HMO's - Understanding The Legislation and its Impact on Lenders and Valuations

By **Lisa Orme** (Mortgage Advisor and Buy to Let Specialist)

HMOs have garnered huge popularity of late, added to which there are lots of people going around quoting 'get all your money out' and 'HMOs are valued at 10 x rent', neither of which usually applies and while lenders are keen to lend on them, it has forced them to tighten policy, especially on valuations.

LEGISLATION

There are three types of HMO licensing:-

Mandatory - this applies nationally and is for five or more tenants over three or more stories forming two or more households.

Selective - this is where a council specifies licensing is required for all rented properties within a certain area, this includes HMOs but is not limited to them.

Additional - this is where a council designates licensing is required for smaller HMOs.

We also then have what's called Article 4; this is a new planning classification C4 for HMOs for up to six people. Effectively this means that HMOs with up to six tenants were given permitted development rights waiving any need for planning permission.

However local authorities were allowed to designate a planning requirement for these HMOs if they wished; these are known as the dreaded 'Article 4 areas' - a misnomer in fact as Article 4 is a benefit…but it's stuck!

This is also where the term Sui Generis comes in to play whereby properties with more than six tenants likely requires planning permission; this has always been the case and has not changed. Existing use requires ten years of use not four as is commonly touted.

With respect to building regulations there are also Section 257 flats, which apply to a converted block of flats.

Section 257 of the Housing Act 2004 relates to a building (or part of a building) which has been converted into, and consists of, self-contained flats (converted block of flats).

Buildings of this description are also classed as HMOs if:

- the conversion work was not done in accordance with 'appropriate building standards' and still does not comply with them, and;
- less than two-thirds of the self-contained flats are 'owner-occupied.'

'Appropriate building standards' usually means the 1991 Building Regulations or whichever later Building Regulations applied at the time the work was done and completed.

Blocks or houses converted to small flats or studios, especially low value units, will often be valued as a HMO rather than flats but that's a whole other story.

Back to legislation; Scotland has compulsory HMO licensing for all shared properties, even two tenants in a two bed flat if they aren't related.

Wales has no Article 4.

Finally, if you have lodgers in your home then more than three households is designated a HMO irrespective of the property/stories. Planning may also apply.

In summary, it is crucial to understand the differences in the various pieces of legislation before you buy or let a HMO; especially so for the 'Rent to Rent' strategy where you and the owner may be unaware of any HMO requirements.

Failure to license a HMO can lead to hefty fines and if safety breaches are found then even a prison sentence. Failure to obtain planning could lead to a fine and certainly a requirement to return the property to its former state.

FINANCING

All of the above now becomes irrelevant to some degree!

Shared or HMO?

The property will usually be deemed to be shared accommodation when all the tenants are on ONE AST. This is where the tenants are NOT related, if they were, then one AST would apply anyway and generally the number of tenants is irrelevant as long as they are genuinely a family unit.

Shared accommodation is NOT a term that will get you around or out of any licensing requirements.

It's mostly used by lenders and brokers to determine the difference between using buy to let finance and specialist HMO or commercial finance.

If you consider a group of friends, students or co-workers who come together to rent a property between them this might be regarded as shared accommodation.

Some, but certainly not all, buy to let lenders will allow sharers. Most of these restrict the number of sharers to FOUR. BM Solutions will allow FIVE.

Some lenders won't allow a certain tenant type or ONLY allow a certain tenant type e.g. Coventry Building Society only allows students.

If using a BTL mortgage the lender will typically only use the market rent for a single let for rental coverage. Be particularly careful with the likes of Mortgage Works BTL where this applies if using an 80% LTV product where there's a higher rental cover requirement.

Locks on Doors

BTL lenders will usually insist on no locks on doors. Property valuers are asked to look for this and to point it out. Yes there are cases that go through with them but it's a risk you take. Internal privacy locks are usually fine however locking doors from the outside usually isn't acceptable.

The reason lenders impose this is many-fold; if it's a genuine shared arrangement then the tenants should know and trust each other (they share a tenancy after all) and as such locks would not be required other than for privacy. Having locked doors could be deemed as 'too easy' for landlords to offer 'rooms'. They can be seen as an increased risk of injury/damage in a fire. They can be seen to affect the value of the house. The lenders make the rules!

Leeds and Kent Reliance are anomalies as they both offer BTL type products for individual tenancy arrangements but are very specific on the max number of tenants, tenancy types, etc., added to which the property must be up and running as a HMO with appropriate licences in place. As such you can't buy and convert to a HMO with these lenders.

Licensing

Some lenders won't lend if there is ANY form of licensing requirement. Many are fine as long as the licensing requirement doesn't affect the value of the property in any way either by nature of the licence or requirements of it. As an extreme example, fitting an external staircase would be a definite refusal.

The difficulty comes if a lender lends then licensing is introduced later; this can't be predicted by anyone let alone the broker! But be careful on which lender/product you choose at the outset if you have plans to do sharers.

“ **Simply put if you could buy a similar house 'next door' the same as yours then you're only going to get bricks and mortar value** ”

Specialist HMO Finance

If you have more than one tenancy and/or six tenants or more you will typically be required to use specialist HMO or commercial finance.

I use the term 'commercial' loosely as challenger banks like Paragon, Shawbrook, Aldermore, Fleet, Interbay etc. regard themselves or their products as not fully commercial in nature and offer a sort of hybrid of BTL and true commercial lending.

For example interest-only terms up to 25 years are not uncommon whereas commercial lenders like Lloyds, RBS and Cambridge & Counties etc. typically want shorter repayment terms.

The term that really applies is specialist lending i.e. NOT buy to let.

You also have Mortgage Works; they offer BTL and separate HMO products. It is imperative you choose the correct one. They may be the same lender but they are extremely strict on the use of their BTL mortgages for HMOs.

Similarly you have Paragon and Mortgage Trust; same lender but you absolutely cannot do HMOs or indeed sharers with Mortgage Trust.

Interbay and Kent Reliance; same lender - different criteria applies.

And so on...

It's a common misconception that some lenders won't lend if there is NO license required.

I do not know of any lender that imposes this requirement as long as you can prove one is not required.

The requirement of a license or C4 planning however CAN lead to a commercial valuation being given. The reason for this is it could be seen as creating a 'unique selling point' (USP) for the property and thus adds value. This is especially so in Article 4 areas where it may be harder to create a new HMO, thus building in scarcity value.

Valuers and lenders alike seem to have no co-ordination over this as yet however so it really is pot luck for now. The point is do not assume you must buy a licensable HMO to get a commercial mortgage/valuation and don't assume that by having a licence/planning you will get a commercial valuation.

Plus it can work in your favour or against. For example a landlord has four HMOs. Three are deemed to be ordinary houses by the valuer so valued on a lower bricks and mortar basis only. The fourth is deemed a commercial HMO so is given a higher commercial valuation. However, as commercial lenders usually lend on vacant possession value this is deemed lower than the bricks and mortar value!

(For the purists and surveyors reading I know in surveying terms bricks and mortar is actually the rebuild/reinstatement/insurance value but most people understand the term 'bricks and mortar' as being its ordinary resale value.)

As confusing as this all is it is becoming increasingly apparent as to when you're going to get a commercial (yield) valuation and when you aren't. Simply put if you could buy a similar house 'next door' the same as yours then you're only going to get bricks and mortar value.

It doesn't matter how many rooms you have, and I've seen this policy applied on a property with 8 rooms and 5 en-suites, the fact is in structure and layout it's pretty much like any other house in the street. This is likely going to be the case with flats and terraced properties certainly.

These days the way to get a commercial valuation is to ensure a complete overhaul of the property and ensure it's nothing at all like a family home. Clearly conversions ▶

and larger premises such as larger detached properties or commercial to residential conversions are more likely to fit this bill. Multiple kitchens can also help though be careful on this as some lenders won't lend if there is more than one kitchen!

To get a commercial valuation the property clearly has to be a HMO with some significant structural changes; an internal shake-up or adding a couple of en-suites rarely does the job.

Of course what loan you end up with is another calculation. Aim for leaving in 10% of your cash and you won't be far off. For example a recent deal I arranged finance for: The valuation was £700k. Purchase price £462k with around £11k from a very light touch up. The product is 75% LTV so the loan should be £525k yes? No!

Here are the lenders actual comments:-

'£462k + £11.6k thereby equals £473,600 to be left in the transaction as a commitment. This would equate to a maximum loan of £426,240.'

As you can see the rent, actual valuation and LTV are secondary. This can work in your favour if you understand it. I've just had a case accepted where the client doesn't fit the criteria but instantly telling the lender they'll be leaving in 10% after all said and done shows them you understand how 'it' works.

On the upside if you do end up with a lower LTV the rate will likely come down.

Remember though even if you do get a commercial valuation there are two important things to consider:-

1. Commercial valuations are not 10 x rent!

They're anything from 6-10 x rent subject to location, property quality and tenant type. Being 'super dooper' on all of those factors may get you 12 x rent but I've only seen that a couple of times. THEN deduct 25-30% of that figure subject to what bills are included and likely repair and maintenance bills.

Housing benefit tenants and properties that haven't been recently refurbished will all mean lower multiples and bigger deductions as may low value comparables.

If the tenants pay the bills this is unlikely to impact the valuation much as you will still have higher voids and maintenance than an ordinary rental and valuers/lenders aren't going to take the time to understand the nuances of each property.

2. Consider two other factors;

a) total spend 'value' - what you bought it for and what you've spent on it.

b) bricks and mortar value, this still must be considered.

Your valuation is likely to end up somewhere around the average of these two and the yield value.

With regards to works, unless it's an up and running HMO you need a serious reality check if you think you can turn a property into a HMO for around £10-20k which is what I regularly hear people quote. If you're spending this level of money you're most likely just creating shared accommodation not a HMO. For a decent HMO conversion TO THE CORRECT STANDARDS and REGULATIONS figures upwards of £50k are the norm and six figure sums are not unusual with larger HMO conversions.

Long and short, on the whole if you have more than one tenancy in place then seek specialist advice from a broker who understands this market. Too many 'high street' brokers don't and quite happily tell you to use a BTL mortgage as the lender won't know or doesn't care. They will know and they care very much! Added to which you're likely invalidating your insurance policy too by breaching your lending terms and conditions.

Hope this helps you get your numbers right before you commit to something that isn't going to pan out as you may expect or you may have been promised!

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