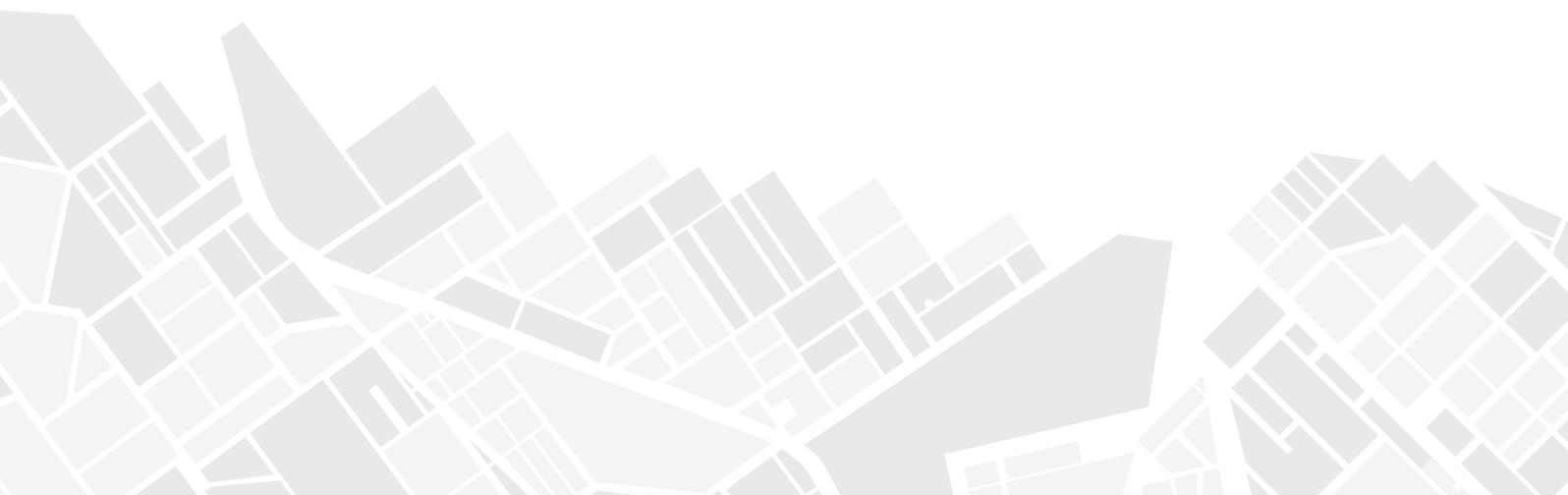


LANDBAY[®]

Democratising Mortgage Lending

How peer-to-peer will redistribute
the profits of buy-to-let

December 2014



CONTENTS

Foreword [3]

Executive summary [4]

SECTION 1 [5-15]

LOW RISK LENDING OPPORTUNITIES

1:1 [5-7]

Property as security

1:2 [8]

Security of income generating property

1:3 [9]

Landlord 'covenant' or commitment to pay

1:4 [10-15]

Positive outlook for tenant demand

SECTION 2 [16-21]

A SECURED PEER-TO-PEER LENDING MODEL

2:1 [16]

General peer-to-peer model

2:2 [17]

Peer-to-peer buy-to-let lending model

2:3 [18-19]

Landbay's approach to risk assessment

2:4 [20-21]

Stress testing

SECTION 3 [22]

CONCLUSION

Foreword by John Goodall



Long-term impacts of profound change are always underestimated, even as short-term expectations overshoot. I believe that peer-to-peer is one of these phenomena – a truly significant development for finance, economics and ultimately society.

However, the revolution of peer-to-peer finance has only so far reached a fraction of the population, and so by definition has barely started. Developing new savings and investment products that make space for a traditionally prudent taste for financial caution will be vital in opening up peer-to-peer finance to everyone.

But new products alone will not be enough to reach this full potential. Finance of all kinds will increasingly rely on an open and transparent sharing of information. When the whole population can be included in the world of finance, a well-informed population will be essential.

Enlightened competition is the future.

For that reason we commissioned this independent report. And for that same reason we decided to provide the Wriglesworth Consultancy with Landbay's own internal stress tests. To my knowledge, these are the first ever published stress tests for any peer-to-peer lender's loan book, and I hope a useful gesture in the direction the financial world must travel.

John Goodall, cofounder and CEO of Landbay
December 2014

DEMOCRATISING MORTGAGE LENDING: HOW PEER-TO-PEER WILL REDISTRIBUTE THE PROFITS OF BUY-TO-LET

Executive summary

- Peer-to-peer lending has started to capture the popular imagination. But for consumers considering placing their money with a peer-to-peer provider there is a confusing array of options and rates on offer. As with other investments, the key to understanding where to lend is understanding the risks.
- Peer-to-peer firms offering personal loans or loans to small businesses will generally pay a higher rate to lenders but with higher risk. For more cautious investors, wanting to test the market, lending to buy-to-let landlords offers a low risk alternative.
- Lending to buy-to-let benefits from four layers of protection: the realisable value of the property; the sustainable rental income; the landlord borrower commitment to pay, which is a claim on their wider financial resources; and the robust outlook for the sector. Yet data from the PRA shows that variable rate buy-to-let borrowers pay 1% or 1/3 more in interest on average than owner-occupied borrowers. We believe that current buy-to-let lending is no riskier than lending to owner-occupiers, suggesting traditional providers are failing to serve buy-to-let borrowers properly.
- Landbay is the first peer-to-peer provider to focus exclusively on the buy-to-let sector. To illustrate the robustness of its portfolio of buy-to-let loans we have stress tested it under a range of scenarios. Under the severe scenario of the bank rate going to 5.75%, house prices falling by 23% and rent arrears reducing landlord rental income by 6%, the average loan-to-value (LTV) rises to 87% and income coverage falls to 104%. These are reassuring results that suggest that Landbay's portfolio should withstand severe circumstances well.
- Landbay's approach to assessing loan applications may provide it with a sustainable advantage in the marketplace. While mainstream lenders making thousands of loans tend to grant these loans based on a series of 'rules', smaller lenders are better positioned to seek a broad picture of the borrower's overall financial position, allowing them to pick the safer borrowers.

SECTION 1

LOW RISK LENDING OPPORTUNITIES

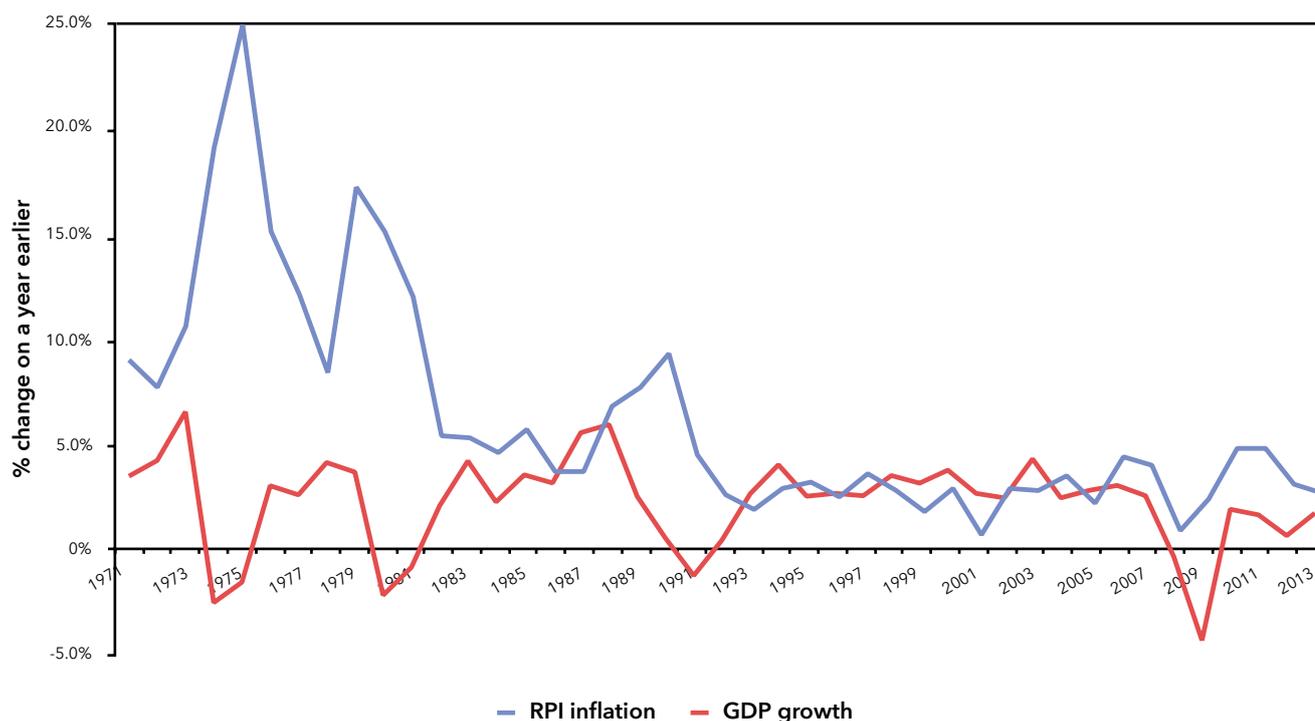
BUY-TO-LET'S FOUR LAYERS OF PROTECTION

1:1 - Property as security

Historically UK residential property has been the safest form of collateral for lenders of all varieties. Fortunately we can track its price performance on a regional basis as far back as 1973, when the Nationwide Building Society started publishing this data.

Over the four decades since 1973 the UK has suffered four major recessions (in the mid 1970s, early 1980s, early 1990s and the 2008-9 period) and seen the economic environment change out of all recognition. This has thrown up a wide range of different challenges from the high inflation of the 1970s, to the high unemployment of the 1980s and 1990s, the financial turmoil of 2008-9 and the falling real wages of recent years.

CHART 1
UK GDP growth and inflation



Source: ONS

Against the background of this changing economic environment house prices have been remarkably robust, rising by over 1,800% between 1973 and 2014. Examining the data in detail we would make the following observations:

- House prices are relatively stable, showing much lower price volatility than other assets such as commercial property or equities.
- Housing is a good hedge against inflation, rising in value during periods when inflation is high.
- Yet housing can also perform well in a low inflation environment as we have seen in recent years, as low interest rates have reduced the cost of servicing a typical mortgage.
- House price changes tend to be serially correlated, meaning that you observe a run of house price gains followed by a run of falls rather than the more random pattern that is generally observed in most other asset markets such as equities or bonds.

Table 1 illustrates this final bullet point, showing how UK regional house prices have performed during the four upswings following the four recessions mentioned above. These upswings tend to be quite long – all lasted at least 5 years and in the longest upswing, house prices rose continuously for over a decade from the start of 1996 to the third quarter of 2007.

TABLE 1
Upswings in house prices

	Q1 1976- Q2 1981	Q1 1982- Q2 1989	Q1 1996- Q3 2007	Q1 2009- Q3 2014
NORTH	94%	117.9%	210.0%	8.0%
YORKS & HUMBER	104.7%	151.7%	236.4%	14.0%
NORTH WEST	119.6%	132.8%	221.8%	12.4%
EAST MIDLANDS	107.8%	188.2%	234.5%	24.2%
WEST MIDLANDS	123.3%	174.8%	206.9%	20.5%
EAST ANGLIA	118.4%	231.9%	253.3%	35.2%
OUTER SOUTH EAST	116.8%	224.0%	259.8%	36.0%
OUTER METRO.	112.3%	216.9%	265.1%	42.4%
LONDON	112.1%	211.0%	327.4%	65.3%
SOUTH WEST	113.9%	202.0%	260.3%	24.9%
WALES	96.2%	143.8%	241.2%	16.2%
SCOTLAND	92.3%	80.5%	186.7%	8.6%
N. IRELAND	91.9%	26.1%	447.9%	-13.5%
UK	109.2%	157.5%	258.5%	26.1%

Source: Nationwide Building Society

The flipside of these long upswings are the downturns in house prices that have coincided with economic recessions. Table 2 shows the maximum falls in regional house prices in the last four market downturns. When inflation was high, in the recessions of the mid 1970s and early 1980s, house price falls were modest or non-existent, illustrating just how much housing benefits from being a hedge against inflation.

With lower rates of inflation in the early 1990s and late 2000s, nominal house price falls were a feature of the market. But for a lender lending up to 72% loan-to-value, even taking the peak-to-trough regional house price falls of the last two recessions would not give rise to negative equity in the majority of regions.

TABLE 2
Peak to trough decline in house prices

	Mid 1970s	Early 1980s	Early 1990s	Late 2000s
NORTH	NO FALL	NO FALL	-14.2%	-16.5%
YORKS & HUMBER	NO FALL	NO FALL	-28.4%	-18.5%
NORTH WEST	NO FALL	-3.0%	-12.5%	-17.9%
EAST MIDLANDS	NO FALL	NO FALL	-25.1%	-19.3%
WEST MIDLANDS	-8.0%	-3.3%	-16.6%	-17.5%
EAST ANGLIA	NO FALL	-2.7%	-35.8%	-21.7%
OUTER SOUTH EAST	NO FALL	NO FALL	-35.9%	-20.0%
OUTER METRO.	NO FALL	NO FALL	-30.9%	-19.1%
LONDON	NO FALL	NO FALL	-31.8%	-20.1%
SOUTH WEST	NO FALL	NO FALL	-28.1%	-18.1%
WALES	NO FALL	-2.2%	-17.1%	-20.0%
SCOTLAND	NO FALL	NO FALL	-6.7%	-15.7%
N. IRELAND	NO FALL	-8.8%	-4.9%	-54.3%
UK	NO FALL	NO FALL	-20.2%	-18.7%

Source: Nationwide Building Society

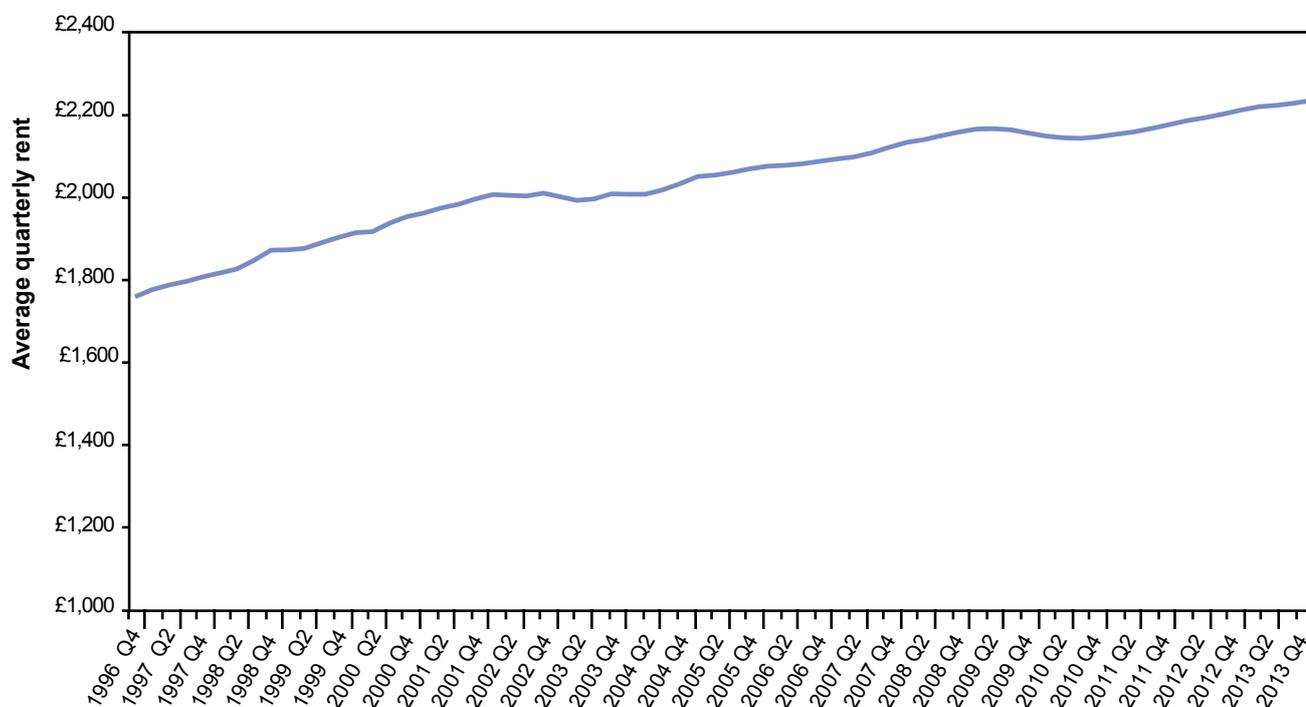
Of course individual properties can experience larger price changes due to a range of factors including localised market distress or the deteriorated condition of the individual property. Lenders need to manage these issues by, for example, preventing loan portfolios from becoming too geographically concentrated.

1:2 - Security of income generating property

While the market value of a buy-to-let property provides security for a loan, it is actually the rental income stream that it generates that really underpins the safety of the lender’s position. As long as the rental income can comfortably service the mortgage payments, the lender can be quite confident that they are ultimately unlikely to face a loss.

While house prices have been relatively stable compared to other assets such as equities, rents have been even more stable, as Chart 2 reveals. This is a major source of comfort for buy-to-let lenders because it demonstrates that the landlord’s cash flow generally remains dependable through different economic conditions. Using the official government private rental series, the largest recorded fall in rents of the past two decades was the 0.5% fall recorded in the late 2000s recession between mid 2009 and mid 2010.

CHART 2
Average quarterly rents



Source: ONS and LSL Properties Services

Lenders need to ensure that rental income is sufficient to meet maintenance costs and unexpected expenses. So it is normal for lenders to insist on an income coverage ratio (ratio of rents to mortgage payments) of at least 125%. Landbay stipulates a minimum rental income of 125% of the mortgage payment, rising to 135% for first time landlords and 140% for houses in multiple occupation (HMOs).

The importance of rental income is also illustrated by a comparison of buy-to-let lending with property development finance. Development finance allows developers to build or convert properties which can be rented or sold once completed. But during development there will be no stream of income and any development project, whether large or small, runs the risk of cost or time over-runs and the risk of disappointment on future sale or rental value. Not surprisingly, lenders require a higher return to compensate for the higher risk of financing property development.

1:3 - **Landlord 'covenant' or commitment to pay**

The lender's third layer of protection is the so-called borrower covenant. An assessment of the strength of the borrower covenant looks beyond the single property on which the loan is secured to assess the soundness of the borrower's total financial position.

In part this is to understand the borrower's wider financial situation – do they have income from a salary of other rented properties? How strong is their overall balance sheet. In part it is to assess the borrower's attitude to debt. Is the borrower likely to prioritise loan payments over other expenditure?

The value of the security and rental income enter the borrower assessment in a fairly mechanical way; all lenders including Landbay apply a maximum LTV and a minimum interest coverage ratio. But there is much more scope for lenders to do things differently when it comes to assessing the strength of the borrower's personal commitment to pay. For example, Landbay seeks a broad overview of the borrower's wider financial position but many larger lenders are focused more narrowly on the property being mortgaged. Some lenders insist on a certain level of employment income, indicating that they are targeting so-called amateur landlords who are managing the business in their spare time.

Many traditional lenders set limits on the number of properties their borrowers can mortgage. By doing so, these lenders are deliberately focusing their attention on the amateur landlord in preference to larger professional landlords with numerous properties. This may seem surprising given that the professional landlord with a portfolio of properties is likely to be far more experienced with a better understanding of the markets they operate in.

1:3.1- **The financial strength of landlords**

When it comes to the borrower covenant, the buy-to-let market has a potential advantage over lending to owner-occupiers. The typical buy-to-let borrower is mature (in their 40s or 50s), is more financially stable and has higher net assets than the typical owner-occupier borrower. Often the buy-to-let borrower will have a substantial amount of equity in the property in which they reside.

For lenders, such landlords should represent a lower risk than a first time buyer in their twenties, with no track record of managing a mortgage and a limited financial cushion should anything go wrong. Even the typical second or third time homeowner is unlikely to be as solid a lending proposition, as most homeowners depend on a single source of income to pay their mortgage - their salary. Having a portfolio of rented properties provides the landlord with more diversity of income and, in extremis, should provide more options for dealing with financial stresses as rented properties can always be sold to meet commitments.

1:4 - Positive outlook for tenant demand

By its nature, the assessment of a lending proposition needs to be forward looking. The lender needs to be confident that the borrower will meet their obligations into the future. Historical experience provides a good grounding for understanding the dynamics of the UK housing and rental markets. And the current financial circumstances and past track record of the borrower should be a good guide to their future creditworthiness. But history is not always a perfect guide to the future.

It is important therefore to understand the factors that are likely to shape the market in the coming years and decades. For buy-to-let lenders, tenant demand is a key variable. We can gauge the possible future demand for rented property by reference to future demographic projections.

Table 3 shows the official government forecast for the UK’s population. It shows that in the 25 years between 2012 and 2037 the UK is expected to see an increase of just under 10 million in its resident population. This increase of nearly 400,000 a year is substantially higher than the rate of growth seen in previous decades, suggesting that demand for accommodation will be expanding at an unusually fast rate relative to the existing stock of property.

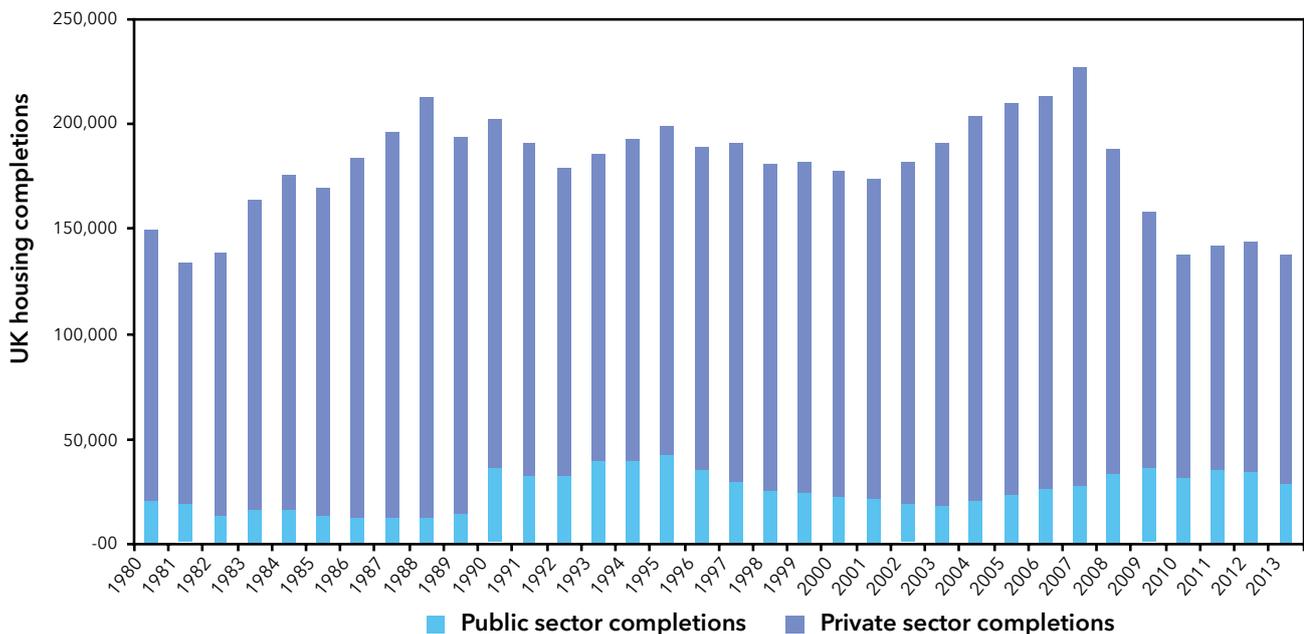
TABLE 3
Population projections (millions)

	2012	2017	2022	2027	2032	2037
England	53.5	55.4	57.3	59.1	60.7	62.2
Wales	3.1	3.1	3.2	3.2	3.3	3.3
Scotland	5.3	5.4	5.5	5.6	5.7	5.8
Northern Ireland	1.8	1.9	1.9	2.0	2.0	2.0
United Kingdom	63.7	65.8	67.9	69.9	71.7	73.3

Source: ONS

The UK has traditionally had a weak supply response – the output of new houses has struggled to rise adequately in response to higher demand. And this effect has become more pronounced in recent years, with house building falling way short of the level required to keep pace with the growth in household numbers. This has created a cumulative worsening of the housing shortage, the result of which has been higher house prices, making it more difficult for people to buy, which in turn has raised tenant demand, putting upward pressure on rents.

CHART 3 UK Housing Completions



Source: Department of Communities and Local Government

As Chart 3 shows, there has been only a modest number of social housing completions in recent years – around 30,000 a year. At the same time, the rate of owner-occupation has been falling since 2002, when it stood at 70%, to an estimated 62% today. This has happened as young people have found it increasingly difficult to access owner-occupation due to a high house price to earnings ratio. In addition, since the financial crisis, tighter mortgage lending criteria and higher deposit requirements.

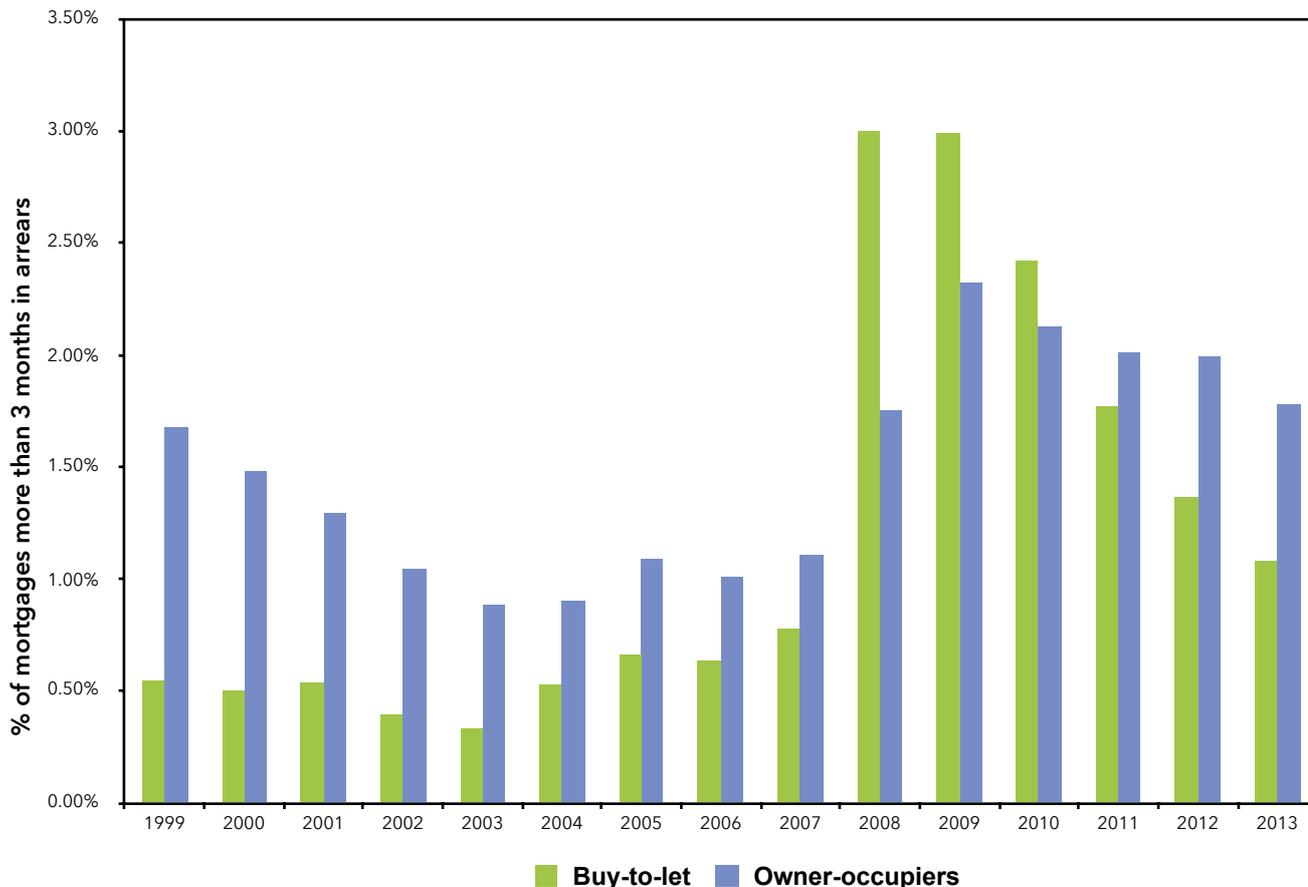
The above factors have been supporting the growth of the private rented sector, which has expanded from 9% of households in 2000 to around 20% today, and point to further growth in rental demand. This higher demand in turn suggests that there will be upward pressure on rents and downward pressure on rental voids over an extended period. This represents a reassuring background for lenders to the private rented sector.

1:5 - Superior arrears performance against mainstream lending

So, buy-to-let benefits from important inherent protections, but how does it perform relative to other loan types? Chart 4 shows three month plus arrears for buy-to-let and owner-occupied lending in the UK since 1999. In 12 out of these 15 years, arrears were lower in the buy-to-let market, which is a remarkable performance for a class of lending that only commenced in 1996.

The three years when three month plus buy-to-let arrears exceeded those of the mainstream mortgage market coincided with the financial crisis and recession (2008-10). Closer examination of this performance reveals that it was very concentrated geographically, by property type and by lender.

CHART 4
Three month plus mortgage arrears

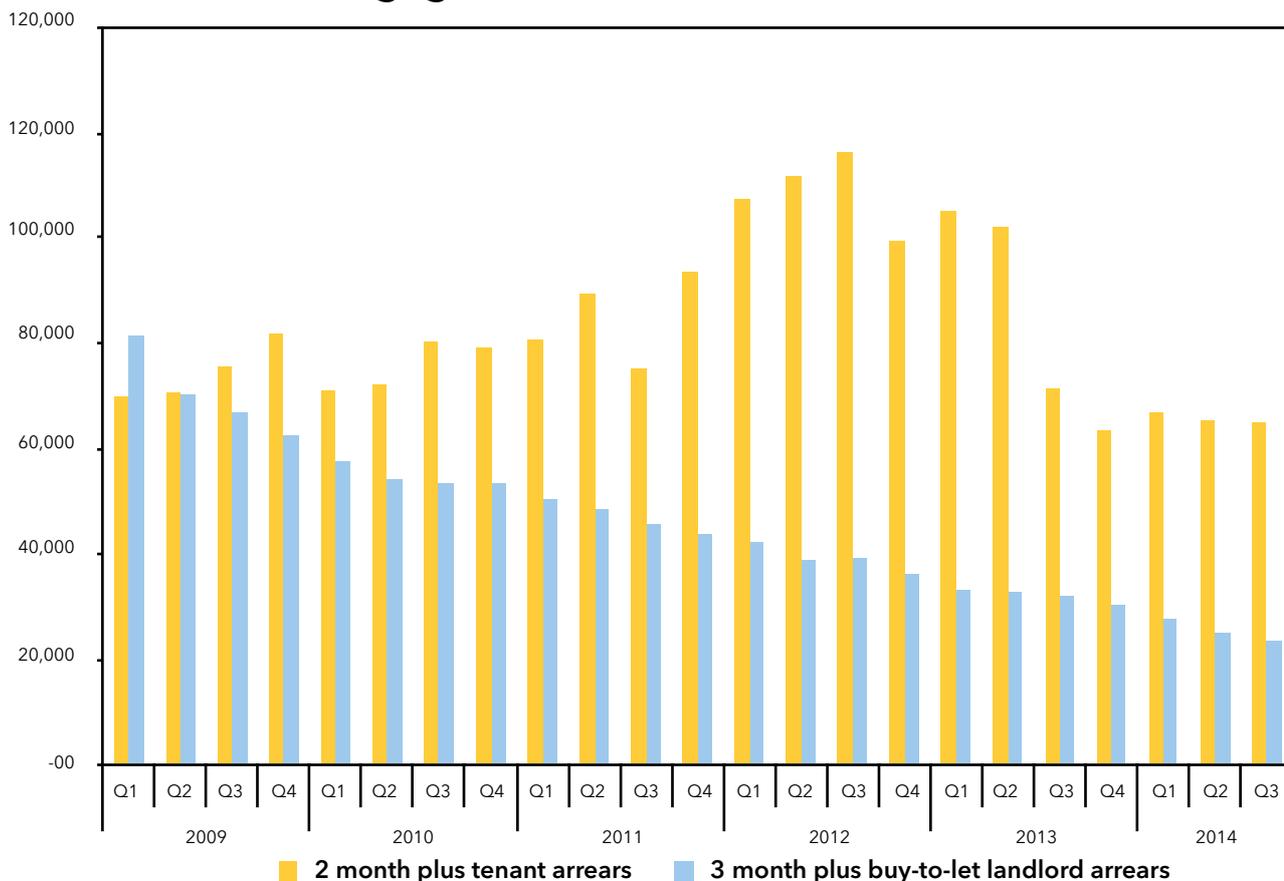


Source: Council of Mortgage Lenders

Indeed, aggregate buy-to-let arrears numbers mask a wide range of performance from individual lenders. In the financial crisis a small number of lenders had a disproportionate share of the sector’s arrears. One of the largest contributors was Bradford & Bingley, who were very active in the buy-to-let market through their Mortgage Express brand, using an automated underwriting process (see Section 2.2 for a fuller explanation).

By contrast Paragon Mortgages, who operate a manual approach to underwriting loans, reported three months plus mortgage arrears of 0.3% in March 2014. During the financial crisis Paragon Mortgage’s arrears were consistently below the industry average not only for buy-to-let but also for owner-occupied lending. We believe its approach to assessing loans was a large part of the explanation for this exemplary record on arrears.

CHART 5
Landlord mortgage and tenant rent arrears



Source: Council of Mortgage Lenders and LSL Property Services

We can also compare buy-to-let mortgage arrears with tenant rent arrears. Chart 5 compares 2 month plus rent arrears with 3 month plus buy-to-let mortgage arrears. Despite the difference in length of arrears between the two series they do allow for a comparison of the trend and the extent to which landlords can absorb tenant arrears. Chart 5 paints quite a positive picture: buy-to-let mortgage arrears have been falling consistently since 2009 despite rising rent arrears up until 2012, showing that landlords were able to absorb higher rent arrears. But since 2012 rent arrears have also been trending down.

There is no comparable industry data on arrears for consumer or personal loans or loans to businesses. This in itself could be considered something of a drawback for individuals thinking of lending to these classes of borrower because it makes it difficult to gauge what a normal level of arrears is for these loans or how cyclical the arrears performance is. Indeed, it is probably more important to understand arrears performance for these other classes of lending. This is because where loans to either individuals or businesses are not secured on valuable assets such as property, the chances of recovering what is owed in the event of default is likely to be much lower.

Despite the lack of published data, anecdotal evidence shows that arrears and losses are typically much higher both for unsecured consumer loans and for loans to small businesses, and this is reflected in the higher rates of interest charged in these markets.

1:5.1- **The management of buy-to-let arrears**

The management of arrears is usually conducted using quite a different framework in the private rented sector. While repossession is the standard avenue when an owner-occupied borrower defaults, buy-to-let lenders will typically appoint a 'receiver of rent' to run a property or even the whole portfolio of a landlord who has fallen into arrears. A receiver of rent can take control of the property at the request of a lender when the borrower has failed to meet their obligations, ensuring that the property is properly run and that mortgage payments are prioritised out of any free cash flow that exists.

A receiver of rent has the power to decide on the ultimate course of action: sell the property, continue to rent it out or return it to the landlord's control. This flexibility allows the receiver to choose the option that is most likely to maximise value for the landlord and the lender. For example, in a market where sales are weak but rental demand is strong, properties can be retained and rented, avoiding the need for sale at a reduced price. On past evidence, there seems little doubt that the receiver of rent allows for more efficient management of arrears in the buy-to-let sector.

1:5.2 - **Credit losses**

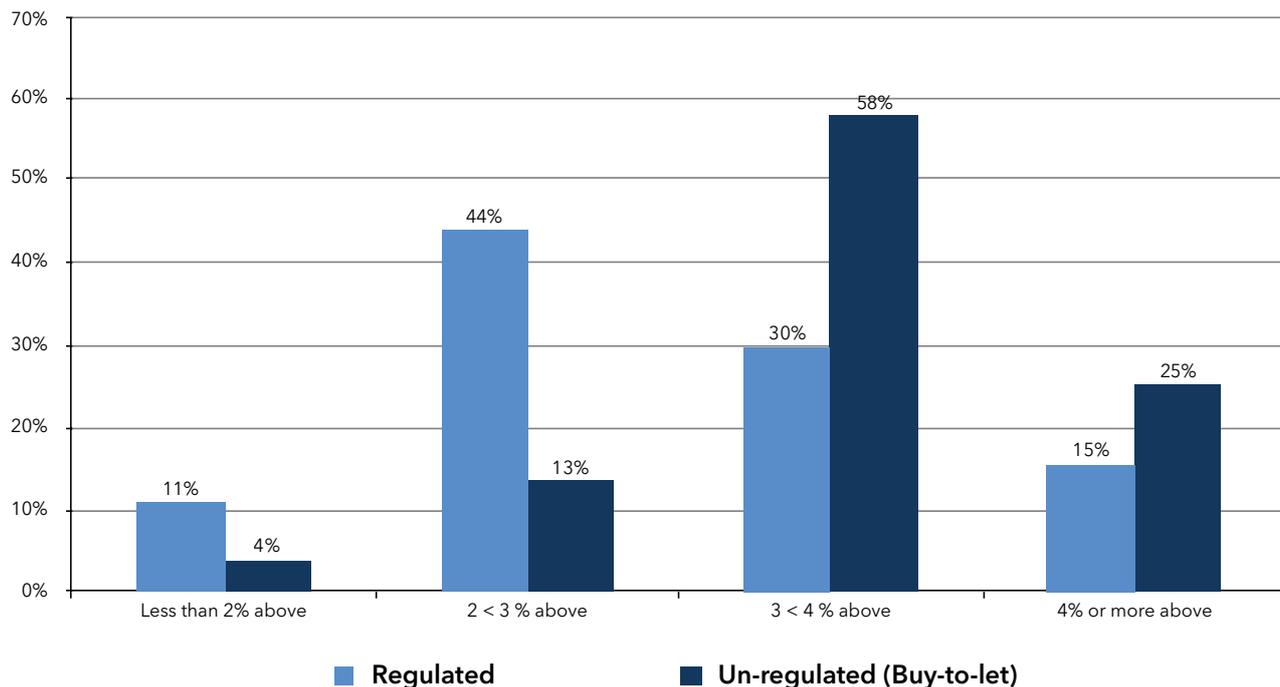
While there is comprehensive industry data on mortgage arrears, unfortunately there is no equivalent data on mortgage credit losses either for buy-to-let or owner-occupied lending. But buy-to-let lenders that use a receiver of rent can substantially reduce arrears and in many cases return properties to the landlord's control. Lenders report that this has substantially curtailed credit losses in recent years.

In contrast, in the owner-occupied market there is considerable pressure from the regulator for lenders to show forbearance to borrowers in arrears. This can give the borrower time to recover their financial position but equally it can allow a borrower in serious financial difficulty to remain in the property for an extended period ultimately leading to a worse financial outcome for both the homeowner and the lender.

1:6 - **Buy-to-let versus owner-occupied mortgage rates**

Data from the Prudential Regulatory Authority (PRA) shows the average mortgage rate charged to regulated (owner-occupied) and unregulated (buy-to-let) borrowers. Chart 6 shows the distribution of interest rates above Bank of England base rate for the latest quarter available. It shows that while 55% of new variable rate owner-occupied loans were at less than 3% above bank rate, the same was true of only 17% of buy-to-let loans. Over recent quarters the average variable rate charged to buy-to-let was 4.0% against 3.0% for owner-occupiers, one third more.

CHART 6
Interest rate paid above bank rate (variable rate loans)



Source: Prudential Regulation Authority

This data is revealing because in view of the superior average arrears performance of buy-to-let over the past 15 years, the additional layer of protection provided by the rental income stream, a robust outlook for rented property and lower maximum LTVs, it is hard to argue that buy-to-let is higher risk than owner-occupied lending. This suggests that the traditional lenders that still dominate the mortgage market are not providing buy-to-let borrowers with appropriate mortgage pricing.

SECTION 2

A SECURED PEER-TO-PEER LENDING MODEL

2:1 - General peer-to-peer model

Peer-to-peer lending is rapidly gaining acceptance in the marketplace with over £1 billion now lent. As public and media interest has grown, the peer-to-peer business model has become a little better understood. It has sometimes been described as the democratisation of finance – bringing savers and borrowers together without the need for a complex and expensive bank sat in the middle.

However, the detail of how peer-to-peer providers manage this coupling of savers and borrowers and how they manage the risks involved is not well understood. Most people have a reasonable comprehension of credit risk – if the borrower cannot pay and any security fails to cover the shortfall there will be a loss. This loss can potentially fall on the lender although most peer-to-peer providers have a protection fund that can absorb initial losses.

But peer-to-peer lenders also face a range of other issues that would be familiar to any bank executive. There is operational risk, market risk, refinancing risk, liquidity risk and interest rate risk. For example, operational risk relates to the robustness of systems supporting the business and customer fulfilment. Peer-to-peer providers need to have robust systems to ensure a smooth experience for both lenders and borrowers.

Lenders on the platform have liquidity risk in the sense that they are entering into a fixed term loan agreement with a borrower. If they want to get their funds back early then they are reliant on someone else depositing funds on the platform in order to “take over” their loan.

2:2 - **Peer-to-peer buy-to-let lending model**

The majority of peer-to-peer lenders that have been established to date have focused on providing either unsecured personal loans or loans to small businesses. By comparison with these alternatives, using the peer-to-peer model to lend exclusively against residential property for rent should offer consumers a safe and transparent lending opportunity and a good route into the nascent peer-to-peer market. The extra security offered by lending secured on residential property is something that ordinary customers can understand, and appreciate the benefits of.

But even within a framework of secured lending there are degrees of risk. The lender has to choose the size of cushion that is built in via the minimum deposit and rental income cover demanded of the borrower and perhaps more importantly it has to develop a culture that sees risk control as central to the business of lending.

The Landbay model is designed to bolster the safety that comes from secured lending with conservative lending limits. Mortgages are limited to an LTV of 72% and an income coverage ratio of at least 125% is required.

Landbay loans are ring fenced for the benefit of the lenders. This can be contrasted with the situation in most banks and building societies, where loans are usually available to meet the bank's general obligations, even when the bank is engaged in other much riskier lending, although of course bank deposits are protected by the Financial Services Compensation Scheme up to £85,000. The Landbay Protection Fund adds a further level of safety.

2:2.1 - **Protection Fund**

In keeping with most other peer-to-peer lenders, Landbay provides a discretionary fund, which is currently receiving 0.25% of loan balances. These funds are ring fenced for the benefit of Landbay lenders. The Protection Fund can be used to make up any future shortfall that could occur in the income from the loan portfolio. Of course, it is not a guarantee of payment but it acts as a buffer in a similar way to bank capital which provides a buffer between the funds that savers have provided and the amount lent out to borrowers.

2:3 - Landbay's approach to risk assessment

A range of factors come together to make an efficient and safe lender. But what can really mark a lender apart is its approach to assessing a loan application or so-called loan 'underwriting'. Successful loan assessment is a crucial element in ensuring the robustness of any lending operation, be it bank, building society or peer-to-peer lender.

When assessing mortgage applications, Landbay has a very clear philosophy:

1. Gather a broad picture of the mortgage applicant and pay close attention to the quality of the borrower.
2. Cash flow is paramount and house prices are the backstop.

As stated above, Landbay uses the basic criteria such as maximum LTV and a minimum income coverage ratio that are key risk measures used across the buy-to-let lending industry. But it is Landbay's desire to understand the full picture of the borrower's financial position that could differentiate it in the longer term.

Landbay's focus on the importance of cash flow also marks it apart from many other peer-to-peer lenders who are lending on residential property. Many of these lend on development opportunities, where developers invest to convert or upgrade a property. Because developers typically receive no income while they are converting or renovating a building, they face additional risk, as does their lender. Landbay avoids this market, focusing instead on ready-to-rent property.

2:3.1 - Automated loan assessment

Landbay's approach can be contrasted with that of the mainstream mortgage lenders that use mainly 'automated' underwriting systems. Automated loan underwriting in broad terms relies on a series of lending rules. If the applicant passes each 'rule' they are approved and if they fail on any they will be rejected.

In addition, automated underwriting does not lend itself easily to the collection of too wide a range of information on the borrower because this adds complexity to what is meant to be a straightforward binary decision making process. So it is normal for a mainstream lender to assess a buy-to-let applicant without a detailed overview of the value of other properties they own relative to the amount owed on them, or an overview of the cash flow they generate on other properties.

Larger lenders may consider it necessary to use a series of rules in their loan assessment process so that each member of a large loan underwriting department can quickly assess whether a loan should be approved. But each additional rule has the potential to reject some high quality borrowers while potentially accepting some poorer quality ones.

For example, one rule commonly used by mainstream lenders is that the property must be let on a single tenancy agreement. Mortgage applicants renting rooms out separately will automatically be declined regardless of the LTV, income coverage ratio or their level of experience. So a mainstream lender lending up to 80% LTV, would reject an application on an LTV of 20% and accept an application on a neighbouring property at 80% LTV where the former was rented by the room and the latter on a single tenancy.

Typically first time or amateur landlords are much more likely to stick to the most straightforward option of renting a whole property. More experienced landlords are more likely to rent properties by the room and will do so where they can see it generates a better return. So while the rule barring renting by the room was imposed to reduce risk, it can have the opposite effect, skewing the characteristics of the population of borrowers being accepted for loans for the worse.

Other examples of mainstream lenders' rules excluding some successful experienced landlords include the rule against lending to limited companies and lending on properties rented to housing benefit recipients (which some professional landlords specialise in). Indeed, many mainstream lenders impose a cap on the number of properties a landlord can mortgage with them. This deters experienced landlords with large portfolios, again skewing the loan book towards the 'amateur' landlord.

The undesirable results of an automated approach to loan assessment can be seen in the events that followed the financial crisis. Buy-to-let arrears and subsequent losses for some lenders rose alarmingly in certain specific locations – mainly new blocks of flats in provincial city centres. The landlords borrowing on these properties met the criteria of the mainstream lenders. However, on closer examination these landlords were mainly amateurs who had been enticed into an over-exuberant market with little consideration for the sustainability of either prices or rents.

The lenders in question also do not appear to have carried out a robust assessment of the potential rental demand when lending on new developments in areas where the overall supply of new flats was known to increase sharply. Instead, these lenders relied on their rules based loan assessment system to weed out risk and deliver quality loans.

Automated underwriting may have also in some cases allowed higher levels of fraud to slip through. Larger buy-to-let lenders like Mortgage Express were hit by some organised fraud that led to substantial losses. In contrast, experienced manual loan underwriters can be quite good at spotting suspicious looking applications, picking up clues that would most likely be missed by an automated approach.

2:4 - Stress testing

We can see the impact of different economic shocks on the LTV and income coverage ratio of the mortgage portfolio originated to date by Landbay. To do this we consider an economic shock which requires the bank rate to rise sharply leading to a fall in house prices. This scenario would be triggered by rising inflation or higher growth or both. So it would be expected that rents would rise alongside other prices and incomes.

One advantage with buy-to-let compared to lending to owner-occupiers is the counter-cyclical performance of the rental market. When interest rates rise and house prices fall, younger households will put off buying their first home, which will increase demand for private rented accommodation. So rents might well rise faster than other prices.

We have considered three scenarios (mild, sharp and severe). These draw on the experience of past recessions which typically saw higher inflation pushing interest rates up, which in turn depressed house prices (early 1980s and early 1990s). The late 2000s recession was unusual in that interest rates fell sharply, insulating the housing market to some extent.

TABLE 4
Scenario results

Assumption	Base	Mild	Sharp	Severe
Bank rate	0.5%	2.00%	3.50%	5.75%
House prices	0.0%	-10.00%	-17.00%	-23.00%
Impacts of ar-rears on rents	0.0%	-2.0%	-4.0%	-6.0%
Rent inflation	0.0%	2.0%	2.0%	2.0%
Impact	Base	Mild	Sharp	Severe
Portfolio				
Average LTV	67%	74%	80%	87%
Average income coverage	164%	139%	120%	104%

Source: Landbay

Table 4 demonstrates the sensitivity of the Landbay mortgage book over a two year period to changes in these key economic variables. In practice management measures would be taken to mitigate potential losses where borrowers became distressed. But even when the income coverage ratio might suggest that the borrower is in a stressed position, the borrower covenant can provide added protection, allowing the book to continue to perform well.

2:4.1 - Scenarios

Mild

The most likely scenario over the next two years is a gradual increase in interest rates coupled with house price growth slowing to around 2-4% pa. Rent levels are expected to grow at a similar pace underpinned by the ongoing increase in demand for rental properties against a backdrop of limited supply.

However, under the mild scenario we have assumed that bank rate increases to 2% and house prices correct by 10%. We expect a 2% hit to landlords' rental income from rising arrears as companies tighten budgets, leading to a rise in unemployment and subdued wage growth. Under this scenario we see rent levels hardening slightly as inflation picks up and rental supply remains restricted. Based on this outlook the average LTV remains below 75% with income coverage comfortably above Landbay's minimum at 139%.

Sharp

A sharper correction would result from higher inflation or faster economic growth, resulting in interest rates moving quickly to the 'new normal' of 3.5%. In this scenario mortgage affordability becomes stretched pushing house prices down 17%, similar to the fall in 2008. We assume that rent arrears reduces landlords' rental income by 4% and we assume that rental prices rise by 2%, a conservative assumption against the backdrop of higher inflation and a continued shortage of rented property.

Under these assumptions, Landbay's portfolio LTV moves to 80%, and income coverage remains close to the criteria minimum at 120%.

Severe

Under the most severe scenario, the bank rate reaches pre-2008 levels at 5.75%, triggering larger house price falls of 23% as mortgage affordability reduces sharply and arrears and repossessions jump. Rent arrears reduce landlord income by 6% as unemployment rises. But this scenario is likely to be associated with significantly higher inflation. This ought to provide an offsetting rise in rental prices, although again we have conservatively assumed that rents only rise by 2%.

This severe scenario drives the average LTV to 87%. Whilst income coverage falls below Landbay's minimum criteria, it remains above 100% thus at least covering loan repayments. Under this scenario the borrower covenant is likely to play a particularly important role as landlords with broader financial resources will find it much easier to weather these conditions. In this severe scenario, the expected reduction in the rate of new house building will further exacerbate the supply/demand imbalance, suggesting that rental price growth could be pushed higher in the subsequent recovery.

SECTION 3

CONCLUSION

With the many problems that banks have faced in recent years, and the poor value for money they have often provided their borrowing and savings customers it is hardly surprising that consumers are looking for better value alternatives. It is equally unsurprising that, in this environment, the peer-to-peer lending model has started to capture the popular imagination.

But consumers' understanding of the peer-to-peer model still lacks depth. For example, while most consumers looking to lend through peer-to-peer sites understand the principle that higher reward goes hand-in-hand with higher risk, few are familiar with the specific risks that different peer-to-peer sites entail.

For savers who want to take a cautious approach, lending secured on rented residential property offers obvious advantages as it occupies the very low risk end of the peer-to-peer lending spectrum. This form of lending offers a series of layers of protection – the security of the property itself, the rental cash flow, the claim on the landlord and the robust outlook for rental demand.

2013 arrears data for buy-to-let lending confirms its soundness with 1.08% of buy-to-let properties in arrears of 3 months or more compared with 1.78% for owner-occupiers, itself historically one of the safest forms of lending. In contrast, industry arrears data is not even available for other lending segments such as personal loans and lending to SMEs. So for the cautious saver looking for a reasonable return, peer-to-peer and buy-to-let may well make the perfect partners.

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