Society of Mortgage Professionals
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Good Practice Guide

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Residential second charge for Mortgage Professionals

This paper is in response to members' requests to provide a summary of good practice within one source document and is based upon the Society of Mortgage Professionals' understanding of the regulator's rules and current stance. Whilst a summary, it is not intended to be exhaustive and should not be relied upon at the exclusion of other sources of information.

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Foreword

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The demand for second charge mortgages is growing with new business levels reported at the highest for a decade. Having worked in this sector for over 15 years I am excited about the renewed momentum within the market and the opportunities this presents for professional advisers and their clients.

Structural changes to the mortgage market, such as the rise of the product transfer market and the changing preferences of borrowers leaning towards longer term fixed rate mortgages, means advisers need to review their client services to ensure they can continue to meet the changing needs of their clients. Second charges are a great example of this.

This Good Practice Guide is designed to provide a valuable insight for mortgage professionals as to when it would be appropriate to consider a second charge for client looking to raise capital.

There are many compelling reasons why advisers need to ensure they are providing a more holistic advice service. The inclusion of second charges within this is critical to ensuring the best possible financial solution is offered to any borrower looking to raise capital, as well as adding significant value to your client relationships.

Background to residential second charges

The second charge market has been going through a period of evolution in recent years. Historically second charges fell within the scope of the Consumer Credit Act 1974 which meant that for mortgage intermediaries there was a disconnect in terms of the permissions required to arrange a second charge mortgage over a first charge.

It also meant more significantly that there was no requirement to provide advice in connection with a second charge and consumers were not protected in the same way as they would have been had they taken out a mortgage.

However all this was to change following the introduction of the Mortgage Credit Directive in 2016 which also coincided with the transference of second charges into the mortgage regime. For the first time the regulatory standards and rules for first and second charges became aligned, meaning that there was a requirement placed upon firms to provide advice in connection with a second charge mortgage.

As a result consumers were offered greater protections under the new regulatory regime and the professionalisation of the sector began in earnest.

Market overview

Whilst the overall size of the second charge market which represents around £1.1bn of annual lending is small in relation to mortgage lending this doesn't tell the whole story about how the market has rebounded following the financial crisis to achieve significant and sustainable levels of growth.

Back in 2011 the Finance and Leasing Association reported annual lending of just £286m, which means in eight years the market has grown over 300%, with all signs pointing to a continued pattern of growth.

It is also significant that there is an equally positive story to tell on the number of repossessions which are on course for a record low in 2019, supporting the view that the way second charges are recommended and assessed under the mortgage regime is underpinned by a prudent and responsible approach to lending, which is a world away from the reputational issues previously associated with this type of lending.

How the changing mortgage market will support the growth of second charge lending

Product transfers overtaking remortgaging

The emergence of the product transfer market has meant behaviours within the mortgage market are changing for borrowers nearing the end of their current product term.

UK Finance reported that in the second quarter of 2019 internal product switching represented £41.4bn of mortgage borrowing of which £17bn was on an execution only basis.

In a more stark warning IMLA reported earlier this year that the 2018 product transfer market activity was more than twice the number of remortgage completions.

With many high street lenders now becoming increasingly proactive in making early contact with borrowers approaching the end of their product term, there are increasing challenges for advisers to maintain their valuable client relationship.

The product transfer market presents a fantastic opportunity for advisers with well executed retention strategies to revisit their clients' needs, even if they have made decisions on their next mortgage product on an execution only basis.

This can include a follow up client discussion to understand their plans and immediate financial goals, many of which could be met by a second charge product. This is the perfect way to maintain the client relationship, and the inclusion of second charges within the adviser toolkit is the perfect opportunity to demonstrate to valuable clients that there are various ways in which they can take care of their financial needs

Changing borrower preferences for longer term fixed rates

The ongoing political and economic uncertainty brought about by the Brexit decision has seemingly impacted on borrowers' preferences for longer term fixed rates.

Paragon's FACT Index for Q1 2019 showed that nearly half of all mortgage customers now opt for a fixed rate mortgage of five years or longer compared to only one in four mortgages back in 2013.

With a similar picture for buy to let borrowers, there is a challenge for advisers to widen their scope of advice to ensure that client contact can be maintained particularly when the opportunity to discuss remortgage opportunities is diminished by the changing structure of the mortgage market.

This is further evidence that it is becoming increasingly important for advisers to extend their product reach and knowledge to make their services more valuable to their clients as their needs and preferences change.

When are second charges a good option?

Allowing further borrowing without disturbing current mortgage arrangements

One of the key benefits of a second mortgage is that it allows borrowers to keep their arrangements intact with their existing first charge lender whilst raising funds to meet a specific borrowing requirement, such as making home improvements or consolidating debt:

- Borrowers who are benefiting from a preferential mortgage rate which may be affected by remortgaging, eg a low tracker rate, or a low fixed rate
- Borrowers who would incur early repayment charges by redeeming their mortgage early
- Borrowers who have an interest only mortgage
- Borrowers on longer term fixed rates
- Borrowers who have recently transferred their mortgage product

Borrower circumstances

One of the key reasons that the value of intermediaries has never been higher is that not all borrowers circumstances are straightforward and often they fall foul of automated underwriting procedures which cannot take into account their individual story or background. The vast majority of second charge lenders operate on a manual underwriting basis which means this can be a lifeline to those mortgage customers who would benefit from a more individual approach to understanding their situation, which might include:

- Their circumstances mean they would may not pass the required credit score for a high street remortgage application
- They have more complex circumstances such as different income streams or a less than perfect credit score
- They have recently changed jobs or become self employed
- They want to take out a loan term which is different to their existing mortgage, eg they have 20 years remaining on their existing mortgage but want to take the additional borrowing out over a longer term to keep the payments lower

Flexibility and speed

Second charges offer a great deal of flexibility across loan size, loan purpose, term and speed for borrowers looking to raise additional finance.

- **Loan size:** Second mortgages offer borrowers access to a range of loan sizes, typically from £10,000 to £1,000,000. Larger loan applications can be particularly beneficial to high net worth borrowers, for example where they are carrying out significant improvements to higher valued properties or business purposes which may not be outside the criteria for a further advance.
- **Term:** Loan terms are typically from 3-30 years. Where second charge mortgages can offer real flexibility is in the fact that the new loan can be taken out on a separate term to the first charge mortgage. For example the borrowers have a repayment mortgage with 15 years left to run, but to keep the payments as low as possible they wish to take the second charge out over 20 years.
- **Speed:** Certain second charge mortgages can be completed in a relatively short space of time. A number of second charge lenders permit automated valuations subject to qualifying criteria which can really speed up the process
- **Sole married/Co-habiting applicants:** A number of lenders will accept applications from married/co-habiting applicants on a single application basis where the property is owned in a sole name. The non-benefitting spouse would normally be required to obtain ILA.

  In addition second charge lenders will sometimes allow non-owning spouses/partners to be added to the loan application even if they are not legal owners of the property, enabling their income to be included within the affordability assessment.

Legal representation

For the majority of second charge mortgages, borrowers do not need to appoint a solicitor to act for them. There are circumstances where borrowers are required to obtain independent legal advice but this is not a standard requirement which means many borrowers will not incur legal costs as part of the application process.

Good practice

There are several options for intermediaries looking to submit a second charge application with lenders and specialist brokers offering various routes to access second charge products. Whilst the sales process for first and seconds will be very similar, the way in which the loan is processed can be fundamentally different.

One of the unique features of the second charge market is that these products are distributed through second charge advice firms sometimes on an exclusive basis. There are an increasing number of lenders who accept applications directly from mortgage intermediaries with varying processes amongst broker firms.

Below is a detailed overview of each option.

1. Outsource the advice and arrangement of a second charge loan to a specialist second charge brokerage (Master Broker Partner).

This is a suitable option if:

- You have limited knowledge of the various second charge products and criteria available which may affect the quality of the advice provided to your client.
- You would feel more comfortable outsourcing the compliance responsibility to a specialist firm.
- You have limited time and resource so this route would enable you to focus on your core business.
- Second charges only represent a small amount of overall business.
- The lender who has the most appropriate option for your client distributes their products exclusively through specialist second charge broker firms.
- You are part of a mortgage network who do not extend your scope of service to include second charge advice.
- You are not an independent broker offering a broad range of products across the first and second charge market.
- You are not familiar with the different processes and documents required in connection with a second charge which can differ significantly to that of a mortgage application.

2. You advise the client on the second charge and outsource the processing (packaging) of the second charge to a specialist broker firm.

This is a suitable option if:

- You wish to retain control over the advice process but do not have the relevant experience or resource to package the loan.
- You cannot commit to providing regular monthly completions.
- You are an ‘independent’ adviser.

3. Submit the application to the lender directly.

This is a suitable option if:

- You wish to have overall control over the application all the way through to completion and you are able to advise on the second charge mortgage.
- You can adapt to the varying requirements of second charge lenders who may require introducing brokers to obtain additional supporting information such as mortgage lender references and consent to a second charge which may incur fees.

Conclusion

There are many compelling reasons to consider second charges if you are not already doing so. The ability to adapt to a changing market will become increasingly important to intermediaries, particularly if remortgaging activity is an important part of your day to day business. The emergence of the product transfer market and the increasing popularity of longer term fixed rates will mean the way in which brokers will interact with their clients will inevitably change.

With second charge rates at a record low starting from around 3.6%, seconds can be a cost effective way of raising additional capital without disturbing your clients existing mortgage arrangements.

The ability to expand your range of advice options will add important value to the intermediary client relationship and, with an even greater choice on the way, intermediaries can access second charge products to create new opportunities for both your clients and your business.