Mortgages for Business

Buy to Let Mortgage Rates: The real costs

February 2013

Where are interest rates headed? Should I be going for fixed rate products?

We are always being asked these questions by clients and the longer that Bank Base Rate stays at 0.5% the more we all know that there must be a price to pay at some time in the future when interest rates will rebound - but when will this start to happen? Unfortunately no one can answer that. Instead we present you with a unique set of data showing what has happened to the average cost of buy to let mortgages over the past five years - and leave it to you to form your own views.

We have compiled 12 indices which track the average buy to let mortgage costs of two, three and five year fixed rate and discounted/tracker mortgage products at 65% and 75% loan to value.

In each of the graphs we have compared the resultant indices with Bank Base Rate and either the relevant term interest rate swap costs (for fixed rate products) or three month LIBOR (for discounted/tracker products).

The data for this exercise has been extracted from details of over 16,000 buy to let mortgage products held in our buy to let mortgage sourcing tool – Mortgage Flow – since 2008. The indices only track commoditised products, not bespoke pricing terms offered by the more specialist commercial lenders operating in the buy to let arena.

For the first six graphs, the percentage cost shown is the annualised cost based upon the total cost of mortgage products available at any given time. Importantly these costs include lender fees, valuation fees and legal fees calculated over the initial term of the mortgage (i.e. the fixed rate period or the period of any discount). Where lenders have offered incentives in the product such as free legal fees and free valuations, costs have been adjusted as appropriate.

By including these costs we have produced indices that more accurately reflect the costs of taking on a buy to let mortgage without distortions caused by the way that lenders have structured fees on their products to meet marketing requirements.

The second set of graphs follows the traditional method of tracking only the average headline rate of buy to let mortgage products over time which belies the true costs involved. This data has been produced to demonstrate the effects of set up costs.

In all graphs, at any time when there were no products available from lenders in a given category this shows as an average cost of nil for the period.

Highlights: Historical rates and margins

Buy to let product numbers

As the banking crisis took hold in the spring and summer of 2008, the number of different buy to let products available fell from over 450 in early 2008 to fewer than 100 in December 2008 and then fell again to around 70 in June/July 2009. It then took until November 2010 for the count of products to recover to 250 and it currently stands at around 450.

During the period 2008-2010 there were only a handful of lenders in the market and few mortgage products. As a result there were several occasions when there were only one or two different products in what should have been the “standard” product ranges from lenders. In particular products at 75% LTV were thin on the ground since there was a period when mainstream lenders restricted LTVs to 70%. Consequently the addition or removal of just one mortgage product can create a significant spike (or trough) in the graphs. The data for the last two years is much more “reliable” given the far greater number of different mortgage products.

Buy to let product pricing

In early 2008 discount and tracker buy to let mortgages cost around 1% more than LIBOR. Fixed rate products cost around 1.5% more than the related term swap. By mid-2009 this margin increased to around 4 - 5% for both product types and has stayed at this level ever since. This increase is primarily caused by the increased perception of risk in all financial institutions who are paying a far higher “risk premium” to raise deposits than they did five years ago. This is also reflected in the interest rates paid by banks on the high street. Whereas they used to pay around 1% less than Bank Base Rate for term deposits, they are now paying around 2% over BBR to attract funds.

Furthermore in response to the banking crisis of 2008/9 the Basel Committee on Banking Supervision is introducing regulations (“Basel III”) which, over time, will require banks to double both their capital and liquidity margins. This additional capital “safety margin” within banks has an inevitable effect on the cost of making loans and will help to ensure that lending margins are unlikely to revert to pre-crisis levels.

The last 18 months have seen the emergence of several new lenders prepared to consider more complex propositions such as HMOs, multi-unit freehold blocks and mortgage applications in a limited company capacity. This has not had a major impact on average margins because any higher pricing for these propositions has been largely quelled by increased competition in the underlying margins and often these propositions attract bespoke pricing rather than commoditised product ranges.

Thus there is good evidence that the average margin over index costs have stabilised for the time being.

LIBOR and Swap rates

Three month LIBOR fell quickly as BBR was cut in in 2008/9 although it took a further six months for it to fall to 0.50% to match the cut in BBR in March 2009. Since then it drifted upwards to around 1.09% in January 2012 as concerns surrounding sovereign debt caused new worries about the stability of the banking system. Since then it has fallen again in response to Bank of England action.

Swap rates for longer periods are consistently higher than those for shorter periods. In part this reflects a normal market characteristic (possibly attributable to an aversion to being locked in to long term commitments) but undoubtedly part of the reason is that interest rates are currently at very low levels and there is a general assumption that they will increase over time.

All Swap rates fell steadily from February 2011 to July 2012 but since then have changed little with swap rates for 1-3 years all in the range 0.5% to 0.75%. Indeed there was a small jump in rates when markets opened in the New Year which is most pronounced in the longer term swaps indicating an expectation that rates could start to rise markedly in three years’ time.

Arrangement fees and other costs

Lender arrangement fees, valuation fees and legal costs can add up to 2% to the effective annual cost of individual buy to let mortgages and the impact of these has varied over time. Costs were at a peak in 2010 when across all categories they added an average 0.66% pa to the average cost but this has since fallen to around 0.57%. Unsurprisingly they have a greater impact on short term (2 year) mortgages where in 2010 they added an average of over 1.1% to annual costs whereas this is now around 0.85%.

Methodology

In order to track buy to let interest rates, 12 “standard” product ranges have selected. These are two, three and five year fixed rate and discounted/tracker mortgage products at 65% and 75% loan to value. Life time tracker products have also been incorporated into the results for each of the above periods for the discount/tracker products.

The total cost of the mortgage (including lender arrangement fees, valuation fees and legal fees) have been calculated over the period of the discount or fixed rate and this has been used to generate an annualised cost over that period. Calculations have been based on a “standard” mortgage of £150,000. NB this result can be markedly different from the APR measurement legislated by the FSA; the APR fails to recognise the effect on borrowing costs of borrowers re-mortgaging once the period of the discount or fix have expired.

If individual mortgage products offered “free” arrangement fees, valuations or legal fees this has been recognised in the calculations of costs for those products.

Costs have been calculated from our database of over 16,000 buy to let products held within our mortgage products sourcing system – Mortgage Flow. The results shown reflect the average cost calculated based on products available on each day since January 2008.

Where short term (< 1 week) withdrawals of products have occurred, the results have been adjusted to eliminate anomalous peaks and troughs in the average rates shown. At any time when there were no products available from lenders in a given category this shows as an average cost of nil for the period.

The resultant interest rates for discount and tracker products have been compared to the daily 3 month sterling LIBOR cost generated by the British Bankers Association.

The resultant interest rates for fixed rate products have been compared to the sterling interest rate swap costs for the related period.

Understanding interest rate swaps

Interest rate swaps help companies, portfolio managers and banks to manage cash flows by fixing interest payments over time. An interest rate swap is a contract to exchange floating payments linked to an interest rate for fixed payments, and is generally used to manage exposure to fluctuations in interest rates.

In an interest rate swap transaction, the parties to the transaction exchange or “swap” two types of interest payments – one a fixed rate, the other a floating rate – over the lifetime of the deal. The swap rate is the cost of switching from a floating rate to a fixed rate. The floating rate is typically determined by the three-month London Interbank Offered Rate used as a benchmark for floating rate mortgages and loans.

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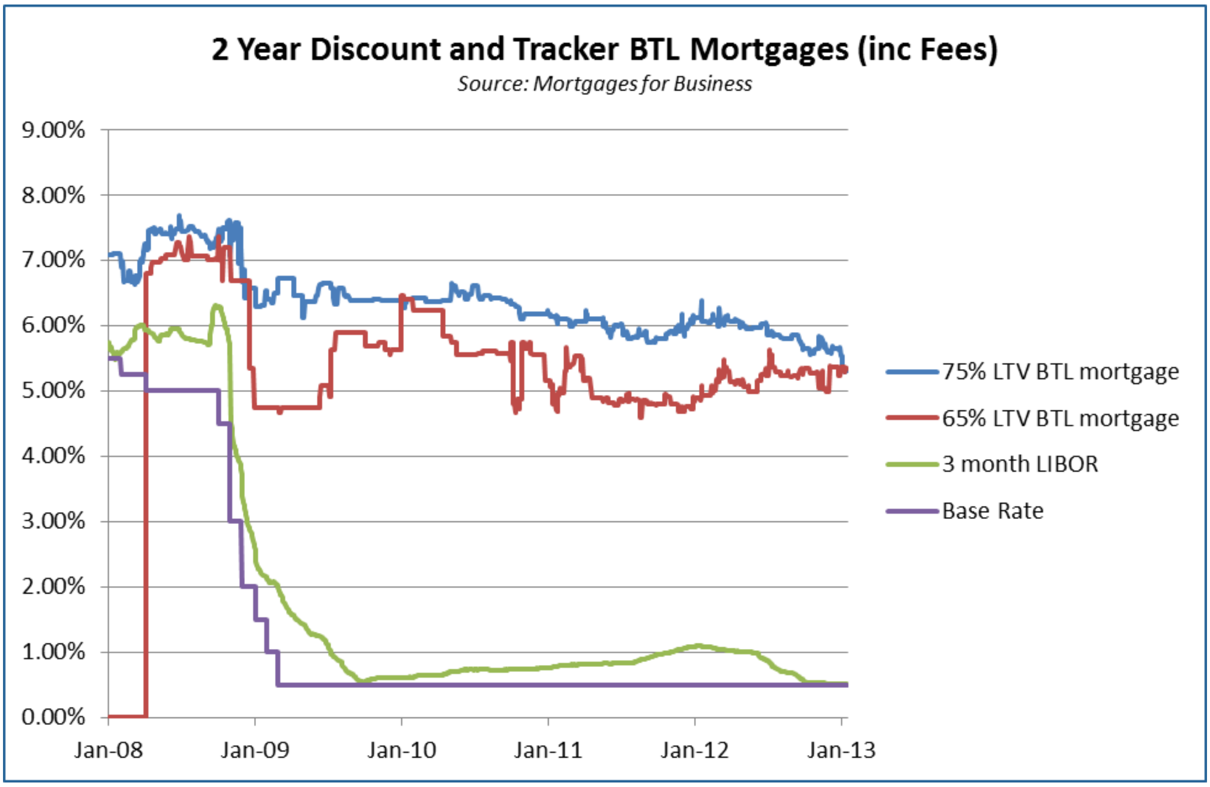

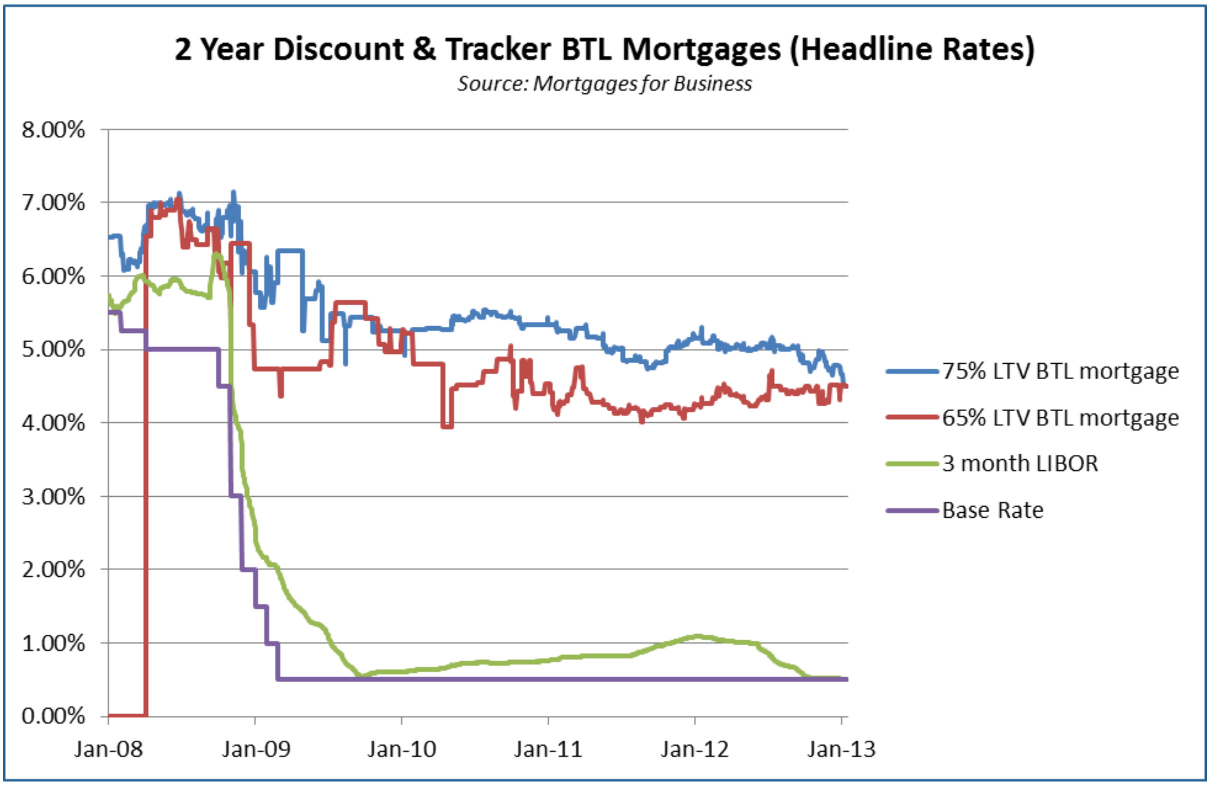

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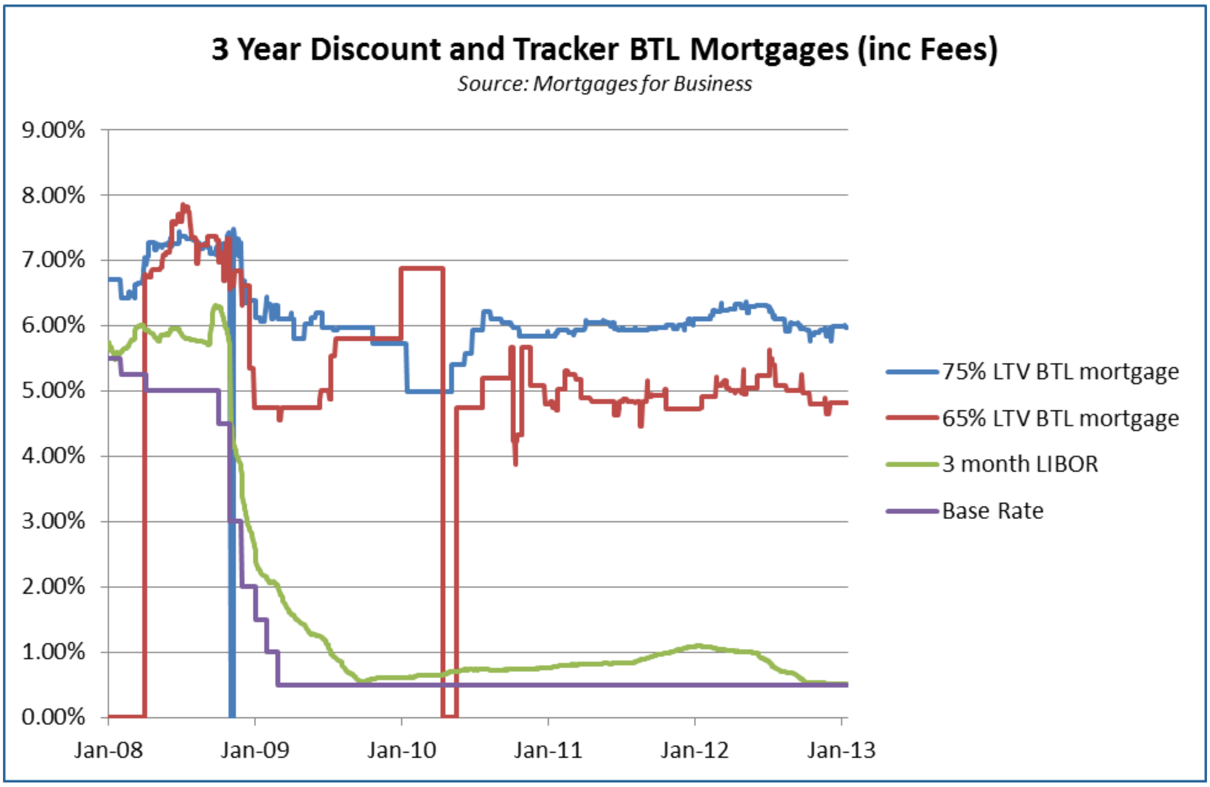

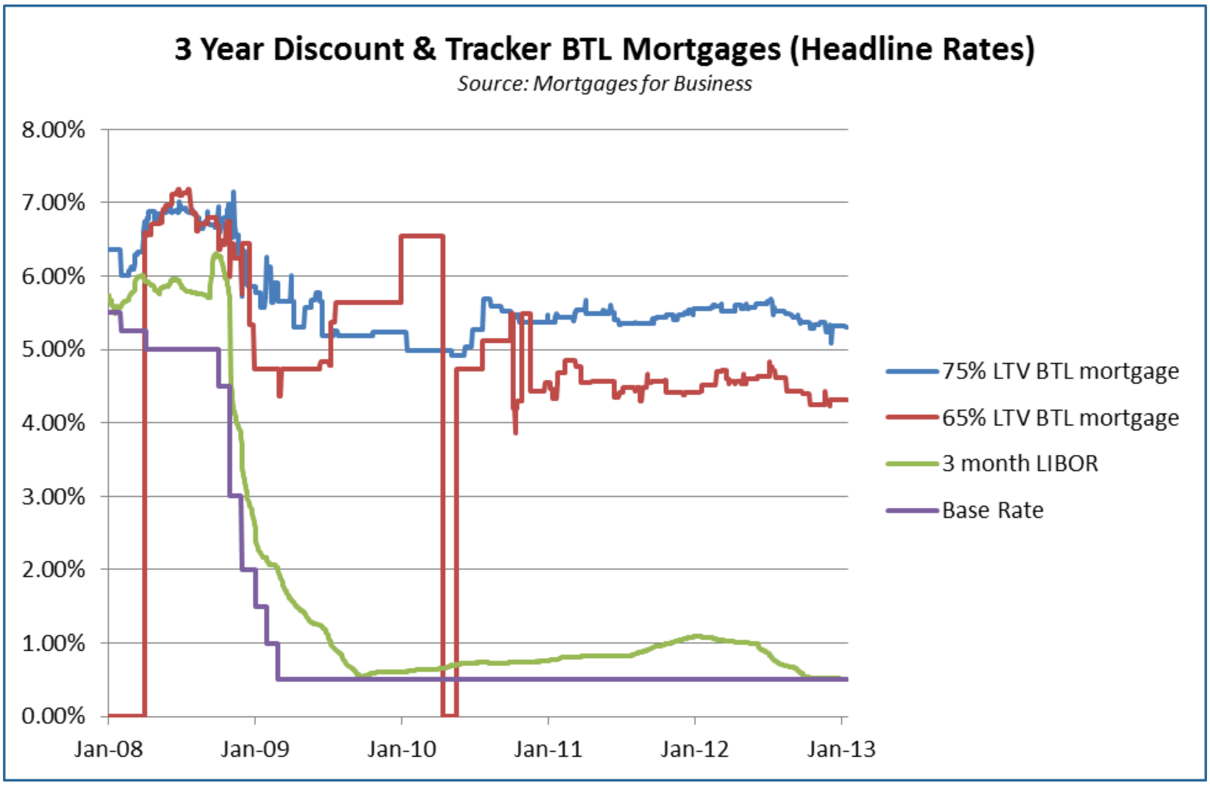

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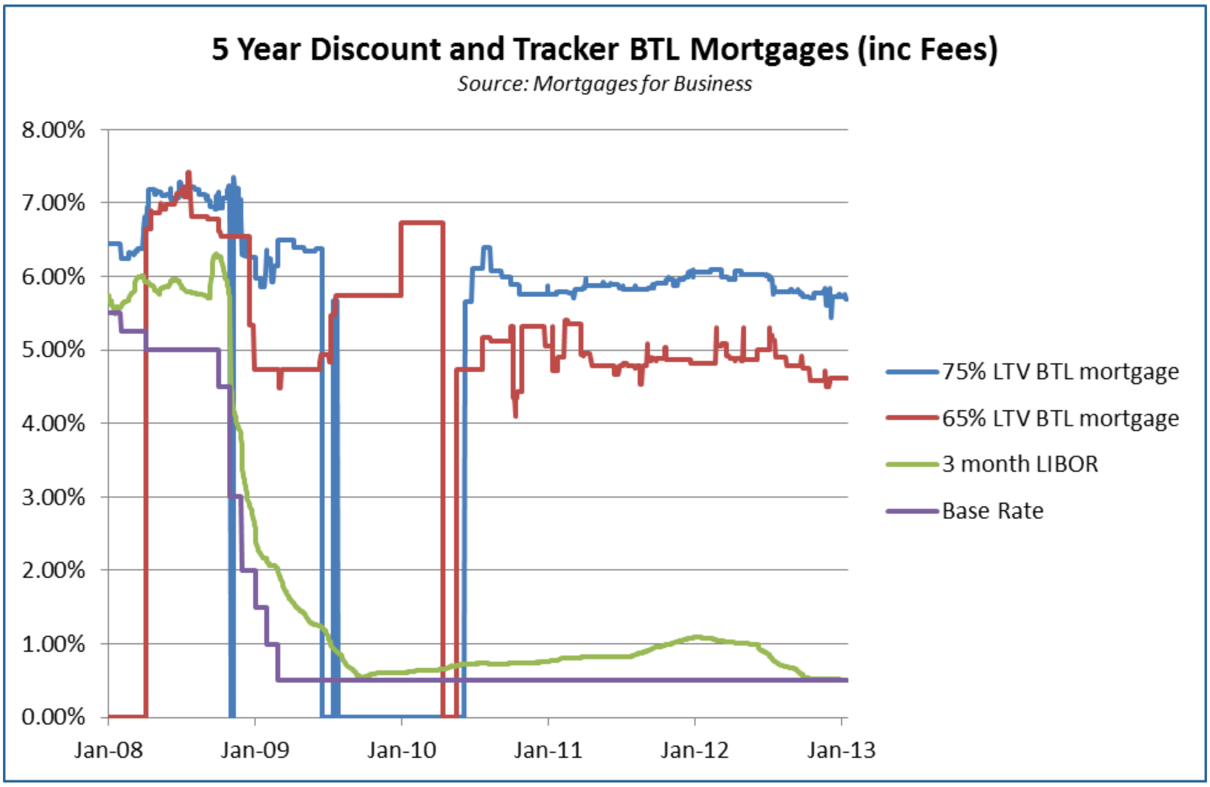

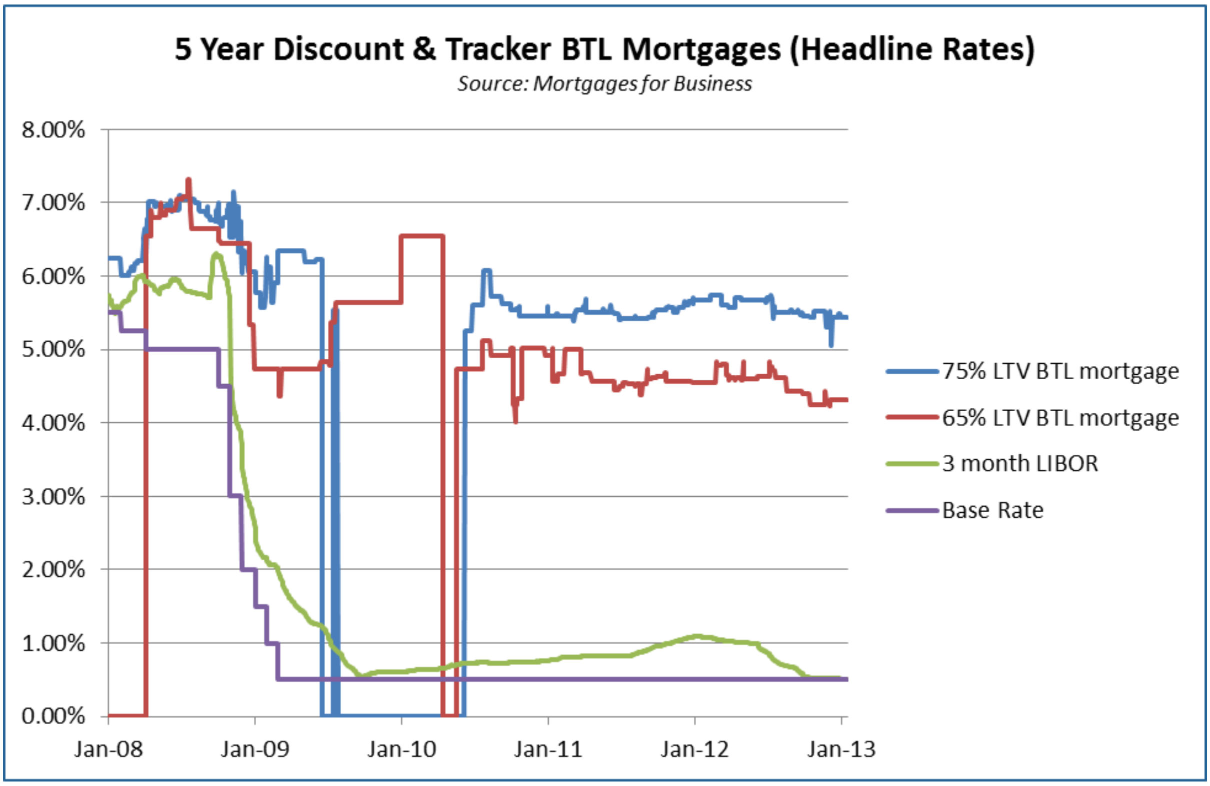

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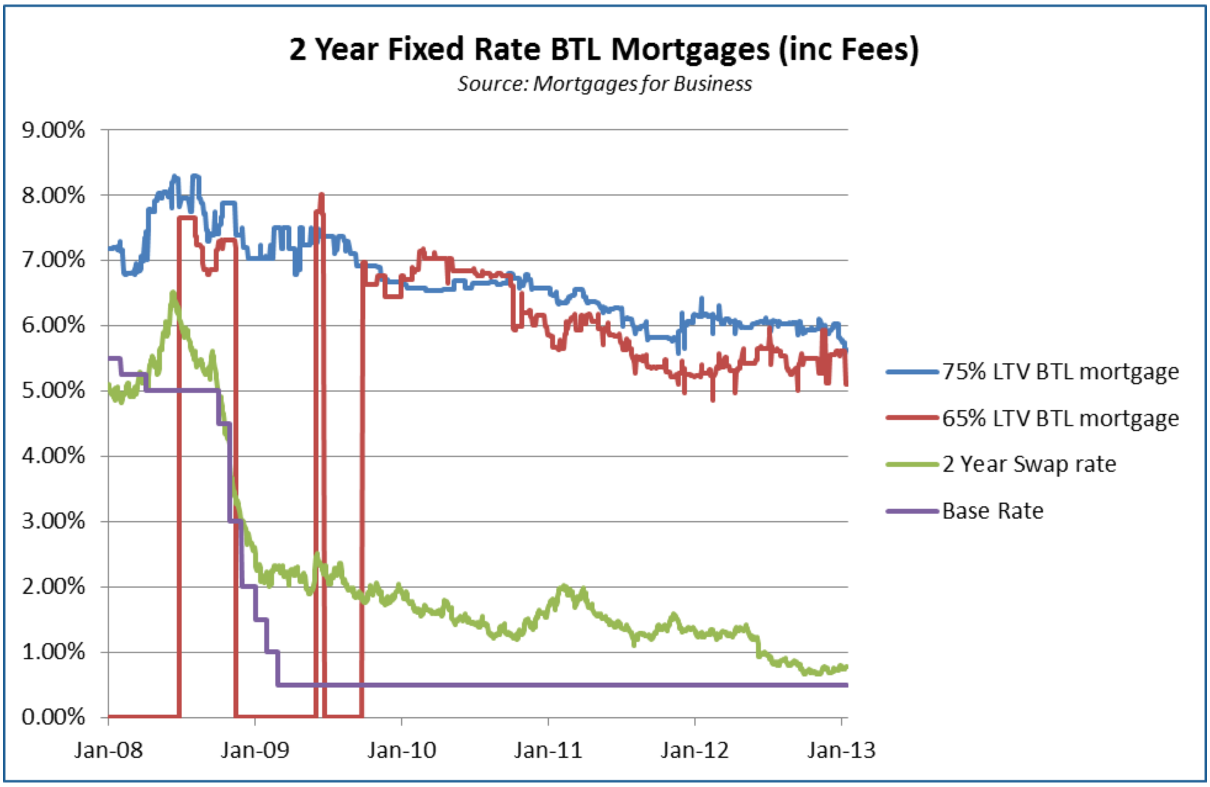

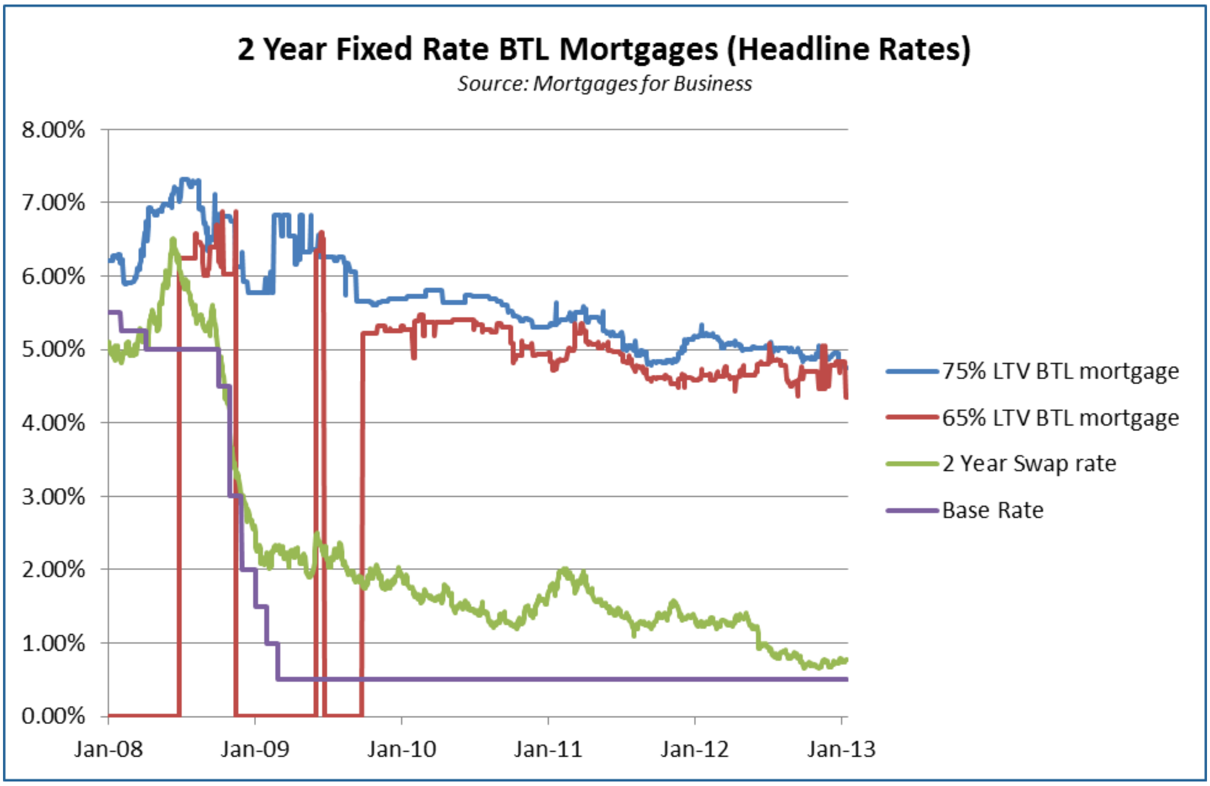

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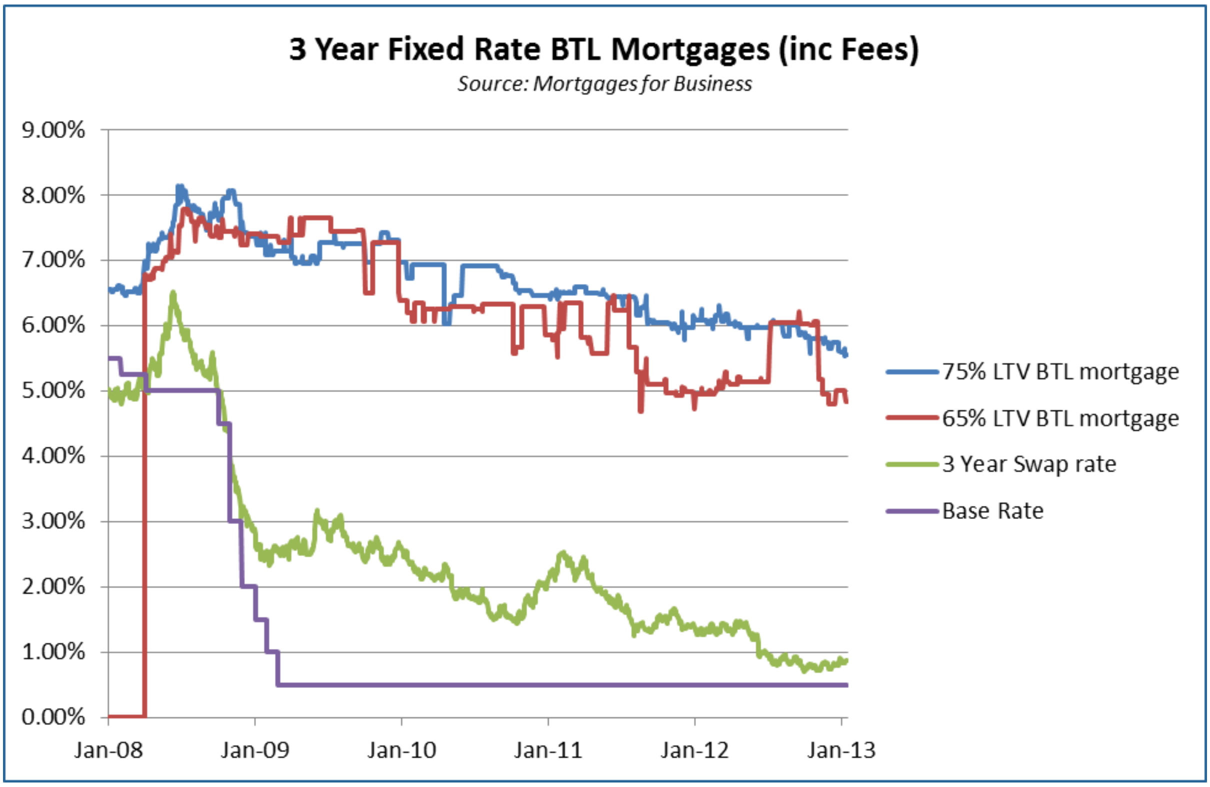

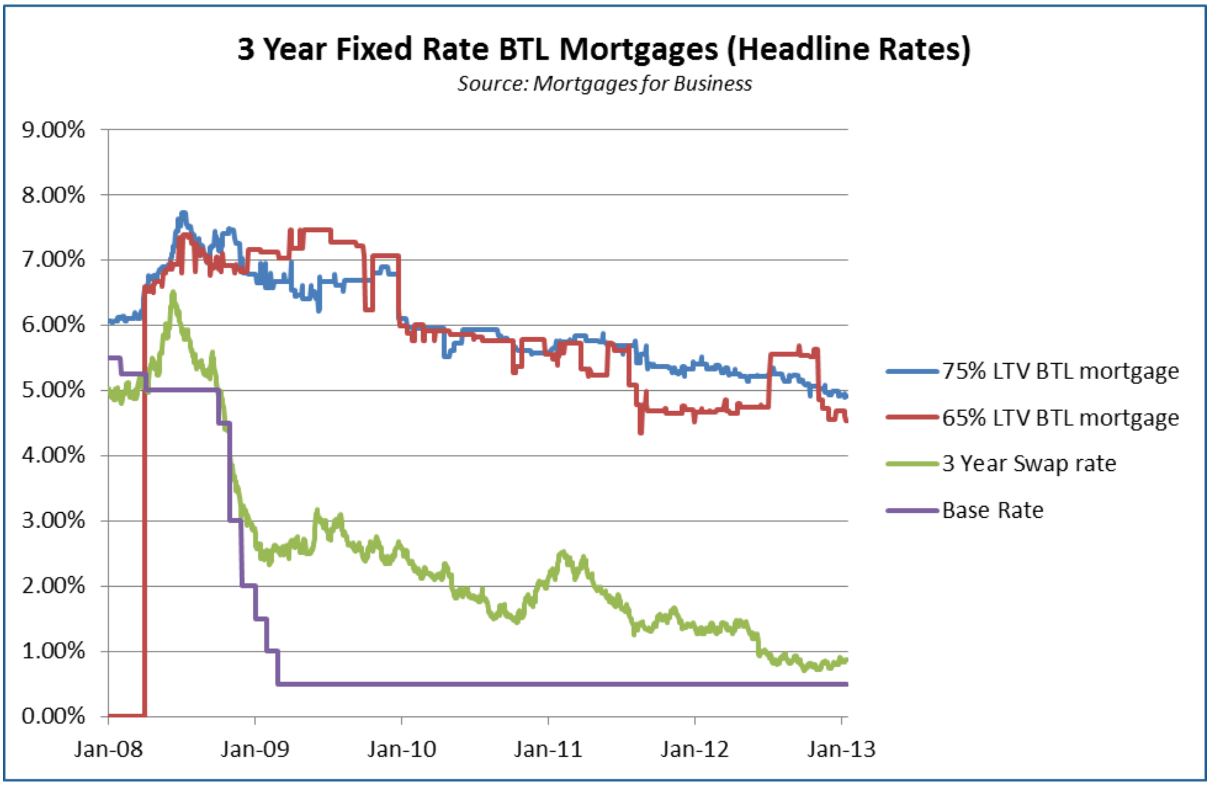

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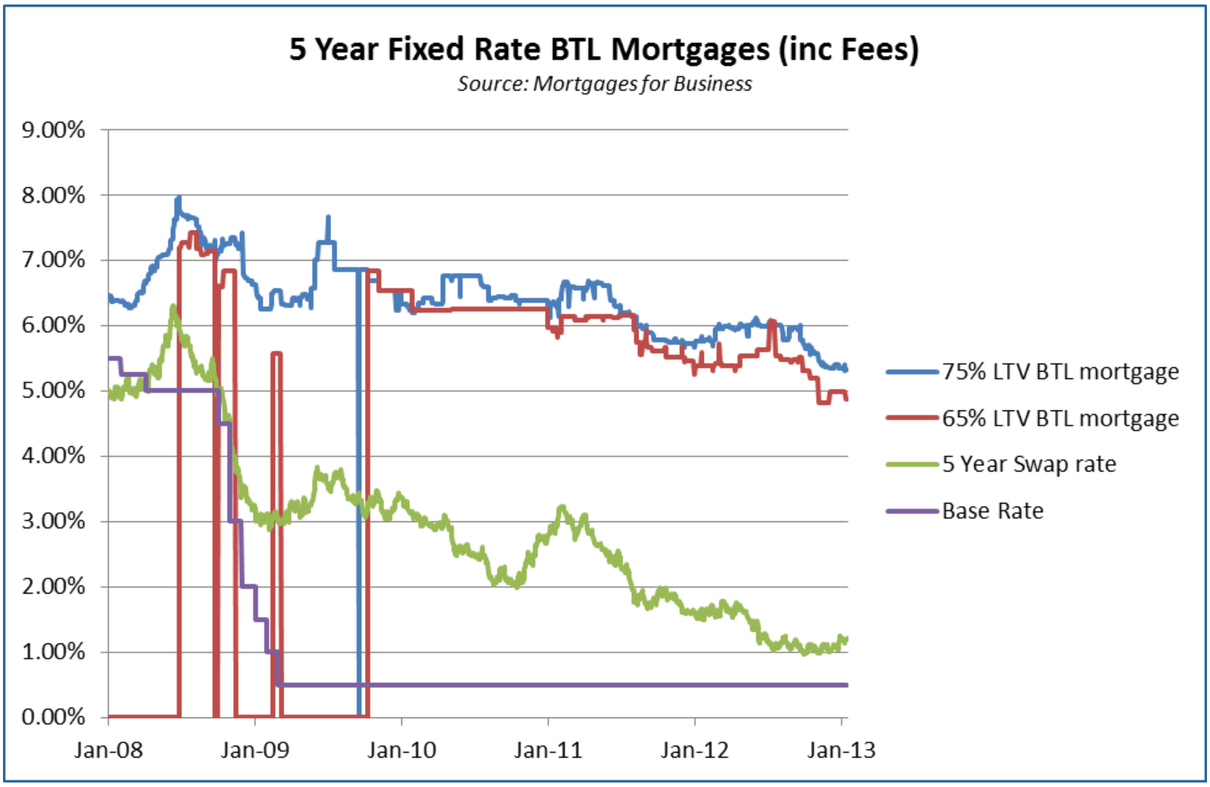

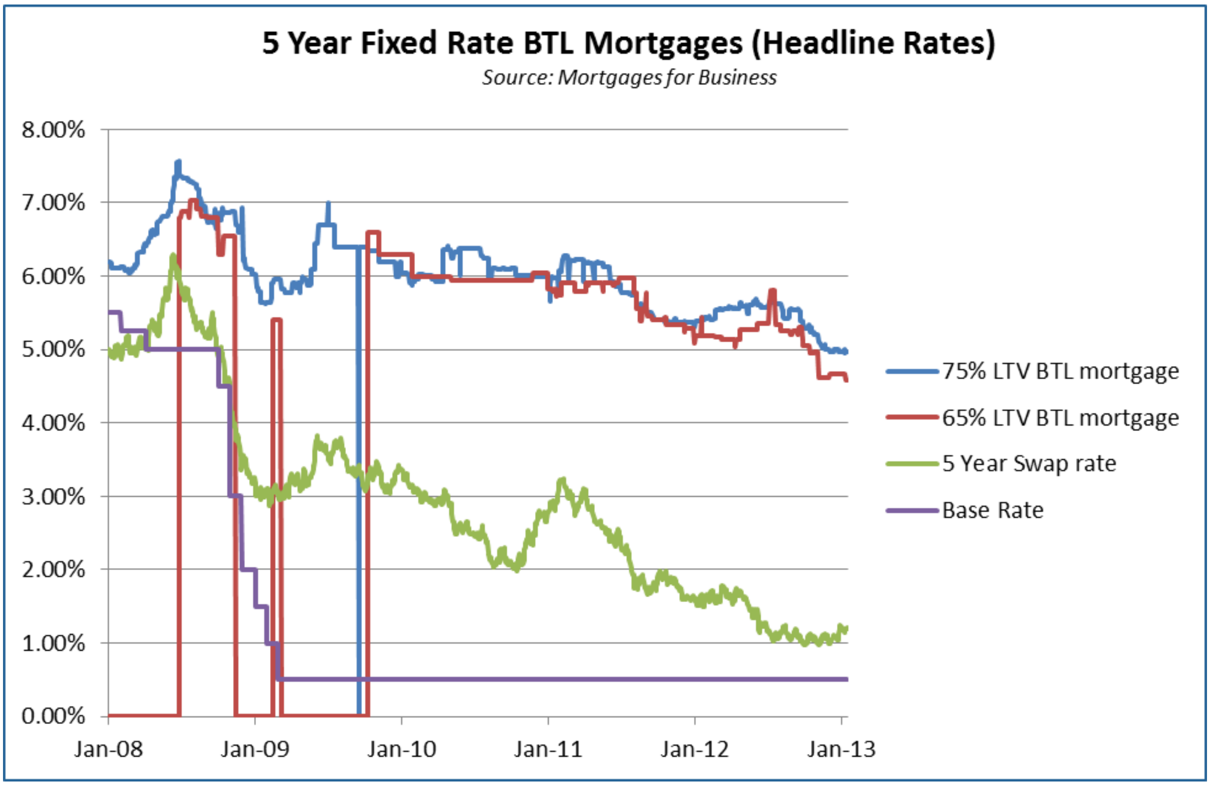

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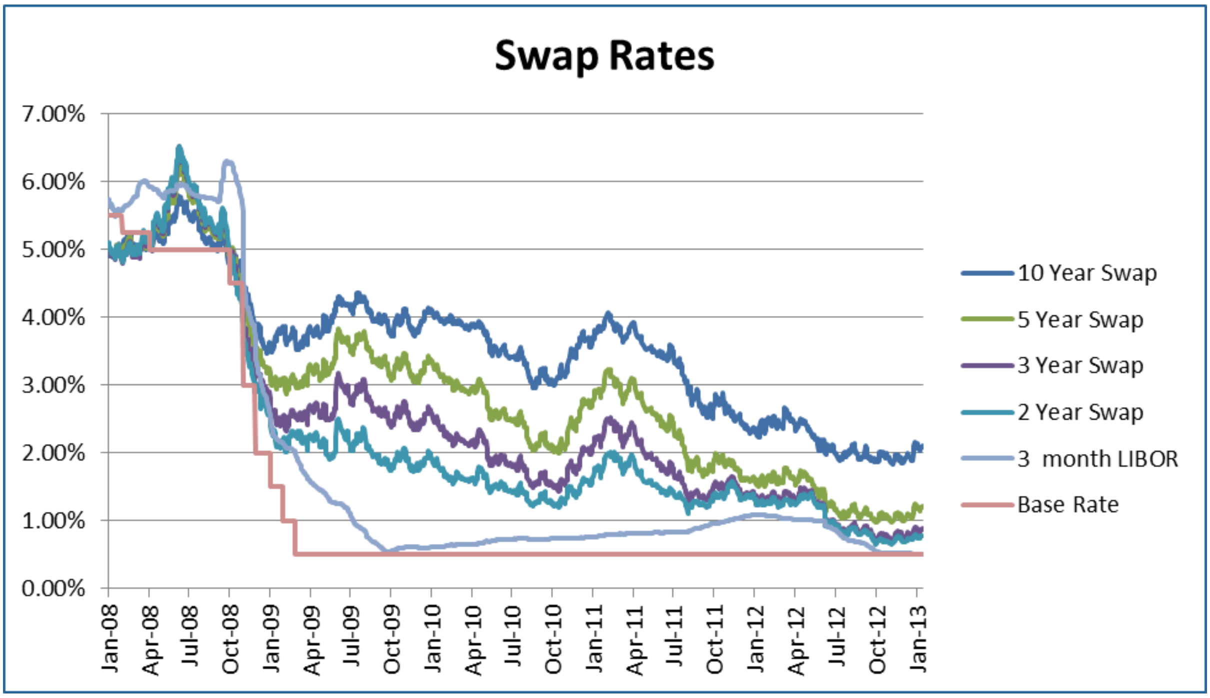

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Effect of Costs on Buy to Let Mortgage Rates													
	2 Yr Disc 65% LTV	**2 Yr Disc 75% LTV**	**2 Yr Fix 65% LTV**	**2 Yr Fix 75% LTV**	**3 Yr Disc 65% LTV**	**3 Yr Disc 75% LTV**	**3 Yr Fix 65% LTV**	**3 Yr Fix 75% LTV**	**5 Yr Disc 65% LTV**	**5 Yr Disc 75% LTV**	**5 Yr Fix 65% LTV**	**5 Yr Fix 75% LTV**	
Average	0.72%	0.84%	1.03%	0.99%	0.35%	0.53%	0.37%	0.68%	0.21%	0.29%	0.24%	0.39%	
Max	2.02%	1.64%	1.93%	1.45%	0.81%	0.96%	0.78%	1.00%	0.49%	0.50%	0.55%	0.67%	
Min	0.13%	0.10%	0.27%	0.52%	0.03%	0.15%	0.12%	0.18%	0.05%	0.04%	0.06%	0.16%	
Averages													**Total Average**
2008	0.44%	0.56%	1.02%	0.96%	0.40%	0.42%	0.38%	0.47%	0.11%	0.20%	0.32%	0.34%	0.47%
2009	0.35%	0.80%	1.35%	1.01%	0.16%	0.55%	0.21%	0.53%	0.10%	0.16%	0.22%	0.49%	0.50%
2010	1.10%	1.01%	1.44%	1.00%	0.27%	0.51%	0.43%	0.91%	0.20%	0.36%	0.27%	0.37%	0.66%
2011	0.68%	0.91%	0.83%	1.00%	0.34%	0.52%	0.45%	0.73%	0.26%	0.37%	0.20%	0.40%	0.56%
2012	0.79%	0.91%	0.74%	1.01%	0.49%	0.61%	0.40%	0.75%	0.31%	0.33%	0.24%	0.38%	0.58%
2013	0.85%	0.84%	0.78%	0.95%	0.51%	0.67%	0.32%	0.67%	0.31%	0.27%	0.31%	0.37%	0.57%
Combined	0.72%	0.84%	1.03%	0.99%	0.35%	0.53%	0.37%	0.68%	0.21%	0.29%	0.24%	0.39%	0.55%

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