HM TREASURY

Government response to the consultation on investment in the private rented sector

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1 Introduction

1.1 *Investment in the UK Private Rented Sector* was published on 3rd February 2010. The Treasury consultation paper was set in the context of preparing for housing market recovery and ensuring that there was a strong supply-side response to support this. The consultation considered the contribution the Private Rented Sector (PRS) could make to addressing housing demand and increasing supply, and identifying if there were any substantive barriers to investment in the sector.

1.2 The recent economic downturn has had a significant impact on the rate of new build, with net additional housing starts and completions in 2008-09 down 42 per cent and 20 per cent respectively compared to 2007-08. As the housing market recovers, the focus needs to move towards ensuring a strong supply-side response to support economic growth by taking action in a number of areas, including land availability, planning and regulatory requirements, industry capacity and provision of supporting infrastructure.

1.3 A responsive housing supply supports key economic and social policy objectives: delivering macroeconomic stability; supporting microeconomic growth; helping households to manage risks associated with housing, assets and savings; meeting people's housing aspirations; creating sustainable communities, and enabling labour market flexibility.

1.4 It was acknowledged in the consultation that the PRS plays a critical role within the housing system, helping to meet growing demand and providing a flexible tenure choice. It is therefore important that the sector continues to grow and improve to help meet the housing challenge, and that it is able to respond to demand.

1.5 The consultation recognised that there are two main classes of potential investor in the UK PRS – individual landlords and institutions. Historically PRS supply has been driven by individual landlords/investors, and in recent years the introduction of buy-to-let mortgage financing had accelerated this, with the PRS growing from 9.7 per cent to 11.3 per cent of the total housing market (2000-2006). In contrast the role of institutional investment has been limited to niche areas of the PRS market, such as student accommodation.

1.6 The consultation focussed primarily on the economic drivers of investment in the PRS and whether the sector will continue to be responsive to changing demand pressures, or be constrained by a lack of investment. It is clear that the level of investment directed by individuals and institutions into the PRS will be key to its future development, and will strongly influence both the volume and quality of supply. The decision to invest can be influenced by many factors, but the balance between risk and returns is fundamental.

The consultation closed on 28th April 2010. The Government received a total of fifty-five responses from a range of organisations and individuals. Respondents represented industry bodies, property professionals, and individual landlords. Treasury officials also held two roundtable policy discussions with stakeholders on individual and institutional investment in the sector. The Government is grateful for respondents' engagement with the consultation process and has carefully considered the responses in deciding how to proceed. Their answers to the questions posed, and other issues raised, are summarised in the following chapter.

2 Responses to the consultation questions

2.1 The consultation posed a number of specific questions about the development of the UK PRS, recent issues, and perceived barriers to investment. The main issues raised by respondents are summarised in the following section and the full set of detailed submissions to the consultation are published alongside this document.

Questions 1 and 2: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing? To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

2.2 The consultation noted that buy-to-let has not only contributed towards an overall increase in the level of PRS stock in the UK, but has also tended to bring in newer properties of a higher quality, suggesting that individual PRS investors were apparently more likely to invest in new-build properties than individual homeowners. Respondents cited a number of factors that could have influenced demand for new-build properties, including:

- Simplicity: The buying process is straightforward for new-build properties. It is more convenient for some investors to buy a new-build unit than to prepare existing properties for renting.
- Maintenance: New-build properties are generally regarded as lower maintenance than older stock.
- Quality: The quality of new-build is normally better than that of the existing stock. New-build properties are seen as more energy efficient, environmentally friendly, economical to run, secure and regulatory compliant.
- Tenant demand: New-build properties are more typically adapted to meet the requirements of tenants, including location and amenities.
- Incentives: Investors have the opportunity to negotiate financial incentives with sales operatives when purchasing new-build properties (e.g. discount for bulk purchases).
- Yields: New-build properties usually achieve higher rentals.
- Certainty of entry date and price: buy-to-let property is ready to let immediately.

2.3 It was also felt that supply had been influenced by Government planning policy. Housing density requirements and use of brown field sites, due to the restrictions on green field sites, had driven the development of inner city apartment blocks. The house building industry has also responded to changing demographics (e.g. smaller households).

2.4 However, a number of respondents believed that the apparent preference for new-build was a temporary phenomenon, and unrepresentative of the behaviour of the majority of professional individual landlords. It was suggested that this activity in new-build was driven by a large number of inexperienced new-entrants to the PRS market whose investment was primarily speculative, and who have been among those worst affected by the housing market downturn.

This seems to be supported by the experience of those lenders who remained focused on professional landlords. Their clients continued to invest primarily in the existing stock.

Question 3: What is the contribution of individual homeowners renting out part of their own home making to housing supply? Are there significant constraints limiting this contribution to addressing housing demand?

2.5 It was recognised that renting out a room can make a useful contribution to addressing housing need but this contribution was felt to be relatively small to the market overall. However, it is difficult to measure scale of activity, or assess whether it is growing or declining, due to the private nature of these arrangements between owner and lodger. Reliable statistics are difficult to obtain because under the rent-a-room scheme rental income below £4,250 per annum need not be declared to HM Revenue and Customs. There is also some anecdotal evidence suggesting that the rent-a-room allowance is not used by many potential users, because of a lack of awareness of it.

2.6 A number of respondents noted that the limit imposed on the level of tax free rental income landlords may receive before being required to submit a tax return has not been increased since tax year 1997-98. It was argued that by not uprating this limit by rental inflation the allowance had now become a constraint on supply. Some respondents proposed that the threshold should be raised to £9,000 per annum.

Question 4: To what extent have the incentives for individual investment in private rented accommodation changed over the last 10 years and why? Going forwards, what are the key prospects and risks for individual investment in the PRS?

2.7 The incentives for individual investment in the PRS mentioned by respondents were the rapid increase in property prices and the ready availability of low-cost mortgage funding. There was a consensus that access to buy-to-let mortgage finance had been a significant factor supporting the substantial growth in PRS housing since 2000 and that mortgage availability would be the key issue facing individual investors in the PRS going forwards.

2.8 Landlords have found obtaining competitive mortgage finance difficult since the withdrawal of the many buy-to-let products in 2007. Mortgage lending constraints, reduced loan-to-value ratios, and higher deposit requirements are currently restricting the entry of individual investors to the PRS. Ensuring the availability of adequate credit to sustain market growth is the key challenge facing the PRS. It was noted that these are the same constraints facing homeowners and first-time-buyers.

2.9 Respondents indicated that uncertainty over property values could impact on individual investment in the PRS in the short-term. However, the medium-term expectation is that capital value growth will return, along with mortgage funding.

Question 5: How important are scale economies in management to viability, and what is the minimum lot size required to ensure institutional investment in residential property is commercially viable?

2.10 The majority of respondents agree that scale economies are vital to the viability of institutional investment in the PRS; however, a few sources, including some academics and current investors, point out that the fact that individual landlords dominate the private rental market suggests that the scope for economies of scale may be limited. Regarding minimum lot size, it was pointed out that given the wide range of characteristics of residential property, it was difficult to say. However, others reasoned that realistically, investors would be looking for a portfolio in the region of £50m / 200 properties to consider investing.

Question 6: What evidence is there that i) the SDLT bulk purchasing rules are a constraint to building up property portfolios, and ii) changes to SDLT rules for the bulk purchase of residential properties would lead to increased investment, either by institutions or individuals, in the private rented sector?

2.11 A number of respondents were of the view that the SDLT treatment of bulk purchases of property presented a barrier to large-scale investment in the private rental sector. It was also pointed out, by a number of respondents, that the current SLDT rules encourage the break-up of existing portfolios when an investor wishes to divest of their portfolio. However, the general view was that SDLT is not the sole barrier to residential investment, and that even if changes were made, this would be unlikely, by itself, to stimulate institutional investment in the PRS. A minority of respondents were of the view that SDLT did not present a fundamental barrier to residential investment, and that it made no material difference to some investment decisions.

Question 7: How might changes to the SDLT rules on bulk purchasing impact on the rate of return on institutional investment in the private rented sector?

2.12 A significant number of respondents to this question were of the view that reducing the level of SDLT payable would increase the rate of return as the initial purchase price would be lower (estimates varied between 20 - 150 basis points depending on assumptions).

Question 8: How do the rates of return on investment in the PRS compare to those expected/required by institutional investors?

2.13 Most responses were of the opinion that UK residential property performs well in comparison with most other asset classes over most timeframes on a total return basis. However, income returns are often more attractive to institutional investors and these are much higher for commercial property than residential.

2.14 Many respondents also made the point that residential property is generally considered in relation to wider property allocation, and is therefore compared to, and has to compete with, UK commercial property.

2.15 It was also noted by some respondents that different institutional investors have different income, capital and total return expectations, and as such should not be considered as a single group.

Question 9: What factors have prompted the recent institutional interest in investing in the PRS, and do these reflect a long-term change in investment opinion?

2.16 The majority view was that current interest by institutions investing in the PRS is driven by short-term incentives, including lower house prices, and particularly, the poor returns to commercial property and other sectors. This has been described as a "window of opportunity". Some responses have also suggested that there is longer term interest from pension funds and life insurers who are looking for secure assets that rise in value in line with earnings. Housing also correlates poorly with other assets making it good for diversification.

Question 10: What are the key barriers to further institutional investment in residential property, compared to commercial property? How could these barriers be addressed, and what evidence is there that such changes would increase institutional investment in the PRS?

2.17 A large number of potential barriers to institutional investment in the PRS were raised by the responses to this question, ranging from concerns about the rate of return to residential property, to the difficulty of managing difficult tenants. These include soft barriers such as reputational risk, and a number of practical barriers including lack of available portfolios, high management costs, and the need to rationalise leases. A number of fiscal barriers were also raised, including VAT, and the lack of capital allowances, and the SDLT treatment of bulk purchases of residential property. It was generally felt that addressing these (fiscal) issues could increase returns, thereby making PRS investment more attractive to institutional investors.

Questions 11 and 12: What are the key barriers to investment in residential property through UK-REITs, and what changes would be needed to address them? What evidence is there of the likely effects of such changes on new, and existing, UK-REITs investing in residential property? And what impact would such changes have on existing UK-REITs investing in commercial property?

2.18 A number of representations suggest that Residential REITs would be viable under the current model if suitable portfolios / vehicles existed to convert into a REIT. In their absence, changes to the REITs regime that have been called for are:

- abolishing the 2% entry charge (to reduce entry costs);
- amending the 90% distribution requirement (because residential properties do not benefit from capital allowances the distribution requirement is effectively higher for residential property - a suggested alternative is to allow 10% wear-and-tear allowances for residential property);
- removing the Registered Stock Exchange listing requirement as this increases compliance costs - alternatives include allowing Alternative Investment Market listing;
- modifying the profit financing-cost ratio (to allow an element of gains to count towards rental profits, given the lower income returns of residential property);
- allowing CGT roll-over relief for individuals selling property into a REIT (in return for shares); and,
- modifying the closed company rules (to allow a smaller number of shareholders to own an entire REIT.

2.19 In addition it has been suggested that 'transitioning provisions' could encourage new, and residential, REITs whereby it would be possible to apply for REIT status and enjoy the flexibility of the regime while working towards meeting the criteria. Parties could form a Transitioning REIT agency to achieve specific criteria with a given timescale.

2.20 Another issue raised by some respondents is the distinction between 'trading' and 'investment' income. Currently, REITs are tax exempt on their property rental business but taxable on their trading activity. It has been suggested that institutional investors would need a higher turnover of residential units to make a reasonable return. This would require that residential REITs have more freedom to trade their properties.

Question 13: How suitable are other collective investment vehicles for residential property investment? What are the current barriers to investment through these vehicles?

2.21 There are a wide range of different vehicles, with different characteristics (e.g. listed or unlisted, open or closed ended) which will be appropriate for different investing models (e.g. geared or ungeared, fixed or indefinite life) and different target investor types (e.g. retail or institutional). It was generally felt that at present, Jersey Property Unit Trusts, and English limited partnerships, offered the most tax efficient means of investing in residential property. It was pointed out that alternative vehicles faced many of the barriers outlined in Question 10; in particular, the lack of availability of suitable portfolios to invest in.

Question 14: How do these collective investment vehicles compare to UK-REITs?

2.22 Respondents to this question suggested that a number of the alternative available structures have greater flexibility and lower costs (including tax costs) than REITs, mainly because the REIT requirements (such as the payment of conversion charge or the need to obtain a listing) do not apply. It was suggested that Offshore Property Unit Trusts offer the widest range of benefits, particularly as partnerships receive less favourable SDLT treatment by comparison. It was remarked that there is no onshore vehicle that offers the 'universal benefits' of Offshore Property Unit Trusts, and as such it remains likely that many new property funds, including residential, will be formed offshore.

Question 15: What evidence is there that institutional investment in the PRS would bring real benefits to the sector, and the housing market more generally?

2.23 Respondents to this question were unable to provide significant evidence that institutional investment would improve the PRS, however, it should be noted that the sector is currently in its infancy. That said, a number of respondents suggested that institutional investment would draw in capital from different sources than buy-to-let, and might help to bring new investment to the housing sector; in turn helping to increase housing supply. There was also a general sentiment that institutional investment could lead to better management and improved quality in the sector. A note of caution was raised by some respondents, however, citing the impact that institutional investment has had in the student accommodation sector.

3 Conclusion and next steps

3.1 The Government inherited an exceptional fiscal challenge. Last year, Britain's deficit was the largest in our peacetime history. Reducing this deficit is the most urgent issue facing Britain. This will be a challenging task, but the Government is committed to doing this in a way that restores confidence in the economy and supports the recovery.

3.2 The Government believes that the best way of supporting the Private Rental Sector is to restore confidence in the economy, stimulate investment, and maintain a stable financial system that supports lending and the long-term growth of the economy.

3.3 At Budget 2010, the Government demonstrated its commitment to supporting business and restoring the UK's diminished competitiveness through measures to reduce the main rate of corporation tax from 28 to 24 per cent by 2015, and reduce the small profits rate to 20 per cent from April 2011. The increase in the employer National Insurance Contributions threshold by £21 a week above indexation in April 2011 will save businesses £150 a year for every employee earning above the threshold, reducing the burden of taxation on labour by over £3bn a year.

3.4 Overall, we believe that stakeholders share these priorities. Indeed, in response to the consultation document's analysis of the development of the PRS and the potential issues it faces going forwards, the key messages flowing out of the consultation from respondents were that:

- The biggest factor affecting individual investment in the PRS is the availability of mortgage finance and buy-to-let. Individual investment into the PRS ought to return once the flow of mortgage lending recovers. There are, however, uncertainties over future prospects for capital growth, which has been an important component of overall investment returns. And it seems unlikely that individual investors will favour new-build properties.
- Institutional investment is likely to remain niche and small scale, so long as the level of income returns to residential property remain low. Significant tax incentives to improve these would be necessary to guarantee substantial institutional investment in the PRS.

3.5 As part of the consultation respondents also raised a number of fiscal issues which they argued either acted as barriers to investment, or could be used as incentives.

Stamp duty land tax (SDLT) on bulk purchase

3.6 A number of those responding highlighted the SDLT treatment of the bulk purchase of residential property as a barrier to investment in the PRS. SDLT is a transaction tax and the rate is therefore determined by the total value of the transaction. A bulk purchase is likely to attract the top rate of SDLT because it is one transaction (regardless of the value of the individual dwellings purchased as part of that transaction).

3.7 The amount of SDLT due is therefore often more than it would have been had the dwellings been purchased individually. The responses we have received suggest that reducing the level of SDLT payable on these transactions would increase the rate of return, as the initial purchase price would be lower.

3.8 However, responses also acknowledged that the SDLT rules are not solely responsible for the low rates of return on investment in this type of property and even were changes made, these alone would not be guaranteed to deliver high enough returns to attract that investment in the sector. Further, any such change is likely to carry a significant cost to the Exchequer at a time when deficit reduction remains the Government's main priority. As such, the Government will not be taking these proposals forward at the present time.

VAT on property management fees, renovations and repairs

3.9 Representations were made for the reduction in the VAT rate chargeable on residential property portfolio management fees to 5%. The types of services that can be taxed at the reduced rate are regulated by European Union legislation. Only certain categories can qualify. These do not include residential property management fees.

3.10 Representations were also made for the Government to consider reducing the VAT rate applicable to the labour element of repair and renovation services carried out on residential property. The reduction in the VAT rate charged could not be limited to the private rented sector and would therefore be extremely costly. A decision to reduce the VAT rate would have to take into account the impact on the wider economy.

3.11 Reduction in the public sector deficit is a priority for the Government. Any changes to tax rates on repairs to residential properties have to be judged in that context. The Government does not have compelling evidence, nor has been presented with such evidence, that leads them to believe that there is a strong case for the change.

Capital allowances

3.12 A small number of respondents suggested that the long-standing exclusion of capital allowances for investment in plant and machinery for use in a dwelling house by property businesses is a disadvantage in comparison with such investments within non-residential buildings, which can qualify for capital allowances.

3.13 Capital allowances do already support the PRS for some plant and machinery investments, such as in the common parts of a building or for other business assets not in a dwelling house, including office computers and cars.

3.14 Capital allowances are not permitted for investment in plant and machinery for use in a dwelling house by property businesses and therefore do not apply to the majority of plant and machinery assets purchased by the PRS. However, the industry already receives tax relief (the wear and tear allowance), which takes account of the depreciating value of certain assets.

3.15 Wear and tear allowance is available to property business landlords of furnished houses to cover the cost of replacing plant and machinery within these properties. This tax deduction, equal to 10 per cent of net rents, is believed to be more generous than capital allowances for depreciation and is also simpler than capital allowances, helping to reduce the administrative burden on this sector.

3.16 It would be an expensive and unnecessary duplication of reliefs to relax the exclusion of capital allowances in plant and machinery for use in a dwelling house by property businesses. As such, the Government does not believe that taking these proposals forward would represent the best way to support the UK PRS.

Residential Real Estate Investment Trusts (REITs)

3.17 The consultation also asked a number of questions about the suitability of the UK-REITs regime for investment in the UK private rented sector. Whilst the majority of respondents suggest that Residential REITs would be viable under the current model if suitable portfolios existed for purchase, a key theme that emerged was that some of the requirements of the REITs regime may also act as a barrier to residential investment.

3.18 The Government would therefore propose to carry out further work looking at the barriers to residential investment through UK-REITs, and whether changes to the entry requirements of the regime might encourage the emergence of new REITs, including residential REITs.

Rent-a-room allowance

3.19 The rent-a-room relief was intended to encourage individuals to provide spare accommodation in their own homes for those on lower incomes, who cannot afford to rent a house or apartment of their own (such as nurses and students). While the consultation showed support for increasing the rent-a-room relief threshold from its current level of £4,250, there is a need to gather more evidence on whether a change to the threshold could deliver a cost effective increase in the supply of rental accommodation.

3.20 The Government will consider the proposal to increase the threshold for rent-a-room relief as part of the Budget process in the context of the wider housing market and other Government measures, including recent changes to the Local Housing Allowance. We will consider whether this is the most appropriate method of increasing the supply of affordable accommodation in the private rental sector and if a change to the threshold is appropriate.

Next steps

3.21 The Government is committed to creating the best possible environment for a sustainable private sector led economic recovery, though the financial position means that priority must be given to maintaining the fiscal base. However, the Government will continue to keep all taxes under review and considers proposals for new reliefs carefully.

3.22 In this context the Government will be considering further the case for changes to the UK-REITs regime in order to reduce barriers to entry to the regime and changes to the threshold for rent-a-room relief to encourage better use of the existing housing stock. To the extent that any such changes are likely to carry a cost to the Exchequer at a time when deficit reduction remains the government's main priority, these measures will need to be considered in the round, alongside other policy priorities, with any announcement made as part of the 2011 Budget process.

A List of respondents

A.1 The Government is grateful to the following organisations for their contributions to the consultation process:

A Social Democratic Future

Assettrust Housing Limited

Association of Residential Letting Agents

Association of Residential Managing Agents

BDO LLP

Berkeley Group

Berwin Leighton Paisner LLP

Bromford Group

Building Societies Association

Central Association of Agricultural Valuers

Chartered Institute of Housing

Chartered Institute of Taxation

CMS Cameron McKenna

DTZ

East Midlands Development Agency

Fast Trak Solutions

First Base Ltd

Grainger plc

Grosvenor

Home Builders Federation

Homes for Scotland

Institute of Chartered Accountants of Scotland

Institute of Chartered Accountants' in England and Wales

Joseph Rowntree Foundation

Leeds City Region

London Borough of Barking & Dagenham

Manchester Salford Pathfinder

Mill Group

National Housing Federation

National Landlords Association

North West Private Sector Group

Nottingham City Council

Paragon Group

Places for People

Plus Dane Housing Group

PricedOut

Property Industry Alliance (representing British Property Federation, British Council for Offices, British Council of Shopping Centres, Investment Property Forum, Royal Institution of Chartered Surveyors, Council of Mortgage Lenders, and the Association of Real Estate Funds)

Residential Landlords Association

Resolution Foundation

Royal Institution of Chartered Surveyors

Savills

Scottish Government

Shelter

Spareroom.co.uk

The British Land Company plc

Professor Alan Hallsworth

A number of private landlords and tenants also submitted responses.

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

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