Contractors applying for buy-to-let mortgages facing tougher lending conditions

Contractors looking for buy-to-let mortgage deals look set to face much tougher lending conditions, with more demanding affordability and 'stress' tests being introduced by lenders.

"Lenders have already started adopting the recommendations of a recent Bank of England Prudential Regulation Authority (PRA) consultation that are designed to improve underwriting standards for buy-to-let mortgages," explains Taj Kang, Contractor Mortgages Made Easy (CMME) mortgages expert.

"The consultation's proposals are just that – proposals and not legislation. But some lenders have already made changes to stay ahead of the market and prevent the PRA from imposing the recommendations as legislation. This means contractors applying for buy-to-let mortgages may find it harder to secure lending, requiring a larger deposit."

What changes are buy-to-let mortgage lenders introducing?

According to Kang, there are three changes proposed by the consultation that will impact on contractors:

Affordability tests will become tougher

Stress testing of 'rental coverage' should be based on much more volatile interest rate scenarios

Contractors with four or more properties become classed as portfolio landlords, and face even more stringent stress checks

He explains: "What most lenders have done since the credit crunch is to ensure the borrower has a 20% margin of rental income over the mortgage payment, which is what's known as 'rental coverage'. This provides a buffer if there are rental voids when the contractor has no tenants, or if interest rates increase over a short period of time.

"The Bank of England's concern is that interest rates are incredibly low at the moment, and that the existing practices are only workable in what is essentially an incredibly favourable and potentially short lived mortgage interest environment."

The recommendation is that the rental coverage test should be more robust with a higher percentage than 20% and should be based on a stressed interest rate. The PRA also recommends that the affordability should take into account the actual income of the buyer.

Interest rates and portfolio landlords

Most lenders currently calculate the rental coverage based on interest rates available at the time. What the PRA would like to see is one or all of the following:

The interest rate used to calculate rental cover should be based on market expectations over the next five years

A minimum increase of 2% in the interest rates used for the calculation

Any other guidance or ad hoc policy from the PRA's Financial Policy Committee.

A minimum stressed interest rate of 5.5%.

"The final recommendation is specifically aimed at landlords with four or more buy-to-let properties," continues Kang. "The PRA now classifies these landlords as 'portfolio landlords', and recommends that even tougher checks are applied to be sure there is sufficient income and a plan in place to cover interest rate shocks and rental voids."

This last measure is particularly tough on contractors with larger property portfolios, as they will be expected to run their portfolio like a business but get none of the perks: "All mortgage lenders have to keep a certain amount of capital in reserve – a capital requirement.

"Because the Government wants to increase lending to small to medium sized enterprises (SMEs), there is a special exemption for business lending that reduces capital requirements. Buy-to-let is excluded from that exemption."

What do the PRA's recommendations mean for landlords?

"On the face of it, these measures are severe and paint a dark picture for buy-to-lets in general," highlights Kang. "Mortgage lenders have already started adjusting policies so for most landlords it has become that bit tougher to secure a mortgage.

“These three elements mean borrowers will have to find properties generating much higher rental yields or put down a larger deposit.”

The worst affected areas are London and the south of England where capital values are very high and rental yields are relatively low compared to pockets in the North, where the opposite is true.

What do the PRA’s recommendations mean for contractors?

“Many contractor landlords will start finding it tougher to secure lending, but all of the classic contractor characteristics work in their favour,” notes Kang. “Lenders can consider earned income to cover any rental shortfall, and contractors generally have much higher disposable income that can be used for this purpose.

“Mortgage advisers will have to do more legwork so that the lender’s underwriter will take a positive view on affordability shortfalls in a stressed interest rate environment. This underlines the importance for contractors to choose an adviser who is a contractor specialist.”

Kang also urges contractors not to forget the changes to mortgage tax relief due to come into force in 2017: “The proposed changes to mortgage tax relief will impact on the affordability, so contractors need to factor this into their plans.”

Kang concludes: “Contractors considering a new buy-to-let investment should talk to a mortgage adviser well before they set their heart on a property to ensure they meet the new criteria.”

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