COPING WITH MORTGAGE COSTS IN A RISING INTEREST RATE ENVIRONMENT …

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Most landlords use mortgages to fund their property purchases, allowing a better return on their own cash invested plus more properties to be purchased with the same cash investment.

In turn, mortgage interest is many landlords' single biggest cost, and so coping with a rising bank rate and tightening mortgage market can be a challenge. It is therefore vital that mortgaged portfolio-landlords understand their borrowings in detail, to enable them to understand their overall debt position and exposure to rising interest rates.

What's changed? Mortgaged landlords have always had to manage their debts and interest rate risk!

As we know, the Bank of England (BOE) Base Rate (known as 'Bank Rate'), which is set by the Monetary Policy Committee (MPC) every month, has risen significantly since December 2021 (from 0.1% to 1.25% at July 2022), with five separate increases (and, reportedly, more to follow).

Bank Rate is the UK's most important interest rate, and is set by the BOE to meet the government's target inflation rate (2% currently). Crucially, Bank Rate influences the interest rates that banks charge mortgage borrowers – whether directly via a variable-rate mortgages, or indirectly in the pricing of fixed-rate mortgages.

The financial crash of 2008 caused Bank Rate to be reduced to an unprecedented 0.5% to support jobs and spending, and Bank Rate remained extremely low, even reducing to 0.1% in response to Covid.

Many landlords have therefore benefitted from a massive reduction in finance costs – for around 13 years - as a result of such ultra-low interest rates. However, all good things must come to an end, and with inflation currently well above the 2% government target, Bank Rate is rising, and may rise further … meaning landlords now more than ever need to analyse their property debt profile to ensure they are able to survive any future rises in Bank Rate.

Understanding your mortgage borrowings and interest rate risk

Many BTL mortgages begin with a fixed term, followed by a variable follow-on rate (the 'revert rate'). In the past it was the norm to remortgage onto a new fixed term mortgage as each fixed term ended; however, with many mortgages having very low follow-on rates in recent years it has often not been worth remortgaging, as the fixed terms on offer were more expensive than the follow-on rate.

However, variable-rate mortgages by definition aren't fixed, which exposes the borrower to more interest rate risk. Most mortgage revert rates will be to either a Bank Rate tracker or the lender's own Standard Variable Rate (SVR):

TRACKER MORTGAGES

Most tracker mortgages follow the Bank Rate, plus a fixed margin. For example, the mortgage rate may be 1.75% above Bank Rate (currently 1.25%) to give a pay-rate of 3%.

Tracker mortgages are attractive when Bank Rate is expected to remain low. Lenders are contractually obliged to cap their mortgage pay-rates to the terms of the mortgage agreement.

However, as we have seen since December 2021, variable rate mortgages that track Bank Rate can lead to month-on-month increases in mortgage pay-rate, so understanding the proportion of mortgage debt that is on variable vs fixed rates is vital for a landlord to understand their interest rate risk.

LENDER STANDARD VARIABLE RATE

Some lender revert rates are set by the lender themselves – this is the SVR. This has meant that many investors did not benefit from historically low Bank Rate, as most lenders did not reduce their SVR even with such a low Bank Rate. These mortgages can be less attractive than tracker mortgages as the pay-rate is set by the lender, regardless of how Bank Rate may change.

Completing a mortgage review

Completing a mortgage review to understand your debt profile, helps to understand your exposure to changes in interest rates. This can be completed by analysing borrowings by property and lender, and mortgage type and margin rate. Multiplying these figures out and allowing for different Bank Rates, provides a simple stress test to highlight how the portfolio copes with different interest rate scenarios.

Yield on debt

A key metric to calculate is the portfolio 'yield on debt'. This is the rental income as a percentage of borrowings. This allows a simple comparison between what the portfolio generates in income, versus what it costs in mortgage interest. There should be a healthy margin between these two percentage figures to enable letting costs to be paid, with some 'spare capacity' to fund contingencies … and rising interest rates.

Using the mortgage review

The purpose of completing the mortgage review is to understand how changes in Bank Rate could affect rental profit. For example, a landlord with a portfolio of tracker mortgages faces a very different interest rate risk to a landlord with 10-year fixed rate mortgages. Most landlords have a mix of tracker and fixed rate mortgages, so understanding the ratio of these is crucial.

Having completed the mortgage review, it is then time to stress test the portfolio using different Bank Rate values to review the current position, the likely break-even Bank Rate, and the Bank Rate that would cause an actual cashflow loss, ie a catastrophic position where mortgage interest payments may be missed, causing credit record damage.

Mortgage review completed, interest rate risk understood … what next?

What action should be taken if the result of the mortgage review of a portfolio can't survive a return to higher rates?

1. **Remortgage expensive mortgages onto better deals … most lenders price their mortgages according the Loan To Value (LTV), meaning a 60% LTV mortgage will have a better rate than an 80% LTV mortgage.**

   It may be beneficial to remortgage some properties upwards (which may sound counter-intuitive!), then use the funds raised to pay down another mortgage to qualify for a better mortgage rate on that property, eg remortgaging a 40% LTV mortgage up to 60% and then using the funds to repay an 80% mortgage down to 60%, could result in an overall saving, ie two x 60% LTV mortgage interest would be better than a 40% LTV + 80% LTV mortgage scenario.

2. **Sell off any properties with a low yield and poor mortgage rate (or high LTV). Many landlords have been able to carry properties with below-par yields if these are financed with a cheap tracker mortgage.**

3. **Keep the mortgage, sell the property. Many mortgages are portable and so can be transferred to another property. This can allow the disposal of a poor property while retaining a good mortgage – so worth checking the mortgage offer.**

4. **Increase the rent – has the rent kept pace with the market? Can the property be let on a multi-let basis? Could developing the property or carrying out repairs allow a higher rent to be charged, which often brings a far greater return than using the refurb funds to repay debt?**

5. **Are there maintenance works that can be done to 'future-proof' the property against future excessive repair bills? Could solar panels or better insulation help to make the property more attractive, and so reduce voids? Get creative to maximise the property potential.**

   And, some lenders offer cheaper mortgage rates for properties with better EPC ratings, so there would be a double benefit of securing better rents and better mortgage rates when doing energy-efficiency repairs and upgrades

6. **Last but not least … pay down some mortgage debt to (a) simply owe less money, and (b) qualify for cheaper mortgages that reflect the lower LTV. Many landlords reach a portfolio size that they are happy with and may have income and capital that could be put to use by reducing LTVs from (say) 75% down to 60-65%, to then qualify for better mortgage rates.**

   Once an adequate cash reserve has been built up, it may make sense to pay down mortgages strategically to eventually reach a point where there are no better mortgage rates available, at any LTV (other than zero, obviously!).

Summary

The leverage benefit of using mortgage finance can greatly increase property investment profits … as cash-on-cash return can be enhanced into double-digits, and more property can be purchased, increasing rental profits and potential for capital gains.

However, it is vital for landlords to understand their interest rate risk … as we likely approach a period of rising Bank Rate. Since mortgage interest is usually a landlord's largest expense, the interest rate environment will be a concern. Understanding your own portfolio borrowings in terms of absolute levels of debt, LTVs on individual properties, mortgage types and rates payable, is crucial to understanding your risk profile, and so enabling planning to ensure that interest rates don't cause a major problem.

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