A bankruptcy order remains in force for 12 months, and those who have been declared bankrupt in the past may be subject to a longer discharge period, if the court feels it is appropriate.

   c) An undischarged bankrupt cannot apply for loans of more than £500, either alone or jointly with any other person, without disclosing the bankruptcy. Because an undischarged bankrupt cannot acquire an interest in land, they cannot secure a mortgage.

2) We saw in Topic 2 that, legally, there is nothing to prevent an individual with an existing IVA from borrowing, but lenders may be unwilling to consider an application.

3) No answer required.

4) a) Concealing criminal property; arranging (ie enabling someone else to acquire, retain, use or control criminal property); acquiring, using or possessing property that the individual knows or suspects to be the proceeds of criminal activity.

   b) Failure to disclose suspicions of money laundering to the authorities, and tipping off, ie alerting the suspect to the fact that they are under suspicion.

   c) A group of UK trade associations that aims to foster good practice in countering money laundering, primarily through the provision of guidance notes.

? TEST YOUR KNOWLEDGE

1) b) Income received in the form of cash is not generally recorded on financial statements.

2) a) Ranbir, because he has a record of managing credit well. Joleena has no credit history on which to base a credit score, while Barry's multiple credit cards indicate difficulty in managing his finances, as do Debbie's payday loan applications.

3) True.

4) d) A person suffering from a mental illness may be regarded as lacking the capacity to contract and therefore any guarantee they give may be invalid.

5) False. An attachment of earnings order can only be made in relation to an employee, as it requires the employer to deduct money from the individual's pay and send it to the court for onward payment to the creditor.

6) c) It requires the Land Registry to note the trustee's interest in the property and notify the trustee of any dealings relating to it.

7) False. Misrepresentation or making false statements are crimes under the Fraud Act 2006, regardless of the outcome.

8) False.

9) All of the options given could potentially be regarded as fraudulent attempts to obtain a mortgage.

10) At least five years from the end of the relationship with the customer.

Topic 12

✓ CHECK YOUR UNDERSTANDING

1) The cost of increasing the period of the debt; whether it is appropriate to secure a previously unsecured loan; and whether, if the customer has known payment difficulties, it would be better for them to negotiate an arrangement with their creditors.

2) How affordable the repayments will be once the customer is dependent on pension income. For customers nearing retirement the adviser may need to see a pension statement; for younger borrowers it may be enough to confirm that they have some pension provision. A prudent approach must be taken.

3) a) Five years from the start of the mortgage, unless the mortgage is on a fixed rate for at least five years or the mortgage term is less than five years.

   b) The rate in place when the mortgage started.

? TEST YOUR KNOWLEDGE

1) True.

2) False. It is very likely that John will retire before the end of the mortgage term, so the lender will need to consider whether his income in retirement would support the payments.

3) A short mortgage term means that monthly repayments will be higher if he has a capital-and-interest mortgage. If he opts for an interest-only mortgage, he will have to make larger payments into a repayment vehicle than if he chose a longer term, and his choice of repayment vehicle may be limited (for instance, limits on savings into an ISA might rule that out as an option).

4) False. Interest-only mortgages carry the risk that the repayment strategy may not provide enough funds to repay the mortgage, and there are other risks, such as interest-rate risk, to consider.

5) c) Providing the value of the other property is equal to or greater than the sum needed to pay off the loan, this is most likely to be considered a credible repayment strategy. Using a pension commencement lump sum (PCLS) might also be a credible approach but only if the pension pot is large enough to provide a PCLS equivalent to the loan. Relying on an inheritance or a substantial increase in the value of the property are both too uncertain.

6) a) At least once during the term.

Topic 13

✓ CHECK YOUR UNDERSTANDING

1)

Absolute	Clear title is established – the most secure form.
Good leasehold	Applies in connection with leases longer than seven years. The leasehold is good but the right of the lessor (freeholder) themselves to grant title may not be guaranteed.
Possessory	The owner is registered as the owner but is not protected from a claim by another person that they owned the land before it was registered.
Adverse possession (unregistered land)	Applies if land has been occupied for 12 years without challenge from the legal owner – at this point the occupier may apply for possessory title.
Adverse possession (registered land)	Applies where the land has been occupied for 10 years without objection from the registered owner.
Qualified	Title subject to defect in registration. Very rare.

2) a) Easements give others certain rights over the property. Covenants impose obligations upon the owner or restrict what the owner can do.

b) A flying freehold is a part of a freehold property that extends above or below another person's property but is not next to or touching the ground. It can be a problem, because the owner of the land may fail to maintain their property, which could result in damage to the property with the flying freehold.

3) Buyers of leasehold properties buy the right to lease the property for a number of years, at the end of which the property reverts to the freeholder. In effect, leaseholders pay a large sum for the right to rent the property for a specified term.

? TEST YOUR KNOWLEDGE

1) c) It may be difficult to establish liability for commonly owned parts of the structure. The freehold is owned outright – it does not have to be renewed. The market is limited only in the sense that it may be difficult to obtain a mortgage. There is no reason specific to freehold flats why an owner may only be able to acquire possessory title.

2) d) An owner must have held a lease for at least two years before they acquire the statutory right to apply to extend it.

3) False – the premium increases as the unexpired lease term reduces, because extending the lease adds more value the nearer it gets to expiry.

4) d) 20 years – the difference between the value with the current short lease and the extended lease would be the most significant of the options. Option a) would have no marriage value, because the current lease still has 90 years to run.

5) There are a number of reasons why a lender might be reluctant to offer a mortgage – a key one is that there might be a limited market for such a property and therefore it might be difficult for the lender to sell should it ever need to repossess it. Another issue is the construction method and materials used; these might require investigation to ensure that it is structurally sound and there are no expensive maintenance requirements, which would affect its value.

6) False. Mundic blocks, although most common in the south-west of England, were used in construction work elsewhere in the country.

7) True. Lenders are not usually keen to lend on multi-use property, such as flats above shops and restaurants.

8) a) A brick-built, detached freehold Victorian property is likely to be most attractive to a lender. A history of mining subsidence would be of concern to a lender. The value of flats tends to be less than that of houses, and leasehold tenure can be more problematic than freehold, although the location would be an important factor.

9) c) and d) are correct.

10) False – the net yield includes running costs but not mortgage payments.

Topic 14

✓ CHECK YOUR UNDERSTANDING

1) a) It would be prudent for Cheryl and Dave to invest in a building survey or HomeBuyer Report: their property is quite old and is potentially built on London clay, hence there might be structural issues.

   b) Katya's house is probably still covered by a new-build guarantee; if this is the case, she could opt for a basic valuation.

   c) Dan and Greg's cottage is old and of non-standard construction – a building survey would be a sensible option.

   d) Iqbal's house is relatively new but is probably no longer covered by a guarantee scheme – as he is on a tight budget he could opt for a basic valuation or a Condition Report.

   An adviser should not recommend any particular survey to a customer, as they might be held liable if the property is later found to have defects that a different type of survey might have uncovered.

? TEST YOUR KNOWLEDGE

1) False: a basic valuation is for the benefit of the lender but it is paid for by the borrower.

2) b) Building survey.

3) True: the insurance value is often different from both the value for lending purposes and the selling price.

4) b) Issues that need urgent attention.

5) True: the HomeBuyer Report will also report on the state of beams, rafters, etc, and any sign of dry or wet rot, etc.

6) False: it would depend on whether the movement was progressive. Historical structural movement is not necessarily a reason for not proceeding.

7) b) The lender is likely to impose a retention if structural repairs are required.

8) d) The lender is most likely to require an undertaking from Karen.

9) False: this guarantee exists only if the builder is covered by the NHBC or a similar insurance-backed scheme.

10) c) Ben is entitled to claim under the Buildmark insurance scheme if the cost of the work is above the minimum claim value. The builder is only held directly responsible for making repairs within the first two years.

Topic 15

? TEST YOUR KNOWLEDGE

1) d) A barn conversion.

2) c) A detached garage with a floor area of $20m^2$.

3) False: there is a strong chance that local authorities will not grant retrospective planning consent. Taking down an 'illegal' extension can reduce a property's value, so lenders require confirmation that all the relevant permissions have been obtained.

4) True: as long as the building is not increased in size, converting a garage internally will not usually require planning consent.

5) False: the scheme continues for the length of the contract, regardless of a change of ownership of the property.

6) True.

7) True: as the value of Glen's share in the buy-to-let flat is below £40,000, it would not be treated as a 'major interest' which means the surcharge would not apply.

8) a) Solicitor's fees.

9) c) Yes. Remember that on buy-to-let and second homes, the nil-rate band only applies to purchases below £40,000. On properties costing £40,000 and above, SDLT is payable at 3 per cent over and above the standard rate applying to the purchase price.

10) True, but he cannot also use multiple property relief.

Topic 16

✓ CHECK YOUR UNDERSTANDING

1) a) Term insurance. The need is to provide cover for a defined term, and there is no need to build up a cash value in the plan; this makes some form of term insurance the answer. The exception is an endowment mortgage, where the plan has dual objectives – to pay off the mortgage in the event of death and to provide a lump sum to pay off the mortgage at the end of the term.

   b) There is no technical reason why whole-of-life assurance could not be used to protect a mortgage. However, there are practical reasons why it is not normally used:

   - It provides whole-of-life cover so is effectively open-ended, while a mortgage has a defined term. Due to its open-ended nature,

whole-of-life assurance is more expensive than term insurance – the insurer's risk is far harder to define.

- Whole-of-life plans usually build up a cash value, which can be released on early surrender. While this may seem attractive, it adds to the cost of the policy, and is not an essential element for mortgage protection.

? TEST YOUR KNOWLEDGE

1) b) Younger couple with children.
2) c) Middle-aged couple, children have left home.
3) a) Young, single person.
4) b) Product complexity.
5) a) The survivor might end up with the whole mortgage while owning only half the value of the property if it was registered as tenants in common.
6) False. A simple way to calculate the shortfall is described in question 8.
7) IHT.
8) b) The difference between the amount of protection that would be needed if the risk event happened, and the amount of protection the client currently has.
9) False. Although the mortgage offer may recommend life cover, it is up to the mortgagor to arrange it.
10) a) Protection of dependants from the effects of loss of income in the event of premature death.

Topic 17

✓ CHECK YOUR UNDERSTANDING

1)

Feature	Convertible term	Whole-of-life	Level term	Decreasing term
Limited term	✓		✓	✓
Can be investment-linked		✓		
Conversion to whole-of-life or endowment	✓			
Level sum assured	✓	✓ (usually)	✓	
Sum assured decreases in line with mortgage				✓
Order of cost (*lowest first – rank from 1 to 4*)	3	4	2	1

? TEST YOUR KNOWLEDGE

1) Universal Credit.

2) True.

3) b) SMI is paid as a loan.

4) b) Decreasing term assurance.

5) a) The new sum assured cannot exceed the original sum assured.

6) c) d) e) Stroke resulting in permanent symptoms, heart attack of specified severity, and most forms of cancer.

7) False.

8) c) HIV not resulting from a blood transfusion, an assault or a work accident.

9) False.

10) Retirement.

Topic 18

✓ CHECK YOUR UNDERSTANDING

1) The ABI provides four model wording definitions for total and permanent disability.
2) Buildings cover should be arranged by the buyer from the date on which contracts are exchanged – the buyer is theoretically responsible for the building from that date.
3) (150,000 x 15,000) ÷ 180,000 = £12,500 less the excess = £12,000.
4) No, the insurer cannot withdraw IPI cover based on claims experience. This is a major difference between ASU and IPI: the latter provides permanent cover.

? TEST YOUR KNOWLEDGE

1) c) f) g) Damage to computers and TVs, replacement of locks and keys, and theft of the insured's money from another building.
2) b) Unfurnished.
3) b) The lender may choose to pay the outstanding premiums and add the payments to the mortgage loan.
4) a) The landlord's contents only.
5) True.
6) c) An ASU redundancy claim is likely to be excluded if the applicant had reason to believe the redundancy was imminent when they took out the policy.
7) b) PPI can be arranged to protect both mortgage borrowers for double the amount quoted to protect one.
8) False.
9) a) Separation benefit.
10) b) MPPI usually allows more than one claim to be made if premiums are maintained.

Topic 19

✓ CHECK YOUR UNDERSTANDING

1) A deferred period during which nothing is payable.

2) ICOBS 6 covers the duty to give a customer appropriate information to make an informed choice.

? TEST YOUR KNOWLEDGE

1) False. Pure protection products contain no investment element.
2) a) A proportion of the person's current disposable income.
3) c) Universal.
4) False.
5) c) Under ICOBS 5, a firm must inform the customer if it finds that parts of the cover do not apply.
6) a) Refuse all claims but return the premiums.
7) b) Fair representation.
8) ICOBS 5.
9) True.
10) b) KFD.

Topic 20

✓ CHECK YOUR UNDERSTANDING

1) Term assurance pays out only if the life assured dies during the policy term. There is no investment element so there is no cash value or surrender value. Decreasing term assurance is designed to provide cover that reduces in line with a decreasing debt eg a capital repayment mortgage.
2) a) A low-cost with-profit endowment comprises two elements: with-profits and decreasing term assurance. The sum assured under the with-profits element is not large enough to cover the full cost of repaying the mortgage initially; it builds up as bonuses are added. The difference between the size of the mortgage to be repaid and the value of the policy is made up by a decreasing term assurance, so that there is always enough cover to repay the loan should the policyholder die before the end of the mortgage term. As the value of the with-profits element increases, the level cover provided by the term assurance decreases.

   b) With a unit-linked endowment, the premiums are used to buy units in an investment fund. The objective is to ensure that the value of the units increases to provide a sum at least large enough to pay off the mortgage.

? TEST YOUR KNOWLEDGE

1) True. The proportion of capital repaid gradually increases as the term of a capital repayment mortgage progresses.

2) False. Repayment mortgages simply repay the borrowed capital over the term.

3) Annual interest paid = £150,000 ÷ 100 x 3 = £4,500

   Monthly interest paid = £4,500 ÷ 12 = £375

   Monthly repayment less monthly interest = £711 – £375

   Monthly capital repayment = £336

   Annual capital repayment = £336 x 12 = £4,032

4) b) The increase in the interest rate means that more of Greg's monthly repayment than originally planned will be used up paying interest. The capital will reduce more slowly and so the mortgage term will have to increase to pay off the full loan.

5) False. The availability of funds to repay the mortgage depends entirely on the performance of the investments chosen as the repayment vehicle or sufficient funds being available from other sources.

6) c) A potential inheritance is not regarded as a credible repayment strategy.

7) False. Retirement interest-only mortgages are pure interest-only mortgages and do not require a repayment vehicle.

8) False. The daily rest calculation of interest benefits early payers, because their total interest is reduced.

9) b) The capital owed would have increased on 1 January this year.

10) d) Early repayment charges.

Topic 21

✓ CHECK YOUR UNDERSTANDING

1) a) The term 'qualifying policy' relates to its tax treatment. There is no tax payable on the proceeds of such a policy on death or maturity.

   b) Premiums must be payable annually, half-yearly, quarterly or monthly for at least ten years. If premiums cease within ten years, or three-quarters of the original term if this is less than ten years, the policy becomes non-qualifying. Sum payable on death must be at least equal to 75 per cent of the total premiums payable. Premiums in any one year must not exceed twice the premiums in any other year, or one-eighth of the total premiums payable.

2) No. They must consult a qualified financial adviser. Many mortgage advisers are not financial advisers and therefore cannot advise on investments.

? TEST YOUR KNOWLEDGE

1) a) Reversionary bonuses cannot be removed but may be reduced if the policy is surrendered early.

2) 'Smoothing' refers to the building up of a reserve when fund performance is good, with the aim of ensuring that when fund performance is poor it is still possible to pay some level of bonus, ie it reduces the potential variation in the level of bonus paid across a number of years.

3) True. A low-cost endowment guarantees to repay the mortgage on the death of the borrower through the automatic inclusion of sufficient life cover.

4) False. It is the low-start low-cost with-profits endowment that has reduced premiums for the first five years.

5) The unit-linked endowment does not have a GSA at maturity. The maturity value is the bid value of the units, which may or may not be enough to repay the mortgage. With-profits plans have a GSA, although in the case of the low-cost version it will not be as much as the mortgage.

   The unit-linked endowment is flexible, in that the premiums and sum assured can be changed (within limits). The with-profit endowment sum assured and premium are fixed at the start and cannot be changed.

   The unit-linked endowment allows the investor to select from a range of funds, while the with-profit endowment offers only the with-profits fund.

   In the event of early encashment, the unit-linked plan will pay the bid value of units. There will sometimes be a surrender penalty in the early years, as stated in the policy terms. The with-profits plan's early surrender value is worked out by actuaries and is unlikely to represent the plan's value at the time or include the bonuses added to date. The company might also impose a market value adjustment.

   The charges on a unit-linked endowment are 'transparent' – that is, clearly stated in the policy terms. Other than a policy administration fee, the charges on a with-profit fund are taken from the fund and are worked out by the actuaries.

6) True: most unit-linked policies can be extended to compensate for a shortfall, subject to qualifying rules.

7) c) Managed (also known as balanced) funds are most commonly used in relation to investments intended for mortgage repayment.

8) True: converting a mortgage to repayment is the safest method of ensuring a full repayment, although it may be expensive.

Topic 22

✓ CHECK YOUR UNDERSTANDING

1) Refer back to your earlier studies if necessary.

2) Refer back to your earlier studies if necessary.

3) With a defined-benefit scheme, the benefit the employee receives under the scheme is defined at the outset, either as a percentage of final salary or as a proportion of the individual's earnings averaged over the length of time for which they have worked for the employer.

   With a defined-contribution scheme, agreed contributions are made but the benefit that the individual ultimately receives is dependent on the performance of the investments into which the contributions are paid.

? TEST YOUR KNOWLEDGE

1) False. ISAs can be in single names only – but joint borrowers can have one each.

2) In principle this is true, but if the manager offers a 'portfolio' ISA it may be possible to contribute to both, subject to overall cash and Help to Buy limits.

3) True.

4) b) £1,150

5) c) It is possible to take the maximum tax-free cash and delay taking an income until later.

6) False. The maximum Tanya can pay in and gain tax relief is £27,500, but her employer could pay a further £12,500 to top up her contributions to the £40,000 annual allowance.

7) a) An ISA can accept irregular payments and can be cashed in at any time. A with-profits endowment cannot accept ad-hoc payments and is not designed to be cashed in early. A pension cannot be accessed until age 55 at the earliest. A unit trust would be a good alternative, but the tax benefits of an ISA make it more suitable.

8) a) £125,000 (£500, 000 x 25%).

Topic 23

✓ CHECK YOUR UNDERSTANDING

1) When interest is calculated on a daily rest basis, it is charged on the balance outstanding at the beginning of each day. It is of real benefit to people who are able to make overpayments regularly, since the reduction in their balance is recognised almost immediately in the interest charged.

2)

Standard variable rate	Simple structure but exposes borrower to risk of interest-rate rises, making budgeting difficult
Discounted rate	Borrower pays less than SVR for a given period but interest rate can still fluctuate
Tracker	Interest rate moves up and down in line with Bank rate or 3-month Libor rate
Fixed rate	Gives borrower certainty in terms of monthly repayment required but means they cannot benefit from reductions in interest rates until the end of the agreed period
Capped rate	Suits borrowers who want to make sure their payments will not exceed a certain level but also want to benefit from reductions in interest rates
Flexible	Allows borrower to make overpayments, or take a repayment holiday or make underpayments if they have previously made overpayments and thus are ahead of the anticipated repayment schedule
Offset	Can be a good option for a borrower with significant savings and no plans to withdraw them

? TEST YOUR KNOWLEDGE

1) False: discounted-rate mortgages offer a discount from the lender's SVR, so the interest rate will move up or down in line with the SVR.
2) True: discount mortgages usually do have an early repayment charge.
3) d) There may be application and early repayment fees.
4) c) Variable monthly costs.
5) True: the benefit of the daily interest calculation is that any early payments or overpayments immediately reduce the interest charged.

6) Will and Grace can draw down a further £46,000, which will take them up to the 80 per cent limit. The lender will need to make sure they can afford the increased payments if they do take extra funds.

7) Bob and Luka should seriously consider taking their financial adviser's advice. If they move the £20,000 into the offset account, they will pay mortgage interest on £100,000. This will save them £67 a month in interest (initially and increasing each month). This outweighs the loss of £33 per month gross on savings.

8) False: a fixed-rate mortgage usually reverts to the lender's standard variable rate at the end of the fixed-rate term.

9) False: not all capped-rate mortgages have a collar.

10) b) Cashback is not subject to tax and could be a fixed amount or a percentage of the mortgage.

Topic 24

✓ CHECK YOUR UNDERSTANDING

1) a) A guarantor is someone who takes legal responsibility for repaying a loan if the individual who took out the loan is unable to do so.

   b) A guarantee can be given on a full liability basis – the guarantor undertakes the responsibility for the whole debt. Alternatively, it can be given on a limited liability basis – the guarantor undertakes responsibility for the additional borrowing over and above the amount the lender would make available without the added security of the guarantee.

2) a) An SPV is a limited company.

   b) The SPV owns the property. Individuals own shares in the SPV but do not own the property directly and are not normally liable for any debts incurred by the SPV.

3) A second charge is a loan secured on a property by a lender other than the first mortgagee; such loans are typically offered by banks and finance houses. Second-charge lending is regulated under MCOB rules.

? TEST YOUR KNOWLEDGE

1) True.

2) b) Application and/or product fees tend to be higher.

3) b) The guarantor must be able to afford their own commitments as well as the guarantor mortgage.

4) True.

5) a) The bank buys the property initially.

6) False: self-build mortgages usually provide funds for up to 75 per cent of the land cost.

7) d) The landlord could claim for actual expenses incurred in replacing or repairing furnishings but cannot claim an allowance under the general description of wear and tear.

8) b) The SPV will be able to claim mortgage interest as a business expense in full.

9) True. Stamp duty is payable on the transfer of shares within an SPV, but there is no liability to stamp duty land tax because the property itself does not change hands.

10) a) Corporation tax – capital gains made by an SPV are treated as trading receipts.

Topic 25

✓ CHECK YOUR UNDERSTANDING

1) A 'regulated mortgage contract' is one where the mortgage is through a first legal charge on land in the EEA, and at least 40 per cent of the land will be used as a dwelling.

? TEST YOUR KNOWLEDGE

1) a) Shared-ownership properties are bought on a leasehold basis, not freehold.

2) False: a loan on which part is repayable at zero or a very low rate of interest is a feature of the equity-share mortgage.

3) False: rent paid on a portion of the property is a feature of a shared-ownership mortgage.

4) b) The buyer must provide a deposit of at least 5 per cent of the full purchase price.

5) They are using the Help to Buy shared ownership scheme.

6) False: 70 per cent is the maximum discount for a house or a flat.

7) Gary and Ayesha have been tenants for six years, which gives them a discount of 52 per cent, subject to the maximum monetary cap.

8) Moira and Ken meet the criteria for lifetime mortgages and home reversion plans schemes. They want to leave as much of their estate as possible to their family, so a home reversion plan would not be ideal, because they would be giving up the value of all (or part of) the house. A lifetime mortgage will allow them to leave the remaining equity to their heirs, and by taking a

drawdown plan they can take money as and when they wish while keeping the compounding effect of interest roll-up to a relative minimum. As long as house prices increase at a reasonable rate, they would have a good chance of leaving a substantial part of the property to their heirs.

9) False: the lifetime mortgage minimum age is usually between 55 and 60, while the minimum age for a reversion plan is at least 65.

10) True.

Topic 26

✓ CHECK YOUR UNDERSTANDING

1) The balance is passed to the borrower.

2) Bridging finance might be required when a borrower wishes to move house but has not managed to sell their existing house, or the funds from the sale will not be available before completion of the new purchase is due. The finance is designed to 'bridge' the funding gap on a temporary basis.

3) Refer to Topic 25 if necessary.

? TEST YOUR KNOWLEDGE

1) c) The existing mortgage must usually have been in place for at least six months.

2) The lender would require the completion of a consent to mortgage form by Karen's partner and her son. Alternatively, they might become parties to the mortgage, assuming joint and several liability for payment; this would require a variation of the mortgage deed.

3) True.

4) b) The lender must provide the borrower with an ESIS based on the further advance only.

5) a) The order of priority for legal charges on registered property is established by the date of the charge's registration at the Land Registry.

6) False. A second charge does not require a deed of postponement.

7) c) The lender does *not* have to provide a suitability report for a second-charge loan.

8) True. The new lender will wish to receive any surplus after the first mortgage has been paid off on possession and sale.

9) Dmitri would need open bridging finance as he does not have a prospective buyer for his previous home and therefore does not know how long the finance might be required.

10) False. With a lifetime mortgage the planholder retains ownership of the property.

Topic 27

✓ CHECK YOUR UNDERSTANDING

1) No, providing the customer is not requesting an increase in borrowing greater than the cost of any application fees, unless it is to fund essential repairs or maintenance to the property.

? TEST YOUR KNOWLEDGE

1) c) Her current lender will not need to carry out a full affordability assessment, providing she is not increasing her borrowing other than to cover application fees or to pay for essential repairs or maintenance.

2) c) The facility to transfer a mortgage product to a new property during the term of a special deal, without incurring charges, is called portability.

3) False: transfer of equity is the addition or removal of a borrower from the mortgage deed.

4) False: contract terms can only be changed with the consent of both parties.

5) True: removing a borrower from the deed may result in a fundamental change in the remaining borrower's ability to pay the mortgage.

6) Alan and Ann are not obliged to make any changes to their endowment policy but as the policy is designed to repay the mortgage, and Ann is now solely responsible for the mortgage, it would be appropriate to transfer the policy to Ann.

7) Yes. Changes to terms and conditions may affect the likelihood of a guarantee being called in and the guarantor must therefore agree to any such changes.

8) False: SDLT is only payable if the total of any consideration plus the share of any mortgage taken on by the new owner exceeds the nil-rate band. When one person is removed from ownership as a result of a court order or agreement between the partners in a divorce, judicial separation or dissolution of a civil partnership, the transfer will be exempt from SDLT.

9) d) Vacation is the technical term in England and Wales for the release from obligation when the mortgage is repaid ('discharge' in Scotland).

10) 'A clog on the equity of redemption' is a condition that, in the opinion of the courts, has been imposed deliberately to prevent or discourage a borrower from paying back a loan. In such cases, the court can set aside the condition, thereby allowing the borrower to make early redemption.

Topic 28

✓ CHECK YOUR UNDERSTANDING

1) Under the 52-week linking rule, a borrower who has already served the waiting period for SMI and then ceases to claim payments for up to 52 weeks will not have to serve a further waiting period at the start of the second claim.

2) a) Under MCOB 4.8A.7, a customer seeking a mortgage to consolidate debts cannot opt for an execution-only sale. They would be defined as a 'vulnerable' customer and any mortgage must be arranged on an advised basis unless they reject the advice and recommendation.

   c) A 'credit impaired' customer is one who:

   - within the last two years has owed the equivalent of three months' payments on a mortgage or other loan, unless late payment was the result of errors by a bank or other third party; or
   - within the last three years has had one or more county court judgments, totalling more than £500; or
   - has had an IVA or bankruptcy order in force within the last three years.

? TEST YOUR KNOWLEDGE

1) False: a lender must contact a borrower within 15 business days of becoming aware of arrears.

2) A lender must write to a borrower within 15 business days of it becoming aware of the account being in arrears. The letter must contain:

   - a Money Advice Service information sheet;
   - a list of due payments either missed or paid in part;
   - the total of the shortfall;
   - the total outstanding debt, excluding charges that may be made on redemption;
   - an indication of the nature and level (if possible) of charges likely to be incurred unless the shortfall is cleared.

3) b) A lender must keep a record of its dealings with a borrower who is in arrears for three years from the date of the dealings.

4) True: making interest-only payments will reduce the monthly payment, although it should only be seen as a temporary measure.

5) Capitalising the arrears adds the arrears to the mortgage, thereby increasing the debt and the payments due. As Gavin cannot afford the current payments, he will not be able to afford the higher payments, which will start almost immediately. He may be better asking to pay interest only for an agreed period.

6) True: the term of with-profit endowments cannot normally be extended.

7) d) If a lender decides to recover a shortfall, it must notify the borrower of its intention within six years of sale.

8) True: the remortgaging costs during an IVA can be deducted from the available amount.

9) False: in mortgage and debt consolidation, the new mortgage must meet the lender's normal affordability and LTV criteria.

10) b) Some mortgage rescue schemes allow the former owner to repurchase the property if their situation improves.

Topic 29

✓ CHECK YOUR UNDERSTANDING

1) a) Subrogation is the right of the insurer to sue the borrower for repayment of any money paid out to the lender in the event of a successful claim on a mortgage indemnity guarantee (MIG) policy.

   b) The fee is a higher lending charge, although in some cases MIGs are arranged by the lender without charge to the borrower. Note that where the lender levies such a fee but does not arrange a MIG, the principle of subrogation does not apply.

? TEST YOUR KNOWLEDGE

1) d) Foreclosure.

2) True: the LPA receiver collects and applies rental income to the mortgage account to ensure that the mortgage payments are maintained.

3) c) 28 days.

4) c) The borrower has the right to regain possession by paying off the full mortgage debt, up to the point at which the lender exchanges contracts with a new buyer.

5) False: a suspended possession order, if enforced, requires that the borrower make payment. If they do not, the lender can return to court to seek possession.

6) False: the lender must sell a repossessed property at the best price reasonably obtainable.

7) False: the lender cannot 'nurse' the property to get the best price. It must sell as quickly as possible for the best available price.

8) True: the right of subrogation has been tested in the courts and confirmed.

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