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The new HMO legislation and what it means for valuers and lenders

New HMO (Houses in Multiple Occupation) legislation is introduced on 1st October 2018, subject to parliamentary approval. In this paper we look at how this will influence approaches to residential valuations, and what the implications are for mortgage lending policy.

The Government currently defines an HMO as having at least three tenants, forming more than one household, sharing a toilet, bathroom or kitchen facilities. The home is a large HMO if it's at least three storeys high, at least five tenants live there, forming more than one household, and the toilet, bathroom or kitchen facilities are shared with other tenants. However, not all houses which are technically HMOs will necessarily need a licence.

Recent history of HMOs

There have been multiple tax changes affecting residential landlords and mortgage lenders have tightened their criteria in recent times.

In April 2016 a three per cent surcharge on stamp duty payable on all second homes and buy-to-let properties was introduced.

'wide-reaching consequences for landlords'

This increased landlord's costs dramatically. Anyone buying a £200,000 second home or buy-to-let before April 2016 paid stamp duty of £1,500. But from April 2016, landlords had to pay three per cent for the first £125,000 and five per cent instead of two per cent on the amount between £125,001 and £250,000, giving them a total bill of £7,500.

Tax relief on mortgage interest would also be phased out over four years to 2021 and be replaced with a flat 20 per cent tax credit.

This has already had wide-reaching consequences for landlords who own their buy-to-lets in their own name. Instead of being able to pay tax only on their profit, they are now forced to pay tax on their revenue. This, in turn, has pushed many into higher income tax brackets and in some cases, has wiped out all profit.

The Bank of England expressed concern that buy-to-let poses systemic risk to the economy. To counteract this, it forced lenders to impose tougher borrowing criteria on landlords from the start of 2017.

This has meant landlords are required by lenders to cover their mortgage payments with a comfortable margin. Where tenants cannot afford big rent rises and landlords' earned income is insufficient, it's made remortgaging existing properties far harder.

In October 2017, landlords with four or more mortgaged buy-to-let properties were affected by newly introduced 'portfolio rules', meaning finances on all their properties were scrutinised every time they remortgaged just one, or sought a new mortgage. The effect on the market has been significant with some investors offloading properties.

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Current Legislation

Planning

HMOs containing three to six sharers don't need specific planning permission and legislation exists for homeowners to convert their residential dwelling to a small HMO with up to six sharers under permitted development except where the local authority has introduced an Article 4 Directive which removes all permitted development rights.

Local authorities introduced Article 4 Directives to stop areas effectively becoming over supplied with this type of accommodation.

Sometimes a lender may seek to obtain proof that the property was used as an HMO prior to the introduction of the Article 4 Direction to gain comfort that its current use is established and permissible. Larger HMOs (seven or more occupants) require a specific planning designation known as 'Sui Generis' and are subject to stricter control.

What is a Sui Generis use?

Not all uses of land or buildings fit within the Town and Country Planning (Use Classes) Order 1987. When no use classes order category fits, the use of the land or buildings is described as Sui Generis, which means 'of its own kind'.

Licensing categories

'Mandatory'

A licence is required if the property is an HMO and the following apply:

- it's rented to five or more people who form more than one household.
- it's at least three storeys high (although this is about to change to include two stories).

- tenants share toilet, bathroom or kitchen facilities.

'Additional'

Even if the HMO is smaller and rented to fewer people (three or more who form two or more households), it may still need a licence depending on the area. Some councils (and the whole of Wales) have introduced Additional Licensing Schemes covering all HMOs. This is intended to bring the quality of all HMOs in the area up to an acceptable standard.

'Selective'

This is a discretionary scheme introduced by some councils requiring landlords, who let any property that does not meet the criteria for mandatory or additional licensing (meaning any other privately rented property) and is in the designated Selective Licensing area set by the council, to get a licence. This enables the council to check that the landlord is a "fit and proper person" to be acting as a landlord.

Compliance

To comply with Mandatory licensing requirements, properties of a certain size need to be fitted with various safety measures dependant on the number of tenants in residence:

- Fire resistant doors with self-closing mechanisms and intumescent strips.
- Hard wired smoke / heat detection systems.
- Emergency lighting.
- Thumb turn locks on external doors.
- Fire blankets / extinguishers.

Regulations can vary from council to council and LACORS (Local Authorities Coordinators of Regulatory Services) produces a useful document on recommended standards for fire safety in HMOs which is considered a benchmark in the industry.

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It does not fall within the scope of a mortgage valuation to confirm compliance, however our surveyors have a good understanding of recommended measures and can identify whether a property is poorly adapted or managed. The landlord is ultimately responsible, and the compliance is policed by the prevailing licensing regime.

The current system will certainly benefit from improvement. One of the significant issues yet to be addressed is the lack of communication between Local Authority Planning departments and HMO licensing. In most cases there is no cross-reference. An HMO department will sometimes grant a licence where there is no planning permission in place. The landlord then is under the wrong impression that his HMO is fully compliant.

The delay in the application for licences causes issues particularly where a house is being purchased with the intention to be converted into an HMO. Licences are often granted without any inspection taking place.

Unfortunately, not all these issues will be dealt with in the forthcoming legislation.

Best practice valuation approach

Here at e.surv, we adhere to best practice which is detailed in the RICS Guidance Note on the valuation of buy-to-let properties and HMO's 1st Edition December 2016.

As such, we ensure our valuers have sufficient knowledge of residential rental and capital valuations; and are familiar with the buy-to-let market in the locality of the property.

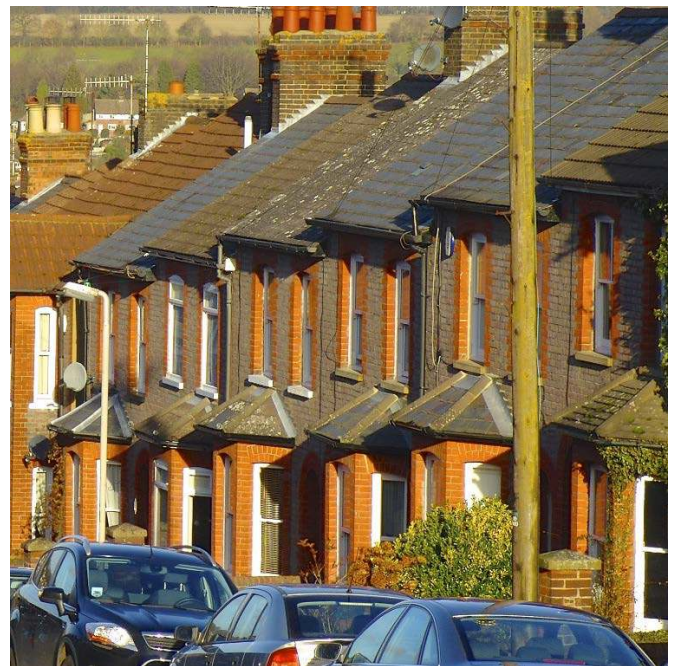
We appreciate that the valuation will assume, unless otherwise stated, that there are no restrictions to letting the property on standard residential terms.

The valuer will use their local knowledge but the expectation is that the lender will carry out all appropriate checks prior to lending.

Apart from some specialist commercial type valuations not carried out by residential surveyors the capital valuation of the property will always be on a 'bricks and mortar' basis and not by an investment approach using rental income capitalised using investment yields.

Many conventional lenders lend solely based on a single rent to a family. This becomes difficult to assess where a property lies in a location where the most likely tenants will be sharers. In this instance and when the rental use for sharers is considered by our valuers as sustainable then a simple 'sum of the rents' approach can be used if agreed by the lender.

Care is taken by our valuers to ensure that quoted rents are net of bills as many landlords offer rents inclusive of utilities, broadband and other benefits.



Issues to be aware of

The valuation of an HMO requires additional

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observation. Landlords and tenants will often try to disguise certain issues or hide them from the surveyor. We pay attention to the following important details:

- The number of tenants in residence.
- A potentially eight-bedroom HMO will often have a landlord who insists only five of the rooms are used to explain the lack of planning permission.
- Is the property being used as an Air B&B or holiday let? In which case it may not be suitable for many lenders. Signs may include tourist information, visitor's books and piles of clean towels or bedding.
- Does the property appear broadly compliant? Is there evidence of safety measures in place? Does this look like a responsible landlord?
- Minimum room sizes. Many local authorities have their own policy in this respect dealt with via their licensing scheme. Some surveyors will exclude rooms like this from their rental calculation. New legislation and rules will be introduced shortly to cover this issue, discussed later in this document.

Performance Certificate rating of 'E', or higher.

- Individual rooms within HMOs are not required to have their own EPC when let. An EPC is only required if the whole property is being sold.

New legislation

The Government has confirmed that the extension of mandatory HMO licensing is due to come into force from 1st October 2018, subject to Parliamentary approval.

Purpose built flats

The regulations bring purpose-built flats where there are up to two flats in the block, into the scope of mandatory licensing. They also remove the three-storey rule – at present mandatory licensing applies to HMOs of at least three storeys and five occupants comprising of two or more family units.

The definition of properties that fall within the Mandatory licensing scheme has not been reviewed since 2006, when licensing came into force following the Housing Act 2004.

The Government has now decided to extend the scope of mandatory licensing to bring smaller HMOs within the scheme.

Mandatory licensing

Mandatory licensing will now include:

- All HMOs with five or more occupiers living in two or more households, regardless of the number of storeys. Effectively this means the storey requirement will be removed from the current definition.
- Purpose-built flats where there are up to two flats in the block and one or both of the



- Minimum EPC requirements: The regulations – which came into force on 1st April – make it illegal for landlords to start new tenancies without the property having an Energy

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flats are occupied by five or more persons in two or more separate households. This will apply regardless of whether the block is above or below commercial premises. This will bring certain flats above shops on high streets within mandatory licensing as well as small blocks of flats which are not connected to commercial premises.

As is the case now, it is the individual HMO that is required to be licensed and not the building within which the HMO is situated. This means that where a building has two flats and each is occupied by five people living in two or more households, each flat will require a separate HMO licence.

It has been made clear that landlords with properties that fall into the category of an HMO, even if previously licensable under discretionary or additional licensing, are required to submit an application by 1st October 2018 at the latest.

There are serious consequences for landlords and letting agents who do not obtain licences for licensable properties. The local authority can bring a prosecution against the landlord in the magistrates' court and fines for Housing Act 2004 offences have been unlimited since March 2015. Local authorities can also issue landlords with civil penalty notices of up to £30,000 per offence as an alternative to prosecution. Tenants and local authorities have additional remedies in the form of RROs (Regulatory Reform Fire Safety Order 2005) where rent or housing benefit can be claimed back from the landlord by order of the First-Tier Tribunal.

Minimum room sizes for HMOs

In addition to licensing legislation, new rules will be brought in at the same time covering minimum room sizes. This is something which is already policed by individual local authorities in Mandatory Licensed HMOs as they reserve the right to set the

maximum number of tenants in an HMO thereby excluding rooms they deem too small for habitation.

This will be standardised across all councils by the following:

- Single bedrooms must be at least 6.51sq m.
- Double bedrooms must be at least 10.22 sq m.
- For children under the age of 10 a single bedroom must be at least 4.64 sq m.

The accuracy of measurement is therefore key and we should expect further guidance from local authorities as this plays out.



Will this improve the quality of HMOs?

Without doubt 'yes'. Good valuation advice and sound underwriting should filter out rogue landlords as a matter of course meaning that finance will not be available for poor-quality HMOs.

The changes to current HMO legislation are positive, a concerted effort to improve minimum standards of properties in the private rented sector, and an opportunity to remove landlords who are not "fit and proper persons".

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While there are rules and guidelines already in place some landlords have been able to operate outside the regulations, and cases of poor housing conditions, particularly among vulnerable tenants and migrant workers, are still found. There are always those who try to operate outside legislation but this legislation will no doubt reduce the scope for this type of landlord/investor behaviour.

What impact is this likely to have on the market?

Market pressures are increasingly driving some landlords to adapt single rental units into HMOs to cover their increased costs and dwindling profit. The effect of this new legislation is likely to prove an obstacle for the less scrupulous landlord but from a lender's perspective this can serve as an extra filter to prevent poorer properties being taken in to their loan book.

In our view the tightening of legislation makes it much easier to identify a property which clearly doesn't meet minimum requirements and to defend the valuation decision if challenged. Valuing this type of property will require some additional checks and will include measuring individual rooms where necessary.

While a few investors appear to have offloaded their buy-to-let properties in recent months due to dwindling returns, most professional HMO landlords have taken a positive approach. Many seek to add value to their investments by providing a premium HMO product, particularly in the student sector, with well-equipped and refurbished HMO's that compete with the more expensive purpose-built student accommodation. The competition in this sector is also driving quality up. The effects of this new legislation will be to further raise the quality of this housing sector.

Conclusion

HMOs remain an attractive investment for many landlords where traditional single unit buy-to-lets have become less attractive due to Government

legislation and tax changes. The increased cost of housing also means demand for this type of accommodation remains strong, so we expect this type of valuation work to be more prevalent in future.

The Government's programme of reforms in housing are raising the quality of housing and shifting sectors such as HMOs from what was a "cottage industry" into the professional arena where it can be properly regulated.

Lenders should welcome the new rules.

Feedback

This paper was produced by the Risk & Governance department of e.surv Chartered Surveyors. We aim to address the issues that matter to our corporate clients and therefore invite your feedback on this paper.

In addition, we are keen to hear about any other subject areas that are of interest to you so that we may consider covering these in future.

Please send your feedback to David Ward at david.ward@esurv.co.uk or ring 01536 535527.