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The Shape of Buy-to-let

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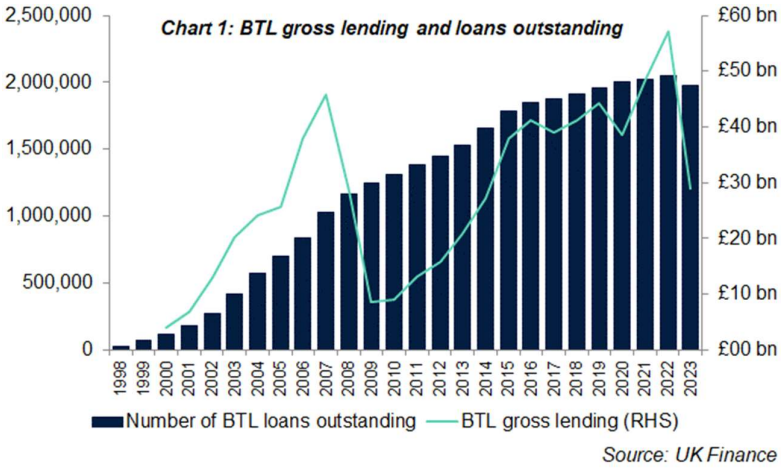
Like the wider economy and housing market, buy-to-let (BTL) lending endured a difficult 2023, with volumes down and more customers falling behind, but recently we have seen tentative signs of improvement. To coincide with the release of our latest **Buy-to-let update**, this report draws out some key results from new research, running a health check for the sector as we emerge gradually from the peak of the cost-of-living crisis.

Why is buy-to-let important?

Over many years **consumer survey data** has shown that homeownership is the long-term aspiration for the majority of households in the UK. But it has also consistently shown that, in the near-term, fewer see homeownership as their intended tenure.

This signals the reality of a population with a diverse set of housing needs where, even if most households want eventually to own their own home, some are not yet in a position to do so, either financially or because they are not in a position to put roots down. Others, albeit a minority, see renting as their long-term preference, enjoying the freedom and flexibility that this tenure offers.

Reflecting this, the Buy-to-let (BTL) market plays an essential role in funding landlords to provide a flexible and high-quality Private Rented Sector (PRS) for those households.



Source: UK Finance

Whilst a majority of housing in the PRS is still unmortgaged (around 55 percent, according to recent Bank of England research), the BTL sector has been growing for nearly three decades, ever since the first products were launched in 1996 (***Chart 1***).

For those able to raise sufficient capital for a deposit (which for BTL is typically higher than for homeowner mortgages), healthy rental demand has offered a stable return on investment into an asset class that, historically, has also delivered real-terms capital growth over the long run.

Why has BTL lending slowed down?

Since 2016, however, a number of factors have combined to create a more challenging environment for landlords. From 2016 a stamp duty surcharge on second and subsequent properties came into force, intended in part to remove a perceived advantage for landlords and purchasers of holiday property when competing with homebuyers for properties on the market. This was followed in 2017 by the progressive removal of higher-rate income tax relief on mortgage interest payments for rental property.

These factors undoubtedly put something of a brake on BTL lending but, overall, the stock of BTL mortgages continued to grow through to 2022. However, in 2023, the rapidly rising interest rate environment added a further, more significant layer of challenge for BTL investors, raising the bar to pass affordability tests for new borrowing.

In the face of these challenges BTL house purchase lending more than halved last year and, for the first time, the number of BTL mortgages outstanding shrank, albeit modestly.

Those higher interest rates have also put pressure on mortgage payments for existing BTL investors. Through 2023 we saw the number of BTL customers in arrears rise, although the proportion of BTL mortgages in arrears remains low. For a number of reasons, which we explore below, BTL arrears rose through last year at a faster rate than that seen in the homeowner sector.

However, in the first quarter of 2024 there was no further increase in BTL arrears, in contrast to a small (expected) increase in homeowner mortgage arrears.

At the same time, the slowdown in BTL lending moderated the first quarter of 2024, and by early Q2 was showing annual growth, although numbers are still well below the levels seen before 2023.

In the absence of unexpected negative shocks, it is possible that the market has moved past the trough in activity and that further rises in arrears may be limited. It is a good time, therefore, to take stock and look at the underlying health of the BTL sector.

A health check for the BTL market

Earlier this year UK Finance conducted a survey[1] of its members with BTL mortgage books to profile the characteristics of the BTL stock and, within this, the small number of loans now in arrears.

The results provide useful context at this pivotal time in the market, and we present some of the key highlights below.

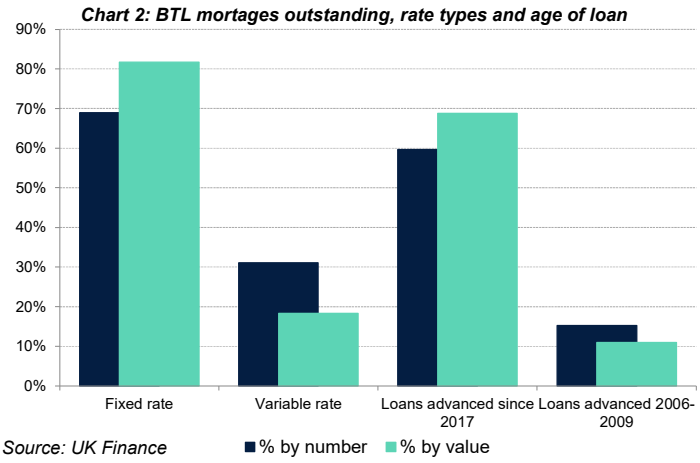
Within the overall BTL stock, we can draw out some characteristics that reflect patterns in new BTL lending over the past few years, some of which are in response to the evolving tax and regulatory landscape.

More BTL loans are on variable rates

Like the residential market, new BTL lending has seen a systemic shift towards fixed rate deals, as interest rates on these products were steadily cut through more than a decade of ultra-low Bank Rate.

[1] The survey was carried out in Q2 2024 and collected data on UK Finance member firms' stock of outstanding buy-to-let mortgages as at December 2023. Responses covered approximately 80 per cent of all outstanding mortgages, with figures grossed up to represent the wider BTL sector.

Even with a modest shift towards variable rate borrowing in the first half of last year, (when fixed rate pricing saw a spike), 90 per cent of new BTL lending was on fixed rates.



Source: UK Finance

Reflecting their dominance in new lending for well over a decade, 69 per cent of the outstanding BTL stock is now on fixed rates (***Chart 2***). But this is significantly lower than in the residential sector, where 83 per cent of the stock is currently on fixed rates.

Conversely, more of the BTL stock is on variable rates, and so has been directly impacted by the interest rate rises seen through the past two years. This was a contributory factor in the greater proportional rise in arrears seen in the BTL sector over this period.

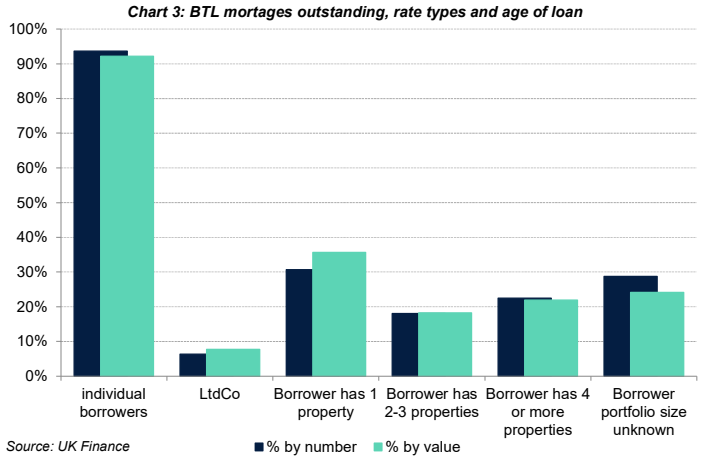
However, whilst more of the BTL stock is on variable rates, the relative typical loan size amongst the variable rate stock is materially lower - £120,000, compared with around £160,000 for those on fixed rates.

This is the flipside of the earlier observation that, for over ten years, the vast majority of new lending has been on fixed rates. This means the majority of variable rate loans are older, and therefore typically lower value, reflecting the lower house prices at the time these mortgages were taken out.

Incorporated landlords are a small but growing segment

The progressive removal of higher-rate income tax relief for BTL mortgage interest, which began in 2017, drove an evolution in the type of borrowing taking place in the BTL market. Lending to borrowers set up within a company structure, commonly referred to as “Ltd Co BTL” has seen a steady increase, as these income tax changes do not affect companies in the same way.

Whilst Ltd Co BTL is still a minority of the overall stock – less than ten per cent (***Chart 3***) – it is growing as increasing numbers of both new and existing landlords have chosen to incorporate. More recently, the modest decline in the size of the overall BTL mortgage stock, seen through 2023, is likely to have come disproportionately from unincorporated landlords. Having seen their bottom lines already eroded by the tax changes, some were then unable to keep their BTL portfolios profitable as interest rates – and therefore their BTL mortgage payments – rose from 2022.



Going forward, Ltd Co BTL is likely to continue increasing as a proportion of the overall stock, with the income tax regime now in place making it more challenging to run a profitable BTL business as an individual.

One third of BTL borrowers only have one rental property

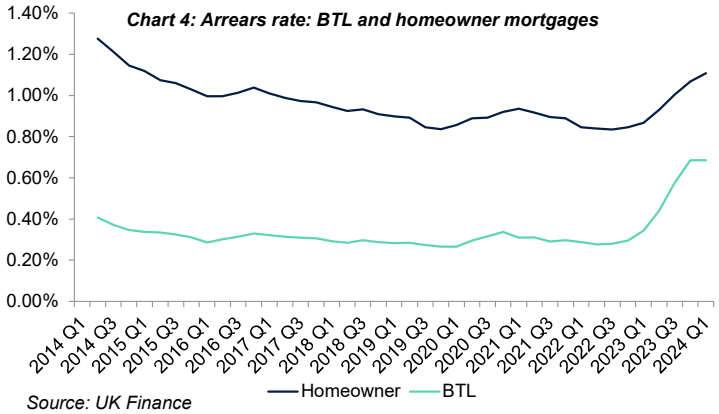
Although we have seen this increasing presence of Ltd Co BTL, one in three BTL mortgages are still held by (predominantly unincorporated) landlords who have just one rental property.[2] These single-property landlords may have a range of motivations for investment, for example as a supplement to retirement income, or as a property to let to their children and their children's housemates at university.

Whilst they are not necessarily less "professional" than larger scale landlords, they are more likely to feel the pinch from higher interest rates. This is, in part, because they are far less likely to have incorporated their rental business and, as set out above, will have seen a progressive erosion of their bottom line since 2017. Additionally, they are

[2] Note that within our survey sample, almost 30 per cent of total loans were reported with unknown portfolio size, and so this statistic should be interpreted with caution, given the greater margin for error.

unable to defray the costs from higher payments (or equivalently, loss of rental income when the property is unlet) across a wider portfolio.

The shape of BTL explains the shape of its arrears



Source: UK Finance
Note: arrears rate defined as the percentage of all mortgages that are in arrears representing over 2.5% of the outstanding balance

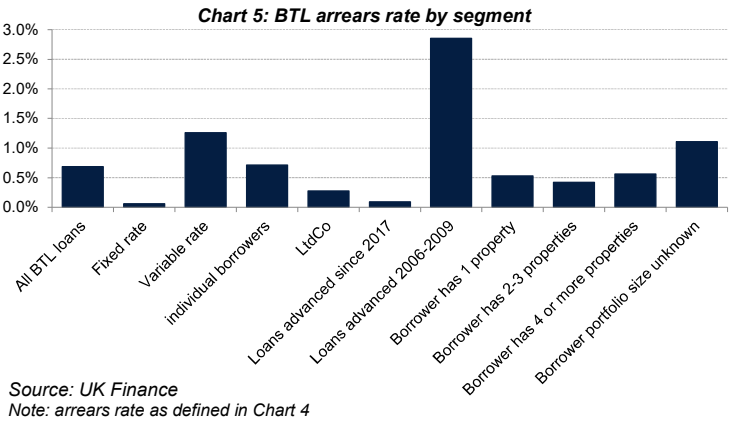
At the end of 2023, there were some 1.98 million BTL mortgages outstanding in the UK. Within this, there were 13,570 mortgages in arrears representing over 2.5 per cent of the outstanding balance. Whilst this represents a significant increase from the 6,060 at the end of 2023, it equates to just 0.68 per cent of the total BTL mortgage stock, which is a little over half of the equivalent proportion seen amongst homeowner mortgages (***Chart 4***).

Because BTL is mostly taken out on interest-only terms, whereas most homeowner mortgages are on a capital-plus-interest basis, rate changes affect BTL borrowers more significantly, as the entirety of the mortgage payment is affected. On this basis alone, then, it is unsurprising that BTL arrears numbers have risen proportionately more than those seen in the homeowner sector, given the increase in rates we saw through 2022 and 2023.

But, despite the more challenging environment for BTL now, as set out above, there have also been a number of factors that have worked to mitigate payment problems in the sector against this backdrop of much higher mortgage payments. These are evident in both the shape of the BTL stock overall and, within this, the small cohort of cases now in arrears.

Since 2017, all new BTL lending has been subject to stringent underwriting rules set out by the Prudential Regulation Authority (PRA). Analogous to the standards required

by the Financial Conduct Authority (FCA) for homeowner mortgages, these rules ensure the customer has sufficient income – which for a BTL mortgage is usually rental income – to cover both the mortgage and other business expenses as a landlord. The rules also require the lender to establish that this would remain the case if the mortgage moved onto a higher, stressed interest rate. And now that rates have risen significantly from those seen in the market through well over a decade of ultra-low Bank Rate before 2022, BTL customers who have borrowed in recent years have this buffer.



Source: UK Finance
Note: arrears rate as defined in Chart 4

As shown in ***Chart 2***, around 60 per cent of the BTL stock relates to mortgages taken out since those rules came into place, and so these customers have a much greater ability to cope with the higher payments they now face. This can be seen clearly in ***Chart 5***, where just 0.09 per cent of BTL loans taken out since 2017 are currently in arrears, a little over a tenth of the rate seen across the wider BTL stock.

In stark contrast, whilst only around 15 per cent of BTL loans currently outstanding are loans advanced in the years immediately preceding the Global Financial Crisis (GFC), this segment has an arrears rate of nearly three per cent, accounting for some 63 percent of all BTL arrears cases.

We can also see that the arrears rate for BTL loans on variable rates - 1.26 per cent - is higher than the average 0.68 per cent rate for the overall BTL stock. This is linked to the fact most of the mortgages taken out in those pre-GFC years are now on variable rates.

However, we can also see that arrears for variable rate mortgages overall are proportionately much lower than those amongst that pre-GFC cohort. By inference, then, variable rates taken out more recently have a lower arrears rate than those taken out longer ago.

This indicates that it is not purely the dominance of fixed rates that is keeping arrears numbers down amongst more recent BTL mortgages, but also the more stringent underwriting standards that have been in place since 2017.

Another factor that has mitigated increases in arrears is the Ltd Co BTL sector. Whilst small in size, we can see that arrears in this segment are under half the rate seen for BTL overall. Although some of this can be attributed to the relative recency of the Ltd

Co portfolio – as we have seen more recent BTL loans have a lower incidence of arrears – it is likely also linked to the tax efficiencies of this business model, meaning that borrowers are better able to manage in the face of higher payments as rates have risen.

A final observation is that the arrears rate does not differ materially between borrowers with one rental property and those with larger portfolios. This should be interpreted with some caution given the significant numbers where portfolio size is not known. In fact, within this segment where portfolio size is unknown, arrears are almost double the overall BTL arrears rate. However, this is driven largely by the fact that older loans – which as set out above have a higher arrears rate – are disproportionately represented in this segment of unknown portfolio size. Nonetheless, there is no evidence amongst the 70 per cent of the cases where portfolio size is reported, that either single-property landlords or those who have built up larger portfolios are disproportionately exposed to payment problems.

Buy-to-let – in good shape for the future?

The buy-to-let sector has seen its share of challenges over the past few years – first from tax and regulatory change, and then more recently from cost and rate pressures. These have dampened new lending activity and for some segments, exacerbated the extent of payment difficulties. And, although the residential sector has also seen a slowdown over the past two years, this has been more pronounced in the BTL sector, both for new lending and for arrears.

Despite this, the performance of the existing BTL stock has shown some resilience, with increases in arrears greatly mitigated by the changes in the profile of lending and the underwriting standards that underpin that lending. Whilst BTL arrears rose rapidly through 2023, they have recently flattened off, as landlords have been able to gradually adjust rents and manage their portfolios to mitigate the higher mortgage payments they now face.

With the majority of BTL arrears cases relating to considerably older, smaller mortgages, the amount by which these landlords might need to raise rents to cover any payment shortfall may be relatively modest, compared with what this would be if those arrears cases were amongst more recent borrowing. New new lending is still well below the levels seen prior to last year's slowdown. But there are signs that, following a muted start to the year, the BTL sector will see some annual growth in Q2 and potentially into the second half of the year.

The challenges facing the sector from tax and regulation change remain, and these will continue to constrain new lending to an extent. Notwithstanding these challenges it may be that, underpinned by continuing strong rental demand and robust lending

standards, the BTL sector is able to emerge from the market downturn seen last year more rapidly than previously anticipated.

Looking ahead, the UK will continue to need a flexible and well-run PRS to provide housing for the wide range of tenants it serves. Within this BTL is evolving and navigating the changes and challenges of the last few years and has the potential to emerge in a stronger position to fund this essential segment of our housing ecosystem.