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. Some years ago, it was possible for some applicants to self-certify their income without the lender checking any further. Self-certification is no longer permitted.

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?

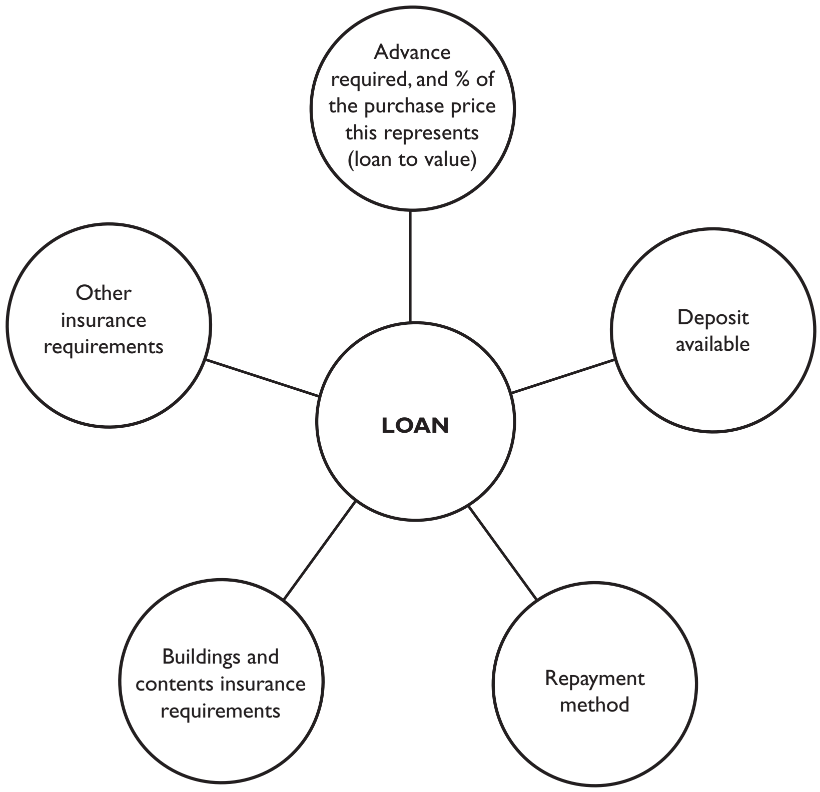
Whether the application form is completed by the applicant or by the mortgage adviser, the applicant should be encouraged to submit correct and unambiguous information that requires minimum effort to corroborate. If the adviser completes the form, the applicant must check it carefully for accuracy. Ultimately 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.

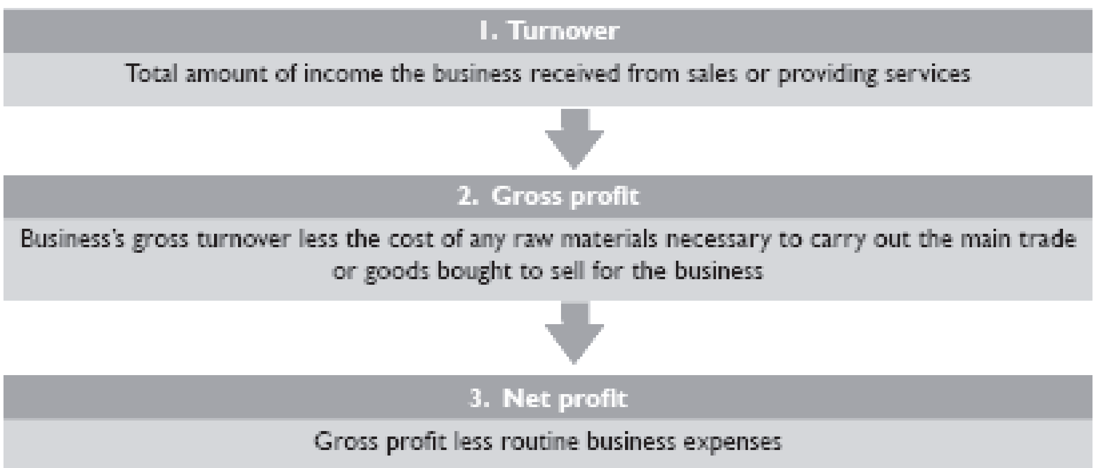
As it is now easy to produce a reasonably high-quality false reference, lenders must exercise special care, following up to establish authenticity where appropriate. In addition, those who employ staff on a casual basis can sometimes be encouraged to provide a reference that indicates the applicant's 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



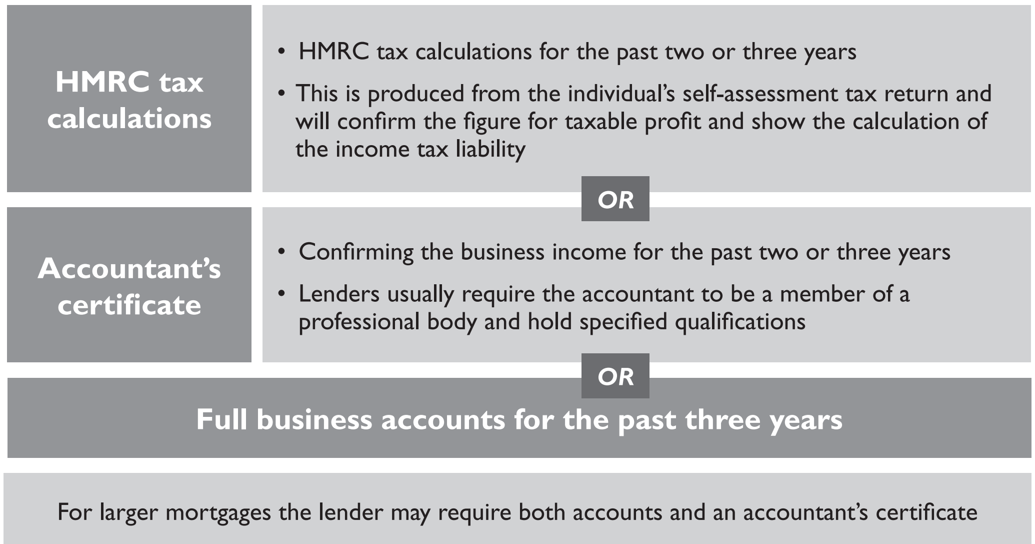
CHECK YOUR UNDERSTANDING 1

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?

Sole traders with turnover below the threshold for making a VAT return do not have to provide detailed accounts for self-assessment tax purposes – they can complete a 'short' tax return, which requires only statements of total turnover, total allowable business expenses and net profit. Sole traders with turnover above the VAT threshold are required to provide a more detailed tax return, itemising expenses in a number of categories. Sole traders with larger businesses may produce a full set of accounts, although this is not a legal requirement.

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:

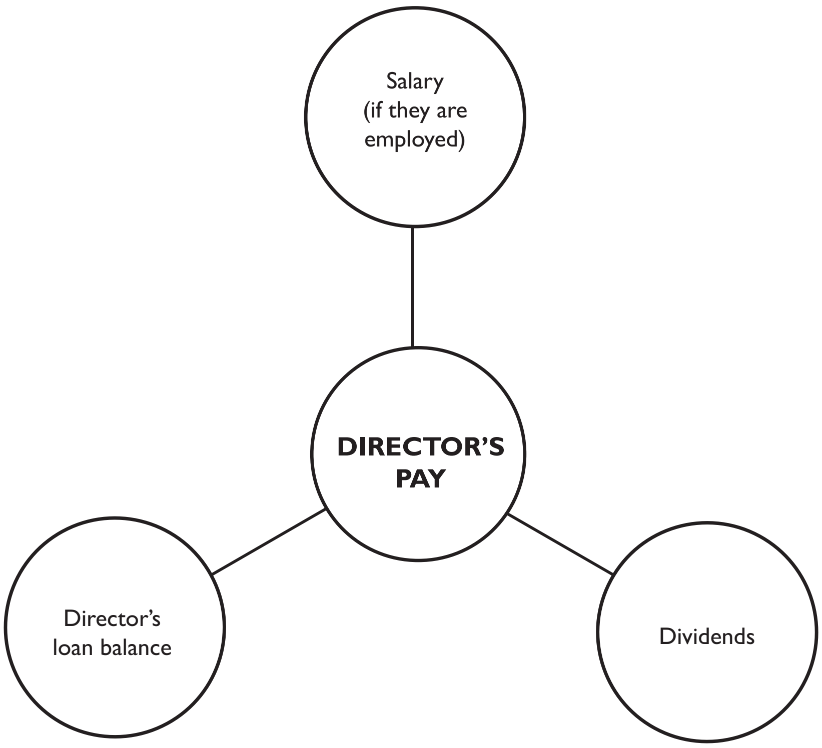
www.gov.uk/corporation-tax-rates/rates

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, which may not accurately reflect 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?

KEY TERMS

CLOSE COMPANY

A company owned by five or fewer participants or by any number of participants if they are all directors.

PARTICIPANT OR PARTICIPATOR

Broadly any individual who holds an ownership stake in a close company, either as a shareholder, director or investor. Shareholders are those with rights to acquire shares, anyone who has provided loans to the company that are still outstanding (but not trade creditors) or anyone who has rights to, or the right to acquire, distributions from the company. Family of a participator are also regarded as participators.

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.

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.

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.

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:

www.gov.uk/directors-loans

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 a full affordability assessment.

MCOB 11.6

The lender can choose to carry out a modified affordability assessment if an existing borrower wishes to vary the terms of, or replace, an existing mortgage with the lender, 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.

The lender can decide on how the modification works, including disapplying the assessment of income and expenditure, and the requirement to assess the impact of future interest rate changes, although the approach must be consistent for all applications rather than tailor-made for each application.

If a borrower is with an inactive lender – one that no longer offers new mortgages – they are termed a 'mortgage prisoner' because they cannot 'escape' to a new arrangement from their existing contract, but may not meet the affordability requirements when they try to move to a new lender. Lenders are able to use the modified arrangement to help mortgage prisoners to move to another lender, although few large lenders offer that facility.

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 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, but if it opts for the adapted rules it must apply the same rules to all borrowers in the same circumstances. It cannot apply the rules to one customer but deny the facility to another in similar circumstances.
- 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. If the switch is to consolidate both a first and second charge on the property, the total borrowing on the new mortgage cannot exceed the amount of the two original loans.
- There must not have been a payment shortfall at the time of the application or in the previous 12 months.
- The new arrangement can be of a different type, eg different interest rate, fixed, interest-only to repayment (but not repayment to interest-only), or a different term, as long as the amount borrowed does not increase. The rule only applies where the new arrangement will be more affordable, which is defined as costing less each month than previously.
- The lender can modify or disapply the income and expenditure requirements of MCOB 11 if the new arrangement is more affordable, and can also disapply the assessment of future interest rate increases. It can choose to disapply the rules regarding 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 10.6 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, known as an interest rate 'stress test' was introduced in 2014. The requirements are set out 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 suggest a rate below 1 per cent would be appropriate. For example, if market expectations suggest an increase of 0.5 per cent, lenders must still use a rate of at least 1 per cent.

As part of an overall strategy on mortgage affordability, the PRA also established the 'loan to income flow limit' (LTI) in 2014. Introduced to prevent an unhealthy number of households becoming overburdened with mortgage debt, particularly in the event of rising house prices, the LTI limits the number of mortgages a lender can provide that exceed 4.5 times the income of a borrower or joint borrowers. Such lending is limited to 15 per cent of the lender's new residential mortgages, measured on a four-quarter rolling basis. The limit applies only to new first charge mortgages, including remortgages where there is additional borrowing.

%

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. The lender takes into account 85 per cent of their free disposable income for calculation purposes.

Their free disposable income is £2,150 – £910 = £1,240. £1,240 x 85 per cent = £1,054 income for affordability purposes.

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 1 per cent, giving a calculation rate of 5.5 per cent when assessing affordability. Using a mortgage cost calculator, we can see that every £1,000 borrowed at 5.5 per cent will cost £6, so we divide their free disposable income of £1,054 by £6; £1,054 ÷ £6 =175.67. They could borrow £175,670.

EXAMPLE 1

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 6.5 per cent at the end of the three-year term (SVR of 4.5 per cent + 2 per cent expectation).

EXAMPLE 2

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.

Reference

FCA (2019) *Changes to mortgage responsible lending rules and guidance – feedback on CP19/14 and final rules* [pdf]. Available at: www.fca.org.uk/publication/policy/ps19-27.pdf

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?

   a) The application is for a remortgage.

   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 for the new deal.

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, where he declares his income without the lender carrying out verification. 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 will consider affordability based on 85% of their disposable income, and 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?

   a) £144,067.

   b) £159,490.

   c) £169,490.

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.