The Residential Roundup

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In the eye of the mortgage storm

Annual inflation figures for July and August are expected to bring better news for the UK economy as the impact of higher energy costs recedes. But higher than forecast rates reported so far this year and rising core inflation measures are leading forecasters to speculate that base rates will need to increase further and stay higher for longer.

Currently fixed rates are pricing in this potentially higher peak, at least until we have further clarity on a few of the key economic indicators. The latest figures from Lifetime Capital suggest best buy rates for a five-year fix have risen by 80 basis points in the last month, now averaging 5.3%, with average rates across the market now starting with a six. The Bank of England estimates that around half of mortgage accounts (circa. 4.5 million) will have already seen increases in repayments since mortgage rates started rising in late 2021.

Higher rates and uncertain market sentiment are impacting prices and activity, but the market may prove to be more resilient than some anticipate.

The latest unemployment figures edged up to 4.0% between March and May but remain below the long run average of 5.9% in the ten years pre-pandemic. Wages are rising too, with a 7.3% annual increase in March to May 2023, albeit still below inflation. Stress testing, introduced as part of a raft of affordability measures in 2014, means a household's ability to repay debt has been tested to higher rates (SVR + 3%) meaning most will, in theory, have been assessed on a repayment at 7% or higher. The strength of the job market is key here and something we will be watching closely over the coming months.

For those borrowers who do struggle with rising rates the governments Mortgage Charter also makes the obligations for lenders clear, with deferred payments, extensions to mortgage terms and the option of interest only all being offered as a solution to rising costs in the short term. It will be challenging for the market, but we are not expecting to see significant distress and forced sales at current rates.

Implications of higher rate – indicative monthly payments on £200,000 mortgage

Mortgage rate	Repayment -25 year	Repayment - 40 year	Interest only - 25 year
3%	£948	£716	£500
4%	£1,055	£835	£667
5%	£1,170	£965	£833
6%	£1,289	£1,101	£1,000
7%	£1,414	£1,243	£1,167
Change per month 3% to 7%	**£466**	**£527**	**£667**

Source: JLL Research

The challenge of buy-to-let and high interest rates

Demand for rental properties continues to outstrip supply. The latest figures from the RICS, reported as a balance of opinion, show +40% of respondents saw an increase in tenant demand in June, yet the net balance for landlord instructions fell to -36%, the most negative monthly figure since May 2020.

Rents on new lets rose 10.4% in the year to June according to figures from Homelet, with London seeing a 12.5% annual increase. And fewer properties are reaching the market to let, with a rise in renewals and lack of new entrants into the market with properties to let meaning available stock levels are 25% down on where they were pre-pandemic (30% lower in London).

Yet the higher proliferation of interest only debt means landlords remains more exposed to increases in interest rates. An increase in mortgage rates from 3% to 7% adding £667 to the monthly mortgage bill on a £200,000 interest only loan, compared with £466 for a repayment mortgage. Meaning even recent rent rises may not be sufficient to counter the increased debt costs for more highly leveraged landlords.

Of course, many landlords will have other sources of income and assets to fall back on. But higher costs for landlords could exacerbate rental increases and stock scarcity for tenants. As landlords who find themselves having to 'top up' their mortgage payments are tempted to leave the sector.

How indebted are buy-to-let investors?

Like the owner occupier market there many landlords, particularly those who have been in the market for some time, who are in a stronger financial position to counter higher rates. Analysis of the English Private Landlords Survey suggests 38% of landlords have no debt secured against their rental properties. Of those with debt just over half (51%) have loans of 50% LTV or more, with 16% of landlords with debt have 70% LTV or higher.

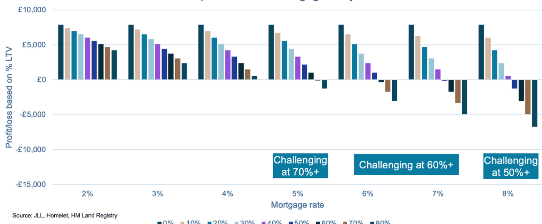
Assuming 5.2 million privately rented homes UK wide this suggests 2 million are debt free. Leaving 3.2 million rental properties. Of those 1.6 million have an LTV of 50% or more, with circa. 500,000 having 70% LTV or higher. Meaning affordability pressures will be most acute for around 10% of the PRS.

Who's at risk?

Obviously, every landlord's situation is different. But to assess the impact of higher rates on buy-to-let landlords we have looked at an average priced property (£285,000) achieving a 5% yield before costs. Based on these values an investor with an interest only mortgage paying 3% would be making £3,000 a year post tax profit at 70% LTV, or £4,400 at 50% LTV. Moving across to a 6% rate sees landlords borrowing at 70% LTV lose £120 per

annum. At 8% losses for those with 70% LTV mortgages increase to almost £5,000 per annum. Of course, some landlords will own their properties within a limited company meaning they can offset mortgage interest costs (other costs and taxes do apply). But even for those landlords a 70% LTV mortgage monthly interest payments of £1,167 at 7% would likely exceed monthly rents after costs.

Rate rises and tax rules challenge buy-to-let investors



Source: JLL, Homelet, HM Land Registry

Assumes 25-year interest only mortgage, with property owned by high-rate taxpayer and not held in a ltd. Company. Profit/ loss based on £285,000 buy-to-let property let at 5% yield. Assumes 20% tax relief on mortgage interest.

What does this mean for the rental market?

With increases in the cost-of-living and rising rents putting additional pressure on tenants many will have limited sympathy for landlords. Many of whom will have made significant profits from their rental properties through income and capital growth.

Indeed, we expect that most will have other sources of income or additional funds to bridge any gaps in the short term. However, for those landlords considering leaving the market, higher costs, alongside new legislation through the Renters Reform Bill and the prospect of additional investment in getting properties up to EPC-C may be the deciding factor in exiting the market.

Calls for support for borrowers has been quickly rebuffed by Westminster, with the government instead encouraging more flexibility from lenders alongside tailored support for those most at risk of default. But for landlords already on interest only deals there a fewer options.

Of course, these properties don't disappear, but the challenge will be attracting new landlords to take their place. Some will be sold to former tenants but overall, it is not difficult to see how this could further reduce the stock of privately rented homes.

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