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MORTGAGE AND PROPERTY REPORT

Kensington

Welcome to the December 2022 edition of the Mortgage and Property Report. In this issue, we look at the UK BTL market and examine how it has developed in recent years. We explore some of the challenges it faces in the current macro-economic environment and the impact that the cost of living crisis is likely to have on landlords.

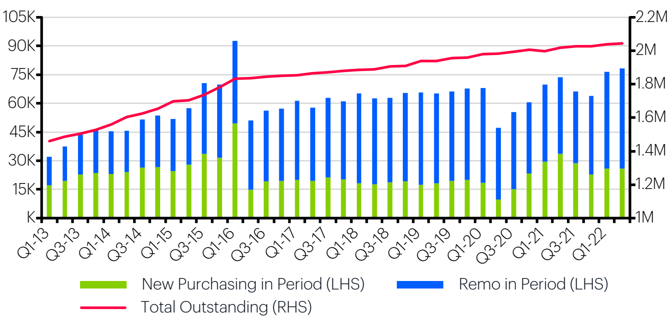
Key Highlights

- The buy to let market has grown from c. 1.5 million BTL loans outstanding at the end of 2012 to over 2 million in 2022
- The sector, which was hit by more stringent affordability assessment requirements several years ago along with changes to mortgage interest tax relief and higher stamp duty, is now coming under pressure from rapidly rising mortgage rates at the same times as personal finances are squeezed
- Significant rental yield increases will be required for property investments to remain attractive in the new higher yielding environment
- Professional landlords are likely to play a bigger role in the future, with a greater shift to Limited Company products expected as an increasing number of individual landlords leave the sector

Introduction

The Buy to let (BTL) market has played a significant role in the UK housing market since it was first launched 25 years ago and has since grown both in size and importance. At approximately 2 million loans outstanding, it represents one fifth of all UK mortgages. The sector was hit by a slew of regulatory and fiscal changes from 2016 onwards which were targeted at re-levelling the playing field to make the housing market more accessible to first time buyers. The changes slightly altered the dynamics of the market, starting a shift towards professional landlords, who can make use of more tax efficient limited companies to hold their portfolios, which we expect to become more pronounced. Now, as the decade and a half of record low rates and sustained house price increases, which kept this sector attractive to amateur investors through time finally seems to be coming to an end, we examine where this leaves BTL investors and the vast portfolio of outstanding loans which finance the UK's rental market.

Fig 1: UK BTL Market by Loan Count



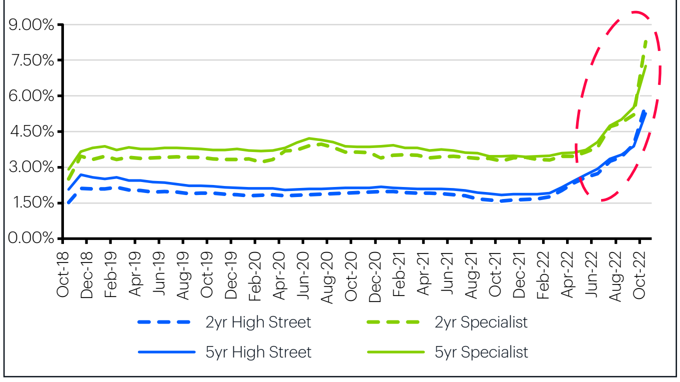
Rising Cost of Mortgage Funding

As the woes of the financial crisis started to subside in the mid 2010s, interest rates were widely expected to start increasing from their near-zero levels. However, that increase has repeatedly been stalled by major events. First, the Brexit vote and ensuing volatility in financial markets led the BOE to cut the base rate in mid-2016, right as the first increases were previously expected. Then, when the COVID-19 pandemic hit in 2020, the 2 small 25bps increases of 2017 and 2018 were quickly reversed, and the UK saw the base rate cut to a new historic low of 0.10%, further extending the era of cheap money, and with it record low mortgage rates.

When the BOE finally started to tighten monetary policy in December 2021, the rate increases were small and manageable. But the persistence of inflation, which has reached levels not seen in decades, has meant those modest steps are no longer enough. The earlier small rates rises have since been replaced by increase after increase, each one seemingly larger than the prior, and none likely to be the last. The disastrous Truss mini- budget dramatically hastened those increases, and while the volatility that came with it has since subsided, the resulting record mortgage rates have only come down slightly and are widely expected to stay at levels not seen for over a decade. Many younger borrowers in "Generation Rent," will never have experienced such high borrowings costs before, and will also have also grown accustomed to the lower rental costs cheap funding made possible.

Please contact Alex Maddox +44 (0)20 7532 9845 alex.maddox@kensingtonmortgages.co.uk
Jasmine Heinen +44 (0)7539 961 441 jasmine.heinen@kensingtonmortgages.co.uk
www.kensingtonmortgages.co.uk

Fig 2: 75LTV BTL Rates



Unfortunately, this increase in the cost of mortgages means that for many landlords the maths just do not add up anymore. The success of a BTL investment is reliant on the monthly rental income from a property being higher than the (normally Interest Only) mortgage payments and other costs, such that the difference is the profit for the landlord. The changes to tax relief on mortgage costs from 2017-onwards (see prior edition) have already squeezed this equation considerably, particularly for higher rate tax payers.

Impact on Rental Yields

In assessing a customer's affordability, lenders typically ensure that the rental income of the property is enough to cover a multiple of the mortgage payment (known as the interest coverage ratio or "ICR"). Although the multiple tends to be similar across lenders (between 1.25 and 1.45 depending on tax status), the rate used to derive the mortgage payment varies, with the most aggressive being "pay rate" lending where the initial fixed rate is used for calculating the rental yield required, with no additional interest rate stress applied.

Looking back at 2018, the rates offered by specialist lenders originating loans with affordability assessed on pay rate were typically between 3.0% and 4.0%. In analysis conducted at the time, we found that mortgages rates were forecast to be c. 1.5% higher in 5 years' time, based on forward Libor rates, which translated to an annual increase in rental prices of c. 2.4% to keep the same ICR. Unfortunately, forecasts seldom align perfectly with reality, which is precisely why additional stresses are so important. Following the recent spikes in rates, a landlord would actually need a 10.36% annual increase in rental prices in order to be able to refinance onto a new 5yr product at current market rates (fig 3).

When we look at the rental increase required to re-mortgage onto a 2yr product, the outlook is even grimmer. Based on 2018 rates, the mortgage would have been assessed on a rate of 5.5%, the minimum required at the time by PRA-regulated lenders, and widely adopted by the market. This would have required an annual rent increase of c. 7.3%. However, as we know, rates have increased far above that, and mortgages fixed for less than 5 years carry an additional 2.0% stress, meaning an annual increase of 17.5% would be required to meet affordability on those loans. With tenants simultaneously squeezed by large inflation-driven increases in the cost of food and energy, their ability to pay such large rental increases will be limited.

While many landlords may have more headroom to play with, these dramatic increases in mortgage rates in a short period still mean that even for those who can afford to re-mortgage when their fixed rate period is up, the drop in income they are likely to experience may well mean their investment is no longer worthwhile and is thus expected to result in private landlords exiting the market and selling their properties. This will likely further increase upward pressure on rents, as the supply of the private rental sector is shrinking, at the same time as many would be home-owners are shut out of the purchase market for the same reason, increasing demand. We are starting to see potential evidence of landlords leaving the market with CPR rates on pre-crisis BTL mortgages starting to rise (discerning between refinancing and sale of property is difficult).

On a positive note, only c. 25% of UK BTL mortgages will reach the end of their fixed rate period in the next 2 years. However, a further 35% are on either a tracker or SVR which means they are likely already impacted by the rapidly rising rates. Nonetheless, the trend towards fixing for 5 years in recent years does mean that a notable portion of the market is, for now at least, insulated from immediate shocks.

With fewer mortgage products in the market in recent months (fig 6) and those available significantly more expensive, good options have been few and far between. The recently announced reduction to capital gains allowance (with the annual exempt amount cut from £12.3K to £3K in April 2024) means that for those landlords deciding to exit the market, selling up is also going to become less attractive, particularly for more recent entrants who may not have benefited from many years of house price increases.

Fig 3: Forecast Rental CAGR Required in 2018 vs Actual Rental CAGR Required based on Today's Rates To refinance into a 5yr 75% LTV £250K Mortgage

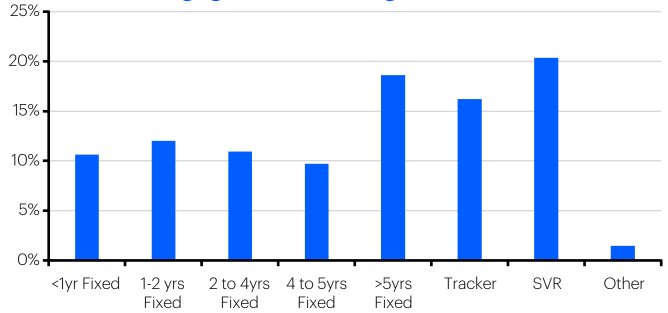
2018 Average Pay Rate Lender	Average Min ICR	Average 2018 Min rental income needed	2018 Forecast Assessment rate in 5yrs	2018 Forecast CAGR Required	Current Min ICR	Actual Current 5yr Assessment Rate	Actual Rental CAGR Required
3.87%	140%	£840	4.35%	2.36%	143%	6.54%	10.36%

Fig 4: Forecast Rental CAGR Required in 2018 vs Actual Rental CAGR Required based on Today's Rates for a 75% LTV £250K Mortgage 2yr Product[1]

2018 Average Pay Rate Lender	Average Min DSCR	Average 2018 Min rental income needed	2018 Forecast Assessment rate in 5yrs	2018 Forecast CAGR Required	Current Min ICR	Actual Current 2yr Assessment Rate	Actual Rental CAGR Required
3.87%	140%	£840	5.50%	7.26%	143%	8.67%	17.52%

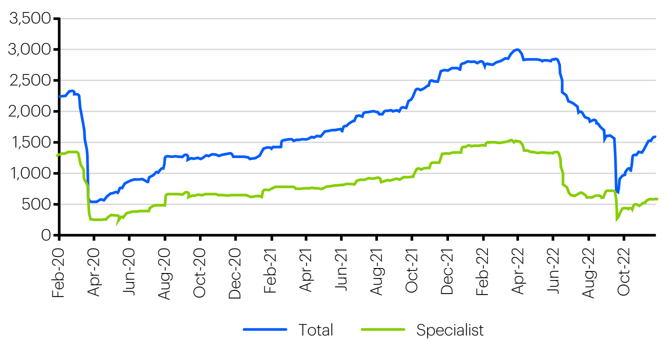
Please contact Alex Maddox +44 (0)20 7532 9845 alex.maddox@kensingtonmortgages.co.uk
Jasmine Heinen +44 (0)7539 961 441 jasmine.heinen@kensingtonmortgages.co.uk
www.kensingtonmortgages.co.uk

Fig 5: Fixed Period Remaining on UK BTL Mortgages Outstanding (as of Q3-22)



On a slightly more positive note for those who landlords who have been in the sector for a long time and are now exiting, their investment will still have been a good one. If when buying an investment property in 2018 a landlord took a 10 year view (with sale of property at the end of that period), they could reasonably expect a return of 6% on their investment based on forecast HPI and mortgage rates (assuming a 75% LTV IO mortgage for a higher rate

Fig 6: Number of BTL Products in the Market



tax payer). Comparing that to how it has actually played out in the 5 years since then (assuming the property is sold after the 5 year point), their yield is likely closer to 10%, thanks to higher than forecast HPI, and persistent low funding costs. Unfortunately, on the flip side if a landlord is looking to enter the market now and takes a 10 year view, the outlook is relatively grim. With HPI forecast to be low or even negative while funding costs remain high, a huge increase in rental yield would be necessary just to break even. A 5% equity return would require a sustained HPI of 4%, which unfortunately is far from current forecasts.

Conclusion

Despite all this, performance of BTL mortgages seems relatively resilient as of yet, although the first cracks are starting to appear. Unfortunately, it is difficult to discern a meaningful trend from available data on arrears or repossessions, as the Covid pandemic created such a skew that distinguishing current trends from lingering after-effects is near impossible. While Ministry of Justice data covering the quarter to June 2022 shows a notable increase in both mortgage and landlord possessions claims vs. the same period in 2021, much of that could be attributed to the large backlog created by the restrictions on enforcement during Covid. Still, increases in both arrears and possessions are to be expected with increased pressure on both landlords and tenants. Nonetheless, there are some positive signs, as more lenders are moving to cut rates slightly, and there has been a bounce back in the number of products offered in recent months. For those lucky enough to have invested in the early days of BTL, house price increases also ensure that an exit from the sector will yield high returns. The market is expected to continue to shift towards professional landlords, as amateurs looking to make a quick return are likely, and probably rightfully, spooked.

Data

1.) Fig 3 and 4: rates based on an average of 3 pay-rate lenders

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