Searching for Low Risk

Why mortgage lending to buy-to-let landlords is so secure

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Executive summary

When the Bank of England first cut its base rate to an unprecedented 0.5% in an effort to help the UK economy survive the global financial crisis, almost nobody expected that six years later it would remain unchanged at that same rock bottom level. Yet now, some predict it may stay there for years yet to come.

Whilst few argue with the necessity for the Bank of England’s approach, equally few would argue that savers have been hardest hit. People in Britain collectively hold more than £1.2 trillion in cash deposits of one form or another, despite these savings earning nothing or next to nothing for years now.

In this context, the search for low risk investment opportunities, appropriate for previously cash-only savers, has becoming increasingly important, if not crucial to the interests of Britain’s struggling savers.

Lending into the Buy-to-Let market offers an intriguingly attractive proposition in terms of being able to secure attractive returns that beat inflation and deposit based savings account, yet without taking the levels of risk associated with stock and shares or even bond markets. This unique opportunity arises from the specific nature and characteristics of the UK Buy-to-Let market which work together to create a remarkably robust way to generate good returns at surprisingly low risk:

1. UK residential property has long been the safest form of collateral for lenders of all varieties. Against a backdrop of a greatly changing economic environment, house prices have been remarkably robust, increasing by over 1,800% between 1973 when accurate records began, and 2014. There have been property price falls on a number of occasions, but each has been followed by an upswing. Notably, residential property prices have been significantly more robust than other assets such as commercial property and equities.

2. While the market value of a buy-to-let property provides security for a loan, it is actually the rental income stream that it generates that really underpins the safety of the lender’s position. As long as the rental income can comfortably service the mortgage payments, the lender can be quite confident that they are ultimately unlikely to face a loss. Historically, house prices have been relatively stable compared to other assets, but rents have been even more robust.

3. Lending to buy-to-let landlords enjoys their stronger commitment and ability to pay than owner-occupier borrowers. This is a function of landlords typically enjoying greater financial security, underpinned by ownership of a number of tenanted properties beyond that being lent against.

4. The outlook for tenant demand in the UK is very strong indeed, with all demographic factors pointing to steady if not dramatic future growth.
5. Buy-to-let lending shows significantly lower arrears than owner-occupied lending. In 12 out of the last 15 years, arrears were lower in the buy-to-let market, which is a remarkable performance for a class of lending that only started in 1996. In addition, the ability to manage defaulting borrowers more swiftly and efficiently makes buy-to-let lending significantly lower risk than owner-occupied lending.

6. The prevailing interest rates charged for buy-to-let mortgages are notably higher than those for owner-occupied mortgages, despite the lower risk nature of the buy-to-let market. Over recent time, owner-occupied lending has averaged a 3% interest rate, whereas buy-to-let has averaged 4%, a full one third higher. This difference appears to be down to significantly lower competitive pressure in the buy-to-let market, with the majority of banks focused much more heavily on the owner-occupied mortgage market.

Given that buy-to-let mortgage lending only started as a distinct category of its own as recently as 1996, it is already a head-turning phenomena. Its growth has been rapid and is set to accelerate greatly. It has already proven itself to be the most attractive lending class available in terms of defaults and losses. The relative lack of interest in the market from traditional lenders – the banks – has left prevailing interest rates 30% higher than owner-occupied mortgage lending. All of this makes buy-to-let mortgages an ideal asset class to power new retail financial products offering new standards in attractive returns at low risk.
What makes lending for buy-to-let low risk?

1. Property as security

Historically UK residential property has been the safest form of collateral for lenders of all varieties. Fortunately we can track its price performance on a regional basis as far back as 1973, when the Nationwide Building Society started publishing this data.

Over the four decades since 1973 the UK has suffered four major recessions (in the mid 1970s, early 1980s, early 1990s and the 2008-9 period) and seen the economic environment change out of all recognition. This has thrown up a wide range of different challenges from the high inflation of the 1970s, to the high unemployment of the 1980s and 1990s, the financial turmoil of 2008-9 and the falling real wages of recent years.

Chart 1

UK GDP growth and inflation

Source: ONS
Against the background of this changing economic environment, house prices have been remarkably robust, rising by over 1,800% between 1973 and 2014.

Examining the data in detail, we would make the following observations:

- House prices are relatively stable, showing much lower price volatility than other assets such as commercial property or equities.

- Housing is a good hedge against inflation, rising in value during periods when inflation is high.

- Yet housing can also perform well in a low inflation environment as we have seen in recent years, as low interest rates have reduced the cost of servicing a typical mortgage.

- House price changes tend to be serially correlated, meaning that you observe a run of house price gains followed by a run of falls rather than the more random pattern that is generally observed in most other asset markets such as equities or bonds.

Table 1 illustrates this final bullet point, showing how UK regional house prices have performed during the four upswings following the four recessions listed above. These upswings tend to be quite long – all lasted at least 5 years and in the longest upswing, house prices rose continuously for over a decade from the start of 1996 to the third quarter of 2007.
Table 1

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NORTH</td>
<td>94%</td>
<td>117.9%</td>
<td>210.0%</td>
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<td>YORKS &amp; HUMBER</td>
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<td>151.7%</td>
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<td>NORTH WEST</td>
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<tr>
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<td>253.3%</td>
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<td>LONDON</td>
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<td>327.4%</td>
<td>65.3%</td>
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<tr>
<td>SOUTH WEST</td>
<td>113.9%</td>
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<td>260.3%</td>
<td>24.9%</td>
</tr>
<tr>
<td>WALES</td>
<td>96.2%</td>
<td>143.8%</td>
<td>241.2%</td>
<td>16.2%</td>
</tr>
<tr>
<td>SCOTLAND</td>
<td>92.3%</td>
<td>80.5%</td>
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</tr>
<tr>
<td>N. IRELAND</td>
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<td>26.1%</td>
<td>447.9%</td>
<td>-13.5%</td>
</tr>
<tr>
<td>UK</td>
<td>109.2%</td>
<td>157.5%</td>
<td>258.5%</td>
<td>26.1%</td>
</tr>
</tbody>
</table>

Source: Nationwide Building Society

The flipside of these long upswings are the downturns in house prices that have coincided with economic recessions. Table 2 shows the maximum falls in regional house prices in the last four market downturns. When inflation was high, in the recessions of the mid 1970s and early 1980s, house price falls were modest or non-existent, illustrating just how much housing benefits from being a hedge against inflation.

With lower rates of inflation in the early 1990s and late 2000s, nominal house price falls were a feature of the market. But for a lender lending up to 72% loan-to-value, even taking the peak-to-trough regional house price falls of the last two recessions would not give rise to negative equity in the majority of regions.
### Table 2

**Peak to trough decline in house prices**

<table>
<thead>
<tr>
<th>Region</th>
<th>Mid 1970s</th>
<th>Early 1980s</th>
<th>Early 1990s</th>
<th>Late 2000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>NORTH</td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-14.2%</td>
<td>-16.5%</td>
</tr>
<tr>
<td>YORKS &amp; HUMBER</td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-28.4%</td>
<td>-18.5%</td>
</tr>
<tr>
<td>NORTH WEST</td>
<td>NO FALL</td>
<td>-3.0%</td>
<td>-12.5%</td>
<td>-17.9%</td>
</tr>
<tr>
<td>EAST MIDDLE</td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-25.1%</td>
<td>-19.3%</td>
</tr>
<tr>
<td>WEST MIDDLE</td>
<td>-8.0%</td>
<td>-3.3%</td>
<td>-16.6%</td>
<td>-17.5%</td>
</tr>
<tr>
<td>EAST ANGLIA</td>
<td>NO FALL</td>
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<td>-21.7%</td>
</tr>
<tr>
<td>OUTER SOUTH EAST</td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-35.9%</td>
<td>-20.0%</td>
</tr>
<tr>
<td>OUTER METRO.</td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-30.9%</td>
<td>-19.1%</td>
</tr>
<tr>
<td>LONDON</td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-31.8%</td>
<td>-20.1%</td>
</tr>
<tr>
<td>SOUTH WEST</td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-28.1%</td>
<td>-18.1%</td>
</tr>
<tr>
<td>WALES</td>
<td>NO FALL</td>
<td>-2.2%</td>
<td>-17.1%</td>
<td>-20.0%</td>
</tr>
<tr>
<td>SCOTLAND</td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-6.7%</td>
<td>-15.7%</td>
</tr>
<tr>
<td>N. IRELAND</td>
<td>NO FALL</td>
<td>-8.8%</td>
<td>-4.9%</td>
<td>-54.3%</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>NO FALL</td>
<td>NO FALL</td>
<td>-20.2%</td>
<td>-18.7%</td>
</tr>
</tbody>
</table>

*Source: Nationwide Building Society*

Of course individual properties can experience larger price changes due to a range of factors including localised market distress or the deteriorated condition of the individual property. Lenders need to manage these issues by, for example, preventing loan portfolios from becoming too geographically concentrated.
2. Security of income generating property

While the market value of a buy-to-let property provides security for a loan, it is actually the rental income stream that it generates that really underpins the safety of the lender’s position. As long as the rental income can comfortably service the mortgage payments, the lender can be quite confident that they are ultimately unlikely to face a loss.

While house prices have been relatively stable compared to other assets such as equities, rents have been even more stable, as Chart 2 reveals. This is a major source of comfort for buy-to-let lenders because it demonstrates that the landlord’s cash flow generally remains dependable through different economic conditions. Using the official government private rental series, the largest recorded fall in rents of the past two decades was the 0.5% fall recorded in the late 2000s recession between mid 2009 and mid 2010.

Chart 2
Average quarterly rents

Source: ONS and LSL Properties Services

Lenders need to ensure that rental income is sufficient to meet maintenance costs and unexpected expenses. So it is normal for lenders to insist on an income coverage ratio (ratio of rents to mortgage payments) of at least 125%. Landbay stipulates a minimum rental income of 125% of the mortgage payment, rising to 135% for first time landlords and 140% for houses in multiple occupation (HMOs).

The importance of rental income is also illustrated by a comparison of buy-to-let lending with property development finance. Development finance allows developers to build or convert properties which can be rented or sold once completed. But during development there will be no stream of income and any development project, whether large or small, runs the risk of cost or time over-runs and the risk of disappointment on future sale or rental value. Not surprisingly, lenders require a higher return to compensate for the higher risk of financing property development.
3. Landlord ‘covenant’ or commitment to pay

The lender’s third layer of protection is the so-called borrower covenant. An assessment of the strength of the borrower covenant looks beyond the single property on which the loan is secured to assess the soundness of the borrower’s total financial position.

In part this is to understand the borrower’s wider financial situation – do they have income from a salary of other rented properties? How strong is their overall balance sheet. In part it is to assess the borrower’s attitude to debt. Is the borrower likely to prioritise loan payments over other expenditure?

The value of the security and rental income enter the borrower assessment in a fairly mechanical way; all lenders including Landbay apply a maximum LTV and a minimum interest coverage ratio. But there is much more scope for lenders to do things differently when it comes to assessing the strength of the borrower’s personal commitment to pay. For example, Landbay seeks a broad overview of the borrower’s wider financial position but many larger lenders are focused more narrowly on the property being mortgaged. Some lenders insist on a certain level of employment income, indicating that they are targeting so-called amateur landlords who are managing the business in their spare time.

Many traditional lenders set limits on the number of properties their borrowers can mortgage. By doing so, these lenders are deliberately focusing their attention on the amateur landlord in preference to larger professional landlords with numerous properties. This may seem surprising given that the professional landlord with a portfolio of properties is likely to be far more experienced with a better understanding of the markets they operate in.

The financial strength of landlords

When it comes to the borrower covenant, the buy-to-let market has a potential advantage over lending to owner-occupiers. The typical buy-to-let borrower is mature (in their 40s or 50s), is more financially stable and has higher net assets than the typical owner-occupier borrower. Often the buy-to-let borrower will have a substantial amount of equity in the property in which they reside.

For lenders, such landlords should represent a lower risk than a first time buyer in their twenties, with no track record of managing a mortgage and a limited financial cushion should anything go wrong. Even the typical second or third time homeowner is unlikely to be as solid a lending proposition, as most homeowners depend on a single source of income to pay their mortgage - their salary. Having a portfolio of rented properties provides the landlord with more diversity of income and, in extremis, should provide more options for dealing with financial stresses as rented properties can always be sold to meet commitments.
4. Positive outlook for tenant demand

By its nature, the assessment of a lending proposition needs to be forward looking. The lender needs to be confident that the borrower will meet their obligations into the future. Historical experience provides a good grounding for understanding the dynamics of the UK housing and rental markets. And the current financial circumstances and past track record of the borrower should be a good guide to their future creditworthiness. But history is not always a perfect guide to the future.

It is important therefore to understand the factors that are likely to shape the market in the coming years and decades. For buy-to-let lenders, tenant demand is a key variable. We can gauge the possible future demand for rented property by reference to future demographic projections.

Table 3 shows the official government forecast for the UK’s population. It shows that in the 25 years between 2012 and 2037 the UK is expected to see an increase of just under 10 million in its resident population. This increase of nearly 400,000 a year is substantially higher than the rate of growth seen in previous decades, suggesting that demand for accommodation will be expanding at an unusually fast rate relative to the existing stock of property.

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2017</th>
<th>2022</th>
<th>2027</th>
<th>2032</th>
<th>2037</th>
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<td>England</td>
<td>53.5</td>
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<td>57.3</td>
<td>59.1</td>
<td>60.7</td>
<td>62.2</td>
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<tr>
<td>Wales</td>
<td>3.1</td>
<td>3.1</td>
<td>3.2</td>
<td>3.2</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Scotland</td>
<td>5.3</td>
<td>5.4</td>
<td>5.5</td>
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<td>5.7</td>
<td>5.8</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>1.8</td>
<td>1.9</td>
<td>1.9</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>63.7</td>
<td>65.8</td>
<td>67.9</td>
<td>69.9</td>
<td>71.7</td>
<td>73.3</td>
</tr>
</tbody>
</table>

Source: ONS

The UK has traditionally had a weak supply response – the output of new houses has struggled to rise adequately in response to higher demand. And this effect has become more pronounced in recent years, with house building falling way short of the level required to keep pace with the growth in household numbers. This has created a cumulative worsening of the housing shortage, the result of which has been higher house prices, making it more difficult for people to buy, which in turn has raised tenant demand, putting upward pressure on rents.
So, buy-to-let benefits from important inherent protections, but how does it perform relative to other loan types? Chart 4 shows three month plus arrears for buy-to-let and owner-occupied lending in the UK since 1999. In 12 out of these 15 years, arrears were lower in the buy-to-let market, which is a remarkable performance for a class of lending that only commenced in 1996.

The three years when three month plus buy-to-let arrears exceeded those of the mainstream mortgage market coincided with the financial crisis and recession (2008-10). Closer examination of this performance reveals that it was very concentrated geographically, by property type and by lender.
Indeed, aggregate buy-to-let arrears numbers mask a wide range of performance from individual lenders. In the financial crisis a small number of lenders had a disproportionate share of the sector’s arrears. One of the largest contributors was Bradford & Bingley, who were very active in the buy-to-let market through their Mortgage Express brand, using an automated underwriting process.

By contrast Paragon Mortgages, who operate a manual approach to underwriting loans, reported three months plus mortgage arrears of 0.3% in March 2014. During the financial crisis Paragon Mortgage’s arrears were consistently below the industry average not only for buy-to-let but also for owner-occupied lending. We believe its approach to assessing loans was a large part of the explanation for this exemplary record on arrears.
We can also compare buy-to-let mortgage arrears with tenant rent arrears. Chart 5 compares 2 month plus rent arrears with 3 month plus buy-to-let mortgage arrears. Despite the difference in length of arrears between the two series they do allow for a comparison of the trend and the extent to which landlords can absorb tenant arrears. Chart 5 paints quite a positive picture: buy-to-let mortgage arrears have been falling consistently since 2009 despite rising rent arrears up until 2012, showing that landlords were able to absorb higher rent arrears. But since 2012 rent arrears have also been trending down.

There is no comparable industry data on arrears for consumer or personal loans or loans to businesses. This in itself could be considered something of a drawback for individuals thinking of lending to these classes of borrower because it makes it difficult to gauge what a normal level of arrears is for these loans or how cyclical the arrears performance is.

Indeed, it is probably more important to understand arrears performance for these other classes of lending. This is because where loans to either individuals or businesses are not secured on valuable assets such as property, the chances of recovering what is owed in the event of default is likely to be much lower.

Despite the lack of published data, anecdotal evidence shows that arrears and losses are typically much higher both for unsecured consumer loans and for loans to small businesses, and this is reflected in the higher rates of interest charged in these markets.
The management of buy-to-let arrears

The management of arrears is usually conducted using quite a different framework in the private rented sector. While repossession is the standard avenue when an owner-occupied borrower defaults, buy-to-let lenders will typically appoint a ‘receiver of rent’ to run a property or even the whole portfolio of a landlord who has fallen into arrears. A receiver of rent can take control of the property at the request of a lender when the borrower has failed to meet their obligations, ensuring that the property is properly run and that mortgage payments are prioritised out of any free cash flow that exists.

A receiver of rent has the power to decide on the ultimate course of action: sell the property, continue to rent it out or return it to the landlord’s control. This flexibility allows the receiver to choose the option that is most likely to maximise value for the landlord and the lender.

For example, in a market where sales are weak but rental demand is strong, properties can be retained and rented, avoiding the need for sale at a reduced price. On past evidence, there seems little doubt that the receiver of rent allows for more efficient management of arrears in the buy-to-let sector.

Credit losses

While there is comprehensive industry data on mortgage arrears, unfortunately there is no equivalent data on mortgage credit losses either for buy-to-let or owner-occupied lending. But buy-to-let lenders that use a receiver of rent can substantially reduce arrears and in many cases return properties to the landlord’s control. Lenders report that this has substantially curtailed credit losses in recent years.

In contrast, in the owner-occupied market there is considerable pressure from the regulator for lenders to show forbearance to borrowers in arrears. This can give the borrower time to recover their financial position but equally it can allow a borrower in serious financial difficulty to remain in the property for an extended period ultimately leading to a worse financial outcome for both the homeowner and the lender.

6. Buy-to-let versus owner-occupied mortgage rates

Data from the Prudential Regulatory Authority (PRA) shows the average mortgage rate charged to regulated (owner-occupied) and unregulated (buy-to-let) borrowers. Chart 6 shows the distribution of interest rates above Bank of England base rate for the latest quarter available. It shows that while 55% of new variable rate owner-occupied loans were at less than 3% above bank rate, the same was true of only 17% of buy-to-let loans. Over recent quarters the average variable rate charged to buy-to-let was 4.0% against 3.0% for owner-occupiers, one third more.
This data is revealing because in view of the superior average arrears performance of buy-to-let over the past 15 years, the additional layer of protection provided by the rental income stream, a robust outlook for rented property and lower maximum LTVs, it is hard to argue that buy-to-let is higher risk than owner-occupied lending.

This suggests that the traditional lenders that still dominate the mortgage market are not providing buy-to-let borrowers with appropriate mortgage pricing.
Conclusion

With inflation at an all-time low of 0% at the time of writing and economic recovery continuing only at modest rates, most commentators talk of interest rates remaining at their current 0.5% level for the foreseeable future, usually in terms of year rather than months. The Government’s recent move to take most people out of cash savings tax is a reflection of how much it knows savers are continuing to suffer in this economic climate.

In addition to this, the Government’s even bolder move to allow those with pensions savings to effectively do what they want with the money come age 55 means that the search for lower risk income generation alternatives paying better returns than cash will become even more important.

This context has naturally led to financial product designers putting their minds to building innovative new solutions for frustrated savers and new income seekers. As this paper demonstrates, these efforts should rightly consider the remarkably robust and low risk opportunities that lending into the buy-to-let market presents.
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