

Section 2

Assessment of status

Introduction

Although the principles of lending are common to all institutions, the procedures and documentation differ widely. You should try to obtain a copy of a mortgage application form and other standard documentation in order to draw practical relevance from this section.

Section 2 details an explanation of the process for assessing a mortgage applicant's status, including: personal details; income and expenditure; credit status; and non-status mortgages.

Section 2 covers part 1 of the syllabus for Unit 4.

2.1 Information gathering

Once a potential mortgage customer has decided to go ahead with an application, all lending institutions start off the process of loan assessment by asking for an application form to be completed. Although there are as many different application forms as lenders, the principles underlying the collection of information are common to all.

The application form can be completed by the applicant or by a telesales operative who collects details from the customer over the telephone. In either case, the applicant should be encouraged to submit correct and unambiguous information that requires minimum effort to corroborate it.

When completing a mortgage application form in the branch office, it is possible for the mortgage adviser to talk through each section, clarifying any requirements where necessary. It is more difficult to check for accuracy over the telephone, so the lender will send out the form not only to have it signed but also to get the applicant to check the information entered into the system.

The application form normally requires the following information.

2.1.1 Personal details

2.1.1.1 Name(s) and address(es) of applicant(s)

This is not just a routine requirement to request the name of the applicant. It is vital that the lender can confirm that the person with whom they are dealing is not operating under an alias. With mortgage fraud so prevalent, the lender has to be certain of the true identity of the prospective client. The lender also has to satisfy his obligations under the Proceeds of Crime Act 2002 and money laundering regulations. It is now standard practice to require at least two pieces of identification from the client.

Current permanent address will be requested and a contact address, if different. If the place of abode has changed in the last three years, a previous address may also be required. The lender must also find out the basis of occupation of the current property – are the applicants renting or living with parents, for example?

2.1.1.2 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.

2.1.1.3 Marital (civil) status and number and ages of dependants

The marital status and dependant's information gives the lender a 'pen picture' of the client's family situation. More importantly, it confirms the ages of dependants: if any are aged 17 or over and they are not to be party to the

mortgage, it is necessary 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).

While it is only people aged 18 or over who can have an overriding interest, lenders generally collect details of people who are 17 or over at the time of the mortgage application, to ensure they have details of everyone who will be 18 at the time of completion.

Some lenders choose not to obtain these consent forms but instead obtain insurance cover to protect them against any potential losses.

2.1.1.4 Occupation, income and outgoings

The following details are required for each person wishing to be a party to the mortgage:

- ◆ occupation;
- ◆ nature of employment – permanent, temporary, fixed term, etc;
- ◆ employer's name and address – required to confirm income and employment details;
- ◆ how long employed;
- ◆ if employed for less than (usually) three years, details of previous employer;
- ◆ basic income;
- ◆ average overtime and the extent to which this is guaranteed;
- ◆ commission, bonuses and other sales-related income;
- ◆ other income, including that arising from maintenance payments, trusts, etc.

The lender has to form a subjective judgment about the quality of income and employment. If the applicant works for a company that has been laying off thousands of workers, it is in the interest of both the lender and the borrower to determine how safe and permanent that employment actually is. It must not be assumed that the person is going to be made redundant but the right questions must be asked to avoid commitment to a borrowing that may be regretted.

Conversely, some of the jobs that have historically been the safest of all may now be in jeopardy. In the past 20 years or so, there has been a fundamental change in the ranks of those made redundant through restructure away from blue-collar, labour-intensive industries towards white-collar, middle-management professions. This is evident in a wide range of occupations, including the financial sector. One outplacement consultancy recently stated that the stereotype of its typical customer is: '35–45 years old, white-collar, middle-management, male, married with children, 20 years in the same firm'.

Income details must 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. The purpose is not to prevent the person from obtaining the size of loan required, but to ensure that the mortgage payments remain affordable if income fluctuates.

Most mortgage application forms, therefore, have separate lines or boxes to be completed for basic earnings (specifying gross or net), regular salary top-ups (such as end-of-year bonuses), overtime, bonuses, commissions and other sources of income.

Where sales-related income is taken into consideration, many lenders take an average of income from this source over a stated number of years (for example, three years).

If the applicant is self-employed, the lender will require details on:

- ◆ the name, address and nature of business;
- ◆ its corporate form – sole trader, partnership, limited company;
- ◆ the business plan;
- ◆ how long the business has been established;
- ◆ if it is a start-up, the applicant's previous career profile;
- ◆ financial information for the last three years, including balance sheet, profit and loss account, cash flow statement;
- ◆ if it is a start-up, as many accounts as are available and projections prepared by a qualified accountant.

Details of the business of the self-employed person must be recorded with care. The word 'income', for example, can mean:

- ◆ income from sales (annual turnover);
- ◆ personal drawings from the business;
- ◆ total income from business and other sources;
- ◆ profit.

Most mortgage application forms are inadequate for the purpose of forming a judgment on the financial position of such a business. This is not down to inadequacy of form design – there are simply too many types of business to consider, each with their own idiosyncrasies.

Invariably, therefore, the lender must collect supplementary information from the self-employed applicant. Well-run businesses have a business plan that sets down essential details of the operation, including financial information (historic and projections for the future), markets and other vital details. These should be supported by financial statements. Most lenders insist that the profit and loss account and balance sheet for each of the last three years be submitted to give a trend in business performance – but these are only useful if prepared and ratified by a professional accountant. For smaller businesses, they are unlikely to have been audited, although most accountants insist that they have sight of bank statements for the relevant periods before they will sign the accounts.

Projections are accepted by some lenders as an indicator of future business. Most often, these are based on the entrepreneur's own perception of the future order book, even if signed off or prepared by an accountant. They are consequently of limited value.

Information on all outgoings is required:

- ◆ existing mortgage(s);
- ◆ other loans;
- ◆ names and addresses of lenders;
- ◆ credit and charge cards;
- ◆ other monthly outgoings;
- ◆ information on debts, bankruptcy and court judgments.

The significance of the information in this section of the application form is that it forms the basis of credit assessment. Many lenders now run the

information collected through a credit-scoring system in order to eliminate unsuitable applicants, as well as to indicate the likely degree of risk.

2.1.2 Property to be mortgaged

The lender will require information on the property to be mortgaged:

- ◆ 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 (if leasehold, years unexpired);
- ◆ number and type of rooms and accommodation (often recorded by ‘ticking the box’);
- ◆ vacant possession available – this is extremely important because the presence of tenants radically affects market value (unless the proposition is buy to let);
- ◆ alterations proposed – details, costs, how funded;
- ◆ proposed use of the property – residential, business, mixed, etc;
- ◆ if new or less than ten years old, name of builder and whether the builder is a member of the National House Building Council (NHBC) or similar protection scheme;
- ◆ if self-build, details of supervising architect if the builder is not an NHBC member.

The property details are invariably checked when a valuer is sent out to assess the property.

When the application is made through a local branch office, it should be possible for the lender to form a judgment about the quality of the property, the area in which it is located and whether the value is in line with other similar properties in the area. This is especially important when the applicants are moving into an area for the first time and may be in danger of paying ‘over the odds’ because they have a limited knowledge of local market conditions.

2.1.3 The loan required

The lender will also examine:

- ◆ the amount of advance required and the percentage of the purchase price that this represents;
- ◆ how the balance between purchase price and loan sought will be funded;
- ◆ the method of repayment;
- ◆ buildings and contents insurance requirements;
- ◆ other insurance requirements;
- ◆ with what frequency payments on the loan are to be made – normally monthly, although some lenders offer an option of quarterly or other instalment periods.

For corporate and semi-corporate applications, the lender will wish to know the source from which loan repayments will be made. Ideally, this should come from cash flow generated by the business.

2.1.4 Other details

The lender will also want to know the details of:

- ◆ the name and address of the solicitor;
- ◆ the name and address of the landlord, if currently a tenant;
- ◆ the vendor;
- ◆ the selling agent;
- ◆ any occupier who is 17 years of age or over who will not be party to the mortgage.

2.1.5 Declaration

All application forms have a *declaration* to be signed and dated by all applicants. This states 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.

Owing to the increase in fraud in recent years, the courts now take a serious view of offences in relation to applications for loans. It is not unusual for custodial sentences to be imposed, even for first offences.

The application may contain a statement of *non-warranty* regarding the purchase price or property condition. This means that the lender agrees that the price seems reasonable but will not guarantee that this is the case, and that it cannot give any guarantee as to the condition of the property.

Many lenders accept applications through the traditional channels of branches, agencies and intermediaries as well as centralised telesales units (or call centres). When face-to-face contact is possible, it is better for the application to be completed by the applicants themselves, with appropriate guidance given at each stage.

Advisers should be aware that the form must be completed accurately and truthfully in all cases. Although in a selling role, an adviser should also be prepared to make appropriate cautionary comments if he believes that the applicants are being less than honest.

Many lenders use standard interview structures in order to complete the application process in a logical manner. One mnemonic structure used by several banks is the CAMPARI acronym, representing: Character, Ability, Margin, Purpose, Amount, Repayment and Insurance.

Each lender has its own system and you should compare the above process with that of your own institution.

2.2 Income criteria

Lenders normally base the borrowing capability of those in pay-as-you-earn (PAYE) employment on a multiple of gross annual income of the main borrower, sometimes taking a secondary income into account.

One example might be main income multiplied by three, plus all secondary income.

The origin of the income multiple approach lies in the 1950s when it was common to use a multiple that would result in a loan requiring no more than one-third of disposable income to service it. This is rather too simplistic today.

Even if discretion is permitted by the lender, income criteria must be applied sensibly at all times. The purpose is not to put rules in place for the sake of it, but to ensure that the borrower has every chance of being able to afford the monthly payments.

The purpose of the income multiple is to ensure that there is a realistic proposition that the borrower can meet the repayments. It does no one any good to advance funds that cannot be repaid, least of all the borrower. Lenders do, however, adopt a flexible approach when it is felt that the borrower has exceptional circumstances. For example:

- ◆ a person who has nearly completed professional accountancy examinations might be deemed to be a good risk for more than the current multiple might indicate because his income is likely to rise steeply in the near future;
- ◆ a person who works for a company that is laying off a considerable number of workers might be deemed a higher risk, so, even if the multiple indicates a certain borrowing capability, the lender may be reluctant to agree a mortgage.

In addition to basic income, many applicants have supplementary income such as:

- ◆ overtime;
- ◆ commission;
- ◆ other sales-related income;
- ◆ maintenance;
- ◆ trust income, etc.

The lending institution must evaluate the volatility or otherwise of such income before it is considered 'permanent' or 'guaranteed'.

The following is an example of the use of income multiples in determining borrowing capability.

Example

Mr Conway earns a basic salary of £18,000 pa and his wife's guaranteed salary is £24,000. As a salesman, Mr Conway usually receives a performance-related annual bonus. There is no guarantee that this will be paid but in the past three years he has received £8,000, £4,000 and £6,000 respectively. Mrs Conway also receives an annual income of £5,000 from a lifetime trust.

A typical lender might employ the following income multiples:

- ◆ 3 x main income + 1 x secondary income; or
- ◆ 2.75 x joint income.

As far as Mr Conway's annual bonus is concerned, a sensible approach will be to take the average over the past three years and add this to his guaranteed basic salary. His income for mortgage purposes is therefore:

$$£18,000 + \frac{£18,000}{3} = £24,000$$

The trust income that Mrs Conway receives is guaranteed for life and can therefore be added to her basic salary. Her income for mortgage purposes is £29,000.

The maximum amount that Mr and Mrs Conway can expect to borrow will be the higher of:

- ◆ $(3 \times £29,000) + £24,000 = \mathbf{£111,000}$; or
- ◆ $2.75 \times (£29,000 + £24,000) = \mathbf{£145,750}$.

A loan of £145,750 will, of course, be subject to confirmation of the stated incomes and a satisfactory valuation of the property that they decide to purchase.

Compare the worked example above with your own institution's approach.

Note that the example refers to 'higher and lower' incomes, rather than 'male and female' incomes. It is unlawful to discriminate on the grounds of gender under the provisions of the Sex Discrimination Act 1970. Likewise, the lender is on dangerous ground if questions are asked of a female applicant that cannot be asked of a male one. If the higher income earner happens to be female and expecting a child, the adviser should not ask whether having the child would affect her ability to repay the loan – the same question cannot be asked of a male. Questions relating to the future earning potential of both partners are less acceptable.

Self-employed people, corporate applicants and partnerships each have to be considered in a different way.

2.1 The self-employed sole trader

The assessment of 'salary' for a sole trader is a little more difficult. A set of accounts will include a number of figures, eg gross profit, net profit and, possibly, personal drawings. The task for the adviser is to decide to what extent some, or all, of these figures should be taken into account in determining the applicant's borrowing capacity. Before considering this issue, we will confirm the purpose of the various documents that the applicant will normally be asked to provide in support of his application.

A set of accounts will normally comprise:

- ◆ a profit and loss account;
- ◆ a balance sheet, although not all sole traders will necessarily produce one of these.

The **profit and loss account** is a record of the income and expenditure of the business for the trading year. It will show figures for gross profit and net profit for that year. **Gross profit** represents the gross income for the business less the cost of any raw materials necessary to carry out the main trade. For example, a painter and decorator will need a number of basic materials to enable him to work on a day-to-day basis. The cost of these materials will be deducted from his gross income to give the figure for gross profit. The **net profit** is arrived at by deducting routine business expenses from the gross profit. Business expenses include:

- ◆ rent and rates of business premises;
- ◆ heating and lighting;

- ◆ motor expenses such as petrol, repairs and insurance (but not the cost of purchase of a vehicle);
- ◆ postage and stationery;
- ◆ telephone charges.

In looking at profit and loss accounts for a three-year period, it is important that the adviser identifies any unusual items or substantial differences between the account for one year and that for another year. The profit and loss account for a particular year may, for example, 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, then this indicates that a new bank loan has been arranged. If the accounts have been prepared by an accountant, then an explanation of this item may 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.

While the profit and loss account covers the trading year, the *balance sheet* is a statement of the business's assets and liabilities as at the end of the trading year, ie on one particular day. The balance sheet will include the balance of what is known as the *capital account*. This gives some indication of the underlying strength of the business because it 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.

The capital account will also include a figure for *personal drawings*, ie the amount withdrawn from the business during the trading year.

In addition to the capital account, the balance sheet details other liabilities such as creditors and outstanding bank loans. The assets of the business will also be shown, eg the business premises, vehicles, equipment, debtors and the bank balance.

The profit and loss account and balance sheet show how well, or badly, the business performed in the past – but what about the future? The mortgage adviser will need some assurance that the business will continue to be viable and that the applicant will be able to maintain the monthly payments, if a loan is agreed.

It is impossible to predict exactly how well the business will perform in the years ahead. The lender may, therefore, require one of the following to help in the decision-making, although they will carry less weight than factual evidence.

- ◆ a business plan/projection;
- ◆ an order book showing work already booked;
- ◆ details of current year sales.

Having examined all this information, the adviser must now decide whether to lend and, if so, how much. Almost without exception, lenders will regard the net profit figure as being the equivalent of gross salary for an employed applicant. It is therefore this figure to which the appropriate income multiple will be applied. It may not be quite that simple, however: the figure for personal drawings is also of vital importance. If this is more than the net profit, then the applicant may well be living beyond his means by taking more out of the business than it is making by way of net profit. Comparative figures, perhaps covering a period of three years, are of considerable importance. If personal drawings have only marginally exceeded net profit in one of those years then there may be a perfectly satisfactory explanation. If personal drawings have regularly been much higher than net profit, then the adviser will need to proceed with caution. If the applicant is running down the capital account he 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.

There is one other matter on which the adviser needs to be fully satisfied and this concerns the genuineness of the accounts. It is possible that the figures for net profit have been inflated to make the loan request look reasonable: how can the validity of these figures be assessed?

The adviser can request the following documentation:

- ◆ *a business taxation computation* – this will show to what extent capital allowances have been used to reduce the figure for net profit and arrive at the taxable profit for the business;
- ◆ *a self-assessment tax computation* – this is produced by Her Majesty's Revenue and Customs (HMRC) and will confirm the figure for taxable profit as shown in the business tax computation and show the calculation of the income tax liability;

- ◆ a *self-assessment statement of account* – this is also produced by HMRC and confirms whether there is any outstanding tax liability carried forward from a previous year.

If the adviser is assessing business accounts covering a period of three years then the taxation documentation described above will need to cover a similar period.

2.3 Corroborating income

In order to *corroborate income*, a lender will require a number of pieces of evidence, including references and bank statements.

2.3.1 References

A lender takes *references*, if appropriate, from the applicant's:

- ◆ employer;
- ◆ banker;
- ◆ building society;
- ◆ other lenders;
- ◆ landlord.

None of these sources is foolproof. The safest reference is likely to be that from the employer, where the company is an established and respected one. An employer's reference should be:

- ◆ on the company letterhead;
- ◆ dated reasonably recently;
- ◆ unambiguous in respect of permanence of employment and income;
- ◆ signed personally by a person in authority;
- ◆ an original letter, not a photocopy.

As it is now easy to produce a reasonably high-quality false reference on even a very basic personal computer, lenders have to exercise special care, following up to establish authenticity where appropriate. In addition, those who employ

labour on a casual basis can sometimes be encouraged to produce a reference that implies greater permanence of employment.

Methods of producing a false reference used in the past have included:

- ◆ drafting one's own reference on the company letterhead;
- ◆ forging the reference where the employer does not have formal letterhead paper;
- ◆ colluding with the employer;
- ◆ colluding with a member of staff of the personnel department;
- ◆ redating an old reference.

The lender must be constantly aware of the danger of fraudulent references. Not only can this lead to committing funds that may not be repaid; failure to make appropriate checks can also invalidate future cover under the mortgage indemnity guarantee.

Lender's references are also useful, although most institutions make a charge of at least £50 for these, so it is more common to rely on mortgage statements. A lender will almost invariably be truthful, especially because it can owe a duty of care to the recipient. The amount of information given will be constrained by the fact that the applicant has access to it under the Data Protection Act 1998.

A landlord's reference may or may not be useful. In extreme cases, a landlord may be delighted to give a glowing reference to a troublesome tenant in the hope of obtaining vacant possession.

2.3.2 Bank statements

Most lenders are prepared to consider *bank statements* (and statements from other financial institutions) in order to assist in corroborating income and personal wealth.

Bank statements are only useful if they provide a representative picture of the customer's financial well-being, or otherwise and the fundamental nature of the person's financial circumstances. The statements should indicate how the applicant has conducted his account over a given minimum period of time.

Bank statements may appear to give a favourable impression of the applicant – but check that the applicant has got bank accounts with other institutions that are being deliberately concealed.

2.3.3 Income assessment for different types of applicant

We can summarise the information that may be required for different types of applicant as follows.

2.3.3.1 Personal applicants – PAYE

Assessing the income of a **PAYE employee** should be relatively straightforward, including the requests for:

- ◆ an employer's reference;
- ◆ a banker's reference or account statements;
- ◆ an existing mortgage lender's reference or statements – a small fee is likely to be charged;
- ◆ P60 (little use – historical);
- ◆ a landlord's reference.

2.3.3.2 Self-employed applicants

Assessing the income of someone who is **self-employed** may be more difficult, requiring:

- ◆ a full set of accounts for each of the last three years – a set of accounts will include a balance sheet, profit and loss account, cash flow statement and any notes to explain unusual items, etc;
- ◆ a bank reference or account statements;
- ◆ a reference from an existing mortgage lender – a small fee is likely to be charged;
- ◆ details of any other borrowings or substantial outgoings;
- ◆ a business plan, order book or projections, although plans/projections may be of limited value;

- ◆ a self-assessment tax calculation and business tax computation. These will enable net profits to be verified and provide confirmation of tax liability and whether there are any outstanding tax payments.

2.3.3.3 Partnership applicants

Assessing the repayment ability of a **partnership** is not dissimilar to that for self-employed individuals. Remember, a partnership – unlike a corporate applicant – is not a separate legal entity and the lender will request:

- ◆ a full set of accounts for each of the last three business years, including the drawings made by the partners from the business. This will give an idea not only of the profitability of the partnership but also of the drain on it by way of partners' drawings;
- ◆ references on all the partners;
- ◆ in particular, references from any existing lenders both to the partnership and to the partners;
- ◆ details of any other borrowings or substantial outgoings;
- ◆ a business plan and/or projections for the partnership business;
- ◆ the partners' tax returns, which may be of help in evidencing their income not only from the partnership but also from other sources;
- ◆ sight of the partnership deed;
- ◆ each partner's share of the profits (this information is contained in the partnership deed);
- ◆ most probably, a resolution to take out the mortgage signed by all the partners or, less frequently, a resolution of all partners agreeing to authorise one or more of them to arrange the mortgage;
- ◆ possibly, guarantees from some or all of the partners as security.

2.3.3.4 Corporate applicants

Corporate applicants will react to provide the lender with:

- ◆ a letter of authority or minute of meeting sanctioning the application;
- ◆ the memorandum and articles of association of the company;

- ◆ Three years' audited accounts (though smaller companies may not be subject to full audit, so a reporting accountant's certificate or properly constructed but unaudited accounts may have to suffice);
- ◆ the business plan;
- ◆ a cash flow forecast.

The assessment of commercial and semi-commercial applications should take account of both quantitative and qualitative information:

- ◆ *quantitative analysis* is concerned with a rigorous analysis of the accounts and other figures submitted to support the application. Many lenders have software packages that will provide a good overview of business performance and will calculate key business ratios;
- ◆ *qualitative analysis* is invariably more subjective and relates to such matters as:
 - is the business in an expanding or declining market?
 - has the business the resources to compete in future?
 - is there a need for capital expenditure and is this provided for in the business plan?
 - does the business buy good quality professional advice?

If the business uses solicitors and accountants who are known to have a bad reputation, this may send a warning signal to the lending institution, even though it may not in itself rule out the possibility of lending.

2.3.3.5 Company directors

It is often necessary to credit assess **company directors** when a mortgage to a limited company is considered. This is because the limited company is a separate legal entity. Therefore, when a loan is made to a company, the institution is lending to the company itself and not to either the directors or the shareholders (those who own it). Consequently, the lender may seek the personal guarantees of the directors by way of security to reinforce his position.

If guarantees are sought from directors, it may also be necessary to obtain the consent of their spouses if a main residence is offered as tangible security in support of their guarantees.

Example

The treatment of limited companies as having a separate legal personality was established in the case of *Salomon v Salomon* (1897). In this case, Mr Salomon ran a business as a leather merchant. He decided to incorporate a company, Salomon & Co Ltd, in 1892, making himself and certain family members into the shareholders of the company. He then sold the leather business to Salomon and Co for £39,000 – a figure well in excess of its true value. He took payment by way of £9,000 in cash, £20,000 in £1 shares and left the rest of the money (£10,000) in the company as a secured loan.

The company ran into trouble and went into liquidation. Although Mr Salomon was the main person behind the business and might appear to have acted somewhat unethically, the courts held that he was entitled to recover the secured loan of £10,000 before other creditors' claims could be satisfied: the courts therefore recognised the clear distinction between the corporate entity and the individual shareholder.

2.4 Outgoings

All applicants for mortgage must provide full details of outgoings to the lender. For a typical household, these might include:

- ◆ present rent or mortgage repayments;
- ◆ credit and charge cards;
- ◆ hire purchase commitments;
- ◆ other borrowing commitments;
- ◆ education fees and associated costs;
- ◆ pension contributions;
- ◆ maintenance (ie payments to a former partner).

It is relatively easy to identify most of these costs and to corroborate them from bank statements. If in doubt, the lender can always seek additional information.

It is here that an applicant is most easily able to deceive the lender. By omitting just one regular monthly payment, a completely false picture of the ability to repay the proposed loan can be given. Similarly, the extent to which the applicant meets his financial obligations each month can critically affect future payment capability.

Take credit cards as an example. An individual may have a credit limit of £1,000 on a MasterCard and another £1,000 on a VISA card. The minimum outgoing is £100 per month, assuming a 5% minimum payment. If the person then goes over the limit by £200 on each, the monthly payment is £100 (representing 5% of credit limit) plus $2 \times £200$, ie total £500. If the individual also has a charge card, the balance has to be funded in full every month. It is not unusual for a family to have at least two credit cards and a charge card, so the extent to which the obligations arising from them are serviced is absolutely crucial. Bad payers will be identified by credit searches but those with an otherwise clean credit history are not necessarily certain to stay that way.

Where lenders are using an income multiple as their basis for assessing whether a customer can afford the loan, it is normal for repayments on other borrowing commitments to be taken into account so as to reduce the amount that the customer can now borrow. For example, the maximum loan available might be reduced by the balance outstanding on other loans or, alternatively, the monthly payments on these other loans might be deducted from the applicant's income.

Example

Lena's income is £35,000 and the lender's normal income multiple is 3.25. Lena has a £12,000 car loan.

In this case, the lender might reduce the advance by the outstanding loan: $35,000 \times 3.25 - 12,000 = 101,750$.

Alternatively, Lena's loan payments of £300 a month might be deducted from her income before the income multiplier is applied:

$£35,000 - £3,600 = £31,400 \times 3.25 = £102,050$.

One threat to the future ability to repay a loan is if the applicant is awaiting an assessment by the Child Support Agency of how much should be paid to support his children. The lender can reduce, but not eliminate, such risks by asking appropriate questions when it is known that the applicant has children by a previous relationship and where a settlement is to be made.

When considering outgoings, the mortgage adviser may be able to make a valuable contribution to improving the financial circumstances of the applicant. For example, there may be existing borrowings at very high interest rates that might, subject to status, be consolidated in a new lending arrangement. In addition, some applicants may have household insurance policies for which they are paying 'over the odds'.

For commercial and semi-commercial applicants, remember that past performance is by no means a guide to future prosperity or otherwise. Entrepreneurs rarely predict their own death but businesses do fail. The problem is compounded by the fact that formally prepared accounts are subject to distortions:

- ◆ the profit and loss account will contain non-cash items such as *depreciation*, which in turn distort the true cash generation capability of the business;
- ◆ the balance sheet is rarely a good guide to the value of the business – most businesses are worth far less when they cease trading and their assets are realised.

Future expenditure by corporate and semi-corporate applicants is subject to even greater potential fluctuation than personal borrowers. For example, a major capital investment may increase borrowings, and therefore monthly costs, substantially. Businesses subject to seasonal fluctuations in income and costs need particular attention when looking at their overall financial health.

Seasonal fluctuation in income is common in a wide variety of businesses, including guest houses, many retail outlets and the wholesale trade.

A good guide to cash generation capability is net operating cash flow, measured by taking operating profit and adding or subtracting non-cash items as appropriate.

2.5 Credit assessment

Although lenders can take references from a number of sources, including employers, lenders and landlords, statements are arguably more useful. These provide a good indication of track record and lifestyle.

Particular points to look for are:

- ◆ bottom line balance on bank statements – whether there is surplus, 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 with information on the application form;
- ◆ overdrafts – amount, frequency and reasons;
- ◆ fees and charges – referral fees and unauthorised overdraft fees, penalties;
- ◆ returned cheques – frequency and amounts involved;
- ◆ maintenance payments – continuous or irregular;
- ◆ mortgage statement – outstanding arrears, regularity of payments, fees and charges and whether information is consistent with that on the mortgage application form.

References and statements will, however, not tell the lending institution about:

- ◆ pending court hearings;
- ◆ action for maintenance/child support claims;
- ◆ borrowings yet to be drawn down;
- ◆ purely cash transactions – income (such as undeclared income) and expenditure (such as cash borrowings from the family).

2.5.1 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. In the majority of cases there is no

difficulty in establishing this. The roll is not, however, 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 address will obviously be different, so it is necessary to cross-refer to the immediate previous address given in 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 reference searches can be made through organisations such as Experian (formerly CCN) and Equifax. These organisations, known as *credit bureaux* or *credit reference agencies*, store and maintain financial and public records of people who have received credit. These organisations have vast databases of information on individuals in respect of previous bad debts and default, county/sheriff court judgments and insolvency.

Advisers should be aware that under the Data Protection Act 1998, data subjects have a right to access any information held by lenders, either on computer or in paper-based files.

Credit reference bureaux provide such information for a fee of £2. Credit references provide an insight into the activities of individuals based on historic information. They are a useful tool in bringing to light specific instances of problems with a named individual. This is in contrast with the statistical insight given by another tool, credit scoring.

2.5.2 Credit scoring

Almost all lending institutions use **credit scoring** as an integral feature of the assessment process. It is a method by which scores are apportioned to various features of the application, based on historical data relating to risk.

Other categories that might be taken into account, for example, are whether the applicant is a first-time buyer or not, their age, their occupation, whether the application has come direct or been introduced, and the amount of the loan.

In simple terms, a certain number of points are then allocated in each category, (eg five points for a first-time buyer, ten points for a subsequent buyer) so that, once the points for each category have been added up, the total score reflects the *credit score*. Applications that receive more than a certain score (often

known as the *cut-off score*) will be accepted, while those that do not will be declined.

Credit-scoring techniques are now well developed and highly sophisticated. They are invariably computerised to enable the lender to apply them quickly and accurately. Scores can even be changed to reflect the changing profile of the organisation's mortgage book.

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 enabling discretion to be applied. Many lending organisations' systems will allow for scrutiny of 'borderline' applications – those that achieve a score at, or around, the lender's agreed cut-off point. This means that such applications can be referred to a supervisor or loans officer for review, in recognition that scoring systems have their limits 'at the margin' and that some human intervention may help resolve these borderline cases. So, for example, the lender's policy may grant discretion to supervisors to override marginal fails that come within a certain number of points of the cut-off. For cases that are clearly well above or below the cut-off, however, intervention and review is unlikely to be necessary if the credit-scoring model has been well constructed.

Credit-scoring models are not static: they have to change with the changing environment and lenders keep them under constant review for their robustness – a model that worked well ten years ago would be unlikely to be as robust today. In addition, it is important to recognise that:

- ◆ there is no single scoring model. Different organisations have different lending policies – some will be happy to entertain a higher risk profile, compensating themselves for this with higher interest rates (for example, those who lend to the credit-impaired or self-employed). Others will have a policy of maintaining the lowest rates they can, as their competitive edge, and consequently will be keen to screen out all but the most creditworthy borrowers;
- ◆ credit scoring is no more than a statistical tool. It cannot tell us 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.

In addition, credit-scoring models will:

- ◆ change over time as lenders learn from experience and refine their techniques;

- ◆ vary from lender to lender with their preferred business patterns;
- ◆ evolve over time with changing circumstances (a model that was once robust may no longer work because of demographic changes).

There are certain elements of credit scoring models that remain constant. There are some factors about applicants that we might ascertain but which would be of limited assistance in predicting their likely future financial behaviour – eye colour and height, for example – and there is clearly little merit in including such criteria. Other factors can be shown to be more consistently useful: such factors as employment status and length of employment, income, credit history, home ownership status and length of time in current residence. Organisations gain experience over time of which items of information contribute usefully to the model and which do not.

On its own, each of the relevant factors presents a far from complete picture and even taken together they present only a statistical likelihood of default. As a tool to help lenders screen out applicants where there is a high likelihood of default, however, and therefore manage their risk exposure, credit scoring is particularly useful.

Credit scoring is best applied when:

- ◆ the institution has a well-developed database on its existing mortgage book;
- ◆ built into a centralised processing system, such as a telesales-based operation;
- ◆ dealing with high volumes of business;
- ◆ lending policy is well defined.

Credit scoring has proven its worth in the field of high- volume unsecured lending operations, such as finance houses. Its speed and accuracy enable credit scoring to be employed as a means of processing many applications in a short time. As technology has improved, lenders have been able to develop sophisticated databases so that credit scoring can now be used for mortgage applications and even quite complex corporate loan applications.

2.5.3 County/Sheriff court judgments

When a person is unable to pay his creditors, a civil case can be brought to the county court in England and Wales or the Sheriff Court in Scotland. The court can make a *judgment* (*decree* in Scotland) against the debtor that then remains in force until such time as the debt is paid.

The application form always requires details of such judgments and it is a criminal offence to knowingly conceal them from a prospective lender.

Although *county court judgments (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.

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.

In 1997, following pressure from the Office of Fair Trading, one lender specialising in such mortgage business introduced less onerous conditions in mortgage contracts for new customers.

2.5.4 Insolvency

Insolvency occurs when:

- ◆ a person's liabilities exceed his assets; or
- ◆ a person cannot meet his financial obligations when they fall due.

Insolvency arises when an order is made under the Insolvency Act 1986 or the Bankruptcy (Scotland) Act 1985. Under the Enterprise Act of 2002, once made, a *bankruptcy order* remains in force for 12 months (in most circumstances). The bankrupt is made responsible to an *insolvency practitioner* whose primary duty is to ensure that the creditors get as much money back as possible during the period that the order is in force.

A bankrupt cannot borrow (except very nominal amounts) in his own right.

Bankruptcy will normally be declared on the mortgage application form – it is a criminal offence not to do so. If undeclared, it will usually be revealed by credit searches and the bankrupt is then legally prevented from executing a mortgage deed.

As a matter of routine, lenders will decline applications from undischarged bankrupts. Some lenders are prepared to consider applications from those who have been discharged from bankruptcy after a specified number of years.

2.5.4.1 Individual voluntary arrangements (IVAs)

An individual voluntary arrangement (IVA) is an alternative to bankruptcy. It is a method by which a debtor can make an arrangement with creditors to reschedule outstanding debts over a specified period, supervised by an insolvency practitioner. For an IVA to be arranged, a creditors' meeting must be arranged. At the meeting, creditors representing at least 75% of the debt 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.

Obviously, 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.

2.5.4.2 Company voluntary arrangements (CVAs)

Company voluntary arrangements (CVAs) are the limited company equivalent of IVAs.

2.6 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.

In the early 1990s, a police federation report estimated that as many as one in twenty mortgage applications may have included some element of fraud. The extent of the crime may vary from a simple overstatement of income to highly organised and systematic professional fraud attempts.

Types of fraud in relation to mortgages include:

- ◆ incorrect income stated on the application form;
- ◆ false salary references;
- ◆ omission of outgoings from the application form;

- ◆ details of existing debts withheld;
- ◆ failure to disclose relevant information;
- ◆ highly organised attempts to obtain mortgage finance on properties that do not exist;
- ◆ fraud perpetrated by dishonest intermediaries, solicitors and accountants;
- ◆ bogus financial accounts;
- ◆ bogus valuations.

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 focus to individual lenders and trade bodies such as the Council of Mortgage Lenders (CML).

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;
- ◆ dealing only with reputable intermediaries;
- ◆ engaging in ongoing dialogue on fraud prevention measures with bodies such as the British Bankers Association, the Building Societies Association, the Council of Mortgage Lenders, 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;

- ◆ reference to specialised databases such as the CML Possessions Register;
- ◆ 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.

The Theft Act 1968 enables a lender to initiate a prosecution where an attempt is made to obtain a mortgage by deception, whether or not the mortgage is actually granted.

2.6.1 Reference checks and the Data Protection Act 1998

During the application process references will be taken on the applicant (where he is an individual), on the partners in the case of a partnership, and on the directors where the applicant is a company.

The Data Protection Act 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 – and so the statement 'we consider this individual to be creditworthy', in response to a credit reference request, would be covered under the Act. The Act requires that reference information should be:

- ◆ fairly and lawfully obtained;
- ◆ held only for one or more specific and lawful purpose(s);
- ◆ used and disclosed only for the purpose(s) held;
- ◆ adequate, relevant and not excessive;
- ◆ accurate and up to date;
- ◆ kept no longer than necessary;
- ◆ available for access, and, where appropriate, correction and erasure, by the Data Subject (the individual to whom the information relates);
- ◆ protected by adequate security measures.

The quality of a reference can clearly have a big impact on an individual's life in terms of their ability to obtain credit. The Data Protection Act covers the treatment of such references and the Act (and the Consumer Credit Act 1974) gives people the right to see the information held on their files with credit reference agencies – for a nominal fee of £2.

2.6.2 Anti-money laundering regulations

The Criminal Justice Act 1993 introduced new provisions aimed at preventing the use and abuse of the financial system to conceal the proceeds of their crimes and, ultimately, to give those proceeds the appearance of being legitimate. Among other things, these require that:

- ◆ financial institutions have procedures to identify their clients adequately;
- ◆ they maintain records in this connection, and in connection with all transactions undertaken, for at least five years;
- ◆ they appoint a Money Laundering Reporting Officer, to whom employees must report any suspicions of money laundering activity;
- ◆ they have in place standards and procedures to prevent the occurrence of money laundering;
- ◆ they ensure staff are trained in how to recognise potential money laundering activity and what action to take should they do so.

The enactment of the Financial Services and Markets Act 2000 brought responsibility for fighting financial crime into the remit of the Financial Services Authority. Prior to this, prosecutions under the Money Laundering Regulations 1993 (issued under the Criminal Justice Act 1993) could only be brought by the UK criminal authorities. The FSA now has a more direct remit in connection with the enforcement of anti-money laundering provisions.

Taking out a mortgage may not appear the most obvious route for a money launderer: after all, lenders are likely to go to some lengths to identify applicants for credit purposes. Money raised by way of mortgage might be expected to remain tied up for some considerable length of time and there is a common (although not always correct) 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 financial institutions undertaking mortgage business just as much as they do to others,

and so such organisations must take specific initial steps to ensure they have obtained evidence of a client's identity. They will also require evidence of the source of any funds deposited with them, which might include, for example, the deposit on a property being bought.

On an ongoing basis, the lender should also ensure that its staff are alert to any use of the account that does not fit the expected pattern and 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 the customer's changing circumstances. It remains important, however, that staff remain alert to the possibility and take appropriate action whenever their concerns are raised.

The current money laundering provisions are contained within the Proceeds of Crime Act 2002.

2.7 Non-status mortgages

The steady increase in house prices in recent years has prompted many people to release the equity in their homes and indulge in spending on luxuries such as cars and holidays. There is considerable evidence to suggest that some people have remortgaged their property with a lender willing to accept self-certification of income. This has certainly led to some applicants being less than truthful about their income: with low interest rates, these applicants felt that they would have no difficulty in meeting the monthly payments on a large loan. In some cases, it has been suggested that mortgage intermediaries actually encouraged applicants to inflate their income on the basis that the lender would not seek verification.

Some self-certification lenders have now withdrawn from the market, while most of those that remain have introduced more stringent underwriting criteria. Although these lenders do not attempt to verify income, they still act prudently by subjecting each applicant to an internal credit-scoring process, as well as making the standard credit searches. It is quite possible that those who deliberately inflate their income have an adverse credit rating, although this will not always be the case.

As far as income is concerned, experienced underwriters will know instinctively what is a reasonable income for a particular occupation and, as

more and more self-certified applications are processed the easier it will be to identify the fraudulent ones.

Applicants should remember that exaggerating income in order to obtain a higher loan amounts to fraud, irrespective of whether a loan is actually granted. In this respect, a lender that specialises in self-certified loans is no different from any mainstream lender is entitled to prosecute an applicant it felt had deliberately set out to deceive – and a mortgage adviser who encourage such deception will no longer be deemed to be a fit and proper person to give mortgage advice by the Financial Services Authority.

Test your knowledge and understanding with these questions

Take a break before using these questions to assess your learning across Section 2. Review the text if necessary.

Answers can be found on page [4] 57.

1. Rebecca and Rachel want to buy their first house. Rebecca is an engineer, earning £25,000 basic and an average of £3,000 overtime in the past three years, although this is not guaranteed. Rachel is a personal assistant, earning £22,000 basic. Which of the following lenders would give them the highest mortgage?
 - ◆ The Generous Society – 3.25 primary plus 1 secondary or 2.25 joint; income based on guaranteed basic plus 50% regular additional.
 - ◆ The Eclectic Building Society – 3.5 primary plus 1 secondary or 2.5 joint; income based on guaranteed income.
2. Andreas is self-employed with an income of £30,000. He has seen just the property he wants at £200,000, which will mean taking out a mortgage of £170,000. A friend has advised him to go for a self-certified mortgage, because he can declare his income as £50,000 and get the mortgage he needs. What would you advise Andreas?

Answer true or false to the following questions.

3. It is illegal to refuse a mortgage on the grounds that the applicant is not resident in the UK.
4. Variable sales-related income is not normally considered by lenders when assessing a borrower's ability to repay a loan.
5. Business projections are of limited use when deciding what size of loan to offer to a self-employed person.

6. Mortgage application forms normally ask about the tenure of the property – freehold or leasehold.
7. All sole traders produce a set of accounts comprising a profit and loss account and a balance sheet.
8. An employer's reference will only be accepted if it is dated.
9. When lending to a partnership, it is important to assess the incomes of all the partners from all sources.
10. Lenders always ask about applicants' credit card commitments.
11. Individuals can obtain details of information about them held by credit reference agencies, on payment of a fee of £10.
12. An 'individual voluntary arrangement (IVA)' is an alternative to repossession of a property by a lender.
13. A person cannot be prosecuted for giving false information in a mortgage application unless a mortgage is actually granted.
14. Opinions about people are not considered to be 'data' for the purpose of the Data Protection Act 1998.
15. A 'non-status loan' is one where the lender does not seek to corroborate the applicant's declared earnings.

Answers

1. The Eclectic would lend them £117,500 based on 2.5 x joint income.

The calculations are:

- ◆ **Generous** – Rachel's income will be £26,500 (basic plus 50% overtime); Rebecca's income, £22,000.

$$3.25 \times \text{primary plus } 1 \times \text{secondary} = £108,125$$

$$2.25 \times \text{joint} = \mathbf{£109,125}$$

- ◆ **Eclectic** – Rachel's income will be £25,000 and Rebecca's will be £22,000.

$$3.5 \times \text{primary plus } 1 \times \text{secondary} = £109,500$$

$$2.5 \times \text{joint} = \mathbf{£117,500}$$

2. Even with a self-certified mortgage, declaring a false income figure is fraudulent and can result in criminal charges. In addition, taking out a mortgage of that size can lead to financial problems.
3. **False:** but it can be difficult to sue a non-resident in the event of default.
4. **False:** variable sales-related income it is usually averaged over three or five years.
5. **True:** business projections are only the business-owner's perceptions and are likely to be over-optimistic.
6. **True:** if a mortgage application is for leasehold property, additional information about the lease is required.
7. **False:** all sole traders produce a profit and loss account but not necessarily a balance sheet.

8. **True:** otherwise the employer's reference could contain out of date information.
9. **True:** a partnership is effectively a group of self-employed persons working together. It is not a separate financial or legal entity.
10. **True:** applicants' monthly credit card repayments are effectively a reduction in their available income.
11. **False:** the current fee for disclosure of credit-rating information, under the Data Protection Act 1998, is £2.
12. **False:** an IVA is an alternative to bankruptcy.
13. **False:** the Theft Act 1968 permits prosecution for fraud whether or not a mortgage is granted.
14. **False:** facts and opinions are both covered under the Data Protection Act 1998.
15. **True:** a non-status loan is also known as self-certification.