HM Treasury

Investment in the UK private rented sector

Consultation response from London Borough of Barking & Dagenham

We welcome an increased private rented sector which is both professionally managed and well maintained as this would offer an expanded tenure choice and believe that this tenure responds best to the needs of those households that require the flexibility to pursue career paths that demand mobility. This is likely initially to be particularly relevant for younger households at early stages in their career development. It might be hoped that as the benefits of this tenure began to become more widely understood and accepted, so that over time private rented accommodation becomes the choice of wider groups within the population.

In order to achieve high management standards it will be important to ensure that there is not fragmentation of the management functions. This could more easily be achieved on new developments that had been built with the purpose of private renting and particularly if the management contract is let to an organisation regulated by the TSA, which might be a RSL or a Local Authority's housing service.

Institutional investment

We believe that there is a key role for new sources of institutional investment into the residential sector for private rented accommodation in terms of helping to kick – start new developments. This is especially relevant whilst the market on homes for sale is still weak in most areas and the availability of grant / investment from the public sector via the HCA's National Affordable Housing Programme will inevitably be curtailed over the next CSR period (and probably beyond).

Allied to this, it would be helpful in terms of seeking to create thriving mixed tenure communities in which households with varying income levels live, that institutional investment is not exclusively funding private rented homes. Whilst it is understood that the principal attraction for the pension and life funds is likely to be the long term secure yield that private rented sector has the prospect of providing, high quality developments which include also social rented, intermediate tenure homes and some outright sale, could provide capital growth and achieve broader regeneration outcomes for communities.

It is clear that one of the historic deterrents to institutional investors from funding and owning private rented homes has been poor and fragmented management of homes and estates. This can now be positively addressed by RSLs and Local Authorities recognizing the opportunity which can emerge and providing the services to the landlord on a contractual basis.

Buy to let

In contrast to the welcome for institutional investment on the basis as described above, the experience of LB Barking & Dagenham over the past 5 years of buy to let is not positive.

Homes that have been bought to let in the borough have come through 2 main sources. In terms of volume the majority were former Council houses which were bought under the RTB. At a later stage owners have either sold on the market with the new owner then letting the house, or in other cases, the owner moving away and letting the property. The second principal source derived from new developments with the market sale units sold off plan and let. In many instances this second route has been frustrating for the Council as we have sought to bring about mixed income / tenure communities in town centres and on the sites of former mono tenure Council estates. The issue being that a many of the homes intended for owner occupation became occupied by households not in employment and in receipt of benefits.

Common to both sources of buy to let has been poor management of the properties which has often led to local issues of nuisance and degradation of neighbourhoods. This effect is exacerbated by transience of the occupants.

Ken Jones
Programme Director – Local Housing Company
LB Barking & Dagenham

15 March 2010

leeds city region
intelligence driving growth

PSR Investment consultation
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27th April 2010

Dear Keith

I write in my capacity as Chief Officer of the Leeds City Region Partnership to submit our draft response to the HM Treasury Consultation 'Investment in the UK Private Rented Sector.' This response is subject to formal confirmation, which I will inform you of in due course.

As you will be aware, the Private Rented Sector Pilot Initiative is part of the Leeds City Region's Forerunner programme agreed with Government in November 2009. The city region partnership has been working with CLG, the Homes and Communities Agency (HCA) and Savills to develop a deliverable product to achieve institutional investment in the private rented sector. We are still undergoing development work and the emerging findings have informed this response to the consultation.

I look forward to the outcome of the consultation process, but in the meantime if you require any further details please do not hesitate to contact Liz Cook on 0113 247 5808 or email: liz.cook@leeds.gov.uk.

Yours sincerely

Paul Rogerson
Chief Officer, Leeds City Region &
Chief Executive, Leeds City Council

Cc: Tony Reeves, Chief Executive, Bradford MBC

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Draft : Feedback on the specific issues identified.

Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

Evidence suggests that a significant proportion of new buy to let has focussed upon new build properties. Buy to let investors have been driven by a number of investment decisions but the key issue has been the potential for capital growth. Many buy to let investors have assumed that higher capital growth would be achieved in new build rather than existing properties or through conversions.

A number of buy to let investors have entered into the market accidentally when the market downturn removed the anticipated value growth between reservation off plan and completion.
Other investment factors include:
- certainty of availability;
- certainty of price;
- ability to let

Buy to let investors will be advised that a new property will be let faster and is likely to generate a rent premium against an existing property. However, it is important to recognise that there is a further subset of buy to let investors who will not anticipate significant capital growth but be motivated by rental yield. Here the focus will be on existing properties and the potential to enhance rental through sub division.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

There is limited evidence that the house building industry has been influenced by buy to let investors, as there is little evidence to suggest that the specification of individual properties or the management of property has been modified to reflect the rental market.

The house building industry is geared towards short term development sale and capital recycling rather than long term investment. Given that the house building industry produced less than 160,000 properties at the peak of the market, it is difficult to see circumstances where this model would switch to large scale rented developments.

The need for increased supply and substantial growth in the private rented sector will require new entrants to the production of housing pulling together landowners, contractors, property managers etc.

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?
The potential for this to increase supply is significant but would require a tax incentive.

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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?

The key investment driver was capital growth, the fundamental changes to the housing market have reintroduced negative equity and uncertainly.

To attract individual investors the rental yield will need to be sufficient to service the debt and deliver a regular income which effectively completes with returns on other investments.

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 commercial viable?

Scale is key as it provides the opportunity to address a spread of property markets; targets a mixture of renters; it mitigates against voids risks and property defects and management efficiency can be achieved.

Institutions are generally interested in investments of £200 million plus which would suggest a portfolio of 1000 plus properties. Portfolios of this size would create management efficiencies and a balance against voids risk and property defects.

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

The consultation document comments that representatives of the property industry; banks; tax advisers have highlighted that the SDLT treatment of bulk purchase of property as a key impediment to investment, we agree with this comment. SDLT at 4% plus on portfolios damages the initial yields and acts as a disincentive.

Residential property is held in a disparate market with multiple landlords with limited property numbers. It is an innovative market that would benefit from consolidation.

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?

Residential portfolios traditionally produce low initial yields – generally under 5%. Over time, rents are likely to rise above inflation, whereas other costs will generally rise at a lower rate. This creates the potential for satisfactory returns of 5% plus to be generated. The imposition of bulking SDLT will typically add 2-3% to the acquisition cost of a property. At a base level this may not appear to be significant, however given the low level of initial yields, this will be sufficient to shift a portfolio of properties from a suitable and fundable investment to one that fails this test.

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Question 8: How do the rates of return on investment in the PRS compare to those expected/required by institutional investors?
Initial yields from residential property are low. Many buy to let investors have acquired properties producing yields of 3%. These investors have subsidised their investment by not seeking a yield on their equity, just seeking to meet their financing and letting costs. This is not sustainable for investors with a larger portfolio unless they are attracted to capital growth. Market performance over the last 2-4 years works against such investments.
Generally, the spread between gross and net yields will be 30-35% and results in initial yields of sub 5%.
The PRS could produce attractive yields were an investor prepared to take a medium term view i.e. 10-15 years. The challenge faced by investors and institutions is the lack of certainty attached to the income stream.

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?

The primary investment decision for institutional investors is certainty of income stream. The investment decisions are complex and investment in the private rented sector needs to compete with all other investment options.

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?

The primary barrier is scale and development of property portfolios to enable investors to spread risk and deliver certainty of return. A model that offers scale and attracts effective tax system and enables the development of large portfolio could be effective in attracting investors.

Question 11: What are the key barriers to investment in residential property through UK REITs, and what changes would be needed to address them?
REITS could operate successfully if there were significant portfolios of residential property to acquire. This is not the case, and in practice, the model will continue to fail unless changes are made to the structure.
The key changes required are:
(i) Scale of percentage holding by a single party;
(ii) The requirement to distribute profits.
(iii) The requirement for listing;
(iv) The cost of conversion.
The Government could adopt a REIT Transitioning Provision whereby it is 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.
Effectively the Transitioning REIT would commit to being fully compliant within say 10 years or agree to sell to another compliant REIT or lose the tax and operating benefits.
This would enable parties to create saleable portfolios, reinvesting profits to build up the portfolio, acquire stock etc. They would then agree to sell down their share to

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achieve the standards of a REIT.

Question 12: 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?
Unknown

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

Existing legal structures, in the form of Limited Partnerships, Limited Liability Partnerships, companies, mutual's and other legal structures could be used to create portfolios of residential properties.

Question 14: How do these collective investment vehicles compare to UKREITs?
No comment

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?
The current PRS is fragmented, the market is largely made up of individuals holding a small number of properties whose key driver is to generate income rather than maintain the property to a good standard and offer potential tenants a responsive housing management. With an increase in demand for private rented property caused by the inability to buy, this situation islikely to continue.

Institutional investment in the PRS could bring the following
benefits:
1. Good quality housing management practices.(for example RSL)
2. Assist in meeting the targets for the provision of new homes. Where funds involve the development of land for housing for rent rather than for sale;
3. Stimulate local economy

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Investing in the UK Private Rented Sector
Manchester Salford Pathfinder (MSP) / Manchester City Council / Salford City Council - Consultation Response

1. Introduction

2. This response has been co-authored by the Manchester Salford Housing Market Renewal Pathfinder (MSP) and the constituent Local Authorities of Manchester and Salford City Councils.

3. MSP is a partnership between Manchester and Salford City Councils established to co-ordinate a long-term strategic programme to restructure the housing market in parts of north Manchester, east Manchester, south Manchester and central Salford. The MSP is situated at the core of the Manchester City Region (MCR) and is populated by 240,000 residents living in 116,428 households. By the start of the Housing Market Renewal (HMR) Programme in 2003, these areas had experienced many years of economic decline, severe population loss and housing market failure, exhibiting exceptionally high levels of deprivation, poor quality housing and very low levels of owner occupation.

4. MSP is working within new city region governance arrangements following the establishment of the Greater Manchester Multi Area Agreement (MAA) (signed with government in July 2008) and the announcement of pilot Statutory City Region status in the 2009 Budget Statement. Most significantly MSP is working with the Commission for the New Economy and the Planning and Housing Commission, which will take on strategic oversight of key spatial planning issues for the MCR.

5. Together, we welcome the opportunity to respond to this consultation. We believe this consultation is both timely and relevant at this important stage in the revival and regeneration of the local housing market within Greater Manchester and in particular within the conurbation core.

6. In summary we believe that in the current market conditions the Private Rented Sector (PRS) could make a significant contribution to addressing housing demand and increasing supply in the MCR area. This paper articulates this view, in response to those questions most relevant to the MCR market, the importance of the PRS to individuals, the housing market and the wider economy and describes the fâctors that have led it to grow in recent years.

7. Housing and the Manchester City Region Economy

8. The MCR is the main driver of the Northwest economy and home to a population of over 3 million residents (47% of population in the NW). The city region generates 50% of the Northwest's total economic output and contributes around £100 billion to total UK GVA: an estimated 10 percent of total national output.[1]

9. GVA and job growth in the city region has been driven by a number of key industry sectors that have helped MCR develop as a major centre of knowledge intensive industries. Between 1999 and 2004, net employment grew by 75,900, driven primarily by traded service sector jobs. These include Financial and Professional Services, Life Sciences, ICT / Digital Communications, Creative /

[1] Manchester Independent Economic Review 2009

Digital / New Media, as well as established industries such as Logistics and Construction.[2]

10. However, despite significant success over the last decade, the annual GVA growth rate between 1999 and 2004 in MCR (2.4%) and GM (2.5%) are both lower than the UK average (2.9%).[3] Moreover, the past two years have seen some of the most challenging conditions that the local housing market has ever experienced. The Manchester Salford Pathfinder (MSP) has not been immune to these and it is fair to say that efforts have been affected by the slow down in both house building and house buying across the sub-region.

11. Despite the correction in house prices, average wages remain well below national averages and this alongside the constraints attached to saving for a deposit has meant the longstanding affordability challenge has now been joined by an inability to access mortgage finance for first time buyers in some of our most important inner area communities.

12. In planning for the recovery, the continuing aim of all local partners remains to support the economic growth potential of the MCR by providing a higher quality housing offer with a more diverse range of types, values and tenures in line with the aspirations of both new and existing residents. While market and economic conditions are currently unfavourable, the latest long term economic and population projections for MCR are still positive and the challenges of increasing housing supply, extending choice and quality and connecting residents to an improved housing offer remain.

13. On this basis the opportunities associated with the growth of PRS (not least the attraction to PRS from upwardly mobile economically active residents) is likely to represent a key element of our supply-side response to the recent slow down. We are keen to capitalise on the increasing rental market demand which has accelerated following the slow down in sales and the tightening of the mortgage markets across MCR.

14. **The Private Rented Sector in MCR**

15. The Private Rented Sector (PRS) is playing an increasingly important role in the housing market in MSP. The latest monitoring figures suggest that across the lifetime of the Pathfinder (2003 – present day), the private rented sector in Manchester – Salford has grown by over 3%. At the regional level, figures for the North West suggest that the number of tenants in the PRS has increased by over 100,000 over the same period.

16. At the same time owner occupation, (outside of Right To Buy) has decreased. Average student (in many instances first time buyers) debt has spiralled - £21,500 in 2006/7. In GM lower than average wages have fuelled an affordability crisis, which has presented a major barrier to home ownership despite the recent correction in house prices. The affordability challenge, a result of the persistent and significant gap between average earnings and house prices has provided further impetus to a sector, which has taken the slack and could accommodate further growth in the coming recovery period and beyond.

[2] Manchester Independent Economic Review 2009

[3] Manchester Independent Economic Review 2009

17. It is important to note that, the private rented sector in MCR cannot be viewed as a single entity homogenous market. The reality is that both from the supply and the demand side the market breaks down into many diverse market segments in various geographies within the MSP area.

18. On the supply side, at the top end of the market is the high value, high quality rental usually for high earning professionals with monthly rentals between £700 and £1,500+ . At the opposite end of the market is a mixture of well intentioned amateur landlords and those almost bordering on criminal activity letting out sub-standard properties to an increasingly desperate and vulnerable group of households. Many of these tenants are unable to access decent homes in the social rented sector, either through there own criminal or antisocial behaviour or histories of poor financial management.

19. In between these extremes are a range of market segments including reluctant landlords (who are unable to sell property and therefore rent); landlords who have inherited property; relatively wealthy individuals who have chosen to invest in property rather than other investments; professional landlords who manage a small portfolio of properties themselves; professional managing agencies; and overseas investors.

20. The one thing that all of these investors have in common is that they are operating in virtually an unregulated market whereby the market itself is expected to drive up standards through competition. Therefore property condition or quality of management is challenged by tenants who have the ability to go elsewhere if the landlord doesn't resolve the issues.

21. This may be the case at the top and middle end of the market but at the lower end, the ability of tenants to exercise market forces on the landlord is extremely limited. This is particularly evident in the bottom end of the market when local housing allowance is applied to properties. The poor quality of much of the property is well documented and in most local authorities the highest incidence of vulnerable households living in non-decent homes is in the private rented sector.

22. The introduction of assured short hold tenancies means it is easier for landlords to evict their tenants. Whilst on the one hand this has probably encouraged more people to invest in the private rented sector, on the other it has presented a barrier to individuals making complaints about their landlord or establishing firm roots in local communities because of the short term nature of the tenancy agreement. Most good quality landlords welcome a good tenant who is prepared to live in their property for a number of years. It would therefore make sense for some form of balance to the tenancy agreement that gave for example a 5 or a 10-year tenancy guarantee providing the tenant complied with the various obligations contained within a lease. Any policy change in this area should ideally be based on more evidence of the impact that longer tenancy agreements would have on the willingness of investors to fund new development.

23. In future, we would welcome the following approach;

- Encouragement and support for high quality higher value market rent with light touch regulation, primarily through self-certification.

- Working to develop successful accreditation schemes, again with a light touch approach to regulation but with a higher degree of support and advice.

Self certification on matters such as property condition, gas and electric and management standards. Incentivisation such as direct payments of local housing allowance to accredited landlords, loan finance for improvements, access to local authority housing registers and support from supported housing schemes.

- Licensing and enforcement for the bottom end of the market with licensing applying to individual landlords or their agents or company. The diverse nature of PRS may mean that restrictions on payment of local housing allowance could in the future be tied to property condition (in certain key sectors), where increasing management standards could be progressed via this type of financial incentive.

- Continued support to address area based issues selectively, particularly where local licensing / management initiatives are supported by developers as a means of protecting new build areas (as was the case in Chimney Pot Park Langworthy).

24. Response to Specific Questions

25. The remainder of this consultation response provides detailed answers to those questions most relevant to the local PRS market in MCR.

26. Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

27. This question betrays the very generalised approach to the analysis in the paper. In parts of the Greater Manchester conurbation there has been significant investment by individuals in existing owner occupied housing on the grounds that it is relatively cheap to purchase and yet will sustain a reasonable market rent.

28. For example, in the period from the 1960s, the south Manchester housing market experienced a significant number of conversions from family type houses to houses designed to attract and accommodate student occupiers. This trend has meant that south Manchester has developed into one of the strongest student rental markets anywhere in the UK and the rents in this area have traditionally reflected this demand.

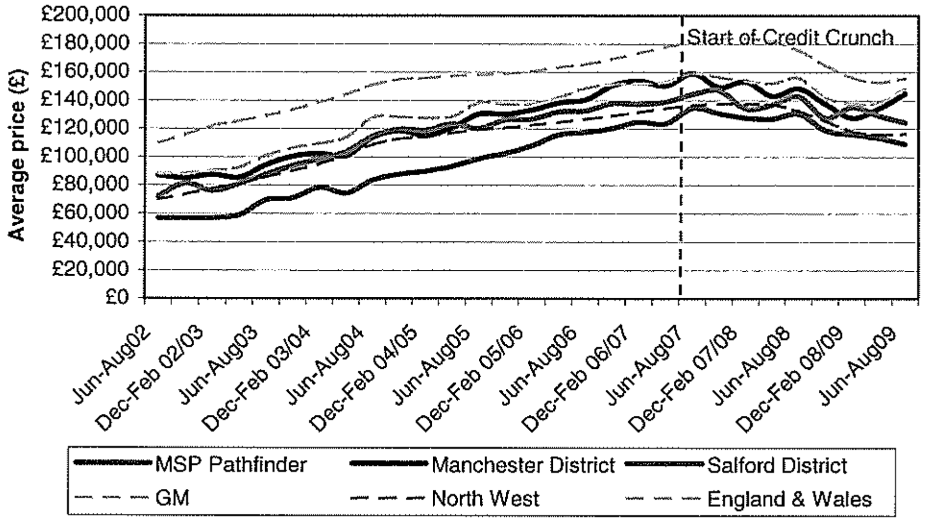
29. A number of other traditional housing markets and house types have witnessed a surge in investment from private landlords in recent years. In many cases opportunistic low-end purchasers have capitalised on the strong rental demand (albeit in lower value markets). This has transformed some traditional streets into PRS hotspots in key areas around the conurbation core (Eg Broughton in Central Salford).

30. In recent years planning policy and a brownfield first approach in particular has pushed the majority of residential development closer the conurbation core. The supply of new build accommodation into the city centre market has delivered a higher quality-housing product (in some instances purpose built rented accommodation capable of attracting students and other young people who have traditionally rented in other areas of the city), which is within close proximity to the Higher Education Campus and the wider city centre offer. In the period from the mid 1990s to 2007 this new product - essentially the "city living concept" was built across the regional centre financed in large part with cheap buy to let mortgages taken out by investors who often bought off plan.

31. We believe we may be witnessing the first early signs of a potential shift in demand from the traditional rental markets of south Manchester to flats in the city centre. The reasons for this are varied and many. However, we suspect that reduced transport costs, good access to the University and a higher quality product are all driving this trend which has pushed up rents to record levels in the city centre, in some instances at the expense of the outlying areas (in the south).

32. Where there has been investment in new build for rent, it may well have been skewed by the prolific growth in capital value in the 5 years to August 2007 which has led investors to speculate more in the property value than the returns that they receive through rental income. The recent downturn in property sales and values may have led many investors in new build property to remain as landlords rather than trying to realise capital growth through sales.

Figure 1 - Average house sale price



33.

34. There may well be other incentives to invest in new build such as lower maintenance costs and NHBC guarantees.

35. **Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?**

36. In the period from the late 1990s the buy to let mortgage market drove apartment development in the MCR regional centre. This central market has now emerged as MCR's strongest rental market both in terms of demand, rents achieved and the availability of residential property to let.

37. Recent estimates suggest that the 20,000 strongcity centre apartment market is now split between 70% investor landlord and 30% owner-occupier.[4] However, in the early days of the city centre residential market, owner occupation was higher as an overall percentage of tenure. The share of buy to let increased in line with

[4] MSP Research 2010

the market peak, suggesting that landlord investors were driving both build rates and rental yields.

38. Over the last two years, rental demand has accelerated as a result of the constraints on mortgage lending on the high street. In the regional centre a significant proportion of this demand has been met by house builders seeking to generate income from unsold stock by renting vacant apartments, originally built for open market sale.

39. In the future it is far more likely that house builders and developers will be positively viewing the PRS as a means of supporting the sales risks of new build developments outside of the regional centre. There is significant interest from several major players in Manchester in developing a PRS investment model for new house building. These are all based generally around an equity investment, high quality management and a desire to mix home ownership with market renting.

40. We would welcome guidance on a good practice approach to developing partnerships to increase the supply of the PRS product particularly in terms of equity options, borrowing and fiscal incentives available to local authorities willing to work with funds to increase supply in the sector.

41. **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?**

42. There is little evidence to suggest that these products make a significant contribution to overall rental market capacity in MCR.

43. 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?

44. Undoubtedly the introduction of assured shorthold tenancies has had the biggest impact on bringing individual investors into the PRS. This coupled with the availability and attractiveness of buy to let mortgages and the incentive of property value increasing whilst other investment choices such as pension funds and the stock market were proving less secure. The recent strength of the market has also enabled property owners to establish reasonable returns on their investments, in the city centre market in particular.

45. The fall in property value is likely to have an impact on this sector although perversely lower house prices linked to an increasing demand for rented property may encourage investors to see renting as a viable option and a reasonably safe bet for capital investment if the market has reached its lowest level. A key risk for investors is that property values fall again or that interest rates on buy to let mortgages increase significantly.

46. 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?

47. Discussions with investors in Manchester indicate that a property portfolio of 5,000 properties over 5 years seems to be the business model that they favour.

This equates to around 20% of the Regional Spatial Strategy house-building target (i.e. 5,100 new homes pa) for the inner core of GM (MCC and SCC) and could potentially meet the entire annual growth point objectives for the two cities (i.e. 1,020 new homes pa).

48. **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?**

49. N/A

50. **Question 7: How might changes to the SDLT rules on bulk purchasing impact on the rate of 30 investing in the UK Private Rented Sector return on institutional investment in the private rented sector?**

51. N/A

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

53. N/A

54. **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?**

55. Institutional investment, e.g. by pension and insurance funds, has been virtually absent from the PRS in the UK to date. Reputation and financial risks, the lack of suitable portfolios and high management costs are all potential barriers. Institutions would also need to be able to deal with residential capital appreciation, as opposed to the traditional commercial property model of rental yield. However it is the strength of the rental market in MCR, which is currently acting as the primary driver for institutional interest.

56. MSP's most recent Quarterly Housing Market Monitor reported increased demand driving up rents in the regional centre with apartments increasing by £25 per calendar month. Over the last 6 months, rents in the regional centre have started to increase in 1, 2 and 3-bed accommodation. This has happened at a time when the number of rental properties on the market has reduced, and the void rate subsequently declined.

57. According to our analysis the top asking rents in Manchester city centre as at w/e 23 April 2010 are;

- 1 Bed - £700 pcm
- 2 Bed - £1,300 pcm
- 3 Bed - £1,500 pcm

58. Averages rents are as follows;

- 1 Bed - £650 pcm
- 2 Bed - £840 pcm

- 3 Bed - £1,200 pcm

59. Anecdotal evidence from agents suggests that demand for apartments in the regional centre has created a strong rental market within which demand is increasing and property is easily let. The (mode) average time taken for a property to be let in the regional centre is now 3 weeks with many agents reporting a lack of properties for rent and an ever-increasing list of tenants.[5]

60. At the peak of the market in early 2007 there was interest from US investors looking at deploying a franchise model in Central Salford. The target market for tenure of this type would have been people renting by choice with average incomes in the region of £30,000 annually.

61. There is some evidence that demand may be shifting from some of the more established traditional rental markets outside the regional centre particular in the inner south suburbs of Manchester.

62. Outside the conurbation core and particularly outside the M60 orbital motorway the rental market narrows dramatically both in terms of availability of property and price.

63. **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?**

64. N/A

65. **Question 11: What are the key barriers to investment in residential property through UKREITs, and what changes would be needed to address them?**

66. N/A

67. **Question 12: 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?**

68. N/A

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

70. Manchester City Council is currently in discussion with partners on the possibility of joining a Private Rented Housing Fund (PRHF) designed to accelerate the supply of private rented sector housing on various sites across the City. The option exists for the Council to join the Partnership as a lead participant most probably by contributing land in exchange for an equity stake in any new development model going forward. Funding for the development would be provided by other private partners, together with debt finance to be funded from future income streams from the properties to be built. In this way, the Partnership

[5] MSP Research April 2010

has the potential to kick-start both residential development and wider regeneration activity in priority regeneration areas of Manchester.

71. It is possible that the Partnership could develop a portfolio of up to 1,000 units per annum spread across a range of sites in a reasonably short space of time. The objectives for the city would be to get stalled schemes moving through this vehicle with the added benefit of securing high quality management standards with RSL partners. Intermediate tenure options may also be considered with possible sales options employed in the medium to longer-term lifecycle of the building.

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

73. N/A – however would like some clarity on the rules governing LA involvement in UK-REITs?

74. **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?**

75. There have been very few new housing starts on new sites in the MSP area in the last 18 months. The majority of house building starts have been on sites that are partially built out and had stalled in the recession. Most of these sites have been supported with public funding through the Kickstart programme or other RSL investment activity.

76. The main blockages to sites being developed are lack of development finance from the banks and lack of mortgage finance for individuals to purchase properties on completion. The institutional investment model offers a means by which development finance can be secured enabling developments to take place. Where the model is concluded with sale to private rent either in whole or part the development financer is assured of receiving payment. Where the development e.g. low rise housing is taking place the guarantee of sales e.g. on 20% of the new units will be sufficient to enable a developer to start building on a given site with the option of making individual house sales where the opportunities present themselves. This in turn will achieve the aims of starting house building on a given site with a mixture of tenure right from the start.

77. In addition to the overall supply of new housing, a high quality rental product also has the potential to contribute to objectives within MCR of providing a housing offer capable of retaining the most highly skilled graduates within MCR. By capitalising on the latent demand, this sector could be broadened and developed in conjunction with an exceptionally well-managed product, providing an offer capable of upping the bar in terms of management standards, which would deliver long-term rental stability and growth, in the short to medium term recovery period.

78. **Other Comments**

79. A number of buy to let developments in and surrounding the regional centre have been significantly impacted upon by the recession with developers left with unsold properties and leaseholders and tenants failing to make payments into sinking funds / service charges. As a result management and maintenance arrangements have been compromised leading to some significant problems –

for example a power supply company seeking a warrant to enter an apartment block to disconnect the electricity supply to common parts of the building.

80. Obviously such issues impact upon the attractiveness of individual developments and the value of units. However, value losses in particular parts of the City will impact in terms of risk analyses and the willingness of institutions to make investment decisions. The view from MSP is that current leaseholder legislation may need review to provide a better framework to safeguard and protect the interests of all parties within a new and relatively fragile segment of the private rented market.

81. In Central Salford the average landlord holds 4 or 5 properties. This presents a significant communication challenge with landlords and limits the scope for major interventions / partnership working. Introducing larger actors into the market may help to tackle some of these issues particularly the management of whole apartment buildings, which have presented management challenges in the past.

82. There may be advantages to be secured through flexible leases particularly extending the length of tenancies, which could guarantee incomes for investors and provide security for tenants with significantly improved management standards. This may also allow tenants to establish themselves in the local community (children into local schools etc) and may reduce turnover / churn which in the longer term could encourage people to buy houses in the area.

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HM Treasury
Investment in the UK
Private Rented Sector

A response from
Mill Group Ltd

Mill Group's Private Sector Co-Investment model:

"This (co-investment) has the potential to be a more significant development in private housing finance than the buy-to-let mortgage.
The number of mortgaged owner occupiers has been shrinking since the turn of the 21st century because of high costs of housing market entry - which has worsened since the credit crunch. People who neither qualify for social housing nor are able to raise the equity for a deposit are the fastest growing housing segment in the UK."

Yolande Barnes, head of Savills Research, November 2009

FINANCE PUBLIC:PRIVATE AWARDS 06

Winner of ' Most Innovative Funder' for IIC Fund II

PRIME MINISTER'S AWARD BETTER PUBLIC BUILDING

Winner of the Prime Minister's Better Public Building Award

FINANCE PUBLIC:PRIVATE AWARDS 05 WINNER

Winner of 'Operational Project with the Best Design' Jubilee Street development,

2004 publicprivatefinance AWARDS

Winner of 'Best non-major health scheme in operation' for Chichester Mental Health PFI project

2003 publicprivatefinance AWARDS

Winner of 'Best Operational Local Government Project' for Hackney Learning and Technology Centre

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Investment in the UK private rented sector

A response by Mill Group

Executive Summary

In submitting our response we would like to highlight the flowing points:

- Mill Group has a substantive track record in delivering innovation by bringing major UK institutional investors into a new asset class.

- Existing models for UK housing investment have failed (and continue to fail) to be attractive to institutional investors.

- We are sceptical that the current proposed models, as with other historic models, will not generate a substantive PRS in the next 5 years.

- Whilst individual investors have supported the Buy-to-Let market over the past five years, there are many inherent problems with the model, which have significantly restricted the inflow of funding post downturn.

- Mill Group's Co-investment Model is a solution for investors (by overcoming the significant investment barriers) and a solution for aspiring home-owners (by providing a bridge between renting and buying).

- Unlike some other PRS models, no major changes are required in taxation and law.

- However, as with all new models, Government support is welcome for Co-investment to successfully enter the market.

About Mill Group

Mill Group has developed excellent long term relationships with institutional investors by offering innovative and socially responsible investment opportunities. Our institutional funds are uniquely supported by public sector pension funds, including the London Pensions Fund Authority and major private sector institutions such as Aviva/Norwich Union, Clerical Medical, and Sumitomo Mitsui. By working closely in partnership with these and other leading institutions, we have been able to identify and develop innovative opportunities to deliver the investment goals of our Investors, as well as efficiently manage their assets.

Formed in 1994, Mill Group has grown steadily and continues to promote new investment funds in property and infrastructure, which mainly comprise housing, schools, health, street lighting and other community PFI investments throughout the UK.

We firmly believe in offering our investors innovative and socially responsible investment opportunities, with clear and balanced information. We remain at the forefront of investment thinking, constantly seeking to create and provide the best property and infrastructure investment funds for our clients.

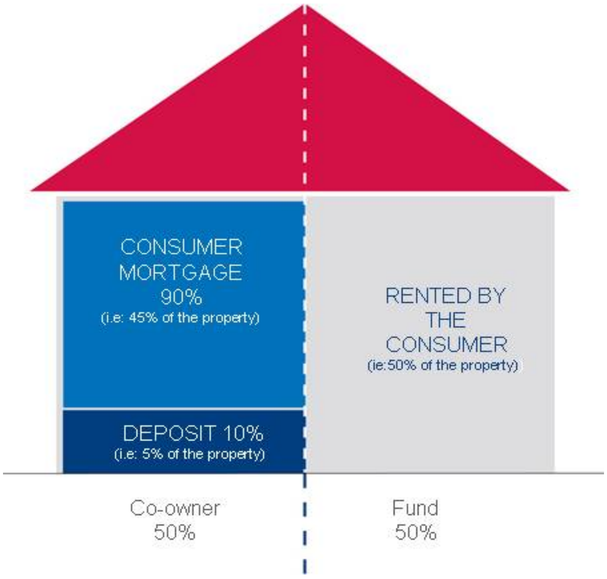
To this end, Mill Group has recently developed a new Private Rented Sector Co-Investment model through which to acquire residential property, generating attractive levels of income on a very cost efficient basis. This new Co-Investment model has considerable benefits over the traditional “buy-to-let” or AST models.

Mill Group is also currently developing an innovative UK residential investment fund called Investors in Housing Fund, which will be managed through its new residential property arm. (for further details please see Appendix 1)

Mill Group Private Rented Sector Co-Investment model

In essence Mill Group's Co-Investment model is a private sector part rent, part-own model, which provides FTB's with access to the unsubsidised housing market by purchasing a property with an institutional investor.

The portion of the property that is owned by an institutional investor is rented by the consumer (or Co-Owner). Instead of buying 1, or 1000 properties, and receiving 1 rental on each, Mill Group's Co-Investment model provides Investors with half properties with 2 'half rents' as income (the specific split of ownership can vary).



The economic efficiencies of this new model lie in the much improved net income through the removal of repeated re-letting, redecoration, void periods, service charge and insurance shortfalls. Co-Investment promises a typical net to gross income of 90% or more, in comparison with 65-70% for normal BTL portfolios.

The problems associated with shared equity leases and attendant mortgage difficulties are obviated. There are no fixed staircasing obligations nor are any assumed in the financial structuring of the investment, giving consumers a long term, stable co-investment option.

The Co-investment model will enable a new group of consumers to enter the market as buyers of both new and existing property – which itself will stimulate more new build schemes to be brought forward in these difficult times. It will also enable people to begin the creation of wealth through home ownership and paying their own mortgage on their part-owned home, as opposed to simply paying their landlord's mortgage.

For institutions, the model removes the major risks associated with the residential sector:

- Lack of void periods once the co-investment is arranged.
- Repairs and other running occupation costs can reasonably be passed to the occupier in full. Management issues are minimal and there is a mutual interest in improvements to the property.
- Both the co-owner and Fund investors share capital growth.

Co-owners will be expected and encouraged to look on the property as their own and to purchase out the Fund's interests over time- thereby generating a realisation /reinvestment opportunity for the Fund

The model offers:

- Very attractive returns for institutional investors
- Leveraging of new institutional funds into residential property which has long been recognised as a desirable asset class, but which hitherto has been seen to have insurmountable barriers to investment related to tenancy management
- Help with the housing aspirations of large sectors of the population who face the realities of high property prices who are currently badly served by Government initiatives and the mortgage market

Over the credit crunch mortgage finance terms have changed radically, increasing deposits as LTVs on mortgage loans have dropped. Potential homebuyers simply do not have accessible cash to put down deposits of such scale – especially when buying London property.

The average FTB in Q2 2009 in London put down a deposit of £49k, with 80% of these parentally supported to fund this scale of deposit. New home ownership in London is currently only accessible to those with wealthy families. Average unsupported first time buyers are now 37 years old and we risk having a lost generation of homeowners unless new models such as Co-investment become new solutions.

The problems are not constrained to FTBs. Large numbers who bought property in the last four years do not have the equity to move up the housing ladder when family circumstances dictate. This results in big retention and recruitment problem for London employers especially public sector employers. Large numbers of Londoners are income secure but equity poor; co ownership is their ideal vehicle onto or up the housing ladder.

With government funding and mortgage finance drying up housing needs continue to grow. New institutional money will help to bridge the gap. Mill Group's Private Sector Co-investment model is one of the first to be launched and addresses the historical barriers to residential housing investment while still delivering very attractive returns (see Appendix 1).

Socially Responsible Investment

Mill Group's Investors in Housing Fund has been described in Pensions Weekly as one of the very rare occasions when attractive investment returns coincide with socially responsible investment. We believe we do this by;

Meeting Government objectives

- Meets the long standing Government policy of encouraging private sector investment into UK residential property (see - Pomeroy Review of Prospects for Private Sector Shared Equity)
- Provides a potential way of accessing a major new investment source of £bns by 2011/2013 when Government resources that have been brought forward to address the current crisis are at a low point.

Stimulating the economy:

- Supports new and moribund housing schemes at all levels in the market, preserving the house building capability so that it survives to build more housing when economic conditions turn again
- Enables all SME's which depend on the house building to return to the market preserving jobs
- Offsets future inflationary pressures now building up because the supply side is drying up
- Encourages homebuyers at all salary levels (both FTB's and existing owners) to re-engage / transact with the market

Meeting Social Objectives:

- Is a sustainable and long-term solution rather than being a response to the exceptional circumstances
- Reduces the risk of a generational divide building up between people whose parents have bought houses and those that have not. Provides the opportunity to share in wealth creation from home ownership for those that would be excluded through not being able to buy 100%
- Encourages suitable use of borrowing matched with available deposits – without pressure to over-borrow to acquire 100%
- Facilitates equity release for those that face financial difficulties and can therefore avoid future repossession
- Enables people to move into permanent accommodation of their choice with an ownership interest they can afford, tackling the new un-affordability issues of lack of cash deposits and Loan to Value levels from mortgage lenders.

Need For Public Sector Leadership

Mill Group looks to government entities to show leadership in supporting the launch of the Investors in Housing Fund with its initial focus on London property. The London Pension Fund Authority will invest up to £50 million, subject to others joining them. The initiative is supported by the Mayor, The Homes and Community Agency, and relevant Government departments.

We are generating increasing interest from institutional investors and others, with the potential to raise significant sums that will have an immediate impact on the UK housing market and the UK economy.

Early adoption of new models is needed by far sighted institutions so that they can prove their value by contributing solutions and options, especially in such a complex and changing market as Housing.

While mortgage lenders are happy with our Private Sector Co-investment few are looking to support innovation given they have limited funds for lending. We look towards government leadership to encourage mortgage lenders to support innovation in the market.

Sir Robert Kerslake – CEO Homes and Communities Agency

"We welcome the product and the innovative way in which it will lever institutional funds into residential housing investment. In our view there is a definite place for this new form of housing tenure in the mainstream market, especially in the high cost areas of London and the South East.

We would be delighted if the local authorities and others who currently have the matter under consideration succeeded in getting this fund underway; it will be a very welcome addition to the mainstream housing options for Londoners, and has the potential to help revive the London housing market with all the concomitant economic benefits that will bring."

Summary

Mill Group's Private Sector Co-investment model is ready to go. Its impact will be immediate and wide ranging. It has all the requirements of scale and can make a substantial contribution to the economy by injecting £billions of new investment. It is socially responsible and can affect the broad spectrum of UK citizens and businesses.

Mill Group has taken the leadership role in this – investing £millions in a fully developed proposition, ready to be launched within months of sufficient investment being raised.

Response to the Consultation

The Treasury consultation has naturally been framed again the background of the recent past and as not been able to allow for new innovations such as Co-Investment.

However, we believe that many old models within PRS, as well as some new models such as Build-to-Let, have a number of fundamental flaws with regards to the benefits to investors and that there are alternative options available which are faster to initiate, will cost less to the public purse and can, in the long run be more effective in delivering the goals of providing a rapid increase in the available housing stock.

Where relevant, we also compare the PRS investment issues with those of Co-investment.

Individual Investment:

Question 1: What has led individuals to invest in new build properties in preference to purchasing and converting existing owner occupied housing?

During the period of exceptionally high growth and easy, low cost availability of lending, not surprisingly, individual investors took advantage of the potentially high returns offered both in terms of capital growth and income. In fact this was a market driven by speculators, both large and small, able to secure a number of properties off plan with small deposits. As easy availability of funds dried up, the speculators have faded away leaving a large number of unsold and empty properties. Take away the potential for dependable capital growth and steady income flows, add the current difficulty of raising funding die to the severe shortage of liquidity, and the BLT model in PRS has lost its sheen.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in the future?

The primary driver for house builders to switch into the PRS market was the expectation that it removed sale risk and gave a short-term return on capital. As the economic downturn has hit lenders, house builders and BTL investors, evaporating risk appetite, developments have largely stopped. A source of credible buyers to pre - commit to purchase units is now required before development commences

Institutional Investors planning to either rent or use the Co-investment model can step in where the individual or small PRS investor has withdrawn.

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?

Individual homeowners renting out part of their own home is the one sector of the market neither the house builder nor the investor will talk about, and is yet potentially the largest and most readily available stock of accommodation available, at the lowest possible cost to the public purse. One should add to this the large stock of empty properties, especially in urban areas, and these properties are mainly privately owned and one is left with the best potential utilisation of existing stock.

Above all what is required is a change of perception and attitude towards homeowners who rent out rooms, ensuring that it is seen as an acceptable and as a socially positive undertaking.

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.

The current primary constraints are the availability of BLT mortgages. The current market conditions have also dented confidence in the capital growth prospects of PRS, which is coupled with an increasing awareness of the risks, both to capital and to income (via voids, maintenance etc.).

Institutional Investment

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?

Scale is the key factor for institutional investors. It needs to be recognised that institutional investors have large portfolios, which are allocated across a number of key objectives. To select a particular sector, in this case the residential property market, they need to be sure that scale exists. The importance of scale is also relevant in the sense that it can mitigate management costs and voids, spreading the risk across a wider number of properties.

Timescales and risks are the other key factors. Large Institutional investors will be looking to allocate £200m **-** £1bn to a market. They do not want to allocate these funds and then have to wait for a number of years before these funds are ‘working’. One of the weaknesses of the new ‘Build-to-Rent’ model of PRS is that not only do the properties need to be built (with all the delays that could entail), they then need to be let, adding to the timelines experienced before any income is being generated. The other key factor for institutional investors is the limited available exit strategies offered by PRS – they need to be sure they have the ability to sell out as investment priorities change.

Net income levels for large scale BTL investments have proven unattractive in comparison with other asset classes, in part due to gross rental levels and also due to voids as well as significant management costs.

For many institutional investors there are easier and more rewarding options than the PRS

Net income is a core issue for institutional investors. It needs to be addressed in a more profound manner than marginally reducing the cost inefficiencies for the PRS asset model through scalability. The co-investment model, on the other hand offers both scale and secure, uninterrupted income.

Scale is achieved by not limiting the investment portfolio to new build home only, and including second hand properties. This enables the institutional investor to spread the risk, invest their portfolios more rationally and more immediately.

The 'built-in' exit strategy of homeowners themselves looking to sell their properties after a number of years provides added security and reassurance for investors. Each time a property is sold, the investors equity stake in that property can either be withdrawn or re-invested.

Co-investment also has the ability to attract both larger and smaller investors, as each portfolio can be properly managed without inherent risks witnessed by PRS investors.

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?

SDLT impact on bulk purchases is modest. However, as an upfront acquisition cost it is undoubtedly undesirable and will lead to some hesitance amongst investors. SDLT also impacts on desirability of breaking up portfolios which is a serious impediment to scale.

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?

The rate of return on institutional investment is related to the savings (and hence in part related to the unit value) and the term over which investments are evaluated.

The impact of 4% SDLT is probably more material in affecting the behaviour of seller as it is more economic to break up portfolios and sell on an individual property basis, enabling institutional purchasers to immediately reduce their SDLT burden from the purchase price.

The lack of scope for residential portfolios to be sold as larger scale transactions is a material issue and a significant barrier to institutional interest in the residential market.

In our experience, institutional investors, rarely have an investment horizon of over 7 years when making initial investment decision . In fact, over this period, we estimate that the 4% SDLT on IIR via co-investment would be 65bp. SDLT does not make a material impact on Investors in Housing.

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

The PRS buy-to-let or build-to-rent models are not generating sufficient income yield to attract interest on is own - without capital gain being factored in. The principal issue is the significant losses from gross income to net income. The initial gross rental yield is also modest in many parts of the country. With uncertain sustainability of historic capital growth the difficulties of getting long term investors interest become clearer.

By minimising to a great extent the impact of voids and maintenance, co-investment delivers minimal losses between gross and net income, making it a more manageable proposition for institutional investors.

Question 9: What factors have prompted the recent institutional interest in investing in PRS, and what changes would be needed to address them?

It is not clear there has been a substantive increase in institutional interest in residential investment amongst institutions. What is clear is that there has been an increase level of hype and PR.

It is clear that the HCA's PRSi promised the possibility of government subsidy/funding support for the build-to-let model and that some institutions/institutional fund managers responded to this when the markets were is crisis. The lack of any tangible support to funds /investors (as distinct from programmes to address negative land value barriers) has been seen to be a disappointment to those closely involved in this programme.

Question 10: What are the key barriers to 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?

Key barriers include:

- no or few precedents and some of those have had poor returns (eg Grainger GMax)
- no or few residential investment funds offered
- unattractive income return (a sought after defensive quality post crisis)
- expensive and difficult management
- voids and unrecovered insurance and service charges
- maintenance costs and hassles
- re-letting costs and redecoration etc costs on re-let
- capital value issues
  - poorly forecast and thin /recent financial futures market.
  - investment indices and total return performance measures only just launched
- unable to invest in scale
  - few funds on offer
  - few assets available to buy in bulk
- delays and risks of new development
  - new build focus for residential investment has downside
  - land /planning and economic viability is challenging
  - risks of delays and cost escalation unquantifiable up front and therefore unattractive
- investment in scale is very difficult to produce
  - a big scale development may not be attractive as a concentrated investment in a particular location (especially in a large unproven regeneration area) few portfolios to buy
- residential fund managers (as distinct from residential asset managers) - there are very few with experience

- no residential performance indices used in investment mandates or performance bonus (recent IPD residential index launch may be significant step in this area)
- PR issues
    - risk from dealing with people in their homes - especially when in financial difficulties /repossession.
- valuation issues
    - residential is valued at discount to vacant possession (VP) value when in bulk (commercial property is at premium to VP value)
    - thin and specialist market with history of a variety of lease structures
    - AST's are short term so no residential market in long term contracts – all have re-letting/ economic risk
    - if buy at VP and make income producing then immediate value hit (plus other costs incl. SDLT to absorb) makes unattractive investment proposition.

Co-investment asset model provides most of the answers and overcomes most of the barriers:

- *attractive income return with minimal costs*
    - *low cost and effectively self managed by the owner occupier*
    - *minimal/no voids (properties are sold on with possession to the next owner occupier),no maintenance charges or service charges – these costs are met by the owner occupier.*
- *capital value defined by market forces*
- *extensive historic data available on owner-occupied market performance, and regularly forecast.*
- *investment indices and performance are therefore more predictable*
- *opportunity to invest in scale*
    - *inexhaustible assets available to buy in bulk*
    - *no delays and risks of new development*
    - *new build plays a manageable share of the portfolio*
    - *land /planning and economic viability is therefore manageable*
    - *quantifiable risks of delays and cost escalation*
    - *investment in scale is readily available*
- *co-investment can work in a big scale development without concentrating investment in a particular location, by 'pepper potting' the tenure through the schemes.*
- *PR risk is minimal*
    - *Less risk from dealing with people in their homes - especially when in financial difficulties /repossession – options exist to help those in difficulties by the fund buying additional share of the property, thus releasing cash – positive PR effect..*
    - *socially responsible benefits of residential investment is already established*
- *Valuation likely to be a low/nil discount to vacant possession values as cashflows more akin to commercial property.*

Question 11: What are the key barriers to institutional investment in residential property through UK REITs, and what changes would be needed to address them?

Institutional investors traditionally look for safe, income generating, low risk investments with relatively low operational costs, hence the historic tendency toward commercial property. Residential property investment historically has used AST which is a short term, management intensive structure, with high levels of voids and maintenance cost.

Culturally, the UK resident has been raised to believe in home ownership, with renting providing a short term, flexible tenure that favours the tenant. By contrast, other European Countries (e.g. Germany) have a greater proportion of residents who are happy to rent long term, providing greater predictability of income and security.

Please refer to BPF/PIA submission for a general discussions on REIT rules as they apply to existing models of PRS:

- *The barriers identified in our response to Question 10 are also generally relevant in the context of encouraging the emergence of residential REITs.*
- *Reducing trading/investment is particularly important for REITs.*
- *Changes should also be made to the way the distribution requirement operates and to the potential impact of the profit:financing cost ratio for residential.*
- *The diverse ownership condition should be reconfigured.*
- *The conversion charge abolished or linked to latent gains (rather than portfolio value).*
- *Rollover relief for those selling to a REIT in return for shares would also be helpful.*

Co-investment model produces Schedule A income that is REIT qualifying but a more detailed analysis of REIT rules has been carried out.

Co-investment model does not require regular sales to provide return to investors, though they are likely to occur in practise:

1) *Trading / investment disposals – this is likely to be a critical issue in the decision to use a REIT structure for co-investment funds.*
2) *Interest cover ratio – the REIT rules are less likely to have unacceptable limitations to co-investment funds than other forms of PRS but remains a serious issue.*
3) *Distribution requirement – this rule also impacts on the landlord obligation under AST to maintain and repair property under AST's. Under co-investment this obligation is taken by the co-owner so this rule is likely to be less of an issue to a REIT using the co-investment model.*
4) *Diverse ownership – these apply equally to co-investment model or other PRS models*
5) *Financial barriers – these apply equally to co-investment as to other PRS models.*

Q12. 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.

With suitable changes to the REIT rules as outlined in the BPF/PIA submissions and commented above, we would anticipate REITS would be the vehicle of choice for quoted residential funds.

Q13. How suitable are other collective investment vehicles for residential property investment? What are the current barriers to investment through these vehicles?

An offshore unit trust investing in an English Limited Partnership structure is currently the recommended fund structure for a residential investment fund for institutional investors as exemplified by ‘Investors in Housing’, despite the obvious costs of maintaining the offshore structure.

Please refer to the BPF/PIA submission for more detailed comments.

Q14. How do these collective investment vehicles compare to UK-REITs?

Please refer to the BPF/PIA submissions for comments

Q15. What evidence is there that institutional investment in the PRS would bring real benefits to the sector and the housing market more generally?

Institutions own a tiny proportion of the UK Housing Market in comparison to commercial property or in comparison to other countries in Europe and elsewhere.

The potential impact of institutional investment in UK residential property is substantial and to some extent has been seen in new markets such as student accommodation, sheltered housing and nursing homes.

Indeed commercial property occupiers would be in a totally different position if Institutional Investors did not dominate commercial property investment. They do not have the capital to own their own property.

And in that sense the residential market has exactly that challenge. People, especially FTB’s and recent purchasers, do not have the capital to own their own homes.

Co-investment on the other hand allows people to use what capital they have to buy a share in their property, whilst simultaneously providing an efficient investment model for institutional investors to commit long-term funds to the housing market.

There has to be doubt about the ability of BTL models to prove a long term financially viable private rented sector. As such it is extremely important to encourage other models to develop to attract institutional investors into the UK residential sector.

The main issues that have been raised are less to do with taxation or issues that need addressing by Government, and more to do with the very business model upon which PRS is established.

Other models should therefore be explored before total and single-minded commitment is made to this one approach to increasing the housing stock.

We have herewith talked about another model, called co-investment.

Appendix 1

The Investors in Housing Fund

Investment Case

The Fund will initially invest in London residential property, with the view to rolling out the concept across other high cost areas in the UK in the next 5 years.

London residential property has comfortably outperformed all the usual asset classes over the last thirty years and has a very low correlation to equities and bonds. Residential property has been the best performing asset class over the last 30 years.

The base case can be summarised as follows :-

- Ungeared IRR of 12% - 15% for a 5 year fund with up to a 2 year tail.
- Returns post all costs and pre-Founder incentive.
- Fund size: £200m to £500m.
- 18 months investment period.
- Distribution of 6% pa indexed from drawdown
- Fund 12-15% IRR value creation through:

• Gross rental yield	6%
• Capital growth projected *	6 - 7%
• Net profit on sale to co-owner	2 - 4%
• Costs (transaction and running)	-2%

- Key assumptions:
  - Base rental at 6% + RPI.
  - HPI value change over 5 years : 7% pa.* - per JLL Feb 2010
  - Average acquisition discount of 15 to 20%.
  - Transaction costs and fees of 3% of full property OMV.
  - SDLT of 1-3% of property OMV
  - All running costs allowed
  - Exit valuation at 90% OMV VP.
  - Disposal costs and fees of 2%
  - 50% Co-ownership.
  - Average house price £250,000 to £300,000.

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Investment in the UK private rented sector

- NLA Response to Consultation

April 2010

Copyright National Landlords Association April 2010

The National Landlords Association

The National Landlords Association (NLA) exists to protect and promote the interests of private residential landlords.

Representing landlords from all over the UK, the NLA is the leading organisation for private-residential landlords. It campaigns for the legitimate interests of landlords by seeking to influence decision-makers at all levels of government and by making landlords' collective voice heard in the media.

With almost 20,000 individual landlords throughout the United Kingdom and over 100 local authority associates, it helps landlords make a success of their lettings business by providing a wide range of information, advice and services. It seeks to raise standards in the private-rented sector while aiming to ensure that landlords are aware of their statutory rights and responsibilities.

Individual Investment:

__Question 1:__ ***What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?***

Private-residential landlords have played an important role in maintaining demand for new-build properties over the last decade. However, it should not be assumed that all landlords favour new properties over existing buildings when making new acquisitions. The consultation estimates that around one fifth of all new homes constructed are initially purchased by private-residential landlords. However, such acquisitions represent a relatively small segment of all housing stock held and transferred into the private-rented sector (PRS) demonstrating that the expansion of rented accommodation is not restricted exclusively to new property.

The PRS is constituted of landlords with diverse business models, and subsequent approaches to portfolio growth. While it has been common for new entrants to the market to focus on the simplicity offered by new build property the majority of established portfolio landlords recognise tenant demand for conventional housing stock.

The PRS mirrors the diversity of cross-tenure housing stock nationally and although new-build dominates certain sub-regions, in particular city centre locations where private-renting is prevalent, it continues to represent only a proportion of total dwellings throughout the country.

Landlords investing in newly constructed dwellings do so for a variety of legitimate business reasons and a number of assumptions reinforced by the industry. In particular these can be categorised as:

1. Simplicity. House-builders have traditionally attempted to minimise barriers to market entry and assisted landlords investing in property. In particular those new to rental property looking for a relatively low risk investment vehicle.

2. Maintenance. New build property is generally regarded as low maintenance compared to older stock. This image is reinforced by warrantee packages often included in new-build purchases.

3. Tenant appeal. There is a perception that tenants are likely to prefer new properties, in particular 'professional tenants' in areas close to business centres.

4. Demand. New properties are often considered high demand and therefore likely to attract premium rents, be less vulnerable to voids and require less proactive marketing.

5. Incentives. During the recent housing boom house builders, sales operatives and letting agents developed significant links allowing for a simplified chain in relation to residential property investments.

6. Yields. Small self contained flats, which are a popular architectural unit with developers of new property, represent relatively good yields compared to other property types.

It is generally the combination of simplicity and the expectation of strong returns which make new-build properties an attractive proposition for landlords, particularly for those with little direct experience of the lettings market.

Question 2: ***To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?***

In recent years residential property investors have been responsible for purchasing approximately 20 percent of newly built property. However, it is difficult to determine the degree of influence that the presence of property investors, in addition to owner occupiers, has had on the decisions and direction taken by the house building industry.

It is certainly relevant that a significant proportion of properties build in the last decade have been absorbed into the PRS. It is also arguable that the presence of property investors has helped to support the building industry at a time when demand from owner occupiers has been relatively inconsistent.

A bigger influence on the house building industry has been house price inflation, which has excluded many first time buyers. This has been exacerbated by politically motivated planning decisions. Housing density requirements, particularly in urban areas, require a certain number of units per hectare meaning that apartments blocks and town houses become more practical solutions for builders. Historically such dwellings have not been preferred by households in the owner occupied sector and as such have found their way into the PRS at disproportionate levels.

Planning Policy Guidance Note 3: Housing (PPG3) requires local planning authorities to "encourage developments which make more efficient use of land (between 30 and 50 dwellings per hectare net) and seek greater intensity of development at places with good public transport accessibility."[1] London and the South East of England, where house price inflation has been at its most severe, demonstrate average densities of 71 and 33 units per hectare respectively (2003 estimated density). Furthermore, as a result of the Town and Country Planning Direction 2005, all planning applications in respect of developments of less than 30 dwellings per hectare in the region must be referred to the Government Office for the South East.

Such density expectations are likely to have a far greater influence on the types, and subsequent demand-led prices, of property than the presence of property investors in the market.

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?***

Reliable statistics regarding the number of owner occupiers who chose to rent out part of their home are very difficult to obtain due to the nature of the service offered by these landlords and the effect of the 'rent-a-room' scheme whereby rental income below £4,250 pa need not be declared to HMRC. It is therefore not possible to accurately ascertain the extent of their contribution to housing supply. However the most recent Survey of English Housing (SEH) for the period 2007/08 indicates that approximately 156,000 households take in at least one lodger, resulting in an estimated total of 207,000 'tenancies'[2]. The number of households including a lodger in 2007/08 was down almost ten percent compared to the preceding year.

The principal constraint on owner occupiers letting part of their home as a resident landlord is the limit imposed on the level of tax free rental income they may receive before being required to

[1] ODPM Circular 01/2005, Office of the Deputy Prime Minister (ODPM), 2005

[2] Communities and Local Government, Survey of English Housing, Live Table S563, Number of Lodgers 1994/95 – 2007/08,

submit a tax return. Currently, under the ‘rent-a-room’ scheme, landlords may receive up to £4,250 pa rent in respect of part of their home before they need complete a tax return.

This threshold has not been increased since tax year 1997/98 and has therefore not taken account of rental inflation.

Year	Mean Rent (pa)	Percentage Change (1997/98 base)
1997/98	£2756	0%
1998/99	£2600	-5.66%
1999/2000	£3276	+18.87%
2000/01	£3120	+13.21%
2001/02	£3536	+28.30%
2002/03	£3952	+43.40%
2003/04	£3848	+39.62%
2004/05	£4524	+64.15
2005/06	£4836	+75.47

The above table illustrates that between 1997/98 and 2005/06 the average mean rent for a room in a resident landlord’s home increased by more than 75%[3] nationally and by a greater margin in areas of high demand such as London and the South East.

Assuming that mean rents have continued to increase year-on-year at roughly the same rate (7% pa) since the most recent government figures were released (2005/06) the average rent for this type of accommodation is approximately £5924 for the tax year 2008/09. As this is well in excess o f the current £4250 threshold any resident landlord wishing to let part of his or her home, for an average market rent, must complete a tax return This represents a major hurdle and potential disincentive for many considering offering accommodation. Besides the obvious benefit of reduced tax liability, removing the requirement to complete a tax return is a major enticement towards letting a room as the majority of resident landlords do not otherwise have to, and are likely to be subject to conventional PAYE arrangements as employees.

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?***

The principle incentive for individual investment has been the prospect of reasonable returns relative to alternative investment models and risk factors. Investment Property Databank (IPD) data illustrates that residential property investment has, over the course of the last decade, outperformed the majority of comparable mainstream investment vehicles. The IPD UK Annual Property Index (2009) indicates a 10 percent total annualised return on investment in residential property compared to 5.9 percent equivalent returns in respect of commercial property, 2.5 percent returns from equities and 5.6 percent return on investment in bonds taking into account an average 2.6 percent rate of inflation[4].

Long term expectations of returns in the PRS have remained resilient despite the economic down turn.

[3] CLG, Survey of English Housing, Live Tables:S548

[4] IPD UK Residential Investment Index, December 2009

	Landlord Optimism (Net Percentage)
Q1 2010	+51
Q4 2009	+50
Q3 2009	+47
Q2 2009	+46
Q1 2009	+42
Q4 2008	+41
Q3 2008	+43
Q2 2008	+38
Q1 2008	+44
Q4 2007	+52
Net optimism metric combines perceptions in respect of capital gains, rental yield, general financial markets, UK PRS and overall prospects.	

[5]

As illustrated by the table above, during the recent downturn overall landlord optimism fell but remained relatively stable and is recovering strongly approaching pre-crash levels.

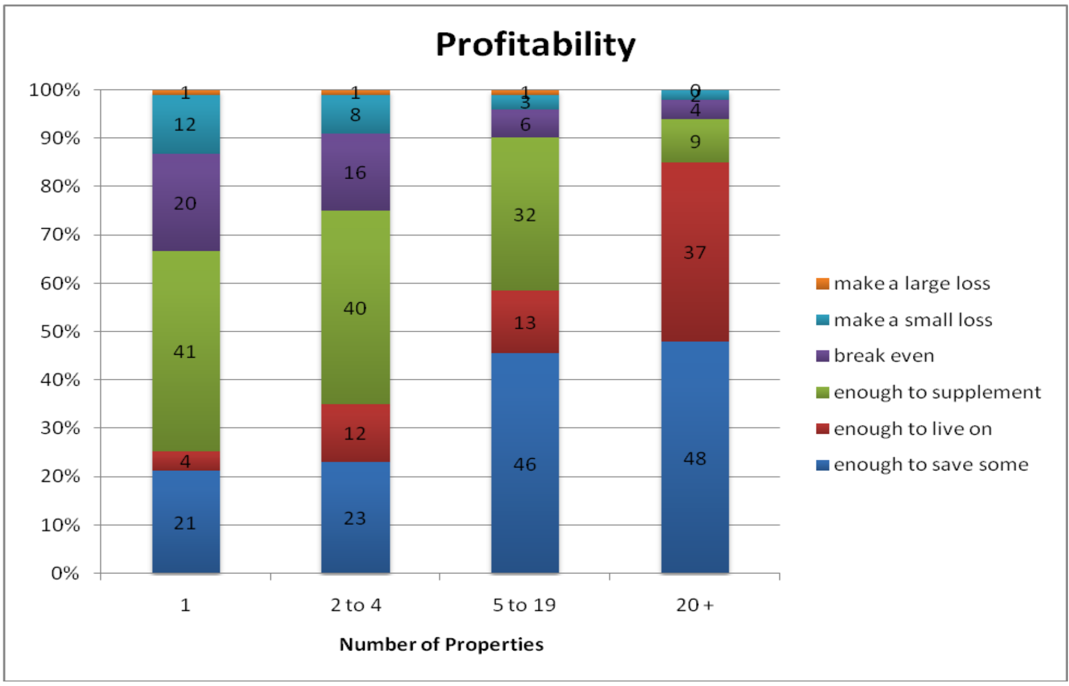
The most relevant factor in the short to medium term which will influence individual investment is likely to be the availability of finance. Landlords have found obtaining competitive mortgage finance difficult since the withdrawal of the many buy-to-let products in 2007, ensuring the availability of adequate credit to sustain market growth is the key challenge facing the PRS.

[5] BDRC Continental, Landlord Panel Syndicated Research Report, Q1 2010

Institutional Investment:

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 commercial viable?***

The NLA's membership is composed largely of individual portfolio landlords and is, as such, not best placed to respond to questions focused on institutional investors. However, we can contribute data in relation to the effect of portfolio size on business prospects.



[6]

Asked to rate the profitability of their letting businesses landlords with more substantial property portfolios related more consistent profits, while small landlords with only a small number of properties are far more likely to report a loss or are breaking even.

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?***

Unlike the majority of taxes SDLT is neither progressive or regressive, operates on the basis of fixed rates dependent on the value of the land or lease at the time of purchase. The bands used are

[6] BDRC Continental, Landlord Panel Syndicated Research Report, Q1 2010

referred to as ‘slabs’ and represent increasing fixed rates of taxation rather than cumulative increases.

The SDLT rates attached to the slab system have not been amended to reflect appreciation of house prices, as such they disproportionately affect the cost of purchasing property. In the South East of England, in particular, there are very few properties available which are valued below the threshold for SDLT. The rate for all SDLT bands should be reviewed in order to reflect contemporary house prices.

Market distortions are even more apparent when multiple land transactions are conducted simultaneously, for example a property investor or landlord purchasing an entire portfolio or a number of properties in a single development.

The NLA believes that removing this disadvantage in relation to bulk purchases would help to incentivise investment in the PRS and act as a stimulus for the housing market.

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?

In practical terms there is very little data concerning the impact that wide scale institutional investment could have on the PRS. However paragraph 5.5. of the consultation document acknowledges that tenant satisfaction levels reported for smaller landlords are marginally higher than for those managed by companies, partnerships or other organisations.

The PRS is currently comprised of myriad different approaches and business models and benefits from the diversity on offer. It is, in part, this variety which allows the sector sufficient flexibility to provide effective housing solutions to such a disparate range of households. There is very likely a wider role which could be played by larger institutional investors . However, the NLA believes that this represents a relatively small niche market and should not be viewed as an all encompassing curative for risks and deficiencies perceived in the market.

NATIONAL
HOUSING
FEDERATION

PRS Investment Consultation
c/o Keith Jackson
Housing, Regeneration and Third Sector team
HM Treasury
1 Horse Guards Road
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SW1A 2HQ

28 April 2010

Dear Keith,

National Housing Federation response to the Treasury consultation 'Investment in the UK Private Rented Sector'

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The National Housing Federation represents 1,200 independent, not-for-profit housing associations in England and is the voice of affordable housing. Our members provide two and a half million affordable homes for more than five million people. Our members are increasingly expanding beyond their core business of social rent and low cost home ownership, seeking out opportunities to work with investors in the development and management of private rented schemes. This provides additional revenue with which to support the provision of affordable homes and delivery of excellent services to existing tenants, whilst allowing them to expand the range of tenure options to people in housing need. In addition to this, housing associations can help relieve the burden and cost of managing private rented properties, by offering housing management and maintenance services to investors.

We welcome government recognition through the consultation, 'Investment in the UK Private Rented Sector', that the persistent undersupply of housing has been a key contributor to the affordability problems facing households. We agree that the private rented sector (PRS) has a role to play in meeting future housing need, however there are currently a number of fundamental barriers which prevent this. We welcome the opportunity to outline our key views on this consultation and look forward to giving a more detailed response to any future consultation, once the government develops more specific proposals to take the PRS forward.

Housing need and the formation of new households is far exceeding new housing supply. A record 4.5m people are currently on housing waiting lists, and more than 2.5m people are living in overcrowded conditions. The need for new homes has been exacerbated by the recession with a stagnated construction industry, an immobilised mortgage market, high levels of unemployment and soaring social housing waiting lists. Our forecasting estimates that the number of new homes built in England and Wales in 2009/10 will slump to its lowest level since 1923.

To date, the PRS has had a negligible impact on the house building industry, except for the support it has offered developers by offering a ready market for new-build homes through off-plan sales. The majority of housing purchased for private renting is existing homes, indeed the NHPAU estimate that only 10% of buy-to-let mortgages are used to finance the purchase of new property[1]. This figure has fallen further since the credit

[1] National Housing and Planning Advice Unit, *Buy-to-Let mortgage lending and the impact on UK House Prices,* 2008

crunch. The recent rise in institutional interest has been prompted in part by the volatility in the financial markets, where the PRS has maintained its performance despite the economic downturn. Investors have become more open to the lower yield but secure return rental income offers. They have also realised that with increased government support, net returns on investment are becoming comparable to commercial property. In the longer term the government can play a key role in helping to make the market more attractive for investors by considering fiscal and taxation measures that can help to level out the rate of return compared to traditional investment markets.

At this point it is worth acknowledging the positive impact the Homes and Communities Agency's Private Rented Sector Initiative is having, in terms of being market focussed, providing scale opportunities and tangible support. However, this is very much a present day opportunity, and the government needs to establish how a competitive investment return and scale of opportunity can continue to be delivered in the future.

Perhaps the most immediate problem associated with the attraction of institutional investment to the PRS is the relatively poor investment yield it offers. For an investment to be sufficiently attractive, institutional investors typically require a yield of around 7% on their investment. Whilst limited information is available, indications suggest that investment performance for residential let properties in England has provided a yield well below this rate, at approximately 3.5%. These rates don't compare favourably with other markets, though the security may offer a different risk reward profile.

Other notable barriers to greater institutional investment in residential property, particularly when compared to commercial property, include the lack of investable stock and the disincentive created by the Stamp Duty Land Tax (SDLT) rules. Government intervention can address these to help develop the PRS through the attraction of increased institutional investment and greater housing association engagement.

We strongly recommend that any tax or fiscal incentives used to encourage institutional investment to enter or remain in the PRS should be explicitly linked to new-build development. This would help support the delivery of new homes and address the housing demand problems identified above. In the long term, such changes would serve to incentivise institutional investment in the PRS whilst contributing to a functioning housing market through helping to deliver new supply.

With reference to the lack of investable stock, the fragmented nature of the PRS market and the small lot size of individual investors continue to hinder the development of institutional investment. Without sufficient lot sizes it is very difficult to generate economies of scale on investments in residential property due to the transaction costs associated with it. In order to ensure institutional investment in residential property to be commercially viable and a real alternative to investment in commercial property plot sizes would need to be considerably bigger, in the region of £50m, though could potentially be split over several schemes.

In the event of scale economies being achieved, we recommend the government introduce a reduced rate of VAT of 5% on the management and maintenance of a residential portfolio. These are functions we have highlighted could be performed well by housing associations, on behalf of investors. This would help retain the returns available to investors and not diminish efficiencies brought through scale economies.

These problems are compounded by SDLT bulk purchasing rules, which are consistently seen as a barrier to institutional investment. They not only create additional costs, but add to the non-standard nature of investing in the PRS. It seems somewhat anomalous that SDLT rules penalise bulk purchase compared to the purchase of individual properties. A bulk purchase of properties is charged SDLT at the rate applicable to the aggregate consideration of the properties (at the maximum SDLT rate of 4% if that consideration exceeds £500,000). This compares with the position where unconnected purchases of individual properties are made, in which case the SDLT is charged on the price of each property (typically at a rate of 1%). This is an obvious disincentive to building up residential portfolios, as demonstrated by the overwhelming prominence of individual and small-to-medium sized landlords in the buy-to-let market.

Whilst changes to SDLT are not certain to increase investment in the PRS, they would improve the modest investment returns, which would be a bigger factor for institutional investors. We recommend that the government review SDLT rules to ensure they exempt or reduce the SDLT paid on privately rented properties, so it is charged at an individual property rate, rather than whole aggregate rate. If we use a £50m portfolio as an example, reducing the SDLT to 1%, from 4%, increases the 3-year total return by 120bp and the 5-year return by 70bp[2]. This provision of better capital usage and increased return would help the PRS compete with other investment classes. To reiterate, tax and fiscal incentives should be exclusively linked to new-build properties to encourage the supply of new housing.

Notwithstanding these proposals, we should not encourage schemes consisting entirely of private rented accommodation. This would have a negative impact upon the government's mixed community and mixed income agenda, with associated implications for social cohesion and neighbourhood management. Another important caveat is that attracting institutional investment into the PRS would not address the inherent problems within the sector – the poor quality of the many properties, the lack of security of tenancy and the absence of adequate recourse against poor landlords.

In closing, we can see that the experience in Europe shows institutional investment has contributed significantly to increasing the supply of private rented accommodation and offering a more viable alternative to owner occupation as a tenure of choice. In England, by explicitly linking institutional investment to new-build properties, we would increase the supply of new homes and add more credence to the PRS – in terms of service provision and management standards, and a greater range of investor opportunity.

Yours sincerely,

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[2] Property Industry Alliance, Council of Mortgage Lenders and Association of Real Estate Funds response, *Investment in the UK Private Rented Sector,* 2010

HM Treasury Consultation Response – Nottingham City Council (NCC)

Investment in the UK Private Rented Sector

This response has been compiled by Housing Strategy and Regeneration (NCC) on behalf of the local authority (Nottingham City Counci) . These views have been assembled by consulting key individuals within this service area who it was felt could provide a valuable input concerning the consultation questions.

Question Responses

Individual Investment

Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

- Lower maintenance and repair costs must be a key factor. The cost savings of not having to pay out money for major refurbishment work is a distinct advantage of buying new-build and also the Buildmark Insurance Certificate - commonly known as NHBC Certificate or Ten Year Guarantee Certificate.
- Mortgage finance may be easier to acquire due to lessened risk associated with new-build property having, for example, structural issues. The NHBC Insurance Certificate could also help in such situations.
- In some cases individuals have been able to invest in property using commercial agents who are buying, for example, blocks of flats off plan for 'pooled' groups of individual investors. Use of such agents has reduced some of the burden of the acquisition process.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

- There is evidence within our city that PRS has significantly influenced the house building industry. The development of city-centre flats that have being deemed attractive purchases by investors, not only in this city but many others, is a clear example of the rental sector has shaped the industry and products offered.
- The future is harder to predict and the key factor is no doubt the availability of finance and in particularly decent financial options. As the amount of single households is predicted to increase then it is reasonable to expect demand for small properties whether flats or smaller houses to increase – this should provide opportunities for the PRS sector, particularly if affordability continues to restrict individuals from being owner-occupiers.

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?

- We cannot provide any evidence for the first part of the question above. However, we suspect that the contribution is minimal. Individuals renting a room could benefit from the ability to save money due to the potentially reduced costs of renting just a room. This could help individuals save for a deposit to move to another property. On the flipside, owner-occupiers renting a room could benefit because the additional money could help pay mortgage costs or potentially help to maintain the property's standard. In some extreme cases that extra income could be the difference between an individual being able to remain in a property by covering mortgage costs.
- With regard to constraints limiting this contribution to addressing housing demand we believe that this option could often be a last resort for many people and not a preferred option due to privacy issues. Therefore uptake is unlikely to be on such a scale that it will make a significant contribution to housing supply.

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?

- The key incentive for individual investment in the PRS has to be house price inflation up until the decline in economic conditions at the end of 2008. The ability during most of the 'noughties' to purchase accommodation and see year by year capital gains together with the ability to generate a regular income was no doubt a massive incentive for individual investment. The opportunity to invest was supported by an extremely positive financing scenario – the key factors being the positive economic conditions up until late 2008, low interest rates and the growth in buy-to-let mortgage packages easily accessible to many individuals. In addition changes made by the 1988 Housing Act (removing rent controls and the introduction of short hold tenancies) had set the stage for a more positive rental investment market. In addition in the last ten years the increase in the number of letting agents has made it easier for new entrants into PRS sector to enter the market as such agencies (for a fee) can take care of the management and administration issues which may have deterred new investors in the past. Another relevant issue is the performance of the stock market during 'the noughties' led to many people inexperienced in housing investment turning to the property purchase and rental to provide a 'nest-egg' for retirement. Consequently the economic downturn has left many such investors in a perilous situation.
- Going forwards, our thoughts on the key prospects and risks for individual investment in the PRS are as follows. The key factor in how the PRS will fair is surely the economic environment and in particular

how the economy recovers and at what pace. Linked to key economic conditions is how the financing environment will unfold as the banks continue to refinance and available credit is hugely restricted and in many cases, even when available, not offered at feasible or attractive rates for capital investment. The housing market has always fluctuated and therefore is often perceived as having certain levels of risk. It appears in the short-term we will not see levels of affordable mortgage finance that were experienced during much of the 'noughties'. Such factors alone my limit the opportunities available to many individuals. In addition, when the recovery comes there could still be issues lingering from pre-2008 that could shape investment. For example, in Nottingham there was an oversupply of new-build flats as investors and developers tried to cash in on city-centre living opportunities. It is therefore unlikely that locally investment opportunities will be geared towards this market as oversupply is still an issue. The present economic conditions and those in the near future will present opportunities for the PRS sector. As stated in the consultation document the current downturn should lead to a rise in renting. This will provide opportunities for some investors who can access finance, but, on the other hand, for many of those that joined the buy-to-let market pre-2008 access to finance may now be out of reach or unfavourable.

Institutional Investment

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 commercial viable?

- Scale economies must be crucial, but as an authority we have no idea of the minimum lot size.

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?

- We do not have much to contribute to this question, but we predict that SDLT amendments would probably only help larger investors, not smaller scale operators. Changes in the SDLT rules will probably have a minimal impact on individual investors.

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?

- No comment.

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

- We cannot comment beyond the figures quoted in 6.11 of the consultation document.

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?

- We would suggest that a decline in other investments could have created some interest and in addition the point made in 6.13 of the consultation regarding net returns on residential property becoming compatible to those on commercial property.

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?

- No comment.

Question 11: What are the key barriers to investment in residential property through UK-REITs, and what changes would be needed to address them?

- No comment.

Question 12: 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?

- No comment.

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

- No comment.

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

- No comment.

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?

- We cannot provide evidence of the benefits institutional investment would bring, but within the City of Nottingham we have lots housing in need of investment. If our housing stock can be improved for the citizens of Nottingham by institutional investment in the PRS (and there aren't many other options) and people want to live in the properties then surely there will be positive outcomes. With public spending likely to be slashed in coming years investment from the private sector will become even more crucial. We are committed to gaining investment to tackle poor housing within the city; this will ultimately lead to regeneration and transformation of neighbourhoods. We see the private sector as a key partner in shaping future housing needs within the city.

- Within Nottingham there is evidence that some investments could have a negative impact. We have had examples of flats managed for investors by management companies falling to maintain adequate standards and service delivery. There is also the issue of the ‘buy to hold’ investors who purchase a property with the intent to never rent, but sit on the investment looking for capital growth; although this is likely to be less prevalent since the recent economic crisis. This leaves empty properties throughout developments reducing the potential housing supply and often blights the development of communities in blocks of flats and other locations.

paragon

Investment in the UK private rented sector

A response from the Paragon Group of Companies

April 2010

Key points

- The private rented sector is dominated by individual landlords, with individuals or couples owning 74% of stock - institutional investment is limited to specialist roles
- Individual landlords have made a vital contribution to the private rented sector in recent years and the sector has grown considerably as a result – it accounts for 14.2% of all households in England
- Individual landlords have driven improvements in standards, with the number of homes classed as decent in the sector rising by 58.5% between 1996 and 2006
- The sector provides accommodation for a diverse range of the population, including young professionals, social tenants and families alike, offering unrivalled flexibility. Its role needs to be protected and nurtured
- Financial factors are inhibiting further growth of the private rented sector, whilst regulatory issues also have the potential to stifle growth. Buy-to-let lending in 2009 was the lowest since 2001. Financial barriers could be addressed in a straightforward manner through support for the securitisation markets
- Institutional investment has been characterised by a history of false starts. Its current role extends only to students, the elderly and large housing developments
- Institutional investment is unsuited to the dispersed nature of the residential private rented sector. Institutions would not be able to deal with many of the issues at the local level that landlords have to confront, and it is challenging to see how many of the duties landlords undertake effectively for free through the investment of “sweat equity”
- Institutional and individual investment should be seen as complementary and treated equally in terms of regulation, tax breaks and other fiscal incentives

Introduction

The Paragon Group welcomes the opportunity to respond to HM Treasury’s consultation on the private rented sector.

Paragon is the UK’s leading specialist provider of residential property investment mortgages to professional and investor landlords. We launched our first specifically targeted mortgage in 1995 and we are currently the UK’s third largest lender on privately rented residential property. We have approximately 40,000 landlord customers and over £9 billion of assets under management.

We are a leading member of the Council of Mortgage Lenders (CML), playing a central role in the buy-to-let working group, and also a member of the Intermediary Mortgage Lenders Association, the Association of Residential Letting Agents' Lenders' Panel and the National Landlords Association. Our roles in the market and within our industry bodies have given us significant market and policy experience.

The private rented sector

The private rented sector has undergone considerable change and modernisation over the last 20 years, bridging the widening gap between social renting and owner-occupation and making a major contribution to housing and regeneration in the UK. The consultation paper rightly acknowledges the wide range of different needs catered for by the sector, and the fact that it remains dominated by individual landlords.

The private rented sector now provides a genuine alternative to home ownership and is a housing option that a substantial proportion of the population proactively choose as their preferred form of tenure. Buy-to-let investment has played a key role in broadening opportunities to rent privately and, by increasing competition within the private rented sector, has helped to widen choice and drive up standards in the sector.

We welcome the recognition by HM Treasury of the importance of the private rented sector, and the consultation paper's acknowledgement that "*it is important that the sector continues to grow and develop to meet the housing challenge, and that it is able to respond effectively to changing demand*". Individual landlords in the private rented sector, funded to a significant degree by buy-to-let, have made a vital contribution to meeting this housing challenge, and respond effectively and efficiently to local patterns of demand. Landlords have kept pace with demand, with the number of households renting privately increasing by around one million between 2001 and 2009 (from 2.1 million to 3.1 million) accounting for 14.2% of all households in England (CLG, February 2010).

The private rented sector in the UK today

The private rented sector is almost exclusively comprised of homes owned by individual landlords. In England, individuals or couples own 74% of the private rented sector stock, with the majority of this being owned by professional landlords. Analysis of CLG data shows 11% of landlords own 73% of the stock, with 58% of landlords owning only 5%.

There were 3.3 million properties in the UK's private rented sector in 2007 (latest available figures) – over 12% of all UK dwellings. The injection of fresh buy-to-let finance since the mid-1990s has also made an important contribution to boosting standards across all UK housing, with the number of homes classed as decent in the private rented sector by CLG rising by some 58.5% between 1996 and 2006.

The private rented sector includes a diverse range of households, from economically mobile young professionals to families looking for long-term housing. The sector also plays a vital social role, reinforced by the decline of social housing in recent years and the limited funding available to reverse this trend. UK social housing stock fell from 5.6 million to 4.8 million between 1997 and 2007; the private rented sector stepped in to assist, and 20% of private renters in England received housing benefit in 2007.

The private rented sector provides a diverse range of housing for a diverse range of demographic and social groups. According to the CLG's English Housing Survey, single person dwellings are the most common type of household in the private rented sector, accounting for 30% of total numbers. This is followed by couples (25%) and couples with dependent children (17%).

The report also shows that a wide range of age-groups live in private rented sector property, which dispels the myth that the sector is the domain of just the young. Under half (48%) of private renters are aged 34 or under, with 22% in the 35-44 age group, 12% in the 45-54 age group and 16% over the age of 55. It encompasses a varied range of economic status – 61% of households are in full-time employment, 9% in part-time work, 5% are unemployed, 9% are retired and 17% are classed as 'other inactive', such as students.

Only a diverse, committed and flexible investor base could provide suitable housing for such a mixed group of population sectors. Individual private investors have a proven ability to react to this level of demand and deliver diversity in housing, and will continue to do so in future given appropriate levels of support.

At present, institutional investors have only a limited exposure to the private rented sector. Whilst institutional investment does have a role to play, it is typically a specialist role in the provision of, for example, student accommodation or larger developments, such as blocks of flats. The institutional route is generally not suited to the fragmented, dispersed nature of the private rented sector. It is important to ensure that the growth of such larger developments does not lead to "ghettoisation" or "studentification", an issue highlighted by the CLG Committee in its 2008 report on the supply of rented housing.

The consultation paper is structured almost to suggest an "either/or" choice between individual and institutional investment; we would argue that they are complementary, and should, therefore, be treated equally in terms of regulation, tax breaks and other fiscal incentives. The consultation paper's tone suggests a preference for institutional investment, despite its initial assertion that "*individual investors have been crucial to the development of the private rented sector to date*".

The Government, via the Homes and Communities Agency (HCA), is currently considering a range of options to promote institutional investment. A number of attempts have been made at this in the past, none of which have been able to make a significant contribution. The consultation paper itself acknowledges that to date larger landlords have only played "*niche roles*" in specialist areas. In the UK, the resurgence of the private rented sector has been driven by individual landlords following the introduction of the 1988 Housing Act, and will continue to grow if landlords are able to access the necessary mortgage finance.

Increasing the supply of private rented accommodation from individual landlords is straightforward. The key factor inhibiting future growth is difficulty in accessing finance to fund new house purchases, despite the fact there is demand in the marketplace. It is disappointing that the consultation paper's policy proposals to increase the supply of private rented sector accommodation appear to be skewed towards the institutional role, and do not give attention to the importance of supporting the buy-to-let market.

There has been a general lack of Government and policymaker support towards buy-to-let and the market has been unfairly categorised by some as high risk. The experience of Bradford and Bingley should not be read across to the whole sector.

In addition, Bradford & Bingley's arrears performance has distorted the overall market figure. Research by credit ratings agency Moody's, conducted in the first quarter of 2009, found that the buy-to-let market's arrears rate was approximately halved when Bradford & Bingley's figures were stripped out.

Buy-to-let arrears have been lower than the wider market for 32 of the past 36 quarters and professional private landlords are typically financially astute and committed for the long-term.

According to ARLA figures, the average landlord is just over 50 years old, has been letting property for nine years, holds an average of 7.8 properties and intends to retain their investment for nearly 17 years. Furthermore, satisfaction levels amongst private tenants of private landlords remain high.

To ensure that sustained growth of the private rented sector is possible, serious attention must be given to encouraging buy-to-let lending by specialist lenders who are at present limited in their ability to lend because of dysfunction in the wholesale funding market.

We provide detailed answers to the consultation paper's questions below.

Individual investment

1. What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

2. To what extent has the growth of the private rented sector already influenced the house building industry? How might it do so in the future?

In order to address the above questions, it is important to establish the composition of property types in the private rented sector. Buy-to-let is wrongly associated with city centre new build property. In fact, the CLG's English Housing Survey shows that just 8% of private rented sector stock is situated in city centre locations, and only 13% of stock has been built post 1990.

The typical private rented sector property is a terraced house (35% of total stock), built before 1919 (40% of stock) and is situated in a 'suburban residential' location (48% of stock).

In addition, we believe that the analysis of the market in section 5.8 of the consultation paper overstates the contribution of buy-to-let to new build property. It states that 346,000 buy-to-let mortgages were approved during 2007 and assumes that 10% of these loans were mortgaged on new build. In fact, there were 346,000 buy-to-let gross advances during that year, but only 183,300 were for house purchase, with the remainder for remortgaging purposes. Therefore, based on the assumptions used in the consultation paper, buy-to-let would have accounted for 10% of new housing supply and not 20%.

However, whilst it is the case that prior to the credit crunch there was an increase in new build property purchase, it is important to distinguish between individual professional landlords operating in the private rented sector and speculative investors seeking capital gain. It is the latter – typically investing via property investment clubs – that focused their purchase activity on new build property, most commonly in city centre locations. Speculative investors have created a sense (completely unrepresentative of the market reality) that genuine landlords focus on new-build.

In fact, new build represents only a small part of the market – according to the CML, only 5% to 10% of buy-to-let lending is secured on new-build property. Indeed, many buy-to-let lenders, including Paragon, restricted lending activity on new build city centre properties due to over-supply concerns.

Professional property investors base their purchase decisions on proven and sustainable levels of tenant demand and the financial viability of the investment, regardless of whether it is an established property or a new build. On the whole, better investments have typically proved to be seasoned property in established communities. Landlords will purchase new build property, but only if the fundamentals behind the investment, including tenant demand and rental yield, are sound.

Rather than being speculators focused on new-build properties, the vast majority of private landlords are professionals. As stated, in England, individuals or couples own 74% of the private rented sector stock, with the majority owned by professional landlords.

Arguably a greater influence on the house building industry has been Government housing planning policy. Its focus on high density targets and the redevelopment of brownfield sites has led to an over-supply of one and two-bedroom flats in a number of areas of the country, not the type of property households demand.

Generally, new-build continues to be depressed and the Government's house-building targets have not been met. Completions are now falling well short of the Government's annual target of 240,000 additional homes, with only 118,000 housing completions in England in 2009, 17% lower than 2008. It is the exacerbation of housing shortages, particularly of larger family homes, combined with an increasing population that has been responsible for the continued pressures highlighted in the consultation paper.

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

Paragon has no data on this subject.

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

Buy-to-let investment has been the major catalyst that has changed the dynamic of the industry and provided a vehicle for private landlords to increase their investment in the private rented sector to meet tenant demand. The 1988 Housing Act was responsible for boosting landlords' confidence in the sector, with the introduction of buy-to-let mortgages in 1996 providing a further injection of finance needed to kickstart the sector.

Significant progress in improving the sector has already been made and continues to be made. The sector offers:

- increased choice at every end of the housing spectrum
- higher standards of property (the English House Condition Survey shows that the proportion of decent homes in the private rented sector has increased by 59% between 1996 and 2006 with the majority of properties now meeting the Decent Homes Standard)
- greater professionalism (CLG survey data suggests that tenant satisfaction in the private rented sector is comparatively high)

Prospects

The consultation paper questions investors' future appetite to invest in the private rented sector, highlighting the reduced potential for capital growth. This fails to understand the prime investment motives of the majority of landlords, who adopt a long-term view and value rental yield over capital appreciation.

Whilst there may be a reduction in the number of speculative investors due to the closure of property investment clubs and mortgage scarcity, evidence suggests that demand from professional landlords remains healthy.

Landlords have not disposed of stock during and after the recession; The Royal Institution of Chartered Surveyors' (RICS) Q4 2009 Residential Lettings Survey showed that the proportion of landlords opting to sell property at the expiry of a tenant lease was 3.6%, a near historical low.

ARLA's Q1 2010 Residential Investment Review & Index showed that nearly a third of landlords (30%) plan to purchase property over the next 12 months, compared to 11% who are planning to sell.

Tenant demand is a key driver of investment decisions. Tenant demand is strong and growing, and will continue to grow due to both short and long-term factors. In the short-term, many people are choosing to rent rather than buy given the current economic uncertainty and the tougher terms that have been applied to owner-occupier mortgages since the onset of the credit crunch.

Longer-term socio-economic and demographic factors, including increasing net migration, population growth, rising student numbers and people delaying home ownership, translate into material growth in demand for rented homes. ARLA forecasts that demand will grow by 20,000 to 30,000 households a year until 2016 because of these factors.

The vast majority of stock is owned by established professional or private investor landlords, with the average Paragon landlord having at least six years' experience and twelve properties in their portfolio. Our evidence suggests sustained demand from these landlords to increase the size of their portfolios.

With adequate finance, the contribution of these landlords to the private rented sector would only increase, but without it, the existing stock of the sector is coming under increased pressure.

ARLA's Q1 2010 research found that 59% of letting agents have seen tenant demand outstrip supply throughout the country, with not enough housing stock coming onto the rental market. RICS' Q4 2009 Residential Lettings Survey showed that 23% more surveyors reported a decline in new lettings instructions than a fall during the period, the lowest level on record.

Risks

Barriers to individual investment remain, however. These broadly fall into two categories – financial and regulatory.

1. *Financial barriers*

The financial barrier is the most significant of these. Mortgage supply in the buy-to-let market has been decimated since the onset of the credit crunch. Moneyfacts data shows that the number of available buy-to-let products has fallen from a peak of 3,662 in August 2007 to approximately 250 today.

This is reflected in lending levels. CML figures show that the number of buy-to-let gross advances declined by 73% between 2007 and 2009, from 346,000 to 93,500. The number of buy-to-let gross advances for house purchase has fallen by 70% over the same period to 55,780, with remortgaging falling by 78%.

The UK mortgage market is experiencing a chronic funding crisis in general, but specialist lending sectors, particularly buy-to-let, have been disproportionately affected because of the concentration of non-bank lenders in these sectors and the re-focus of High Street lenders on their mainstream mortgage books. Specialist lenders' gross new lending volumes have fallen from 17% of total mortgage lending in 2006 to 3.5% in 2009.

Non-bank lending has been the catalyst for growth of the private rented sector and it is these lenders that have been disproportionately impacted by the closure of the wholesale funding markets because of the importance of securitisation to their funding models. In the 12 months prior to the credit crunch, 80% of the net funding needs of the UK mortgage industry were provided by capital markets. Bank of

England figures show that securitisation accounted for 22% of total outstanding mortgage stock by 2007.

Significantly, non-banks were not included in the Government measures referred to on p24 of the consultation paper. This created a competitive imbalance between non-banks and the banks and building societies that were able to utilise the various schemes.

The lack of wholesale funding for the sector in the face of increasing tenant demand has put severe pressure on landlords who are now struggling to respond to tenant demand. Competition in the wider buy-to-let market has collapsed – 75% of buy-to-let funding is now provided by just two lenders who are heavily biased towards those amateur investors who will not have a meaningful contribution to UK housing supply. Only three lenders from the 2007 top ten buy-to-let lenders by gross advances are currently offering new products.

There have been recent signs of improvement in the securitisation markets with successful Residential Mortgage Backed Securitisations (RMBS) in the latter half of 2009 and Q1 2010. However, the markets still remain largely dysfunctional and the recent deals completed have all been brought to market by mainstream banks and building societies.

The Government needs to be bold in its support for a revitalised RMBS market. The UK has suffered because of US-generated problems in the securitisation market. By contrast, UK performance in the sector has been more sustainable, lower risk and more straightforward. Securitisation has to have a role to play in the future because deposits alone will not meet lending needs (a fact highlighted by both the Financial Services Authority (FSA) and the CML), and Government and Bank of England mortgage support mechanisms will be expiring in the coming months. Without a vibrant RMBS market, the entire mortgage market, buy-to-let and owner-occupier alike, will face a serious funding shortage.

2. Regulatory barriers

The Government's approach to regulation in recent years has been directed by a number of important objectives, attempting to address some of the issues with, for example, rogue landlords and quality of stock.

However, there has been a failure to consider regulation as a whole, resulting in a patchwork quilt of regulation and a lack of coherence and consistency that adds cost and bureaucracy to landlords and local authorities alike. The National Landlords Association has calculated that there are currently more than 50 Acts of Parliament and 70 sets of regulation that apply to the sector. There must be a strong case for rationalising and consolidating these.

Six out of 10 landlords surveyed by Paragon Mortgages in December 2009 said they were worried about the level of regulation required in relation to the running of their property business.

The Government has accelerated the introduction of new regulations during its current term. Recent statute includes mandatory licensing for Houses in Multiple Occupation (HMO), a national tenancy deposit scheme and Energy Performance Certificates for rented property.

Regulation has, at times, been knee-jerk, and as a consequence, new measures have been poorly targeted, and in some cases, ineffectively implemented and policed. Recent changes to HMO legislation, requiring landlords to apply for planning permission to change a building's use to form an HMO, is a good example of blanket legislation to address a small, localised problem. These, in turn, have a negative impact on supply, adding to landlords' costs.

The patchwork approach to regulation of the private rented sector is indicative of the absence of a co-ordinated and cohesive strategy towards the sector, and housing more generally. There have been nine Labour Housing Ministers during its 13 years in Government, which seems to have inhibited the development of a clear strategic view of housing management and development.

Separately, HM Treasury and the FSA are currently considering the case for regulation of buy-to-let mortgages. Paragon believes that given the business nature of the transaction between buy-to-let lenders and landlords with multiple property portfolios, there is no case for extending regulation beyond the first transaction. We continue to engage with HM Treasury and the FSA on this, and welcome HM Treasury's recent statements regarding the scope of buy-to-let regulation.

Institutional investment

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?

Scale is central to the success of the institutional investment model; this model can only generate acceptable returns from low cost, high density and high yielding property. This is why the institutional route is best suited to large scale development, such as student accommodation or blocks of flats. There is some demand for such properties, although it is not as significant as overall demand for accommodation in the wider private rented sector. There is a risk that a "build-to-let" model will encourage more of the vacant city centre apartment blocks that have been so criticised by policymakers in recent years.

The major issue with scale economies is that they reflect attempts to plan communities without reference to the individuals that comprise such communities, or their housing preferences. This can, ironically, lead to the very "ghettoisation" that the changes to HMO planning legislation recently introduced by CLG have been designed to prevent.

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?

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?

Any measures introduced should be applied equally across individual and institutional investment and recognise that private landlords have been the mainstay of the UK’s private rented sector. It is vital that Government policy avoids skewing supply in the sector by introducing specific incentives, for example new fiscal incentives, for institutional investors only. A level playing field between private and institutional investors must be maintained. Otherwise there is a risk that private landlords will be discouraged from maintaining their commitment to the sector, reducing competition and tenant choice. Any changes to SDLT bulk purchasing rules taken forward should be extended to private landlords as well as institutional investors.

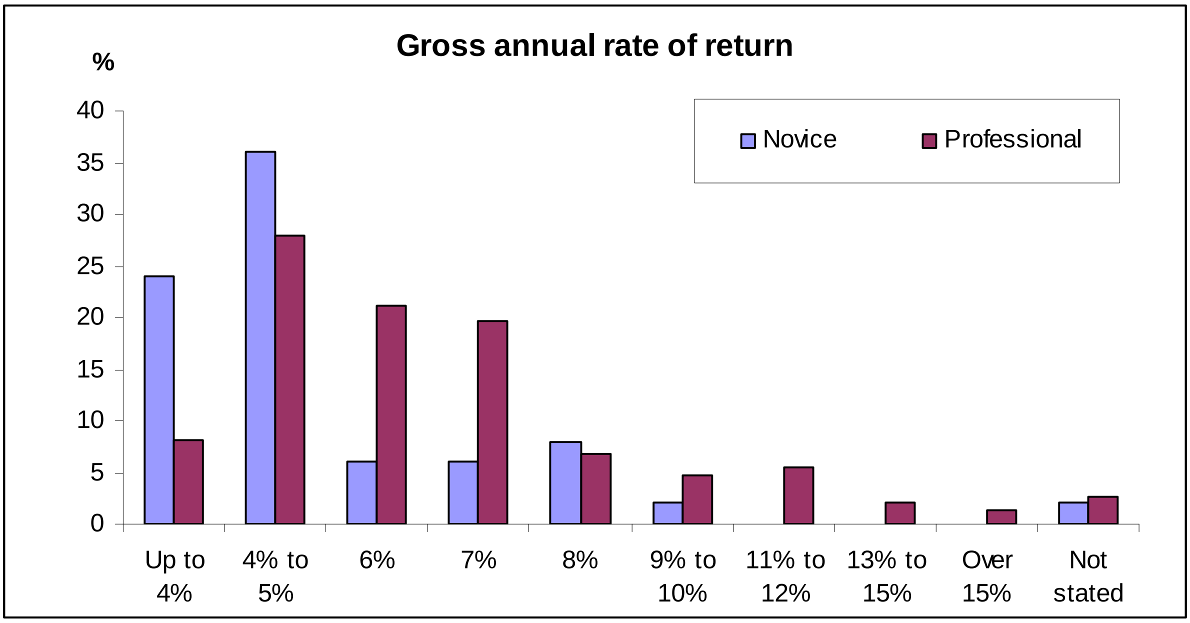
As noted above, buy-to-let has had a considerable impact on driving up property and management standards in the private rented sector, and we would argue that the tax system should be used to promote this role further when appropriate and affordable, such as for bringing derelict property back into use.

It is essential that landlords are positively encouraged by the fiscal framework to continue to modernise and improve the condition of their properties where this would provide a better experience for tenants. The cost of renovations can, in some cases, be considerable, so using the fiscal framework to incentivise landlords to invest further in their existing properties, particularly in the current economic environment, would help to encourage more landlords upgrade their properties. The Landlord Energy Savings Allowance has had some limited success in this regard, but in our experience, has been poorly publicised and, consequently, under-utilised.

In conclusion, it is essential that the fiscal framework faced by landlords encourages, rather than discourages, their continued engagement with the sector. Professional landlords regard their property portfolios as long-term investments. Any measures that could have a bearing on the costs faced by landlords, tax-related or otherwise, must be appropriately calibrated to ensure that this long-term commitment is not weakened. This is of particular importance in the current economic environment, with more people looking to the private rented sector to meet their housing needs.

8. How do the rates of return on investment in the private rented sector compare to those expected/require by institutional investment?

There are a number of different ways in which the rates of return within the private rented sector can be measured. The data on the next page is taken from our own landlord base and shows gross rate of returns, not including capital appreciation, for Q1 2010. This suggests that professional landlords are earning a better gross rate of return than their novice counterparts. Analysis of these figures show that the average gross rate of return earned on professional landlords’ residential portfolios is 6.3%.



Separately, ARLA's Q1 2010 Review and Index shows that the average annual rate of return, including rental income, capital appreciation and void periods, on a non-geared investment is 9.6%. On a geared investment, assuming a 75% loan-to-value mortgage and an interest rate of 2.5%, this rises to an annual rate of return of 23.3%.

However, both measures do not take into account the fact that private landlords do not charge for their time, instead investing "sweat equity", unlike the kind of management companies that the institutional investment model would require. The institutional investment model would have to factor these additional costs into management, reducing investment returns and, in turn, the economic viability of this model. Institutional investors also currently lack the appropriate investment management skills needed for operation in the private rented sector.

9. What factors have prompted the recent institutional interest in investing in the private rented sector, and do these reflect a long-term change in investment opinion?

There is a long history of attempts to increase institutional investment in the private rented sector, much of which has failed to lead to significant new homes being brought to the market. The October 2008 Rugg Review of the Private rented sector concluded:

> *"There is a long history to the attempts made to frame taxation regulations to effect large-scale institutional investment. The Review concludes that much of this debate reflects the attempt to construe residential letting as commercial letting, when in reality the two sectors are very different. The residential market has, at present, very few large landlords operating at a scale where major institutional investment is appropriate. Policies should therefore concentrate on helping good landlords of all sizes to expand their portfolios. It is important that this policy should include smaller landlords, since the larger landlords generally grow through portfolio acquisition."* (Rugg Review)

One current initiative is the HCA's Private rented sector Initiative (PRSI), launched in May 2009 to encourage institutions to fund new homes for private rent. Whilst the impetus of this may have resulted in some change to investment opinion, its scope remains limited and we understand that the HCA is currently only in discussion with a small number of funds.

The HCA's original announcement of the fund suggested that it was a response to growing demand from people who cannot afford homes given the "limited" supply of quality homes in the wider private rented sector, and a means to make mothballed mixed-tenure development projects more viable. Whilst there could be a valuable role in the latter context, subject to our concerns expressed above around "build-to-let", CLG data, outlined above, shows that the quality of private rented sector stock, overwhelmingly sourced from individual landlords, has improved markedly in recent years.

Sir Bob Kerslake, Chief Executive of the HCA, said on calling for expressions of interest on 1 May 2009:

> *It is only potential at this stage. We will engage with the private sector to develop a market driven proposition which is attractive to investors. Projected rental yields and the current market suggest that the time is right, and that is why we are engaging with the market to develop the proposition further.*

It is disappointing that the Government is using public funds to encourage institutional investment driven by "projected rental yields" when landlords stand ready and able to help when, and if, the necessary finance becomes available from the private sector.

In conclusion, it is private landlords rather than institutional investors who have shown willingness over the last two decades to respond to tenant demand by making a sustained investment in the sector. Institutional investors' reluctance to date raises the question of how well suited institutional investment is to privately rented property.

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 private rented sector?

11. What are the key barriers to investment in residential property through UK-REITS, and what changes would be needed to address them?

12. 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?

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

14. How do these collective investment vehicles compare to UK-REITS?

15. What evidence is there that institutional investment in the private rented sector would bring real benefits to the sector, and the housing market more generally?

Whilst there are undoubtedly some fiscal issues, particularly in relation to the financial viability of investment, other barriers to institutional investment should also be considered:

- We have discussed the issues with regard to the "sweat equity"
- Private landlords understand and react to local housing issues and are better placed to respond to specific local housing needs
- It is uncertain that there would be sufficient levels of demand from prospective tenants for the kind of properties that institutional investors are likely to invest in through "build-to-let" schemes, such as two-bedroom flats
- It is doubtful whether institutions would be well-placed to deal with issues such as anti-social behaviour
- Those worse off from institutional investment would be social tenants with new-build developments becoming modern ghettos

We reiterate that institutional investment, and by extension, UK REITS, could have some benefits at the specialist ends of the market. However, HM Treasury should consider in more detail some of the pitfalls of institutional investment.

Response to the HM Treasury "Investment in the UK private rented sector" consultation

Places for People

April 2010

1.0 Introduction

1.1 This paper sets out Places for People's response to the HM Treasury (HMT) consultation paper on investment in the UK private rented sector (PRS).

1.2 Our views are drawn from a combination of experiences together with research including how housing policy should change as set out by the Housing Futures Network.[1] We have also contributed to the submissions to this consultation from the British Property Federation (BPF) and the Home Builders Federation (HBF).

1.3 The residential property sector faces undoubted and unprecedented challenges. Difficulties in the future economic environment and the financial sector will require the next Government to create a new housing policy and investment framework for all parts of the residential sector.

1.4 The new housing policy and investment framework needs to incentivise private sector funding into the PRS and Affordable Housing sector, both of which would support increased levels of supply from housebuilders. In relation to the PRS, we believe that the demand for this tenure will continue to grow and that institutional investors are going to need incentives to invest on a large scale, such as the creation of a Residential REIT vehicle.

1.5 By achieving this outcome, the Treasury will be able to maximise the direct (residential businesses), indirect (supply chain) and multiplier (which has been estimated up to 3 times) economic benefits available from the sector.

1.6 Our response sets out how we think the future housing policy and investment frameworks could develop.

1.7 If you have any queries about the content of this response, please contact:

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[1] Members include: Places for People; Affinity Sutton; L&Q; Gentoo; Riverside housing associations. The Housing Futures Network "Homes for Tomorrow" report is available at: http://www.placesforpeople.co.uk/documents/HFN_report.pdf

2.0 Background

2.1 The Consultation document sets out the history of the private rented sector, including its recent growth in response to a combination of demographic and affordability issues.

2.2 In practice, the private rented sector sits alongside and interacts with all other forms of housing tenures including social rented, outright sale and various forms of intermediate tenures such as shared ownership and shared equity.

2.3 However, the current policy and investment framework for housing does not view the overall sector in the round and consequently does not incentivise enough investment to enable the quality of existing and the supply of new housing to increase.

2.4 The consequences of not viewing the sector in the round are that there will be inadequate levels of private and public investment to build all forms of housing tenure. There will be lower amounts of affordable housing due to the lack of Government funding and the increasing inability of housebuilders to cross-subsidise the cost from land values through the S106 process. There will be lower amounts of owner occupied housing as the housebuilders would increasingly have to build according to their cashflow capability and sell at a premium to pay dividend to their shareholders. There will also be lower amounts of private rented housing as the increased cost of new housing reduces the „discounts to market values' that individual and institutional investors require to generate a viable yield from a mix of revenue and capital appreciation.

2.5 We believe that, given the future economic and socio-demographic circumstances that the housing sector faces, it is crucial that future housing and investment policy is constructed in a manner that incentivises additional institutional investment into the private and social rented sectors of the housing industry.

2.6 Only then would investment into the private rented sector be encouraged enabling it to grow sustainably and provide a crucial element in the response to the challenges facing the future provision of housing in the UK.

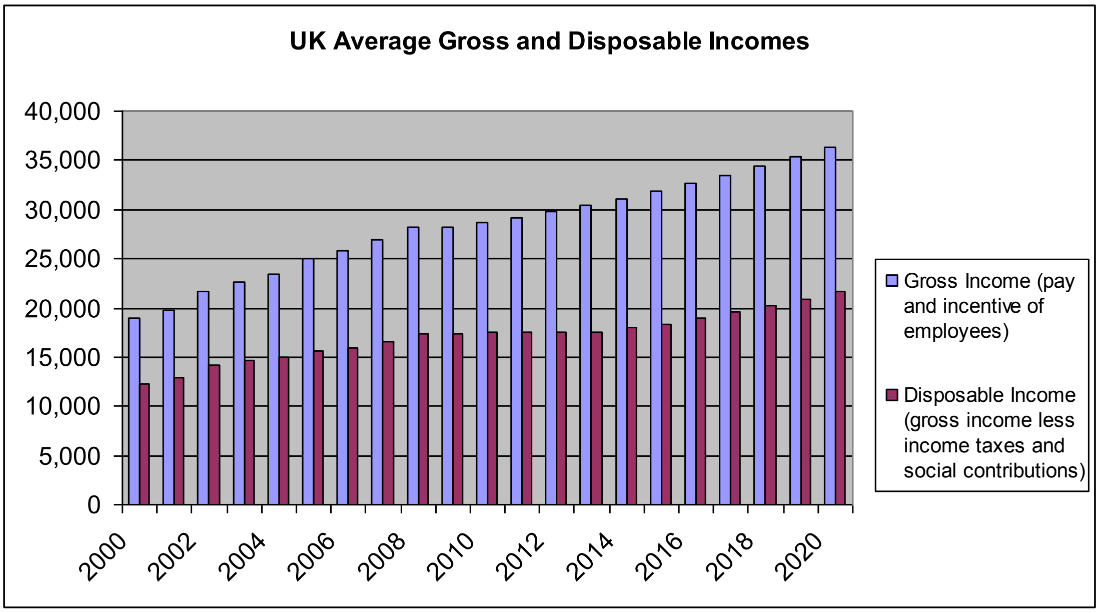
2.7 The following section (Section 3) outlines our view of the future for the private rented sector and the investment framework that needs to be put in place to enable it to growth effectively. We have given our input to the BPF and HBF submissions and are content to rely on their responses to the Consultation Questions.

3.0 Looking Forward

Economic context

3.1 Undoubtedly the biggest issue that any future Government faces is how to deal with the national debt. Prior to the recent Budget 2010, notwithstanding any potential efficiency savings that the main political parties have set out during their election campaigns, the Centre for Business Economics and Research (CEBR) estimated that a future Government will need to implement a combination of tax rises and public spending savings to reduce debt by about £130bn.

3.2 Whilst political parties will vary in their approach, it is estimated that around 60% of the £130bn comes from public spending savings. The remaining 40% of the £130bn would have to come from tax rises which may take the form of a rise in VAT or an increase in average income tax. The graph below shows that increases in income taxes will flatten average disposable incomes (red lines).



3.3 Against this background, the continuation of the current historically low interest rates would help to provide some stimulus to the economy in particular housing. However, the potential implications on future interest rates of credit rating agency actions relating to either a hung parliament in the UK and/or the Greek sovereign debt crisis present some clear risks to that situation.

3.4 Most commentators are predicting further growth in house prices during 2010 and into 2011 albeit at differing rates as the economy starts to pick up. However, the pace of house price recovery from 2010 onwards will be critically determined by the demand for housing and the availability of land. The demand for residential property is projected to remain strong, with population and households estimated to grow by another 8m and 5m respectively by 2026. However, unless there is a radical overhaul in planning policy, land will continue to be in short supply thereby contributing to the growth in house prices.

3.5 Against this context of reducing real incomes on the one hand and rising house prices on the other, it is likely that affordability levels will be exacerbated. The size of the housing market that cannot afford to buy outright at market levels is likely to increase substantially from its current level of 6.8m households (2.6m who receive some form of benefit and 4.2m who are not on benefit but cannot afford to buy a house at lower quartile prices).

Investment challenges

3.6 The residential property sector may be the largest asset class in the UK, but it only accounts for 1% of the total investment made by the institutions. Historic issues include lack of compatibility and comparability to tax efficient vehicles in other sectors (eg. REITs in the commercial property sector) and consequently a lack of scale to enable institutions to make sizeable investments.

3.7 In relation to the owner occupier and buy to let markets, it is clear that future funding is at best likely to remain at subdued levels and at worst could contract.

3.8 Some recent research by the Council of Mortgage Lenders (CML) has revealed that by 2015 lenders will need to refinance £300bn of temporary Government funds issued through the Special Liquidity Scheme (SLS) and Credit Guarantee Scheme (CGS) initiatives before additional mortgage lending can be considered. The £300bn is equivalent to a quarter of the total value of outstanding mortgage debt (£1.235bn) and it cannot be filled by retail deposits alone due to a combination of low earnings growth and low interest rates. Further Mortgage Shortages are likely if the Government does not provide more backing to the Mortgage Backed Security market in the future.

3.9 Crucially though, high levels of deposits and lower income multiples will remain an issue, particularly for first time buyers and buy to let investors. The Banks are likely to continue to structure their mortgage offers to offer lower rates to lower Loans-to-Value (LTVs) (eg Banks can lend 9 or 10 times the amount of 60% LTV mortgages compared to 90% LTV mortgages) whilst at the same time requiring more traditional income multiples of 3 or 3.5 compared to the last ten years.

3.10 In addition, the need to reduce future levels of Government debt will undoubtedly require funding cuts in public sector expenditure on housing. These are likely to include cuts to the Social Housing Grant, Housing Revenue Account and Housing Benefit Account amongst others.

3.11 The challenge for the next Government is to find a new investment approach that is capable of attracting private sector investment at lower levels of public sector investment in order to maintain the supply of new houses above the levels of 150,000 per annum.

A new approach

3.12 The next Government would firstly need to look at how it can create a new approach that facilitates the investment required to build the volumes of sub-market affordable housing which the country will need in the future. In the absence of affordable housing funded from S106 agreements and the reductions in public expenditure in public housing as outlined above, alternative investment approaches will need to be explored.

3.13 We believe that the best option would be to release the latent assets in the balance sheets of Registered Providers by **Writing off the Social Housing Grant**. This will enable affordable housing to be an attractive investment for the major institutions. The current RSL sector has £67.7bn housing properties at cost, with £32.7bn of this representing social housing grant. By writing off the existing £32.7bn social housing grant in the sector and enabling the rents to rise over a period of time, it would enable Registered Providers to restructure and take advantage of the remaining equity on their balance sheets.

3.14 Initial modelling that we have undertaken estimates that Writing off the Social Housing Grant would release sufficient funding to build 163,500 new sub-market affordable homes assuming rents rise by some 8% over a period of time to generate a net 7% to 8% return. These figures are based on some initial discussions with institutional investors about the likely levels of return that would make the current equity attractive.

3.15 This future approach to the production of sub-market affordable housing would not require social housing grant from the Government. It therefore relieves the Government of this debt and at the same time reduces the reliance on S106 agreements therefore improving the viability and volume of housing production. There will be a small impact on Housing Benefit (circa £1bn) from the increase in rents, but we believe that this could be more than outweighed by the reduction in local housing allowances which the Government had begun to examine.

3.16 This new approach would then enable Registered Providers to work with Housebuilders and Private Rented Management companies to provide a continuum of tenures across the housing spectrum including social rent, shared ownership, shared equity, intermediate rent and out-right sale.

3.17 Indeed, we believe that the Government can add further private investment capacity to the housing sector by combining the Writing-off of Social Grant with a new **Residential REIT** proposal and changes to the current SDLT.

3.18 The UK REIT legislation was introduced on 01 January 2007, however to the best of our knowledge there is yet to be a UK residential REIT launched. Those that have considered it (both private companies and not for dividend companies like ourselves) have decided against it for a number of reasons, the main ones being:

- Difficulties in achieving critical mass in order to offset the set up/listing costs;
- Entry charge of 2% of gross assets which is not able to be sustained at current yield levels for residential properties;
- The current rules on incomes arising from properties developed for sale mean that residential properties developed for rent and sold within 3 years are taxed;
- Typically, residential property portfolios have a high geographical diversification resulting in exposure to local property market volatility. Large institutional investors saw this as a potential issue when compared to larger portfolios or global REITs which clearly diluted any risks of localised volatility.

3.19 In order to attract institutional investors like pension funds, we propose that the Government suspend the 4% stamp duty tax and increase the flexibility over the timing and level of dividends paid for first 10 years. In addition, the Government should consider waiving the personal tax applied to savings if people invest in these residential REITs. The Government could then apply the 4% stamp duty at the end of 10 years or when the REIT or parts of it are disposed whichever happens first.

3.20 The Government could apply the following conditions for Residential REITs:

- can only be used for new housing production;
- people would initially rent the new house but could convert into a partial or full ownership product over time;
- people can use their savings to purchase tax free equity stakes.

3.21 The benefits to the Government of these proposals are that there would be little additional upfront investment by the Government as Residential REITs would be designed to lever in private finance. Also, the Government would get a flow of funds from staircasing and/or sales of housing from these schemes in the long term benefiting from any appreciation in the property market over the medium and long term.

3.22 In addition to a new Residential REITs proposal, we believe that the Government should amend the current **SDLT** treatment of bulk private rented housing acquisitions. Whilst we appreciate this was introduced to stop buyers avoiding paying stamp duty by artificially breaking up the value of transactions, it cannot have been Government's intention to erect an obstacle to private rented housing supply. This must be an even more pressing need since the Budget's introduction of a 5% rate for properties valued at more than £1 million.

3.23 Also, it seems undesirable that an individual investor can buy several dwellings, with each being treated as an individual transaction for stamp duty purposes, whereas a large-scale investor buying a number of properties in bulk ends up paying a significantly higher rate of stamp duty. There should be a level playing field between all rental investors, of whatever size.

3.24 Amending the rules seems unlikely to result in any significant loss of revenue for the Government, compared with current SDLT revenues, because there are probably few such bulk purchases at present. This measure would benefit all large-scale institutional investors and support the increase in the supply of new housing.

3.25 Compared to the overall economic benefit created by building a sizeable volume of new housing (ie. at least 150,000 per annum), we believe that the overall costs of the new approach outlined above are minimal. Whilst there would be some increase in Housing Benefit, this would be more than mitigated by reductions in the local housing allowances. Both the Residential REITs and SDLT proposals are unlikely to cost the Government much in lost revenue as there is little or no investment in them currently.

Government debt classification

3.26 Recent increases in borrowing to support the financial sector together with the recent court case classifying Registered Providers as public sector organisations provide the Government with the opportunity to reclassify its borrowing rules in line with EU accounting practice.

3.27 We believe that the Writing off of Social Grant and Residential REITs proposals outlined above would enable the Private Sector organisations (Registered Providers, Private Landlords and Private Developers) responsible for developing and managing housing in the UK to sit outside of the public sector borrowing requirements for the support given by the Government. This would unlikely to be the case if the Government maintained a regime of providing capital grant support to new housing schemes.

Response to Treasury Consultation on the Private Rented Sector

Submission by PricedOut

This report is the work of PricedOut. Please feel free to use the information produced in this document but please cite this report, PricedOut as the authors and include a link to our website www.pricedout.org.uk

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Introduction and Summary

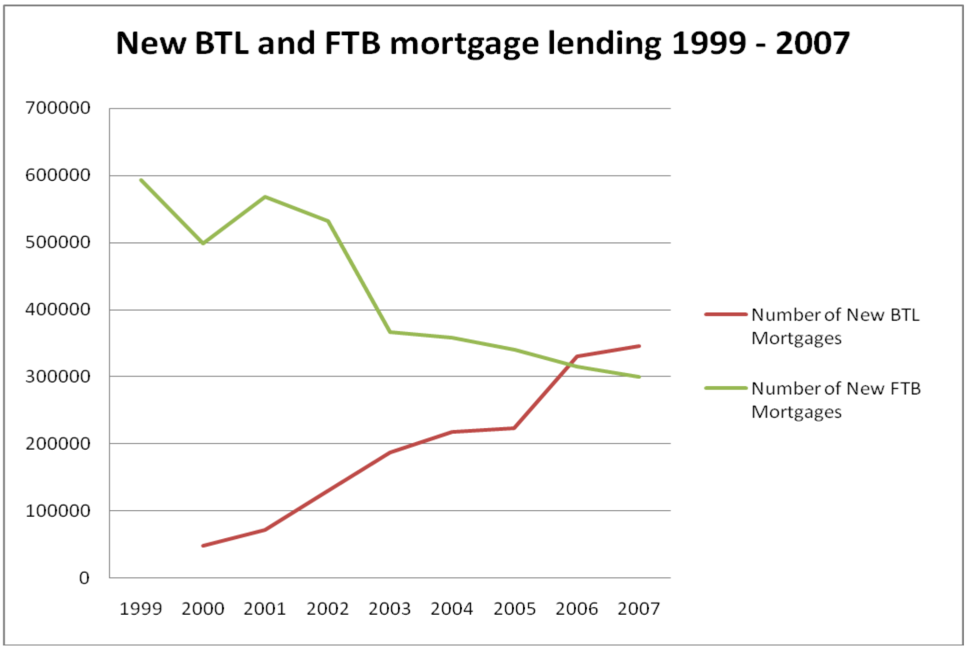
PricedOut is a group representing the interests of First Time Buyers (FTBs) who are currently unable to afford housing in the UK. PricedOut aims to raise awareness of the damage being caused by unaffordable house prices through its website, its campaign activities and active canvassing of policy makers and the media.[1] PricedOut was founded in February 2006 and is staffed entirely by volunteers. We have more than two thousand registered members.

Whilst there are a number of organisations, charities and campaigns dealing with the important issues of social housing and homelessness there is no group representing First Time Buyers who are being negatively affected by unaffordable house prices.

We welcome the opportunity to comment on this consultation of the future of the Private Rented Sector (PRS), however are concerned by the deep weaknesses displayed in this consultation document.

PricedOut has **six key causes for concern** for First Time Buyers:

1. **The Treasury paper shows a weak understanding of the dynamics of the UK housing market and fails to address the impact of increased demand created by the exponential growth of the Buy-to-Let (BTL) sector on UK house prices and the negative impacts this has for First Time Buyers and the UK economy**.



Source: CML BTL mortgage lending data, Halifax First Time Buyer Review 2007

The number of Buy-to-Let mortgages increased tenfold from just 3.5% of house purchase mortgages in 1999 to 28.9% in 2006.[2] This represents over 1 million new Buy-to-Let mortgages. Additionally, it is estimated that only 54%[3] of Buy-to-Let landlords use Buy-to-Let mortgage finance to purchase their

[1] See http://www.pricedout.org.uk/

[2] Council for Mortgage Lenders data

[3] See Ball, M. (2006) Buy-to-Let: The Revolution Ten Years On – Assessment and Prospects, Association of Residential Letting Agents (ARLA)

properties, meaning that, in reality, the number of UK Buy-to-Let properties is significantly higher. Conservative estimates calculate that this additional demand has added at least an extra 7.4% to UK house prices, equivalent to £13,485 on the average British Home.[4] This dwarfs the average amount spent by FTBs on stamp duty - £1,750 according to Halifax.[5]

High house prices, driven in part by the rise in Buy-to-Let, have displaced an estimated 1.2 million „new' households away from Owner Occupation[6] and have led to around 1.4m fewer First-Time Buyer mortgages since 1999.[7] A recent report by the Council for Mortgage Lenders (CML) found that levels of Owner Occupation are at their lowest since the 1980s.[8]

High housing costs also contribute a damaging drag on UK economic performance. They increase personal debt levels, concentrate individual wealth portfolios disproportionately in one asset class and increase vulnerability to external credit shocks. High house prices reduce labour mobility, add an additional cost to UK businesses in higher wages and drain disposable income out of the wider economy. The misallocation of resources impacts on the total level of investment capital available for businesses and wider consumption levels.

2. **The Treasury Paper fails to address the negative impact of the speculative and volatile nature of the Private Rental Sector investment, which creates instability in the UK housing market and the wider economy.**

Buy-to-Let activity has been highly volatile. The number of outstanding BTL mortgages increased ten-fold from mid 2000 to 2007. It then halved in 2008 and halved again in 2009. The main Buy-to-Let lenders in the UK were at the forefront of using new financing mechanisms, such as the use of wholesale funding markets and Mortgage Backed Securities issuance, which enabled the credit boom and left the UK particularly vulnerable to the credit crunch. Repossessions of Buy-to-Let properties are also higher than in the UK residential mortgage market – substantially so, well over twice the rate, when the „Receiver of Rent' mechanism available to creditors is taken into account.[9]

As a result, eight of the top nine UK Buy-to-Let lenders in 2007 have now either been rescued by the tax payer after threatened bankruptcy, are closed for further business or have been badly damaged by the financial crisis and are undergoing substantial retrenchment.

3. **The Treasury Paper fails to acknowledge or address the highly uneven playing field created for PRS investors in the UK residential property market. Buy-to-Let investors are able to use financial products that give them greater purchasing power and exploit generous tax breaks to out bid First Time Buyers for UK property.**

Unequal purchasing power due to the UK tax system and lax financial regulation has given Buy-to-Let investors an unfair advantage over First Time Buyers and lies behind the growing displacement of First time Buyers with property investors.

[4] See „Buy to Let mortgage lending and the impact on UK house prices: a technical report', Ricky Taylor, National Housing and Planning Advice Unit, Department of Communities & Local Government.

[5] Halifax First Time Buyer Review, December 2007

[6] „Affordability – more than just a housing problem', NHPAU, May 2009

[7] http://www.telegraph.co.uk/finance/newsbysector/constructionandproperty/2821472/First-time-buyers-set-to-rescue-house-prices.html

[8] Council of Mortgage Lenders, http://news.bbc.co.uk/1/hi/business/8547902.stm

[9] Council for Mortgage Lenders, „Buy to Let lending in 2009' http://www.cml.org.uk/cml/media/press/2540

Council for Mortgage Lenders data analysed by PricedOut shows that, for an average First Time Buyer property, BTL investors' mortgage costs – given their tax advantages and use of interest only mortgages – amount to just over a seventh of their net income, whereas FTB average mortgage costs amount to a nearly a third of net income. PricedOut are calling on the government to change the tax system to stop this unfair advantage and allow First Time Buyers a chance to get on the housing ladder.

4. **Contrary to stated UK government policy objectives, the UK Private Rented Sector has decreased the supply of UK housing available for Owner Occupation.**

Rather than increasing the supply of UK housing, Buy-to-Let investment has created a net loss in the supply of houses available to UK First Time Buyers and Owner Occupiers. In the last six years, the net loss of total supply, including new build market housing, from Owner Occupation to BTL mortgage purchasers was 647,300 dwellings. Despite substantial levels of private sector house building, BTL purchases has led to the total stock of Owner Occupation houses declining by nearly two thirds of a million homes. Rather than building new homes, since 2003 government housing policy has effectively removed at least 647,300 British homes that First Time Buyers can buy – flying in the face of government rhetoric to be helping First Time Buyers.

5. **The Treasury paper fails to take into account the negative social impact of Private Rented Sector investment in the UK housing market, including rising house prices. Additionally, it fails to acknowledge its impact on inequalities in wealth distribution**

High house prices, exacerbated by rising levels of Private Rented Sector investment in the UK housing market, have contributed to wide-reaching negative social impacts. Waiting lists for social housing are currently at a record high of 4.5 million people. A recent study by Shelter found that 1.5 million adults say that they are unable to look after their elderly parents because they can't afford to live near them, whilst 21% of 18-44 year olds, equivalent to 2.8 million people, are actively delaying having children because of high housing costs[10].

Inequalities in housing wealth are now highly pronounced and growing. According to new data, the aggregate value of housing wealth held by those aged 50 to pension age (representing 7.1 million people)- was £1,280bn, more than twice the housing wealth held by any other age group. The next wealthiest group is those between pension age and 75 (5 million people), whose housing wealth was £600bn. This is despite these groups being smaller in population terms that the 35-44 age group[11]. Yet the Treasury paper completely fails to acknowledge the wealth distributional impact of the Private Rented Sector, both through its macro level on increasing house prices and in the rents PRS investors secure over tenants- many of whom are priced out First Time Buyers.

6. **The Treasury paper over-estimates, and fails to scrutinise, the demand for private rented accommodation in the UK, the majority of which is created by priced out First Time Buyers. Additionally, the paper fails to acknowledge or explore the relationship between greater levels of tenant security and the larger and more stable Private Rented Sector that exists in many European countries.**

[10] Shelter Research from February 8th 2010 and 18th January 2010 http://england.shelter.org.uk/news/february_2010/affordability_crisis_fractures_families and http://england.shelter.org.uk/news/january_2010/housing_costs_forcing_delay_in_having_children

[11] ONS, „Wealth in Britain' survey, 2010. http://www.statistics.gov.uk/downloads/theme_economy/wealth-assets-2006-2008/Wealth_in_GB_2006_2008.pdf

PricedOut challenges a key assumption of the Treasury paper, which states that the PRS meets the demand for rented properties in the UK. Whilst there is some demand for flexible, rented accommodation, a recent study by the Royal Institute of Chartered Surveyors found that only 13% of those who rent in the UK do so by choice. Instead, many would-be Owner-Occupiers are being displaced by Buy-to-Let investors. Sustainable, affordable housing is more important to priced out renters than flexibility.

UK renters face significantly weaker tenants' rights than their European counterparts. PricedOut is concerned that, although the remit of this Treasury paper is the Private Rented Sector, it fails to address the rights of UK tenants. It also demonstrates a bias towards further reducing tenant's rights as the key to growing the Private Rented Sector, a position which the European experience of greater tenants rights combined with larger and more stable Private Rented Sectors than the UK offers little support.

These failures are depressing - HM Treasury is meant to rigorously represent the broad and long term interests of the UK economy. Yet the terms and framework of this consultation paper are extremely narrow and conceptually flimsy.

The failure to recognise or explore the additional price pressures, risk and volatility that the PRS sector has added to FTBs housing choices, the UK housing market and the UK economy is worrying. The mooted proposals, notably to further extend the tax breaks available to the PRS sector over First Time Buyers and to seek to encourage additional speculative PRS investment flows into the UK residential housing market, are highly alarming.

HM Treasury and the UK government should start to ask much tougher questions about the direction this consultation paper sets out and take a much more critical assessment of the wider economic and social costs of the PRS sector.

PricedOut is campaigning for the following **four changes to UK government policy**:

- The current unfair tax advantages BTL investors have over First Time Buyers should be removed. For existing residential property, BTL investors should not be able to write interest payments off against tax. These tax breaks should only be available for new build property built specifically for BTL investors and a new category of private rented housing.

- The Financial Services Authority should oversee BTL mortgage regulation and implement much tighter oversight of BTL mortgage borrowers and lenders. A central element of this regime should be to outlaw the use of interest only mortgages without a parallel and financially robust repayment vehicle for the capital value of the house.

- The Government should seek to discourage investment into the PRS sector that is primarily based on expectations of capital gains. The Government should reverse its previous cuts to capital gains tax to a level consistent with current income tax rates and introduce a substantially higher capital gains tax rate on investment property owned for less than ten years. The government also should clamp down on widespread capital gains tax avoidance.

- The Government should improve tenants' rights to levels comparable to the rights of tenants in the European countries cited in this paper (table 5). PricedOut recommends an incremental system such as the model that exists in the Republic of Ireland, whereby tenants' rights increase proportionally to reflect the amount of time that a tenant has lived in a property. Such a change would keep the flexibility of the Private Rented Sector where a short let is required, but increase the sustainability and security of housing for tenants.

Chapter 1: The Impact of Buy-to-Let on the UK Housing Market

1.1 The Role of Increased Demand in Higher UK House Prices

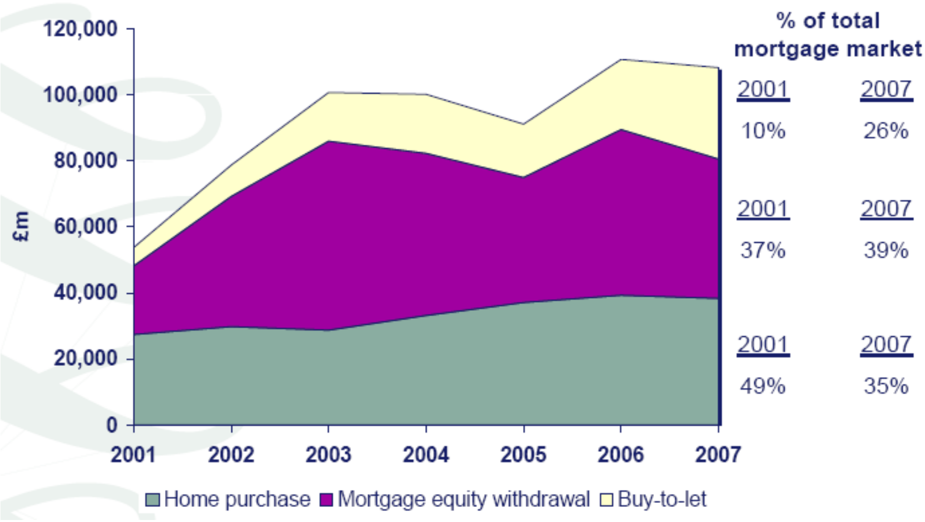
The UK housing market is far from a perfect market. It suffers from a supply base that is extremely restricted and sluggish in its responsiveness to changes in demand. It has volatile levels of demand and has a strong cyclical nature – notably driven by price expectations, the business cycle and levels of credit availability (see for example Andrew Farlow)[12].

To quote the economist David Miles, UK housing supply is "all but fixed in short run". Britain's total housing supply grows extremely slowly, at less than 1% of the total stock per year, and bears a weak relationship to total levels of demand.

The result of this irresponsive supply side is that sudden changes in demand are mainly reflected through price changes rather than extra supply.

The PRS has undoubtedly been a very important new component of total UK housing demand, yet the consultation document totally fails to explore what the implications of this are for the market – both in terms of prices and levels of volatility.

Graph 1 – UK Mortgage Lending by Purpose 2001 - 2007



Source: FSA, Bank of England, CML, taken from „The Mortgage Market: Issues for Debate', Adair Turner Chairman FSA Mortgage Conference 12 May 2009

1.2 The Impact of Increasing Buy-to-Let Demand on Higher UK House Prices

The raised availability of mortgage finance is known to stimulate the demand for housing (Pain and Westaway, 1996).[13]

The growth of mortgage finance for BTL has been impressively large. As the consultation paper notes, the number of outstanding BTL mortgages increased ten-fold from mid-2000 to reach over one

[12] Andrew Farlow, Oriel College, Oxford „UK House Prices, Consumption and GDP in a Global Context' http://www.economics.ox.ac.uk/members/andrew.farlow/Farlow%20Housing%20and%20Consumption.pdf

[13] Pain, N. and Westaway, P. (1996). Modelling structural change in the UK housing market: A comparison of alternative house price models. National Institute of Economic and Social Research and Bank of England. http://www.niesr.ac.uk/pubs/dps/dp98.pdf

million by 2007, with a total value of over £122 billion. It has been *the* outstanding area of growth in total mortgage financing for UK house purchases (see graph 1 above).

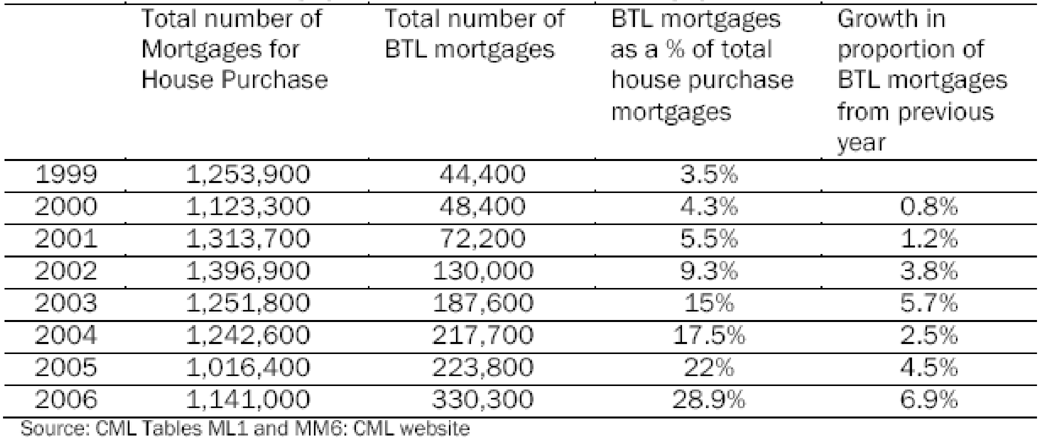
Official BTL financing is almost certainly an understatement of the total level of BTL finance in the UK residential market – given the widespread use of mainstream mortgage finance to fund investment and the large numbers of cash purchases involved. Michael Ball of Reading University estimates that only 54% of BTL landlords use mortgage finance for purchasing their properties.[14] In addition research based on interviews with landlords has confirmed that BTL mortgages are used by around 50% of landlords but are not the only funding mechanism (Stoke-on-Trent CC 2006, unpublished research for Gateway and West Yorks Housing Partnership).[15][16]

Question: 'There is a very large gap in our knowledge of the size and structure of the new PRS sector. What is the government proposing to properly track the number of PRS landlords and properties?'

But even just using the narrow definition of BTL mortgage financing, BTL has grown in the space of just six years from a marginal niche sector to a very large part of the UK housing market. For a market as mature as the UK housing market these trends are very striking.

As table 1 demonstrates, BTL mortgages rose from just 3.5% to 28.9% of total house purchase mortgages in the UK between 1999 and 2006.

Table 1: Buy-to-Let Mortgages and House Purchase Mortgages 1999-2006



	Total number of Mortgages for House Purchase	Total number of BTL mortgages	BTL mortgages as a % of total house purchase mortgages	Growth in proportion of BTL mortgages from previous year
1999	1,253,900	44,400	3.5%	
2000	1,123,300	48,400	4.3%	0.8%
2001	1,313,700	72,200	5.5%	1.2%
2002	1,396,900	130,000	9.3%	3.8%
2003	1,251,800	187,600	15%	5.7%
2004	1,242,600	217,700	17.5%	2.5%
2005	1,016,400	223,800	22%	4.5%
2006	1,141,000	330,300	28.9%	6.9%

Source: CML Tables ML1 and MM6: CML website

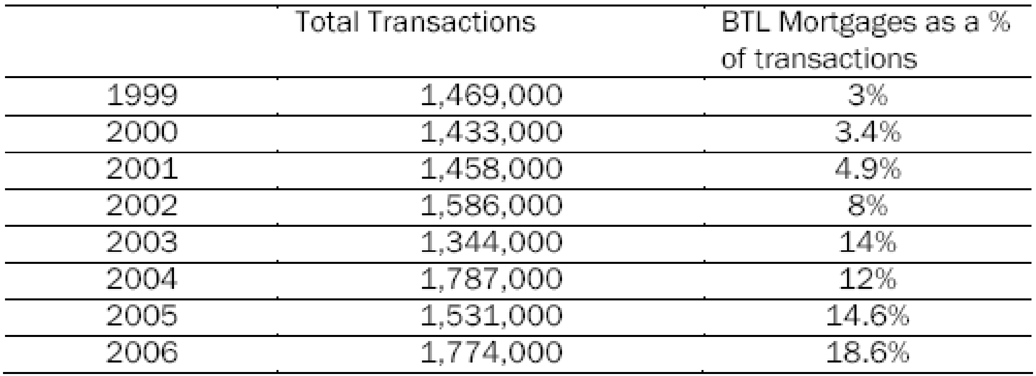
And as table 2 demonstrates, BTL mortgages as a percentage of total housing transactions grew from 3% in 1999 to approaching 20% of transactions in 2006.

Table 2: Buy-to-Let Mortgages as a Proportion of Transactions 1999 - 2006

[14] See Ball, M. (2006) Buy-to-Let: The Revolution Ten Years On – Assessment and Prospects, Association of Residential Letting Agents (ARLA), available at: http://digitalnation.fileburst.com/arla/arla_btl_report_2006.pdf

[15] Stoke-on-Trent City Council (2006) Private Rented Sector Study. On line (www.stoke.gov.uk/ccm/content/hcp/housing_misc/private-rented-sectorresearch-.en)

[16] Cited in Buy-to-let and the wider housing market, Nigel Sprigings, University of Glasgow, People, Place & Policy Online (2008): 2/2, pp. 76-87



	Total Transactions	BTL Mortgages as a % of transactions
1999	1,469,000	3%
2000	1,433,000	3.4%
2001	1,458,000	4.9%
2002	1,586,000	8%
2003	1,344,000	14%
2004	1,787,000	12%
2005	1,531,000	14.6%
2006	1,774,000	18.6%

Source: CLG Live Table 532 and CML Table MM6

Even using the narrow definition of BTL and investor activity, it is clear it that this growth in demand is of a scale that has the potential to drive up prices in a market with comparatively fixed supply.

Any source of funding that has grown in six years from negligible levels to account for nearly 30% of house purchase lending and nearly 20% of housing transactions has the potential to have a "price driver" impact. Given the scale of price rises in the same period it is reasonable to assume that the role of the BTL sector in price rises has been significant.

> *"Residential property markets have been penetrated to significant levels by investment money unrelated to occupancy of the target stock. This has occurred to such an extent that it is no longer primarily household consumer activity that drives the market."*
>
> *Nigel Sprigings, University of Glasgow*[17]

A research paper by the National Housing and Planning Advice Unit (NHPAU) commissioned by the Department for Communities and Local Government found that "there are good reasons to assume that the rapid growth in BTL investment has increased house prices. The record levels of investment could have raised demand and with supply more or less fixed in the short-term, this would help to push up prices."

The study concluded that BTL lending may have increased the average UK house price by 7.4% by 2007.[18]

This was the equivalent of an additional £13,485 on UK house prices ["BTL lending had increased prices by £13,485 (or 7.4%) over and above what they would otherwise have been"]. This dwarfs the average amount spent by FTBs on stamp duty - £1,750 according to Halifax.[19]

Another study on the UK housing market from the independent research consultancy Oxford Economics found BTL purchasers "undoubtedly contributing to the overvaluation of housing".[20]

These national studies are backed by several local studies. One local level study of Glasgow found that one in three landlords explicitly attributed the rental market investment to contributing to higher house prices (Gibb and Nygaard, 2005)[21]. A second local level study also included anecdotal

[17] Buy-to-let and the wider housing market, Nigel Sprigings, University of Glasgow, People, Place & Policy Online (2008): 2/2, pp. 76-87

[18] See *„Buy-to-let mortgage lending and the impact on UK house prices: a technical report'* Ricky Taylor, National Housing and Planning Advice Unit, the Department of Communities and Local Government Website http://www.communities.gov.uk/documents/507390/pdf/684943.pdf

[19] Halifax First Time Buyer Review, December 2007

[20] See http://www.guardian.co.uk/business/2007/aug/06/housingmarket.houseprices

[21] Gibb, K and Nygaard, C (2005) „The impact of buy to let residential investment on local housing markets: Evidence from Glasgow, Scotland' European Journal of Housing Policy 5.3 pp301-26.

evidence that the buoyancy of the private rented sector of Burngreave in Sheffield had contributed to house price inflation (Hickman et al, 2007).[22]

Unsworth (2007)[23], for example, found that the city centre market in Leeds between 2001 and 2004 was driven by speculative investors looking for short-term capital gain. Most apartments were bought off-plan with little regard for the quality of the product or the location. This type of investment is also reported in studies elsewhere in Yorkshire and Humber (Hickman et al, 2007)[24], in Stoke-on-Trent (ECOTEC and SURF, 2006)[25], Manchester and Sheffield (Allen and Blandy, 2004)[26] and Glasgow (Gibb and Nygaard, 2005)[27].

Question: 'Why has the consultation paper not cited any of these papers and the evidence they give of the impact of Buy-to-Let on increased house prices?'

There are a variety of economic models that try to explain the large growth in house prices in the UK over the past ten years. Many are based primarily on assuming the changes are to be explained by an imbalance between housing supply and demand from a growing number of households. However recent experience and other evidence should lead us to be more critical of these assumptions.

The first is the difference between the substantial growth in UK house prices and the static and falling levels of UK market rent levels. If demand from increasing households was the main cause of house price rises this is difficult to reconcile with falling levels of rents.

The second is the long history of cyclical behaviour in the UK housing market and the clear effect that factors such as credit availability, growth in effective demand and expectations have on the pricing of UK housing.

Economist and MPC member David Miles in a study for Morgan Stanley found that expectations of capital gains, rather than supply and demand fundamentals, accounted for nearly 40% of UK house price growth between 1998 and 2008.[28]

As the consultation paper observes, and we explore below, BTL investment since 2004 has, due to very low and negative yields, *been almost solely reliant on an assumption of future capital gain – i.e. expectations of price rises*.

[22] See *„Buy-to-let mortgage lending and the impact on UK house prices: a technical report'* Ricky Taylor, National Housing and Planning Advice Unit, the Department of Communities and Local Government Website http://www.communities.gov.uk/documents/507390/pdf/684943.pdf

[23] Unsworth R (2007) City living in Leeds 2007 KW Linfoot, Morgans City Living and the University of Leeds: Leeds

[24] Hickman P, Robinson D, Casey R, Green S and Powell R (2007) Understanding housing demand: Learning from rising markets in Yorkshire and the Humber Chartered Institute of Housing/Joseph Rowntree Foundation: Coventry/York

[25] ECOTEC and SURF, University of Salford (2006) Dynamics of the private rented sector in Stoke on-Trent ECOTEC: Birmingham

[26] Allen C and Blandy S (2004) The future of city centre living: Implications for urban policy CRESR, Sheffield Hallam University: Sheffield

[27] Ibid

[28] See „How will housing and mortgage markets emerge from the credit crunch?' David Miles, June 2008, Morgan Stanley investor presentation at http://www.niesr.ac.uk/event/wef%202008%20seminar%203%20-%20how%20will%20housing%20and%20mortgage%20markets%20emerge%20from%20the%20credit%20crunch%2023.06.2008/d%20miles%20wef%203.ppt.

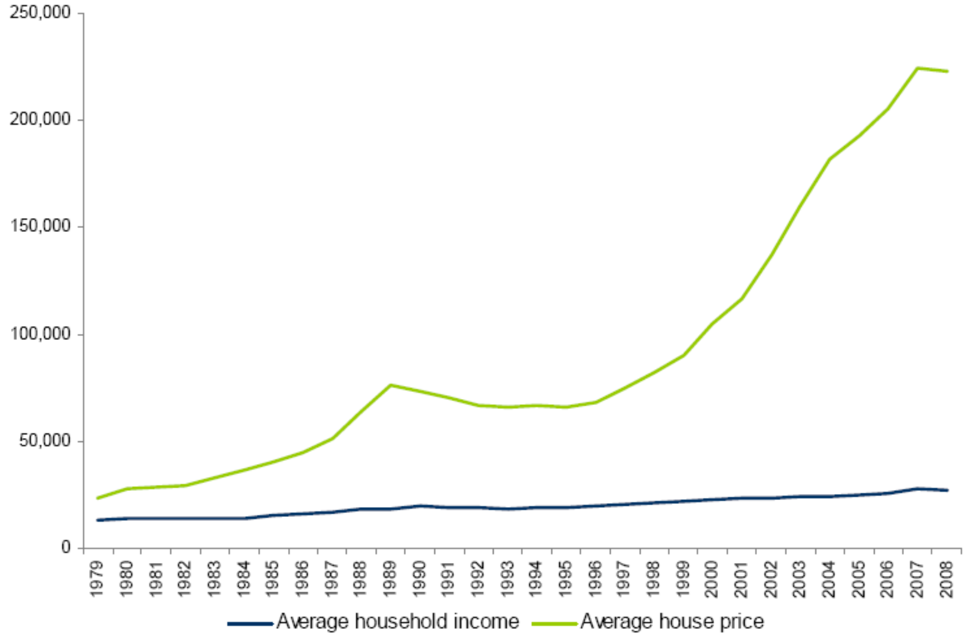
BTL as an investment class has the sole rational of financial gain, rather than the dual use of Owner Occupation where price is balanced against occupier use. It is reasonable to assume therefore that the BTL sector has been an important mechanism through which expectations of price rises have been transmitted and amplified into the UK housing market.

BTL investment has also benefited from the large growth in credit availability and liquidity in the UK mortgage market before 2007. The main UK BTL lenders were also at the forefront of using new financing mechanisms, such as the use of wholesale funding markets and Mortgage Backed Securities issuance, which enabled this credit boom – and left the UK particularly vulnerable to the credit crunch.

Again, it is reasonable to assume that the growth in the BTL sector has been an important mechanism through which excessive credit availability has been transmitted and amplified into the UK housing market – and led to higher UK house prices.

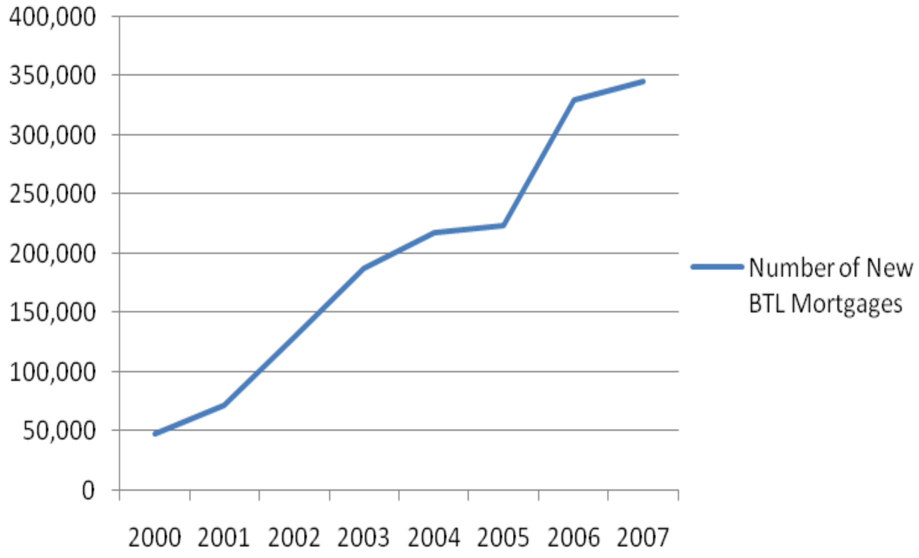
There certainly seems to be a strong correlation between the period of very high growth in BTL lending from 2001 to 2007 and the period of very high growth in UK house prices. The relative novelty of BTL lending is also striking when looking at how UK house prices appear to have departed substantially from long term historical price to income ratios in this matching period (graphs 2 & 3).

Graph 2: UK Average Income and Average House Price 1979 - 2008



Source: Taken from „Time to Stop Betting the House: Mortgages, Resilience and the Long Finance', David Steven, 2010

Graph 3: Number of New Buy-to-Let Mortgages 2000 - 2007



Source: Council for Mortgage Lenders

Question: 'Does the UK government see a relationship between higher residential house prices and the PRS sector?'

Question: 'Is the UK government concerned that the PRS sector's contribution to higher residential house prices acts against government policy aimed at improving housing affordability and leads to negative wider economic and social outcomes? What steps could it take to address this?'

1.3 The Negative Social and Economic Impact of Higher House Prices

> *"The high price of fuel is causing understandable outrage across the country. Transport is, after all, fundamental to our lives. Yet housing is still more important. Moreover, across the UK as a whole, the real price of housing has more than doubled over the past decade. Yet this socially destructive development is, for many, an occasion for self-congratulation. ... Putting the price of housing beyond the means of a large proportion of young people is not merely economically inefficient but socially destructive."*
>
> *Martin Wolf, Financial Times*[29]

- **The Social Costs of High House Prices**

Improving housing affordability and housing conditions are very important strands of government social and economic policy. Yet the past ten years have seen signal failures in several stated government objectives – driven significantly by high house prices.

[29] Financial Times, *September 22 2005, http://www.ft.com/cms/s/1/b7c6d4c4-2b95-11da-995a-00000e2511c8.html*

Housing affordability has worsened considerably, with First Time Buyers now at all time lows. High house prices create more pressure on the social housing market and reduce the amount of housing goods available for people across all income groups. This has led to significant worsening in waiting lists for social housing (a record 4.5 million people in England are on housing waiting lists[30]) and led to overcrowding and housing pressure through the market – particularly for lower income groups and younger age groups.

The range of negative social impacts is wide reaching. To take just two examples, according to the housing charity Shelter, 1.5 million adults say they are unable to look after their elderly parents because they can't afford to live near them whilst 21% of 18–44 year olds, equivalent to 2.8 million people nationwide, are actively putting off having children because of high housing costs.[31]

- **The long term economic costs of high UK house prices**

Increasing house prices do not represent increased levels of wealth, but rather redistribute the future earnings of new buyers into the increased asset values of current owners.

High housing costs also contribute a damaging drag on UK economic performance. They increase personal debt levels, concentrate individual wealth portfolios disproportionately in one asset class and increase vulnerability to external credit shocks. High house prices reduce labour mobility, add an additional cost to UK businesses in higher wages and drain disposable income out of the wider economy. The misallocation of resources impacts on the total level of investment capital available for businesses and wider consumption levels. As Martin Wolf observes, economically, "it is mad to applaud ever-rising prices" [32]

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[30] NHF press release, 8 February 2010

[31] See Shelter research from 1st February and 18th January 2010, http://england.shelter.org.uk/news/february_2010/affordability_crisis_fractures_families and http://england.shelter.org.uk/news/january_2010/housing_costs_forcing_delay_in_having_children

[32] Martin Wolf, Financial Times, July 10 2008 http://www.ft.com/cms/s/0/69ebb588-4ead-11dd-ba7c-000077b07658.html

Chapter 2 – The Financial Impact of Buy-to-Let Investment

In addition to the recent large growth in demand generated by the PRS and its impact on UK house prices, there are substantial reasons to be concerned about the *nature* of this demand.

2.1 Buy-to-Let and Financial Volatility

BTL activity has been highly **volatile**. The number of outstanding BTL mortgages increased ten-fold from mid 2000 to reach over one million by 2007.

To take a more specific example - the rate of growth of BTL mortgages as a proportion of house purchase lending accelerated at a staggering rate throughout 2006. The total of BTL mortgages for the first 6 months of 2006 was 152,000 and in the second half of 2006 it was 177,000. This is a 20% increase in identifiable investor consumption of housing in a very short period.

And as the consultation paper notes (see paragraph 5.16) the number of Buy-to-Let mortgages then fell – with 2008 seeing almost half the level of gross lending than the 2007 peak in lending. In turn, 2009 saw BTL mortgage halve again from 222,700 Buy-to-Let loans advanced in 2008 to 93,500 in 2009 – an additional 58% decline.[33]

The consultation paper is remarkably unreflective of the role this highly volatile pattern of lending played both in house price increases during the period, its impact on total market stability and the impact this has had on house buyers who have either been priced out or now find themselves in negative equity.

Question: 'Why is the government seeking to encourage a more volatile source of market demand in the UK residential housing market? How can the government take steps to ensure that volatility is reduced?'

2.2 Buy-to-Let and Speculative Investment

BTL activity also appears strongly **speculative, which contributes further to its volatile nature**.

The consultation paper admits that BTL investment has been primarily based on the expectation of capital gain: "much of the return to current investment in the PRS comes from capital appreciation, as opposed to rental yield" (paragraph 6.4).

For most BTL investors, *current BTL yields are clearly negative when financing costs, voids and maintenance costs are taken into account.*

One study sponsored by the Department for Communities and Local Government found that: "by 2004, however, net rental yield was clearly moving downwards, making it a less attractive investment proposition in terms of rental income. This indicates that *expected capital gains alone have driven the most recent wave of investment in the sector*" [our emphasis].[34]

Any investment which generates negative income flows and is reliant upon expected growth in capital value *is by its definition speculative investment.* It is surprising the paper is unaware of this and is

[33] Council for Mortgage Lenders, „Buy to Let lending in 2009' http://www.cml.org.uk/cml/media/press/2540

[34] „Rapid evidence assessment of the research literature on the buy-to-let housing market sector', ECOTEC and Professor Ian Cole at the Centre for Regional Economic and Social Research at Sheffield Hallam University, February 2008, commissioned by NHPAU http://www.communities.gov.uk/documents/507390/pdf/684939.pdf

seeking to encourage further speculative investment from the PRS sector into the UK residential market.

Question: 'Why is the government seeking to encourage speculative investment into the UK residential housing market?'

2.3 Buy-to-Let and Investor Financial Vulnerability

As well as being volatile and speculative, BTL lending is also higher risk and more financially vulnerable than mainstream Owner Occupation.

According to the Council of Mortgage lenders the majority of Buy-to-Let lending is based on interest only mortgages. This has possibly substantial longer term negative implications for BTL borrowers who are not making any reduction in their capital debt[35]

Low yields when set against outgoing mortgage costs suggest higher levels of vulnerability to shocks for the BTL sector. Initial poor or negative income flows and the higher possibility of income „shocks' – notably through rental voids – means the ability to ride out short periods of financial stress may be more limited.

BTL investors may state that they are „in it for the long term' but their poor financial yield, when combined with capital losses and negative equity means they are likely to be subject to short term pressures to sell – notably from tighter credit requirements from mortgage lenders.

This is often compounded by gearing – the use of remortgaging from previous properties to invest in new properties, a practice which tends to reduce the overall level of portfolio equity and any cushioning to price falls from previous market rises: a particular problem for as cyclical a market as UK housing.

According to one study almost half of all BTL landlords funded deposits on the purchase of another property by a remortgage on an existing BTL property (Scanlon and Whitehead, 2005).[36]

BTL investment also offers the ability to achieve substantial debt based leverage – unlike most other financial investments (such a practice is illegal for investing in the stock market). According to the CML "the ability to 'gear' their investment by borrowing has been one of the key attractions for Buy-to-Let landlords, allowing them to magnify the benefit of capital gain".[37] This enables BTL investors to multiple the benefits of price rises, but raises the risk of compounding losses from any price falls. This makes BTL a high risk investment with the ability to make losses much higher than the initial investment stake.

BTL investors are also more likely to get into repayment difficulties than mainstream borrowers. In 2009, according to the Council for Mortgage lenders, repossessions of Buy-to-Let properties were higher than in the UK residential mortgage market – substantially so, well over twice the rate, when the „Receiver of Rent' mechanism available to creditors is taken into account.[38]

A study conducted by BDRC for Alliance and Leicester in 2007 added to this concern about BTL financial vulnerability – finding that 29% of BTL landlords were breaking even or making a loss based

[35] The CML do not disclose how high this percentage is. Council for Mortgage Lenders, „Buy to Let lending in 2009' http://www.cml.org.uk/cml/media/press/2540

[36] Scanlon K and Whitehead C (2005) The profile and intentions of buy-to-let investors CML: London

[37] „The growth of Buy-to-Let', CML, *Housing Finance* Issue 09 2006

[38] Council for Mortgage Lenders, „Buy to Let lending in 2009' http://www.cml.org.uk/cml/media/press/2540

upon income (this study did not take into account any additional financial loss from recent declines in capital value).[39]

Question: 'Has the government considered what impact higher levels of BTL financial vulnerability has for the wider residential housing market?'

Question: 'What steps should the UK government take to place limitations on gearing within BTL portfolios?'

Question: 'Is it responsible or sensible for the UK government to be seeking to encourage significant numbers of UK small investors to undertake investment based upon debt based leverage on an assumption of possible capital gain?'

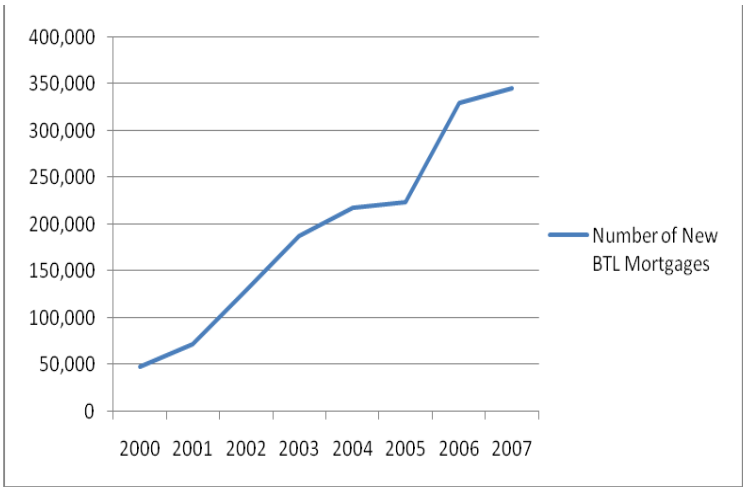
2.4 Buy-to-Let, Wider Financial Stability and Costs to the UK Economy

> *"Some of the lending which has gone on of late has been madness, complete and utter insanity. ... If you've got a portfolio of 20 flats in city centres then God help you. There are far too many of them and they are far too expensive."*
>
> *John Goodfellow, Chief Executive, Skipton Building Society*[40]

The BTL sector has been funded by financing sources that have proven highly unstable. This has not just been a problem for the health of the PRS sector but has imposed very large economic costs on the UK economy and taxpayer. Unbelievably, the consultation paper makes no reference to these highly damaging externalities of the PRS sector.

The main growth period in BTL mortgage finance – between 2000 and 2007 – occurred alongside the growth in reliance of the UK banking sector on wholesale market funding and on Mortgage Backed Securities issuance (see graph 5). This is no coincidence – these funding sources were pioneered by the major UK Buy-to-Let mortgage providers.

Graph 4: Number of New UK Buy-to-Let Mortgages 2000 - 2007

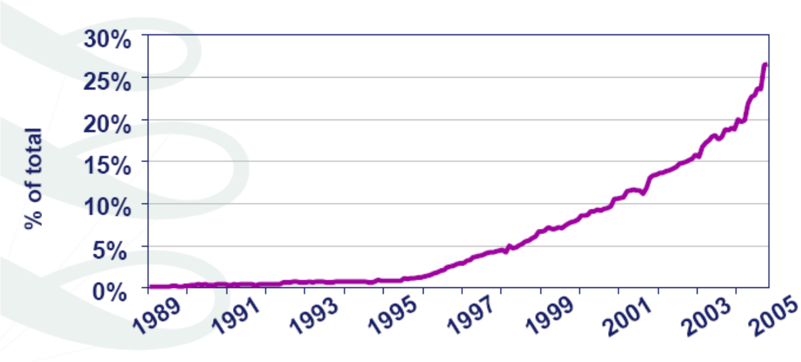


[39] See: http://www.alliance-leicester-group.co.uk/html/media/non-indexed/release.asp?txtTable=pressreleases&txtCode=PR1701071

[40] Interviewed in Scotland on Sunday, 24th February 2008

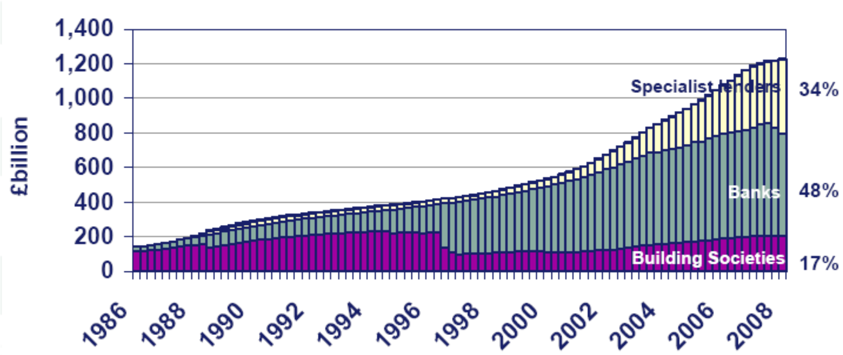
Source: Council for Mortgage Lenders

Graph 5: Estimated Share of Securitised Loans in UK Mortgage Lending



Source: FSA calculations, Bank of England, ONS, taken from „The Mortgage Market: Issues for Debate', Adair Turner Chairman FSA Mortgage Conference 12 May 2009

Graph 6: UK Mortgage Balances Outstanding by Type of Lender



Source: FSA calculations, Bank of England, ONS, taken from „The Mortgage Market: Issues for Debate', Adair Turner Chairman FSA Mortgage Conference 12 May 2009

This higher risk sources of financing coupled with higher rates of BTL loan impairment has meant that ***eight of the top nine UK Buy-to-Let lenders in 2007 have now either been rescued by the tax payer after threatened bankruptcy, are closed for further business or have been badly damaged by the financial crisis and are undergoing substantial retrenchment (see table 3).***

This is an astonishingly high casualty rate – much higher than in mainstream Owner Occupation mortgage lending during the credit crunch- and is perhaps unprecedented in the history of modern UK mortgage lending.

Table 3: Top 10 UK BTL lenders in 2007 and Current Trading Status

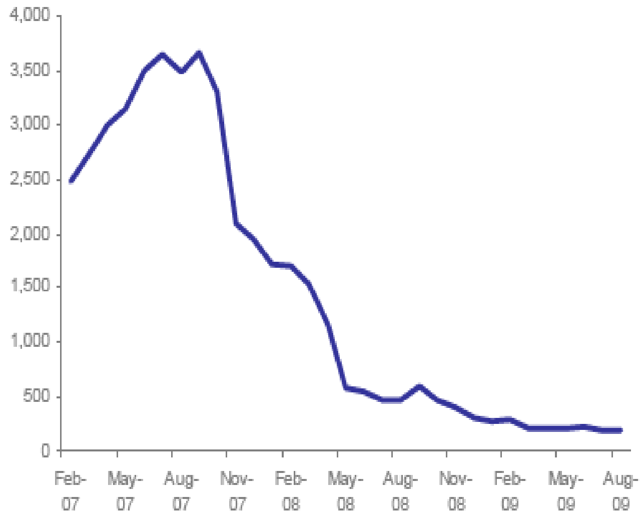
	Lender	***Parent Company***	***Current Status***
1	Mortgage Express	Bradford & Bingley	Closed to new business after parent company nationalised to prevent bankruptcy
2	Birmingham Midshires	HBOS	Trading at reduced volumes & parent company taken over and part nationalised

3	Paragon Group	-	Substantial restructuring, emergency rights issue and has ceased trading new mortgages
4	Bristol & West Group	Bank of Ireland	Ceased trading and parent company part nationalised
5	Cheltenham & Gloucester	Lloyds TSB	Trading at reduced volumes, parent company part nationalised
6	Northern Rock	-	Nationalised to prevent bankruptcy
7	Capital Home Loans	Irish Life & Permanent	Ceased Trading
8	Mortgage Works	Nationwide	Substantially reduced business
9	Mortgage Business	HBOS	Ceased trading and parent company taken over and part nationalised
10	Woolwich	Barclays	Continued trading

Source: CML / Paragon Mortgages ranked by balances outstanding in 2007[41]

This list of mainstream BTL lenders excludes substantial numbers of non-balance-sheet UK BTL mortgage originators who traded via specialist mortgage brokers – see graph 6 - for example GMAC RFC. Many of these have these have now ceased trading (see graph 7).

Graph 7: Live Buy-to-Let Products Feb 2007 – Aug 2009



Source: CML and Paragon Mortgages[42]

[41] Quoted in „BTL credit performance, underwriting and regulation’ presentation by John Heron from Paragon Mortgages to the CML, September 2009 http://www.cml.org.uk/cml/filegrab/JohnHeronpresentation.pdf?ref=6576

[42] Quoted in „BTL credit performance, underwriting and regulation’ presentation by John Heron from Paragon Mortgages to the CML, September 2009 http://www.cml.org.uk/cml/filegrab/JohnHeronpresentation.pdf?ref=6576

Case Study: Buy-to-Let and Bradford & Bingley

Bradford & Bingley was the UK's largest provider of Buy-to-Let residential mortgages through its Mortgage Express brand. At the end of June 2008 its Buy-to-Let loans totalled almost £25bn out of a total mortgage book of £42bn

Before its nationalisation, Bradford & Bingley's shares had dropped 94% to 20p, the bank had undergone three failed attempts at rights issues and had failed to attract any alternative buyers. Intervention from the UK government led to the taxpayer underwriting a loan book of almost £900 million.

Bradford & Bingley's troubles stemmed from the quality of its loan book. Arrears – the percentage of loans not paid for three months or longer – were substantially higher at B&B than its peers. Most of its mortgages are Buy-to-Let, where values have fallen sharply, or self-certified, where borrowers do not have to offer any proof of their salary. In March 2009, B&B reported an extraordinary 20-fold increase in bad debts, rising from £22.5m in 2007 to £508m in 2008. The number of its mortgages three months or more in arrears trebled to 4.6% of its book in the last quarter of last year compared to 1.6% a year earlier.[43][44]

Question: 'What role did the financing model of Buy-to-Let lending play in the recent financial crisis and recession? Has HM Treasury sought to learn any lessons from this?'

Question: 'What role did the financing model of Buy-to-Let lending play in the collapse of Bradford and Bingley and other mortgage lenders? How much did this cost the UK economy in intervention costs and what impact has it had on damaging the reputation of the UK's financial sector?'

Question: 'Why was BTL mortgage lending not under FSA regulatory supervision?'

Question: 'Is the government prepared to accept these large damaging externalities caused by the PRS sector on the UK economy? What steps could it take to reduce the speculative element of BTL investment and recoup losses through additional taxation on the sector?

[43] http://www.propertyweek.com/story.asp?storycode=3124161

[44] http://www.guardian.co.uk/money/blog/2009/mar/31/buy-to-let-scandal-exposed

Chapter 3 – Buy-to-Let and its Negative Impact on First Time Buyers

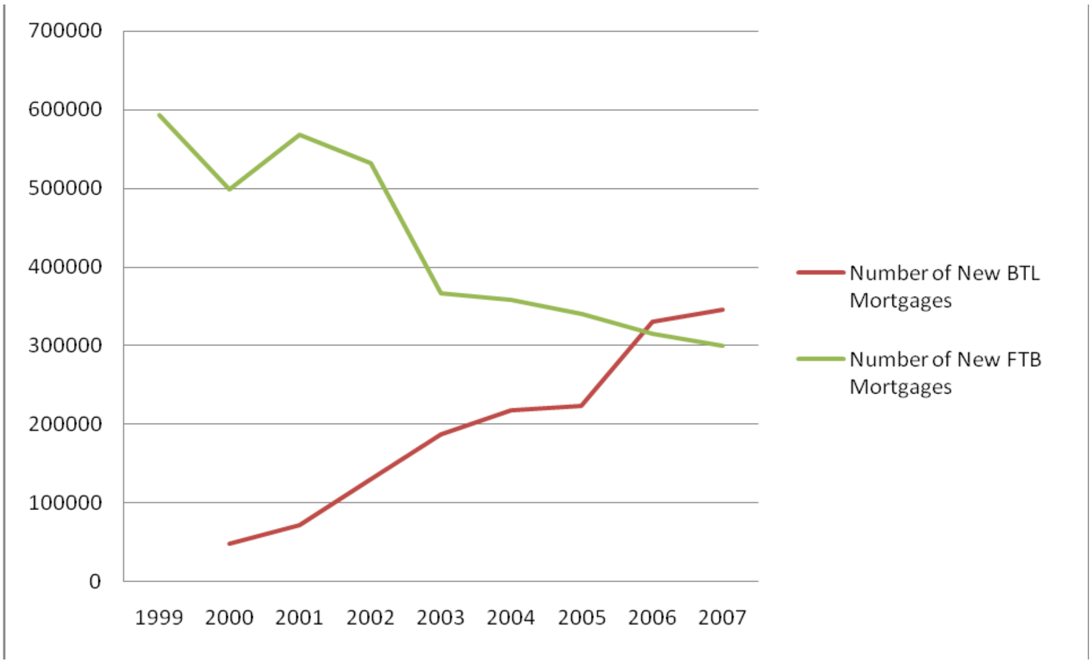
> *"It has become much harder for First-Time Buyers to get onto the housing ladder in recent years. There were less than 200,000 in both 2008 and 2009, less than half the longer-run average."*
>
> *Council for Mortgage Lenders*[45]

3.1 Buy-to-Let and First Time Buyers

First Time Buyers have been increasingly unable to enter the UK property market. As we have seen, the BTL sector has played a very important role in causing this. BTL has been an important driver for much higher UK house prices, BTL has absorbed many more homes than the private sector has been able to build (see Chapter 6) and has been competing directly with FTBs for the type of properties that FTB would have previously typically bought.

As graph 8 shows, there is a striking correlation between declining numbers of First Time Buyers and increasing numbers of BTL mortgages over the past ten years.

Graph 8: New Buy-to-Let and First Time Buyer Mortgage Lending 1999 - 2007



Source: CML BTL mortgage lending data, Halifax First Time Buyer Review 2007

Analysis from the National Housing and Planning Advice Unit (NHPAU) suggests "that as many as 1.2 million „new' households cannot be formed in England alone because high housing costs oblige young adults to stay at home or sharing".[46]

In addition, RICs have calculated that high house prices have led to around 1.4m fewer First-Time Buyer mortgages since 1999.[47]

[45] Source „Affordability and First Time Buyers', CML Housing Finance Issue 01 2010)

[46] „Affordability – more than just a housing problem', NHPAU, May 2009

The assumption contained in the consultation paper is that greater levels of FTB postponing home ownership and renting is one of choice – due to greater flexibility and cultural changes (paragraphs 2.4 & 2.7). Unfortunately this isn't supported by the evidence.

In a recent survey by Rightmove, 61% of people who expected to live in a rented property for 2010 said they would like to buy a home but could not afford to do so. Just 13 percent of people who plan to rent said they were doing so out of choice, rather than necessity.[48]

Why have BTL investors been able to displace FTBs? The primary cause is the significant financial advantage that BTL investors have over FTBs when buying UK residential property.

This is something that the consultation paper hints at in paragraph 2.6 when citing figures that "in 2007, rents [were] around 24% to 40% lower than mortgage payments for the same property" – in a market where BTL had an equal financial footing to FTBs how could this disparity occur?

There are two significant components of BTLs financial strength over FTBs:

- BTL investors use financial products that give them greater purchasing power than FTBs
- BTL investors have substantial advantages under the UK tax system over FTBs

3.2 Buy-to-Let, Financial Products and Purchasing Power

BTL investors benefit from using financial products that give them greater purchasing power than First Time Buyers.

There are two areas where this is pronounced:

- ***Interest Only vs. Repayment Mortgages***

According to CML "most Buy-to-Let mortgages are taken out on an interest-only basis"[49] (Although it does not publish a precise figure so it is difficult to gauge how large this percentage is, the mortgage product profile of the major UK BTL lenders suggests that it is a very substantial amount of BTL mortgages).

In contrast a large majority of FTBs use repayment mortgages. In December 2009, 90% of mortgages advanced to First Time Buyers were repayment mortgages.[50]

The use of interest only mortgages means that an investor does not have to pay the additional costs of paying down the overall capital – giving them additional purchasing power in the housing market relative to First Time Buyers. This additional purchasing power increases the lower that levels of interest rates are – something of greater relevance in the low interest rate environment of the past decade.

[47] http://www.telegraph.co.uk/finance/newsbysector/constructionandproperty/2821472/First-time-buyers-set-to-rescue-house-prices.html

[48] http://www.telegraph.co.uk/finance/personalfinance/borrowing/mortgages/7261604/House-prices-60pc-of-renters-are-priced-out-of-the-market.html

[49] http://www.cml.org.uk/cml/media/press/2272

[50] http://www.cml.org.uk/cml/media/press/2543

Question: 'Should interest only mortgages be permitted to be used by BTL investors? Should capital repayment vehicles be made a mandatory obligation for BTL investors?'

- ***Yield vs. Affordability***

BTL investors and lenders also tend to calculate the rationale of their investment based upon yields and the efficiency of capital allocation, rather than more traditional levels of affordability ratios of price to income.

FTBs are looking at the cost of somewhere to live based against their incomes and lenders look primarily at lending to income ratios.

Although there are many variables in calculating what this means for the overall level of pricing of UK housing, *in a market of limited supply a large BTL market presence would tend to push up the price of housing to a level at which it becomes reflective of the marginal profit rate between rental income and overall income yield.*

In an environment of high housing demand and low levels of either financing cost or alternative returns on investment (for example from a savings account) this price rationale for individual UK properties would tend to be higher than traditional price to income ratios used by First Time Buyers.

This again gives PRS investors an advantage over First Time Buyers

These financial advantages also pose concerns about the role the PRS sector may have in increasing risk levels for FTBs. In raising the overall market price level for typical First Time Buyer properties, BTL financing also raises the overall risk level for potential First Time Buyers. BTL investors are taking substantial risks on debt gearing ratios, their assumption of capital gain and in their ability to pay the final capital value upon loan maturation. If they want to compete in the same market, FTB's have to expose themselves to these levels of risk and vulnerability on market pricing.

This concern is backed up by historical data analysing FTB mortgage financing. In 1984, the average FTB used income multiples of 1.99 to obtain a mortgage, by 2004 this figure was 3.03. In the mid 1990s only 1 percent of FTB mortgages were based on income multiples of 4.0 or above, by 2005 this applied to 20 percent of them. [51]

Question: 'What is the government's view of the impact of BTL financing on UK residential house pricing? Is it concerned about the implications this has for FTB risk exposure?'

3.3 Buy-to-Let and Tax Advantages over First Time Buyers

BTL investors currently benefit from significant tax advantages over First Time Buyers.

BTL investors are able to deduct interest payments as a business cost against tax. As the majority of BTL investors use interest only mortgages this means the main financing costs of purchase is tax deductable. BTL investors are also able to deduct other expenses, such as repairs, insurance, legal costs, against the cost of their „business'.

Any gains that a BTL property is gifted from rising property values are also taxed at an 18% rate through capital gains tax - lower than the tax a FTB would pay on earned income. BTL investors would also get an annual capital gains exemption for each owner (e.g. husband and wife) of £8000.

[51] „Affordability – more than just a housing problem', NHPAU, May 2009

First Time Buyers, in contrast, have to pay their mortgage costs out of net income. They have to pay for any repairs, insurance and legal costs from net income. This represents a significant loss of purchasing power.

The CML have recently conducted analysis that helps illustrate how large this disparity in purchasing power is from tax advantages and the use of interest only mortgages.

According to CML the average proportion of income First-Time Buyers spend on mortgage interest payments in August 2009 was 15% of *gross* income.[52]

However, most First Time Buyers have repayment mortgages and all have to pay mortgages after paying income tax. CML have also estimated that the typical capital and interest payments of an average First Time Buyer in 2009 would represent about 29% of take-home income.[53]

This gives a good indication of the impact that tax disadvantage and use of repayment mortgages has on FTB purchasing power over BTL purchasers. Assuming a similar income profile, ***BTL investors' mortgage costs – given their tax advantages and use of interest only mortgages – amount to just over a seventh of their net income, whereas FTB average mortgage costs amount to a nearly a third of net income.***

This is a very large gap and one that help explains how, on the same income, a BTL investor will be able to pay substantially more for any one property. It also may help explain why UK data on First Time Buyer purchases since 2003 has appeared to depart so substantially from historical price to income ratios.

In a UK taxation system that has a long history of being both progressive and in favour of Owner Occupation. In a political climate where support for FTBs is given much emphasis this distortion against FTBs is striking. The tax advantages for the BTL sector are both regressive and create a distortion that helps imbalance the UK residential market – which is widely perceived as having negative knock on effects for social outcomes.

> *"Taxation of property should be heavier, not lighter. But it should also be less regressive. ... Higher taxation would also lower the intensity of property speculation. Can anybody doubt the damage that highly geared purchases of property can do to the financial sector, the economy and even the purchasers? The British have become a nation of property speculators. Today, as usual, the hope is that houses should be as expensive as possible. But a house is a place to live, not a good way for people, let alone a nation, to become rich. ... the UK should try to raise more revenue from property taxes."*
>
> *Martin Wolf, Financial Times*[54]

Levels of taxation on property in the UK are already extremely low when compared to income and to other assets.[55] Whilst avoidance of Capital Gains Tax, particularly by BTL investors, is widespread. CGT avoidance includes changing the assignment of primary residence to gain total exemption at sale. Another is the ability of BTL investors to release funds through remortgaging – which postpones the payment of capital gains, and if the property is never sold the capital gains tax due is never paid.

[52] http://www.politics.co.uk/opinion-formers/press-releases/employment/cml-media-note-in-advance-of-mpc-decision-$1332671$364298.htm

[53] This was based on an estimated effective tax rate for recent first-time buyers in 2009 was about 25%. Source „Affordability and First Time Buyers', CML Housing Finance Issue 01 2010

[54] Financial Times, September 24 2009

[55] See „A Survey of the UK Tax System' Institute of Fiscal Studies, April 2009

Question: 'Why is the UK government giving tax advantages to private investors who create little or no additional wealth for the UK economy?'

Question: 'Why is the UK government not seeking to remove the distortion in favour of BTL investors over First Time Buyers and Owner Occupiers?'

Question: 'Why is the UK government seeking to increase tax distortions in favour of BTL investors over FTBs?'

The proposal put forward in the consultation paper on Stamp Duty Land Tax (SDLT) to reduce the tax burden on multiple property purchases from property investors (see paragraph 6: *"in most cases this would result in a lower SDLT bill, it will never result in a higher bill")* would further increase the tax advantage of BTL investors over Owner Occupiers and First Time Buyers. This proposal is highly worrying and difficult to justify either on wider economic or social grounds – particularly at a time of such pressure on public finances.

Question: 'What loss of revenue would the SDLT tax break cause to the UK exchequer?'

Question: 'What additional revenue to the UK government could the PRS sector contribute through higher taxation?'

Chapter 4: Institutional Investment and the UK residential property market

4.1 Institutional Investment and Increased Demand in the UK Housing Market

The aim of the government to increase institutional investment into the UK residential housing market amplifies many of the concerns about the impact of Buy-to-Let from individual investors.

As already noted, increasing the volume of money in a market with relatively fixed supply will lead to an increased upwards pressure on house prices.

This is something the consultation paper recognises, albeit does not put great emphasis on (see paragraph 6.22; *"Additional investment, particularly if geographically concentrated, and/or directed into the existing stock, could be expected to have some impact on house prices"*).

The total additional volume of finance available through external financial investors is potentially very large indeed – be it from UK pension funds, property unit trusts or other financial vehicles be they UK based or global. Such large financial flows into the UK residential property market would undoubtedly have a powerful upwards impact on UK house prices. The consultation paper cites approvingly the £25 billion worth of property funds under the management of just one institutional investor, Avia Investors [paragraph 6.14]. Yet £25 billion represents nearly 20% of gross annual UK residential mortgage lending in the UK – enough to have a very substantial price impact.[56]

4.2 Institutional Investment and Volatility

Increasing reliance on funding from investment finance is also likely to increase the volatility of the UK residential housing market.

The experience of the UK commercial market over the past six years is instructive here.

Between 2004 and 2007, UK commercial property saw huge net flows into Property Unit Trusts (PUTS), Limited Partnerships and other indirect investments. The traditional investor base of UK pension funds also broadened to include high-net worth and overseas investors and growing numbers of retail investors.

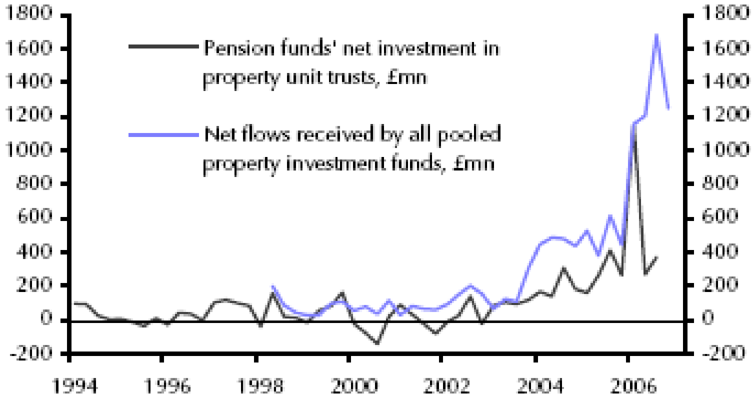
Pooled property funds, invested £7.7bn of new money between 2004 and 2006, over six times larger than net investment in the previous three years. In 2006 alone, retail investors placed a net £3.6bn into commercial property funds. [57] Another source estimated that new small investors put about £15bn into property unit trusts - £5bn pouring in during 2006 and early 2007 alone.[58] As graph 9 shows, this rapidly increased the volume and type of money entering the UK commercial property market.

[56] CML data, Gross Mortgage Lending in 2009 was £143,506 million.

[57] Capital Economics, „UK Commercial Property Focus', May 2007

[58] Guardian 18 Jan 2008 http://www.guardian.co.uk/money/2008/jan/18/property.moneyinvestments

Graph 9: Net Investment in Indirect Commercial Property Investment Vehicles, 1994 – 2006, £million



Source: ONS, Association of Real Estate Funds, Capital Economics[59]

As Capital Economics has noted, these new funds represented additional risk factors that were not present in previous UK commercial property cycles.[60] The short term and global nature of these funds made a reversal more likely even through small changes in perceptions of investor risk from UK residential property or the UK economy.

Commercial property markets were therefore more vulnerable to a shift in investor sentiment and in 2007 these indirect investment flows went into reverse and acted as a catalyst for a very large market correction. In the period since 2007, UK commercial property prices collapsed 44% in just over two years – twice as fast and nearly twice as hard as the 1989-93 crash.[61]

Question: 'How desirable is increasing the volume of volatile external investment flows into the UK residential property market?'

4.3 Wider Policy Implications for the UK Housing Market

In the context of the stated UK government policy objective of improving housing affordability, it is by no means clear that the increase in supply that could be gained from additional investment capital would outweigh the negative effects of higher market prices that this capital could cause. Nor is it clear from the consultation paper that the government is thinking of these questions.

Given the size of the total UK housing market stock, any additional supply boost from new investment capital is likely to be very small and thus result in a relatively small downward pressure on prices. In contrast, investment capital inflows impact on residential market demand is likely to be immediate and large.

The consultation paper is not clear in how the government would seek to address questions of how to limit the impact of institutional investment capital on the wider residential market. Given the size of potential new investment flows, this is worrying.

[59] Capital Economics, „UK Commercial Property Focus', May 2007

[60] Capital Economics, „UK Commercial Property Focus', May 2007

[61] Financial Times, September 18th 2009 http://www.ft.com/cms/s/2/d6ff1cea-a47a-11de-92d4-00144feabdc0.html

Nor is it clear that the public benefit to be gained from any additional levels of market supply would justify the continued tax breaks already offered to institutional investors in UK property through the UK Real Estate Investment Trust (REITs) and the disadvantage this gives to Owner Occupiers and First Time Buyers.

The consultation paper only asks question relating to the barriers facing institutional investment in the UK residential property market and what could be done to reduce these. It does not raise any questions about the negative impacts on the wider residential market and the potential social and economic downsides associated with this (see paragraph 6.22; *"the Government is ... interested in any evidence of the net benefits institutional investors might bring to the UK residential property market"*). It seems odd for a government committed to evidence-based policy making to only be asking for evidence supporting one side of a cost benefit analysis.

Question: 'Why is the consultation paper not interested in further understanding the potential negative impacts of increased investment flows into the UK residential property market?'

There are much wider political questions to be raised for a strategy to increase global investment flows into a housing market that has such important social linkages and distributional consequences.

The UK residential housing market has previously been one that is substantially socially imbedded with market pricing based upon ratios of average wages and often (in the case of building societies) collective local saving and lending institutions.

The step to explicitly encourage financial flows into the UK residential property market from investment vehicles is one that would lead to the further financialisation of the residential market and of residential market prices. This potentially brings with it substantial negative social and distributional impacts.

Chapter 5 – Buy-to-Let, Housing and Wealth Distribution

> *"The trouble here is that housing bubbles (unlike other investment bubbles) do not generate an increase in income-generating assets. Yes, if people rent out property, they make money. They may also benefit from the rise in prices. But this is mainly a question of redistributing wealth."*
>
> *Andrew Farlow, Oriel College, Oxford*[62]

> *"The money borrowed by young families ended up in the bank accounts of older households…The increase in house prices over the decade to 2007 – and the massive financial flows associated with that appreciation – represent a huge redistribution of wealth between different households within our society."*
>
> *Spencer Dale, Bank of England Chief Economist*[63]

> *Quote: "[UK] Landlords tend to be wealthy, with relatively high numbers found in the groups with the highest income, highest socio-economic status or those living in the wealthiest neighbourhoods."*
>
> *Mintel 2007*[64]

5.1 Housing and Growing UK Wealth Inequality

Several studies (ONS, IPPR and recently David Willetts)[65] identify increasing ***inequality in housing wealth as an important driver of widening inequalities in wealth distribution in the UK*** – both between social classes and between generations.

IPPR identify increasing inequality in housing wealth as one of the main drivers of overall levels of UK wealth inequality.[66]

The Office for National Statistics „Wealth in Britain' study, covering the 2006-08 period, showed that UK household wealth disparities far outstrip those of disparities in income. The wealthiest half of UK households had 91% of UK total wealth. The wealthiest 10% own 44% of the country's personal assets and were nearly five times more wealthy than the bottom half.

Household wealth, estimated at £9,000bn, is dominated by pensions and property assets, each accounting for two-fifths of the total. The other components, financial wealth and physical wealth – such as cars and antiques – each accounted for one-ninth of the total.

Property wealth is more unevenly distributed than income and physical wealth. 30% of households have no or negative household wealth, whilst the distribution of property wealth represented a Gini coefficient of 0.62 – a high level of inequality (the Gini coefficient takes a value between 0 and 1, with 0 representing a perfectly equal distribution and 1 representing „perfect inequality'). For comparison,

[62] „UK House Prices, Consumption and GDP in a Global Context', Andrew Farlow http://www.economics.ox.ac.uk/members/andrew.farlow/Farlow%20Housing%20and%20Consumption.pdf

[63] Spencer Dale speech, „Separating Fact from Fiction', 24 September 2009. Available: http://www.bankofengland.co.uk/publications/news/2009/071.htm

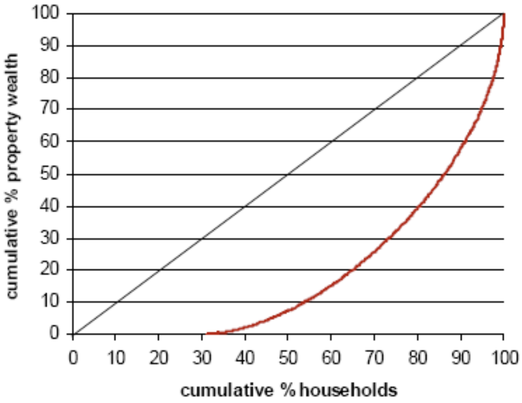
[64] Quoted in „BTL credit performance, underwriting and regulation' presentation by John Heron from Paragon Mortgages to the CML, September 2009 http://www.cml.org.uk/cml/filegrab/JohnHeronpresentation.pdf?ref=6576

[65] „The Pinch: How the Baby Boomers Took Their Children's Future – and Why They Should Give it Back', David Willetts, Atlantic Books, 2010

[66] „Housing Wealth: First timers to old timers' Dominic Maxwell and Sonia Sodha, IPPR, June 2006

in 2007 the UK's income equality Gini coefficient was 0.36, Brazil's was 0.55 and South Africa's was 0.58.[676869]

Graph 10: UK Distribution of Net Household Property 2006/08



Source: Office for National Statistics

Inter generational inequalities in housing wealth are now highly pronounced. According to new data, the aggregate value of housing wealth held by those aged 50 to pension age – 60 for women and 65 for men (7.1 million people) – was £1,280bn, more than twice the housing wealth held by any other age group. The next wealthiest group were those between pension age and 75 (5 million people), whose housing wealth was £600bn. This is despite these groups being smaller in population terms that the 35-44 age group (8.9 million).[70]

There are also clear signs that the ability of younger age groups to access housing assets is increasingly dependent upon existing family wealth. In 2008, 80% of First Time Buyers under the age of 30 relied on parental assistance.[71]

5.2 The Distributional Impacts of the Private Rented Sector

However the distributional impacts of the PRS sector, both through its macro level impact on increasing housing prices and in the rents PRS investors secure over tenants – many of whom may be priced out First Time Buyers – are completely unexamined in this consultation paper.

Most PRS investors are existing Owner Occupiers, from wealthier parts of the population and demographically older.

[67] Property wealth appears to be a very important factor driving the wealth of medium to well off income groups. From the 4th to the 8th deciles of the UK population, net property wealth is the largest component of total wealth; it is most important in the 5th and 6th deciles, where it made up over half of the total, in the 9th and 10th deciles, net property wealth accounted for 39 and 32% of total wealth respectively.

[68] Office of National Statistics, „Wealth in Britain' Survey, 2010. http://www.statistics.gov.uk/downloads/theme_economy/wealth-assets-2006-2008/Wealth_in_GB_2006_2008.pdf

[69] UN Human Development Report 2009 http://hdrstats.undp.org/en/indicators/161.html

[70] See Financial Times, 16 February 2010, http://www.ft.com/cms/s/0/c3cc07bc-1b3c-11df-953f-00144feab49a.html#

[71] Council for Mortgage Lenders data

The growth of the PRS sector represents a greater concentration of wealth in the hands of private investors. In the short term the advantages the PRS sector hold over FTBs allows them to collect rents from priced out potential buyers. In the long term it also further concentrates the distribution of this asset – diverting it away from the broader base of Owner Occupiers and diverting the wealth uplift from rising property prices into a smaller number of hands.

The tendency of house prices to rise is also, in large part, the function of explicit government intervention – through restricting development via the planning system and the failure to counter balance the resulting excess levels of demand through higher levels of property taxation or other forms of demand management.

Unlike other investments, gains from increasing house prices are not the result of increased productivity growth or economic innovation but are much more characteristic of a windfall based upon capturing of value from within a state controlled market.

Question: 'What role would a growing PRS sector have in further concentrating wealth inequality?'

Question: 'To what extent does the PRS sector capture of further housing capital gains represent a windfall and how could the government seek to recoup this windfall from the PRS sector?'

Question: 'Why is the government seeking to give further tax advantages to property investors in an asset that is so unequally distributed?'

Chapter 6 – Housing Supply, Buy-to-Let and the Impact on Owner Occupation

6.1 Buy-to-Let and UK Housing Supply

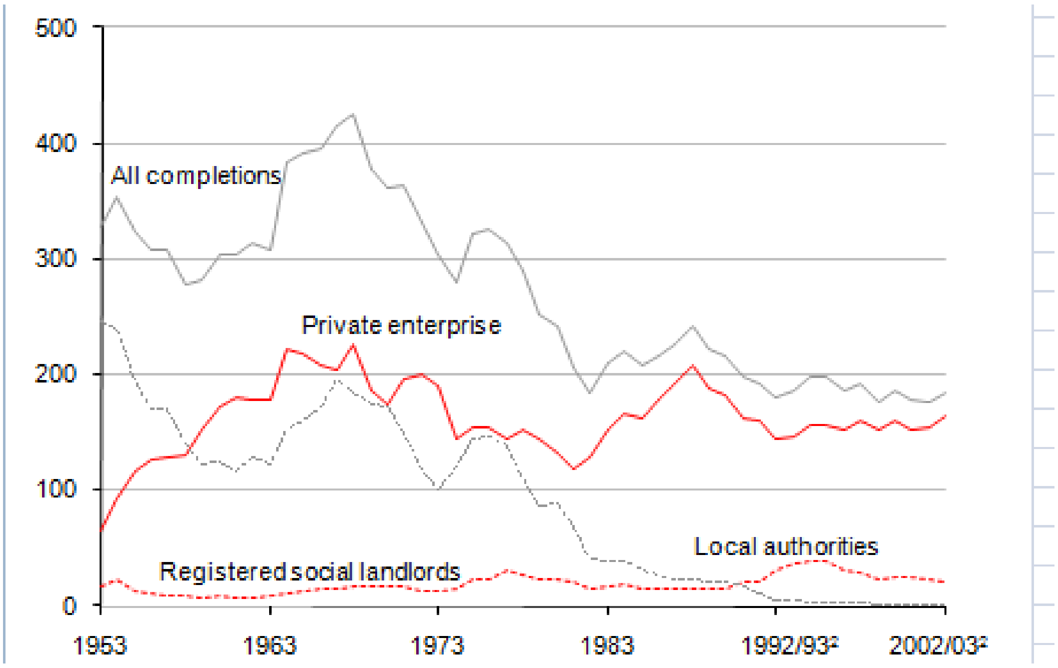
The consultation paper asserts that PRS has been a positive force for new housing supply. Yet this issue is not explored in any rigorous way.

- The consultation paper fails to consider in any robust way the relation between PRS demand and the supply response of the UK housing stock.
- The consultation paper also considers supply only in the context of the PRS sector – without considering its impact on supply within the Owner Occupation sector (see paragraph 5.7).

Has the PRS sector been a significant driver in new supply?

Between 2002/2003 and 2006/2007 – a period of very large growth in the BTL sector, when BTL mortgages rose by over 100% - new housing completions rose from 124,460 to 145,680 – an increase of just 17%.[72] Any supply response that can be attributed to the BTL sector is therefore clearly not a very powerful one. Nor is it one that adequately compensates for the overall increase in BTL demand – the annual increase in market housing supply between the year 2002/03 to the year 2006/07 represents only a fifteenth of the total number of BTL mortgages taken out in 2006/07.

Graph 11: UK Housebuilding Completions by Sector (Thousands)



2. From 1990/91 data are for financial years
Source: ODPM; National Assembly for Wales; Scottish Executive; Department of the Environment, Northern Ireland, ONS

It also doesn't look convincing when compared against long term trends in historical supply (graph 11).

[72] Communities and Local Government House Building Statistics, via ONS website

145,680 new private sector completions are clearly moderate when compared to previous high private sector house building periods in the 1980s, 1960s and 1950s. As Buy-to-Let did not exist in the previous periods, it is worth the government considering in more detail what drove these previous high levels of private sector house building.

Nor does the consultation paper factor in the slump in house building that has occurred in 2008/09 and 2009/10 – caused in large part by the consequences of the loose lending and financial instability to some extent inherent in the BTL boom period.

What is also clear from this historical graph of completions is that the primary area of government policy failure for the past thirty years has been a gross failure to build adequate levels of social housing – despite us being a much wealthier society. The main „housing supply gap' has been a social housing not a private sector one.

6.2 BTL Impact on Supply in the Owner Occupation Sector

As table 4 demonstrates, in every year from 2003/4 to 2008/09, the number of Buy-to-Let Mortgages outstripped the number of new market housing completions.

In these six years, between 2003/04 and 2008/09 the net loss of total UK housing market supply from Owner Occupation to BTL mortgage purchasers was 647,300 dwellings. In short, despite substantial levels of private sector house building, BTL purchases has led to the stock of Owner Occupation houses declining by nearly two thirds of a million homes. ***Rather than building new homes, since 2003 government housing policy has effectively removed at least 647,300 British homes that First Time Buyers can buy – flying in the face of government rhetoric to be helping First Time Buyers***.

Table 4: Net Annual Loss of Owner Occupation to BTL dwellings in UK Housing Supply 2003 - 09

	New UK Private Sector Housing Completions	New UK Buy-to-Let Mortgages	Net Annual Loss of UK Housing Supply from Owner Occupation to BTL
2003/04	172,360	187,600	15,240
2004/05	184,500	217,700	33,200
2005/06	189,680	223,800	34,120
2006/07	192,130	330,300	138,170
2007/08	187,230	346,000	158,770
2008/09	139,250	222,700	83,440

Sources: DCLG housing statistics and Council for Mortgage Lenders data

It is important to note that this is probably a *dramatic understatement of the likely total size of the BTL sector* given the widespread use of other sources of finance to source BTL investment. Michael Ball from Reading University estimates that only 54% of BTL landlords use mortgage finance for purchasing their properties, and not all of this mortgage finance will be in the form of BTL mortgage finance.[73]

This finding is backed up by other studies looking at new build supply. A survey of who bought new homes in London in 2006 by the Greater London Authority and the London Development Agency found that only 30% of purchasers were by Owner Occupiers whilst the remaining 70% were property investors.[74]

Rather than contributing to new supply towards Owner Occupation, the BTL sector is depriving it of supply.

> *"What is also quite clear is that far from „adding to supply' and helping to expand the housing market, BTL investment is simply* ***switching ownership of a fairly static stock****. Since 2003 BTL purchases have significantly exceeded the level of new supply (measured as new completions) so they are eroding the stock owned by household owner occupiers. ... [This] is a significant issue for housing policy predicated on promoting home ownership."*
>
> *Nigel Spingings, University of Glasgow*[75]

It would be more accurate for the consultation paper to say that, rather than have an overall net positive effect on market supply, BTL has redistributed current and new supply away from Owner Occupation and to the PRS sector.

Question: 'Is it a government objective to reduce the number of homes available for Owner Occupation in the UK?'

Question: 'Is the government happy that despite six years of private market house building there has been a net loss in property available for Owner Occupation?'

Given the widespread political and local opposition to building new houses, it is also worrying that all new supply since 2003 has been so heavily negated by the growth of the BTL sector.

This evidence undermines government arguments around the need to build homes for „First Time Buyers' and risks reducing the political legitimacy of the government's house building programme. Arguing for building on green fields in order to help private BTL investors is not a convincing way to build support for a loss of a perceived communal good.

6.3 Buy-to-Let – Providing the Wrong Supply Incentives?

There is a strong basis for believing that the boom in BTL lending and their higher purchasing power, combined with highly restrictive planning policies, has distorted incentives for developers to shift activity into building stock that is suitable for investment buyers rather than meeting the needs of Owner Occupiers and society as a whole (something the consultation paper implicitly recognises – see paragraph 5.7).

There are a series of studies that back up this view.

[73] Ibid

[74] London Development Research (2006) Who buys new market homes in London? The Greater London Authority/London Development Agency: London

[75] Buy-to-let and the wider housing market, Nigel Sprigings, University of Glasgow

The number of new flats as a percentage of private sector completions rose from 12% in 1997/98 to 40% in 2004/05 (source CLG). Yet when polled by Mori only 2% of the UK population expressed a desire to live in modern apartments.[76]

BTL investment has spurred developers to construct smaller, studio apartments (Knight Frank Residential Research, 2007[77]; Rowlands et al, 2006[78]). This is because rental yields can be higher in these units (Allen and Blandy, 2004)[79]

This association is further demonstrated by evidence from lenders that BTL investors bought properties cheaper than average prices, £78,000 compared to more than £100,000 (Pannell and Heron, 2001).[80] This study also suggested that 80% of rented properties held by residential landlords was made up of flats and terraced houses. Gibb and Nygaard (2005)[81] found consensus among stakeholders that BTL activity targeted one- and two bedroom properties at the lower end of valuations.

[76] Source Ipsos Mori 2002, http://www.ipsos-mori.com/researchpublications/researcharchive/poll.aspx?oItemId=972

[77] Knight Frank Residential Research (2007) Central Nottingham Housing Market Analysis Knight Frank: London

[78] Rowlands R, Murie A and Tice A (2006) More than Tenure Mix: Developer and purchaser attitudes to new housing estates Joseph Rowntree Foundation by the Chartered Institute of Housing: Coventry

[79] Ibid

[80] Pannell B and Heron J (2001) „Good bye to buy-to-let?' Housing Finance 52, November 2001 pp18-25

[81] Ibid

Chapter 7 – Tenants' Rights

7.1 Buy-to-Let and UK Tenants' Rights

The Treasury paper cites the 1988 Housing Act as a turning point for the level of Private Rented Sector investment in the UK housing market. The 1988 Housing Act removed rent controls and introduced 6 month short-hold tenancies. Section 21 of the Act introduced the mandatory 2 month notice to quit, which gave landlords the power to serve tenants 2 month's notice without having to provide a reason. Even so, as the Treasury paper acknowledges, 'recovery in the PRS was initially slow', and it was not until the late 1990s that the exponential growth in the Buy-to-Let sector began.

The key question is why the boom did not begin until the late 1990s? This paper, surprisingly, fails to acknowledge the impact of a key amendment to the 1988 Act, which was not made until 1996. This amendment enabled landlords to serve the 2 month notice to leave *regardless of whether the tenant had signed a prior agreement* - between 1988 and 1996, landlords were finding that the law did not support the eviction, and that Section 21 was difficult to enforce. Without an assurance that the tenant can be evicted, property investment, and particularly Buy-to-Let investment, becomes more restricted.

7.2 European Comparisons of Tenants' Rights

Chapter 4 of the Treasury paper points to international comparisons and highlights the fact that, in other European countries such as Germany and France, the Private Rented Sector represents a larger share of the housing market, as high as 50% in Germany. However, what the consultation paper noticeably fails to acknowledge is the significantly stronger security of tenure that tenants in these countries have. As table 5 shows, in Germany, for instance, landlords must give a specific reason for evicting their tenants, and the eviction process can take up to 12 months. By comparison, landlords in the UK can serve 2 months notice to quit and are not required to cite a reason. A typical tenancy agreement in France is 3-4 years in length, and is often unlimited in Germany. This compares to the standard 6 month short-hold tenancy agreement in the UK. The consultation paper's strong assumption is that reduced regulatory „burdens' on the PRS sector hold the key to higher levels of PRS holdings (see paragraphs 4.2 and 5.1) yet the European experience suggest no such direct correlation.

Table 5 below shows the rights of UK tenants compared to their European counterparts:

7.3 Security of Tenure and Sustainability of PRS Investment

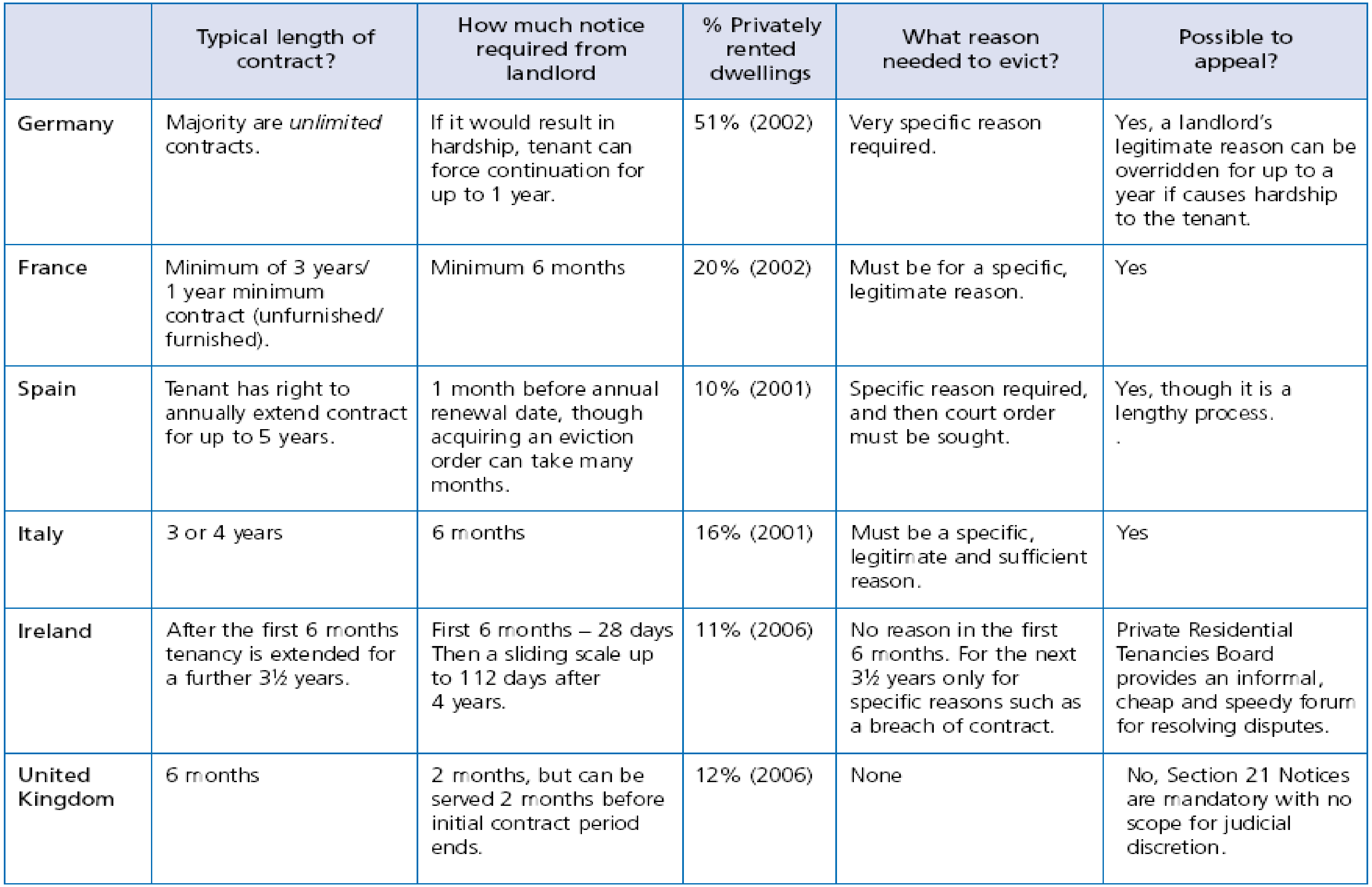
Security of tenure for those living in private rented accommodation in the UK has a direct impact on the type of investment that the UK government can expect to see from private sector property investors.

In France and Germany, investment in the PRS is more sustainable: prospective investors must finance their investments based on the assumptions that their tenants have the right to stay in the property for a significantly longer period of time than in the UK, with contract lengths in Germany often unlimited. Rental yields are therefore much more important than investors calculations of potential capital gain. In contrast, the lack of security of tenure faced by UK tenants enables investors to purchase properties on an entirely speculative basis, safe in the knowledge that tenants can be evicted quickly and easily. The insecure and speculative nature of investment in the UK private sector, and its corresponding volatility, is highlighted elsewhere in this paper (Chapter 2).

Question: 'What type of investment does the UK Government wish to see from investors in the UK Private Rented Sector? Can improving the security of tenure of tenants help reduce the level of speculative investment in the UK PRS sector?

Question: 'Does the Treasury intend to conduct research into the correlation between the sustainability of PRS investment and the security of tenure experienced by tenants in the UK?'

Table 5 - Security of Tenure in Selected European Countries



	Typical length of contract?	How much notice required from landlord	% Privately rented dwellings	What reason needed to evict?	Possible to appeal?
Germany	Majority are *unlimited* contracts.	If it would result in hardship, tenant can force continuation for up to 1 year.	51% (2002)	Very specific reason required.	Yes, a landlord's legitimate reason can be overridden for up to a year if causes hardship to the tenant.
France	Minimum of 3 years/ 1 year minimum contract (unfurnished/ furnished).	Minimum 6 months	20% (2002)	Must be for a specific, legitimate reason.	Yes
Spain	Tenant has right to annually extend contract for up to 5 years.	1 month before annual renewal date, though acquiring an eviction order can take many months.	10% (2001)	Specific reason required, and then court order must be sought.	Yes, though it is a lengthy process. .
Italy	3 or 4 years	6 months	16% (2001)	Must be a specific, legitimate and sufficient reason.	Yes
Ireland	After the first 6 months tenancy is extended for a further 3½ years.	First 6 months – 28 days Then a sliding scale up to 112 days after 4 years.	11% (2006)	No reason in the first 6 months. For the next 3½ years only for specific reasons such as a breach of contract.	Private Residential Tenancies Board provides an informal, cheap and speedy forum for resolving disputes.
United Kingdom	6 months	2 months, but can be served 2 months before initial contract period ends.	12% (2006)	None	No, Section 21 Notices are mandatory with no scope for judicial discretion.

Source: 'The Tenant's Dilemma', Debbie Crewe, June 2007, Crosby, Formby and District Citizen's Advice Bureaux

HM Treasury consultation paper on

Investment in the UK Private Rented Sector

The combined response of the:

Property Industry Alliance (PIA)*

Council of Mortgage Lenders (CML)

Association of Real Estate Funds (AREF)

28th April 2010

*The Property Industry Alliance comprises:

British Council of Offices (BCO), British Council of Shopping Centres (BCSC) British Property Federation (BPF), Investment Property Forum (IPF) and Royal Institution of Chartered Surveyors (RICS)

EXECUTIVE SUMMARY

THE CURRENT INVESTOR AND HOUSE BUILDER SITUATIONS

Inadequate new building, constrained buy-to-let investment, and a window of opportunity to promote residential investment to institutional investors.

a. **Need for housing –** There is increasing need for housing of all tenures as a result of population growth and new household formation, but new supply is falling well short of requirements.

b. **Private investors –** Buy-to-let (BtL) investors have been responsible for substantial growth in PRS housing since 2000, but access to debt is likely to constrain growth in BtL for the foreseeable future. If need is to be met new sources of equity finance need to be found.

c. **Institutional investors –** Of the few funds that began investing from 1999 onwards, many are now approaching the end of their investment lives. Despite interest, few have converted to more tax efficient vehicles; instead many of these funds are selling their assets into the owner occupier market. New funds are slowly being created in response to the HCA's PRSI, but material and psychological barriers exist and are the subject of this Consultation Paper.

d. **House builders –** revisions in planning policy in 1998 drove a move towards higher density development on brownfield land. The next decade saw house builders become highly dependent on off-plan sales of high density apartment schemes to investors. There are currently few off-plan sales being made and house builders will need to find sustainable business models that can attract off-plan investors as a means of reducing their risks; some are already returning to building medium density housing and others are investigating building blocks of flats for rent that may attract long term institutional investors.

THE OBSTACLES TO GREATER INSTITUTIONAL INVESTMENT

Scale, higher investment costs and high tax barriers to investing are the most critical obstacles.

The top 10 investment managers have some £62bn of property under management, of which only 1% is invested in residential property. All funds in the IPD universe account for £119bn of investment, of which residential accounts for 0.9%. Table 1 illustrates the breakdown by type of investor.

Table 1

Investor Type	% of total IPD universe	% in resi. of investor type
Development Agency & Other Public Sector Funds	0.1	0.0
General Insurance Funds	0.4	0.2
Life Funds	14.8	1.7
Other Unitised Funds	11.4	0.5
Pooled Corporate Pension Funds (Managed)	4.0	0.2
Property Companies	18.9	0.2
Segregated Pension Funds	18.7	0.0
Shareholder Investment Funds	0.9	0.4
Traditional Institutions	2.6	7.6
Unit Linked Life or Pension Funds	12.1	0.1
Unregulated Property Unit Trusts	16.1	1.9

a. **Scale –** The residential sector may be the largest asset class in the UK, but for most institutional investors it remains effectively a new asset class; investors will only be attracted to a new asset class if they can make a material investment in the sector, and that it offers an attractive balance of risk and returns relative to other asset classes. Institutional investors need any new asset class to be scalable, as this will allow them to make sizeable investments, whilst scale is also critical to asset management efficiencies.

b. **Investment costs –** Institutions investing in housing have a number of higher costs than others investing in the sector, such as owner occupiers and individual investors; this reduces the investment attraction of a new asset class, reduces investment returns and has led to limited investment by only a small number of major institutions in the PRS and new housing.

c. **Tax efficient vehicles** – Residential investments are highly management intensive and therefore collective investment funds are generally the preferred institutional route to investment in the sector. Investors need tax efficient investment options that offer comparable tax transparency to commercial property vehicles in order to attract the widest range of long term investors. Existing unlisted fund structures would be suitable (subject to the 'solutions' section below). REITs are of considerable benefit to commercial property companies but have had no success in the residential sector, for the reasons discussed in the attached paper.

THE SOLUTIONS THAT WILL ATTRACT GREATER INSTITUTIONAL INVESTMENT

A level tax playing field (at minimal cost to Exchequer).

The Government has a unique opportunity to translate the recent institutional interest in the PRS into real, large scale investment in the UK's housing supply. Political commitment supported by a modest investment in tax terms could help to deliver transformational change to the PRS and the markets for both new and existing housing.

a. **Scale issues** – At present it is difficult for institutional investors to invest in the sector on a significant scale as many existing units are in fragmented ownership and there is a lack of new build properties to buy off-plan from house builders. Increasing the supply of new housing should provide scale, asset management efficiencies and geographic concentrations within PRS markets. The UK house building sector remains a casualty of the "credit crunch" and this has led to a material reduction in supply and a failure to meet demand for housing in some regional markets. Political parties have expressed an interest in making much better use of Government land holdings and the HCA's recent market-facing initiatives have offered encouragement to institutional investment that this type of land release can make a real difference to achieving scale.

b. **Tax efficient investing**

- Level the playing field with private investors – The higher costs of SDLT paid by institutional investors on scale purchases needs to be reduced to the current SDLT rate payable on each individual property purchased and VAT can be a higher cost for institutions.

- Investment vehicles – The encouragement of tax efficient investment vehicles (e.g. REITs, private funds and PAIFs) will attract many liquidity driven institutional investors to invest in the sector; these vehicles may also allow current portfolios (owned by institutions) to remain in the sector. Some existing non-listed tax efficient investment vehicles will also attract new domestic and international investors, many of whom already have experience of similar residential sectors, if a level tax playing field exists between private and institutional investors.

c. **Tax changes generally** – A number of our recommendations are likely to carry at least a risk of net cost to the Exchequer, because reliefs from or reductions in taxes which currently hinder greater investment in residential are not certain to deliver sufficient indirect or longer term tax revenues to pay for themselves. However, it is important to keep the wider context in view: both as regards the importance of the policy objective for more and better housing delivery in the UK, and as regards the – probably significantly higher – cost of alternative ways of seeking to achieve that policy objective.

THE FULL BENEFITS TO THE GOVERNMENT

Ensuring accessibility to housing through an increased supply of PRS homes.

a. **Current housing needs –** There is a growing housing crisis, as house builders and mortgage lenders struggle to meet current demand; encouraging institutional investment now will assist the house builders to open new sites, allow Government to make better use of its' land holdings and help reduce the funding needs of mortgage lenders. The PRS is a low cost means of delivering flexible tenure to meet the needs of those unable/unwilling to become owners, but the sector needs encouragement.

b. **Future housing need –** There will be considerable future demand. The HBF figures show growth in house building would need to average 18% per year for the new build targets by 2020 to be met. Many of future first time buyers already have to wait until they are in their late thirties to own their first property, given the much higher deposit now required by mortgage lenders; this will bring additional demand, which is likely to will lead to an unhealthy and unsustainable supply / demand imbalance for PRS properties and for intermediate renters.

c. **Investing for all –** Long term investors are critical to the sustained growth of the PRS, whether they be individuals, or the many individual savers that contribute to life insurance products and pension funds. It is critical that investment managers can offer their savers attractive returns and tax efficient means of investing in the PRS sector, whilst helping to reduce the need for individuals to make illiquid investments in markets they may not be fully conversant with and where high levels of leverage are often utilised.

d. **Costs –**

- A change in the SDLT regime is low cost, as little or no investment in the sector is currently being made.

- A reduction in VAT would add value to the sector and lead to higher quality properties. The current problems with VAT recovery in the residential sector (both on development and on operating costs) present a disincentive to invest in residential property. Such a reduction could even result in increased revenue for HM Treasury through the greater use of contractors within the VAT regime.

- Creating a level tax playing field for institutional investing vehicles has a very marginal cost, as currently no new residential vehicle has been created.

- A change to the listed vehicle regime will attract a new investor base, SDRT from the trading in these vehicles could off-set the VAT costs.

e. **Quality assurance and service innovations** – institutional investors will help raise standards by offering tenants greater access to redress and a more co-ordinated approach to property maintenance and management.

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INDUSTRY EXPERTISE THAT HAS CONTRIBUTED TO THIS RESPONSE

This response has been collated from the output of a number of working groups and one-to-one meetings/conversations with institutional investors. The following particular individuals have helped contribute to the drafting of our response:

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BACKGROUND

THE IMPORTANCE OF THE PRIVATE RENTED SECTOR

To housing need

a.1 The private rented sector has delivered nearly all household growth over the past decade. Whilst owner-occupation has been relatively stagnant and the social rented sector has shrunk over the period, the private rented sector has grown to accommodate an additional 1.1 million households. Housing 14.2 per cent of all households, the sector is now the largest it has been since the 1970s.[1]

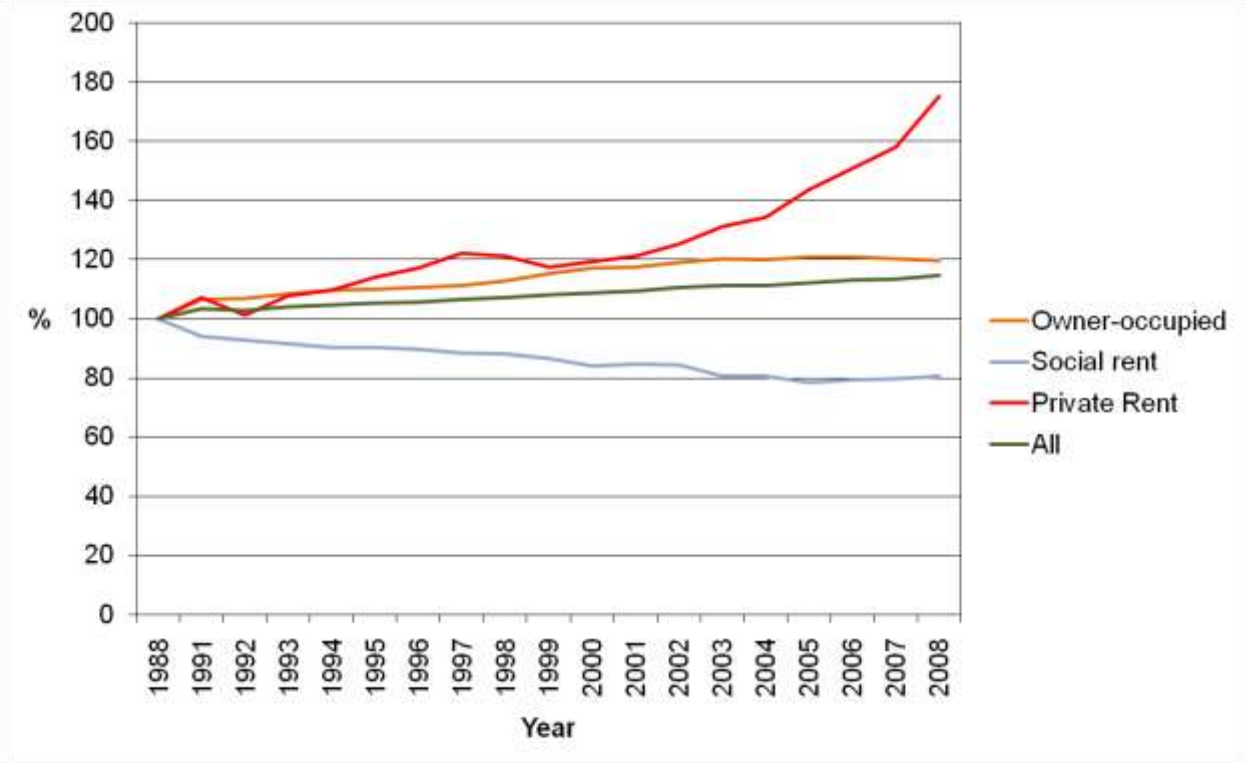
Although it lags the total social rented sector in size (housing association and council housing combined), it is an important part of the housing market for several categories of occupier:

- more couples are now in the PRS than social renting;
- virtually the same amount of couples with children are in the PRS as in social renting;
- as many lone parents with children in the sector as either housing associations or council accommodation;
- as well as the sector's more traditional customer base of singletons and multi-person households (students, etc.).

Two-thirds of all new households created find their first home in the private rented sector

a.2 The PRS is supplying the majority of household need – two-thirds of all new households created in 2008/09 found their first home in the private rented sector.[2]

Chart 1 - Growth in Household Tenure



Source: English Housing Survey

[1] English Housing Survey, Headline Report 2008/2009

[2] Ibid, p21.

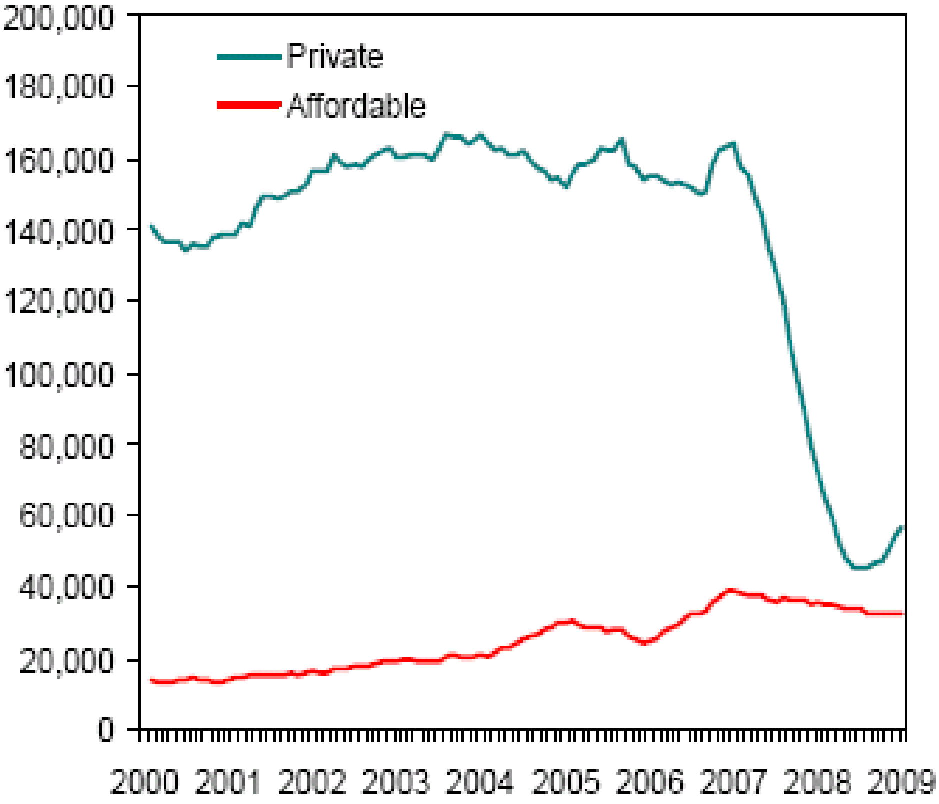
To development

a.3 The private rented sector has made a disproportionate contribution towards development. As the consultation paper recognises, the PRS accounts for one-fifth of new build, and in turn that equates to 35,000 units per annum and between 42,000 and 52,000 construction jobs. The ability and willingness of investors to forward purchase new units became a vital part of funding of new development, particularly higher density and brownfield schemes.[3]

For every £1bn invested in building new rented property 7,500 new construction jobs would be created

a.4 Through support for development private investors have also made a significant contribution towards the provision of affordable housing, at the peak of the boom contributing towards the provision of 6,000 homes per annum via the s106 process.

Chart 2 – Rolling 12 month Housing Starts



Source: Hometrack using NHBC data

To labour market flexibility

a.5 A higher proportion of households in the PRS are in employment than in any other sector. Part of this is explained by the relatively higher proportions of households in social renting and owner occupation that are retired. For every three people that are in

[3] Home Builders Federation Manifesto 2010 estimates direct job creation per home at 1.2 to 1.5

full time employment in the social rented sector one is unemployed. The corresponding ratio in the private rented sector is fewer than one in twelve.[4]

a.6 The PRS, although only accounting for 14.2% of all households, accounts for about 50 per cent of all household moves each year, oiling the wheels of the housing market and providing much needed labour market mobility.[5]

a.7 The economic downturn has illustrated just how important the PRS is, providing a place to live for those who have either voluntarily, or via repossession, vacated their homes because of mortgage arrears. For those unable to find employment, the PRS has also been hugely important in allowing them to move around to find work. It is easily forgotten that prior to the 1988 Housing Act, it was very difficult to find private rental accommodation and queues outside lettings agents were not uncommon.

To affordability

a.8 The average first-time home buyer is now 37 years old. In part, this reflects social trends, but also increasing difficulty in accessing mortgage finance. As one recent survey illustrated, 59 per cent of private renters expect to eventually own their home, 24 per cent within the next two years - but that is down from 34 per cent two years ago, whilst the proportion expecting to have to wait five years or more has grown from 35 per cent to 42 per cent over the same two-year period.[6]

a.9 Availability of mortgage funding is improving, but for those first-time buyers without the support of family or friends, raising a deposit is now a significant hurdle. The average deposit paid by a first-time buyer to purchase a home is now £33,000. For the average 25 year-old this represents about 18 years of savings.

a.10 In contrast, the private rented sector is very accessible. The would-be occupier often only requires a month's rental deposit, which should now be protected in one of three Government recognised schemes. Repairs and maintenance are included – costs that an owner-occupier would incur.

a.11 Relative affordability in comparison with owner-occupation has changed significantly over the past decade. Growth in private rented sector rents has broadly kept pace with average earnings, meaning for those in work, the PRS is no more expensive than it was a decade ago.[7] Average house prices on the other hand, even allowing for the corrections over the past two years, have nearly doubled. At the present time, 80 per cent of private renters cannot afford to buy their own home, The PRS is therefore providing an essential service, supplying homes for people who cannot afford to buy, but equally have no chance of accessing social housing.

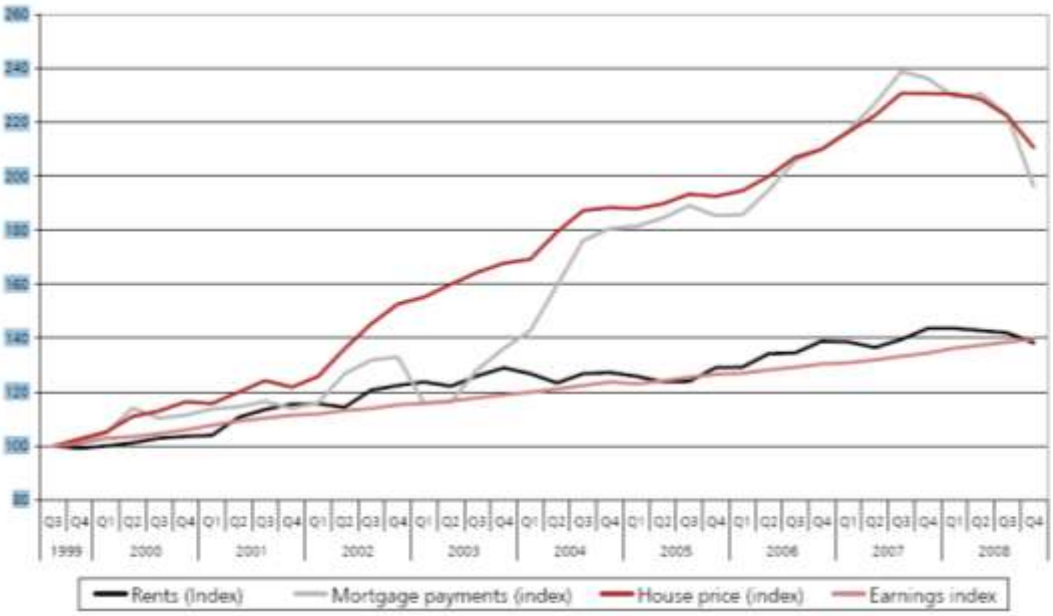
[4] English Housing Survey, Headline Report 2008/2009

[5] Can't Buy, Can Rent, Wilcox for Hometrack, 2007

[6] English Housing Survey, Headline Report 2008/2009

[7] Another important consequence of the close correlation between PRS rents and average earnings is that it renders PRS rental income very attractive to institutional investors like pension funds, as their liabilities, too, are linked to average earnings. This is discussed further below.

Chart 3 - Comparison of rents, earnings, house prices and mortgage payments



Source: Survey of English Households, Communities and Local Government; Survey of Mortgage Lenders, Communities and Local Government; Department for Work and Pensions.

To quality housing

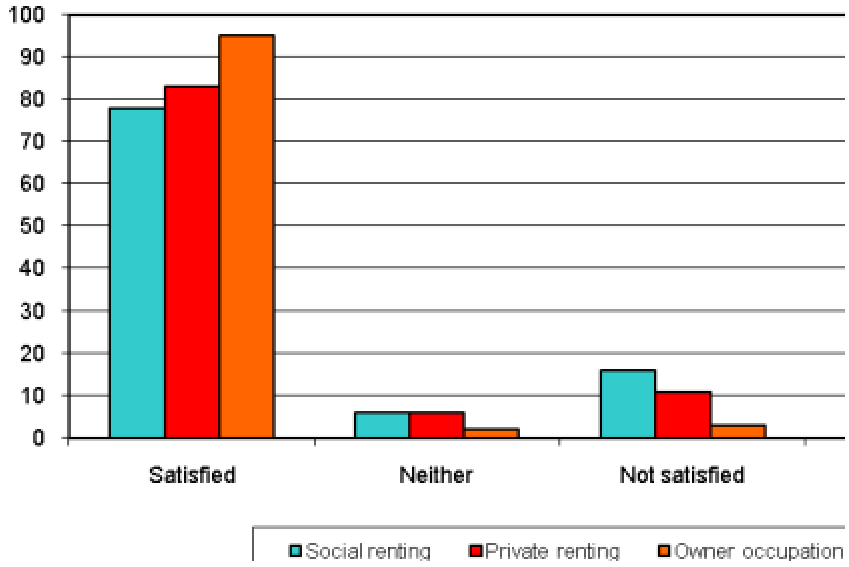
a.12 The private rented sector achieves good satisfaction ratings. In the latest English Housing Survey, 83% of private tenants were content with their accommodation, compared with 78% of social tenants and 95% of owner-occupiers.[8]

a.13 There is a legacy of older stock in the PRS, with over 40% of housing in the sector pre-1919. The influx of new-build accommodation into the sector is however, having a very positive outcome on quality, with decent homes in the sector rising from less than 800,000 in 1996, to over 1.8 million in 2008.[9]

[8] English Housing Survey, Headline Report 2008/2009

[9] Ibid

Chart 4 – Occupier Satisfaction by Tenure



Source: English Housing Survey

THE STATE OF THE HOUSING MARKET

a.14 The private rented sector is playing a vital and increasingly important role in the housing market as:

- the primary source of supply for new households;
- a key customer and (through its willingness to buy new stock off plan) mitigater of risk for the development industry;
- a flexible tenure which helps our housing market and labour market to function more efficiently;
- an affordable tenure, as owner-occupation becomes increasingly difficult to access and social housing is rationed by what the nation can afford;
- and, an improving sector in terms of quality and customer satisfaction.

a.15 If anything, owner-occupation and social renting face even greater challenges in the years to come than they have faced over the past decade. Whether the private rented sector can continue to take up the slack is therefore critical to meeting future housing demand.

a.16 In terms of housing numbers, the number of new homes built each year has ranged from around 130,000 to around 170,000 in recent years. By contrast, the NHPAU estimates a range of 238,000 to 290,000 new homes per year are required to meet housing need, as particularly demographics, but also factors such as net migration, fuel demand.

a.17 As the HBF points out, however, the backlog of undersupply, added to the pent-up demand suppressed so far by the recession, combined with high levels of projected household growth mean that there is a high risk of serious under-supply. The HBF shows that from the low point reached in 2009 (when only 118,000 new homes were completed, the lowest since 1947), **growth in house-building would need to average 18% per year for the new build targets to be met by 2020**. Given that the average rate of growth between 2001 and 2007 – the booming pre credit crunch era – was less than 5% per year, this raises serious questions about whether the nation's housing needs can be met via owner-occupation and about the social and economic consequences if they cannot.[10]

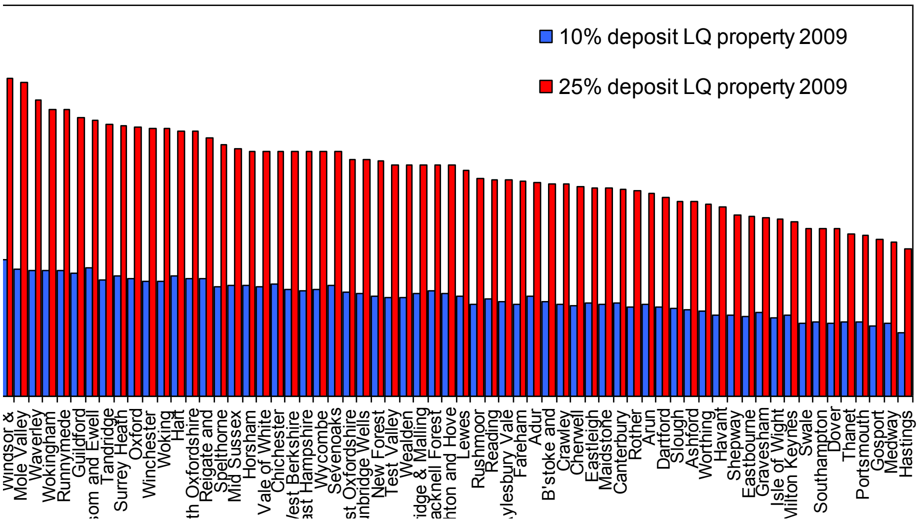
a.18 Challenges for the future include the expectation of a higher number of new households forming over the next decade than over the previous decade. Between 2011 and 2016, an average 272,000 increase in households each year is expected, followed by an average 266,000 between 2016 and 2021. This compares with an average of 199,000 new households each year between 1996 and 2001.[11]

The challenges facing owner-occupation

a.19 The owner-occupied sector was facing significant challenges even before the recession, with affordability becoming ever more an issue for first-time buyers. The growth of shared ownership and shared equity was a reflection of this.

a.20 Affordability pressures have if anything been exacerbated by the recession, and although mortgage finance is becoming more available and house prices have eased a little, more first time buyers seem unable to access a mortgage. With the average deposit at £33,000 for a first time buyer and loan-to-values currently hovering at 75 per cent for that clientele, the problem is not so much affordability, as accessibility.

Chart 5 – The changing amount of deposit required to buy in the South East



Source: Hometrack

a.21 Some first time buyers will be able to access home ownership with parental support, but first time buyers whose parents are unable or unwilling to spare their equity are virtually excluded from the market. Furthermore, even where the deposit challenge can be overcome, mortgages that seem affordable at today's historically low interest rates may prove unaffordable when interest rates rise.

a.22 The broader mortgage market also faces significant challenges. Some lenders, particularly specialist lenders, are no longer in the market. More traditional lenders are repairing their balance sheets and still very reliant on emergency funding mechanisms and the next few years are going be difficult as the mortgage market makes the transition off these and returns to more normal conditions with a securitisation market willing to buy mortgage-backed securities.

[10] Home Builders Federation

[11] CML Budget Submission 2010, based on NHPAU data

The challenges facing social housing

a.23 The challenges facing social housing are no less acute. The HCA's current budget for 2009-2011 will deliver 117,000 new homes, of which 63,325 will be for social rent.[12] What the public finances are able to afford beyond that is uncertain.

a.24 Another significant way that registered social landlords raise finance for house building is through borrowing, but that has been more constrained, with only a handful of lenders in that market and interest rate terms post credit crunch far less favourable than before.

The challenges facing private renting

a.25 The PRS is not without its own challenges, particularly if it is to rise to the task of continuing to meet housing need for new households.

a.26 The driver of growth in the sector over the past decade has been buy-to-let. This is often portrayed as a group of (mainly) individuals operating a small portfolio with between one and four properties. Statistics from Hometrack, however, illustrate that the majority of PRS housing stock, about 80 per cent, is owned by about 20 per cent of landlords, some individuals, some companies and institutions.[13]

Buy-to-let lending in 2009 was only one-quarter its peak level in 2007

a.27 Research by BDRC illustrates that landlords with more than 20 properties tend to have a very different approach and outlook to their smaller counterparts. For example, gearing is significant amongst smaller landlords, peaking at about 50% loan to value for landlords with 2 to 4 properties, whereas landlords with 20+ properties have gearing on average of 25%.As a landlord passes from having 2 to 4 properties to 20+, it becomes their vocation, rather than something they do in their spare time. Two-thirds of landlords with 20+ properties cite it as their main source of income. The average landlord now has a portfolio of £1,260,000, annual gross rental income of £40,000 and 14 tenants.[14]

a.28 As in the case of other tenures, a significant constraint on future growth could be access to loan finance, particularly for small landlords and potential new entrants. Buy-to-let now represents 11.5 per cent of the total value of mortgages outstanding in the UK and so is an important source of housing finance. Buy-to-let lending in 2009, however, was only about one-quarter its peak level in 2007. Several major lenders to the sector have greatly curtailed their activities as they are themselves unable to secure funding. Survey evidence suggests though that there is significant latent demand for funds with landlords keen to add to their portfolios whilst house prices are lower. The buy-to-let sector is therefore likely to remain an important source of housing finance, but will be more constrained by access to loan finance.[15]

a.29 To conclude this introduction to our response, given the projected future demand for housing and constrained lending markets it seems sensible to suggest that the private rented sector will play an even greater role in meeting housing need over the next decade, than it has over the past decade. Sources of funding for housing, particularly loan finance are likely to be constrained for some time to come and therefore if need is to be met there is likely to be a greater reliance on equity finance. The sheer quantum of housing needed would suggest that all sources of equity will be required, whether that be individual landlords with spare equity (40% of landlords have no borrowing at all)[16], individuals wanting to invest collectively in a bit of the sector, or institutions

[12] HCA Corporate Plan, 2009/2011

[13] Hometrack

[14] BDRC Landlord Panel Q4 2008

[15] CML

[16] BDRC Landlord Panel Q4 2008

investing their pension and life funds. The need to support additional supply and support the construction industry as an important creator of jobs and wealth should also focus any Government support on adding to supply and therefore on helping the rented sector to provide the demand for more new build.

QUESTIONS

QUESTION 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

- *The vast majority of buy-to-let investors did not enter the new build market.*
- *Those who did, however, have been the focus of much attention, because they were often investing in the wrong place, creating an unsustainable investment for themselves, empty properties and a headache for local authorities.*
- *Property Investment Clubs were a strong influence on these bad investment decisions.*
- *Some investors don't want the hassle of preparing properties for renting, but want 'oven-ready' product and therefore will always have a propensity to go for new build.*

1.1 The leading buy-to-let lenders report that only some 10% of new buy-to-let lending was on new build properties prior to the credit crunch and they report that the proportion has since fallen further. Buy-to-let lending on new build property has attracted a disproportionate amount of attention because it has been the source of many problems that have not afflicted the mainstream buy-to-let market which consists of lending on existing properties.

1.2 New build tended to attract a different type of investor than mainstream buy-to-let. The mainstream buy-to-let investor typically buys property close to where they live, often undertaking management and minor repairs themselves with a long term investment horizon – the latest ARLA landlord survey shows that 76% of landlords expect to keep their properties for 10 years or more and less than 1% expect to keep them for less than 2 years.

1.3 This can be contrasted with the new build buy-to-let market where many investors were encouraged to buy by unregulated property investment clubs, often using high pressure sales techniques. Many of the investors lived hundreds of miles from the properties they bought and were looking for a relatively hassle free investment where management and repairs would be undertaken by local professionals.

1.4 A lot of such activity was also speculative, or what has been termed 'buy-to-flip', with the investor buying off plan and selling the property for a profit before completion.

1.5 During the housing boom property investment clubs were able to offer developers the advantage an institution would provide – off-plan finance for a bulk disposal – but without the disadvantage of a hard bargain on price to reflect the benefit of lower risk to the developer. Many of the PICs received fees from both investors and vendors; this lack of transparency led to problems.

1.6 The improvements and conversions that will be required to make an existing property suitable to be rented can also add cost and uncertainty to the process. The time taken to make the improvements will lead to a significant void period where no rental income is being received and there can be unknown risks associated with conversions which can cause delays and cost increases.

1.7 New build properties also present a range of advantages including a better quality product which more adequately meets the expectation of tenants. One example of this is that many new build properties will have more than one bathroom. There is also a perception that new build properties will require less spending on maintenance in the short term and that they are cheaper to run on a day to day basis. New build properties will also be more likely to meet fire safety rules as they will have smoke alarms and fire retardant materials already in place.

QUESTION 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

- *The change in planning policy and commitment to 60% new build on brownfield land led to a whole new city centre housing market being created.*
- *Investment sales also helped facilitate this, off-plan sales helping to reduce risks and improve cashflow for house builders.*
- *Lenders have become a lot more cautious about financing the purchase of new-build property.*
- *Institutions could form a key part of providing forward sales to developers and unlock a large volume of residential consents that may otherwise remain undevelopable for many years to come.*

2.1 The quantity and format of house supply has been driven by a number of factors over the course of the last decade. The change to planning policy in 1998 and commitment to 60% of housing development on brownfield sites has been a major influence, as has the broader policy support for an urban renaissance, both have led to more development in-town and therefore more high density flats, rather than houses.

2.2 A whole new city centre housing market that had previously not existed was created – in 2000, the average value of a new flat was 120% that of a re-sale flat. This made the development of apartments highly lucrative and developers started chasing higher volumes through high-density development. By 2007, 45% of all homes started were flats compared to just 15% in 1998.

2.3 The capital intensive nature of high-density development meant developers and their funders become increasingly reliant on 'forward sales', which could be more readily achieved from investors who were willing to buy 'off-plan' up to two years ahead of completion. The attraction for these investors was that they were offered a very highly leveraged call on house prices, which were rising at the time, as they only needed to pay between 5%-10% on exchange of contracts (and the remainder on completion), often many months in the future. By contrast, owner occupiers would only purchase much closer to completion. Investor sales became a key part of enabling new high-density developments to proceed over the course of 2000-07.

2.4 However, after about 2004 – the point at which yields and mortgage rates converged – some investors began to see housing as a commodity, rather than looking at a realistic exit value of the property into the owner occupier market. Thus investors distorted pricing for new-build flats and this has resulted in a greater re-correction in prices in this segment of the market than in the mainstream housing market. In Northampton, for example, an average 2-bed flat is currently trading 35% below its peak level in 2007, while a 3-bed home in the same city is down by just 6% over the same period.

2.5 The ready supply of investment buyers willing to purchase flats, has therefore been a major factor in making the move to a more brownfield-orientated planning policy work. Building flats is significantly riskier for house builders than building houses, because the sale to individual owner-occupiers tends to only proceed once the block is significantly complete. In the meantime, the developer is having to find cashflow and is exposed to risks, both specific to the development and broader economic risks.

2.6 At the height of the boom in 2007, a report by Molior for the GLA (Who Buys New Market Homes in London?), estimated that around two-thirds of new build flats and houses in the capital were bought by investors. Summarising the benefits of this to developers, the report states that:

- *Investors perform a valuable market function by allowing perceived development risk to move from the developer to the purchaser, therefore increasing confidence among house-builders. Forward buying is often a condition of bank lending and it also helps reduce development interest costs for developers, as* *investors are willing and able to buy homes ahead of construction completion. Owner-occupiers, on the other hand, generally purchase homes following or just before construction completion. The report concludes that many housing schemes, particularly larger ones in emerging areas, would simply not go ahead without sales to investors.*

- *Market participants generally concurred that investor demand leads to more new homes being developed, especially in emerging areas where there is not an established residential market.*

- *The report concludes that if the investment market were to shrink there is a real danger that the number of new homes being built would fall to the detriment of all. It believes that investment sales should be viewed as providing a valuable function in the market for new homes.*

2.7 However, lenders have become a lot more cautious about financing the purchase of new-build property both for owner-occupiers and buy-to-let investors. Buy-to-let mortgage lenders experienced a higher proportion of write downs in values on new properties than on older properties in more established rental markets.

2.8 The net result of the major re-correction in new-build pricing is that a significant proportion of new-build housing that was both under construction and in the planning phase was, and has been, rendered unviable. Developers are now adopting a much lower risk approach to development - moving the emphasis of their development activities back towards house-orientated schemes on smaller sites.

2.9 Houses are likely to account for 75%-80% of new housing starts in 2011. This changing mix of housing starts presents a major challenge for the planning system and has implications for future level of new housing development. On the basis that the house building industry built 180,000 homes in 2007, with a mix of 45% flats and 55% houses, reaching 240,000 homes a year with just 25% of these homes developed as flats would require 67% more land for housing to be delivered through the planning system.

2.10 Attracting institutional investment into the private rented sector could form a key part of providing forward sales to developers in order to help unlock a large volume of residential consents that may otherwise remain undevelopable for many years to come.

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?

- *Renting a room can make a useful, but relatively small contribution to addressing housing need. For practical and psychological reasons supply and demand for such accommodation is limited. Current economic circumstances are probably leading to some cyclical increase, but not the sustained increase in housing numbers the country needs.*
- *Anecdotal evidence suggests that the rent-a- room allowance is not used by many potential users, because of a lack of awareness of it.*

3.1 The consultation paper states: "*…there is no published data that allows the number of private landlords with lodgers to be estimated with any degree of accuracy, and Government cannot be precise about the numbers benefiting from the rent-a-room scheme, as provided the income does not exceed the threshold for the relief there is no need to declare it.*"

3.2 Given the lack of data, it is difficult to respond, and by their very nature many of these arrangements are private so difficult to track.

3.3 Intuitively, we believe that homeowners who rent out part of their home to individuals make a helpful, but modest and marginal, contribution to improving the efficiency of the housing market. There is well recognised under-utilisation of existing housing stock, although the biggest contributor to this is the demography of an older population, with couples or a surviving partner occupying the family home. Older people, however, are probably not the most likely candidates to rent out a room to younger people in housing need.

3.4 Anecdotal evidence suggests that there has been an increase in owner-occupiers renting out rooms as economic conditions impact on some household incomes. By its very nature, however, such housing 'supply' is cyclical and not likely to lead to a significant long-term improvement in housing numbers.

3.5 The rent a room scheme also encourages homeowners to let out spare space, but is not cost free, the relief forgoing £120 million per annum in income tax revenue. As a scheme it is of some benefit and is used by c. 100,000 households with a home, but it is difficult to calculate how much of this provision is additional and dependent on the allowance, likewise there is anecdotal evidence in the sector that awareness levels result in proportionally low take up. What is clear is that it only scrapes the surface in terms of need for rented accommodation, and has to be seen in the wider context of 1.1 million households finding a home in the private rented sector in the period 2000-2008/9. There has been a recent campaign to raise the rental limit from £4,250 to £9,000 per annum. HMRC estimates this would cost another £10m, and therefore help about another c. 5,500 income tax payers, with some deadweight cost.

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?

- *For a variety of reasons individual investment in residential has proved attractive relative to other forms of saving.*
- *Individual investors have also been able to make their investment go further through leveraging in the buy-to-let market.*
- *The buy-to-let lending market is currently constrained and likely to remain so for some time to come, but demand for rented housing shows no signs of easing.*
- *There will be unwelcome social consequences if demand is not met.*
- *The smaller investor will also miss out on a relatively stable and well performing asset class.*

4.1 Part of increased popularity of residential investment reflects its relative attraction compared to other forms of investment – residential has offered a higher return than the traditional savings account, which in the low interest rate environment of the past decade has been perceived as relatively unexciting. Equity investment, on the other hand, has offered perhaps too much excitement, with significant volatility.

4.2 Residential investment has therefore appealed to the man in the street. It has performed well in terms of capital gain. The nation's housing shortage makes investors believe that the downside risks are capped. It is tangible – easy to point to and say: "that is my investment" – a not inconsiderable factor in the era of Equitable Life, endowment mis-selling and banks on the brink of failure.

4.3 The growth of the buy-to-let mortgage market and commensurate access to lending on competitive terms has also played a significant part in attracting individual investors – buy-to-let mortgage loans grew from some £9bn at the end of 2000, to some £73bn in 2005 and now stand at some £140bn.

4.4 The political environment has also been relatively stable in comparison with past decades, even between changes of Government, with the assured shorthold tenancy now well embedded in the sector.

1.1 million additional households have been accommodated by the private rented sector since 2000.

4.5 Looking ahead, it is going to be more difficult to expand PRS housing provision at the same rate relying on the individual but-to-let market. The buy-to-let lending market is currently constrained and likely to remain so for some time to come.

4.6 The constraint on lending has been driven by the funding constraint lenders have faced since the start of the credit crunch. Those buy-to-let lenders that are dependent wholly on wholesale funding, such as Paragon Mortgages, have been unable to do almost any new lending while banks and building societies also face funding constraints. This has reduced competition in the market and made it harder for landlords to source debt finance.

4.7 Gross buy-to-let mortgage lending, which was running at £8.7bn a quarter in the peak year of 2007, reached a low of £2.2bn in Q2 of last year and had only recovered to £2.6bn by Q4. Lenders have scaled back lending by tightening their lending criteria and by reducing their maximum loan-to-value ratios with many lenders now offering buy-to-let loans only up to 75% of the property's value.

4.8 This means that landlords will need to have access to significant cash or equity to grow their portfolios. This is not necessarily a bad change as credit conditions were overly loose prior to the credit crunch, but it will potentially constrain the rate of growth of the buy-to-let market going forward.

4.9 We believe, however, that there remains a strong appetite among individuals to invest in the residential market. Partly, investment will continue to flow from existing investors, who have a strong equity position, and can either generate internal funds or access the lending market. It is worth reiterating that 80% of stock in the private rented sector is owned by 20% of investors, many of whom are individuals who started with one or two properties but now have a significant portfolio.[17]

4.10 A significant reduction in the availability of buy-to-let finance, however, will reduce housing provision, with the social and economic consequences that implies. Fewer homes will mean fewer jobs in the construction industry, more overcrowded accommodation and more family tension as generations live under the same roof, and greater reliance on commuting, with the strain that puts on people and infrastructure.

4.11 It will also deprive some individual investors of the opportunity to invest in housing and its performance as an asset class, which provides a good mixture of capital growth and steady income returns. For the smaller investor unable to access buy-to-let lending, there will remain a desire to invest in residential property and some of that market might be satisfied in future via the collective investment, rather than individual investment, route.

4.12 Changes to pension rules might also lead to some changes in strategy for individual investors. The withdrawal of higher rate tax relief from pension contributions by high earners may lead to reduced investment in pension funds and SIPPs, and investing in the PRS may be an attractive alternative investment option.

[17] Hometrack

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 commercial viable?

- *Entering a new asset class is costly and will have minimal impact on performance if there is not sufficient scale of investment, c. £50m for smaller funds and c. £200m for larger ones.*
- *Non-recoverable management costs - void rents, repairs, maintenance and letting costs – mean that net rents are only about two-thirds of gross, and therefore any efficiencies can have a significant impact on returns.*

5.1 Scale is important both in management as well as in quantum; for institutional investors to invest in a new sector requires them to be able to show that this can make a material benefit to their overall returns, particularly as there will be entry costs. For many of the largest institutional investors, this suggests a minimum investment of £200m, for smaller institutional investors commitments of £5m to £50m are required for sector returns to make a significant contribution to their overall investment portfolio returns. Being able to invest in scale is often critical in terms of 'do we' or 'don't we'.

5.2 Operationally, economy of scale is an important component to an investor's business plan because of the following:

- residential is far more of a 'service offering' than commercial property and therefore marketing efficiency requires a geographic concentration and range of homes to attract the largest number of tenants.
- scale is critical to manage the repairing, insuring and regulatory costs efficiently. Management costs are very significant The gross rents are netted down by non-recoverable management costs, including void rents, repairs, maintenance and letting costs so net rents are only about two-thirds of gross.

5.3 Most investors will enter the market through investment in a number of residential funds, offering them a wider access to different business plans, portfolio types and operating platforms. Minimum lot size is important in three aspects:

- The size of a 'club' investment vehicle – Like-minded experienced institutional investors are likely to invest larger sums in closed ended fixed life 'Club' funds (managed by a third party). Scale in this case may mean an individual investment of £50m-£75m per investor.
- The size of indirect investment vehicles – Liquidity of underlying assets is far more critical in a listed vehicle (or an open-ended vehicle); investors may be constrained by internal restrictions, as well as UK regulatory constraints, and often limit their investment in residential property to well under 20% of the total value of the respective vehicle.
- The ability of the indirect investment manager to invest minimum amounts in local property markets – The fund manager's business plan is critical to investors in indirect residential funds; the fund manager must be able to show that it has the experience and knowledge to invest sufficiently large scale in terms of concentrations, type of property (such as flats) and by percentage of total assets.
- Minimum lot size is critical for larger vehicles (£200m or more) as few will want to invest in less than 150 units in each location, at a cost of £30m-£50m per portfolio. In the current UK environment these portfolios will have to be sourced off-plan either from house builders, or 'built-to-rent' on land owned by the HCA, or Government departments.
- There are almost no funds currently available to institutional investors with existing residential stock of any meaningful scale given the lack of attractiveness of the sector and the long time it takes to build a portfolio of scale due to the relatively low unit cost of residential property (c. £150k per unit versus say £10m+ for commercial property).

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?

- *There is consistent and wide feedback from institutions that the SDLT bulk purchasing rules are a barrier to investment by them.*
- *Practical examples and modelling illustrate the rules have a material impact on capital usage and yield.*
- *The best remedy would be to charge on a per unit basis.*

6.1 The SDLT anomaly through the 'linked transaction' rule that imposes a higher charge on large scale investment compared to single acquisitions has been identified consistently by property companies, fund managers and others who have made or are considering making, or advise in relation to, investments in residential property, as the biggest tax barrier to large scale residential investment. The use of calculations and models makes it clear that the extra cost arising from this anomaly represents a constraint to building up residential portfolios. This will increase in the future on certain acquisitions when the new 5% charge is implemented. Furthermore, its continued existence is widely perceived as a sign that the Government is not particularly interested in stimulating greater institutional interest in residential property investment.

6.2 The simplest and most neutral way of eliminating the anomaly would be to provide that the acquisition of more than one dwelling should be chargeable to SDLT at the marginal rate applicable to each dwelling, based on a just and reasonable apportionment of the aggregate price. The value of such a measure would be greatest to the viability of the investment model where low value dwellings are involved, as the marginal change in the applicable rate of SDLT would be greatest. For a PRS portfolio with an average per unit value in the range £150,000 to £200,000, the measure would allow acquisition on a large scale at a marginal rate of 1% rather than 4%. The impact of that on returns is discussed briefly in response to Question 7 below.

6.3 It is of course impossible to say whether eliminating the anomaly and reducing the SDLT cost of bulk purchases of residential property "would" lead to increased investment. However, the impact on yields would be material, and we would expect institutional investors in particular be more attracted to investing in residential property, because they are perhaps more likely than individuals to need to purchase in bulk (see further the response to Question 5 above).

6.4 It is worth mentioning that the current SDLT anomaly also operates to discourage existing large scale residential investors from disposing of portfolios as a whole (which could remain within the PRS), rather than of individual units. The higher SDLT cost payable by the purchaser would otherwise be reflected in a lower price. There are of course broader reasons for large scale investors to sell individual units, not least the fact that it may be the best way to capture capital growth (as owner-occupier purchasers may be willing to pay the highest price). However, as the UK currently lacks a liquid large scale PRS investment market, there is little scope for designing business strategy on the basis of a sale to another PRS investor. It would be easier to change that position if the SDLT regime did not make a bulk transaction within the PRS more expensive than individual sales out of it.

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?

- *Lowering the SDLT rate to the individual unit costs and investing the SDLT saving in a larger number of units, makes a material difference to returns.*
- *The three year unleveraged total return is improved by 120bp and the five year return by 70bp.*
- *A leveraged portfolio can lead to a three year total return improvement of 150bp and a five year improvement of 100bp.*

Note: these figures were arrived at independently by various organisations' modelling work and the calculations can be available.

7.1 The quantifiable impact on the rate of return differs, depending on whether the investment is leveraged or not and the time held.

7.2 For unleveraged investments, reducing SDLT to 1%, from 4% provides a better capital usage and increases the rate of return. Using a £50m portfolio as an example, an SDLT reduction to 1% increases the 3-year total return by 120bp and the 5-year return by 70bp, helping the PRS to compete with other investment classes.

7.3 With regard to leveraged investments, the lower rate of SDLT will affect both the number of units that can be purchased and the total return. For example, assuming leverage of only 25% to invest £50m in a portfolio and paying only 1% SDLT, the reduced cost could lead to the purchase of 15 additional properties, with the leveraged total return being increased by 150bp over three years and 100bp over five years.

7.4 That difference of 15 new homes (depending on whether SDLT is payable at a marginal rate of 4% or 1%) represents properties which are simply not acquired if the SDLT has to be paid – and if they are not acquired, not only is the rent from them not collected, but the capital growth they could have delivered is not secured. Regardless of the SDLT cost, the investor has invested £50m, but a higher SDLT cost reduces both the yield and capital growth components of the total return on the investment, reducing the attractiveness of residential property as an investment asset class for large scale investors. In policy terms, the apparently higher SDLT revenue implied by the current rules may be illusory. This is on the basis that transactions subject to it are simply not done because the commercial return is not sufficient. Alternatively, if some new homes are sacrificed to cover the SDLT cost of transactions that do go ahead, it may come at a price.

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

- *UK residential performs well in comparison with most other asset classes over most timeframes on a total return basis. However, income returns are often the key attraction for institutional investors and these are much higher for commercial property than residential. The higher management costs of investing in residential plus irrecoverable VAT costs exacerbate this and are a major drag on residential investment income returns and a significant disincentive to institutional investors.*
- *Residential is usually considered part of a wider property allocation and therefore compared with UK commercial property, which it must compete with.*
- *'Institutional investor' is a generic phrase, which actually encompasses a variety of different investors with different income, capital and total return expectations.*
- *For some pension and life funds income is important and the 'income' component of residential is generally below their expectations.*
- *To attract greater pension and life fund interest this response focuses on ways of reducing operating costs via the tax system.*

8.1 The historic returns from the main UK asset classes, including residential, are set out in the table below. Based on house price inflation and the average net income return from residential according to the Investment Property Databank (IPD) dataset, PRS investment would have outperformed the returns from all the other asset classes since 1971, assuming the current rules for Assured Shorthold Tenancies had applied throughout this period.

Table 2

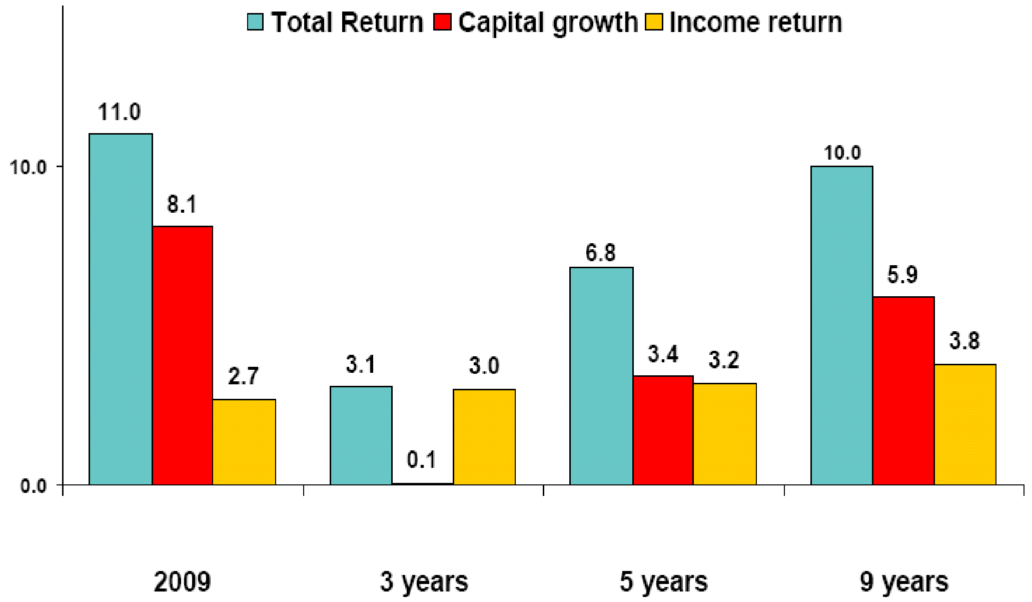
Correlation of Annual Returns (1971-2009)	UK Residential	UK Equities	UK Gilts	UK Cash	UK Commercial Property
UK Residential	**1.00**				
UK Equities	**0.05**	1.00			
UK Gilts	**-0.21**	0.58	1.00		
UK Cash	**-0.12**	0.13	0.20	1.00	
UK Commercial Property	**0.70**	0.29	0.04	-0.04	1.00
Average total returns pa (%)	**13.4**	12.6	10.1	8.5	10.8
Historic volatility (Standard deviation) (%)	**11.6**	30.2	13.8	3.7	17.4*

Source: Nationwide, IPD, DataStream & LaSalle Investment Management
* Unsmoothed, 11.6% smoothed

8.2 Investors in UK commercial property expect a return of 2.5%-3% in excess of the risk free rate. The risk free rate today, as expressed through medium-dated index-linked bonds and gilts, is below the long term average so, in practice, commercial property investors are seeking 7%-8% pa (unlevered).

8.3 Residential property has to deliver a return in excess of commercial to attract attention and the historic data suggest that it can. Once residential is established as a natural part of most property portfolios, investors will probably accept a similar return to commercial because the income stream it delivers is probably more stable in all economic circumstances. However, more of the return is delivered through capital gain which is inherently more uncertain.

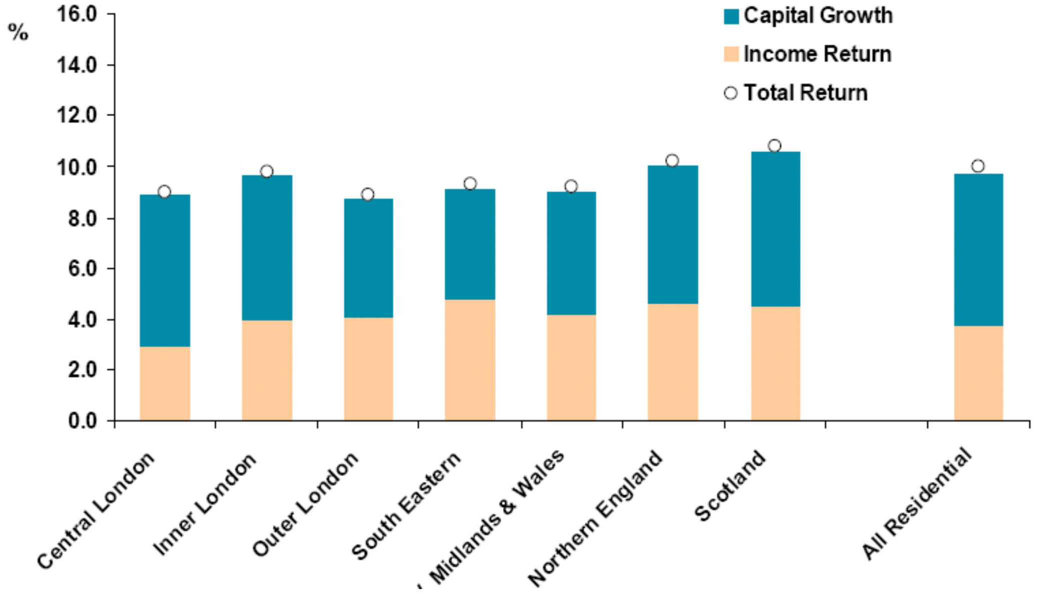
Chart 6 – IPD Residential Performance to Dec 2009



Source: IPD

8.4 Chart 6 shows that the overall performance of residential over various timescales relies heavily on capital growth, for example, of 5.9% per annum over the last decade, compared with 3.8% per annum income return. For that reason, the mainstream residential sector is generally seen by the market as a 'total return' investment class, delivering a combination of a relatively modest income yield and (historically, at least) relatively predictable and substantial capital growth. Chart 7 shows some variation in regional performance.

Chart 7 – Regional Performance 2000-2009



Source: IPD

8.5 Institutional expectations/requirements will differ. Generalising, there are a number of existing and potential investors in the sector whose expectations are met in terms of total returns. However, some pension and life fund investors are looking for a better balance between capital and income return, the latter being about 200 basis points below the long-term performance they would expect.

8.6 The responses to Questions 6 and 7 above discuss ways in which the tax system can help attract a broader range of investors in the residential sector.

Different institutional investors

The term 'institutional investment' is used generically, but actually encompasses a diverse range of different types of investor, with different income, capital and total return expectations, for example:

- larger public and private companies;
- pension and life funds;
- sovereign wealth investors;
- investment funds, using a variety of different 'wrappers' (vehicles)
- other institutions, such as charitable trusts

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?

- *A nexus of different issues currently explains interest in residential investment – the comparable performance of other assets; state of the house building market; less access for buy-to-let investors, on-going strong demand for housing; correction in house prices; difficulties people face accessing home-ownership; and, the HCA and HM Treasury's interest.*
- *If housing demand is going to be met then it is important Government considers long-term measures that will draw investment into the sector.*
- *There are some valuable lessons to be learnt from the HCA's Private Rented Sector Initiative – being market focused, providing scale opportunities, and tangible support.*

9.1 There are a number of reasons for recent institutional interest in the PRS. These include:

- The downturn in the commercial property market has led institutions to review their existing portfolios. The residential sector differs from the commercial property sector and therefore offers opportunities to reduce volatility of returns and diversify investment risk.
- Distress in the house building industry - new private housing work in 2009 was 28% lower compared with the previous 12 months and lower still than the levels in 2006 and 2007 (ONS, Q4 2009), which may present a new opportunity for institutions to invest in residential property in the lot sizes they require.
- Encouragement given by the HCA and HM Treasury. For example, the recent offer of six HCA sites provides residential funds (and their institutional investors) with another means of entering the sector in scale. The HCA in the future could offer many more Government or Department owned housing or mixed use sites to residential funds, which will bring forward developments at a time when house builders are finding their balance sheets constrained and funding hard to source.
- The correction in house prices and the tightening of bank lending criteria to the residential market as a whole, and to the buy-to-let market in particular.
- Recognition of the importance of the the PRS and the leading role it has to play in providing housing for those in need, particularly a generation of 25-34 year olds who may have to wait to their mid-30s, to make their first home purchase.

9.2 It is too soon to say whether these factors will lead to a long-term change in investment opinion but current discussions with institutional investors do indicate that there is a significant latent long term appetite for investing in the residential sector if some of the issues raised in this paper can be addressed. We think that period 2010-12 represents the best opportunity to effect a change in investment opinion among institutions in a generation.

9.3 The Homes and Communities Agency's Private Rented Sector Initiative has illustrated that there is wider latent investor demand than perhaps is appreciated.

9.4 The PRSI has been well supported in the sector. Raising an initial £1bn of investment will be a useful contribution to increasing housing supply in current economic conditions.

9.5 We believe, however, that meeting future housing need requires sustained investment by institutions in the PRS, and whilst the PRSI is a useful programme, it is about the 'here and now' predominantly, and the wider PRS needs to be encouraged and supported by Government for years to come if it is to meet demand for housing.

9.6 Emphasising the lessons of the PRSI, what matters to institutions is scale of opportunity and meeting institutions' return expectations. The way this is being achieved in the PRSI is predominantly by using HCA land and therefore ensuring the price paid for the stock provides a competitive return.

9.7 If institutional investment is to be maintained after the PRSI, however, and to make a useful contribution towards satisfying housing market needs, the Government will need to consider how a competitive return and scale of opportunity can be delivered on an ongoing basis.

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?

- *Practical measures are needed to encourage institutional investment in the PRS, but Government should also not ignore the psychological barriers and how much it can achieve with appropriate signals, or how much it can stop with the wrong messages.*
- *A combination of practical measures is required to ensure appropriate support for continued housing development and supply for those in housing need. What support is provided is ultimately down to Government and its ambitions for the sector.*
- *Per unit SDLT, reductions or refunds of VAT and changes to the REITS regime (outlined below) could make a significant difference to the returns from the sector and investment in it, send a strong psychological signal of support and help to stimulate institutional investment.*
- *A further huge barrier to investment is access to stock. In the short term this can be satisfied by access to existing mothballed schemes and access to land via the HCA. In the longer term, sustained investment on the scale the country requires would require a steady source of stock.*

10.1 Institutional investment must be seen within the wider context of the rental and housing markets and shortfall of housing supply. Appropriately channelled, institutional capital invested in new stock can help add to housing and reduce the gap in supply.

10.2 Barriers will differ between institutions and resolving them will depend on the Government's ambitions for the sector. At their most basic, institutional investors in the PRS are no different than any other business investor, wanting a stable economic and political climate, with no shocks to the system.

10.3 Beyond the general, there are specific barriers that Government might consider addressing. As stated, the extent will depend on what contribution the Government believes the sector should be making to housing shortfall. If its ambitions match the scale of the UK's housing supply problems then a combination of reforms will be required.

10.4 The main economic problem pension and life funds investing in new build face is that the very dominant owner occupier market sets prices according to what people are prepared to pay (and can borrow) to live where they want to live. The result is that rents (which depend on earnings rather than on capital values) cannot deliver a sufficient yield, so the PRS is structurally reliant on capital growth on an ongoing basis to deliver an acceptable total return.

10.5 That reality has probably contributed significantly to the resistance that many institutional investors appear to have as regards residential property. That resistance is probably the result of two key factors. First, institutions are generally conservative organisations and significant departures in asset allocation need to be justified. As residential is a new and unfamiliar asset class for many of them, a certain amount of caution and hesitation is probably inevitable.

10.6 Secondly, potential investors can see that residential is more than an asset class: it is also housing, and therefore very sensitive socially and politically. As a result, there is perceived to be a high risk (as compared to other asset classes) of regulatory intervention (which may be driven to varying degrees by sound policy justification or short term political concerns). That regulatory uncertainty is something which makes institutional investors and asset allocation advisers nervous. While it clearly cannot (and should not) be eliminated altogether, Government must carefully manage the signals it sends through regulatory initiatives and policy announcements if it wishes to encourage substantial, stable and lasting institutional investment in residential. The

HCA's PRS Initiative has shown that the mental block can be overcome, and more messages from the Government indicating that there is a strong policy desire to encourage greater institutional investment in housing, and that it understands the need for certainty and predictability in the tax and regulatory environment would also help enormously.

10.7 It is not realistic to expect radical price change in the UK housing market and thus if the institutional investment market is to grow and make a significantly greater contribution to housing supply some policy intervention is necessary. There are some relatively simple and quick ways of improving the income yield and thus attracting more institutional investment in the sector.

10.8 As discussed in our responses to Questions 6 and 7 above, the acquisition cost of residential portfolios can be reduced (increasing the gross income yield) by changing the application of the SDLT legislation in relation to bulk purchases of residential property. For example, 1,250 homes each of which is worth £200,000, if sold individually to owner occupiers and small investors, will yield £2,500,000 in SDLT (ignoring the potential impact of the temporary first time buyer incentive). However, an institutional buyer of the same portfolio would have to pay £10,000,000 (which would of course reduce the amount available to buy properties). Levelling the playing field so that the bulk purchaser pays at the rate applicable to the unit price would still deliver£2,500,000 in SDLT to HM Treasury, while at the same time, the effective reduction in purchase costs would help improve the rental yield for investors, as well as sending a message to the market that the Government wants to support large scale investment in the PRS. Our understanding is that the unfavourable SDLT position itself is enough to dissuade institutional investors, particularly as it must be paid upfront and therefore acts on a drag on investment performance in a fund's early years.

10.9 In the context of residential investment, operating costs consume around a third of the gross yield from rental income, significantly reducing the net yield actually available to investors. A significant element of those costs is attributable to unfavourable tax treatment – most importantly, irrecoverable VAT. Uncertainty as regards the trading/investment distinction is also unhelpful. Improving the tax treatment of residential investment to tackle those issues would also send a very encouraging message to institutions uncertain about whether to invest in residential property.

VAT

10.10 As regards VAT, two specific proposals that the Government should consider are extending the reduced rate for renovation and repairs (taking advantage of existing flexibility in the applicable European legislation), and introducing a refund scheme to reduce the VAT cost associated with management of a residential portfolio.

10.11 The operating costs of managing a large residential portfolio are relatively high as compared both to commercial property (where most costs are generally passed down to tenants) and to small scale residential investment (where costs are often absorbed by the individual investor carrying out management, repairs and maintenance in his own time, or are outsourced to contractors below the VAT threshold).

10.12 Any large scale institutional investment in residential property would need to benefit from efficient external management of the portfolio to manage relationships with tenants, lease renewals and voids, repairs and maintenance. The external manager would inevitably be VAT registered, adding, under current law, 17.5% to the commercial cost of its services. The impact is to reduce the yield available to investors and eat into the efficiencies of scale which ought to encourage large scale investment in residential.

10.13 The Government should consider:

- reducing the VAT cost to 5% to the maximum extent permitted by European law;

- and/or introducing a refund scheme to reduce the VAT cost of operating a large residential portfolio, either for all investors or at least for institutional investors who are registered as such.

10.14 We would specifically recommend that any refund scheme should be operated by a department or agency primarily concerned with the social policy aspects of the measure rather than with tax collection.

10.15 It is worth emphasising in this context that the zero rate for new build remains vital for the delivery of new homes, which is in turn essential both in broad policy terms and for the emergence of an institutional PRS capable of flourishing in the longer term. The impact of VAT needs to be reduced overall – both on housing delivery (through maintenance of the zero rate) and on improving the quality of the existing stock (through a reduced rate for repairs and alterations). Those two elements should not be seen as alternatives.

VAT

VAT on the labour element of housing repairs, alterations and renovation reduces the net yield to institutional investors. It is a cost that individual investors are often not subjected to, either because they do their own repairs, alterations and renovation, or use contractors that are not VAT registered.

The 'Cut the VAT Coalition' recently published research by Experian, which showed cutting VAT on the labour element of such costs to 5% would have significant benefits for the economy:

net revenue loss from this measure of £102m to £508m per annum. This would stimulate £1.4bn of additional economic activity in 2010 alone, which in turn should generate sizeable taxable profits;

creation of up to 24,200 extra full time equivalent jobs in 2010 alone with total jobs created in the construction sector rising to 34,500 by the end of 2019;

31,000 jobs created in the wider economy;

a release of £450m of funding to spend on the UK's social housing stock; and,

an extra 174,000 homes being retrofitted with loft and wall insulation, double glazing and energy efficient boilers over the next decade. This would lead to a saving of up to 337,000 tonnes of CO2.

Reducing the VAT rate on housing repairs, alterations and renovation is permitted under EU law. There are also precedents in that a number of existing housing-related activities attract a rate of 5%:

conversions of premises to a different residential use;

renovation or alteration of empty residential premises;

installation of energy saving materials;

installation of mobility aids for the elderly.

Trading/investment uncertainty

10.16 The potential uncertainty inherent in whether profits on disposals of residential property are taxed as trading profit or capital gains can be unattractive for institutional investors. As explained in more detail in our response to Question 11, in order to provide an acceptable return for investors, it is normally the case that some property in a residential portfolio will need to be sold so that capital growth in the portfolio as a whole can contribute to total returns on an ongoing basis. Whether profits realised on any such disposal are treated as arising in the course of a trade will be question of fact and law and while it may be relevant in particular to a REIT (see further Question 11), it will also be relevant to an investor who is exempt from tax on capital gains (such as a UK pension fund or a non-UK resident).

10.17 In our response to Question 11 below, we propose that a 'white list' should be introduced for transactions by a REIT in residential property, similar in concept to the definition of "investment transaction" in the Authorised Investment Fund Regulations. This would provide clarity that investment treatment will apply in certain cases which might otherwise be uncertain. While addressing this uncertainty is critical for REITs, however, it is also important for other types of institutional investor, who will be seeking certainty in their investment. Accordingly, we would recommend that such a 'white list' also applied more generally to transactions in residential property by any collective investment vehicle, registered pension scheme or offshore fund.

10.18 It is worth noting that the critical nature of the trading/investment distinction gives rise to particular problems in the context of shared ownership. In the first place, where the investor acquires a new home and immediately sells part of the interest in it to the occupier, that sale may be regarded as a trading transaction, even though it is, as a matter of commercial reality, no more than a necessary step in creating the shared ownership structure. In the second place, the flexibility of shared ownership which allows the occupier to increase his interest in the property a short period after entering the structure can also give rise to trading risk – the sale of a further proportionate interest by the investor may be regarded as a trading transaction. If shared ownership is to help improve the affordability of owner-occupation, legislation needs clearly to recognise that it is fundamentally an investment activity despite the transactional activity that it may encompass.

Other possibilities

10.19 In current economic conditions, we believe that making the operation of a residential investment business more tax efficient and less uncertain, as outlined in the preceding paragraphs, would improve the yield to investors and improve their confidence in residential, and should therefore deliver increased investment in the sector.

10.20 To create such scale of investment will require a significant delivery of new build property. This is being achieved in the HCA's PRSI, for example, via access to 'public land' in return for some share in later returns seems a successful model.

10.21 To allow the broadest possible access to the sector by individuals and institutions, it is important to ensure that appropriate vehicles exist through which such investment might be made. The most natural choices under current law would probably be offshore tax transparent vehicles such as an FCP or Jersey Property Unit Trust and (but for a number of issues identified in our response to Question 11 below) REITs. These tax transparent vehicles are well understood investment vehicles, where the rent is taxed in the hands of investors and gains are outside the UK tax net, so that different sophisticated investors are able to invest together without losing their individual tax status/attributes. The REIT regime represents a tremendous opportunity for a well regulated, transparent, liquid, UK resident alternative, open to a broader investor base, and our response to Question 11 discusses a number of changes that should be made to it so residential REITs can emerge.

10.22 We believe that both the UK's REIT sector and the UK's PRS are incomplete in the absence of residential REITs. However, it is important to remember that neither the REIT nor any other vehicle represents the single vehicle of choice for residential investment. Different vehicles will suit different investors or categories of investors better – so a healthy legislative environment would be one that allows fund managers and investors to choose between them, just as it should accommodate different business models (with different levels of debt and property disposals for example). Our responses to Questions 13 and 14 discuss the main options in terms of vehicles for collective investment in residential property.

10.23 It is worth making it clear that investment by institutions should not be seen as a rival or replacement for buy-to-let, but as another important source of equity finance without which new housing cannot find its way into the market – particularly as debt finance for housing in its various forms is likely to be scarcer for the foreseeable future. The private investor will remain a key source of capital and investment in the PRS and buy-to-let an important method of raising finance for housing. As an important component of the buy-to-let sector is the new entrants who start with a single rented property substantially financed using debt, reviving the buy-to-let mortgage market should therefore be seen as another policy imperative. It is from the ranks of those new entrants that the buy-to-let investors who build much larger, professionally run portfolios with lower gearing are drawn.

10.24 Partly in that context, it is worth noting that capital gains tax suffered by the seller of a rented property is one of the costs inherent in a thriving transactional market and rollover relief should be introduced for individual PRS so investment in a social good – housing – is maximised.

QUESTION 11: What are the key barriers to investment in residential property through UK REITs, and what changes would be needed to address them?

- *The barriers identified in our response to Question 10 are also generally relevant in the context of encouraging the emergence of residential REITs.*
- *Reducing trading/investment is particularly important for REITs.*
- *Changes should also be made to the way the distribution requirement operates and to the potential impact of the profit:financing cost ratio for residential.*
- *The diverse ownership condition should be reconfigured.*
- *The conversion charge abolished or linked to latent gains (rather than portfolio value).*
- *Rollover relief for those selling to a REIT in return for shares would also be helpful.*

11.1 As explained above, the fundamental attributes of the residential property sector in the UK mean that, in order for an investor to obtain an attractive return having regard to their risk of investment, it is normally the case that property will need to be sold regularly to crystallise some profit to return to investors. This is because (unlike commercial property) residential property in the UK tends to produce a modest net income yield which cannot alone provide sufficient return to compete against other asset classes for institutional capital. The reasons for this characteristic of residential property are that:

- There is a disconnect between the amount that needs to be paid to acquire a property and the rents that are possible to achieve. This is because a landlord needs to compete with owner occupiers who do not value properties based on a multiple of rental yield (as would be the case for commercial property). The result is a low income yield but a high expectation of strong capital growth.

- Investors in residential property generally meet the cost of maintaining the property themselves (whereas these costs are generally met by the tenant of commercial property).

- Lease lengths of residential property tend to be relatively short term – typically 6 months (versus 5 to 21 years for commercial leases). This, coupled with the low individual unit value and rent, means that there is a potentially higher incidence of annual void periods and increased costs of re-letting.

11.2 The result is that rental yield alone is generally insufficient to deliver an acceptable return to investors. Furthermore, where a residential portfolio has even a modest amount of gearing (e.g. more than around 20%-25%), the rental yield may not be sufficient to meet financing costs. Generally, therefore, residential is seen as a total return asset class, with capital growth typically delivering two thirds of the return. As a result of that position, under current rules, some residential funds are treated as holding their property on trading account – something that is incompatible with the REIT regime. Even for other funds which hold their property on investment account, the investment/trading distinction (and the dramatic consequences of falling on the wrong side of it) can introduce a problematic degree of uncertainty, both generally and in the context of the REIT rules.

11.3 It has also been explained above that there are a number of aspects of the UK tax system which adversely affect the return to investors in residential property:

- The SDLT aggregation rules mean that a large scale investor suffers a higher effective rate of SDLT on bulk purchases than would be applicable to independent purchases of the individual units. That operates to reduce the gross income yield generated by the portfolio, as well as the total quantity of stock that can be acquired and the capital return that can be delivered.

- A residential landlord is unable to recover input VAT incurred on property repairs and renovation. The effect is to increase the costs which eat into the gross income yield, reducing the net income yield available to investors.

- The absence of any tax depreciation for investors in residential property also reduces the net income yield available to investors.

11.4 These issues also apply to residential REITs. However, in addition to this, we have described below the features of the UK REIT regime which represent specific barriers to investment in residential property through REITs. After describing each barrier, we make recommendations as to how it might be addressed with minimum disruption to the existing regime.

11.5 Of the five key factors outlined below, the first three (trading risk, interest cover ratio and distribution condition) derive from a mismatch between the current REIT rules and the existing attributes of the UK residential property market; the fourth factor (diverse ownership condition) has impacted on institutional investment in REITs and the fifth factor (entry charge) may impact on the launch of new REITs.

Legislative barriers to residential investment by UK REITs

Risk of disposals being treated as trading

11.6 As explained above, in order to provide an acceptable return to investors, a residential REIT would need to dispose of property regularly in order to realise capital growth in value. Maximising this capital growth in a residential portfolio requires the asset manager to actively manage the portfolio and dispose of and acquire assets to anticipate or respond to changes in market sentiment.

11.7 A profit on a disposal of property may be taxed as either a trading profit or a capital gain. The dividing line between the two depends on principles derived from tax case law which are complex, uncertain and often contradictory. As a practical matter, however, it is probable that a residential portfolio is more likely than a commercial portfolio to be viewed as trading because of the larger number of individual transactions carried out by a residential landlord and the greater reliance on accessing capital growth in the investment proposition.

11.8 The distinction is critical to a REIT because a trading profit is fully taxable whereas a capital gain would be tax exempt (and under current rules would not be required to be distributed to shareholders). In addition, while it is possible for the returns in a REIT to withstand tax on a small proportion of its disposal transactions, if some transactions are characterised as trading by HMRC, it makes it more likely that the entire residential portfolio of the group will be 'tainted' and viewed as trading because one of the case law tests looks to the types of transaction that a property vendor would typically carry out.

11.9 Even if the portfolio is not so tainted, the treatment of individual property disposals as trading transactions could generate significant tax costs and, if there are enough such transactions, it is possible that a REIT could fail the condition of the regime that requires at least 75% of its assets to relate to its property rental business. In this case, it would lose its status as a REIT. A similar issue arises in relation to satisfying the 75% profits condition.

11.10 In bringing a residential REIT to market it is obviously critical that there is certainty over whether the vehicle will be able to meet the conditions of the regime and also that an accurate forecast can be made of the likely returns to investors, and hence the tax costs to be suffered. Given the lack of statutory definition on what constitutes a trading or capital disposal of property, this certainty cannot currently be obtained.

11.11 It should be noted that the issue of the trading/investment boundary is also important to non-REIT vehicles that may be used to invest in residential property because, for example, a pension fund would be tax exempt on a capital profit arising via a tax transparent vehicle such as partnership whereas it would be taxable on a trading profit. A non UK resident company has a similar issue. As a policy matter, the Government may wish to consider whether any proposed solution has general application in the context of residential property investment, or should be limited to REITs.

Recommendation:

11.12 We would recommend that a "white list" is introduced in the REIT legislation for transactions in residential property only, similar in concept to the definition of an "investment transaction" in the Authorised Investment Fund regulations (SI 2009/2036).

11.13 Those regulations essentially state that all transactions involving specified types of asset will be treated as investment transactions, regardless of the conclusion to which the application of case law principles might lead.

11.14 We would suggest adopting a similar approach and providing that all transactions involving interests in residential property will be treated as investment transactions, with profits accordingly being treated as tax exempt for the purposes of the REIT rules.

11.15 We discuss how 'residential property' might be defined (both for these purposes and, potentially, in relation to other suggestions made in this section) below.

11.16 We recognise that it may be appropriate to qualify that proposed rule so that, for example, disposals by house builders continue to be subject to normal case law principles.

11.17 We also recognise that, even within the context of large scale investment in the PRS, government may wish to set boundaries around automatic investment treatment. If so, one approach that we would support would involve a three step analysis:

(1) A 'gateway test': Does the overall rate of 'churn' in the relevant portfolio exceed 20% of the total value of the properties at the start of the accounting period. If not, chargeable gains treatment applies to all disposals. If the churn exceeds this level, proceed to the next step.

(2) A 'safe harbour': Has the individual asset being disposed of been held for at least three years prior to disposal? If so, chargeable gains treatment applies. If not, proceed to the next step.

(3) If neither the portfolio test nor the asset test results in investment treatment, apply normal case law principles to determine the correct treatment.

Interest cover ratio

11.18 The legislation requires a REIT to meet an interest cover ratio between rental profits from exempt property and financing costs relating to this property of 1.25:1. The consequence of failing to meet this test is that the REIT is taxed on a notional additional profit that equals the amount of "excess" financing costs i.e. the amount of cost that caused the REIT to breach the ratio.

11.19 As explained above, net rental yields from a residential portfolio are typically low. With anything more than a modest level of gearing, therefore, it can be difficult to meet the ratio set by the REIT regime. While some institutional investors are likely to prefer a low gearing (which would not give rise to difficulties with the interest cover ratio), it is also common for large scale investment in the PRS to use higher levels of gearing, such that financing costs are often partially funded through realising capital uplift on residential properties. We recommend that the REIT rules should be rendered capable of accommodating both approaches.

Recommendation:

11.20 We would recommend that a REIT should be able to include tax exempt profits from the disposal of residential property in the amount of "profits" used to calculate the interest cover ratio if it is otherwise unable to meet the test. This would also have the merit of reflecting commercial reality on how the interest costs on the residential portfolio are met.

11.21 To the extent that a REIT needs to add disposal profits into the calculation in order to meet the test, that element of profits should then be subject to the distribution requirement. The policy objective of the interest cover ratio is to prevent a REIT from reducing its distribution requirement by introducing a high level of gearing. If the REIT does not wish to include disposal profits in the interest cover ratio because it does not wish to distribute further amounts of its profit, or indeed if it still fails the test having include all its available disposal profits in the ratio, it will be subject to the penalty in the normal way.

Distribution requirement

11.22 A REIT is required to pay out 90% of its rental profits to shareholders year on year. Rental profit for these purposes is calculated as for a corporation tax computation. In a commercial property portfolio, the amount required to be paid out is significantly reduced, therefore, by the availability of capital allowances. However, capital allowances are not available on residential properties (a concessionary wear and tear allowance of 10% of net rents is allowed as a tax deduction against rents from furnished residential lettings only).

Recommendation:

11.23 There are two broad approaches to this issue with a view to making it easier for a residential REIT to meet the distribution requirement.[18]

11.24 The first approach is conceptually REIT specific, and would involve reducing the distribution requirement for a REIT's residential investment business profits to, say, 80% (see below for how one might approach defining 'residential property').

11.25 The second approach would be to allow REITs to calculate the profits of their residential property rental business (whether furnished or unfurnished) by applying a notional wear and tear allowance (similar to that currently available for furnished lettings). This solution, while not conceptually REIT specific, would operate to reduce the amount that a REIT holding residential property needs to distribute with no more than a modest revenue impact – it would chiefly operate to soften the impact on residential REITs of the 90% distribution requirement.

Legislative barrier to institutional investment in UK REITs

Diverse ownership requirement

11.26 The current legislative form of the diverse ownership requirement may be an impediment to institutional investment in a REIT. For example, a listed company held by five major pension funds and life companies could fail this requirement despite all these institutional shareholders being diversely owned themselves. This could prove to

[18] We note, in this context, the Government's recent announcement of an intention to allow the 90% distribution requirement to be satisfied by an issue of new shares, allowing scrip dividends to be used to improve cash retention by REITs generally. While that will be very welcome, we do not believe that it is sufficient to support residential investment in REITs, because scrip dividends should be an option available to a REIT, not something on which it is structurally reliant.

be a barrier to large-scale institutional investment in residential REITs. The diverse ownership requirement is as described below.

11.27 The REIT regime requires that the principal company of the REIT group should be widely held by investors. The test is based on the 'close company' rules already available in the tax legislation, but with some modifications. Without these modifications, a REIT which is controlled by a corporate shareholder which is not itself 'close' would be able to meet the close company requirement.

11.28 The original policy reason for the modifications to the close company rules as applied to REITs was to prevent a REIT from meeting the test simply by being held by a single large corporate. This might, for example, have enabled 'internal' REITs to be set up within an occupier group. This situation, however, could now be prevented by use of the Prescribed Arrangements Regulations brought into effect in 2009 and the modifications are therefore no longer required to meet that policy objective.

11.29 Furthermore, there are arguably good policy reasons today for making it easier for organisations (for example, financial institutions which have repossessed numerous properties) to assemble a portfolio within an initially wholly owned or closely held REIT which might gradually be sold out into the market.

11.30 The removal of the modifications would make it more likely that any new REIT would be able to get off the ground as, especially in the early stages, there is likely to be a concentration of share ownership. The promotion of new REITs is especially important in the context of residential assets as there are currently very few existing large residential portfolios within corporate structures which could easily convert to REIT status.

Recommendation:

11.31 The REIT rules should be amended to change the 'close company' test such that a REIT is no longer precluded from taking advantage of s444 or s447(1)(a) CTA 2010 to meet the test.

11.32 Furthermore, (once re-instated) the exceptions in s444 and s447(1)(a) should be further relaxed so that the close company test can be met where a REIT is controlled by diversely owned entities that are not companies (such as registered pension schemes, fund of funds, ISAs, or overseas REITs).

11.33 A list of permitted entities could perhaps be set out in a statutory instrument, in a similar way to Regulation 7 SI 2006/2867. We would point out that there is already a precedent for relaxing the close company rules in the REIT context (in respect of limited partnerships).

Financial barriers to investment in UK REITs

Entry charge

11.34 The current entry charge requirement is another key factor which is stifling the formation of residential (as well as commercial) REITs, because it is very difficult to justify paying it in connection with the launch of a new REIT which assembles a new portfolio and has no deferred tax provision in respect of latent gains.

11.35 The entry charge is calculated as 2% of the gross market value of the property assets held at the point of conversion to REIT status. The policy purpose for the entry charge was expressed by HMRC at the time of the initial launch of the regime as being to ensure that the introduction of the regime was cost neutral for the Exchequer. The entry charge therefore needed to equate to the present value of the future loss of tax to the Exchequer as a result of gains on sale of properties and rents being exempt from corporation tax. Gains on sale comprised both latent gains at the time of conversion and potential future gains.

11.36 Property businesses converting, or considering conversion, to REIT status have overwhelmingly tended to regard the entry charge as a quid pro quo for being able to write off existing latent gains. It was largely on that basis that the UK's existing listed property companies – which generally had substantial latent gains at the point of conversion – concluded that it made sense to enter the REIT regime and pay the charge.

11.37 That logic does not apply for new entrants. Where a new portfolio has to be acquired, there are no latent gains at the point of conversion. An entry charge calculated in this way therefore results in a significant cost compared to the benefit obtained by entry into the regime. That cost is difficult to justify commercially, and has led to many potential (generally commercial) REITs choosing a different structure capable of delivering tax efficiency without the cost of the entry charge.

11.38 Indeed, the Government needs to appreciate that tax efficiency for property investment is available through the use of different vehicles, each of which has its own attributes and characteristics (which particular investors may view positively or negatively), but none of which is subject to an entry charge. Entry charges such as that for access to the UK REIT regime are also unusual in REIT regimes internationally.

11.39 A number of existing tax efficient residential funds which might consider converting are substantially held by UK pension funds and life companies. As such investors may not pay tax on capital gains, here too, it is extremely difficult to make a commercial case for paying the entry charge.

Recommendation:

11.40 The entry charge is a major barrier to the emergence of new REITs (as opposed to conversion by groups with existing portfolios), both residential and commercial, because the way it is calculated exaggerates the tax benefits from entry into the regime.

11.41 If the Government wishes to encourage the emergence of new residential REITs (and growth of the REIT sector more generally), we would recommend a time-limited entry charge 'holiday' (along the lines of the stamp duty holidays with which we are familiar). The holiday should last at least two or three years, recognising the lead in time for assembling a new portfolio and launching a new REIT. Existing anti-avoidance provisions provide ample protection to ensure that the regime is not used in an inappropriate way to derive tax benefits outside the policy objective.

11.42 An alternative approach would involve not automatically (or not wholly) linking the entry charge to the market value of the relevant portfolio, but instead linking it to the amount of latent gains in that portfolio (possibly at the election of the relevant REIT).

Other factors

11.43 We have previously identified other issues which may militate against residential REITs being launched in the UK. In this response, we have deferred them to this final section because we consider them to be less critical, and so lower priority, than the points discussed above. In particular, those other issues include:

- The requirement that REITs list on a recognised stock exchange and therefore incur the costs of this listing.

- The lack of rollover relief which would enable vendors of residential property (whether buy-to-let investors or institutions wishing to reduce their exposure to an existing portfolio), to exchange their properties in return for shares in a REIT without the crystallisation of capital gains until a later disposal of those shares (as discussed briefly at the end of our response to Question 10 above).

Defining residential property

11.44 There are numerous existing definitions of residential property in UK statute law, including for different stamp duty, VAT and capital allowances purposes. To the extent that the REIT rules might be amended for residential property only, we would suggest that a simple definition would be attractive, probably identifying residential property by reference to its key characteristic of occupation (or intended occupation) as a person's home. We would be very happy to assist officials in exploring how residential property might best be defined for these purposes.

QUESTION 12: 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?

- *The available evidence is generally theoretical and anecdotal, with the experience of other countries of very limited help in predicting how changes to the specific UK REIT environment would impact on market behaviours.*
- *There is no reason to believe that UK-REITs investing in commercial property would be disadvantaged by measures designed to support the emergence of residential REITs – and they may benefit, either directly or simply through the growth of the UK REIT sector overall.*

12.1 We believe that certain relatively modest changes to the existing REIT rules, as set out in our response to Question 11 above, are required to create a viable UK-REIT market specialising in the residential property assets.

12.2 Institutions invest on an asset allocation basis. The residential property asset class is clearly different from the commercial property sector. Importantly, it has a weak correlation with commercial property (and other asset classes), rendering it a good risk diversifier as part of a balanced portfolio. For that reason, we would expect new residential REITs to complement, rather than compete with, the existing commercial REITs, supporting the expansion of the UK REIT sector and bringing greater specialisation – both features likely to attract more capital to UK property overall, particularly from global and institutional investors. None of the commercial REITs in our membership have expressed concerns about residential REITs restricting their access to capital. Neither have we seen any evidence from the United States to suggest that the housing sub-sectors of the REIT market impact negatively on other sub-sectors. It is true that one would typically expect an institution to make a single allocation to property to cover both commercial and residential (if any) – but the size of that single allocation can and does vary significantly over time, it is not a zero sum game whereby a pound allocated to residential is a pound taken away from commercial.

12.3 Institutions are wary of investing in sectors with low net income yields (as in the case of the residential property business model). Lowering the barriers identified in our responses to Questions 10 and 11 would help to increase the income yields generated by residential property. Having said that, it seems to be an inescapable fact that residential property is a total return investment proposition, with 2/3 of the total return typically resulting from capital growth. As explained in the response to Question 11, reducing the trading/investment uncertainty affecting residential portfolios (particularly in the context of REITs, where particular problems arise) should help institutional investors to get comfortable with the total return nature of residential property.

12.4 Institutions are also unable to invest where sufficient scale of investment product is not available. The slight modifications to the rules that are required to accommodate the residential business model will make it easier for a residential REIT sector (and residential funds more generally) to emerge, thus allowing for that scale of investment product to become available.

12.5 Offering investors another class of investment (residential) in this way will assist in the delivery of the Government's vision and policy objectives set out in 'Promoting more flexible investment in property: a consultation' through the REIT regime. We acknowledge that there is limited concrete evidence to substantiate this view, but we would also point out that a number of UK residential property companies have cited legal rules which are at odds with their business models as the reason for not converting to REIT status.

12.6 Ultimately, asset allocation decisions by investors are not likely to be materially influenced by the availability or otherwise of one particular 'wrapper' (vehicle or structure), unless there is an absolute lack of acceptable alternatives. We do not consider that to be the position here: the fact that REITs are currently unavailable for residential investment is disappointing, and may have prevented a small number of conversions. However, the success of the commercial UK-REIT sector so far owes nothing to the unsuitability of REITs for residential investment – and it is the broader changes discussed elsewhere in this response, not changes to the REIT rules alone, which are needed to prompt the emergence of a residential PRS on a large scale.

12.7 The changes we have recommended in our response to Question 11 would make it possible for REITs to invest in residential property, either alone or alongside commercial property. Two of the most useful of those changes – modifying entry charge and reducing trading/investment uncertainty – as well as some of the others (like amending the diversity of ownership test) would deliver real benefits to the wider REIT sector if they are implemented generally (as we would recommend), rather than being limited in their scope to residential investment through REITs.

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

- *Different vehicles with different characteristics (e.g. listed or unlisted, open or closed ended) 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 is vital that a range of different investing options should exist.*
- *Cost efficiency (including as regards tax) is a key consideration at the outset, particularly in the context of the modest income yields offered by residential.*

13.1 There are a wide range of potential collective investment vehicles for residential property investment. The table set out as an appendix to our response to Question 14 sets out some of the most common investment vehicles, by way of example.

13.2 In choosing an appropriate investment vehicle, particularly in the residential sector, where the income yields are low, cost efficiency will be crucial. This will clearly include tax efficiency in the vehicle itself, as well as any additional costs that could further reduce the yield and make the investment less attractive when compared with alternatives. While many fund managers would like to use a UK vehicle where possible for practical reasons, particularly if aimed at the UK market and UK real estate assets, in practical terms the need to achieve tax efficiencies where possible - in particular VAT in the residential sector and stamp duty on transfers of units - is often driving them to use non UK situs structures.

13.3 Precisely which vehicle is selected for any particular fund will depend on a number of factors. These factors will depend on the product offered and the detail of the business plan - for example is the fund to be open or closed-ended, of fixed or indefinite life, geared or ungeared.

13.4 Another relevant factor is the make-up of the investor base – is the investment to be marketed to the public at large or, say, only institutional investors?

13.5 Where a fund is aimed at the public the options are closed-ended vehicles, like ordinary listed companies (which are, however, not tax efficient) or REITs (their tax efficient equivalent), or open-ended vehicles such as a property authorised investment fund ("PAIF"). REITs could also be used for products aimed at sophisticated investors, as could "PAIFs", possibly structured as a Qualified Investor Scheme ("QIS").

13.6 Non-UK income transparent structures, such as the offshore property unit trust (e.g. the Jersey Property Unit Trust or "JPUT"), are popular in the institutional commercial property market and are fairly flexible. There is, for example, no tax leakage in the fund for exempt investors and capital gains can be rolled up in the vehicle tax free, where appropriate. Also, there are no regulatory constraints in terms of financing, units in the fund can be traded without stamp duty, stamp duty reserve tax or SDLT and management fees are outside the scope of VAT. The UK unauthorised unit trust could also be useful, being tax efficient for income and gains for institutions, although they are more constrained in terms of the investor base, being restricted to UK exempt funds and life companies.

13.7 The challenges identified elsewhere in this response generally apply for residential investment regardless of the particular vehicle chosen. However, certain vehicles present additional problems. Those affecting REITs are discussed in our response to Question 11.

13.8 PAIFs, which could be attractive open-ended vehicles for sophisticated investors looking at residential property, continue to grapple with the challenge of dealing with the three streams of income required by UK tax rules and the low gearing threshold may make the Non-UCITS Retail Scheme (NURS) unattractive to certain business models (specifically, where gearing is required) – though both these aspects may be manageable in a fund for sophisticated investors only.

13.9 Offshore structures have additional costs and practical implications that need to be built into the business model as a result of the need to be run overseas. This is particularly important in a low yielding model. The regulatory cost likely to be imposed on property funds by the EU Alternative Investment Fund Managers Directive and potential adverse affect on marketing into the EU may also impact on use of these structures in the future.

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

- *A number of the alternative available structures have greater flexibility for achieving lower costs (including tax costs) than REITs, because REIT specific requirements (such as the payment of conversion charge or the need to obtain a listing) do not apply.*
- *The alternatives also generally have more general business flexibility (e.g. because there is no balance of business test to satisfy).*

14.1 Appendix 2 sets out in tabular form some of the principal differences between REITS and some of the more common alternative residential property investment vehicles.

14.2 The principal differences are:

- for start-ups, the alternatives do not have to pay the listing costs or the conversion charge required in the REIT. This effectively improves the returns those alternatives can deliver;

- PAIFs and the offshore vehicles are able also to benefit from not having to pay UK VAT on management fees, either through the availability of an exemption (as in the PAIF) or through the supply being outside the scope, again improving yield;

- save for the PAIF structures (which are subject to certain constraints in order to be able to benefit from the tax benefits, some of which were referred to in the response to Question 13 above), the alternatives are generally more flexible than the REIT structure. There is, for example, no limit on the amount of finance available (subject to the usual rules on transfer pricing etc) and there is no balance of business test that must be satisfied to be sure that the intended tax consequences will remain available. There is also, generally, no constraint on the holdings of any particular investor nor any restriction on the payment of dividends to any corporate investor owning 10% or more, which may be important as institutions investing will be likely to include UK life companies, who may wish to take a substantial interest;

- dealing with distributions and funding of expenses is likely to be more flexible with the ability to have accumulation units etc. (again, putting REITs at a disadvantage relative to most of the alternatives); and

- retail investors (including ISAs) are not able to invest in the alternatives (other than the PAIF NURS and the offshore listed company), effectively restricting investors to the institutional market. If the Government would like to encourage the public to invest in residential property indirectly (rather than only directly in bricks and mortar as tends currently to be the case) enabling them to do so through UK-REITs would be an extremely important step.

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?

- *The need for increased housing supply is undeniable, as is the recent phenomenal growth in the private rented sector, current constraints on mortgage finance and lack of public finance for housing.*
- *Institutional investment could help underpin housing supply and therefore provide support for the construction sector.*
- *Against the backdrop of the credit crunch making the sector less reliant on debt may also be seen as a good thing.*
- *On a more practical level institutional investment would bring tangible benefits in terms of service innovation, quality assurance, and a broader range of opportunities for investors to invest in housing.*

15.1 The private rented sector is large and growing. It houses a sizable number of households who, for different reasons, are unable or do not wish to access the owner-occupier market. This is a key point at a time when house building output is low and funding affordable housing is a major challenge against a reduction in Government spending.

15.2 The PRS is part of the wider affordable housing market and for many is more accessible than grant-funded, low-cost home ownership products which have been the primary way of meeting housing demand for those who can access social housing. The PRS also punches well above its weight in housing market liquidity terms, accounting for half of all moves a year in the private housing market, something that is vital in supporting labour mobility and economic growth.

15.3 A sizable proportion of privately rented homes are owned by private landlords that deliver a decent offer (66% stock is decent and satisfaction rates are higher than those for social housing). This group will continue to play an important role and they should be encouraged to do so.

15.4 The PRS needs an approach that sees an increase in new supply to deliver greater choice of quality supply for households through investment. The growth in the PRS over the last 10 years has come largely from individual investors, who have benefitted from tax and leverage benefits. Institutional investment is more likely to be lowly (if at all) leveraged, which will help reduce house builders, developers and constructions companies' dependency on the banking sector at a time when finance from this source is extremely limited.

15.5 Residential investment has a very low correlation with other institutional asset classes and so has attractive characteristics in terms of portfolio diversification. Therefore, once engaged; and providing the regulatory environment does not change detrimentally, institutions are likely to invest consistently in the sector in the long term. Experienced investors have the financial scale and commitment to encourage the provision of 'build to rent' properties from new entrants, such as construction companies and mixed use developers. This in turn will help underpin the construction industry, which employs nearly 1.9m people (ONS, Q1 2008), and maintain the number of newly-built properties at times when the house building sector may see only limited owner-occupier demand.

15.6 Reputation is of key concern to institutional investors. Given this, they will be concerned to channel their funding to the most responsible managers - those that will meet or exceed the Government regulatory requirements for the sector; have a vested interest in maintaining their properties and being responsive to the Government's energy saving targets and ensure that the quality of build-to-rent properties is improved.

15.7 As with the commercial property market, given the appropriate legal and tax regimes, experienced fund managers would promote long-term investment vehicles to attract individual and overseas investors. This would provide still greater funding for the increase and improvement of the PRS stock.

15.8 There is clear evidence that can be drawn from existing activity that institutional investment would be beneficial, but also a lot of claims and counter claims that cloud the issue.

15.9 It is probably unhelpful to make comparisons with rental markets abroad, the USA or Germany, for example, which have very different housing and planning conditions, availability of land, etc. A larger institutional sector in the UK will reflect UK conditions, although if attractive, could attract capital from beyond our shores.

15.10 What the evidence shows is that a UK institutional sector would deliver:

Support for development

15.11 The buy-to-let sector over the past decade has illustrated the importance of investment sales to housing delivery. Off-plan sales to buy-to-let investors have reduced risk for house builders, particularly on riskier products, such as high density flats. A source of long-term development capital that similarly is prepared to commit to buying stock before completion will be beneficial to development and will therefore help deliver more stock overall. That in turn will mean more construction jobs and the benefits that flow from additional economic activity.

Less exposure to debt markets

15.12 If the big pension and life funds can be encouraged to invest in the sector, it will provide relatively patient money for housing. Debt itself can be very helpful and generally the £140bn of debt that buy-to-let has raised over the past decade has meant significantly greater finance for housing. That debt, however, has in large part been raised off the back of peoples' equity - smaller investors being prepared to put some of their savings in housing. Attracting more long-term equity finance into the sector, will help to ensure a better balance of sources of finance for the sector and less exposure to changes in interest rates. That is not to say that all institutions will be totally ungeared, but they are likely to raise the majority of their funds as equity, and that should make a positive contribution to the stability of the UK's housing market.

Innovation in services and service delivery

15.13 The student sector has illustrated that new innovative players in a sector can make an impact beyond their own activities. Companies like Unite in the student sector have had an impact far beyond their own direct activities, forcing universities to consider the quality of their own provision and smaller landlords how they will differentiate themselves in the market.

15.14 Unite and the like are providing greater choice in the market. Customer satisfaction levels are very high. New concepts, such as branding are being introduced to the sector – not something that would be seen as innovative to other sectors, but that is currently rare in the private rented market. With branding come service delivery standards and the qualities that are embedded in a brand. Service itself has benefitted from competition. For example, the broadband access that private student accommodation providers have introduced has become commonplace also in university provided accommodation. Being able to book your accommodation online, again may not sound innovative, but should be as commonplace in the PRS as it is in booking a hotel.

15.15 The competition in the student sector is not all one-way traffic. The larger private providers have adapted their product over the years to incorporate some of the things that make smaller student houses attractive, for example, allowing a group of friends to co-ordinate their booking of a group of cluster flats.

15.16 The growth in the private provision of student halls has also helped alleviate housing pressures in some local markets.

Quality assurance

15.17 There is a lot of claim and counter claim about the quality of private rented accommodation and what institutions can provide. What can be said with confidence is that an institutional sector will be different offering some aspects of service that small landlords cannot provide.

15.18 One aspect of institutional provision that it is not so easy to replicate with small landlords is direct redress. Institutions that sign up to the BPF's Code of Practice are required to provide independent third party redress to tenants via the Housing Ombudsman or Surveyors Ombudsman. Currently small landlords provide redress for tenancy deposits via one of three Government schemes, but not wider independent redress directly, although indirectly if they work via a professional agent about 50% will have access to redress via the agent's membership of RICS, ARLA, NAEA or NALS.

15.19 Another differentiation between larger and smaller landlords will be in blocks of flats. With an institution the block management and lettings management would mostly be done by one firm, meaning the management of the whole entity is relatively seamless. This is something institutions strive for to maximise co-ordination and economies of scale, although sometimes a social housing element to the development can hamper that. By contrast, individual investors will sometimes manage the letting themselves or via their agent. For the block as a whole there will then be a managing agent. Where there are problems, for example anti-social behaviour, this can be problematical in terms of co-ordinating a response, for example who does the tenant complain to – the landlord, letting agent, managing agent of the flat, or managing agent of the block?

15.20 Large landlords may also be able to on-sell other services to tenants at discount. Cable TV, high speed broadband or telecoms for example, which a small landlord cannot negotiate.

15.21 Standardisation may also be seen as a benefit, in terms of branding and the values and service standards that encapsulates. As the student sector has shown, however, some tenants prefer a small landlord and the 'personal' service they provide, and a small landlord can be very good at pastoral care and providing a more flexible service.

Greater choice for investors

15.22 Much of the focus of this response has been on the economic and social benefits for expanding the PRS for Government and occupiers. Supporting growth of an institutional sector, however, should also bring benefits that Government would want to see for investors. At present, for the 'man in the street' wanting to invest in housing, the only avenues are to buy for oneself or as an investment for others to occupy. Both of these avenues usually involve significant gearing, exposing the buyer to interest rate risk. There are many groups in society who probably benefit from being able to make a collective investment in residential property. The saver, who wants the returns residential can offer without having to invest in the whole property by way of a loan. Also, today's youth is going to find it harder to get on the housing market without parental help. Being able to save for a deposit in a product that is shadowing house prices would seem to make a great deal of sense. At the other end of the investment spectrum, making it easier for institutions to invest in the sector should have benefits in terms of creating a more liquid market and allowing investors to more easily diversify their holdings.

15.23 To conclude, institutional investment is needed to support housing delivery and the development sector. Having a sector that is less reliant on debt will bring economic benefits and reduce volatility. Institutional investors will also bring service innovations and different standards. Through their investment in new build the standard of accommodation in the sector will rise and indirectly, through innovation, competition and difference it should help raise the quality of the PRS overall.

APPENDIX 1 – PROPERTY INVESTMENT CLUBS

Unregulated PICs became synonymous with the housing boom. Typically, would-be investors would be offered a free evening seminar promoting the benefits of investment in property, focusing particularly on the potential for large capital gains and the ability to buy with little or no money down. In many cases more in-depth seminars, commonly a two-day course over a weekend, would be promoted at a cost of up to £5,000. Even larger sums would then be charged for club membership.

The main purported benefit of membership was that the club could negotiate significant bulk discounts by sourcing property direct from developers and passing these discounts onto its members. However, the discounts were often more illusory than real and lending on the back of such deals was more risky than appeared because of the lack of transparency around the incentives paid by builders to the buyer or to the club. Deposits paid by borrowers often turned out to have come from the builder, so the reported loan-to-value was distorted.

Not surprisingly, in the wake of the downturn property investment club activity has become subdued, while the introduction of the CML disclosure of incentives form, which builders must now complete before lenders will grant a mortgage, has increased the transparency of new build transactions. The new build market is thus likely to be less beset by the problems that have arisen over recent years.

PICs also benefitted hugely from the distortion in the SDLT system, individual investors paying only the unit rate, whilst benefitting from bulk purchase. A single large scale investor, by contrast, would have to pay SDLT at the rate attributable to the total price, which might be three or four per cent higher.

APPENDIX 2 TO QUESTION 14: COMPARISON OF DIFFERENT RESIDENTIAL INVESTMENT VEHICLES

	REIT	**Limited Partnership (LP)**	**JPUT/ELP**	**PAIF (QIS)**	**PAIF (NURS)**	**Listed closed-ended offshore company**	**UEUT**
Suitable investor type	Suitable for marketing to all Not fully tax efficient for offshore investors	Not retail	Not retail	Sophisticated investors only	Suitable for all	Suitable for marketing to all Not tax efficient for UK tax-exempt investors	UK exempt investors / s.431 life companies
Open/closed-ended	Closed	Either	Either	Open	Open	Closed	Either
Conversion charge	2%	None	None	None	None	None	None
Listing costs	Yes	No	No	No	No	Yes	No
Gearing restrictions in vehicle	No limit, but 1.25:1 profit:financing ratio	None	None	100% of Net Asset Value and 1.25:1 (profit:financing ratio)	20% of Net Asset Value	None	None
Management jurisdiction	UK	UK (assuming ELP)	Jersey for JPUT/ UK for ELP	UK	UK	Typically Guernsey/Jersey	UK
Tax in vehicle	PRB[19]: income and gains exempt Residual taxable	Tax transparent	Transparent for income Exempt for gains[20]	Nil	Nil	20% on net income Exempt for gains[20]	20% on income, paid out as annual payment

[19] Property Rental Business

[20] Provided managed and controlled offshore

Potential withholding tax	20% on property income distribution (unless gross recipient)	20% on rent to non-residents (unless NRL clearance in place)	20% on rent to non-residents (unless NRL clearance in place)	20% on interest and property distributions	20% on interest and property distributions	None	20% (credited against tax in vehicle)
Streaming	2 streams	None	None	3 streams	3 streams	None	None
Distribution requirements	90% of PRB income	None	None	100% of income	100% of income	No	None
Potential close company issues	Yes	No	Yes	No, but widely held requirement	No, but widely held requirement	Yes	No
VAT on management fees	Yes	Yes (assuming ELP)	Yes in ELP	No	No	Yes	Yes
SDRT/ SDLT on transfer of units	0.5%	4% SDLT	No	0.5% Schedule 19	0.5% Schedule 19	No	0.5% Schedule 19
ISAable	Yes	No	No	No	Yes	Yes	No

RESIDENTIAL LANDLORDS ASSOCIATION

H M TREASURY: INVESTMENT IN THE UK PRIVATE RENTED SECTOR – RESPONSE BY THE RESIDENTIAL LANDLORDS ASSOCIATION

Executive Summary

(1) In the past the PRS has been a dominant tenure. It then contracted but since 1988 it has expanded from around 9% of the housing provision to 14.2%. Regulatory relaxation coupled with "buy to let" mortgages has led to this growth.

(2) The PRS has a vital role as a housing provider for a number of reasons:-

- Its flexibility and ease of access
- Availability of short term accommodation without ongoing commitment
- Labour mobility
- Affordability – rents tend to be in line with average earnings rather than being driven by increasing house prices.
- Provision of "intermediate" housing for those who are unable to access social housing.
- The provision of specialist accommodation e.g. furnished accommodation, single people, sharers and students, especially in HMOs.
- Contribution to new development.
- Helping provide for overall housing need.
- Specialist provision of new accommodation by way of conversions.

(3) This role will continue and investment introduced by the PRS will remain a vital component if overall more housing is to be provided.

(4) More housing is needed due to population and more but smaller households. We already have a shortage of accommodation and this is at the heart of the problem.

(5) Currently availability of credit is a difficult. We only have very tentative size of recovery at present. There will not be any significant recovery in housing provision until more normal credit conditions return. In the meantime steps are needed to help the PRS and lay the foundation for future expansion.

(6) Greater pressure on the PRS to continue to provide accommodation especially for single households is anticipated.

(7) The current boom and bust cycle caused by an imbalance as between the supply and demand is the fundamental problem with the UK housing provision. Due to rising prices in boom cycles people are priced out of owner/occupation and there is the adverse consequence of owner/occupation being seen to be an investment vehicle.

(8) The RLA has concerns about restraints on development due to planning laws, additional infrastructure costs, requirements for affordable housing, Section 106 contributions and the new community infrastructure levy. Alongside this standards are being raised leading to additional costs.

(9) As a result there needs to be a fundamental rethink of the whole strategy in relation to the provision of new housing whether by way of new build or conversion. The PRS has a vital role to play in this.

(10) Treasury interest is welcomed.

(11) Broadly we believe that a consultation paper's findings are to be endorsed although we have comments on certain aspects.

(12) We do not quarrel the suggestion that there is a rough equilibrium as regards supply and demand in the PRS at the moment but this is likely to change as increased pressure mounts for additional housing provision.

(13) The UK housing market has been skewed too far towards owner/occupation although this is redressing itself to a certain extent at the moment. Market forces will play their part rather than artificial targets.

(14) There is an increasing problem with lower income owner occupation, particularly as they may not be able to meet maintenance costs and costs of improvements e.g. to deal with energy efficiency.

(15) UK PRS trends tend to be in line with the rest or Europe with the exception of the lower percentage of total housing stock in the PRS.

(16) Government support for the PRS if required particularly the right regimes both from a regulatory and a fiscal/taxation perspective. This will lead to growth in the PRS in absolute terms. The RLA believes that this can be by and large achieved by the current make up of investors in the PRS.

(17) The RLA questions the extent of investment in the social sector and particularly problems with maintaining its stock following the Decent Homes programme.

(18) Investment is needed not only to ensure the provision of new accommodation but also for the maintenance of stock condition.

(19) Availability of loan funding is key. It is not just a matter of buy to let mortgages but long standing provision by high street lenders to portfolio landlords. The sector itself is not highly geared.

(20) Not a lot can happen until the Banks repair their balance sheets and start to lend again. Going forward re-establishment of credit is fundamental.

(21) The buy to let phenomenon is dead at the moment in the sense of individual investors buying properties in the hope of instant capital gain. Likewise, the off plan purchase phenomenon has come to an end.

(22) It is vital to encourage a businesslike approach and a professional PRS. We believe that individual/small corporate operators will remain the mainstay of the PRS rather than the institutional investor.

(23) The current system of individual investment/small corporate practice has the advantage of providing hands on management, which helps in keeping costs down.

(24) We are concerned that concepts such as REITS may distract for more meaningful and effective ways of improving the level of investment in the PRS.

(25) We believe that the way in which the PRS aided the house building industry in the boom years up to 2008 was artificial and instead we need a more sustainable approach to build to rent.

(26) The current VAT regime needs to be re-examined as it is skewed against build to rent.

(27) Perception is important to the PRS and the PRS has enjoyed a negative perception in the past, in our view wrongly, but this is changing. Satisfaction levels are high on the part of tenants with the PRS.

(28) The answer to the reputation issue is increased professionalism, improvements in training and education of the landlords. A code of

management standard is needed. We believe in an approach concentrating on people and management is the way forward coupled with a Consumer orientated approach giving tenants choice.

(29) Self regulation needs to be developed whilst ensuring that the landlords comply with the same legal standards.

(30) Landlords complain of increased regulatory burden since the Housing Act 2004. We have concerns about the Government's attitude towards the HMO sector. Likewise, we are concerned about proposals for Financial Services Authority and regulation for mortgages for the sector.

(31) Returns on rent have been insufficient and the sector has been dependent on yields resulting from capital growth. Existing PRS investors take a longer view which means this is a sustainable business model but the RLA has doubts as to whether this approach is always acceptable to institutions.

(32) We are concerned about pressures on the sector from increasing lending margins imposed by lenders.

(33) The cost of acquisition has been driven up particularly as a result of a shortage of housing. Thus, the increase in the supply is vital. In the long run this should result in better rental returns reducing the reliance on capital growth.

(34) The reality is that owner/occupiers and PRS landlords/investors will have to compete under the same pricing structure. We do not believe that a separate asset class for rental properties is either practical or socially desirable. It could have the reverse effect and push up prices for the PRS investor.

(35) Whilst we acknowledge the current difficulties with the public finances we believe that a package of tax/fiscal measures will reinvigorate the sector and lay the foundation for growth in the future once the current problems regarding mortgage funding recede. We believe that a stimulus will produce additional investment and generate tax revenues elsewhere. This is particularly so as there is no real problem finding tenants at the moment.

(36) The fundamental problem is that landlords of residential accommodation are not treated as traders and this has various disadvantages namely inability to offset allowances for losses against other income; no capital gains tax roll over relief; no entrepreneurs relief and pension contribution tax relief is not available.

(37) We advocate the following:-

- A system of capital allowances to provide tax relief on improvements, conversions and major works, including energy efficiency measures.
- Capital gains tax on active residential property investment businesses (i.e. roll over relief for those landlords who personally manage properties on sale and reinvestment). This will free up the market and improve tax revenues.
- Extension to the landlord's energy savings allowance and incorporating this in the proposed general capital allowance regime;
- disaggregation of SDLT on portfolio sales.
- Improvements to the VAT regime.

(38) Importantly, we advocate two schemes which could immediately start to incentivise the PRS and stimulate the growth.

- Private rented sector exemption scheme – modelled on the business expansion scheme allowing relief from capital gains tax and income tax corporation tax on rental income. This would be restricted to newly provided accommodation only.

- Extension of self invested pension schemes (SIPPS) to residential investment again for new property for a limited period. This would be based on the maximum purchase price and it must be let out by accredited agents to ensure that they are brought into the letting market.

(39) We believe that the make up of the market by and large is working and has proved itself since 1988. It is in line with world wide trends. Extra investment by institutions could play a part if it were to be forthcoming.

(40) We need to look at long term tenancies for those who see the PRS as a long term housing option.

(41) Housing benefit/local housing allowances are a vital element particularly in relation to the sub-sector which caters for tenants in receipt of benefits. The link with market rents needs to be maintained and we oppose any suggestion of incorporating housing costs into overall benefit rates.

(42) We then go on to give our responses to the various questions posed of the background of the general matters outlined already. Firstly, we believe that in the boom years investment in new build properties was driven by a number of factors which came together and is not likely to be repeated. More emphasis has to be placed on the element of investments which was made in properties which were not new build. We do not think this new build model is a workable way going forward and instead we need sustainable build to rent policy which is attractive to individual investors whether acting individually or collectively. To help this the taxation regime needs rewriting and the disadvantages already outlined e.g. the planning system need to be removed.

(43) As regards the influence of the PRS on the house building industry we consider this as being led by planning policies as well as increased density involving to additional flats being built. We do not believe this will be repeated in the short to medium term. Rather, we need to stimulate longer term rent to build policies, particularly once loan funding becomes more readily available. This would stimulate the house building industry and provide jobs.

(44) We believe that renting out a room in ones home does have a part to play but only a small part. We advocate the doubling of the current rent a room allowance to assist.

(45) In relation to incentives for individual investment as well as prospects and risks, we believe that the majority of individual investors are in the sector on a long term basis. It is likely to be some time before we see any capital appreciation but it will come. Existing investors are well geared and have equity available if only loan finance was forthcoming. We are unlikely to see similar expansion as we have done over the past decade but, at the end of the day, the major driver is going to be the continuing need to increase available housing stock as well as the growing demand for accommodation in the PRS. We believe that the individual investor is best placed to provide this and has a proven track record.

(46) As regards management, we believe that economies of scale may, in fact, be a myth. For individual landlords self managing is often the most cost

effective way. Institutional investors main concern is selecting asset class and then investing significant sums.

(47) We believe that the existing disaggregation rules for SDLT are wrong and need to be reformed. They lead to the break up of portfolios, extra acquisition costs and reducing yields.

(48) As to the question regarding rates of return being comparable to those required by institutional investors, it is difficult to answer this but return is not simply a matter of rental yield as capital appreciation comes into it.

(49) We remain sceptical as institutions have not played a great part to date save in certain specialised areas. Rather, the Government may be better on concentrating on helping the existing investors.

(50) Historically institutions have been reluctant to invest even in the benign conditions we have seen so why would this change? The owner/occupier market sets the prices and there are serious constraints on development systems already outlined above which make it difficult to provide what institutions may perceive as an adequate return.

(51) As regards REITS this has limited penetration in the USA and whilst it may benefit a small minority we do not believe it is a solution.

(52) The REITs mechanism is complex and other simpler methods of collective investment could be attractive. However, property owners tend to want more hands on ownership. The LLP model is one model which could be pursued. Other collective methods besides this have various drawbacks.

(53) In relation to institutional investment whilst investment from whatever source would contribute to the amount of stock available again we would reiterate that we consider the existing landlord investor based has proved itself and needs attention to help stimulate it going forward. Institutional investment has had certain downsides e.g. higher rental costs for students.

(54) In the long term the RLA view of the PRS is an optimistic one. With the right regulatory regime and improved tax system with normality returning for the lending market the sector can rise to the challenge.

About the Residential Landlords Association (RLA)

1. The RLA is one of the two direct membership national residential landlords associations in England and Wales. Although Northern based we have members throughout the country. We have a growing membership with over 7,500 subscribers representing a membership of around 13,000. Our members comprise mainly landlords/investors but also letting and managing agents. Members are active in all the subsectors of the private rented sector (PRS). Our members range from landlords owing a single property to owners of much larger portfolios. As a generalisation, the Association is representative of individuals/smaller corporate investors; rather than institutions.

2. The RLA was represented at the round table meeting for individual investors and this Response is intended to amplify our views. Our submissions concentrate on the contribution to be made by individuals/smaller corporate investors, rather than institutional investors, to the development and improvement of the PRS.

The place of the PRS in the housing market

3. The PRS is one of the three pillars of housing provision in the UK, the other two, of course, being owners/occupation and social sector (for these purposes comprising both local authorities, their off shoots such as arms length management organisations and registered social landlords/housing associations).

4. Prior to World War 2 the PRS was a dominant tenure but largely due to rent control and rising social aspirations/increasing personal wealth, owner/occupation has come to the fore as the dominant tenure by far. Until recently, the PRS was seen as the Cinderella but we all know how Cinderella's life turned out!

5. As the Consultation Paper identifies, of late, the PRS has expanded now representing some 14.2% of housing provision overall according to the latest information from the Department for Communities and Local Government (CLG). This is an increase from around 9% at the time of the passing of the Housing Act 1988. Over the same period of time the social sector has contracted but there has been some further growth in owner/occupation. The abolition of rent control for new lettings coupled with the ability to rent under assured shorthold tenancies has played a key regulatory role along with the provision of substantial finance for the sector, mainly via "buy to let" mortgages leading to this growth.

The importance and role of the PRS

6. The PRS has a vital role as one of the three providers of housing accommodation. It is important for a number of reasons:-

(i) Its flexibility and ease of access

Unlike renting in the social sector (with waiting lists and point systems) it is very easy for someone to access the PRS. There is a wide variety of accommodation available often with a minimum of formality. Transaction costs are low (unlike owner occupation) and are usually represented by a bond/deposit equivalent to a month or six weeks rent and perhaps an administration fee coupled with the initial instalment of rent.

(ii) Availability of short term accommodation without ongoing commitment

Again, unlike owner occupation, in the PRS accommodation can be taken for a short term basis e.g., between house moves or pending finding new accommodation when moving to a different area e.g. taking a job.

(iii) Labour mobility

The PRS has a vital role in facilitating labour mobility. This is particularly important at the present time with rising levels of unemployment. If someone can find work in a different area then it is important that there is a readily available source of rented accommodation.

(iv) Affordability

As the Consultation Paper acknowledges, unlike mortgage repayments which have often been driven up by increasing house prices, the general level of rents tends to track earnings levels. Growth in PRS rents has, by and large, been in line with average earnings. This has been the case over the last 10 years or so whilst average house prices during this period have more or less doubled. This has meant that many more people cannot afford to buy their own homes. These people would not be able to access social housing, even if they wanted to, because of the growing waiting lists for this kind of accommodation.

Moreover, at a time when house prices are not really rising, due to affordability, as a matter of choice, more people are preferring to rent in the PRS as opposed to purchase their own homes.

(v) "Intermediate" housing

Increasingly, in our view, the PRS is providing a form of what we term "intermediate" housing for those who might prefer social housing (if only because of the cheaper rents) but are unable to access it. By the same token they are, of course, unable to purchase. Linked with affordability, as referred to in the preceding paragraph, the PRS is increasingly providing accommodation (including longer term accommodation) for many households, perhaps with assistance towards the rent from housing benefit and working tax credits etc. Often these will be low paid workers, lone parents with children and the like.

(vi) Specialist accommodation

Very importantly, the PRS caters for certain sectors of the community for whom no other provision is made. By their very nature they could not afford to buy and the social sector makes no real provision for them. These include people who require furnished accommodation, those who want single person accommodation and those who wish to share. These will include single people and groups of sharers such as young professionals, nurses etc. It also embraces the very considerable student market. The PRS provides the necessary accommodation for many of our universities and colleges. For this reason the RLA has increasing concern at the Government's apparent hostility towards the house in multiple occupation (HMO) sector which provide much of this specialist accommodation. Whilst paying lip service to its importance, recent moves by the Government have threatened this sector and imposed significant regulatory burdens. We will refer to these later.

(vii) Development

As the Consultation Paper identifies, the PRS has made a large contribution towards new development up until 2008. The PRS has accounted for one fifth of new build and PRS investors have provided finance for many developments as a result of forward purchase of new developments (or purchase "off plan"). This has occurred especially in flat developments and some Brownfield sites. A by product of this has been that as a result, developers have, in turn, provided affordable accommodation in part funded through the PRS acquisitions of new build properties. We doubt that this method will continue.

(viii) Overall housing need

The PRS has played its part in providing an increasing amount of accommodation to meet housing need. As a result the PRS now provides accommodation for couples, couples with children, lone parents and lone parents with children as well as the specialist provision already referred to for single persons and groups of sharers including students.

(xi) Conversions

One particular talent enjoyed by the PRS is the provision of new units by conversion of existing properties. As household sizes decrease over time, larger older houses lend themselves to subdivision. This helps increase the supply of housing.

7. There is every reason to believe that this important role will continue due to the difficulties in purchasing ones own property because of the cost as well as the shortage of available mortgage funding. Likewise, there is no signs of any significant growth in the provision of social housing in the coming years because of the current economic downturn. The capital introduced by the PRS into housing provision will therefore continue to be a vital component if more housing is to be provided at a time when there is pressing need for it.

The need for Housing

8. Overall, the UK population is predicted to rise to 70 million overall. There are more and more households due to demographics and social change. There is also the effect of immigration particularly from the EU. We already have a shortage of housing coupled with a lack of investment. There is also the need to address the issue of improving the housing stock particularly in relation to energy efficiency which is another driver for further investment in the PRS.

9. At the moment we have the most ferocious recession since the Great Depression. This is coupled with a lack of availability of credit. We are over-borrowed both publically and privately. Following the Kate Barker Review the Government set targets for building new homes so as to

improve supply but this recession has put paid to these plans at least for the moment. We only have the most tentative signs of recovery. There will not be any significant recovery in housing provision until more "normal" credit conditions return but, in the meantime, there are steps which can be taken to help develop the PRS.

10. As well as considering the picture nationally, it is worthwhile looking at the situation in Northern England, particularly because it comprises a number of major cities as well as extensive rural areas. For these purposes Northern England comprises three regions, Yorkshire and the Humber, the North West and the North East.

11. Key Data (Source: King Sturge Residential Northern England 2010) shows house price growth has averaged 7.1% per annum over the last 12 years.

- House prices in the North are typically 25% lower than the UK average. The average house price is currently around £119,000.
- Residential development completions in the north have halved falling from 45,500 units in 2007 to 23,350 units in 2009.
- On CLG projections Northern England will see an average increase of 66,000 households per annum over the next 10/20 years.

12. King Sturge predict:-

- Housing demand is expected to increase over the next few years as the economy begins to expand again due to growing population and increasing incomes.
- The lack of recent and planned residential development looks likely to mean that there will be an undersupply of housing measured against household projections.
- Unless there was an appropriate response, demand and supply in balance is likely to come exaggerated leading to significant upward pressure on house prices.

13. We believe that this is representative of the UK as a whole. In the wider UK as well as the North, over the last 10 years, up to 2007, increased housing demand has been fuelled through a combination of increase in population, higher household income and a favourable mortgage market. Importantly, stronger growth in household numbers in the North and across the country is anticipated to continue over the next 10/20 years.

14. Statistics on households (provided by King Sturge) are as follows:-

- In the North in 1981, the number of households was 5.4 million.
- This has increased by an average rate of 30,000 per annum to reach around 6 million by 2001.
- The anticipated growth between 2001 and 2011 is 58,000 additional households per annum.

- Between 2011 and 2031 numbers of households are expected to grow by around 66,000 per annum.
- At the end of this period it is likely that there will be around 7.9 million households some 2.5 million more than in 1981.
- Both Leeds and Manchester are predicted to experience growth in households of more than 30% between 2011 and 2031.

15. The main driver behind the growth in household numbers over the next 20 years or so both in the North and nationally is the anticipated expansion in one person households. In the Northern Region there are currently around twice the number of multiperson households totalling 4.4 million compared to 2.2 million single households. However, the number of one person households is forecast to rise by 39% to 3.1 million by 2031. Over this period multi person households are only expected to grow by around 10%. The average household size in Northern England during this time is expected to shrink from the current average of 2.25 persons to 2.09 persons. It was 2.35 persons in 2001 (source King Sturge and CLG). We believe that this is again representative of the UK as a whole.

16. As we have already pointed out, the PRS is a major provider for single households. It is therefore anticipated that there will be a corresponding increase in pressure on the PRS to continue to provide for this group of the population throughout the UK. At the end of the day, price is the function of supply and demand. Periodically, we see spurts of inflation in the housing market and then prices fall due to the market becoming overheated, but falls do not correspond with the preceding rises. In other words it is boom and bust. Many people suffer in consequence. At the present time artificially low interest rates are ameliorating the position but these will need to be unwound. Many more are then likely to suffer.

17. When we have boom times not only do we have a situation where people are priced out of the owner occupier market but there is another adverse consequence in that investing in housing for owner occupation is seen to be a "good thing". Rather than simply providing a roof over one's head, house purchase is driven by financial gain. This skews the market even more towards owner occupation for all the wrong reasons. Private Residents Capital Gains Tax relief shelters these gains; not that for one moment we advocate its abolition. Rather, we suggest a level playing field with tax relief for active landlords/investors who reinvest. We will come back to this later.

18. The fundamental is that, as the Consultation Paper recognises we need more housing to match demand and there is a particular need to continue to expand the PRS. Clearly, this cannot be achieved quickly but rather with long term constant provision of new housing including both new build and conversion.

19. In saying this we have to recognise that there are currently major constraints and these are not just due to the lack of available credit. They are due to planning laws the additional infrastructure costs which are being

imposed; the requirement for the provision of affordable housing; Section 106 contributions and the new Community Infrastructure Levy.

20. Added to this is the rising cost of providing accommodation due to the ratcheting up of standards especially in relation to reducing carbon emissions and the provision of sustainable homes. There are ever rising standards imposed under building regulations and the like. Improved standards may be unavoidable but when coupled with planning restraints and infrastructure costs, it makes development non viable and destroys land values. Without land owners being able to obtain what they perceive to be a worthwhile value from their land, land will not be made available for development.

21. The RLA strongly believes that there has to be a fundamental rethink of our whole strategy in relation to the provision of new housing, whether by new build or conversion. This is vital to ensure continuing provision in the PRS for much needed additional accommodation which this sector could provide if the conditions were right.

Treasury Involvement

22. The RLA welcomes the interest taken by the Treasury in the need for investment in the UK PRS. Treasure involvement is vital both because of the lead which the Treasury often takes in policy making but also to ensure that we have the right fiscal/taxation regime. We are very pleased that this involvement has followed on from the Rugg Review of the PRS. The RLA is largely supportive of this review and particularly welcomes the central tenet of the report that renting out in the RPS should be treated as a business. However, we do feel that the way in which the Questions have been posed puts limits on the issues which need to be examined and rethought. We have therefore set out our overall views in detail before answering the specific questions posed.

The Consultation Paper

23. The RLA believes that the Consultation Paper is welcome and is, by and large, a perceptive analysis of the current state of the PRS. Subject to what we say below, we very much endorse the conclusions of the Paper in its findings. We would wish, however, to make the following comments on the analysis:-

1.2 However well intentioned, measures taken by the Government have not tackled the problems created by the planning system and the related infrastructure costs.

1.3 It is hoped that the reference to the disproportionate part played by the PRS in providing new build supply is not pejorative, although we do not believe for one moment that it is intended to be.

1.4 It is not just a matter of investment in the provision of properties to rent out in the PRS but it is also a matter of investment to refurbish and repair properties so as to ensure that there condition is not just maintained but improved. This is an important issue as we need to ensure that the necessary capital is provided for these purposes. Mortgage funding is, of course, a key way in providing the necessary capital plus finance for working capital.

2.2 There are two important omissions from the list, namely provision for families (including one parent families) and single people such as working people, where in such cases they pay their own rents.

2.6 No mention is made of the significance of low interest rates which prevail at the moment. As already pointed out, this is an artificial situation which is of a temporary nature. Over time they can go only one way and they must increase. This will exacerbate the extra costs incurred in owner occupation, as compared with rental levels in the PRS.

3.6 Where there has been refinancing, our experience is that this money has been retained in the PRS either to assist in the purchase of new properties or in refurbishing properties to rent out in the PRS. In the owner occupier sector there may well have been substantial equity withdrawals to fund other expenditure. We do not believe that this has been the case with mortgages in the PRS. We would be much more emphatic than the Consultation Paper in saying that buy to let financing has led to a significant increase in the level of PRS and that this has been positive in its impact both in relation to supply and stock condition. The problem is that “buy to let” has been used in a disparaging way in some instances. In contrary, the RLA is of the firm view that this has been highly beneficial. One of the problems is that buy to let has no clear definition. You have to remember that large amounts had been advanced to landlords/investors in the PRS by the traditional high street banks. More appropriately buy to let refers to the specialist providers, the majority of whom have now disappeared from the market anyway.

4.10 We are pleased to note the recognition given to the improvements to the general condition of the PRS stock. However, you have to recognise the very real problems for the PRS in dealing with older pre 1919 stock. The PRS tends to have a disproportionate amount of this stock. It is hard to treat due to single walls, no cavities, attics so there are no lofts, lack of original damp proof courses and so on. Sadly the Consultation Paper fails to acknowledge the vast amounts of money which have been invested in the social sector under the Decent Homes programme. According to the National Audit Office, this amounts to at least £37 billion by March 2011 (see National Audit Office Report – The Decent Homes Programme) , although this does include related area investments and other capital work. No-one knows the exact amount. Large sums have therefore been poured into the social sector at a time when grants for the PRS have become virtually unobtainable. Some £26,500 approx per non decent property has been spent in the social sector. PRS is regularly criticised for its stock condition but this massive public investment in the social sector is overlooked. However, if one recalls the general state of the stock in the social sector prior to the start of the Decent Homes programme you will realise that the PRS on the other hand has been able to make significant advances in its overall stock condition with hardly any public investment. Private sector expenditure over this period has been only £1.27 billion! This represents less than 4% of the social sector expenditure. This is of course for both the PRS and the owner/occupied sectors! The RLA firmly believes that it is often unfair to level criticism at the PRS having regard to the older nature of its stock and depredations resulting from the adverse impact of so called fair rent system. A significant number of lettings still remain controlled by the Rent Acts. There has been no commensurate public investment in the PRS compared with the social sector.

5.10 We would not, at the moment, quarrel with the suggestion that there is a rough equilibrium in the PRS as regards supply and demand. The PRS has been able to acquire new stock both as a result of new build and some conversion, as well as obtaining new stock from the owner occupier sector. This, however, masks the very real problem which we have already identified, namely the overall lack of supply of housing generally as the population increases and households become smaller. We cannot emphasise too strongly the problem that the nation faces in coming years because of the lack of housing availability overall.

24. We believe that the current rough equilibrium is set to change. As the population increases, households become smaller and the other sectors (both owner/occupier and social sector) remain stagnant so far as the provision of new accommodation is concerned there will be increasing pressure on the PRS. Even allowing for this there are issues relating to the return on investments in the PRS which the Consultation Paper does not seek to address. We deal with this below.

25. Subject to these points above, we believe that the Consultation Paper gives a balanced and accurate view of the current state of the PRS. We are particularly delighted to see that the Consultation Paper even acknowledges the disastrous impact of rent control and restrictions on the right to obtain possession under the Rent Acts prior to their abolition for new lets from 1989 onwards. If only one thing can be learned, hopefully this fiasco will be avoided by any future Government. Tinkering with the current position about obtaining possession under the Housing Act 1988 could have the most unwelcome consequences.

The position of the PRS vis a vis other sectors

26. The RLA believes that the UK Housing Market has been skewed too far in favour of owner/occupation to the detriment of its overall health as well as the health of the National Economy. Market forces must play their part and artificial targets for the relative sizes of the sector would not be the

correct way of proceeding. Nevertheless, some rebalancing is needed and there is clearly evidence of this occurring even allowing for the current serious recession. We have already argued that current pattern of boom and bust cycles fuels a desire not to be left behind each time there is an inflationary surge in house prices. This forces people to buy into the owner occupier sector when in the long run it is not really affordable for them to do so. They cannot then afford to maintain their properties and may well suffer the adverse consequences of increasing mortgage interest rates.

27. The recent report of the CLG Select Committee Beyond Decent Homes examining the Decent Homes programme identifies low income owner occupation as an increasing problem and shows that these owner occupiers will face increasing problems. These householders are being "forced" into owner occupation unnecessarily. If they were in the PRS they are relieved of the significant cost of repairs and upgrades, and to a large extent insulated against rising interest rates over time.

28. Section 4 of the Consultation Paper giving international comparisons rightly points out that the PRS has tended to have a lower percentage of the total housing stock compared to most of the rest of Europe. We believe that this is due to the undue emphasis in the UK generally on the virtues (so called) of owner/occupation, largely as a social phenomenon as well as a perceived economic model. Unfortunately it is not always the right economic imperative particularly for the low paid. Again, at the heart of this problem lies the lack of housing supply which drives up prices and also promotes owner occupation as a supposed investment benefit.

29. One way of countering this trend is for the Government to support investment in the PRS going forward and to ensure that we have the right regimes for promoting such investment, both from a regulatory and a fiscal/taxation perspective. We believe with the right support the PRS can grow, thereby increasing the overall housing stock and rebalancing relative proportion of that stock which is provided by the PRS. What is more this can by and large be achieved by the current make up of investors in the PRS.

30. By the same token, the question must be raised as to whether national policies towards the social sector are correct. Much is made of long waiting lists but this is hardly surprising when rents are set at the current level and are subsidised to the present extent. At the moment, we have around 3.8 million households in the social sector. Over the last decade this has fallen. We believe that proper investigation is needed as to the real cost of the provision of social housing. It may well reveal that renting in the PRS assisted where appropriate with housing benefit is a more economic way of providing accommodation.

31. We have already alluded to the significant cost that the tax payer has had to bear in upgrading the social sector stock from the decent homes programme, a programme which is not yet finished. As the CLG Select

Committee Report Beyond Decent Homes rightly points out, no-one now seems to know where the funding will come from to ensure that once the stock has been upgraded it will remain in a good state and condition. Subsidised rents in the social sector have meant woeful under investment in that sector's stock. This has been comparable with the situation which has occurred in the PRS in relation to properties which have been subject to rent control under the Rent Acts. We do, therefore, question whether significant further investment in the social sector is the right way forward in the longer run.

The need for investment

32. Whilst it is important to concentrate on the need for investment to provide new stock (whether by way of new build or conversion) we feel that prominence also needs to be given for investment to ensure that PRS stock condition is maintained. Investment is needed not just for day to day repairs but for significant refurbishment and upgrading. This is particularly so because of the age of the stock and the significant amount of pre 1919 stock within the PRS, to which we have already referred. At the moment, in particular, there is the need to invest to promote energy efficiency and the reduction in the carbon footprint.

33. Investment will enable ordinary repairs to take place is always problematic. Whilst lenders may have been keen to provide funding for purchases and even significant upgrades, they are frequently reluctant to provide what is essentially working capital to facilitate repairs even with more expensive measures such as works to improve energy efficiency/insulation. This normally has to be provided out of rental income.

Finance/buy to let

34. Availability of funding is key. The RLA considers that this is evidenced by the expansion of the PRS which has occurred since the implementation of the Housing Act 1988 in 1989. Some landlords at the time thought that the main consequence would be a significant increase in institutional investment. This did not occur. Rather, mortgage lenders became increasingly willing to provide finance by way of mortgage loans. The ability of the landlord to regain possession under the Assured Shorthold Tenancy Regime was the key to this, coupled with the introduction of market rents.

35. We have already referred to the problems of definition surrounding the expression "buy to let mortgage". The reality is that particularly for portfolio borrowers, finance has always been available to some extent but has become increasingly so, particularly from high street and main stream banks. The Buy to let mortgage phenomenon was essentially based on wholesale funding via the wholesale money markets. When these closed then buy to let mortgage products largely evaporated so that now there are only a small number on offer when there were thousands before. Even

those which are available are hedged around with considerable difficulties of access because of various restrictions. They may only be on offer for a short period The restoration of more normal credit conditions is, in our view, fundamental. As evidenced by the Rugg Review, the sector is not one which is on the whole highly geared. Many landlords, particularly portfolio landlords, tend to take a conservative view of the borrowing levels. This does mean that potentially there is considerable equity capital to unlock.

36. The reality is that banks need time to repair their balance sheets and for the wholesale credit markets to reopen. Not a lot can be done about this in the short term but it is very important, in our view, that the right conditions are now created to ensure that going forward so that investment in the PRS will increase over time. This will then enable improvements on the supply side.

37. Without the funding which has already been provided from the 1990s onwards up until the onset of the credit crunch the PRS would not have been able to expand in the way in which it has. The buy to let mortgage phenomenon has therefore been hugely beneficial and it has also led to an improvement in the general standard of the stock in the PRS as evidenced by the English Housing Survey. Over time this will also certainly help improve the perception of the PRS i.e. its reputation which we consider to be essential.

The buy to let phenomenon/off plan investments

38. The RLA feels that at the moment the "buy to let phenomenon" (as opposed to the buy to let mortgage) is dead in the sense of individual investors buying properties in the hope of instant capital gain. We do need to ensure that as with any other business there is a steady stream of new landlords/investors to replace those who retire/die off. What we need to do, however, in our opinion, is to encourage a business like approach and a professional PRS. At the same time we believe that the individuals/small corporate operator will remain at the main stay of the PRS; rather than the institutional investor.

39. Similarly, the purchase off plan phenomenon which assisted many developers in the boom years up to 2007/2008 has ended. We believe that this was really all about investment, not housing provision. In many cases this was also true in relation to the buy to let phenomenon. Neither is likely to return in the foreseeable future.

Individual –v- Institutional Investment

40. An analysis of the PRS on a world wide basis, has shown that (with the exception of its size) the make up of the PRS in the UK is very similar to what it is internationally. It is essentially non-institutional and made up of individuals and smaller corporate bodies. Whilst the Government seeks to promote institutional investment, we do question whether this is a realistic

approach. Indeed, the Rugg Review rightly recognises the somewhat "cottage industry" nature of the PRS and we strongly believe that this is one of its strengths. After all it has played its part in significantly increasing the sector since 1989 when the shackles of the Rent Acts were removed. Whilst some landlords expected institutions to move in, they have not done so. Indeed, in the RLA's opinion, the current system has significant strengths because many landlords/investors are also hands on managers. This keeps costs down significantly to the benefit of tenants generally. Whilst concepts such as REITS may benefit a very small number, they could prove to be a distraction from other more meaningful and effective ways of improving the level of investment in the PRS. We would argue that an improved taxation/fiscal regime for example coupled with other measures to promote investment to which we refer below would have far more impact drawing on existing and new smaller investors; rather than institutions.

Build to Rent

41. In answer to question 1 we highlight the rather artificial way in which the PRS aided the house building industry in the boom years up to 2008. We argue for a more long term sustainable approach to generate a new supply of housing within the PRS (and indeed the wider provision of new housing). The RLA considers that there are three major constraints, namely planning restrains, infra structure costs including the provision of affordable housing (which are dealt with further below) and the tax regime. Furthermore, demand of late has been distorted by the density of development, particularly flat development, although at least to some extent this has been recognised and planning policies are beginning to change. However, they may well not be changing fast enough and this raises much wider issues such as building on the green belt to a limited extent as less and less suitable brown field sites become available.

42. One of the major decision disincentives, in our view, is the current VAT regime. This is skewed against build to rent. The house builder who sells the freehold (or grants a long lease) makes a zero rates supply and is able, therefore, to recover his input tax. It does not matter whether the sale is to an owner/occupier or a landlord/investor. However, the landlord/investor/developer is treated as making a exempt supply when he rent accommodation out in the PRS. He is effectively treated as the ultimately consumer (which he is not) and cannot recover his input tax. On the other hand the landlord/investor who purchases from a builder quite rightly suffers no VAT on the purchase price because it is a zero rated supply so far as the builder is concerned. The RLA strongly believes that there is a considerable amount of potential capital which could be harnessed by putting the landlord/developer on the same footing. It is appreciated that the existing VAT code does make provision for certain situations particularly conversions but the rules are complex and not always generally understood. They are not universally applicable.

43. Importantly, however, is the adverse impact of the planning system and what we have termed infrastructure costs including the provision of affordable housing, to which we refer in the next section.

Constraints on new developments

44. The RLA firmly believes that we have reached a crisis point and that the Government has so burdened the development sector with additional costs that this will prevent any kind of real recovery. Key factors are:-

(1) The Planning System – anti development lobbies are so vocal and effective that they are putting a real brake on the necessary development to meet the increase in population/the larger number of smaller households. This is adversely affecting housing provision generally, including new provision in the PRS. The system is complex and long winded. There is a huge cost involved in obtaining planning consent with consultants, planning fees and the whole length of time it takes to secure planning permission, if it can be obtained at all.

(2) Infrastructure costs – it used to be the convention that the tax payer met off site infrastructure costs. Increasingly the burden has been moved to the developer and this has pushed up the cost of development and, in turn, depressed land values. Less land is therefore forthcoming and you get into a vicious circle. The new Community Infrastructure Levy will be yet one more cost. Section 106 contributions are another expense.

(3) Affordable housing – This is a major element of the overall cost. The percentage required for affordable housing is ever increasing reaching 30 and 40% with calls for it to be even 50%. "Killing the goose that lays the golden eggs" comes to mind. This approach is particularly pernicious as far as the PRS is concerned because in many respects as we have already pointed out the PRS is providing what we term "intermediate" housing. This may not be the usual use of this term but what we mean is housing which the lower paid or even the unemployed can afford perhaps with the assistance of housing benefit depending on their financial position.

PRS perception

45. For too long the PRS has wrongly been associated with the three Rs namely Rackman, Rigsby and Rogue (as in rogue landlord). We feel that as part of any strategy to enable increased investment in the PRS to occur there are three different Rs which need to be addressed namely Reputation, Regulation and Return. We look at each in turn as the general perception of the PRS needs to be revisited and improved.

Reputation

46. The PRS unfortunately suffers from a poor reputation. This perception is changing but it takes time. We believe that it is a wrong perception. Consistently tenant satisfaction surveys in the PRS show that satisfaction in the ratings in the PRS are higher than for social renting. The latest English Housing Survey indicates that 83% of private tenants were

satisfied with their accommodation compared with 78% for social renters. 15% of social renters positively stated that they were not satisfied as against just over 10% in the PRS.

47. It may be the case that this perception does on occasion put off larger investors and institutional investors because of a perceived reputational risk. In any event, this perceived reputation (however wrong it may be) certainly does not help the PRS. The situation has not been helped by politicians and local authorities who have often made sweeping generalisations which are critical of the PRS. Unfortunately it is the nature of the system that incidents which are reported at constituency surgeries and the like are taken as being typical when this is certainly not the case. Relations traditionally between local authorities and the PRS have been poor and there has been a lack of understanding by local authorities up until recently of the nature of the PRS and how it operates. We are pleased to say that there are signs of change, but a lot remains to be done. Landlord Association are trying to play their part in imposing perception.

48. The problems surrounding evictions of tenants where landlords have defaulted on their mortgage have led to the enactment of legislation, strongly supported by the RLA and other landlord organisations. This is one example of how change will undoubtedly lead to improvement in the perception of the Sector.

49. The answer to this problem is increased professionalism on the part of landlords/investors. For example we need a tax regime which recognises that this is a business. The RLA has strongly advocated the use of training, education and wherever possible this should be mandatory. We have helped facilitate this by developing training courses and on line learning. We have strongly argued for a code of management to set management standards and it is only belatedly that CLG have accepted the principle that this is needed. Our argument is that you have to concentrate on management issues and the people involved rather than just property condition. Property conditions are often the symptom and not the cause. We believe in a consumer orientated approach giving tenant choice. However, this can only work if there is a sufficient supply of accommodation in the PRS. We want to see self regulation developed but we emphasise that the legal requirements for a self regulated landlord would be at least as stringent as for any other landlord. We have suggested a banning order procedure for use in appropriate cases to remove particular landlords from the PRS although we would regard this as a last resort.

Regulation

50. The RLA believes that the burden of regulation on the PRS has increased significantly. This view is shared by the landlord community.

51. The BDRC survey has recently given the following responses:

In answer to the Question "To what extent do you feel that the burden of regulations increases in the introduction of the Housing Act in 2004"?

- Significant increase 40%
- Slight increase 33% (together making 73%).
- No real change 18%,
- Reduced nil.

9 of the respondents were unable to comment as they had only become landlords recently.

The overall negative reaction (over 7 in 10) was strongest amongst professional portfolio landlords. 61% of landlords with 20+ properties report a significant increase in the burden (contrasting with 31% of landlords with one property).

52. Many landlords view with concern the introduction of HMO and selective licensing which has led to a significant increase in costs due to licence fees and the significant associated bureaucracy. Likewise, there is concern over tenancy deposits with the very severe penalties if you happen to get it wrong as well as the associated costs for the use of the insurance based schemes.

53. To ensure a healthy expansion of the PRS we have to design a better regulatory model. This is emphasised by the Rugg Review. The RLA has supported the idea of a national register of landlords but with reservations. We are concerned at the potential cost and bureaucracy particularly associated with the idea of having to list out properties. This has raised very considerable opposition within the landlord community and, again, would be a significant regulatory burden.

54. This issue is linked in with the previous section relating to Reputation but we believe that the way forward is self regulation through accreditation. Accreditation schemes have grown nationally but only reach around just under 50% of the country. We consider that pre-vetted landlords who join such schemes should be subject to self regulation so that the accreditation scheme rather than the local authority is the enforcement agency. At a time when we face significant cut backs in public expenditure this is the only realistic way forward as it will free up local authority resources to concentrate on non compliant landlords. At the moment too much time is spent dealing with compliant landlords. We need to ensure that we have the right regulatory regime going forward, as the Rugg Report rightly points out.

55. One area of major concern on the part of the RLA in relation to the regulatory burden is the recent change to the Use Classes Order involving the sub-division of old Use Class C3 into a revised use Class C3 and a new Use Class C4 for smaller HMOs. This is primarily aimed at smaller shared houses occupied by groups such as students, young professionals, nurses etc (normally up to six in number). This coupled with the freeing up of

powers to enable local authorities to impose additional HMO licensing is viewed in many quarters of the landlords community as an attack on the HMO sector. It is yet another example of an increasing regulatory burden. It will work to the detriment of the PRS because it will reduce the flexibility in the provision of accommodation. The same property one year may be let to a family and another year to a group of sharers.

56. The Government's recent proposal to introduce regulation of buy to let mortgages by the Financial Services Authority is something which the RLA has opposed. This idea has been put on hold pending further consideration following this Consultation. Issues have emerged from consultation on proposed regulation as to whether advice should be centred on the taking out of a particular financial product or should be more widely addressed towards the whole principle of investing in the PRS in the first place. As we have repeatedly pointed out, in line with the Rugg Review, the intention should be that investment in the PRS is a business activity. Individuals have to take responsibility for their own business decisions. The consultation on FSA regulation readily acknowledged the additional costs which would be imposed. We are very concerned that this is yet another regulatory burden which will erect a further hurdle so as to disincentivise investment in the PRS. Even the consultation document on this subject recognises that it is going to be impractical in reality to regulate portfolio landlords and anyone other than the smallest of landlords.

Return

57. One of the questions (question 8) refers to the issue of rates of return on investment in the PRS. Return on investment in residential property (as indeed for most investments) is based on both the income yield and any capital appreciation (or indeed the risk of capital depreciation). Traditionally, rental returns on residential accommodation in the PRS have been in the region of 3% to 4% per annum.

58. This is in line with the experience of the RLA and is borne out by the research referred to in the consultation by IPD. These returns do vary from region to region. According to IPD over the last 10 years the total return has been in the region of 10% to 11%. Our experience is that the larger individual investors with greater sized portfolios are by and large in this for the long term. Indeed smaller investors coming into the market usually also come in and take a longer term view of their investment. The great advantage of individual investors is that they are prepared to take this longer term views and their overheads are frequently lower because they adopt a hands on approach. They frequently self manage and often carry out repairs and maintenance themselves. It is a myth to think that there are economies of scale in the PRS. Our experience is that the larger the organisation the higher the overheads. It can be very expensive to look after larger portfolios in diverse locations.

59. Grainger plc the largest corporate residential landlord have reported that the PRS was not generally viable on rental return alone but was dependant on capital appreciation. You have to take capital profits for the business model to be viable. We consider that this issue links into the need for capital gains tax roll over relief for reinvestment so as to enable these profits to be realised with a view to reinvestment in the PRS.

60. Return on investment is of course linked to two other factors. Firstly, the cost of mortgage funding. We have a significant concern that going forward in the short to medium term due to repricing by banks and lenders rental returns are going to be depressed. At the moment members report to us that lenders are looking to price loans at a margin of 3.5% to 4.5% over Libor as opposed historically to bank base rate. This trend could well have a damaging impact particularly as credit becomes more available.

61. The second key influence in relation to return is the cost of acquisition. Inevitably, not just at present but historically, this is related to the price of housing in the open market where the PRS is in competition principally with owners/occupiers but on occasion with the social sector. Here we believe that the key factor must be supply. As we have strongly emphasised elsewhere, we believe that an increase in the supply of housing (including new housing for the PRS) is vital. We have criticised the boom and bust cycle and pointed out the deleterious effects of the shortages of accommodation. It is absolutely imperative that the stock of housing is increased as the population grows and the need to cater for smaller households increases.

62. The consequence of greater numbers of available units of accommodation will be less dependence on anticipated spurts in underlying capital values and an evening out of the peaks and troughs that we have historically experienced. We could expect that over time that rental levels (which tend to be tied in with earnings anyway) would improve as over reliance on capital appreciation (which can be hit or miss) is reduced. We look further at the price issue in the next section.

Acquisition pricing in the PRS

63. As indicated in the previous section, the PRS and the owner occupiers sector (along to a certain extent with the social sector) are in the same pool for the purposes of pricing the acquisition of properties to rent out. Residential property investment, as such, is not a separate asset class. There have been suggestions that it should be in some quarters e.g. by way of a creation by a separate planning use class. The RLA would be strongly opposed to any such move. Indeed, we are gravely concerned at the recent creation of a new private sector use class (Class C4) for smaller HMOs (see paragraph 55 above).

64. On the contrary, the creation of special asset classes may well push up prices in the PRS for housing; thus militating against investment. We

believe that to a certain extent this has happened in the Headingley area of Leeds. The market in the Headingley area peaked before the general crash around 2007/08. Prior to that a separate pricing method had begun to emerge based on either yield (more in line with commercial properties) or a price per bed space. It peaked at around £50,000 per bed space. This was in fact higher than the amount one would have expected to have paid for a comparable property in another area. Owner/occupiers we selling into the PRS and leaving the area, receiving a significantly higher price than one would have expected for an owner/occupied property. This came about because a very significant percentage of properties in the area were rented out to students (and to a lesser extent young professionals) and as properties became vacant when owner/occupiers sold, they were purchased by landlords/investors. In the long run, whilst a separate asset class might be attractive to existing landlords/investors it could well push up prices.

65. In any event we feel that a separate asset class is socially undesirable. The PRS seems to operate generally very happily alongside owner occupation and the social sector providing generally a mix of properties in a locality. The flexibility between owner occupation and renting out is vital. At times such as the present we see a significant increase in the number of accidental/involuntary landlords. These are people who cannot sell their houses or have to move or people who inherit houses. As they cannot sell them (or at least sell them for what they perceive to be a realistic price) they rent out properties. This is a very important source of supply, especially in the current recession. This was also the case in the early 1990s. In principle, we are strongly opposed in any case against any form of "social engineering" such as by allowing the planning process to determine tenure and who can live where.

Loan funding

66. As the Rugg Report identifies, gearing in the PRS is at a healthy level, especially among professional landlords with larger portfolios. We are, however, concerned that as interest rates inevitably rise there could be an increase in the number of repossessions/appointments of receivers in those cases where landlords have over borrowed and capital values have fallen. This time round, lenders seem to have been more sensible in that rather than selling repossessed properties into a falling market, they have taken steps to appoint receivers and collect rental income. We are, however, concerned that in some instances although mortgage payments are up to date lenders are invoking covenants relating to loan to value. For instance they may set a loan to value ratio of 70% or 75% even though the landlord/borrower is still able to service the repayments, some banks are treating the landlord as being in breach. This particular problem is compounded because lenders surveyors are taking a every conservative view of current values.

67. Elsewhere we have cited our concerns at the increased margins being imposed by lenders. The RLA has worries about the drying up of buy to let mortgages which have been provided by the specialist providers. As

we point out some major banks are also reducing the level of their mortgage books for residential accommodation. It is vital that a more orderly lending market is re-established and until this is done in our view the reality is that loans will not return to a normal sustainable level. However, in the meantime it is vital that the Government take steps to lay a sure foundation for recovery which will enable the PRS to expand. The Government can therefore help greatly with an improved tax/fiscal regime for the PRS.

Tax/fiscal regime

68. At a time when the public finances are in melt down and tax revenues are falling, one would anticipate that the Treasury would resist any calls for tax reliefs. We strongly believe, however, that this is an incorrect view and failure to provide these reliefs will impede any recovery, which is extremely fragile at the moment in any case. It is vital that the link is established between a healthy and expanding PRS, the construction industry and other related sectors but especially the construction industry.

69. It is important to note that during the recession generally speaking the PRS has remained in a healthy state. Voids have been limited. Landlords can usually find tenants readily. As regards rental income the survey of English households shows that between quarter three of 2007 and the end of 2008 rental levels have fallen to some extent but this has been limited. The IPD Residential Performance Survey to December 2009 shows that the average income return is now down to 2.7% annually as against a figure of 3% annually over the last three years.

70. Whilst, therefore, experiencing some levelling in rental income the PRS has stayed relatively buoyant compared to other sectors of the economy. As a result we have a sector which is still performing quite well and which has the right conditions for recovery. We face increasing demand due to rising population, an increased number of households, and the non affordability at the moment of owner/occupation. By stimulating the PRS there would be a beneficial knock on on other sectors particularly the construction industry but also certain sectors of retail (e.g. provision of new furniture, carpets etc). One has to recognise that the PRS provides a considerable amount of work to builders and tradesmen such as plumbers, electricians, joiners and so on.

71. Although it may be thought therefore that tax reliefs would adversely affect the Exchequer the reality is that they would stimulate growth and therefore tax revenues from elsewhere. Indeed, the apparent loss of revenue directly from landlords/investors might not materialise anyway because, without this stimulus, the underlying economic activity would simply not happen at all. In other words the Treasury would be better off having a percentage of something rather than a percentage of nothing. Having regard to the current dire state of the public finances economic recovery is one of the key ways in which the UK can fight its way out of

the current recession. We believe that the PRS has a vital part to play in stimulating this recovery. This can be done by refurbishing properties and converting properties. There is also a huge amount of work to be done to improve energy efficiency in the private sector generally; not just the PRS.

72. When it comes to the tax/fiscal regime the fundamental problem is that historically rental income has not been treated as trading income. This follows on from the decision in Fry -v- Salisbury House in the 1930s when the Courts blocked attempts by the Inland Revenue to treat this income as trading income holding instead that it was Schedule A income. Ever since the Inland Revenue have held to this position. The position was ameliorated for furnished holiday lettings although the Government have recently tried to reverse this. In the view of the RLA it is now vital that the Treasury reconsider its attitude to the treatment of income from rented accommodation. This would be in line with the urgings of the Rugg Review to treat the Private Rented Sector as a business.

73. Already, in practice, in view of the provisions of the current Schedule A income from rented accommodation is treated as income from a business (but not from a trade). This has alleviated the problems which have previously been experienced with regard to expenses to be set against rental income.

74. On the other hand, as a result of the current treatment landlords/investors in the private rented sector do not receive :-

(a) Allowances for losses to be set against other income – this could be particularly disadvantageous in set up situations.
(b) No capital gains tax roll over relief.
(c) No entrepreneur relief.
(d) Pension contribution tax relief is not available.

We have always argued that providing a main residence for someone is more important than providing holiday accommodation. We have never understood why income from residential accommodation in the PRS should not be treated as trading income. However, we would argue that this treatment should be confined to active property investment businesses; not passive investors.

75. Another major problem has been the inability to claim relief in respect of major expenditure on repairs/refurbishment on capital items against capital gains tax only. This relief may never be forthcoming e.g. because of the uplift on death. We strongly advocate a scheme of capital allowances which again will stimulate such expenditure. In particular it could absorb the LESA scheme for allowances in respect of energy efficiency improvements. Again, this would stimulate activity in related employment sectors. More importantly it would encourage landlords to make these improvements sooner rather than later and they would not have to rely on

the provision of spend to save type schemes which will have to be funded by energy companies and other sources otherwise.

76. We also have to look at VAT treatment particularly as EU law now allows beneficial treatment in certain respects.

77. By way of improving the current tax systems so as to stimulate development and growth in the PRS we would advocate the following:-

(1) Capital Allowances

There should be a system of capital allowances to provide tax relief on expenditure to carry out works to improve rented accommodation in the private rented sector including major refurbishment/repairs. For example, programmes of works may be needed to improve energy performance, fire safety or to install new amenities. Normally such work would only qualify for capital gains tax relief as and when the property is eventually sold. Again this would encourage work and help the construction industry.

(2) Capital Gains Tax on Active Residential Property Investment Businesses

For many years, the Association has argued that residential property investors who are actively involved in managing their businesses should be treated as traders. This would then enable those carrying on actively managed residential property investment businesses to claim Capital Gains Tax rollover relief for reinvestment. On first sight, it might be suggested that this would lead to a loss of tax revenue. On the contrary, it would free up the residential property investment market expressly now that it is largely stagnant. Properties would change hands more often. At the moment, many landlords sit on properties because of potential significant Capital Gains Tax liabilities. This damages both the housing market and tax receipts generally. There is concern about private rented sector stock condition. This would be helped because when experience shows that a property changes hand the new owner will invariably refurbish and improve the property. New owners have new ideas and will make investment in the property. Similarly when properties change hands the Government receives stamp duty land tax (SDLT) and other taxes. All in all, freeing up these properties will both improve the state of the private rented housing stock and increase tax receipts and help landlords update and improve their portfolios. It will make the PRS more efficient leading to increased profits. This would offset any short term losses so far as Capital Gains Tax receipts are concerned.

(3) Landlord Energy Savings Allowance (LESA)

LESA needs to be expanded as a key encouragement to landlords to promote better energy efficiency. It could form part of an overall system of capital allowances. It needs to extend to the whole range of measures which can reduce energy consumption and improve the warmth in dwellings. The current limit needs to be increased so as to encompass all ways of effecting these improvements. Energy Efficiency improvements can in some cases cost up to £6,500 at least depending on the age/design/condition of properties and more. This will particularly help with pre 1919 properties which are difficult to deal with e.g. because of solid walls.

(4) Stamp Duty Land Tax

Portfolio sales should not be aggregated so that tax is paid on the value of individual properties instead. Again this will encourage sales with consequent tax revenues. We look at this in answer to the relevant questions.

(5) Value Added Tax

(a) Now that the EU has recently agreed to a rate of 5% tax rate for renovation and repair work, the VAT should be reduced to 5% for such works. This move has a degree of support from the CLG Committee – in its recent report Beyond Decent Homes. This will provide a real boost, encouraging landlords to bring forward programmes for renovations and repairs. Stock condition surveys recognise that many properties comprised in the PRS are pre-1919 as we mention elsewhere. They are older type properties which are more expensive to maintain and often need refurbishment. This is, therefore, a unique opportunity to encourage landlords to carry out works on their properties. This will take tradesmen off the dole queue and help manufacturers of building products, builders merchants and the like.

(b) At present, there is a significant disincentive to converting properties, as opposed to new build. We have already looked a the VAT disincentives to development. There is concern at the lack of take up of build to rent. The same could be said of "convert to let". Many buildings lend themselves to sub-division, extension etc and provide a viable alternative to new build. However VAT treatment in such circumstances is disadvantageous as compared to new build for sale where zero rating is available. There needs to be a review of the VAT treatment of conversions. Zero rating or at least reduced VAT rates should apply where a property is converted for residential purposes, whether it is sold off or rented out. In this way, bringing new properties into the rented market would be encouraged and this would increase the supply of available housing.

78. Importantly we would advocate two schemes which can immediately start to incentivise the PRS and stimulate growth:-

(1) Private Rented Sector Expansion Schemes

(a) The Business Expansion Scheme was originally introduced alongside the introduction of the current Assured Tenancy Regime but ended a long time ago. It stimulated growth in the PRS. It led to new build. Our scheme is modelled on the same kind of principles. It should be aimed at the provision of new accommodation.

(b) By providing tax breaks for new build and the creation of new units by conversion/extension, not only is this much needed accommodation provided but as already pointed out the Government can increase tax receipts. Now is a good opportunity for land to be acquired to provide new housing (for instance what about all the empty pub sites?)

(c) What we call the Private Rented Expansion Scheme, modelled on the old Business Expansion Scheme, should be reintroduced to stimulate growth in the PRS. As already stated there is still good demand for rentals and it is likely that this will increase. It is not therefore going to be a case of new dwellings being provided only to stand idle.

(d) We should also look at using tax breaks to encourage landlords in the PRS to buy up new build units which are standing vacant (or vacant conversions) which have been carried out with a view to being sold so far unsuccessfully to the owner/occupier market.

(e) What form should the new Scheme take? Firstly, there should be capital gains exemption so long as these properties are kept within the private rented sector for, say, five years. Realistically it will be some time before there is capital appreciation anyway and in any case there is no immediate loss of tax revenue. By the time sales take place the economy should be in a much stronger position but in the meantime the Government will have received tax revenues. For example, there will be stamp duty land tax on transfers where applicable, and transactions such as money paid to furnish properties, work done to finish off properties so that they can be sold etc., will provide tax revenues.

(f) Secondly, all rental income for these newly created units should be tax free for five years. Obviously the landlord would not then get the benefit of related expenditure which was otherwise tax allowable; nor related tax relief on interest. As these are new units of accommodation by definition there would be no loss of tax revenue because at the moment no tax revenue would be received for these properties anyway as they are not currently in existence/use. However, by stimulating demand in this way the Government would receive a number of tax advantages namely stamp duty land tax where applicable, Council Tax on new units, and all the related tax revenues from associated suppliers e.g. builders, plumbers, furniture sales etc.

(g) Just as importantly, we would have a ready source of new homes to rent for those in need. Pressure would therefore be taken off local authorities, particularly local authority homelessness sections. There would be a saving on costly provision of bed and breakfast type accommodation and expensive contracts to provide short term housing for the homeless.

(h) All round this should be win win not just for tax revenues but for the economy as a whole particularly as it would stimulate the down and out construction Sector. People would get back in to jobs with a saving on benefits. It would help regeneration particularly existing derelict sites.

(i) The Business Expansion Scheme was proven to work so it is a tried and tested means of promoting economic development.

(2) Self Invested Pension Schemes ("SIPPS")

To promote employment, retention of skills in the construction sector and to take up empty units the Government should allow self invested pension funds, for a limited period, to invest in residential units, up to a maximum purchase price of £250,000 per unit outside London (with a suitable adjustment for London prices). The units must then be let out by an ARLA, NALs etc affiliated letting agent. These measures would prevent any abuse, mop up unsold flats, allow part finished developments to be completed, free up capital for both building companies and banks. The tax take on stamp duty land tax would also increase as would employment taxes as a gradual improvement in prospects would follow. There would be a beneficial knock on effect on retailing as these properties would be furnished and this would also help the economy. The real cost of this measure is negligible yet it could reap very great benefits very easily. It is suggested that this be introduced for a limited period of 5 years in order to stimulate demand

79. By adopting these changes referred to in this section and the last section the RLA believes that when you have an effective tax regime which going forward will help stimulate the necessary investment in the PRS. The Government may not be able to magic up loan capital in the current climate but it will certainly do something to provide the right fiscal/tax environment. It would lay the correct foundation going forward and provide immediate stimulus.

Is there anything fundamentally wrong with the make up of investors in the PRS?

80. The RLA considers that, by and large, the current make up of landlords/investors in the PRS is working. They are resilient and adapt to change. We believe that as demonstrated by what has happened since 1988 there is unlikely to be any significant influx of institutional investors. As we have pointed out elsewhere this make up of the PRS is not out of line with what happens elsewhere so there is no reason to suppose that a significantly different make up will emerge. Extra investment via institutions could still play a part if it were forthcoming.

Longer term tenancies

81. One problem identified by the Rugg Review is the need for longer term tenancies. The non shorthold assured tenancy regime was introduced to provide these but has never caught on within the private sector (it is a standard model for registered social landlords). Complaints are made that the PRS is a short term sector. Short term tenancies meet the needs of many people in the PRS and are therefore a vital component of tenancy mix. However, as the PRS provides more and more accommodation for families and the like work does need to be done to provide a longer term tenancy arrangement to meet such a demand. The RLA believes that this can be done by making some adjustments to the non shorthold regime to

make it more acceptable to landlords who might then be willing to enter into longer term commitments, perhaps after initial assured shorthold tenancies have been successfully conducted. This was always the intended model under the 1988 Act but we do need to look again at the grounds of possession in this respect.

Housing Benefits/Local Housing Allowance

82. The DWP are conducting a separate review into the local housing allowance. However, in strategic terms the importance of housing benefits/local housing allowance must not be overlooked in relation to investment in the PRS. The PRS caters for those on lower incomes and the unemployed. Without these tenants receiving adequate housing benefits/local housing allowance to meet their rental commitments the PRS would no longer be able to perform this vital function and accordingly investment would suffer.

83. The link between benefits and market rents must be maintained and this has been a cornerstone up to now of the housing benefit system. We are opposed to any suggestion of flat rate benefits which include provision for housing costs. Peoples circumstances are far too variable for this to work. It must be recognised going forward that housing benefits and the local housing allowance (as it becomes more widespread) underpin investment in this major sub sector of the PRS.

Responses to Questions

Our replies to the various questions should be read in the light of our general comments.

Question 1 – What has led individuals to invest in new build properties in preference to purchasing and converting existing owner/occupied housing?

84. As the Consultation Paper states, it is difficult to estimate the proportion of new build acquisitions in the boom years up to 2008. Estimates vary between 10% and the Treasury’s own estimate of around 20%. Do not forget that at least 80% were not new build. This phenomenon, often involving off plan purchases, was, in the RLA view fuelled by the drive for higher density housing, particularly flat developments brought about by planning policies and targets. New build purchases and buying flats went hand in hand.

85. Marketing operators, including property investment clubs, often negotiated deals with developers, frequently at an apparently discounted price for bulk purchases. Oversees investors were attracted, the Southern Irish Community being one such example. Frequently these investors were living at some distance from their investment. The deception was that because of low interest rate the rental income would cover the mortgage and associated costs. The main driver was capital growth. Indeed it was not at all uncommon for some of these investors to buy and leave the

properties vacant with a view to selling them at an increased price later on. Undoubtedly, these acquisitions helped support new build but whether it was the right sort of new build in the right places was often a moot point. It has lead to the problems which have been experienced in certain cities e.g. Leeds where there has been an oversupply of flat developments. Gradually the market is correcting itself. This phenomenon has attracted a considerable amount of publicity because of these resulting problems. It is important not to overlook purchases by investors of existing properties which were assisted by buy to let mortgages. Normally these investors will acquire properties in the vicinity of where they reside. Frequently they will manage these properties themselves. By and large these are long term acquisitions purchased for their rental return but with the expectation over time of capital appreciation.

86. We do not believe that this model of new build is a workable way in the long term of bringing new investment into the PRS. It came about because of a combination of factors namely easy credit low interest rates and the drive for high density housing particularly flats, coupled with the phenomenon of city centre redevelopment.

87. The RLA believes that there is a need for a long term sustainable "build to rent" model particularly one that is attractive to individual investors whether acting individually or collectively with others. It should be recognised that many individual landlords/investors either also operate as builders or have building experience. It is not at all unusual for builders to branch out into property investment in the PRS. Many landlords/investors particularly those with growing portfolios have the necessary skills to branch out into development even if they might contract out the building work. We believe that there is a significant source of potential growth to be tapped. After all prior to the Second World War many new housing developments were developments by builders who built houses and then rented them out.

88. Unfortunately there are major taxation disadvantages and other restraints on development which would prevent this happening at the moment, which we have identified already (paragraph 44). Likewise, if only in the short term, we have considerable constraints due to the lack of available credit but this will ease over time. We need to be looking now at actions which are required to enable build to rent to grow as the recession comes to an end. It is fair to say that in the boom years landlords/investors were carrying out developments particularly conversions and extensions to provide new PRS accommodation on a more modest scale but we need to harness these energies and expand on going forward. We refer to this issue under the section "Build to rent" (paragraphs 41 – 43). Clearly the PRS and the construction industry go hand in hand and by stimulating development this provides work in the construction industry. In principle, it should not matter whether the landlord/investor develops and/or self builds or prefer to purchase units from the house builder in the traditional way. Any tax structure needs to be neutral in this regard.

Question 2 – To what extent has the growth of the PRS already influenced the house building industry? How might it do so in the future?

89. Housing supply through new build has been influenced significantly by planning policies including increased density of development and use of brown field sites, with the restrictions on green field sites being developed. This has increased the amount of flats built because of the higher density and we believe that targets have skewed development away from houses to such an extent that the families are disadvantaged. Flats however are attractive to some segments of the PRS especially single people and couples without children. Also, there has been a demand in city centres for flats where there were none before. These have been attractive to the PRS in that they have provided investment opportunities to rent out to young professionals and alike. However because of the boom there was over provision. Trying to disentangle the cause and the effect however is difficult. Perhaps various phenomena simply came together at or around the same time. Investors in the PRS have been tempted perhaps on occasion to invest in flats because they perceive there was less management involvement. They thought that there will be management of the development as a whole via the developer or more likely a management company structure. The reality is that this in itself can generate problems because of the division in responsibility between the individual flats on the one hand and the development on the other. Forward sales off plan undoubtedly helped accentuate this move towards flat development. Pre-sales gave developers the confidence to proceed.

90. As to the future, however, it is highly unlikely that this will be repeated certainly in the short to medium term. The wholesale retreat from development at the moment coupled with all the problems surrounding the shortage of mortgage funding lead one to the conclusion that it is not going to be repeated for a long time, if at all.

91. As we have already stated, the RLA's view is that we do need to stimulate build to rent and that there is an appetite for this given the right conditions. Planning policies are now changing and more emphasis is being placed on building a higher proportion of houses as compared with flats, which is the right way forward to meet demand. Flats however still have their part to play. We do not consider that PRS can solely rely on acquiring existing stock to expand, although this undoubtedly has a part to play. We need real growth in the overall number of PRS units. There is the need for flexibility so that a house or flat can switch between the owner occupied sector and the PRS. Overall the amount of stock both generally in the PRS needs to be increased and this can only come from additional provision both by new build and conversion. We make suggestions as to how this can be done. For example we suggest two means of stimulation via tax breaks, one replicating the former successful business expansion scheme and the other a temporary extension of the SIPPs regime into residential property. Both are designed so as to stimulate the increase in numbers because both concentrate on the introduction of new housing which has not being previously occupied at all. In particular our private rented sector

expansion scheme would encourage smaller investors to group together, as happened under the old business expansion scheme regime. Collectivisation should not be compulsory however and any such scheme should be open to individuals and groups.

92. New investment from the PRS would then stimulate the house building industry and provide jobs for the construction sector. This in turn would help stimulate much needed economic recovery. We also strongly believe that a change to the capital gains tax rollover relief regime would bring forward properties particularly for conversion. Properties would as a result be refurbished extended upgraded and converted, thus stimulating further investment in the economy. As we have stated elsewhere investment is not just about providing new units but also maintaining and improving existing units so as to generally improve the sector.

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

93. Renting out a room or rooms in ones home does play a part in the provision of housing accommodation but only a small part overall. At the RLA we for example provide forms of tenancy agreement for this purpose. It is very difficult to gauge the extent of this practice overall and it does vary according to economic conditions.

94. The regulatory regime for such lettings is favourable, at least where accommodation is shared between landlord and tenant. However there are all the usual social problems and people can be reluctant to rent to strangers. Undoubtedly there is under utilisation in the housing stock with an aging population but it is in many cases not realistic to expect older people to rent out rooms in their own houses.

95. The RLA is very concerned that nothing has been done to update the rental room allowance. This has remained at £4,250.00 for a number of years as if the Treasury wanted to see it die a natural death. We are opposed to this approach and believe that the level should be raised to at least £9,000.00 per annum.

96. The Government has recently introduced another major disincentive arising out of the amendments to the Use Classes Order which we have referred to elsewhere. As a result of class C4 if an owner occupier were to rent out rooms to three or more lodgers then planning permission could be needed. This is a pity when as we have already said the actual regulatory regime so far as tenancies are concerned is favourable. As is so often the case however this may not be well known.

97. Renting out rooms in ones home in this way is a useful contribution to the provision of stock the PRS but it only makes a small contribution towards

meeting overall housing need and in our view this is likely to continue to be the case.

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

98. The first point to make is that many current investors in the PRS have been involved in the sector for more than ten years anyway. In some cases this will be because investments have been passed down from one generation to another within the same family. Their investment decisions, depending on their personal circumstances, over the past 10 years have in many cases being to increase their investment. As with others cheaper credit and more available credit prior to 2007/2008 would have helped them increase the level of their investment. They remain the backbone of landlords/investors in the PRS and their contribution should not be underestimated.

99. Over the past decade residential investment has been very popular up until the start of the credit crunch. It was seen as the "sexy thing" when compared to other forms of investment. In particular, pensions were treated with the upmost suspicion. This was due to a number of factors, the Equitable Life scandal, pensions mis-selling and high levels of management charges. Furthermore owning ones own property gave one more hands on involvement and many people came into the PRS seeing property investment as a form of long term investment for their pensions. Direct investment in equities were seen as potentially volatile and risky. Property however represented "bricks and mortar". At the time one could not think otherwise because their appeared to be a repeat of what had happened in previous booms namely significant capital appreciation. As with the longer term investors the growth of buy to let mortgages and the ready availability of credit was a significant driver. Rent seemed to cover interest and costs.

100. This is now, of course, changed. Our low interest rates mean that for the time being credit may still be cheap this can not endure. Lenders are looking for every opportunity to increase their margin e.g. when it comes to refinancing when fixed term loans run out. Although prices have fallen lack of available credit means that at the moment landlords/investors and reluctant/unable to purchase. Lower values anyway mean that would be sellers prefer to hang on to their properties waiting for better times. So far as potential purchasers are concerned there are still worries about a "double sip" recession and further possible falls in prices. There is also concern in the background that, when interest rates rise, more properties will come onto the market as repossessions follow; again depressing prices.

101. Current views among members seem to be that it will be some considerable time before we see any steady capital appreciation again but eventually it will come. These things always seem to be cyclical. By and

large rents have kept up relatively well and there have not been many voids. However if unemployment were to increase then this could generate problems particularly in relation to rental arrears. Some landlords have worries about Government's intention towards housing benefit in view of forthcoming public expenditure cutbacks.

102. In the short to medium term perhaps prospects are therefore not good. On the other hand many landlords/investors are well geared and have equity available if only loan finance could be found on reasonable terms. You have to appreciate that landlords have been used to cheap money like everyone else and, as we have already pointed out elsewhere, the increased margins demanded by lenders are posing problems.

103. Going forward, the PRS in the short to medium term is certainly not going to expand in the way it has done in the past decade In particular the buy to let lending market is currently restricted. Lenders dependant on wholesale funding such as Paragon Mortgages are only just beginning to talk about reopening their lending books. Other lenders such as Yorkshire Bank/Clydesdale Bank are actively cutting back their residential property loan books.

104. Any lenders who are out in the market have not only increased their margins but have generally tightened their underwriting criteria. They have reduced loan to value ratios. Having said this we do not advocate a return to the former loose conditions.

105. Nevertheless the RLA's opinion is that the major driver is going to be the continuing need to increase the available housing stock and the growing demand for accommodation in the PRS. This is being driven by non availability of owner occupation and also by local authorities increasingly looking to the PRS to provide accommodation because of the constraints on the social sector going forward.

106. Talking to individual landlords especially those with larger portfolios we find that there are many who are looking to buy and expand further either now or in the near future. As always around the bottom of the market the bargain hunters come out as well. Investors still perceive that the rental returns present a good investment with the possibility of capital appreciation in the long term combined with the solidity of bricks and mortar.

107. The main risk therefore is the current state and likely future state of the mortgage market in the short to medium term. The key prospect, as indicated, is increasing demand.

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 properties commercially viable?

108. We have made the point elsewhere that economies of scale may in fact be a myth. The most economically effective form of management is for the individual/small corporate landlord/investor to self manage. This hands on approach keeps costs down. Experience shows that when a landlord has more than 20 properties in his portfolio it is more likely that it is to be fully involved in management as opposed to operating on a part time basis. When one gets fifty units plus then you need to take on staff to assist.

109. By its very nature, residential investment properties tend to be more scattered although in some instances they will tend to be grouped within certain streets/areas. This does not lend itself to large scale institutional investment.

110. Our perception is that institutional investors' main concern is selecting asset class and then investing significant sums. In practice it is not possible to find large swathes of property in one go and this may well be some reason why the world over institutions are reluctant to become involved in residential property. There are also significant practical management issues that residential property is management intensive. For example the landlord is responsible for the majority of repairs, unlike with commercial property. Thus more staff and resources may be needed to manage the asset compared with other asset classes. Management can be delegated to managing agents but this comes at a cost and one still has to liaise with the managing agents. It can also be difficult purchasing parts only of blocks of flats because of the involvement of other flat owners in the decision making process.

111. In any case, as we have stated elsewhere, we do not feel that in reality in institutions are going to be able or willing to provide the kind on investment which the Government is seeking. As has been historically the case in the RLA view the need is to grow the existing investor base of individual/small corporate landlords. We need them to expand their portfolios and become more professional. We need new small investors to come in to replace those who leave and also to increase numbers generally.

Question 6

What evidence is there that:-

(i) the SDLT bulk purchasing rules are a constraint to building up property portfolios.
(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?

112. The RLA believes that this is one of a number of restraints on disposals, including the lack of availability of capital gains tax roll over relief for reinvestment. On occasion, landlords want to disinvest either to move into say the commercial sector or to retire. If they have built up a significant portfolio, it is far easier to sell this at one go. Frequently, there are other

portfolio investors out there who would then be willing to purchase. Practical experience shows that the aggregating of values for SDLT purposes is a disincentive. It leads to payment of higher rates of SDLT so that the overall cost is significantly greater than will be the case if properties were taxed individually. This is particularly so in areas of lower house prices. Exemptions could be available in those areas which are lost for portfolio purchasers. As a result there is a perverse incentive to break up the portfolio. This does happen. Overall, it would be far better to assist and encourage the creation of larger portfolios. As we have already point elsewhere this aids professionalism and allows the PRS to develop as a business. So far as evidence of this is concerned perhaps one has to start to think about the rather murky area of SDLT planning and avoidance techniques. The Treasury has had to legislate against various schemes and therefore as it well knows this is a very real issue. From talking to members the need to pay extra tax (which might appear relatively small in the overall equation) is irksome to say the least.

113. We certainly share the view that the current regime does lead to the unnecessary break up of portfolios for those retiring from the PRS. Likewise, for those looking for new investment, inevitably in the same way the rules are a disincentive. They make it more difficult to purchase the properties from developers and would therefore impede any growth in "build to rent". The RLA has long campaigned for a change to these rules. Any loss to the Exchequer would be more than counterbalanced by the advantages of enabling larger portfolios to be built up and also to encourage portfolio purchases of new build properties. In the current climate we need to do everything we can to encourage this and not put this kind of obstacle in the way.

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?

114. This is not just a question for the potential institutional investors. Clearly, it also impacts on the calculation of returns for individual investors. Individual investors vary in their sophistication but a considerable number make careful calculations (as do their potential lenders) of rates of return. They base their pricing decisions on this as to whether it is worthwhile to proceed or not.

115. Undoubtedly, if the rules were changed so that SDLT rates simply applied to the individual property (and not the aggregate of the portfolio value) then this would improve the rate of return. We would stress that the rate of return on rental income is not high and therefore anything that can be done to improve this will assist in the encouragement of investment in the sector.

Question 8

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

116. As an Association representative of individuals/small corporate investors and agents we are not really in a position to answer this question which is directed at potential institutional investors. Having said this we would make the point, as we have already done elsewhere, that return is simply not a matter of rental yield in the PRS but capital appreciation comes into the equation as well.

Question 9

117. What factors point to the recent institutional investment into the PRS and do these reflect the long term change in investment opinion?

118. Again, this is more for the institutional investors and potential investors to answer. However we remain sceptical that institutions have a great part to play save in certain specialised areas e.g. student accommodation particularly for first year students and asylum seekers. We believe that the current interest is as a result of the current state of the economic cycle. It may however have a part to play in increasing investment in the PRS. As the Rugg Report points out, however, we believe that the Government should concentrate on encouraging and helping existing smaller investors who, from their track record have shown that they can come up to the mark. After all the sector has significantly expanded already since 1988 and there is no reason why, once we are over the present immediate credit problems, this should not continue; given the right incentives and encouragement.

Question 10

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

119. Again, this is more for institutions to answer. History shows a reluctance on the part of institutions to become involved in the PRS even though the regulatory regime has significantly been relaxed since 1988 as a result of the introduction of assured shorthold tenancies. There has also been the ready availability of credit until 2007/2008. If they will not do it then why should they in the future? To the RLA the problems seem to be the need for institutions to invest large sums on one go, the non availability of sufficiently large portfolios because of the disparate nature of the sector and the more intense management which is needed in relation to PRS as compared with other assets and particularly commercial property. It is well recognised that much less management input is needed for commercial property where, more often than not, the tenant takes full

responsibility for repairs, unlike in the PRS. Institutional investment also tend to want a more stable economic and political climate. Perhaps the small investor, whilst unhappy with it, is more used to changes in the regulatory climate.

120. Others, as well as ourselves, have made the point that the owner occupier market sets the prices and for new build these prices are heavily influenced at the moment in an upward direction by the costs resulting from the operation of the planning system and the infrastructure costs, as well as affordable housing provision. We have pointed out that rents in themselves do not deliver a sufficient turn. The smaller investor is more likely to take the longer term view in the institution that capital growth will come along sooner or later. Institutions do tend to dip in and out of sectors whereas the existing body of investors take the longer view, as research regularly shows. We oppose any suggestion of planning system being used to provide a separate asset class for residential property for the reasons explained elsewhere. We do not believe that this is likely to happen anyway, in practice, having regard to how pricing is based on what both owner/occupier and landlords/investors will pay when competing for the same stock.

121. We would be strongly opposed to changes to the tax system which would favour larger institutional investors at the expense of smaller investors because small investors already provide the proven backbone of the current PRS. We believe there need to be tax changes across the board so as to lead to increased investment as we point out under our section relating to Tax (paragraphs 78 and 79).

Question 11

What are the barriers to investment in residential property through UK REITSs and what changes would be needed to address them?

Question 12

What evidence is there of the likely effects of such changes on new, and existing, UK REITS investing in property? What impact will such changes have on existing UK REITS investing in commercial property?

122. We will deal with both of these questions together although again these are questions more for institutional and potential institutional investors. There have been suggestions that the introduction of the REITS model for residential property would go along way to solving investment problems and increase investment in the PRS. We remain extremely sceptical. REITS emanate from the USA and evidence from their shows that only about 1% of the residential investment market is provided by the REITs mechanism. Thus, in the RLA view, the REITS model, although of benefit to a small minority, is not a solution. It is not a panacea which will introduce a flood for new funding/investment into the PRS.

Question 13

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

Question 14

How do these collective investment vehicles compare to UK REITS?

123. Again, we will look at both of these questions together. The REITS mechanism is complex and in our view of limited assistance. Other methods of collective investment could prove attractive. Traditionally, individuals/small corporative investor has looked for a direct interest in the property in question (i.e. hands on ownership). In a sense it is a difference between owning a gold bar in a bank vault and having a piece of paper which says you have a share in a gold bar. In the former case you can take your gold bar away; in the latter you cannot. Experience shows that individual investors do join together in groups in the form of property partnership to own properties rented out in the PRS. We believe, however, that larger scale indirect investment (e.g. through property unit trusts) faces the same problems as through institutional investment (i.e. difficulties in assembling portfolios, need to invest in large tranches and management problems). The recent financial difficulties have show that property is an illiquid asset and withdrawals have had to be restricted. There tends to be a herd instinct about investments of this kind and people want to want to get out together. We believe that again, the existing body of individual/small corporate landlords are undervalued. As we have already mentioned, they take the long term view and they (and often their families, through the generations) "stick with it". We need to encourage this long term approach.

124. However, we consider that our proposal for the private rented sector expansion scheme lends itself to collective investment as much as individual investment. This was the experience with the former business expansion scheme.

125. At the moment, the limited company is often shunned as a means of investment in property generally. This is because of the potential double tax charge on disposals i.e. corporation tax liability on capital gains on disposal of the property and then capital gains tax liability on distribution of the proceeds to the investors. Likewise, there can be issues of additional tax on income especially for higher rate tax payers when rental income is distributed out. Lower tax rates for corporation tax encourage retention of income. This is true of all sizes of companies whether listed or not.

126. There is therefore a need for any model to be tax transparent as with REITS. The limited liability partnership model does provide an appropriate model but does have the significant draw back of stamp duty

liability on the transfer of units, potentially up to 4%. This can cause problems for members wishing to retire or for the introduction of new members. If the usual 0.5% rate applicable for shares was applied then this would assist this model of investment as a vehicle for straight forward collective investment in the PRS. The British Property Federation is providing comparable information on various collective investment vehicles in its response. Many of these sections are complex ways of individual investment and do not appeal to the average investor who requires a more direct method of investment such as via an LLP structure or the ordinary partnership mode.

Question 15

What evidence is there that institutional investment in the PRS would bring real benefits for the sector, and the housing market more generally.

127. As we have indicated already we are sceptical that it can or will make a significant contribution. Clearly, more investment from whatever source would increase the amount of stock available in the PRS so as to meet the significant projected demand. We believe that the existing landlord/investor base has proved itself and that we should concentrate on helping and developing this. Otherwise the danger is that a great deal of time and effort would be spent on trying to draw in the institutional investment but, we believe, from experience that this will not materialise to such an extent that it is of any real significance. In other words, "better the devil you know". Throughout this response we put forward the ways in which we think this can realistically be achieved. We also firmly believe that institutional investment is more liable to fads and sudden changes of direction. We are doubtful that institutional investors are prepared to take the long term view and leave their equity invested in the PRS in the same way that individual investors/small corporate operators are prepared to do.

128. Indeed, where institutional investment has occurred, it can have some real downsides. For example there has been specialist provision of new build student accommodation on the large scale by providers such as UNITE. However, the National Union of Students is currently running a campaign because of their concerns at the high level of rent being demanded by such operators. In contrast traditional student provision by the private rented sector in the form of shared houses offers a far more affordable rental level but still provides good standards; rather than the really high standards which these large scale operators provide.

129. It is also doubtful whether institutional investment will provide an assurance of any greater quality. We have already established that tenant satisfaction is high in the PRS compared with the social sector. The social sector is provided on an institutional basis. We have advocated improvement of management standards in the PRS and there has been a lot of progress. Hands on management by smaller landlords can often be far more responsive and personal.

Going forward – conclusion

130. The RLA view of the PRS is an optimistic one. We believe that the existing body of landlords functions well. With the right regulatory regime, an improved tax/fiscal system and normally in the availability of debt funding, the sector can rise to the undoubted challenge facing housing in this Country. Improved supply is vital. If supply and demand overall can be brought into the equilibrium then we firmly believe that many of the current problems would be solved. Indeed, it is worthy of note that the Consultation Paper itself believes that the present PRS is roughly in equilibrium as regards supply and demand. The current health of the PRS shows that if this situation could be extended to the housing market generally very many problems and challenges going forward could be dealt with and satisfactorily resolved.

131. Perception of the Sector is important and needs to be improved as does the way of regulating the Sector. The Sector needs to be recognised more as a business than it has been. Stability is needed with regard to regulation and we need to avoid over regulation. Indeed, self regulation for the compliant landlord is required because otherwise local authorities simply cannot cope with the regulatory responsibilities. A barrage of regulation in the longer term does no one any good and ultimately the cost of it falls on the consumer i.e. the tenant through increased rents. For example any attempts to undermine the current system of obtaining possession under the assured shorthold tenancy regime would reek havoc with the market. Political uncertainty and attitudes towards the sector can also create problems. What we need are landlords/investors who continue to be committed to the sector and see it as a long term opportunity for their investments. Policy issues should be aimed at encouraging responsible businesslike landlords to continue to operate in the sector.

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Resolution Foundation response to HMT consultation, ‘Investment in the UK private rented sector’

Summary

The Resolution Foundation is an independent research and policy organisation that works to improve the outcomes and wellbeing of ‘low earners’ – the 7.2 million UK households who earn on average £15,800 per annum, living on below median income while remaining broadly independent of state support.

We welcome Her Majesty’s Treasury consultation (HMT) on addressing barriers to investment in the private rented sector (PRS). The PRS has, until recently, received little attention from the policy or research world. Increasing the supply of PRS accommodation is especially important in the existing climate where a tighter mortgage market has made access to home ownership more difficult. It will also help to reduce rents, increase choice for tenants and weed out bad landlords.

The private rented sector plays an important role in particular for low earning households, who are squeezed when it comes to housing choices: too rich to qualify for social housing and too poor to access home ownership. Our analysis suggests that there are 800,000 low earning households living in private rented accommodation, making up 27 per cent of the PRS market.

Low earners will share some of the experiences of the niche markets identified within the consultation. For example a proportion will be living in the Housing Benefit sub-market of the PRS, the tied market, migrant market and older peoples’ market . However, in overlooking them as a group there is a danger that their needs and experiences are not fully understood. For example, anecdotal evidence suggests that some landlords view receipt of benefit as a guarantee for payment of rent. Low earning tenants who have to cover the full, or part, rent themselves may be deemed higher risk and as a result access may be more constrained.

We urge the Governement not to overlook the needs and experiences of low earning tenants when developing policy on the sector. It is important to understand how these segments, including the low earner segment, operate to ensure that supply is focussed where it is most needed and that it makes for suitable accommodation. Over the summer the Resolution Foundation will be undertaking research to profile low earners in the private rented sector and to understand their housing experiences and needs. We will keep HMT colleagues informed of emerging findings.

In looking at measures to increase investment in the PRS we support HMT's approach of looking at barriers to investment across the scale, from individuals to institutions. As the consultation suggests, tenant satisfaction levels with smaller individual landlords are in fact marginally higher than for those managed by companies, partnerships or other organisations. However, we also think that there may be benefits to larger landlordism in terms of greater security of tenure and reduced rents due to the creation of economies of scale. We would encourage HMT to look at barriers to investment in atypical providers, such as Housing Associations. A small number of these offer rented accommodation at market rates and the holistic services they deliver as part of their 'housing plus' approach could be very attractive to low earners.

We also recommend that HMT consider affordable PRS accommodation within a wider strategy of investment in affordable accommodation of all tenures. Many low earners rely on social housing and aspire to home ownership, and yet lack of investment in the supply of affordable accommodation means access is increasingly constrained, limiting choice and widening the gap between the haves and have nots.

This response includes:

- What we currently know about the low earner segment of the PRS;
- Investment in the affordable housing market.

1. Low earners in the private rented sector

1.1 Understanding low earners needs and experiences of the private rented sector is essential to fully understand the market and ensure supply is properly targeted and well designed. In Rugg's analysis of the sector she identified the following niche markets:

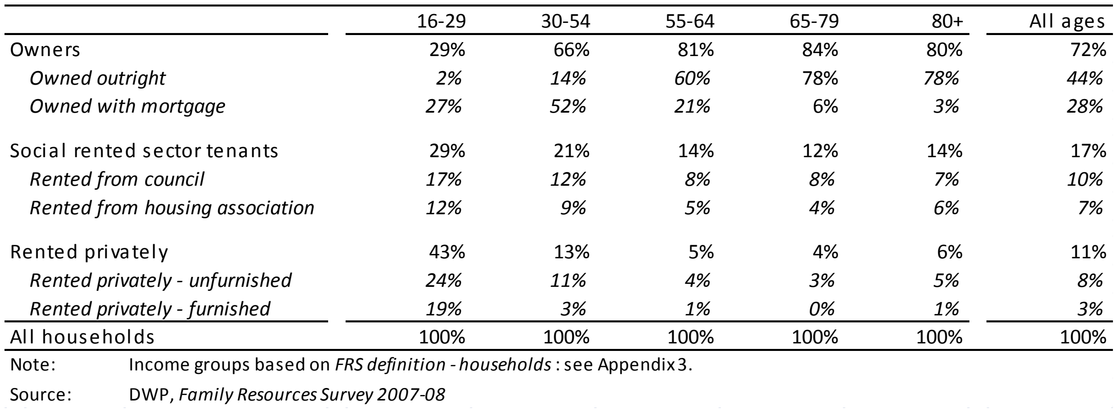
- Young professionals
- Students
- Households on Housing Benefit
- High income households
- Housing tied to employment
- Older households and regulated tenancies
- Immigrants and asylum seekers

1.2 Low earners experiences of the PRS will fall within some of these niche markets. However, in overlooking them as a group there is a danger that their needs and experiences are not fully understood. We will be seeking to address this evidence over the summer by producing some qualitative research on low earners needs and experiences and quantitative profiling of who they are. The sections below provide some indication of their experiences from our work so far.

2. Low earners reliance on the private rented sector

2.1 The PRS provides accommodation for a significant number of low earning households: 800,000, making up 27 per cent of the PRS market[1]. 61,000 of these households are receiving Housing Benefit, but it is likely that many more entitled to it. The Department for Work and Pensions (DWP) has estimated that around half of working people entitled to Housing Benefit do not claim it.

Housing tenure among low earner households by age of head of household: *UK 2007-08*



	16-29	30-54	55-64	65-79	80+	All ages
Owners	29%	66%	81%	84%	80%	72%
Owned outright	*2%*	*14%*	*60%*	78%	*78%*	*44%*
Owned with mortgage	*27%*	*52%*	*21%*	6%	*3%*	*28%*
Social rented sector tenants	29%	21%	14%	12%	14%	17%
Rented from council	*17%*	*12%*	*8%*	*8%*	*7%*	*10%*
Rented from housing association	*12%*	*9%*	*5%*	*4%*	*6%*	*7%*
Rented privately	43%	13%	5%	4%	6%	11%
Rented privately - unfurnished	*24%*	*11%*	*4%*	*3%*	*5%*	*8%*
Rented privately - furnished	*19%*	*3%*	*1%*	*0%*	*1%*	*3%*
All households	100%	100%	100%	100%	100%	100%

Note: Income groups based on *FRS definition - households* : see Appendix 3.

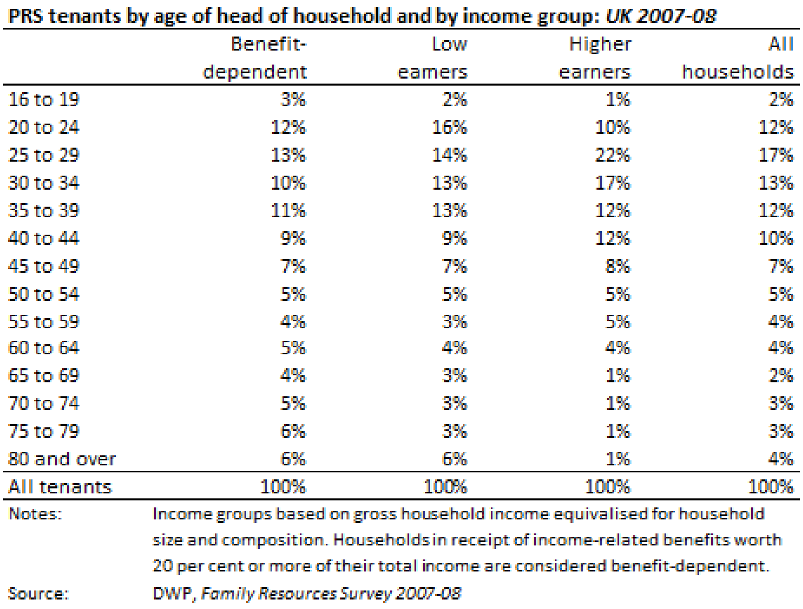
Source: DWP, *Family Resources Survey 2007-08*

2.2 Reflecting the private renting population in general, low earning households in the PRS are, on the whole, likely to be younger than those in other tenures. Indeed there is a greater proportion of low earning tenants aged 20-29 when compared to this demographic in other income groups. Greater proportions of low earners aged 30-39 also depend on it compared to benefit dependent groups.

2.3 While higher earners are also reliant on the PRS, they are more likely to be using it as a temporary bolt-hole, living in it for periods of 12 months or less, whereas low earning families are likely to live in it for longer periods: 25 per cent of renters in the lower middle quartile have lived at their address for 5 years or more[2].

[1] Resolution Foundation (2010) 'The low earners audit. March 2010 update: low earners household finances'

[2] Rugg, J and Rhodes, D (2008) 'The Private Rented Sector: its contributions and potential', Centre for Housing Policy, University of York



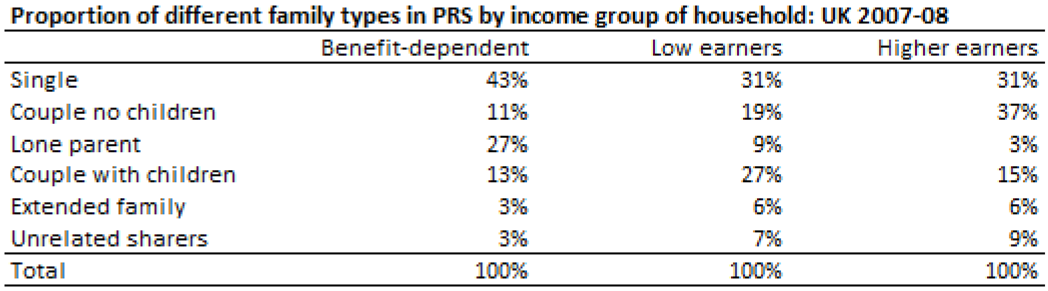
PRS tenants by age of head of household and by income group: *UK 2007-08*

	Benefit-dependent	Low earners	Higher earners	All households
16 to 19	3%	2%	1%	2%
20 to 24	12%	16%	10%	12%
25 to 29	13%	14%	22%	17%
30 to 34	10%	13%	17%	13%
35 to 39	11%	13%	12%	12%
40 to 44	9%	9%	12%	10%
45 to 49	7%	7%	8%	7%
50 to 54	5%	5%	5%	5%
55 to 59	4%	3%	5%	4%
60 to 64	5%	4%	4%	4%
65 to 69	4%	3%	1%	2%
70 to 74	5%	3%	1%	3%
75 to 79	6%	3%	1%	3%
80 and over	6%	6%	1%	4%
All tenants	100%	100%	100%	100%

Notes: Income groups based on gross household income equivalised for household size and composition. Households in receipt of income-related benefits worth 20 per cent or more of their total income are considered benefit-dependent.

Source: DWP, *Family Resources Survey 2007-08*

2.4 As the consultation suggests in section 3.15, the PRS provides an important home for many single people and demographic trends suggest that this will increase. However, a significant number of low-earning families are also reliant on it for accommodation, in particular couples with children. This is likely to have increased following the recession due to repossession of family homes and more constrained access to mortgage credit. It is important that PRS accommodation is also available to meet their needs.



Proportion of different family types in PRS by income group of household: UK 2007-08

	Benefit-dependent	Low earners	Higher earners
Single	43%	31%	31%
Couple no children	11%	19%	37%
Lone parent	27%	9%	3%
Couple with children	13%	27%	15%
Extended family	3%	6%	6%
Unrelated sharers	3%	7%	9%
Total	100%	100%	100%

Source: DWP Family resources survey 2007-08

3. Low earners experiences the private rented sector

3.1 Low earners' experiences of housing can be dissatisfactory. Research for the Department for Communities and Local Government on attitudes to housing found that:

- while three quarters (74 per cent) of private renters were satisfied with renting from a private landlord, this was the lowest of the three tenure groups (owner occupiers, social renters and private renters)

- the evidence on satisfaction levels in the private rented and social sectors suggests that low earners have worse experiences. In the private rented sector those on lower incomes, single parent families and those living in London were most dissatisfied. Within the social sector those on higher incomes, likely to be low earners, were among the most dissatisfied.

3.2 A number of reasons have been identified for this:

3.3 Constrained access

Tenants in receipt of Housing Benefit can find it difficult to find landlords who are prepared to let to them due to concerns that they will default on their rent. Shelter[3] found, from a survey of 110 landlords, that 60 per cent would not accept Local Housing Allowance (LHA) claimants.

That said, it is possible that access is even more constrained for those on Housing Benefit in work, or those low earning households who are not claiming Housing Benefit at all. Anecdotal evidence suggests that some landlords view receipt of benefit as a guarantee for payment of rent. Low earning tenants who have to cover the full, or part, rent themselves may be deemed higher risk. This is a key issue we will be exploring in our research over the next two months.

3.5 Affordability

Paragraph 2.6 of the HMT consultation points out that the PRS is more affordable than home ownership. However, while it may be the case that the PRS is more affordable across the board, low earning tenants still struggle to meet rent payments. For example,

- In a survey of low earning tenants, Shelter found that 24 per cent spend more than half their income on rent compared to 15 per cent of households in social housing and seven per cent in home ownership. [4]
- Research for DCLG found that high rents were most commonly mentioned as the worst thing about the sector, especially for those with incomes between £9,500 and £17,499.[5]
- Meeting private rented sector housing costs has become increasingly difficult following the recession. Shelter found that nine out of ten PRS tenants were falling behind or struggling with their household finances following the recession, an increase from 51 per cent of a similar sample in 2006.[6]

3.7 Insecurity

The fact that a landlord only has to give two months notice to end an Assured Shorthold Tenancy can mean that some low earners live in perpetual fear of homelessness. This may be more perception than reality: research for Shelter[7] found that tenancies most commonly end due to poor property conditions. Nonetheless, the feeling of insecurity it creates is real. It can also effect employment: research for DWP found that PRS tenants identified insecurity linked to tenancy conditions and

[3] Shelter (2009) 'For whose benefit? A study monitoring the implementation of Local Housing Allowance', London: Shelter

[4] Shelter (2008) 'Breaking point: how unaffordable housing is pushing us to the limit', London: Shelter

[5] Communities and Local Government (2009) 'Attitudes to housing: Findings from Ipsos MORI Public Affairs Monitor Omnibus Survey (England)' available at http://www.communities.gov.uk/documents/housing/pdf/1298556.pdf

[6] Shelter (2008) 'Breaking point: how unaffordable housing is pushing us to the limit', London: Shelter

[7] Rugg, J. (2008) ' Research report: A route to homelessness? A study of why private sector tenants become homeless;, London: Shelter

unsympathetic attitudes of landlords to financial problems as significant barriers to employment[8].

Insecurity has heightened further following the recession due to landlord repossession with cases of tenants being given very little notice that they have to quit the property.

3.8 Poor conditions

Conditions in the PRS are worse than in other tenures, particularly at the lower end. Almost one half of households fail to meet the Government's Decent Homes Standard.[9] Tenants can also be reluctant to complain to their landlords in the event of 'retaliatory eviction', as reported by Citizens Advice[10].

A CAB in East London reported a client whose flat was in serious disrepair. She reported this to the council who deemed the property not fit for human habitation. When the landlord found out that the client had reported the problem, he issued a Notice to Quit. However, he offered to let the tenant stay as long as she agreed to a rent increase of £110 per week to cover the costs of the repair.

3.9 Freedom and choice

Low earners have less freedom and choice in the PRS than higher income groups. They are more likely to have lived in their current home for longer,[11] particularly if they are on Housing Benefit, because of the hassle associated with identifying a landlord who will take on an HB tenant and the administration involved with a change in circumstances.

Shelter research found that a significant number of low earners are not able to choose where they live. Across all the tenures, 11 per cent are unable to live near work, 9 per cent could not live near their family, and 14 per cent have to live in housing that is too small for them.[12]

[8] Fletcher, D; Gore, T; Reeve, K and RobiNson, D with Bashir, N; Goudie, R nad O'Toole, S (2008) Social housing and worklessness: qualitative research findings' available at http://research.dwp.gov.uk/asd/asd5/report_abstracts/rr_abstracts/rra_521.asp

[9] Rugg, J and Rhodes, D (2008) 'The Private Rented Sector: its contributions and potential', Centre for Housing Policy, University of York

[10] Citizens Advice Bureau (2007) 'The tenant's dilemma. Warning: your home is at risk if you dare complain',

[11] Shelter (2009)'Taking the strain: The private rented sector in the recession', London: Shelter

[12] Shelter (2008) 'Breaking point: how unaffordable housing is pushing us to the limit', London: Shelter

4. Investment in the affordable housing market

4.1 A number of policies have been suggested by stakeholders to help encourage supply of PRS accommodation including changes to Stamp Duty Land Tax and VAT on repair and the development of a Build to Let model.[13]

4.2 We are not in a position, as yet, to comment on these. However, we support HMT's approach in the consultation of looking at barriers to investment across the spectrum from individual investment to institutional investment. There appear to be benefits to both with some individual landlords providing valued familiarity and flexibility[14] and some larger landlords offering longer term contracts and being able to provide below market rents due to economies of scale.

4.3 We also encourage HMT to consider investment in non-typical landlord providers, such as Housing Associations. A few Housing Associations are providing rented accommodation at market rates. It is possible that their 'Housing plus' approach would work well for many low-earning tenants. The CIH has recently produced a report looking exploring this[15]. We will tease out low earner preferences of different types of landlord in our research.

4.4 The PRS provides an important home for many low earners but many also rely on, or will rely on in the future or aspire to move into, social housing or owner-occupation. This requires a mixed economy approach to affordable housing, with investment channelled across all the tenure types. We encourage the Government to look at investment in affordable housing across all tenures to ensure that low earners have a more equal hosung choice in the future.

[13] Daly, J (2008) 'Overcoming barriers to institutional investment in residential property' available at http://residential-investment.savills.co.uk/articles/gla-published-report.pdf

[14] Rugg, J and Rhodes, D (2008) 'The Private Rented Sector: its contributions and potential', Centre for Housing Policy, University of York

[15] Davis, A (2010) 'Future directions in intermediate renting' available at http://www.cih.org/policy/FutureDiscussionsIntermediateRenting-Apr10.pdf

INVESTMENT IN THE UK PRIVATE RENTED SECTOR: Response to HM Treasury consultation by A Social Democratic Future, April 2010.

Introduction

A Social Democratic Future has been set up to provide a forum for those, regardless of party affiliation or of none, who want to contribute to a new politics marked by social democratic values shaping strategic policy development, not tactical interventions geared to short-term control of news agenda.

It aims to progress a social democratic political methodology that requires future public policy choices and development to be assessed against the primary benchmark of their relative impact on the lifetime opportunities available to low and middle-income households, particularly the poor and disadvantaged, without sacrificing economic efficiency.

Housing is a prime and current example of a policy area where the *technical* and *political* dimensions of social democratic strategy and policy can and should be combined.

Since the seventies the UK housing system, particularly in England, has contributed to systemic economic and social failure across three crucial areas, all of which are quite inimical to the achievement of the core strategic social democratic end of achieving economically efficient, balanced, and sustainable growth combined with social cohesion and fairness.

First, to the loss of economic efficiency that has resulted from the operation of boom-bust in the speculative housing market. Second, rising house prices have increased class and generational inequality, and skewed housing opportunities away from less established and low- and moderate income households. And third, social housing has become increasingly a residualised and stigmatized sector occupied by the economically inactive: membership of the tenure itself has become an indicator of social exclusion within an increasingly fractured society lacking cohesion.

The objectives of expanding access to affordable housing, blurring tenure divisions, the stabilization of house prices intra-cycle by flattening both peak and trough, and the related ones of shifting resources towards production rather than consumption in housing, and even more crucially, across the wider economy generally: all require mechanisms that are firmly social democratic in both intent and character. To some extent they are also supported already in varying degrees and in different ways, although sometimes ostensibly, across the political spectrum. Certainly cross-party political support will be required if housing reform is to be effective and sustained.

The future role of the private rented sector (PRS) rightly merits serious review and attention in that light. That review needs to focus on optimising the contribution of the PRS to the expansion of housing supply and opportunity. It should become an integral component of a housing policy framework that is integrated with wider macro-economic and income maintenance strategic objectives, namely, securing sustainable growth, reduced inequality, and making work pay. Taken together, these are defined in this response as *wider housing objectives*.

This response of *A Social Democratic Future* to this consultation is structured and made accordingly.

Summary of response

The terms of reference and scope of the review covered by the consultation is too limited. Essentially, the questions that it asks are not focused on the actual policy issues and challenges that remain to be addressed and overcome if the PRS is to most effectively contribute to the achievement of *wider housing objectives*. The mechanisms and policy channels by which private institutional investment can be best attracted into the sector consistent with those objectives are not explored or discussed sufficiently within the consultation.

The consideration of the past and future role of the sector is not integrated with an analysis of the wider housing system and market referenced to its systematic tendency towards boom followed by bust. Most notably, the negative part played by the unsustainable growth in the buy-to-let sector in fuelling the latest almost catastrophic boom-and-bust across both the wider economy and housing systems is not identified. Buy-to-let investment has largely been expended by individuals on purchasing existing properties, not on funding new supply: thus it has been largely financial speculative investment on a portfolio asset rather than physical investment in the provision of new supply capacity or improved stock.

The essential problem with the substantive buy-to-let activity and the associated transfer of stock into the PRS that has taken place over past decade and half is that it comes attached with an opportunity cost: such dwellings are no longer available to first-time purchasers to buy or occupy on intermediate tenure terms.

Crucially, fuelled by taxation reliefs and over-easy credit, ballooning buy-to-let activity by inflating money demand for housing provided a key driver that propelled the long boom in house prices prior to its implosion in 2008. Investors bid up prices and ‘crowded out’ prospective first time or other individual purchasers, a process that also widened asset-based inequalities in Britain’s already highly unequal society: two highly adverse outcomes.

That process also aggravated Britain’s tendency to over-consume and under-produce that pervades both the UK’s economic and housing systems. It is linked to the institutional relationship between house prices and consumer expenditure that has emerged across the UK over recent decades, one most concentrated in London and the South-east, and some other sub-regions. It is somewhat disappointing and surprising that these wider economic implications are not identified and analysed within a HM Treasury document.

The taxation reliefs accorded to buy-to-let investors represent in addition a wasteful use of potential public expenditure resources that could generate much improved economic and social returns if invested elsewhere in the housing system.

The facilitation of the growth of an institutional private rented sector providing new and refurbished housing with improved space and sustainability standards consistent with *wider housing objectives* could be one such area.

This is because increased investment in the private rented sector by pension funds and financial institutions could offer the potential advantage of substantially increasing the private financing of *additional or improved housing tangible assets* linked to their facility to offer a reasonably certain return from a mixture of rental yield (that could be linked to average earnings) and future capital gain (assuming a steady rate of real house price increase of 2% per annum). A total average target annual return of up to six per cent is potentially identifiable (*target return*). That return could be net on the basis of taxation reliefs made conditional on the provision of access, security, and reinvestment terms consistent with wider housing public objectives.

The key policy conflicts/issues that need to be addressed and resolved for such an avenue is to be explored and progressed in any meaningful way, revolve around the question as to how investment in an institutional PRS can most effectively widen the access to affordable quality accommodation to low and moderate income households. That is because private new or refurbished housing attached with such a target return to investors provided through an institutional PRS is unlikely to be affordable to such households without public support of some kind, whether capital grant, housing benefit, or the discounted or free disposal of public land.

Likewise the related issue as to whether using public resources to facilitate the growth of an institutional private rented sector geared to the achievement of *wider housing objectives* could be cost effective relative to alternative affordable housing programmes, such as Homebuy, Rent-to-buy, should not be ducked. The emerging facility for local authorities to self fund new housing (noting that pilot projects have required c.50per cent of capital costs to be met by grant) through the de-pooling of resulting rents and receipts from the Housing Revenue Account (HRA), provides another dimension to that issue.

Certainly to realise a capital gain properties provided by the institutional PRS will need to be sold at some future point, which, even if such a sale is the sitting tenant, would then reduce the stock of available affordable rented accommodation. The quantum and type of public subsidy required to make a property affordable, of course, will vary depending on the income circumstances of the target group. The issue as to whether policy attention and resources in this area should be targeted towards moderate income households generally on the margin of full home ownership or, rather, to those households unable to maintain any tenancy without housing benefit support, or a mixture of both, will also need to be addressed. It mirrors other wider social policy issues relating to the extent public assistance should be targeted to the poorest or spread more widely, the relationship of such assistance to work incentives, and the need to blur rather than polarise tenure divisions. For instance, a social rented sector further residualised by its separation from an emerging publicly regulated PRS is unlikely to be successful even on its terms.

All these issues are problematic and complex, and clearly hinge, not only possibly on political preference, but also overall public funding availability: no easy answers are apparent or available, at least to this respondent. Nevertheless, this response by A*SocialDemocraticFuture* does attempt to offer some preliminary pointers as to how a future regulatory funding regime relating to an emerging institutional PRS could be structured. It also concludes that progress in this sub-area needs to be related and integrated to broader strategic housing change, covering the wider reform of the speculative housing market and its partnership planning, alongside, perhaps, the social rented sector in accordance wit*h wider housing objectives*, if real sustainable progress is to be made. Tall orders, certainly, but necessary; a point that should be read in conjunction with the one made in the introduction concerning the importance of cross-party commitment and support to the essential planks of reform and the objectives of the process pushing that reform.

Commentary is made that follows the individual chapter headings of the consultation. An appendix offers an outline funding profile for developments that could be funded by private institutional investment.

Introduction

Para 1 .2: *It has become clear that that a persistent undersupply of housing has been a key contributor to the affordability problems households have faced. The Government has therefore pursued an ambitious agenda to develop a more flexible and responsive housing market. A key focus has been to increase housing supply and improve affordability, and the Government has set out wide ranging packages of measures for reform of the planning system, and for investment in housing and infrastructure. However, the recent housing market downturn has had a significant impact on supply, making achievement of Government objectives more challenging.*

Response

The downturn in the UK housing market cannot be divorced from the impact of the overall package of macro-economic and housing policies pursued since 1997: most notably, a reliance on an unsustainable rate of house prices to feed a consumer 'feel good' effect conducive to consumption-led growth, itself excessively reliant on increased personal indebtedness.

Para 1 .3 *The Private Rented Sector (PRS) plays a critical role within the housing system, helping to meet growing demand and providing a flexible tenure choice.*

Response

This statement ignores the largely adverse substitution or switching effect of the transfer of owner occupied stock into the predominant buy-to-let segment of the current PRS. Growing demand to be met requires additional supply, not tenure substitution.

Para 1 .4 *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 key. Although this Treasury consultation covers the United Kingdom, responsibility for many aspects of the relationship between tenants, landlords and investors lies with other government departments, non-departmental public bodies, and the devolved administrations who determine their own policies and priorities on housing. This Treasury consultation paper is therefore 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*.

Response

Substantive and sustainable progress will depend upon the co-ordination of macro-economic with linked strategic housing and income maintenance reform. Besides that, the economic analysis that underpins the consultation is somewhat partial and incomplete (*see para. 1.2. 1.5, and 1.7 responses*).

Para 1 .5: *Demand for housing is increasing over time, driven primarily by demographic trends and rising incomes. Yet by 2001 the construction of new homes had fallen to its lowest level since the Second World War. Kate Barker's Review of Housing Supply*[1] *concluded that a consistent under-supply of housing was a major factor contributing to the UK's historically high upward trend in prices. Therefore, to reverse this trend, improve affordability and help those priced out of the housing market, the Government committed itself to a step-change in housing supply.*

Response

The availability of housing credit (mortgage finance) was a key driver in stoking and enabling an unsustainable rise in the level of money demand for housing during the latest boom-bust cycle. The consultation fails to identify that fundamental factor, nor addresses the attendant policy implications, despite their macro-economic importance. The Housing Green Paper (HGP) target of an annual increase of 240,000 additional houses by 2016 likewise was not supported by a sustainable strategic policy framework. That target to be achieved was always dependent on a level of private speculative building that could only be approached transiently at the peak of an unsustainable house price cycle.

Para 1 .7: *Subsequent Budget announcements and policy statements have continued to support and build on that agenda. The house building industry responded well to the challenge of increasing housing supply, with delivery in 2007-08 reaching 207,500 additional homes – the highest level achieved since 1977. PRS investment is believed to have made a disproportionate contribution to that growth, accounting for around a fifth of new-build purchases.*

Response

These two sentences encapsulate the unfortunate tendency of this consultation towards political spin at the expense of analytic honesty. First, as was noted above, the provision of over 200,000 additional homes in 2007-2008 represented an unsustainable private speculative response recorded at the peak of an unprecedented boom on the cusp of bust, rather than the product of a strategic policy framework capable of sustaining that level of supply over the medium term. Such a level of supply was last approached in 1988 at the height of the 'Lawson' boom *(when it could have been exceeded, noting 'discontinuities' in official time series statistics, which seem to have been identified in the pre-election period)*. Two years after the successor 'Brown' boom imploded in 2008, the level of new housing starts, which, after a lag, will translate into completions, had more than halved from their peak, and in England at least, had had by the beginning of 2010 may have dropped to their lowest level *since 1946.* Second, the observation that PRS investment is believed to have made a disproportionate contribution to that growth (in new supply), accounting for around a fifth of new-build purchases, needs to be considered alongside the information provided later in *para 5.8* of the consultation that only ten per cent proportion of buy-to-let loans actually financed new build activity.

And, although buy-to-let demand by bolstering demand for new build flatted developments, at least in some areas, may have possibly induced additional new build activity supply, it failed to do so on a sustainable or optimal basis. The resulting multiplication of 'cereal box' cramped one bedroomed units, whose provision by developers was underpinned by demand purchases made for financial speculative rather than for long-term use reasons, were not necessarily in location, type, and design characteristics aligned with prospective users' preferences: evidenced by plummeting demand for such units in particular sub markets, such as inner city Leeds or Manchester, presaging the wider bust that subsequently shook the national housing system in 2008.

The marketing of such units by developers for purchase by investors was also associated with practices, such as off-the-peg disposals to investors rather than users, the registration of prices by developers above in excess of those actually paid by buy-to-let purchasers, that further distorted the market to the specific detriment of the first time buyers who did buy units in such new build developments for their personal use.

Para 1.18 *As the housing market recovers, we need to ensure a strong supply-side response to support the recovery. The PRS is an integral part of this - a key issue will be how well the sector responds to changing demand, and the level of investment directed by individuals and institutions into the sector will be crucial to that. It is in this context that the Government announced at the 2009 Pre-Budget Report our intention to publish this consultation paper, to consider the contribution the PRS could make to addressing demand and increasing housing supply, and any barriers to investment. While this consultation paper asks some specific questions around individual and institutional investment in the PRS, the Government would welcome any other comments relating to investment in the UK PRS.*

Response

The issue, risk, and opportunity set that face individuals rather than institutions, and the public policy implications that follow, can be quite different. That needs to be understood in policy development terms (while noting that institutional investment in the PRS will at the final analysis can be expected to be funded from the recycled collective savings of individuals).

Chapter 1: The Role of Private Renting

Para 2.2: *The Rugg Review*[2] *identified how the sector is highly segmented into niche markets, serving a range of different needs, including:*

- *Young professionals*
- *Students*
- *Households on Housing Benefit*
- *High income households*
- *Housing tied to employment*
- *Older households and regulated tenancies*
- *Immigrants and asylum seekers*

Response

Many younger households occupy the PRS because they cannot access the current owner occupied sector due to either income or deposit constraints, or because they do not 'qualify' for social housing The extent that that the PRS can provide a sustainable long term solution to their housing needs and preferences relative to owner occupation and intermediate tenures is a key issue. Immigrants and asylum seekers mainly occupy the PRS due to lack of eligibility for, or unavailability of, social housing.

Para 2.3: *The Rugg Review highlighted how for many the PRS is a tenure of choice and provides a long-term home, with over a fifth of PRS households having lived at their current address for five or more years*.

Response

This point suggests the need for long term tenure security. This can be best provided by institutional long-term investment in the PRS given the more contingent basis of individual investment. Britain's biggest individual investor, a married couple owning multiple properties in Kent, currently are disinvesting in that stock, resulting in potential homelessness for some of their tenants and other potential impacts on both the local housing market and the demand for social housing. Households have also been made homeless by foreclosures by buy-to-let mortgage lenders.

Para 2.6. *Renting has also been a more affordable tenure for households with, in 2007, rents being around 24 per cent to 40 per cent lower than mortgage payments for the same property.[3] And that affordability has remained relatively constant, with average PRS rents having risen roughly in line with average earnings during the period 1999 to 2007, while house prices more than doubled over that period with a similar trend in mortgage payments.*

Response

This on first sight appears rather puzzling. It rather suggests that that most PRS properties let by individual owners/investors were purchased some years ago: an individual owner letting a property recently purchased would need to cover their current mortgage repayments. It is probably explained by the fact that Buy-to-let purchasers, who generally finance their purchase through an interest-only mortgage, benefit from the existence of tax relief on their total repayments at their highest marginal rate (so that many receive 40 per cent relief on their interest payments), compared to first time buyers, who since the abolition of mortgage interest subsidy (MIS), have received no such help.

Buy-to-let purchasers also benefited from the relatively low interest rates that have been a key feature of the post-1997 macro-economic environment. Most first time buyers finance their purchase by a repayment rather than an interest-only mortgage. Low interest rates mean that they are required to pay back a higher portion of the principal outstanding on their mortgage loan earlier on during their repayment term; this is precisely when their budget constraint is most likely to tight. Their expected short-term repayment liability is consequently higher *relative* to competitor buy-to-let buyers purchasing with an interest-only loan attached with no need to repay principal, and benefiting from tax relief on the interest payments. The question merits more detailed research/analysis, but if the above explains the phenomenon the relative cost differential between renting and purchasing by mortgage is largely a function of the differential favourable tax treatment of buy-to-let investors and mortgage terms.

Para 2.7: *Younger households have shown an increasing preference for the labour market flexibility of private renting and prefer the locations that they can afford to rent in, over those where they could afford to buy.[4]*

Response

This finding reinforces the need for a strategic housing policy framework to deliver an expanded supply of affordable rental opportunities for those not currently eligible for social housing, rather than relying on the expansion of owner occupation to deliver increased opportunity and choice.

Para 2.9: *If an adequate supply of rental accommodation was not available, households could be forced to over-burden themselves with debt in order to access home ownership instead. Those households would in turn be most likely* *to suffer from negative equity, in the event of house prices falls, and rising interest payments if rates are increased. So the PRS not only supports the move to home ownership for those households that desire it, it can also improve the likelihood that this will have been a sustainable choice for that household to make.*

Response

As above. It is a pity that this message was not taken to heart or relayed by policy makers earlier in the house price cycle. The expansion of intermediate tenures would also reduce the risks associated with full home ownership, while also expanding affordable opportunity and choice.

Para 2.11: *The PRS provides the essential lubrication that allows the market in buying and selling homes to function efficiently. If a homeowner who wishes to move cannot, or simply does not wish to, sell their existing property, they still have the option to rent it out. The PRS therefore increases the liquidity of the homeownership market, encouraging households to place their properties on the market and providing a means for them to realise some return on their investment even if they do not sell or occupy the property themselves. It therefore helps improve the utilisation of the existing housing stock, reducing the level of voids, and in turn reduces the pressure on overall housing supply.*

Response

ASocialDemocraticFuture would not wish to discourage owners being able to rent out their properties in full or part for contingent work or life pattern reasons, but does not believe that providing tax incentives for them to 'make a return on their investment' actually makes sense on economic or housing policy grounds: one person's house price gain is another person's affordability loss.

Para 2.12: *The PRS can also add to overall housing supply, with investors financing new-build properties specifically designed for the private rental tenure (e.g. serviced student accommodation) or buying new-build market properties from developers.*

Response

The real contribution that an expanded PRS could make to the achievement of wider housing objectives is though expanding the long-term availability of affordable rental units by means of institutional investment in new build and refurbishment of neglected or sub-standard stock. See response to para 1.7, for the problems associated with off the peg purchases by investors from developers.

Chapter 3: Tenure choices and changing demand

Para 3.4: *Buy-to-let mortgages were designed for landlords to allow them to purchase residential properties to rent out to tenants. The landlord can benefit from capital gains as house prices rise over time while also earning a rental return that can contribute towards the mortgage costs.*

Response

The problem with individual investment is that it predominately involves tenure switching of existing stock from owner occupation to private renting. Such switching does not actually increase the net supply of affordable dwellings, with resulting impacts on the prices of houses for sale and their affordability in conditions of excess credit and demand: again, one person's house price gain is another person's affordability loss.

Para 3.5: *Over the last decade the buy-to-let mortgage market grew rapidly to become a major driver of overall supply in the PRS, as the chart below illustrates. The emergence and growth of wholesale funding markets reduced the cost of lending and enabled specialist lenders to enter mortgage markets, including the buy-to-let market. By 2007 85 lenders were active in the buy-to-let market with £1 22 billion of loans outstanding, financing 35 per cent of the PRS stock. Buy-to-let has played an important role in financing a sector that is of increasing significance in the overall housing market*.

Response

The entry of the wholesale funding markets into the buy-to-let sector contributed to conditions of excess credit and demand, while also and introducing new and under-regulated risks into the UK housing market. These materially contributed to the longest and deepest recession in the UK since 1945 (parallel phenomena in the US, perhaps provided the precipitating cause of the latest global crash). The Northern Rock story is a salutary example. More generally, the deregulation of the formerly mutualised building societies introduced by the 1986 Building Societies Act generated substantial unintended adverse consequences. The mortgage lending market needs to be better regulated.

Paras 3.7 to 3.18:

These paragraphs contain some useful and informative analysis of socio-economic trends affecting the UK housing system and the PRS in particular, although the macro-economic dimension is neglected, however.

Chapter 4: International comparisons

Paras. 4.1 and 4.2: *The PRS in the England as a percentage of the total housing stock has tended to be low compared to most of Europe. In France around a fifth of housing is in the PRS, while in Germany it represents a major share of the housing market at nearly half.*

These national differences can reflect a number of factors, e.g.:

- *Regulatory burdens – and the extent to which these may have deterred investors. Rent controls had a particularly negative effect impact on both supply and quality of UK rental accommodation over the period to 1988;*
- *Social housing – large scale provision of social housing, in the UK and Netherlands especially, has reduced demand for PRS accommodation;*
- *Privatisation – bulk transfers of previously social housing stock into the PRS have had a large impact in Germany for example (accounting for around 13 per cent of current PRS stock);*
- *Owner occupation – the promotion of ownership, both through cultural expectations and financial incentives, can also influence demand for the PRS.*

Response
The scale and position of the PRS in any particular polity and its housing system is a complex function of the interplay of particular country-specific or at least patterned historical, institutional, cultural, economic, and public policy factors, some of which are noted above. The abstraction of policy lessons from a broad comparative analysis accordingly needs to be considered alongside that health warning, especially as often one factor is related to another polity-specific variable, rather than being freestanding.

The clearest conclusion that can be drawn is that future development of the PRS in the constituent countries of the UK needs to be related and integrated to broader strategic housing change, covering the wider reform of the private speculative housing market and its partnership planning, alongside, perhaps, the social rented sector. More information is provided in the response to chapter 6.

Para 4.3: *Some European countries have also provided strong incentives for investment into their PRS, and have often geared those incentives particularly*

[1]

towards new-build (build-to-let). In the UK, the majority of investment in the PRS has been in the existing stock.

Response

The primary point made by *ASocialDemocraticFuture* is that the focus of future policy attention/incentives should be on build-to-let, not buy-to-let.

Para 4.7: *In the UK, small individual landlords, not institutions, dominate PRS supply. It is estimated that in England individuals or couples own 74 per cent of the PRS stock, and with over two thirds of those owning five or fewer properties.*

Response

If the PRS is to expand and make a sustainable and substantial contribution to the housing choices and opportunities open to low and moderate income households, institutional investment accordant with regulatory conditions that further the achievement of wider housing objectives must drive that expansion and transform the current position that is reported above.

Chapter 5: Individual Investment

Para 5.4: *A key factor underpinning the continuing role of individual investors in the PRS has been the development of buy-to-let mortgage finance. Chapter 2 explained how buy-to-let is a relatively recent phenomenon that grew rapidly, with the number of outstanding mortgages increasing ten-fold from mid-2000 to reach over one million by 2007, with a total value of over £122 billion*

Response

The Table below shows that how the development of buy-to-let mortgage also restricted the opportunities available to first time buyers. Existing properties purchased by individual investors to let are no longer available to first-time purchasers to buy or occupy on intermediate tenure terms.

The percentage of all mortgage loans taken by first time buyers fell steadily from 45 to 35 per cent during the first ten years of New Labour government, inversely racking increase purchases by buy-to-let landlords. Since 2002, fewer first time buyers have entered the market each year than they did during the nineties downturn, with the exception of 1991.

Table 1: Number of mortgage loans for house purchase, by type of purchaser

	First time buyers Number	% of total	Buy-to-let purchasers Number	% of total	**Total ‘000s**
1997	501,500	*45*			**1,104**
1998	525,200	*48*			**1,088**
1999	592,400	*47*			**1,254**
2000	500,200	*45*			**1,123**
2001	568,200	*43*			**1,314**
2002	531,800	*38*	85,030	*6*	**1,397**
2003	369,600	*30*	117,120	*9*	**1,252**
2004	358,100	*29*	143,810	*12*	**1,245**
2005	372,300	*37*	120,460	*12*	**1,015**
2006	401,000	*36*	173,760	*15*	**1,126**
2007	357,800	*35*	183,460	*18*	**1,017**

1. This table excludes loans for re-mortgaging purposes and loans provided to other mortgagors;
Source: CML.

Para 5.7: *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, with landlords frequently buying 'off plan' from housing developers. It has been suggested that buy-to-let investment has also been effective in providing developers with forward funding for high-density developments with significant infrastructure requirements.*

Para 5.8: *High quality data on the relative proportions of buy-to-let investment currently flowing into new-build or existing properties are not readily available. However, based on a sample of buy-to-let mortgages taken out between 2004 and 2007, it has been estimated that around ten per cent of loans were for a new-build property. With 346,000 buy-to-let mortgages approved in 2007 this suggests that it may have accounted for some 35,000 new-build acquisitions out of a total new housing supply of 182,800 in the UK – or around a fifth of all new housing. And this figure would have been boosted by cash acquisitions by individual landlords. Individual PRS investment therefore appears to have made a significant contribution towards the increase in new housing supply, and to make a disproportionate contribution to new-build given the size of the tenure as a whole*.

Response

The estimated 35,000 new build acquisitions by investors would have represented tenure switching rather than actual build-to-let activity, in the main. And a*s per response to para 1.7*: buy-to-let demand by bolstering demand for new build flatted developments, at least in some areas, may have possibly induced additional new build activity supply, it failed to do so on a sustainable or optimal basis. The resulting multiplication of 'cereal box' cramped one bedroomed units, whose provision by developers was underpinned by demand purchases made for financial speculative rather than for long-term use reasons, were not necessarily in location, type, and design characteristics aligned with prospective users' preferences: evidenced by plummeting demand for such units in particular sub markets, such as inner city Leeds or Manchester, presaging the wider bust that subsequently shook the national housing system in 2008.

The marketing of such units by developers for purchase by investors was also associated with practices, such as off-the-peg disposals to investors rather than users, the registration of prices by developers above in excess of those actually paid by buy-to-let purchasers, that further distorted the market to the specific detriment of the first time buyers who did buy units in such new build developments for their personal use.

Chapter Six: Institutional Investment

Para 6.14: *Despite the barriers to institutional investment described above, Aviva Investors, which has approximately £25 billion of property funds under management, announced in July 2009 a proposed £1 billion private rental residential fund which will be focussed on new purpose-built residential blocks of 100 units or more in London and the South East. The Homes and Communities Agency (HCA) through its PRS initiative is now assisting Aviva and its partners to identify suitable sites. The HCA is also working closely with several other prospective consortia looking to invest funds in the PRS. Interestingly, these prospective funds seem to have different objectives in terms of their geographic focus, the size of the units they are looking to acquire, and whether they are looking to acquire stock on a build-to-rent basis, or purchase existing market sale stock.*

Para 6.1 5: *From their engagement with these investors, the HCA believes that institutional investment in the PRS in the UK is set to grow significantly in the short- to medium-term, though this is from a very low base. Accordingly institutions seem unlikely to threaten the dominant role of individual investors in funding overall PRS supply. However, given institutions' general preference for new-build properties (see paragraph 6.6), they could be* expected to develop an increasingly significant role in new-build housing supply.

Response

This chapter of the consultation largely catalogues the problems/issues that the institutional PRS faces. It appears to conclude that the continuing/recovered individual investment is best relied upon. *ASocialDemocraticFuture* believes that that approach is misplaced because it fails fundamentally to take account of the negative substitution and cyclical impacts of such a reliance on buy-to-let activity. Only the above two paragraphs_appear to focus on the potential opportunities that expanded institutional investment could provide.

Increased investment in the private rented sector by pension funds and financial institutions could offer the potential advantage of substantially increasing the private financing of *additional or improved housing tangible assets* linked to their facility to offer a reasonably certain return from a mixture of rental yield (that could be linked to average earnings) and future capital gain (assuming a steady rate of real house price increase of 2% per annum). A total average target annual return of up to six per cent is potentially identifiable (*target return*). That return could be net on the basis of taxation reliefs made conditional on the provision of access, security, and reinvestment terms consistent with *wider housing public objectives.*

The key policy conflicts/issues that need to be addressed and resolved for such an avenue is to be explored and progressed in any meaningful way, revolve around the question as to how investment in an institutional PRS can most effectively widen the access to affordable quality accommodation to low and moderate income households. That is because private new or refurbished housing attached with such a target return to investors provided through an institutional PRS is unlikely to be affordable to such households without public support of some kind, whether capital grant, housing benefit, or the discounted or free disposal of public land.

Likewise the related issue as to whether using public resources to facilitate the growth of an institutional private rented sector geared to the achievement of *wider housing objectives* could be cost effective relative to alternative affordable housing programmes, such as Homebuy, Rent-to-buy, should not be ducked. The emerging facility for local authorities to self fund new housing (noting that pilot projects have required c.50per cent of capital costs to be met by grant) through the de-pooling of resulting rents and receipts from the Housing Revenue Account (HRA), provides another dimension to that issue.

Certainly to realise a capital gain, properties provided by the institutional PRS will need to be sold at some future point, which, even if such a sale is the sitting tenant, would then reduce the stock of available affordable rented accommodation. The quantum and type of public subsidy required to make a property affordable, of course, will vary depending on the income circumstances of the target group. The issue as to whether policy attention and resources in this area should be targeted towards moderate income households generally on the margin of full home ownership or, rather, to those households unable to maintain any tenancy without housing benefit support, or a mixture of both, will also need to be addressed. It mirrors other wider social policy issues relating to the extent public assistance should be targeted to the poorest or spread more widely, the relationship of such assistance to work incentives, and the need to blur rather than polarise tenure divisions. For instance, a social rented sector further residualised by its separation from an emerging publicly regulated PRS is unlikely to be successful even on its terms.

A paper *Affordable Housing Partnership Planning* that is accessible on SocialDemocraticFuture's website http://www.asocialdemocraticfuture.org/ describes a model of housing supply partnership planning (HSPP) that is focused directly on *wider housing objectives*: achieving a housing supply target at a sustainable national, regional, and local level that is consistent with medium term demand requirements; securing greater social sustainability in terms of terms of an improved tenure balance; and of securing greater stability in house prices with attendant macro-economic benefits. A refocus of business planning focus on construction rather than speculation

With the parallel application of the use of HomeBuy and Rent-to-Buy mechanisms, under HSPP the Town and Country planning framework would require (certainly in areas of excess housing demand) at least 50 per cent of all dwellings provided in developments over a defined size threshold to be affordable. The land for the affordable housing portion of each such development would be provided in effect at nil cost: the cost of the affordable units would be limited to construction cost plus agreed constructor profit and overheads. That requirement in itself would tend to deflate directly the land cost component of supplying new housing. *By deflating land prices directly HSPP could provide a means where institutional landlords could* *assemble land build for let in on affordable terms and meet HSPP planning requirements*. Developer profit would in future derive from construction, not landhoarding or speculation – activities that can also lead to large losses and even bankruptcy.

The phased but progressive removal of the fiscal relief available to buy-to-let investors on their interest payments that is currently estimated to be worth around £2.2bn annually should help ease the affordability problem for first time buyers, and over the longer term reduce the likelihood of future house price booms, due the its associated dampening impact on house price inflation. In addition, the consequent savings in fiscal resources could be used to reinvest in supporting the provision of affordable housing, including that provided by an expanding institutional sector.

Critics of this approach, such as the Council of Mortgage Lenders, assert that removal of the relief would destabilise the housing market in the short term (and so perhaps induce a second housing-related recession), and increase rents as supply dwindled. But the removal of the relief could be phased, in the same way that the abolition of MIS was an incremental and progressive process that was spread over more than a ten year period, from 1988 onwards. This could allow it be withdrawn in tune with wider macro-economic and housing market circumstances, with relief at the higher rate abolished first.

A house price correction followed by a more stable house price trend would in any case improve access to affordable housing and contribute to longer term macro-economic stability. It would also represent a transfer of resources from buy-to-let investors to first time purchasers: the former group generally have higher incomes and greater savings.

Enquiries or comments about this response or *ASocialDemocraticFuture* generally should be e-mailed to enquiries@asocialdemocraticfuture.org or newtjoh@aol.com.

More detailed background papers can be downloaded from:
http://www.asocialdemocraticfuture.org/

Question 1: What had led individuals to invest in new-build properties in preference to purchasing and converting existing owner occupied housing?

The purchase of new-build properties off plan can be attractive as:

- Fixed price;
- Greater certainty about the initial purchase because there won't be a chain of related transactions;
- Purchasers can agree re-sales prior to their assuming ownership.

However, not all landlords entering the buy to let market with new builds have remained in the market because they have become disillusioned as the promised yields and rise in property values have not been forthcoming. The difficulties of reliably valuing properties and estimating rental yields in a fast moving market may not have been made clear.

Converting/renovating old properties can be less attractive because:

- Less certainty about the initial purchase because of chains of transactions (although purchase at auction doesn't have this problem);
- Less certainty about costs , e.g. the costs of renovation/converting;
- Planning problems.

As the London property market is extremely strong these general distinctions between new-build properties and old properties may not apply.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

City centre apartments have been favoured over family homes. Although city centre apartments have been attractive to relatively short term investors, sometimes through property investment clubs, the number of city centre apartments which are now void is likely to discourage both the house building industry and potential landlords from these types of properties in the future. The failure of development in Leeds city centre is a stark example. There is strong anecdotal evidence that developments should contain a mix of family homes and apartments in order to generate sustainable communities.

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?

Unfortunately we cannot provide information about this market, and we are not aware of any other organisation which holds this information.

In order to encourage this form of housing the rent-a-room tax exemption should be increased, in particular to reflect market rents for rooms in London. There should also be more information made available to assist home owners in their decision whether to rent a room, including how to deal with safety, social, or financial issues which may arise.

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

Individual investors/landlords may have expected capital growth and therefore looked to the PRS to substitute or augment their pension provision. We fear that the disappointment of these investors will stall future investment in the PRS for some time to come.

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?

Achieving scale economies are crucial to institutional investors.

Question 6: What evidence is there that (i) the SDLT bulk purchasing rules are 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?

Although we are unable to provide the evidence which is being sought, we believe that the current rules are a significant constraint and that the changes being proposed would lead to increased investment. Other tax incentives should also be considered, including the possibility of reclaiming VAT on repairs, and capital allowances for landlords to encourage ongoing investment in their properties.

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?

Reducing the level of SDLT payable would increase the rate of return as the initial purchase price would be lower.

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

Risk appetites may have been influenced by the financial crisis.

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 option?

Institutional investors' main interest is commercial property, including retail. The recent financial crisis has changed commercial clients' behaviour and risk appetites, e.g. retailers may have reduced their high street presence and shifted more of their business online. One effect of the declining commercial market is that it has led institutional investors' to give more consideration to diversification, including to the PRS as a possible long-term investment option.

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?

The possibility of anti social behaviour may worry some institutional investors, both in terms of risk to reputation and in terms of possible increased management costs.

Question 11: What are the key barriers to investment in residential property through UK-REITs, and what changes would be needed to address them?

No reply.

Question 12: 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?

No reply.

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

No reply.

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?

To meet demand the PRS must expand. Unfortunately the disappointment of individual landlords arising from the recent financial crisis may mean they exit the market, or at least do not expand their portfolios. It is likely the PRS will be unable to meet the demand unless institutional investors enter this market.

ARMA
ASSOCIATION OF RESIDENTIAL
MANAGING AGENTS

PRS investment consultation
c/o Keith Jackson
Housing, Regeneration and Third Sector
team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

4th March 2010

Dear Sirs

Response to the Paper 'Investment in the UK private rented sector'

The Association of Residential Managing Agents (ARMA) is grateful for the opportunity to respond to this paper on the private rented sector. We think the paper is a welcome step to promote the next phase of the development of the private rented sector.

ARMA is not able to respond to the details of the questions about institutional investment posed by the paper but we do think that changes suggested would promote a new additional supply of private rented housing. At a time when additional supply in the housing market is desperately needed and such supply would help to bridge the affordability gap for students and young professionals.

ARMA's members are currently agents of blocks of private residential flats sold on long leasehold; but we believe they are more than well placed to work with institutional investors to provide economical and efficient management services. ARMA's members fit with private rental models where institutions invest in blocks rather than pepper potting their stock as has happened with the buy-to-let market.

ARMA members are:

- Used to acting as the agent for large freeholder clients; indeed they understand the client/agent relationship well.
- Used to a high degree of resident involvement; the majority of ARMA's members' clients are companies run by the residents of blocks of flats. The residents decide, the agents advise and action
- Not landlords in themselves competing with investors.
- Skilled in providing long term maintenance to blocks of flats; something which many lettings agents that also manage do not experience.
- Skilled in providing a high level of communal services including the employment of concierges, gyms, pools and other leisure facilities.
- Experienced in the management of large complex mixed residential and commercial developments.
- Experienced at working with social landlords on mixed tenure schemes.

- Used to operating at much lower fee levels than lettings agents for the management of properties and many (over one third) of ARMA members are also lettings agents; most lettings agents are not also block managers.

In addition to the proposals in the paper for possible changes to SDLT and the tax regime for institutional investors we also suggest that the following are barriers to institutional investors.

- The need to grant a minimum of 6 months tenancy for assured tenancies if landlords need to recover possession with any certainty. Greater flexibility should be given.

- The long delays and costs in obtaining possession for rent arrears or other breaches of tenancy means that the costs to landlords of dealing with unsatisfactory tenants are unreasonable. The current law on possession should be reviewed.

Formed in 1991, ARMA is the only body in England and Wales to focus exclusively on matters relating to the block or estate management of long leasehold residential property. With over 240 corporate members managing in excess of 850,000 units in more than 34,000 blocks of flats or estates (at least 60% of which are lessee-controlled properties), the Association's founding principal aims are to represent its members and the interests of lessees, resident management companies and investor freeholders.

Yours faithfully,

David Hewett
Chief Executive

HM Treasury consultation on Investment in the UK Private Rented Sector
28th April 2010

INTRODUCTION

Assettrust Housing Limited was established in 2003 to work with Registered Social Landlords (RSLs) and residential property developers to invest in affordable housing on either a Shared Ownership or tenancy basis.

Assettrust Housing has developed over 800 properties without any government grant or subsidies, building a portfolio in excess of £130m.

In March 2010, Assettrust Housing received in principle agreement from the Tenant Services Authority to acquire portfolios of shared ownership properties from RSLs. Assettrust Housing is well advanced in raising institutional investor money and plans to invest over £1billion in such properties over the next 12-18 months.

Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

The former is closer to a pure financial investment as it has low initial effort and ongoing maintenance compared with property development activity. The fact that such properties can be acquired "off-plan" means the investor can benefit from house price inflation (HPI) before even paying for the property in full.

Individuals want property exposure without development timescales and risks.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

Buy to let developments have been created by developers to offer individuals access to HPI and rental yield. Given the strength of residential property returns compared to equities, bonds or commercial property individuals will want to continue to access this market via the most efficient and easy route. Investment in Low Cost Home Ownership properties is the most efficient and easiest access point with the lowest volatility followed by purpose built buy to let developments. Formalisation of the existing PRS market into coherent large scale investment opportunities through established channels will ultimately drive house building.

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?

No Comment.

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?

Over the past 50 years tenure in the UK has transformed from a minority to a majority population of property owners. Over the past 30 years individuals have become increasingly financially aware, have been incentivised by Governments to invest for themselves and have accepted the need to invest for their future. Over this period direct investment in financial markets such as equities has boomed, however, individuals have also become aware of the volatility of financial markets.

Against this backdrop, individuals have consistently sought growth and safe harbour investment opportunities in residential property due to it being a familiar asset class with often perceived more tangible features. However, in virtually all cases this investment has been piecemeal and limited to single or micro property portfolios.

Individuals have identified the PRS as providing an ongoing income stream with capital appreciation over the long term. Furthermore, as an investment residential property is significantly easier for an individual to tailor their risk return profile via leverage compared to other forms of investment.

Over the last 10 years, high levels of house price inflation and stable interest rates have made residential property one of the highest performing asset classes.

Going forward, interest rate risk, tighter lending requirements for buy-to-let mortgages and potential volatility in house price inflation will make it less attractive for investors who are unable to acquire macro portfolios to diversify away these risks.

Individual investment by higher net worth individuals in PRS will continue, at suspected lower levels. However, the recent phenomenon of high and middle income earners investing in residential property that is not their primary residence is unlikely until such time as either; the economic environment stabilises or large scale broad based residential investment opportunities can be offered in investor friendly formats.

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?

Once committed to an investment strategy institutional investors need to be able to put their money to work quickly, putting the emphasis on a smaller number of large acquisitions.

Scale is required to achieve a balanced, diversified portfolio, smoothing the effects of voids, tenant default, varying regional HPI, etc.

In addition, scale is required to achieve commercial viability in relation to the cost associated with sourcing, analysing, acquiring and thereafter managing portfolios of residential properties which are significantly higher than for say a single site commercial office building.

Institutional investors will therefore wish to acquire portfolios of residential property in value quantities similar to those seen in the commercial property sector. In particular each lot size will be over the threshold for the highest rate of SDLT.

Since large scale investment by institutional investors in the residential sector would constitute a new market initiative, institutions and individual investors will want to know the market has sufficient scope for future growth in order to justify the initial work required to assess the suitability of the investment.

With all forms of property investment the up-front costs of investment are substantial and this creates a return profile in the shape of a "J-curve" whereby returns initially go negative before returning to positive.

Individual investors will compare J-curves when making investment decisions and in the case of residential property will compare the institutional J-curve to their own costs if investing directly.

Clearly, there is a fundamental difference in SDLT treatment between individuals acquiring properties piecemeal and institutions acquiring properties in bulk and the considerable cost differential of such make a significant impact on the relative J-curves.

Commercial property has lower up-front due diligence costs (legal fees, surveys, searches, land registry fees, etc) as well as lower management costs and as such has a more shallow J-curve than residential property currently acquired in bulk.

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?

When looking at current SDLT bulk purchasing rules it is imperative to acknowledge that unlike commercial property, residential property assets appreciate.

However, other aspects of taxation should also be looked at in the analysis:

The rules relating to residential property place a disproportionately large tax burden on the investor market, impacting the investment case of residential compared to other forms of investment.

This can easily be demonstrated by the following example (ignoring the Income Tax held on the life ;

Residential Property Acquisition

Portfolio of 200 residential properties 2010 average value £150,000. Total value £30,000,000.

SDLT at point of acquisition = £1,200,000.

Residential Property Sale to Follow on Investor

Average value at point of sale in 2030 £400,000. Total value £80,000,000.

Capital gains tax £50,000,000*18% = 9,000,000

SDLT at point of sale paid by acquirer (assuming 5% SDLT) = £4,000,000.

TOTAL TAX PAID BY INVESTORS ON RESIDENTIAL ASSETS = £14,200,000

Commercial Property Acquisition

Single office building 2010 value £30,000,000.

SDLT at point of acquisition = £1,200,000.

Commercial Property Sale to Follow on Investor

Single office building 2030 value £3,000,000.

Capital gains tax £0*18% = 0

SDLT at point of sale paid by acquirer (assuming 5% SDLT) = £150,000

TOTAL TAX PAID BY INVESTORS ON COMMERCIAL ASSET = £1,350,000

Equities Portfolio Acquisition

Portfolio value at 2010 £30,000,000.

Stamp Duty at point of acquisition = £150,000.

Equities Portfolio Sale to Follow on Investor

Portfolio value at 2030 £80,000,000.

Capital gains tax £50,000,000*18% = 9,000,000

Stamp Duty at point of sale paid by acquirer (assuming 0.5%) = £400,000

TOTAL STAMP DUTY PAID BY INVESTORS ON EQUITIES = £9,550,000

Bond Portfolio Acquisition

Portfolio value at 2010 £30,000,000.

No Duty at point of acquisition.

Bond Portfolio Sale to Follow on Investor

Portfolio value at 2030 £30,000,000.

Capital gains tax £0*18% = 0

No Duty at point of sale.

TOTAL TAX PAID BY INVESTORS ON BONDS = £0

Assettrust Housing is currently looking to raise over £1bn from institutional investors to acquire portfolios of Shared Ownership properties from Registered Social Landlords.

The money paid to the RSLs will be used to fund the development of further affordable housing without requiring additional grant from the Home and Communities Agency (HCA).

There is currently no investor market for this particular type of property as until now RSLs have not been able to sell properties out with the sector.

In order for Assettrust Housing to attract investors, recognising the risks associated with establishing a new market and the underlying residential property market characteristics, the returns need to be at least as good as established market returns.

The HCA has already indicated that there is likely to be changes to the grant awarding programme, recognising future restrictions on government spending. It is key for the continued delivery of affordable homes that institutional investment is attracted to the sector.

As can be seen from the example above, the current bulk purchase rules on SDLT and other tax regimes for residential property presents one more hurdle for investors to clear compared to investing in other asset classes and work against the case for individual investors investing through aggregated channels.

This is impacting the pace and volume with which Assettrust Housing is able to bring investors to this market.

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?

When investors compare returns from residential to other investment markets the more intensive and costly management required on residential property (voids, re-letting fees, maintenance, insurance, etc, all exacerbated by the shorter nature of residential SAT leases) result in significantly lower net rental yields than commercial property equivalents.

Given the depreciation of commercial assets a higher yield is expected, however, the reliance on appreciation via HPI is a significant factor in assessing whether a residential investment is likely to deliver better or worse total returns than a commercial investment.

As explored in Question 6, there is also a significant difference in the amounts of tax/duty payable by investors over the long term and a reduction in SDLT would greatly strengthen the argument for investment in residential assets.

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

The costs associated with a PRS investment erode up to half of the annual rental income from the properties. Therefore even if headline yields on PRS appear equivalent to commercial property yields the net yields are considerably different. Investors therefore have to take a view on the capital appreciation as outlined in Question 7.

When comparing the investment case for PRS to Equities or Bonds the initial and ongoing costs of investment are significant.

The investment community is actively seeking ways to reduce these costs and improve risk adjusted returns through economies of scale, however, current SDLT rules are counter to this approach.

A reduction in bulk SDLT will increase the pace and scale of investment.

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?

There has always been institutional interest in the PRS but it has always been considered a management intensive asset class with difficulty in predicting future returns – see previous comment on reliance on HPI.

However as more data becomes available, allowing investors to make more informed decisions, the PRS becomes more attractive and as mentioned previously a number of organisations including Assettrust Housing are developing ways for institutional investors to access the market.

As with all infant markets, removal of barriers to entry and comparative disadvantages are key to initiating and continuing investment.

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?

The key difficulty for residential investment is achieving the pace and volume of investment and returns to attract institutional investors to a new market.

Therefore, it is necessary to find ways to acquire large portfolios with relative speed and minimise the drain on returns from initial and ongoing costs.

The due diligence costs (legal fees, surveys, searches, land registry fees, etc) associated with acquiring a large commercial property are proportionately less than those to acquire a similar sized residential portfolio due to the larger number of individual properties.

One way to efficiently acquire and manage a large residential portfolio is to look at the new build market rather than having to identify and select individual properties.

However "build-to Let" involves development and letting risk. This requires an investor prepared to take the speculative risk (like a housebuilder takes development and sales risk) and able to hold the development until sufficiently let that it would then make a suitable investment for a longer term hold institutional investor.

In such a situation, a "selling housebuilder" would see its customers paying SDLT based on each individual property value whereas a "letting housebuilder" would see its customer paying SDLT on the value of the entire development.

An alternative approach is to work with owners of existing large portfolios. RSLs currently own or manage almost 2.4million properties. Facilitating institutional investors working in partnership with RSLs could inject much needed capital into the sector which could be recycled to develop new affordable homes.

Key to delivering institutional investment in residential property are economies of scale and risk reduction through diversity. Current SDLT rules work against the concept of economies of scale.

Question 11: What are the key barriers to investment in residential property through UK REITs, and what changes would be needed to address them?

No comment.

Question 12: 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?

No comment.

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

The type of investment vehicle is usually selected to meet specific investor requirements, e.g. ability to leverage the investment, tax transparency or the ability to list the vehicle. Most vehicles are suitable for residential property investment.

While certain vehicles are tax transparent for income and capital gains purposes, one feature of such collective investment vehicles is that they can lose any SDLT exemptions that would normally apply to the investor making the investment in their own name. For example charities that would not pay SDLT on their own property activities would incur the charge if investing through a collective vehicle.

Similarly, RSLs do not pay SDLT but a disposal of their properties to an investor would attract SDLT.

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

No comment.

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?

In the case of Assettrust Housing, removal of the SDLT payable in relation to regulated housing stock would eliminate a considerable cost to investors, who are ultimately replacing the Government in providing capital to develop social and affordable housing.

This would significantly increase the pace of investment in the acquisition of affordable housing as an investment asset class.

Investment in the UK private rented sector
Response to HM Treasury Consultation document

From BDO LLP – 21 April 2010

By email to PRSinvestmentconsultation@hmtreasury.gsi.gov.uk

BDO LLP are pleased to respond to the HM Treasury consultation document on Investment in the UK private rented sector. We have set out our comments below.

BDO LLP is one of the UK's largest accounting firms, and the UK member of the BDO global accounting network with offices throughout the world. The Firm is a recognised market leader in the real estate sector. We advise a large number of FTSE and private real estate companies, including a significant number which have large residential property portfolios.

As a firm of accountants we are not best placed to comment on the commercial factors driving residential property investment. Our expertise is in advising clients on the structuring aspects and the choice of investment vehicle, with particular regard to tax, accounting and regulatory aspects. Our response is therefore limited to those questions within our expertise, in particular those which consider how the UK's current tax system encourages or inhibits investment in residential property and those discussing the suitability of existing available collective investment vehicles.

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?

The tax system encourages individual investment in private rented accommodation in various ways.

- Rent a Room relief which encourages home owners to let out part of their own residence.

- Principal Private Residence Relief. Although aimed at owners' homes, the relatively favourable rules for periods of absence and letting do act as an incentive to retain properties previously used as the owner's main residence.

- The relatively favourable treatment of capital gains as compared to income. The Treasury document comments on the relatively low yields on residential property. This is less of an issue for wealthy or high earning individuals who can afford not to receive income, or even to subsidise property ownership in the short term, in return for anticipated capital growth.

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?

For portfolio acquisitions of residential property, 4% SDLT (potentially rising to 5%) is charged regardless of the value of individual properties within the portfolio. This initial SDLT cost reduces a 6% yield on purchase price to 5.76%.

By contrast an acquisition of a single property on its own, where the value of the property is less than £0.5m benefits from lower SDLT rates varying from 0 to 3%. This puts an institution at a comparative disadvantage to a person acquiring a single property (whether for investment or rental).

The upfront SDLT cost is not the only way in which SDLT impacts on residential property investment, nor is it the only tax which so impacts. Other SDLT and tax impacts which in practice act as a disincentive to residential property investment are explained below.

Portfolio "churn"

- The HM Treasury document comments that because of the owner occupier element in residential property, yields tend to be lower than for commercial property. This can be overcome to some extent through "churning" part of the portfolio each year to turn some capital growth into cash. This can supplement income and give an acceptable cash dividend to investors.

- In a churn situation, the impact of SDLT is more significant than on the investment yield. If a property is sold for, say 10% more than its actual purchase price, at 4% SDLT, 40% of the cash generated on the resale is effectively absorbed in SDLT cost.

- The profits of sale on churning a portfolio are themselves subject to income or corporation tax. In contrast to trading business assets, there is no "rollover relief" ie deferral of taxation where the assets sold are reinvested in similar assets.

- *Other tax issues acting as disincentive to invest in residential property*

- In contrast to commercial property, residential property does not benefit from any tax depreciation or capital allowances. This can distort the investment decision making process – for a residential and commercial property with similar yields and growth potential, the tax treatment would tend to favour the commercial property.

- SDLT impacts on property investment at other occasions other than the upfront purchase. SDLT can also be due when a lease is granted to a tenant. This can increase the actual SDLT cost beyond the initial 4%. It also inhibits more innovative forms of residential property ownership being developed in the current market to enable those without significant equity get on the housing ladder, such as equity sharing leases. Although there are special relieving provisions in the SDLT legislation for shared ownership leases, these are available only to certain Public or Local Authority bodies. They do not assist institutions attempting to invest in residential property on a commercial basis.

- VAT can also be a significant cost in residential property investment. Rental income from residential property is normally regarded as exempt for VAT purposes which means that the landlord cannot recover input VAT suffered. Sales of second hand residential property are also normally exempt, with similar input VAT recovery restriction.

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?

Changes to the SDLT bulk purchasing rules would significantly reduce the SDLT cost where the individual lot size was less than £500k. Any reduction in SDLT is likely to be helpful in stimulating activity, because of the factors noted at 6 above. As noted above, the initial acquisition is not the only point at which SDLT impacts.

Other SDLT and tax changes which might also help stimulate investment in the private rented sector are:

- Extending the SDLT relief for shared ownership leases so that it is available to investors looking to promote increased home ownership on a commercial rather than social basis.

- Introduction of rollover relief where specified types of residential property are sold and reinvested in similar residential property. Even a partial deferral relief where, say, 50% of the gain only is deferred could act as a significant incentive to invest.

- Introduction of capital allowances for residential properties on the same basis as for commercial properties to reduce distortion in investment decisions.

- Changes to VAT rules to allow recovery of VAT in residential property investment businesses.

Question 11: What are the key barriers to investment in residential property through UKREITs, and what changes would be needed to address them?

UKREITs are in theory attractive vehicles to hold a residential property investment portfolio. However we have noted factors which may make these less attractive for residential property investment.

- *2% conversion charge*

- The 2% conversion charge can act as a disincentive to investors trying to build up portfolios of residential property. In order to obtain REIT status, a REIT must own at least 3 properties, none of which must be more than 40% of the total value. A new, as opposed to existing, investment company must acquire three properties before it can elect for REIT status. SDLT would normally be payable on these acquisitions. A further 2% conversion charge would be payable when the company elects for UKREIT status.

- In theory the company could acquire 3 quite small properties to minimise this cost. However, the company would have to have raised funds even to acquire the 3 small properties. If the entire fund raising is carried out before UKREIT status is obtained, the company will enter the UKREIT regime with significant cash, which would be more than 75% of its total assets. If, by the end of the first year as a UKREIT, the cash is not invested such that 75% of the company's assets are in property, the company loses its UKREIT status ab initio.

- A further problem is that the 2% conversion charge is calculated on the value of the property at the end of the first year, rather than its acquisition value, which can increase the charge if values have risen.

- Even where the problems above can be overcome, for a company trying to build up a large value portfolio, the need to buy 3 small properties is a somewhat tedious distraction from its main commercial objectives. In practice it is harder for a large institution to acquire 3 small properties than may be imagined.

Other issues

- UKREITs must be listed on a full stock exchange, and must also comply with some complex detailed tax conditions. The costs involved in this mean that a UKREIT must have a large portfolio to make the vehicle worthwhile. As already noted, it may be difficult to achieve significant portfolio sizes.

- A UKREIT must distribute 90% of its taxable rental income. For commercial property, because of the availability of capital allowances, this requirement has not generally proved onerous. Capital allowances are not available for residential property and this requirement may then be more difficult.

The following changes would assist in making the UKREIT regime more attractive for residential property investment.

- Allow UKREITs to be listed on AIM or other secondary markets.

- Extend the UKREIT regime to privately held companies, possibly with a condition that they must be reasonably widely held.

- Modify the distribution requirement for UKREITs holding residential property.

- Other tax changes as noted under Q7 above.

It is noted that to date UKREITs have been used primarily by existing large property groups electing for UKREIT tax status, with relatively few "de novo" UKREITs being formed. The modifications above could also be helpful in extending the use of UKREITs for all forms of property.

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

An important tax attribute of a collective investment vehicle is that it should be "tax transparent". That is to say that the vehicle itself is not subject to tax, but income and gains are taxable on the investor according to his/its tax status. This means that institutions can benefit from their tax exempt or tax favoured status.

The main alternatives to a UKREIT available for residential property investment are the same as those for other forms of property.

Offshore unit trusts

These offer an acceptable tax regime for property investment, including residential. Because they have to be managed and controlled offshore, they tend to be expensive and so may not be suitable for smaller portfolios. The fact that the landlord is offshore may be a concern when dealing with tenants. The offshore trust must also comply with the formalities of the Non-resident Landlords Scheme, which imposes an additional administrative burden and in some cases additional UK tax cost.

Partnerships

These are cost effective vehicles. However they suffer from two tax disadvantages:

- Transfers of units in an Investment Partnership, whether on or offshore, attract SDLT at 4%. This compares unfavourably with companies or unit trusts where transfers are subject to stamp duty at ½% if the company is onshore or 0% if offshore.
- The introduction of new investors is regarded as a capital gains disposal by existing investors, even if the latter do not receive any cash. This can make partnerships less attractive than unit trusts, especially where it is intended that the fund may need to raise expansion capital.

UK Open Ended Investment Companies (PAIFs)

UK OEICs can elect to be taxed under the Property Authorised Investment Funds tax regime. These impose similar conditions to the UKREIT regime, and in particular require genuinely diverse ownership, thus broadly excluding companies owned by a small number of related persons.

The PAIF regime offers a tax efficient status, comparable with UK REITs and offshore unit trusts. However an OEIC is required to allow investors to redeem their units at a price reflecting the underlying net assets (or create a market allowing investors to sell at such a price). In practice with property investments, it isn't possible to generate this level of liquidity, except in the largest of funds. PAIFs are also subject to other detailed rules, which can make them less attractive, in particular the requirement for genuine diversity of ownership.

UK Authorised Unit Trusts

The Tax Elected Fund regime for UK AUTs is not available where the Trust holds property directly. Therefore these are not normally suitable vehicles for collective property investment.

UK Unauthorised Unit Trusts

Where all unitholders are themselves exempt from capital gains tax, the trust itself can be exempt from tax on capital gains. However in other situations the trust is liable to corporation tax on its gains, and therefore a UK UUT is suitable only in limited situations.

UK companies

Because these are not tax transparent they have not normally been used for property investment, and would not generally be suitable for residential property collective investment.

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

The Property Authorised Investment Fund regime offers a similar tax status for open ended companies as the UKREIT regime does for close ended companies. As noted above, the requirement to allow investors to make redemptions can make open ended vehicles less suitable for property investment, except for larger schemes.

Partnerships and Offshore Unit Trusts also offer a broadly equivalent UK tax treatment to UKREIT. However, as noted above, partnerships have certain UK tax and SDLT disadvantages which mean they may not be suitable in all cases. Offshore Unit Trusts overcome these issues, but the requirement to be offshore increases costs and introduces additional complexities.

UK Authorised and Unauthorised Unit Trusts and UK companies are not currently generally suitable vehicles for collective property investment.

There is currently no UK vehicle which offers the universal benefits of the Offshore Property Unit Trust. The UKREIT and PAIF regime tend to be more suitable for widely held and larger Funds. For these reasons, it remains likely that many new property funds, including residential, would be formed offshore.

The Berkeley Group
Holdings plc

Investing in the UK Private Rented Sector

Comments on Consultation Paper

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1 Executive Summary

1.1 Berkeley, a residential-led property developer in London and the South-East, believes that stimulating the UK Private Rented Sector (the "PRS") is an important element of addressing the under-supply of housing and providing the necessary confidence for new homes to be developed.

1.2 From a developer's perspective, the PRS has traditionally been led by individual private investors buying off-plan.

1.3 In our response to HM Treasury's Consultation paper, we have identified four areas in which actions could be taken to promote and provide support to the PRS. These are:

(i) The tax system should recognise the value of the private rented sector which is currently disadvantaged when compared to commercial property or pension investment.

(ii) Legislation and regulation should ensure the balance of protections afforded to investors and developers is equitable. We are concerned that increased legislation and regulation could tip the balance away from the developer to the extent that the PRS suffers. For example, further regulation from the OFT on the form of contractual terms and the introduction of a customer charter, as currently drafted, will make it difficult to sell off plan to private investors.

(iii) Institutional investment has traditionally chosen other asset classes, due partly to the high cost of management and the fragmented market. Selective investment in new-build developments can mitigate these concerns and, in our view, there is a strong case for financial stimulus to encourage this investment. This can be through either:

a) Direct Government Investment

b) Recognition in the planning system

(iv) The UK banks do not currently support buying at an early stage in the development cycle as mortgages have limited availability periods; typically, less than six month.

If this can be addressed, for example by insurance for the banks to take a longer term view, we believe this will stimulate the market.

1.4 There is a fundamental under-supply of quality housing in the UK, especially in London and the South-East. HM Treasury has identified how changing long-term demographic and economic trends mean that the PRS has an important role to play in addressing this and Berkeley welcomes this opportunity to contribute to this debate to identify ways in which investment in the PRS can be stimulated.

2 Introduction

2.1 The Berkeley Group Holdings plc ("Berkeley") welcomes the invitation to comment on the HM Treasury Investment in the Private Rental Sector Consultation paper (the "Consultation paper").

2.2 As a residential and commercial property developer we have witnessed, first hand, the shifts in the market over the past 30 years.

2.3 As the Consultation paper notes the UK Private Rental Sector ("PRS") has, to date, been dominated by private individual investment. Our responses, therefore, reflect our experience of this market as a developer. Certain of our comments and observations on the Consultation questions on Institutional Investment are therefore inevitably at a higher level, although a number of questions in this section do have equal relevance to the Individual Investor market.

2.4 We support HM Treasury's contention that the PRS plays a critical role within the within the housing system, helping to meet growing demand and providing a flexible tenure choice.

2.5 In its introduction, the Consultation paper notes the "disproportionate" role the PRS has played in funding new build supply in recent years. While we recognise the percentage is disproportionate in comparison to the size of this form of tenure as a whole (20% v. 14%), we do not believe it is disproportionate to the right natural level for all the reasons set out in the Consultation paper, as the PRS has a significant role to play in the future of the UK housing market.

2.6 As the Consultation paper sets out very clearly, there are a number of reasons for the percentage of new homes supporting the PRS increasing. These include:

- Historical factors (rent controls up to the 1988 Housing Act) reducing the opening figures
- Long-term demographic pressures (more mobile population and work-force, people are living longer, smaller household sizes, later family formation, etc.)
- Availability of buy-to-let finance

2.7 The most important factor, however, is the persistent and chronic under-supply of quality homes, particularly in London and the South-East.

2.8 For these reasons, we do not believe there is a risk of any new institutional activity in the PRS detracting from the existing individual PRS, a potential concern raised in the Consultation paper.

2.9 What is particularly important is that the PRS is seen as a wholly acceptable and sensible alternative to home ownership, as a tenure of choice, rather than being viewed as "niche" or secondary. Such categorisation is unhelpful and outdated and does not reflect the changes in long-term demographics.

2.10 In terms of the PRS itself, the Consultation paper acknowledges that this largely comprises individual, rather than institutional investors. There are certain aspects of the PRS that has, historically, made it particularly suited to individual investors as opposed to institutions who compare the asset class to commercial property.

2.11 There are a number of features of today's new-build developments which mean some of the perceived barriers to institutional investment are greatly reduced in terms of management costs and the fragmented nature of the market.

2.12 For developers, speculative development finance is currently scarce and institutional investment can provide developers with the financial security in effectively forward funding development through off-plan purchases.

2.13 Off-plan sales, to both private and institutional investors, are an important feature of the housing market as they provide customers with an opportunity to secure properties at competitive prices and they provide developers with security of future cash flow to enable them to commit capital to development.

2.14 There are four broad areas we have identified where action could help stimulate the PRS.

- Taxation (2.15)
- Regulation (2.16)
- Mortgage availability (2.18)
- Direct Government assistance (2.20)

2.15 In terms of taxation, the PRS is presently at a significant disadvantage to investment in both, commercial property, and pensions. We highlight the following areas where action by the Government could further increase the attractiveness of the PRS to investors, both individual and institutional:

- A "Loi Scellier" type scheme – the French scheme provides a tax timing incentive for private individual investors in the PRS
- SDLT changes – Applying SDLT to individual properties, not entire transaction values
- VAT changes – Making residential lettings effectively zero-rated, rather than exempt
- SIPP changes – Allowing SIPPs to invest in residential property
- REIT legislation – Reviewing the REIT qualification factors

2.16 In 2007 and 2008 the OFT conducted a market-study in to the house-building industry. The study concluded that the industry was generally competitive but that home-buyers need more protection when buying a new home.

2.17 Berkeley is concerned that, in working together to achieve this, the industry and OFT, do not introduce measures that have the unintended consequence of making it difficult to sell off-plan to investors due to the nature of the regulation introduced.

2.18 The availability of buy-to-let mortgages is one reason why individual investment in the PRS has increased over the last 10 years, however, the events of the last 24 months have both, limited the supply of such finance, and diminished confidence of individual investors over the certainty of the availability of sufficient mortgage finance when buying off-plan.

2.19 Mortgage offers typically last for 3 – 6 months. Extending this period, perhaps through some form of insurance, would provide the necessary certainty for the individual investors who underpin the PRS in the UK, to continue to invest at this time.

2.20 Finally, there is an important dynamic with the availability and provision of social housing. The international comparisons in section 4 of the Consultation paper are interesting as it is clear that the public sector has a major role to play in the overall provision of housing.

2.21 In the UK, we have welcomed the preparedness of the Homes & Communities Agency to work with developers in kick-starting housing supply.

2.22 As we emerge from the global financial crisis and housing market downturn, this relationship between the HCA and developers will continue to be central to the success of the provision of new homes, both for sale and for the rental market.

2.23 Extending this relationship to investors would be another way of securing housing supply in the coming years as would recognising homes built for the rental sector within the planning system.

2.24 In conclusion, it is our belief that addressing the points raised above would have a material impact on the ongoing attractiveness of the PRS to investors in both the existing, well-established individual investor sector, but also in introducing institutional investment.

2.25 This would contribute significantly to addressing the under-supply of quality housing in the UK and, at the same time the knock-on benefits to employment and the wider economy associated with a buoyant housing market.

3 Individual Investment

3.1 Q1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

3.2 There are a number of attractions for investors in buying new-build properties in preference to existing housing stock. These include:

- It is a straightforward, chain free, buying process;
- New-build properties are lower maintenance and come with a 10-year Home Warranty from the NHBC or similar warranty provider;
- New-build properties achieve higher rentals;
- A wide variety of mortgage products have developed;
- If the customer is buying to let, the property is ready to let immediately;
- The properties are more energy efficient, environmentally friendly, economical to run, secure and regulatory compliant;
- They are well planned and adapted to contemporary lifestyles;
- There is the chance to negotiate financial incentives with the sales team;
- Investors can buy new-build properties "off-plan" at highly competitive prices, with the ability to assign properties between exchange and completion if desired;
- If the investor selects wisely, new-build developments are typically well-located with access to local amenities and travel networks; and
- Properties are high specification, sustainable and come with long leases.

3.3 Successful developers respond to both the prevailing market-place and Government policy.

3.4 Changing demographics (smaller house-holds) and the reality of today's job market (international and flexible) have required a very different approach to meeting housing demand today, compared to, say, twenty years ago.

3.5 Government policy over the last 15 years has moved towards increasing densities and brown-field development.

3.6 These characteristics are particularly strong in Berkeley's chosen market-place of London and the South-East. Developing to meet demand means that we develop new-build properties that exhibit more of the characteristics necessary for investors to achieve their financial objectives.

3.7 For Berkeley, a residential-led developer that has focused on urban regeneration over the last ten years, it is therefore unsurprising that, approximately 50% of underlying sales are to investors.

3.8 Typically, these are private individuals who either run small portfolios of 1 – 10 properties or second home owners, rather than institutional investors.

3.9 It is right to recognise that overseas investors have played, and continue to play, a critical role in individual investment in the PRS, particularly in London. This is driven by the allure of London as World City for investment, employment and education. The recent weakness of sterling has added further to this attraction and it is important that this significant element of the PRS continues to be encouraged.

3.10 Q2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

3.11 The house building industry is led by customer demand and government policy.

3.12 Undoubtedly, as discussed previously, the long-term demographic shift, coupled with the Government policy of the last 15 years, has influenced the housing stock coming on to the market.

3.13 New-build development represents a small proportion of the overall housing stock. To the extent overall housing demand patterns change, it is inevitable that new-build homes are targeted to the changing requirements of the market-place, as the existing stock was built at a time when the market dynamics were different.

3.14 It is important to recognise that demand and supply patterns do vary from region to region. Given the changing long-term demographic trends and shortage of supply of good quality homes, which are particularly strong characteristics of the market in and around London, where Berkeley operates, the PRS will continue to influence the house building industry.

3.15 The current reduced availability of mortgage finance is likely to place an even greater increase on demand for rented accommodation.

3.16 Q3: 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?

3.17 We do not have sufficient knowledge in this area to answer this question.

3.18 *Q4: 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?*

3.19 The last ten years have seen a combination of factors which together have seen individual investment in the PRS increase.

3.20 The changing long-term demographic features of society and increased house prices, putting pressure on affordability of home ownership, have combined to increase demand from the PRS.

3.21 On the supply side, developers have built homes suited to the PRS and the emergence of buy-to-let mortgage finance at a time of benign interest rates have both increased the attractiveness of the PRS and widened the pool of potential investors.

3.22 In addition, many people are attracted to property by the lack of alternative investment opportunities and their belief that, over the long term, property investment will out-perform equities and pensions. Investors are able to gear up property investment to increase returns and shelter rental income from taxation through interest payments.

3.23 Many people are simply more comfortable in investing in bricks and mortar, compared to other asset classes that they feel less able to relate to and understand.

3.24 Ultimately, the objective is to achieve sustained financial returns.

3.25 The last two years have demonstrated the risks for off-plan investors. A property market downturn, accompanied by a dramatic change in the mortgage market, has clearly had an impact.

3.26 However, the incentives remain the same for investors who are able to take a long-term view and we have already seen a return of property values, if not to the peak prices of 2007, certainly to levels achieved shortly before the peak.

3.27 The demographics suggest the demand for rented accommodation will only increase and the PRS has a vital part to play in meeting housing supply targets.

3.28 The difference currently is the availability of mortgage finance. While the increased lending commitments of RBS and Lloyds and other banks have been most welcome, the criteria being set for lending are different to those available in the mid-2000's.

3.29 This makes home ownership less viable for all but those with access to sufficient equity and will increase the demand from the PRS. Institutional investors, who have access to equity, could play a vital role in ensuring the housing stock is available to meet demand from the PRS.

3.30 Going forward the rewards and risks remain the same for investors because of reduced liquidity. The barriers to entry are slightly higher now but the rewards (and risks) remain unchanged.

4 Institutional Investment

4.1 ***Q5: 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 commercial viable?***

4.2 The Consultation paper identifies the reasons why institutions have historically been unwilling to invest in residential property, making a comparison to investment in commercial property, citing the relatively high costs of management, linked to the fragmented nature of portfolios, as a significant issue.

4.3 Historically this has certainly been a consideration. The nature of the available properties has meant the PRS is well suited to individual investors who can manage the properties themselves and pay them the attention that they merit.

4.4 However, the emergence of new-build developments as providing stock to the PRS does present a major opportunity for a shift in perception in this area.

4.5 Firstly, well constructed new build properties should require significantly less management time and expense with such properties which also benefit from a 10-year home warranty.

4.6 Where properties are within modern flatted developments and investors acquire a number of units in a single development, the approach to management can more closely mirror that of commercial developments.

4.7 The other area of perceived management inefficiency comes from a higher turnover of tenants in the residential rental sector, compared to the commercial sector.

4.8 The reality of the changing long-term demographics mean that, while tenancy agreements for residential tenants are typically for one year only, the actual rate of turnover of tenants is likely to reduce as the PRS becomes a more recognised housing solution.

4.9 Furthermore, annual leases provide landlords with the opportunity to adjust rents annually, whereas commercial rental agreements typically have rent increases only every five years.

4.10 ***Question 6: What evidence is there that the SDLT bulk purchasing rules are a constraint to building up property portfolios, and 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?***

4.11 Any investment is simply a dynamic between investment, risk and return.

4.12 Applying SDLT to a portfolio value, rather than individual properties, adds 3% or 4% to the cost of investment, increasing the required level of income to hit the investor's hurdle rate.

4.13 There is little logic in SDLT being applied on a portfolio basis simply because a portfolio of assets is being acquired.

4.14 Somewhere in the value chain this leakage needs to be recovered, either by the vendor reducing its price or the investor reducing its return aspirations.

4.15 With many different asset classes competing for capital, this puts investment in residential real estate at a clear disadvantage.

4.16 It is inconsistent on the one hand to be recognising the need for an increase in the PRS and, on the other, to penalise investors who are prepared to make a significant contribution addressing this need.

4.17 This must be addressed if investors are to be convinced of HM treasury's commitment to Institutional Investment in the PRS.

4.18 *Q7: How might changes to the SDLT rules on bulk purchasing impact on the rate of return on institutional investment in the private rented sector?*

4.19 This is addressed in the response to Q6 above.

4.20 *Q8: How do the rates of return on investment in the PRS compare to those expected/required by institutional investors?*

4.21 Property returns are a combination of net rental yield and capital growth. The Consultation paper notes that the dynamic is different in the commercial sector where value is driven more by yield, compared to the residential sector where owner occupiers drive the value of the market.

4.22 There are a number of factors that can result in the gap in yields between residential and commercial investment reducing.

4.22.1 The historic returns for the PRS do not reflect the competitive prices one would expect Institutional Investors to be able to expect.

4.22.2 With development finance scarce, institutional commitment to fund developments presents an opportunity for investors to buy-in at a very competitive entry price – effectively "build to let".

4.22.3 When investing in new build developments, early investors can benefit from both market sales price inflation and the appreciation of values as the developer creates a sense of place once the development is completed. There are of course market risks associated with an early commitment but the price paid should reflect this, as well as the security and certainty being provided to the developer.

4.22.4 The level of rental income is the other major variable in the yield calculation. Investors will take a view on whether the increased demand from the PRS will result in an increase in rents.

4.22.5 Another factor is the economies of scale available as discussed in the response to Q5 above.

4.22.6 The final point is the individual requirements of investors and the unique features of the residential sector. While rental yields may be lower than commercial yields, the opportunity for capital growth may be greater in certain residential situations.

4.23 The choice of investment asset class comes down to the risk appetite and knowledge of individual investors. Investment in the PRS provides a different profile of risk and opportunity to investment in commercial property and should be seen a complementary to other asset classes and an opportunity to diversify risk.

4.24 *Q9: What factors have prompted the recent institutional interest in investing in the PRS, and do these reflect a long-term change in investment opinion?*

4.25 Investment capital will always gravitate to where it sees the greatest returns and opportunity. An appreciation of the factors set out in the response to Q8 above will all have contributed to increased interest from institutional investors looking to enter the PRS.

4.26 These factors, like the changing long-term demographic of UK society, are not short-term and reflect changes in the wider market place.

4.27 Undoubtedly there is also a sense that property prices are at relatively low levels and this presents an opportunity.

4.28 In addition, the encouragement of the HCA to both institutions and developers has added impetus to interest in the PRS.

4.29 The evolution of a "build to let" relationship between institutional investors and developers has clear attraction to both parties.

4.30 Returns are naturally the key driver for investors. At the launch of the "IPD UK 2009 Residential Index" on 13th April 2010, Mark Weedon (Head of UK Residential Services at the IPD) concluded his presentation by noting that

"Residential market let investment has consistently rewarded investors with greater returns than commercial property and other asset classes since 2000 despite lower income returns. Long term performance represents a hedge against inflation and volatility whilst maintaining impressive performance relative to other sectors."

4.31 The IPD press release announcing the launch of the IPD UK 2009 Residential Index is attached as it provides a clear summary of the changing dynamics between the UK residential and commercial property investment markets and explains why residential property is becoming increasingly popular as an investment class for institutional investors.

4.32 Q10: 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?

4.33 One area where residential property investment is at a disadvantage to commercial property investment is in the recovery of VAT.

4.34 A high proportion of commercial property tenants are registered for VAT, allowing commercial investors to elect to tax their properties. This means they account for VAT on the rents they charge and can recover the VAT on their costs. Their tenants are happy as they can recover the VAT themselves.

4.35 As residential tenants are individuals they cannot recover VAT. Residential property investors therefore cannot elect to charge VAT on their properties and are unable to recover VAT on their costs as, without an election to the contrary, the letting activity is an exempt supply.

4.36 This contrasts with sale of residential property which is a zero-rated supply.

4.37 By allowing recoverability of input VAT on costs for residential lettings, the same net result would be achieved as for commercial property investment.

4.38 Q11: What are the key barriers to investment in residential property through UK REITs, and what changes would be needed to address them?

4.39 The REIT legislation worked well for commercial property companies where there was an established listed property company environment.

4.40 There is no similar established corporate residential investment sector. It would seem that some form of relaxation of the REIT shareholding requirements that recognises this would enable a residential investment sector to develop, enjoying the same tax advantages as the commercial sector.

4.41 Without this, the relative advantage provided to the commercial sector will be a barrier to entry for new residential ventures.

4.42 *Q12: 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?*

4.43 We do not have sufficient knowledge in this area to answer this question.

4.44 *Q13: How suitable are other collective investment vehicles for residential property investment? What are the current barriers to investment through these vehicles?*

4.45 We do not have sufficient knowledge in this area to answer this question.

4.46 *Q14: How do these collective investment vehicles compare to UK-REITs?*

4.47 We do not have sufficient knowledge in this area to answer this question.

4.48 *Q15: What evidence is there that institutional investment in the PRS would bring real benefits to the sector, and the housing market more generally?*

4.49 It is a widely accepted that there is a persistent shortage in supply of good quality housing.

4.50 It is also recognised that the affordability of home ownership is an ongoing issue for many households.

4.51 As another source of housing, the emergence of institutional investment in the PRS will bring clear benefit to the housing market.

4.52 It can play a vital role in stimulating supply by providing much needed financing through forward funding developments as an alternative to traditional development finance.

4.53 The demand for housing is such that the emergence of institutional investors in the PRS will not detract from individual investors or indeed house-builders selling direct to owner-occupiers but will help promote the much needed delivery of quality homes.

5 Other comments

5.1 SIPP investment

5.1.1 One aspect considered in recent years has been whether individuals should be able to invest in residential property through self-invested personal pensions ("SIPPs"). To date this has not been allowed. Enabling individuals to hold residential investment property in SIPPs would increase demand in the PRS and this can only be good for housing supply.

5.2 "Loi-Scellier" or roll-over relief

5.2.1 Another incentive that is already working well overseas is the "Loi-Scellier" scheme in France. This allows individual investors to benefit from a 25% tax credit, spread over a period of nine years. To benefit from the tax credit, the owner of the property commits to the rental market over this period.

5.2.2 Introducing this time of incentive or, perhaps, some form of asset roll-over relief for re-investment in the sector would encourage sustained investment in the PRS.

5.3 Underpinning mortgage finance

5.3.1 One area where the confidence of individual investors has been affected over the last 24 months, is certainty over the availability of sufficient mortgage finance when buying off-plan.

5.3.2 Mortgage offers typically last for 3 – 6 months. Extending this period, perhaps through some form of insurance, would provide the necessary certainty for the individual investors who underpin the PRS in the UK, to continue to invest at this time.

5.4 Working in partnership with Government

5.4.1 Developers already work closely with the public sector in the provision of affordable housing. Most recently, Berkeley has welcomed the preparedness of the Homes & Communities Agency ("HCA") to work with developers to kick-start housing supply as we emerge from the global financial crisis and housing downturn.

5.4.2 The continuation and development of this relationship will be central to the delivery of new homes over the coming years. Given the importance of the PRS, consideration should be given to extending this relationship to include some form of partnership with investors in the PRS to encourage further investment in the sector.

5.4.3 Similarly, providing recognition within the planning system for homes developed for the rental market would be another way to incentivise growth in this sector. Such recognition would need to be matched by a commitment to make the properties available for rental for a period of time. It would provide competitively priced product to the investment community and stimulate the supply of new homes.

IPD UK 2009 Residential Index Launch

On the pulse of
the property world

IPD

Market let UK residential property delivers double-digit returns

London, 13th April 2010: Investment grade market let residential property delivered an 11.0% annual total returns last year, **according to the IPD UK Residential Index**, representing a three-fold outperformance of the commercial property market.

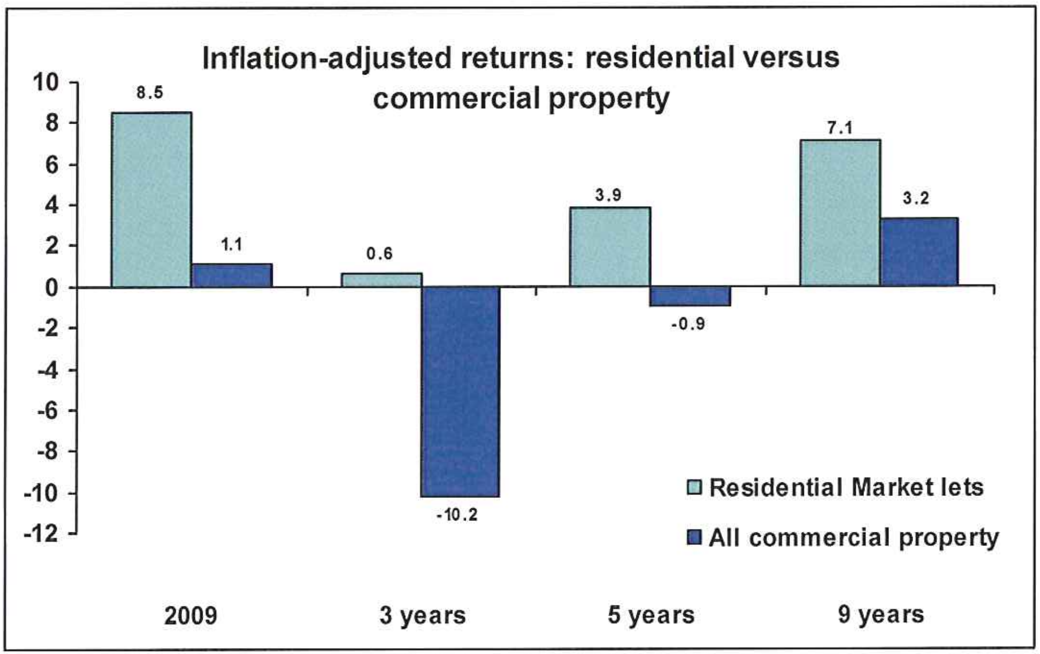
The double-digit 2009 UK residential total return – comprised of an 8.1% capital growth and a 2.7% income return – is the third consecutive year in which the market has outperformed the broader commercial sector, delegates at the **IPD UK 2009 Residential Index Launch** were told.

Speaking at the breakfast index launch – held at the Society of Medicine in central London – **Mark Weedon, Head of UK Residential Services at IPD, told delegates:** "2009 has seen a strong recovery by residential market let property. London and the South East enjoyed the greatest recovery with central London setting the pace. At the other end of the spectrum, the North and Scotland lagged the market, delivering negative returns for a second successive year. Indeed in Scotland performance worsened year-on-year."

Central London experienced the lowest income return and dragged down the overall market net yield with most other regions faring much better, the South East, South West, Midlands and Wales realised income returns close to 5%.

Weedon added that one of the unique features of residential returns was the correlation between risk and return. "Usually, high risk is associated with higher returns and vice versa. But in the residential sector the evidence points to the contrary; residential investment has significantly lower standard deviation (a measure of risk) compared to the commercial market, with higher returns."

On an annualsied inflation-adjusted total returns basis, the residential sector outperformed the commercial market over three, five and nine years (back to the launch of the index in 2001).



Source: IPD UK Residential Index and IPD Annual Property Index

Weedon concluded: "Residential market let investment has consistently rewarded investors with greater returns than commercial property and other asset classes since 2000 despite lower income returns. Long-term performance represents a hedge against inflation and volatility whilst maintaining impressive performance relative to other sectors."

Conference chairman **Ian Cullen, co-founding director of IPD,** added that the UK return is the second highest residential total return so far reported for 2009, behind Sweden's 13.9%.

Q&A session

Following Weedon's presentation, **Rob Weaver, Head of Residential Invista Real Estate Investment Managment**, told delegates: "The results confirm something we all know and cannot now hide away from – residential property has outperformed commercial property over the short, medium and long term. It has had the greatest performance for the lowest risk and you can't get away from that fact."

Hugh Seaborn, Chief Executive at Cadogan Estates, said: "Residential has clearly delivered a lot better returns than commercial property over the decade. The market has been helped by scarcity of supply, while an influx of wealthy overseas investors has helped smooth volatility."

Philip Littlehales, Investment Director at Terrace Hill Group agreed and added: "There is a massive tension between demand and supply in the sector – and these dynamics have not changed throughout the 'noughties'. As a result, residential property ticks a lot of boxes for investment over the next decade as well."

Cullen then put a delegate's question to the panellists: "Why is that despite the outperformance of the sector, relative to the commercial market, over the short, medium and long term, that there is not more mainstream institutional interest in the residential investment?"

The panellists argued a combination of scale in the market, supply and demand restrictions, access to product, perceived low income returns, regulatory uncertainty and a lack of market understanding are all considered hurdles to overcome.

Allan Collett, Chairman, Allsop Residential Investment Management, said: "The commercial market is today unrecognisable from the 1980s; average lease lengths have come down from 25 years to around eight or nine years. So it is coming close towards the average period of tenure, around three years, in residential leases. Also, residential sector management skills are dramatically better than 10 years ago."

Speaking after the morning Residential Index Launch, **Ian Fletcher, Director of Real Estate Policy at the British Property Federation,** said: "These results are very impressive and illustrate why residential is, and should be, on the radar of investing institutions. The past shows that residential returns have consistently exceeded commercial property returns with lower risk."

Fletcher added: "The future is a place where demand for housing will continue to exceed supply, providing some assurance that residential will continue to perform well. Finding the right property to invest in will remain the sector's biggest challenge, but also presents an opportunity for investment to be channeled into housing through suitable support for the build-to-let model."

UK private rental sector presentation

A presentation on the importance of the private rental sector in the UK was delivered by **Richard Donnell, Director of Research at Hometrack.** He said: "Demand for rented housing is only going to increase in the future because housing liquidity has dried up in the owner-occupier market. The wider housing market is facing continued illiquidity, price volatility, accessibility issues which will maintain rental demand.

"Transaction levels have fallen in volume to 1960s levels, just 600k sales in 2008 and likely to be 15% lower in 2009. This lack of available housing has driven the so-called housing recovery. The private rented sector packs a punch well above its weight in helping to improve liquidity in the wider housing market."

Donnell added: "Industry needs to make a better 'policy case' for rented housing as well as a strong investment case."

---ENDS --

Notes to editors:

The £3.8bn IPD UK Residential Databank is comprised of £2.4bn worth of market let properties and £1.4bn non-market let units which are excluded from the index.

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BERWIN LEIGHTON PAISNER LLP

RESPONSE TO HM TREASURY CONSULTATION ON INVESTMENT IN THE UK PRIVATE RENTED SECTOR

Introduction

On the strength of feedback from our clients and our knowledge of the legislation and practice relating to the UK PRS, our responses to the HM Treasure consultation paper on Investment in the UK Private Rented Sector are given below. Our submissions are made in support of the detailed combined response submitted by the Property Industry Alliance; the Council of Mortgage Lenders and the Association of Real Estate Funds.

Berwin Leighton Paisner LLP

Berwin Leighton Paisner LLP is a full service international law firm, with offices in London, Abu Dhabi, Brussels, Moscow, Paris and Singapore. Our clients spread the whole portfolio of businesses, including financial institutions, major multinationals, FTSE 100 companies, Government, prominent public sector organisations, entrepreneurial private businesses and individuals.

Our real estate group is the pre-eminent legal practice in the UK. We have over 60 partners and nearly 300 lawyers. Much of the complex work we carry out requires a cross-team approach involving many legal specialisms. We are particularly well placed to deliver this, given the depth of real estate sector expertise within our tax, finance, funds and corporate teams.

With sector specialists in all these core disciplines, our lawyers have a broad exposure to the market and active knowledge of key issues and trends.

Submissions

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?

SDLT rates are normally higher for bulk buying investors compared to individuals (who generally buy one property at a time). This is because the linked transactions rule means that bulk-buying investors are charged to SDLT on the aggregate price paid for a number of properties. As such, large-scale investors pay SDLT of 4% for purchases of more than six properties in a single transaction for which an aggregate of more than £500,000 is paid. For transactions with an effective date following 6 April 2011, some large-scale investors will pay SDLT of 5% when they purchase fewer than six properties for which an aggregate of more than £1m is paid. In contrast, individual investors attract a rate of between 0% and 3% SDLT for the purchase of a single property worth less than £500,000.

As outlined above, the SDLT regime causes large-scale investors to be at a disadvantage when compared with their competitors in the residential sector (individual owner-occupiers and individual buy to let investors). This is one of the main reasons that large-scale investors choose to invest in commercial property, rather than residential. It is also considered to be one of the major reasons for the lack of large-scale institutional investment in the residential sector to date.

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?

By making minor changes to the SDLT legislation, Government could remove the competitive disadvantage for large-scale investors in residential property and encourage bulk investment in residential property.

The legislation could be changed by imposing a per unit SDLT charge on the average purchase price for individual properties in a bulk purchase of residential property. There are already several definitions of residential property in the tax legislation and finding a suitable definition that covers the entire sphere of the private rented sector that is the subject of this consultation should be possible.

We support the combined PIA, CML and AREF response to this consultation, which sets out the quantifiable impact of a change in SDLT rules for bulk purchasers. We also note that one of our clients has indicated that, on the basis of internal computations, a change in the bulk purchasing SDLT rules would cause an improvement of approximately 25 basis points assuming a static portfolio which is held for 10 years.

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?

Current levels of pricing and the availability of new build stock have clearly encouraged recent institutional interest in the residential sector. In addition, the market's view of the residential market as stable and its exposure to risk have made the sector more attractive at a time when other asset classes are experiencing a period of volatility.

It is too early to say whether this change of attitude is long term, however, in advising the Homes and Communities Agency in connection with its Private Rented Sector Initiative, institutional interest has been strong and with continued encouragement from the Government would not appear to be short lived.

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?

The feedback we have received from our clients and the wider sector indicates that the primary barriers are:

- Tax efficiency - the SDLT and VAT regimes (as mentioned elsewhere in this submission response and the combined PIA, CML and AREF response), are widely seen as barriers to institutional investment.

- Management issues - The lack of standardised management systems and associated costs can be much higher than costs incurred in managing commercial stock.

- Scale of delivery - Acquisition of new build stock of a quality and at a quantity that would attract institutional investment is an issue. This could, to some extent, be addressed by schemes such as the Homes and Communities Agency's Public Land Initiative which seeks to release potentially large amounts of publically owned land for residential development.

- Current lack of standardisation of residential leases - There are currently a variety of forms of residential leases which attract varying degrees of security of tenure.Is there a case for further rationalisation? A related point is that for the returns for institutional investment to be worthwhile in the residential property sector where the value of individual lots is low, due diligence needs to be highly streamlined so as to be cost effective.

- The highly complex state of the current collective first refusal rights legislation - the Landlord and the Tenant Act 1987 is widely acknowledged as being 'ill drafted, complicated and confused'; a rationalisation would be welcome.

Question 11:

What are the key barriers to investment in residential property through UK-REITs; and what changes would be needed to address them?

We support the outline of the key barriers to investment in residential property given in the combined response submitted by the PIA; CML and AREF. We would like to add that feedback from our clients indicates that the 2% charge on entry to the REIT regime is particularly obstructive in the formation of new REITs.

Berwin Leighton Paisner LLP

28 April 2010

Bromford Group
Response to H M Treasury consultation
Investment in the UK Private Rented Sector

HM Treasury consultation on the Private Rented Sector

Question 1

What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

- The quality of the product and immediate environment which usually better meets the expectations of tenants
- Mortgage-ability by the investor – higher loan to value ratios
- No need for improvements which cause delays between purchaser and first letting.
- Lower maintenance costs in earlier years and NHBC style guarantees on latent defects.
- Certainty of cost - Unknown risks associated with conversion and refurbishment which can cause delays and cost increases.
- VAT on conversion/improvements is a deterrent
- Historical discounts from house builders for buy to let investors on the property purchase "asking price". Off-plan purchases

Question 2

To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

- During the "boom years" this led to a growth in the number of new build apartments as these were popular with the buy to let market. Homes for "young professionals" and single people and couples became a dominant factor in design criteria as the reward/margins were better and sales easier to secure.
- Marketing of new schemes was often targeted at investors
- The collapse of the Buy to let market has contributed to the fall in housing production as it substantially reduced the number of potential buyers/sales and increased developer risk.
- A growth in the PRS through institutional investment and public sector "gap funding" would enable developers to anticipate "pre-sales" on new developments – even if these are at a discounted price the certainty and benefit from a "block sale" would contribute positively to the development financial appraisal. This would lead to improved confidence and could encourage developers to start new developments.
- Institutional investment on the PRS would/should be coupled with higher quality management and landlord standards which in turn helps the reputation, image and sustainability of new developments. Industry based

minimum standards for management and lettings – agreed standards enforced by regulation of the process.

- The market rent product also offers an alternative to ownership to sit alongside affordable housing (rent and low cost home ownership) and market sale thereby improving access to housing, widening choice of commitment to a home and helping to create a mixed tenure, mixed income community.

Question 3

3.1 What is the contribution of individual homeowners renting out part of their own home making to housing supply?

- In a very limited number of cases it can be a solution, offering
  - extra income during a short term or prolonged period of financial difficulty
  - company and security for a lonely person - home owner and/or tenant.
  - reduced home running costs so the home-owner does not have to move to a smaller home.

3.2 Are there significant constraints limiting this contribution to addressing house demand?

- The question has to be asked - is this an attractive housing option – why would people want to rent out part of their home? Also why would people want to share a home as a tenant? Students do it for a short period due to cost, multi occupancy homes are a solution for people in real housing need with few options available to them.
- A non researched view would be that this is not an option of choice but one of necessity, a short term option for homeowners and tenants alike, rather than a logical and supportable initiative that improves communities, household quality, and quality of life for all concerned.
- It seems unlikely that such an initiative would add any meaningful volume and many potential participants would be deterred due to:
  - The tenant preferring a self contained unit
  - Landlord worried about risk and security
  - Tax implications

Question 4

4.1 To what extent have the incentives for individual investment in private rented accommodation changed over the last 10 years and why?

- Mortgage funding for Buy to let became easy to come by and at low cost,
- Rapid growth in values made it an attractive investment; confidence in value growth compensated for low rental yields when compared with other investments.

- Low capital input by the investor (buy to let mortgages with high loan to value percentages)
- The rent covered the mortgage cost in most cases.
- Tenants were relatively easy to find
- Plenty of new build properties to choose from
- Attractive discounts on value offered to buy to let investors by house builders BUT often these were discounts on inflated prices.
- Few changes made and the attempt to establish REITs for market rent housing failed, and no other meaningful incentives were put in place.

4.2 Going forwards, what are the key prospects and risks for individual investment in the PRS?

In recent years the principle drivers have been the availability of high percentage low cost mortgages, a market anticipation of continuing capital value growth and good demand from potential tenants. Factors 1 and 2 no longer exist and are deterring small/medium sized investors.

- Individual investment in PRS will remain constrained due to:
  - Uncertainty on property values – (potential to fall? - stagnant or at best having very limited growth
  - Mortgage loan to value percentages at a low level meaning a higher capital investment by the landlord.
  - Mortgage restrictions on apartments as a mortgage-able product.
  - General mortgage conditions relating to rent to mortgage repayment ratios and other restrictions and credit checks on individual borrowers.
  - Lenders want low risk loans to borrowers with good credit history on sound properties in good locations.
- Potential exists to expand the individual investment in PRS through tax relief and a more optimistic lending policy. However such changes are unlikely and may not even be desirable.
- A preferred route would be to attract institutional investment, which would have greater impact on volumes, take a longer term view, have the capacity to “ride out” market fluctuations and improve management quality. The yield gap for new investment in volume terms is still the big constraint

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 commercial viable?

- There are competing challenges in relation to scale – too many PRS units would be counter to the principle of a balanced and mixed tenure community for a new development, but be more efficient to manage.
- Too few would make the investment unattractive (too much trouble for small scale investment) and the management more expensive.

- However the wider view of the community has to be taken into account and a single development of say 25 or even 50 homes within an established residential area could be seen as opening up the tenure/household mix of the neighbourhood.
- There are other factors at play as well as the number of homes for rent in a single development – the mix of the surrounding area, level of demand, and the quality and range of the product.
- In medium sized new developments of say 50 to 100+ homes we would suggest that numbers should be limited to say 25% of the whole.
- Linking new rented homes with existing (or other new) stock within a catchment area can counter the impact of higher management costs by achieving the desired economies of scale.
- Many RSLs are geographically spread and have established high quality management services for their affordable housing. These RSLs may be better suited to provide "dispersed management" services at an economical cost whilst maintaining a high standard.

Question 6

What evidence is there that:–

6.1 the SDLT bulk purchasing rules are a constraint to building up property portfolios,

- It appears wrong that an institutional investor in private rental properties will pay SDLT on the bulk price (at 4%) when individual buy-to-let investors will pay a much lower rate. SDLT should be calculated on average individual unit price.
- The current SDLT structure reduces investment in housing as any cost (capital or revenue) to the investment is a factor in determining the yield from the investment. Currently the yield and capital growth from PRS (except in limited areas of very high demand) is inadequate to attract institutional investment – any action that improves the yield is beneficial.
- Reducing SDLT on bulk purchases if linked to other market incentives has to be a beneficial factor in determining viability for large scale investment and would be a step in the right direction.

6.2 Changes to the SDLT rules for the bulk purchase of residential properties would lead to increased investment, either by institutions or individuals, in the private rented sector?

- Currently, the market cost of acquiring good quality units does not provide an adequate yield to attract institutional investment on any scale.
- Any change in SDLT which reduces the cost will benefit the financial model and contribute to the closing of the yield gap thereby making investment more attractive.

- It would be beneficial for the wider housing market if the SDLT rules were re-visited to "support" first time buyers and reflect the current market conditions.

Question 7

How might changes to the SDLT rules on bulk purchasing impact on the rate of return on institutional investment on the private renting sector?

- On a portfolio acquisition where the average price is £150,000 per property the SDLT at the current portfolio rate of 4% is £6,000 per unit. If treated as a single unit the SDLT would be 1% or £1,500 – net saving of £4,500 or 0.15% on the yield

Question 8

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

- Investment in PRS has to compete with yields in other use classes; the commercial sector has yields of (say) 6.5% - (5.5% for higher quality property to 7.5% for lower quality) - this yield would require a rent of over £800 per month for a £150,000 unit – a yield rate that is unlikely to be achieved.
- The Internal rate of return is seen as having to be in the region of 9-10% which is not seen as likely with current growth forecasts.

Question 9

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

- Now that house values have stabilised (and even perceived to be increasing) the residential property market could look marginal more attractive than the commercial/retail/industrial property sectors.
- The move by the HCA to encourage institutional investment in the PRS is supported by the market's aspiration that this means the HCA may provide some form of "gap funding" to create a viable model for investment.
- This "gap funding" could be based on deferred land payments or even discounted land when public sector land is sold via the HCA
- Such an initiative will help to close the "yield gap" and make large scale investment financially viable.
- Also the house building industry is keen to attract such investments either in free standing all private rented developments or as part of larger mixed tenure developments. In the current uncertain market, house-builders are likely to be willing and able to offer attractive discounts against full market value, for volume purchases.

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?

- The yield on new build housing for market rent is not sufficient for the current market conditions.
- Build costs are likely to rise thereby widening the yield gap, as energy standards (Code for Sustainable Homes) are introduced.
- Market acceptance is needed by prospective tenants of a quality PRS product; historically renting a home has been from a council/housing association, a low quality private sector and latterly a better quality small time investor landlord. Marketing has to make it "cool" to rent from a new type of landlord – institutionally financially backed, but with a quality service image/reputation.
- Current commercial leases include for the lessee to pay for maintenance and repairs whilst in residential it is the landlord's responsibility. This increases management activity for the residential investor.
- Some market perception of the PRS as being complicated and subject to legislative intervention.
- A market more tuned to sourcing the homes, creating a portfolio, the provision of a reliable and quality management service and an understanding around long term investment/management to make home renting an attractive proposition for all involved.
- Current investors favour a 10 year investment when the property is "churned" (sold) thereby removing it from the rented sector – if this means short term lets then this is not conducive to either attracting investors or tenants.

Question 11

What are the key barriers to investment in residential property through UK-REITs, and what changes would be needed to address them?

- The basic yield gap and their financial structure appear to make them unattractive to investors.
- The difference in lease terms for residential and commercial property, which tend to be 6-12 months for residential tenancies and 10 years for commercial leases.
- It appears that in other countries REITS have been structured to provide rented housing; it seems logical therefore to create a UK model that was equally attractive to our own investment and property markets.

Question 12

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?

- No comment

Question 13

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

- No comment

Question 14

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

- No comment

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?

- The Government's stated object is to increase production of housing to meet the forecasted demand contained within the Barker report. At a time when the industry will be operating at circa 60% of the output levels of 2007, any new "end users" of homes able to invest in housing will mean more houses will be built.
- The impact of more new build housing activity will be beneficial on all associated business sectors, reducing unemployment and contributing substantially to economic activity. For each £ invested in housing there is a further £3 invested in the wider market as a result.
- The provision of more market rented homes will also help labour mobility and enable particularly younger people to occupy good quality well managed homes at a time when there is some scepticism about enticing them into more rigid and long-term forms of home ownership.
- Increased activity in the PRS would also come at a time when output of affordable housing is vulnerable to cuts in Social Housing Grant and the reduction in output from section 106 agreements. This would mean rented housing being more available (with Housing Benefit support) for those who cannot afford to buy their own home or afford market rented housing without financial assistance.

April 2010

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Investment in the UK Private Rented Sector

Response by the Building Societies Association

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Investment in the UK Private Rented Sector

Response by the Building Societies Association

The Building Societies Association

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 51 UK building societies. Mutual lenders and deposit takers have total assets of almost £375 billion and, together with their subsidiaries, hold residential mortgages of almost £240 billion, 19% of the total outstanding in the UK. They hold over £245 billion of retail deposits, accounting for just under 22% of all such deposits in the UK. Mutual deposit takers account for about 36% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Executive Summary

2. The private rented sector (PRS) has an increasingly important role to play in the overall housing tenure mix, and so far investment in the PRS has largely been undertaken by private individuals.

3. New build properties have a number of advantages from a landlord's perspective compared to older properties, encouraging investors to invest in new build property. The planning system has encouraged developers to build properties that particularly appeal to both tenant and landlord demand.

4. Declining rents for such properties mean that developers will have to reassess the types of property that they build in the future.

5. It is likely that institutional investment will remain concentrated in the future on purpose built accommodation serving specific groups of tenant.

6. The PRS has so far been supported by small investors, and it is of paramount importance that small investors are able to continue to participate in the sector.

The Role of the Private Rented Sector

7. We believe that the private rented sector has an important role to play in the UK housing tenure mix, and agree with the consultation paper that the PRS now provides a good standard of accommodation to tenants.

8. But the growth of the PRS is not simply a result of high, compared to earnings, house prices. *The Report of the Shared Equity Task Force*[1] found that a fifth of tenants in the PRS could have bought a home in their region if they so wished, demonstrating that for many people it has become a tenure of choice.

[1] Report of the Shared Equity Task Force, HM Treasury / DCLG 2006 at http://www.hm-treasury.gov.uk/d/pbr06_sharedequitytaskforce_442.pdf

9. It is not surprising that the numbers of people living in the private rented sector have increased. According to the *English Housing Survey*[2], the PRS accounted for 14.2% of households in 2008-9, compared to just 10% in 2001. The Survey also shows that 3.1 million households are accommodated by the private rented sector, representing a figure just 800,000 short of the numbers of households in the social housing sector.

10. 90% of the new households that have been created have been accommodated by the PRS. According to the *English Housing Survey,* the total number of households increased by 1,127,000 between 2001 and 2008 - this growth almost matches that of the PRS, with an increase of 1,005,000 in the number of households in the PRS over that period.

11. As noted in the consultation paper, investment in the PRS has been largely undertaken by private individuals, sometimes operating as a small company, with institutional investment providing only around a quarter of properties. It is important that any measures that seek to encourage institutional investment in the sector should not be to the detriment of the smaller investors who have sustained the sector so far.

12. We recognise that the number of private investors in the sector has fallen, and the numbers of mortgage providers operating in the buy to let sector has also decreased. Despite this short term setback, we expect that the private rented sector will continue to thrive into the future, and will remain both a tenure of choice for many people and an investment category of choice for many private investors. We explore this in further detail later in this paper

13. However, we remain concerned that Government interest in regulating the sale of buy to let mortgages could result in more lenders withdrawing from the market. We do not believe that the problems of the buy to let market are a consequence of missold mortgages - they are often a result of poor investment advice received by the borrower.

14. If the Government wishes to protect consumers, it should concentrate its efforts on regulating the advice that is given to potential investors, rather than only regulating the sale of buy to let mortgages. It is the receipt of poor advice on the likely returns and ease of operating in the PRS that has seen landlords encounter difficulties, rather than being sold an inappropriate mortgage.

15. Regulating the sale of buy to let mortgages under a residential mortgage regime would not stop this, but regulating the advice given to buy to let investors would ensure that potential investors received appropriate advice and that they were not hoodwinked into making unwise investment decisions.

16. We make the following comments in response to the questions posed in the consultation paper.

1 – What has led individuals to invest in new build properties in preference to purchasing and converting existing owner – occupied housing?

17. From a private investor's perspective, there are a number of advantages that new build properties enjoy over existing stock. New build properties tend to be finished to a high standard, providing landlords with a property that needs little or no work to get it ready to let out. New build properties also tend to have lower maintenance costs, providing a further incentive for landlords both financially and in terms of making the property easier to manage.

[2] The English Housing Survey, Headline Report, CLG, 2010 at http://www.communities.gov.uk/publications/corporate/statistics/ehs200809headlinereport

18. The high build standards of new build property is not the only factor attracting landlords to it. The glossy marketing, sales brochures and advertising used by developers, coupled with a ready access to surveyors and legal advisors and other incentives provided by developers often make it easier to purchase such properties compared to existing properties. This further boosts the attractiveness of new builds to investors.

19. The lack of a chain for new build property is a further incentive. This allows the potential buy to let investor the opportunity to buy a property very quickly compared to buying property in a chain.

20. New build developments are also often sold “off plan”, allowing an investor the opportunity to “buy” a property, often at a very significant discount, before it is built. Such investors, taking advantage of a rising property market, would seek to “sell” their property to another investor before it was completed. This again attracted some investors to favour new build properties over older ones.

21. Government planning policy (contained in *Planning Policy Guidance 3 : Housing* and then *Planning Policy Statement 3*[3]*)* has encouraged local authorities to favour new developments on previously used land, with good public transport links built at high density levels.

22. This saw developers building large numbers of one and two bedroom flats in town and city centre locations. They particularly appealed to young professionals and other groups who find private renting to be an attractive form of tenure, meaning that landlords found a ready market for such properties.

2 – To what extent has the growth of the PRS already influenced the house building sector? How may it do so in the future?

23. The types of properties that developers build are determined by both what the planning system allows and the types of property for which there is demand.

24. As outlined in the answer to the previous question, the planning system has resulted in builders being encouraged to build the small, city centre flats that appealed to both private rented sector tenants and landlords. As noted by the consultation paper, as demographic and employment patterns have changed, this market expanded, to the mutual benefit of developers, tenants and landlords.

25. In turn, this created a virtuous circle. Developers found that they were being encouraged to build these types of properties, and found a ready market from landlords who, in turn, found a ready supply of tenants for these properties.

26. However, as supply of such properties has increased, rents have started to fall. The ARLA *Members Survey of the Private Rented Sector*[4] found that on average for the six months to September 2009 an average of 29.1% of their members believed rents for flats had decreased, with only an average of 3.2% believing that they had risen.

27. Against such a background, and the economic uncertainty which still remains, even though the economy is now out of recession, we anticipate that tenant demand for such property may have peaked (at least for the time being) and builders will have to reassess the types of property that they are building if they are to be successful in the future.

[3] Planning Policy Guidance 3 : Housing and Planning Policy Statement 3 both published by CLG in 2000 and 2006 at http://www.communities.gov.uk/publications/planningandbuilding/pps3housing and http://www.communities.gov.uk/archived/publications/planningandbuilding/planningpolicyguidance

[4] ARLA Members Survey of the Private Rented Sector, Association of Residential Letting Agents, 2009 at http://www.arla.co.uk/uploads/reports/ARLA%20PRS%20Report%20Q409.pdf

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

28. We are unaware of any data demonstrating take up of the Government's rent-a-room allowance. However, building societies require mortgage borrowers to inform them should they choose to participate in the scheme, and they report that the numbers of borrowers doing so is very small, with even large societies reporting that only two or three borrowers are participating in the scheme.

29. As a consequence, while the allowance may help some people, anecdotally we doubt that it will make a substantial contribution to meeting housing supply. Although it may meet the very short term housing needs of small numbers of people, it is not an attractive form of tenure for most people (from both a tenant and landlord perspective) and we expect it to remain a niche in the overall tenure mix.

30. We note that the maximum income limit allowable under the rent-a-room tax allowance has not increased since 1997. Increasing the limit to take account of any rental price inflation since then (although we have no evidence of such inflation) to ensure that homeowners can continue to enjoy a tax free income from a „rent a room' tenant may help to increase the attractiveness of the scheme.

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

31. The economic downturn, with both property values and rental incomes falling, has changed the economics of the private rented sector. During the period of high house price growth, investors were attracted by the opportunity to achieve very rapid capital growth in their buy to let portfolio.

32. According to the *ARLA Private Rented Sector Report 2009* [5] yields enjoyed by landlords have remained around the long term average of 5%. The downturn has meant that to remain successful, investors are now having to take a much more active role in managing their properties to ensure that rents remain above the costs that are incurred in managing the property (mortgage repayments, management fees and covering for voids for example) and they can no longer rely on significant levels of capital growth in the short term.

33. At the same time, the Government has introduced new requirements on landlords aimed at increasing standards in the sector and giving tenants greater protection. Such requirements include health and safety issues (including, for example, gas safety testing), the requirement for energy performance certificates, financial issues (the introduction of the tenancy deposit protection scheme, for example) and the soon to be introduced registration scheme for landlords.

34. This has seen landlords incurring further costs, and increasing the level of "hands on" management that is required by landlords. As such, the barriers to entry into the PRS have been raised making it less easy for landlords to enter the sector and take a relaxed attitude to managing property, relying primarily on capital growth for their returns.

35. However, once the housing market stabilises, we expect that interest amongst new landlords entering the PRS will again increase. Indeed, this may already be happening – the ARLA *Private Rented Sector Report 2009*[6] found that 53% of their members believed landlords were being tempted back into the market.

[5] ARLA Members Survey of the Private Rented Sector, Association of Residential Letting Agents, 2009 at http://www.arla.co.uk/uploads/reports/ARLA%20PRS%20Report%20Q409.pdf

36. At the same time, building societies are reporting (in a telephone survey of societies carried out in April 2010) that while landlords recognise that the days of significant capital growth are over, at least for the foreseeable future, they anticipate a steady growth in the value of their buy to let properties, and remain committed to the sector. They expect, even at reduced levels, capital growth to be sufficient to generate a worthwhile retirement income.

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

37. We are unable to comment on the rates of return required by institutional investors.

38. However, one of the reasons why the PRS has been so attractive to private investors is that the use of leveraged mortgage financing has seen them able to realise rates of return that often surpass those of other investment categories. An example is provided below.

The use of mortgage finance means that a buy to let investor could realise higher returns than an investor choosing another investment category, even though the housing market underperformed that other investment category.

Consider, for an example, two investors looking to invest £20,000.

Investor A chooses to invest £20,000 in stocks and shares. Over the first five years, the investor enjoys a 10% return on his investment, resulting in a profit of £2,000.

Investor B chooses to invest £20,000 in the buy to let market. The £20,000 is used as a deposit on a £100,000 rental property. Over the first five years, the value of the property rises by 5% (half the rise of the stock market).

This sees the property increasing in value by £5,000, and results in the investor enjoying a 25% return (2.5 times that of the investor who chose the stock market) on the original £20,000 investment. This is despite property values increasing by only half the increase of the stock market.

The use of mortgage finance allowed the buy to let investor the opportunity to enjoy the 5% growth in property prices not just on the £20,000 investment but on the whole £100,000 value of the property.

It should be noted that should property prices fall, then investors can lose much more than their initial investment, while the other investor's loss would be limited to their initial investment.

This is a simplified example – the investor choosing the buy to let property example will incur costs in running the property, and generate income from rents. Property is also a much less liquid investment than stocks and shares.

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?

39. We are unable to comment in detail on the barriers to further institutional investment in the private rental sector.

40. However, as noted by the Consultation Paper, involvement in the PRS is not easy for landlords. Numerous requirements need to be met to be able to rent out a property and then,

[6] ARLA Members Survey of the Private Rented Sector, Association of Residential Letting Agents, 2009 at http://www.arla.co.uk/uploads/reports/ARLA%20PRS%20Report%20Q409.pdf

when a tenant is found, the demands of meeting tenant's needs can be substantial, as routine maintenance has to be carried out, rental payments chased and void periods managed. Agents do offer services for investors which sees the agents undertaking these requirements for the landlord, and managing the property on their behalf.

41. Against such a background, it is no surprise that institutional investment in the sector has so far been concentrated in high volume new build accommodation (such as, for example, university halls of residence or care homes for the elderly) rather than individual rental properties. As noted by the consultation paper, by concentrating on purpose built accommodation that serves only a certain group of people, institutional investors can easily achieve the economies of scale that would be difficult to realise amongst a large portfolio of individual properties.

42. If institutional investment is to increase in the private rented sector, we would expect that it would be concentrated in these existing areas. If it was to expand beyond this, we would expect it to be limited to areas such as the bulk purchase of new build property with a high degree of homogeneity amongst both property types and tenants.

15 – What evidence is there that institutional investment in the PRS would bring real benefit to the sector, and the housing market generally?

43. The PRS has so far been supported by the small, individual investors who, as noted by the consultation paper, have so far provided around 75% of the investment in the sector. If the Government is to introduce measures to encourage greater levels of institutional involvement in the PRS, it must ensure that this does not harm the interests of smaller investors.

44. The *Rugg Review*[7] reported that landlords are finding that they have to offer a high standard of property and service to attract and retain tenants (although we recognise that problems remain at the very bottom of the market), we support the findings of the consultation paper that tenants feel that a larger landlord will not necessarily deliver a better level of service than a small landlord.

45. Small investors have supported the private rented sector since its inception, and it is of paramount importance to the 3.1 million households dependent upon it for a home that small investors are able to continue to meet their housing need.

Contact

46. This response has been prepared by the BSA in consultation with its members. The BSA looks forward to working with the Treasury throughout its consultation process. Comments and queries should be addressed to Neil Johnson, Mortgage Policy Advisor on 020-7520 5903 or Neil.Johnson@bsa.org.uk

[7] „Review of Private Sector Housing' by Julie Rugg and David Rhodes published by the University of York 2008

CENTRAL ASSOCIATION OF AGRICULTURAL VALUERS

Jeremy Moody

DO WHAT IS RIGHT COME WHAT MAY

100 years

Secretary and
Adviser

Patron of the Centenary Year: HRH The Prince of Wales

PRS investment consultation,
c/o Keith Jackson,
Housing, Regeneration and Third Sector team,
HM Treasury,
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London,
SW1A 2HQ

By e-mail: PRSinvestmentconsultation@hmtreasury.gsi.gov.uk

28th April 2010

Dear Sirs,

HM Treasury consultation on investment in the private rented sector
CAAV Consultation Response

I write on behalf of the Central Association of Agricultural Valuers in response to the HM Treasury consultation paper on investment in the private rented sector.

Introduction

The Central Association of Agricultural Valuers (CAAV) represents, briefs and qualifies 2500 professionals who advise and act on the very varied matters affecting rural and agricultural businesses and property throughout England and Wales. Instructed by a wide range of clients, including farmers, owners, lenders, public authorities, conservation bodies, government agencies and others, this work requires an understanding of practical issues.

The CAAV does not exist to lobby on behalf of any particular interest but rather, knowing its members will be called on to act or advise both Government and private interests under developing policies, aims to ensure that they are designed in as practical a way as possible, taking account of circumstances.

Our particular interest in this consultation arises because many of our members advise property owners who own privately let dwellings. In some cases, particularly on traditional rural estates, an agricultural valuer may be responsible for managing many let residential properties on a wide variety of different agreements owned by a single landlord as part of a larger property. In other cases, our members act for larger numbers of individual landlords who own single properties or small portfolios of privately let residential property.

Our members are located throughout England, Wales and the Scottish Borders. In preparing this response we have consulted our membership generally and our technical Property Committee in particular.

I set out below the CAAV response to the consultation.

Consultation Questions:

Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

The factors which lead individuals to choose new-build properties include:

- the opportunity to buy multiple units in a single location
- the opportunity to secure developer discounts for multiple purchases
- no refurbishment costs
- lower repair and maintenance costs
- newer properties are often more attractive to tenants

However, our members frequently manage portfolios of traditional rural estate properties which have been owned and let for very many years. Whilst these properties are often located in attractive rural areas and frequently provide housing for local communities, they can bring their own problems of refurbishment, particularly in respect of energy efficiency in older housing stock.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

The preference from individual landlords looking for properties to add to their portfolios is often for small (two bedroom), modern houses which give a good return on investment and are perceived to appeal to young, professional tenants who are likely to be fairly short term renters. There is perceived to be less risk in such investment as they are likely to be more easily realised if necessary. Fewer landlords will consider investing in family sized property, partly as the returns are not always as attractive and the risk is higher. This preference for small units can be widely observed in new housing developments.

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?

The contribution is very limited and not making a material contribution to the market in the experience of most of our members, although it is recognised that such homeowners will often not use professional advice and are more likely to be in urban areas; so our members are less likely to encounter them in practice. However, the threshold for rent-a-room relief has not increased from £4,250 for very many years and one way to incentivise homeowners to consider taking in more lodgers would be to increase the threshold and keep it under regular review, or index-link it to maintain the real value of the relief to taxpayers.

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?

More individual landlords are considering property investments as part of their pension arrangements, whether formally as part of a scheme or informally. Risks include the further tightening of regulation which will deter smaller scale landlords; an example is the regulation of HMOs which is not well understood - some letting agents will refuse to let a house to a group of three tenants for fear of falling foul of HMO obligations when the legislation was not intended for such a situation.

The proposals to require all landlords to be registered is another example of a heavy handed approach to regulation which will deter the average small scale landlords, but will not necessarily deal with those landlords who operate illegally or on the fringes of the law. Better enforcement of existing regulation is preferable to additional red tape.

Questions 5 to 15 deal with institutional investment in the private rented sector. The CAAV does not have a view on these remaining questions, which we consider to be outside our sphere of interest.

We trust that the responses given above are helpful and would be pleased to discuss matters further with officials if required.

Yours faithfully,

Jeremy Moody
Secretary and Adviser
Central Association of Agricultural Valuers

Investment in the UK private rented sector
Response by the Chartered Institute of Taxation

1. Introduction

1.1. The Chartered Institute of Taxation (CIOT) is pleased to be able to comment on the consultation on Investment in the UK private rented sector.

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

2.1. Rent- a -room relief was introduced by F(No 2) A 1992 Schedule 10, effective from 1992/93 onwards, in a bid to increase the supply of private residential accommodation. The relief was initially set at £3,250 by reference to relevant residential rental values at that time. Subsequently, the IT (Furnished Accommodation) (Basic Amount) Order SI 1996/2953 specified a sum of £4,250 effective from 1997/98. The relief has remained at this level since that uplift, and cannot be taken to reflect current rental values. A review of the threshold is, clearly, long overdue, and is essential if the relief is to contribute effectively to housing supply by encouraging the release of unused accommodation in the existing housing stock.

3. 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?

3.1. The potential limitation of SDLT on portfolio properties to the value per property rather than per lot would be of interest and value to purchasers with an ability to purchase numbers of units in a single transaction. As noted at paragraph 5.5 below, the application of the current rule in FA 2003 section 108 is a particular barrier for the development of residential REITS.

3.2. The linked transaction rule in FA section 108 is an example of anti-avoidance legislation which is too widely framed and, consequently, catches transactions outside its target. It is understood that the purpose of the provision was to prevent disaggregation of a single property transaction to artificially reduce the rate at which SDLT would be chargeable. The intention was not to apply a higher rate of SDLT on a bulk purchase than would otherwise apply to the purchase of the individual properties. If the linked transaction rule was more closely targeted, ideally with a clear motive or purpose test, the provision would operate more effectively.

3.3. However, we are not convinced that a change to this rule on its own will have a significant impact in attracting investors to the residential property sector. A wider review of the tax barriers is required. In particular, the current policy rationale for the distinction between property and trading income is unclear; as indicated in the Rugg review, the activities of a responsible landlord involve significant input, and are akin to running a trade. It follows from this conclusion that the tax reliefs available to a trader (sideways loss relief, rollover relief, capital allowances and IHT Business Property Relief) should therefore be available to a landlord.

4. Question 11: What are the key barriers to investment in residential property through UK – REITS, and what changes would be needed to address them?

4.1. The REITs legislation was introduced following extensive and welcome consultation. However, there remain significant areas of concern in terms of the continued development of the REITs regime, particularly for the residential sector.

4.2. The entry charge for companies entering the regime is levied at 2% of gross property rental assets. This is in addition to SDLT, payable at 4% (and now to be 5% in respect of residential property, with effect from 6 April 2011 for single transactions involving less than six properties) when properties are acquired. The level at which the entry charge is set is intended to compensate for two elements: first, the enjoyment of future tax exemption on income profits and capital gains in respect of rental properties, and, secondly, the benefit of eliminating historic latent capital gains on assets held by a company when it enters the REITs regime. The second element is not relevant for a newly formed REIT acquiring a new portfolio and, therefore, the rationale for the charge upon entry and at the current level is not met.

4.3. To the extent that residential REITs are likely to be formed via a new IPO rather than through conversion of existing residential property companies, the current level of entry charge is a barrier to entry for new residential REITs.

4.4. Another problem faced by existing groups contemplating moving properties into a REIT which could be spun off is the TCGA 1992 section 179 'degrouping' charge. This has undoubtedly deterred some property-rich groups (or sectors) from setting up REITs.

4.5. As noted above, a further barrier to the assembly of a residential property portfolio, and thus the promotion of residential REITs, is the requirement in the SDLT legislation to apply the SDLT rates thresholds to the aggregate value of a transaction. A bulk purchase of properties is charged to SDLT at the rate applicable to the aggregate consideration at the maximum SDLT rate of 4% if that consideration exceeds £500,000 (rising to 5% for consideration in excess of £1m with effect from 1 April 2011 for fewer than six dwellings per transaction). This compares with the position where unconnected purchases of individual properties are made, in which case the SDLT is charged on the price of each property.

5. The Chartered Institute of Taxation

5.1. The Chartered Institute of Taxation (CIOT) is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

The CIOT's comments and recommendations on tax issues are made solely in order to achieve its primary purpose: it is politically neutral in its work. The CIOT will seek to draw on its members' experience in private practice, Government, commerce and industry and academia to argue and explain how public policy objectives (to the extent that these are clearly stated or can be discerned) can most effectively be achieved.

The CIOT's 15,000 members have the practising title of 'Chartered Tax Adviser'.

The Chartered Institute of Taxation
28 April 2010

HM Treasury Investment in the UK private rented sector: CIH consultation response

This consultation response is one of a series published by CIH. Further consultation responses to key housing developments can be downloaded from: http://www.cih.org/policy/papers.htm

‘Shaping Housing and Community Agendas’

HM Treasury consultation: Investment in the UK private rented sector: CIH Consultation Response

1. The Chartered Institute of Housing (CIH) is the professional body for people involved in housing and communities. We are a registered charity and not-for-profit organisation. We have a diverse and growing membership of over 22,000 people – both in the public and private sectors – living and working in over 20 countries on five continents across the world. We exist to maximise the contribution that housing professionals make to the wellbeing of communities.

2. General comments

2.1 Recent volatility across UK housing markets is nothing new. Over the last forty years the UK has experienced seen several cycles of boom and bust, yet despite efforts to avoid the painful impact on families and communities, we have been unable to prevent or mitigate for the next period of market instability.

2.2 However, the severity of the current economic downturn, and the central role of housing within it, provides opportunity to secure lasting change in how we think about housing. Over the last few years there has been a comprehensive overhaul of the government regulatory structures and framework which has fundamentally reshaped the way public policy influences housing markets and provision. However unless there is a shared vision about what is trying to be achieved, then the potential for real and lasting change is unlikely to be realised.

2.3 Last year CIH published *Rethinking Housing* to help inform the expected rented housing reform green paper. It argued that "reforms must look at all tenures and should consider how change in one tenure can support or enable change in another." A failure to recognise that different market sectors are interdependent risks undermining the effectiveness of interventions designed to address pressing problems and further fragment an already problematic approach to housing provision. Current efforts to rebalance housing markets have focused on a renewed interest in growing the private rented market.

3. Composition of the private rented market

3.1 The private rented sector is a very diverse sector with landlords ranging from large property companies managing hundreds of properties to a person renting out a single property.

3.2 Today around one in 10 households in England rent their accommodation from a private landlord. This is a significant decline from its peak at the turn of the last century when some 90% of stock was private rental accommodation. Despite its relatively small size in comparison to other tenures the private rented sector has been growing and is increasingly recognised as playing an important role in both national and local housing markets – notably because of its almost unique ability to provide both flexibility and choice.

3.3 Despite the Government's wish to draw large-scale company landlords and institutional investment into the private rented sector as a means of guaranteeing better standards of management and maintenance, the number of company and large-scale landlords appears to have been declining in recent years. Instead the sector has been increasingly dominated by small-scale private individual landlords renting property as a sideline activity.

3.4 Nearly two thirds (65%) of privately rented dwellings are owned by private individuals. Private individual landlords typically have other paid employment (65%) and rarely (39%) derive more than a quarter of their income from rent. Most, however, see their property as an investment (73%). Dwellings let by companies and other organisations account for less than one third (30%) of privately rented dwellings. Many company and organisational landlords have small portfolios of properties (26% have less than 10) and only two fifths (41%) derive more than half their income from rent.

3.5 Over the past decade there has been a big increase in the proportion of dwellings owned by 'side-line investor' landlords - individuals and companies for whom renting property is not a primary occupation or source of income, but who, nevertheless, see their property as an investment (whether for income, capital growth or both).

4. The role of the private rented sector in housing markets and changing demand

4.1 A well managed, well maintained, affordable private rented housing can play an important role in balancing housing markets. The sector already makes significant contribution towards meeting short term housing need and offering greater flexibility, and responsiveness (such as improved resident mobility) than other tenures. In recent years, as affordability and supply issues have become more pronounced, the private rented sector has taken a more prominent role in providing a positive housing option. However, it is important to recognise that the private rented sector is a housing option that can be determined by constrained choice. Some tenants may be waiting for social housing or are unable to gain access social housing; others may be finding it increasingly difficult to secure or afford a mortgage. With mortgages likely to remain constrained for some time demand for private rented homes looks set to continue.

5. Growing the private rented sector

5.1 Interest in growing and developing a more sustainable private rented housing market is not new. Efforts to attract sustained, substantial investment following deregulation were kick-started by the Business Expansion Scheme (BES). Although the BES had some success in attracting corporate investors its overall impact was limited. Similarly, it was also hoped that Housing Investment Trusts (HITs) and Real Estate Investment Trusts (REITs) would attract more institutional investment by making it possible to invest through shares (and therefore avoiding the need for direct ownership). In turn it was hoped that the flexibility of investing through shares (with greater liquidity and without the management responsibilities of direct ownerships) would attract corporate landlords who could help professionalise the sector. Complex operating rules and low predicted returns have however meant that these vehicles have not achieved their aims.

5.2 Instead, the vast majority of new investment in the sector since the mid-1990s has been by buy-to-let landlords. Although this has helped provide rented housing to meet growing demand, it was principally delivered by individuals operating on a local level. Since these individuals largely operate outside of any wider investment and regulatory framework it has raised a number of concerns around: its impact on local housing markets and mix in communities, the quality of housing management and, since the onset of tighter lending practices, the wider sustainability of the business model itself.

5.3 With capital growth dominating the investment model at the expense of a strong rental yield there have also been restraints on entrants in to the market. While this approach may have appealed to some smaller investors, it was not attractive for institutional investors who are trying to match investments against liabilities, often pension payments, and hence prefer a steady and reliable income stream.

6. HCA Private Rented Sector Initiative

6.1 The latest attempt to reinvigorate the private rented sector is the Homes and Communities Agency's Private Rented Sector Initiative (PRSI). The HCA is working with institutional investors to develop a long-term funding model for new private renting. At the same time it will be hoping that a new approach could help kick-start schemes that have stalled as a result of the downturn. The PRSI aim is to deliver a significant increase in high quality new homes for rent, managed in a consumer focused way, so as to help make private renting a positive choice for consumers and help relieve pressure within the housing market.

6.2 The funding model works by separating the investment in assets from their management. The investment vehicle is exclusively focused on buying homes for rent from developers and house builders, and owning the assets solely for investment purposes. The homes themselves are managed either by professional housing management companies or registered providers such as housing associations. It is hoped that this separation of functions will help attract institutional investors who do not wish to be burdened with responsibility for day-to-day management of the stock.

6.3 The fund will be able to leverage its buying power to acquire homes in entire schemes or to buy up rental elements within schemes. Large-scale build-to-let elements within PRSI funded projects will create new scope for different approaches to pricing within blocks which could support a different approach to securing mixed-tenure communities.

6.4 This new approach to investment could help reposition the private rented market away from its current narrow emphasis on short-term gains towards the long-term approaches more evident in the commercial property sector by shifting the focus of the return on investment away from the capital appreciation to rental yield. The prospect of a secure income stream combined with longer term capital appreciation may also appeal to buy to let type investors looking for a more stable approach to investing in housing.

6.5 If it is successful (and early interest from non-traditional investors has been encouraging) the PRSI could represent the first step towards growing a private rented market more akin to that found elsewhere in Europe. More importantly it could help deliver much needed new supply, transform the private rented market into a positive choice for consumers and rebalance the housing market away from its current heavy bias towards owner occupation.

7. Some caveats

7.1As a first step the PRSI provides a clear shift in thinking about the positive role that private renting can play. However, what is less clear is how this rebalancing of the market will affect the other two dominant tenures – social renting and home ownership.

7.2 Home ownership remains, rightly or wrongly, the tenure of aspiration and choice for the majority of the population and in recent years considerable investment of both time and effort has focused on supporting people in to home ownership through low cost home ownership options. If this is still the ambition then can an expanded private rented market help provide a stepping stone towards ownership, for example by increasing the choice of flexible tenure offers? Or is it an acknowledgement that home ownership is not achievable or indeed sustainable for a growing proportion of the population and an expanded, and different, rented sector is needed to cater for these needs?

7.3 In a similar vein, social rented housing is under supplied. What isn't clear from the PRSI is how new government programmes designed to encourage investment in private rented housing will sit alongside ongoing (and increasingly squeezed) investment in affordable rented housing.

7.4 The difficult question is not around the investment model but around the wider public policy aims of government intervention in expanding the private rented sector. In particular, what remains unclear is the particular niche market that the expanded sector is designed to fill given that the social rented market already caters for some of these consumers. As it stands social housing offers greater security of tenure, sub-market rents, high space and quality standards, and a well regulated, highly professional management service. Any government backed private rented initiative needs to be able to offer a product that is sufficiently differentiated and complementary to this social offer. In particular, there should be distinction around what the different rented products offer consumers and how movement (in both directions) between the tenures could better be supported.

7.5 The CIH discussion paper *Future directions in intermediate renting* (April 2010) considers if it possible to develop more variation and flexibility in the forms of tenancies available and rents charged in order to develop a more fluid and dynamic affordable rented sector. This would allow for further developments whereby social tenancies change to offer a wider range of options.

7.6 The CIH would be happy to discuss in further detail any comments made within our response.

CIH contact: Joanne.kent-smith@cih.org tel: 024 7685 1715

CIH provides a wide range of services available to members, non-members, organisations, the housing sector and other sectors involved in the creation of communities. Many of our services are only available to CIH Members, including discounts. Our products and services include:

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PRS Investment Consultation
C/o Keith Jackson
Housing, Regeneration and Third Sector Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Your Ref:
Our Ref: MERO

28 April 2010

Dear Mr Jackson

Consultation Document: Investment in the UK private rented sector – February 2010

We write in response to the Government's invitation to comment on the specific questions raised in this Consultation Document.

CMS is a leading European provider of legal and tax services, with a particular focus on the property and fund industries. We represent the interests of some of our clients, whose businesses are involved in investing in the UK private rented sector.

We set out below our comments on specific questions of relevance to our clients:

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 commercial viable?*

We understand that larger developments would allow some economies of scale, as they do within the commercial sector. We also understand that scale economies would be important to some indirect funds, i.e. where the investment manager does not necessarily want to get involved in the day-to-day running of tenanted accommodation.

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?*

We understand that there is some interest in the private rental sector, but that only a few funds have been launched within this rental sector.

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Question 11: *What are the key barriers to investment in residential property through UK-REITs? What changes would be needed to address them?*

The close company rule would prevent small groups of investors taking advantage of any investments in REITs. We suggest consideration should be given to making amendments to the investment rules for REITs and also for distribution purposes.

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

The UK has several vehicles, which can be suitable vehicles for holding residential property investments. UK Property unit trusts (PUTs) are established and could be used to invest in private rented properties. However due to the corporation tax charged on the rental profits in the PUTs, the PUTs are not tax efficient for tax-exempt investors to invest in these vehicles.

The Property Authorised Investment Fund (PAIF) vehicle moves the point of taxation from the PAIF to the investor, with the result that investors face broadly the same tax treatment as they would have had they owned the property directly. A PAIF is therefore a tax-efficient open-ended vehicle for both taxable and tax-exempt investors in property, including the private rented sector.

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

PUTs and PAIFs are open-ended alternatives to REITs which are closed-ended. PUTs are not tax-efficient for tax-exempt investors, but PAIFs are suitable for both taxable and tax-exempt investors.

We would be pleased to be involved in any further consultation by Government on investment in the UK private rented sector. Please contact Melville Rodrigues in our London office, should you wish to discuss further or seek clarification on any of the above comments.

Yours sincerely

CMS Cameron McKenna LLP

CMS Cameron McKenna LLP

RESPONSE TO CONSULTATION ON INVESTMENT IN THE PRS

I am a small landlord, whose family holdings were hit by the rent restrictions prior to the 1988 Housing Act. I have worked in the sector for 25 years. I am a member of many of the landlords associations, and active in two of them. I am an accredited landlord with Manchester City Council.

The opinions here are my own, not those of a landlords association.

Role of the PRS in retention of housing stock, and increasing the number of dwellings by subdivision.

In considering the contribution that the PRS has made to the supply of housing, (para 1.7) it is important to include the contribution made by **renovation of properties** as well as that of new build. An increase in housing supply is the net effect of gains and losses. Without renovations, many properties in what were twilight areas would have been lost to the national housing stock.

There is a need for clarity in **definition of what is meant by 'housing'**. Is it a dwelling? Clearly a block of flats contains several dwellings. So does an HMO. How are these counted? What about the conversions of small terraced houses in, e.g., Fulham, where a single dwelling is now four, one in the basement, one each in the original ground and first floors and one between the chimney pots.

Many of these conversions increase the housing stock and are effected thanks to the PRS. They are not new build, yet they are very cost effective in providing extra accommodation in areas whose character has changed since they were built.

Government policies have an effect here. For instance the Prescott proposals to demolish run down but inherently gracious houses in Liverpool have been resisted. Some of these houses still remain. What are needed there are primarily jobs. Re-gentrification will follow.

Energy efficiency

I congratulate the writers for the factual approach in para 5.6. In a situation of housing shortage, policies and allowances which help to reduce the energy inefficiencies in the older stock are needed.

VAT differences between new build and renovations

Fiscal policy has an effect here, as new build and renovations are rated differently with respect to VAT.

Interaction of jobs, housing and infrastructure, with cost consequences

More jobs support the retention of housing in run-down areas. Conversely, a demand for extra housing is generated by regional imbalances in jobs. This ultimately generates greater pressure on infrastructure, for example water supply, so that new capacity is needed in buoyant regions, while capacity goes spare in the less affluent ones. This has a cost.

Return on investment in residential property

Until there is some improvement in the supply of housing, there will be a measure of dependence on small investors with small portfolios. As para 6.10 acknowledges, the rental yields do not reflect the underlying price of the asset. The report 'Can't Buy, Can Rent' sets out detail on this. The gap has previously been filled by the capital gain, now non-existent for recent purchasers, but still significant for those longer term investors.

Many small investors manage their own property, preferring to have a hands-on relationship with their tenants rather than pay a managing agent 15% of the rental income. Boy the owner/manager's work is not recognised as such by the tax system, which chooses to pretend that work done by others somehow evaporates when undertaken by the owner of a property. This is an unfair anomaly.

Subsidising council house rents - at what price?

It was recently announced that 50,000 new council houses are to be built. This is seen, almost by definition, as an unalloyed good thing.

But it saddles the country with a subsidy on the rent of each home, until that home is sold at a discount to the tenant, in other words at a loss to the taxpayer.

It remains to be seen where these houses are to be built, and whether a further subsidy is involved if the land they are built on is given, or sold at a discount, to keep the nominal cost of the new houses acceptable.

All this may well be in the public interest. The sale of council houses has stopped some areas sliding into becoming sink estates. But it is not a cost-free 'solution'.

Criticism of the outlier rents at the very top of those charged by the private sector has been exploited politically, leading to a downward pressure on all HB rents.

There is still a considerable gap between market and council rents. In parts of London a market rent is four times the subsidised rent. At the lower end of the rent spectrum, tenants who rent from the council are in a better position to move from benefits into work than those who pay the market rents (inevitably higher) charged by the private rented sector. These risk losing their home by starting work.

It seems to me that council house rents should rise over time to meet the market rent in their area, which I accept may fall in consequence. But the rent could not fall substantially below the true cost of providing accommodation, including repairs, maintenance, voids etc.

Equivalence of rents would remove part of the problem of fraud by those council tenants who sublet their subsidised home at the market rent, while having secured another council property to live in themselves. The government has just made this subletting a criminal offence.

There are many ways of tackling this gap between PRS and Council rents. Unaddressed, it both leaves the PRS open to criticism of exploiting the poor by charging 'Rackman' rents and pilloried for harbouring those unwilling to get a job.

At the NLA conference in 2009 I asked Julie Rugg whether the difference quoted in her report between the rents charged in the PRS and for council housing reflected profiteering by the PRS or subsidy by the state. She unhesitatingly replied that it was subsidy.

Are there any data available which show the amount of public money spent on

- Charging below the market rent on council houses
- Selling council houses at a discount
- Building council houses at a discount?

Should the Treasury review the imbalance here?

Question 2

The apparently laudable aspiration of preferentially using brownfield sites for development has been distorted by the definition of brownfield which includes all land within the curtilage of an existing building. This has resulted in a rash of inadequate developments of blocks of flats in areas previously occupied by houses with large gardens, a sort of rich man's studentification. Had these flats been larger, with more 3 bedroom ones, and with larger rooms, they might have filled a gap in accommodating the older people in the area who wanted to downsize. Instead, many have become white elephants, as they are in the wrong area to attract young professional couples for whom small 2bed flats are desirable. Of course, as soon as these occupiers start a family, the want a house with a garden. There is a need to rethink how the role of the planning officers needs to be improved, so that what is built in an area more nearly accords with what is needed and wanted, rather than what will generate the best short term profit for the developer.

Question 4

Over the last 10 years, the main challenge for small individual investors has been the 2004 Housing Act. Many of its provisions have been challenging to both landlords and local authorities. Some, such as licensing are good in principle, but have turned into a very expensive paper chase and tick box exercise, when scarce resources could have been better spent in rooting out the relatively few bad landlords rather than involving all landlords in a desktop exercise. Some have been ill-advised. For instance, the Tenancy Deposit requirements were adopted with an over reliance on a scheme in New South Wales, where the overall legal framework of landlord and tenant law is not comparable to ours in the UK. The result was rushed and muddled in its inception and is turning out to be expensive in practice. There is a need for GOOD protection of deposits, but this will not be achieved by a process akin to expecting a freshwater fish to live comfortably in seawater.

It is a shame that so much money and effort has been misdirected into tying the reasonable landlords in knots while allowing the real rogues to escape the net. Better schemes were needed.

There is scope for small investors to strengthen and retain older houses and communities if the demand for housing is strengthened by transfer of jobs from the south east to the regions.

Dr M M F Collier
Private Landlord

HM Treasury: Investment in the Private Rented Sector

Response from DTZ plc

Summary

This paper focuses on the urgent requirement that will face governments over the next decade of securing required levels of investment in new homes in the UK, and in the regeneration of major urban brownfield sites. Public finances will not support the same level of affordable housing provision as in the past. At the same time the supply of mortgage finance is likely to be more constrained in the next decade than in the decade to 2007, and more costly. This will limit the investment in new homes by home buyers and investors. The traditional models of financing the provision of new homes are substantially impaired, which will merely lower levels of new supply; leading on the one hand to worsening affordability in the home ownership market and even greater demand on a limited stock of affordable housing.

Government needs to unlock a substantial new source of private finance for housebuilding, if the housing requirements of the nation are to be met – just as in the late 1980s and 1990s huge sums of private investment was unlocked for investment in the social housing sector through mixed funding. The opportunity in this decade is to demonstrate how major financial institutions – the insurance companies and pension funds – can receive an predictable returns from investing in residential property that meet their investment criteria. To unlock this investment it is a priority to establish a demonstration programme that meshes the institutions as investors, landowners, asset managers, and planning authorities in a mutually beneficial system that delivers the nature of returns the institutions need. This initial focus of this demonstration programme should be in London, since this is the city with the largest PRS, the city location where affordability of home ownership is most constrained, and where work and lifestyle patterns are most conducive to growth of the PRS; and where perceived risks of investment are lowest.

To establish the demonstration programme the public sector has a key role. It can de-risk the initial investments by making land available, taking a long term interest itself in the financial performance of the investment. Government and planning authorities also need to accept that mid-market purpose built PRS homes are an intermediate form of housing tenure, housing the same sort of people who government has helped into intermediate forms of home ownership. There should therefore be no expectation that such purpose built developments provide affordable housing as defined by PPS3, provided that the units are to be retained as rented units for the longer term. Fiscal incentives also have a role to play in de-risking early stage investments and encouraging volume investment in purpose built new PRS homes.

Scope of Response

This document has been prepared by Christopher Cobbold, Head of the Housing Practice at DTZ Consulting, in consultation with Charles Whitworth and John Knowles of DTZ Corporate Finance. Mr Cobbold has been a member of the CLG's Housing Markets and Planning Analysis Panel for the past three years. Along with Charles Whitworth and John Knowles, Mr Cobbold has been working with the Homes and Communities Agency over the past year on the Private Rental Sector Initiative, engaging with institutional investors interested in investing in new build private rented housing, undertaking financial modelling and research into the market prospects for institutionally funded PRS housing development.

This document focuses specifically on why, in DTZ's view, the government needs to work with the institutions to create a new model for delivery of new, purpose built private rented homes to complement the dominant 'current trader' model of the private housebuilding industry in the UK. The paper sets out the challenge of the next decade in terms of providing homes for the growing number of households in the UK, the constraints on the growth of the owner occupied sector and the affordable housing sector as conventionally defined. The constraints on the growth of both owner occupation and social renting means that the Private Rented Sector has an increasingly important role in meeting the housing requirements of the nation.

The paper then goes on to set out the essential elements of the business model that would be needed to draw in significant institutional funding into building new private rented sector homes. This business model depends critically on a partnership between the public sector and the private sector to create the right land use and planning framework for this new form of development. If the investment model can be shown to deliver the right financial returns and be replicable in numerous locations residential property could become a significant investment asset class in its own right. The co-operation of the public and private sector is a pre-condition for unlocking substantial investment from institutional investors.

In terms of the questions posed in the Consultation Paper, this document addresses many of the issues posed by Questions 5-15 in the Consultation document, but particularly questions 15 and 10. We have not presented detailed market analysis to support our analysis of likely patterns of affordability and accessibility of home ownership in this paper, but have undertaken research on these topics that support the analysis set out in this document. DTZ would be happy to meet with HM Treasury to discuss this response and share our expertise. The key point of contact is Chris Cobbold, who can be contacted at chris.cobbold@dtz.com or on 020 3296 3000.

Tenure Trends 1990-2020

In brief let us review the major tenure trends of the past decade, and look forward to what is likely to happen to tenure trends and housing delivery over the decade to 2020.

As the Consultation Paper shows (Chart 3E) the proportion of home owners in the UK peaked in 2004. This marked the high point of a long four decade long growth in the proportion of households who own their home.

In the decade to 2007 the ratio between house prices and incomes deteriorated. The impact on the affordability of home ownership during the first part of this decade was offset by falling interest rates, which made borrowing cheaper; and then towards the latter part of the decade by increasingly lax lending conditions – with mortgage terms being extended beyond the conventional 25 year term, high loan to value ratios, availability of interest only and self-certified mortgages. Even with cheap credit and easy terms the fall in home ownership rates from 2004 showed that incomes and house prices had diverged so far that increasing numbers of households, who it times past might have been able to become owners, could not do so.

Since the downturn, affordability, measured in terms of the relationship between incomes and house prices, has improved somewhat as a consequence of the fall in house values (which house price indices imperfectly capture, since they are a record only of what is transacted, and what is being transacted in the current market is not representative of a 'normal' market); and for many of those with tracker mortgages there has been a windfall in terms of reduced mortgage costs. But for new market entrants home ownership has become less accessible, with substantially increased deposit requirements, and reduced availability of funds for lending and much reduced competition in the market, allowing mortgage lenders to be more selective in terms of those households to which they lend.

The consequence has been that the numbers of first time buyers has fallen significantly in the last two years; those that have been able to buy have relied to much greater extent on inter-generational transfers of wealth to fund deposits (the 'bank of mum and dad'); a continuation in the trend that sees the average age of first time buyers increasing. The corollary of these trends, will have been (though statistics have yet fully to pick this up) an increase in the number of private rented tenants, and an increase in the numbers of young people continuing to live in the parental home, and therefore some suppression in the rates of hew household formation.

The question for the UK Government as it contemplates housing policy for the next decade is will the trends of the last 3-5 years be reversed, returning to something approximating the pattern of tenure change in the decade to 2007? In DTZ's view it is inconceivable that in the wake of a global financial crisis, the roots of which lie at least in part in the residential sector, a deep recession and the new environment for public expenditure, that the financial markets that underpin the housing market and the residential development sector will return exactly as they were before the crisis.

DTZ's scenarios for the housing market anticipate:

- A slow growth in mortgage volumes over the next 3 years, but with no return to the easy access to credit of the 5 years to 2007. The wholesale finance market which funded much of the expansion of mortgage lending is still largely frozen; if mortgage lending is tied to lending against retail deposits then mortgage volumes could be constrained by historic standards for some considerable period of time. However the re-emergence of house price inflation (see below) could unlock international wholesale funding for UK mortgage lending.
- Accessibility to mortgages will remain difficult compared to the decade to 2007 for first time buyers. With constrained funds for mortgage lending, and more cautious lending policies, mortgage lenders will continue to favour lending to those with substantial equity; and those able to put up substantial deposits. The market may, however, see some innovation: for example with new lenders willing to take equity shares in housing to take advantage of long term UK house price inflation. Such innovation will probably be tightly targeted at particular groups in particular areas.
- Over time bank rate will rise from its current very low levels. This will tend to push up mortgage lending rates. The impact on first time buyers may be muted, since they already face relatively high borrowing rates, and when combined with a modest rise in lending volumes it may be that an element of competition for new borrowers creeps back into the market. Tighter regulation of mortgage lending as outlined in the FSA Consultation Paper will however restrain any return to easy lending criteria – not that such a return is likely even without regulation.

Issues around the accessibility to mortgage finance will continue therefore to constrain access to home ownership. However DTZ expect real house price inflation to reassert itself in the course of the next decade driven by shortage of supply (see Appendix 1, DTZ's Residential House Price Scenarios 2010-2020. The shortage of supply comes from our expectation that housebuilding levels in the decade to 2010 associated with traditional methods of delivery (the housebuilder model and the housing association model) will not reach the levels of 2006-07. Supply shortages over time are also building up because of increased longevity of home owners mean that stock is not getting recycled through the market.

In view of these trends DTZ anticipate affordability problems, and difficulties accessing mortgage finance associated with deposit requirements will continue to be a significant barrier to entry of households to home ownership in the next decade.

Where will households who cannot access home ownership live? The affordable housing sector (comprising social rented housing and shared ownership/shared equity homes) has faced considerable pressure of demand for many years. With higher unemployment anticipated to persist for many years it will continue to be under pressure.

Additions to the stock of affordable housing have in the past depended heavily on public funding in the form of grant aid. We expect any government to seek to deliver more homes with less public funding. This will be tough to achieve, though more extensive use of publicly owned land for building of affordable housing, and borrowing against the asset base of local authority and housing association homes will help to maintain volumes. There is likely to be less cross subsidy for affordable housing from private development because of higher borrowing costs, higher build costs associated with the Code for Sustainable Homes, and lower overall levels of new private house building.

Any government will do very well if it is able to maintain the output of affordable homes and a decline in the annual output of new affordable homes is a more likely outcome.

The logical outcome of constraint on access to home ownership and affordable housing, the former due to constraint on the ability to borrow linked to affordability issues, the latter due to excess demand from low income households, is that the private rented sector has to grow. Can the PRS grow and will it?

DTZ is confident that the PRS will grow of its own accord, but it will do so primarily through existing housing being brought into the PRS. There is sufficient equity in the existing PRS for investors with mature portfolios to borrow to invest if the financial incentives are right. DTZ believe the prospects for rental growth due to lack of alternative options for middle income households are good. Moreover the long term prospects for capital growth are positive due to demographic pressure and constrained new supply. This two factors will mean that investment funds will flow into the PRS, largely through small scale professional or part time landlords.

Critically, however from a public policy perspective, this investment model will do nothing to add to overall housing supply. Hence this will do not help address long term affordability issues. Nor will it help bring forward brownfield urban regeneration sites. Individuals, professional landlords and lenders will not easily forget the scale of losses made on buying new build flats in major urban developments in the last two years. Thus, outside of London and the South East, the model for major residential developments in urban areas of building dense flatted developments, where pre-sales to investors was a precondition of bank finance is no longer functional: for the developers, the banks and the investors, the perceived risks of such development are too high.

Another issue for policy maker is that investment by small scale professional and part time landlords in existing housing is that this could lead to particular neighbourhoods being dominated by private renting. This is not necessarily a problem, but in some areas may create localised difficulties. Another issue is that reduced supply of affordable housing, and growth in the PRS, combined with increasing demand from low income households may mean a growth in the overall Housing Benefit bill as more low income households are housed in the PRS, and demand for renting grows. With limited new supply of housing coming forward rents will tend to be driven upwards.

Why the Government Needs to Unlock Institutional Funding for the New Build Private Rented Sector Homes

The UK Government needs to take action to unlock institutional funding for the PRS because there will be insufficient public sector funds to support the expansion of the affordable housing sector as conventionally defined to accommodate all those who are unable in the next decade to become home owners. At the same time major regeneration sites in Britain's cities will not be developed because the current funding model for large scale residential development on brownfield sites is broken. The existing business models for development of new housing, namely the output of the housebuilding sector and of housing associations, will not generate sufficient new homes to offset worsening affordability problems.

Thus there is a need for a significant new source of investment for new build development sector in the UK residential sector. For many years there has been talk of the major UK pension funds and insurance companies investing in the rented property in the UK, with a view to establishing residential property as an investment asset class in the UK. The work undertaken by DTZ on behalf of the HCA has established that there is the appetite among a number of major institutions to invest in the residential sector. While there are various routes by which they can invest indirectly in existing residential assets, the business model that will deliver the required level of returns on new build development has yet to be proven.

DTZ has undertaken financial modelling for new build private rented development in London, that would deliver a gross income return of 8%. Our assumptions has been that these would be retained as long term rented properties, so the capital value at the end of a 10 year appraisal period is based on the value of the stabilised revenue stream, rather than the break up value of the units were they to be sold out for owner occupation. This is consistent with the overall aim of seeking to establish residential rented property as a tradeable asset class – rather than an investment opportunity of fixed duration where the bulk of the return is delivered by break up and trading at vacant possession value.

The conclusions of our modelling are that, the business model for new build institutionally funded residential development has a number of key components, if it is to deliver the required financial returns. The starting point for defining the model is that the market will determine the level of rent passing for the rented property. If rents are determined by the market, securing the target income return then depends critically on the acquisition cost, and the relationship between gross rents and net rents, which reflects management, maintenance and void allowances.

- An effective way of driving down management, maintenance and void allowances is for the institutions to investing in the development of purpose built blocks of rented housing. A block of 50-100 units of rented accommodation can be managed and maintained much more cost effectively than a portfolio of 50-100 individual properties. There is also the scope for selling services to tenants as an additional income stream.
- The need to drive down acquisition costs also points to a business model where institutions invest in the development of purpose built blocks of rented housing, where standard designs are used, and possibly modern methods of construction are applied. Volume construction of standardised blocks is likely to reduce unit costs of construction significantly and reduce finance costs.

However the modelling that DTZ has undertaken would suggest that this model of development on its own does not deliver schemes that are viable in London, because of prevailing land costs which are determined by traditional housebuilder-developer model of building for owner occupation and individual investor sale; and the development costs imposed on residential development through the land use planning system in terms of affordable housing obligations and other Section 106, Community Infrastructure Levy or Tariff charges.

If the government is to unlock significant institutional funding for new build rented housing it has to address two fundamental issues that would transform the financial viability of such investment.

- It must find a mechanism for releasing land at a current value below that set by the demand for private residential for sale; either by wise use of its own land or creation of a separate use class for long term private rented housing developments.
- It must recognise that private rented housing is an 'intermediate' housing tenure and that there should be no requirement that new affordable housing (as defined in PPS3) should be provided in conjunction with new purpose built PRS homes for long term renting.

DTZ's recommendation to Government regarding the issue of land value for purpose built PRS stock is that it needs to use land assets in public ownership to help demonstrate that the institutionally funded model works. This is not about the public sector giving away land, or selling at discounted value. DTZ recommend an investment approach whereby the public sector retains a long term interest in the land, and stands to share long term returns with the investor, be those associated with rental value growth or in the longer term capital receipts. Our view is that seeking to introduce a new use class would be time consuming and meet with much opposition from private landowners. With the scale of public landownership there is no need to now to pursue the difficult option.

DTZ second recommendation is that planning authorities need to recognise two aspects of purpose built new PRS housing. First that it is not viable for purpose built PRS housing to cross subsidise 'affordable housing'. But more fundamentally recognition should be given to the fact that this form of housing is a form of intermediate housing. DTZ's analysis of the demographic of mainstream private renters in terms of age and income is almost identical to that of the buyers of government subsidised shared ownership or shared equity schemes. Yet under our current planning regime, intermediate housing for sale is defined as 'affordable housing' in planning terms, but property built for long term private renting is not.

It is recognised that purpose built new PRS housing cannot be granted total exemption from affordable housing contributions. There must be some expectations about the duration for which the property is being rented; that it is providing mid-market private rented accommodation (not top end rented accommodation); and that there is some mechanism for securing appropriate contributions if the development is broken up for sale before the expiry of a certain defined period of letting.

DTZ are of the view that the government role as landowner and in shaping land use planning policies are fundamental in terms of establishing a development model that works for the major investing institutions. Fiscal incentives may also have a role to play in incentivising early investment and in encouraging investment at scale. DTZ doubt that fiscal incentives alone are enough to establish the business model for investment in purpose built new build PRS housing. From a public policy perspective there is also the issue that the PRS has grown without such incentives over the past decade. There is a particular public interest in encouraging new build development for the PRS and using this as a tool to support regeneration objectives. In a difficult fiscal environment there is a particularly strong case for targeting fiscal incentives on that element of the PRS which delivers these added benefits.

As a footnote to these conclusions it is worth commenting why it is appropriate, in effect, for government to use its land for development for a use that could well deliver a lower land value than suggested by an open market sale. The simple fact is that land for housing development is in short supply. Thus, collectively land owners stand to benefit from shortages of new housing supply. Over the long term shortages of new housing will drive up the price of homes above what they would have been had there been a larger supply. Patient investors can therefore expect to reap 'monopoly' profits. However, this produces sub-optimal outcomes for the nation as a whole, transferring wealth from home buyers (especially new market entrants) to landowners, and from the public sector to the private landlords, because as prices are driven up by shortage of supply, so rents are driven up, which push up the costs of Housing Benefit.

Precedents for Establishing New Development and Funding Models

There are two precedents that are informative of how significant sources of private sector funding have been unlocked for residential development.

The first precedent is the initiative in the 1980s to introduce private finance into the housing association sector. Between 1988 and 2008 some £50bn of private finance has been raised by housing associations for development and improvement by mixed funded housing associations and stock transfer associations. Mixed funded transformed investment patterns in the social rented and intermediate housing sector – but it needed government backing to make it happen. In similar vein the government has a key part to play in unlocking investment in new build private renting by creating the right operating environment in which a business model can take root and flourish.

The second precedent is the development of student residential accommodation. This has developed without formal public sector support, but has often involved HE Institutions in providing land, and, particularly in the early years, providing in effect guaranteed occupancy and hence elimination of a significant part of the letting risks. This de-risking of the investment in the early years of the development of the business model was important to encouraging early stage investment by the private sector. The business model has also used standardised design and procurement to drive down build costs, a model of relevance to the new build PRS market. Once the nature of the investment returns became predictable the sector has attracted significant private sector investment. In many respects the investment does not have to be regarded as residential investment; it has similarities to investments in other assets that produce a stable and predictable income stream.

Christopher Cobbold
Head of Housing Practice, DTZ Consulting
125 Old Broad Street, London, EC2N 2BQ

FastTrak

PRS investment consultation
C/o Keith Jackson
Housing Regeneration & Third Sector Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Wednesday 28th April 2010

Dear Mr Jackson,

I am writing to you in response to your department's consultation "Investment in the UK private rented sector".

Introduction: Fast Trak Solutions

Fast Trak Solutions is a new organisation that works to break down the barriers welfare claimants face when trying to find decent quality housing in the private rented sector (PRS).

Housing support claimants renting in the PRS have long faced a series of entrenched problems. Even before the current system of Housing Benefit (the Local Housing Allowance) in was introduced in April 2008, social tenants faced issues with landlord stigma regarding their ability to meet rent payments. At the same time, local authorities have often been the cause of a delay in rent payments and, for any number of reasons, suspend or cease benefits payments to social tenants during the tenancy. Justifiable or not, this provides no security to private landlords that rent payments will be made regularly and on time. The result of this situation is that the majority of private landlords are simply unwilling to consider LHA claimants for tenancy agreements, leaving them no other option than to fall back on social housing, exacerbating the current shortage of property in this sector.

Fast Trak Solutions is a company with a strong sense of social responsibility and vision of how the private rented sector can be used to provide accommodation quickly and effectively for some of the UK's low-income and vulnerable households. We have developed a comprehensive solution to the issues highlighted above. Fast Trak guarantees private landlords that the tenant will have the available funds to meet rent payments. It also includes an ongoing rent guarantee, providing landlords the assurance that rent payments will be made regardless of either a tenant defaulting on a payment or a local authority suspending the benefit and insures the landlord against the tenant causing damage to the property. This gives the reassurance necessary for landlords to grant tenancy agreements to social tenants. For the tenant, the scheme substantially reduces the large upfront costs that he or she must pay; even to rent in the private rented sector via LHA (dilapidations deposit, first month's rent and administration fees). On average, these costs usually amount to some £1700. In London, the average is approximately £2500. Fast Trak reduces these costs to just £450.

Our response to this consultation is a reflection of a wider mission that stretches beyond any narrow commercial concern. We believe that the debate around housing policy in Westminster does not give the private rented sector sufficient attention when discussing how the Government fulfils its duty of care to some of the UK's most vulnerable households and that with greater recognition of landlord engagement models such as Fast Trak Solutions, the PRS has the potential to help find some of the UK's poorest households accommodation in the mainstream of the market.

A more detailed explanation of the Fast Trak Solutions model can be found in Appendix A.

Our response to the consultation

Fast Trak Solutions has a wealth of experience and knowledge in dealing with housing tenants reliant on Housing Benefit in the PRS. Most importantly our innovative work in bringing together social tenants and private landlords in the PRS (who have traditionally repelled each other) means that we are uniquely placed in our ability to understand the two opposing views of one of the most important problems facing the PRS.

Fast Trak Solutions would like to make a number of general comments that we hope might help inform the Treasury's work in this area before making a small number of specific observations directly related to the questions in the consultation.

General comments

Housing Regeneration & Third Sector Team will no doubt be well versed in the problems related to social housing in the UK; while many people benefitted from the housing boom of 1990s and early 2000s social housing organisations have seen a massive growth in demand for housing services throughout that period. By 2007/08, 4 million people were waiting to be allocated social housing and that number has increased in the current recession. At the same time, the Government has struggled to meet its own social housing building targets. Current policy is not only failing to provide homes to those already on the waiting lists, but it is also failing to provide homes for new demand. Building new houses is a resource intensive measure. The recent Building Britain's Future announced £1.5 billion of funding to build just 20,000 new affordable homes over two years, at a time when 1.8 million households need accommodation. With widespread anticipation that future governments, whatever their hue, will have to significantly cut public spending in order to close the current budget deficit it is extremely unlikely that this funding will be forthcoming at any point in the near future.

As shown by your department's publication of this particular consultation document, the collapse of easily accessible mortgage finance has meant that people are now turning to the

PRS to meet their housing needs. We believe that the Government should also take the opportunity to look for new ways to engage with that sector to help find accommodation for those people currently waiting for social housing. We believe that the Fast Trak Solutions' model is a live example of how it could overcome the long-term problems that exist to make that market viable for those people. Our company is a practical, working example of why the Government should be looking to the PRS to help those people with little or no chance of finding social housing in the near future find decent, good quality accommodation quickly and easily in the sector.

It is because of our belief in the potential of the PRS to provide homes for some of the UK's poorest households that we warmly welcome the stated policy aim of seeking to ensure a strong supply-side response to the UK's economic recovery that includes the PRS (1.18; p.5). Making the PRS a more attractive investment opportunity for large scale institutional investors will mean a greater supply of accommodation that delivers benefits to all tenants both in terms of cost and choice. For those tenants in receipt of housing support, the increased supply should result in a reduced cost to the public purse, as the price of rents fall.

Specific comments
There are two specific points that Fast Trak Solutions would like to address in our response.

- **Stamp Duty Land Tax (SDLT).** We support notion that bulk purchasing rules currently act as a disincentive to the building up of property portfolios. Fast Trak Solutions works closely its network of letting agents around the country to help understand their and their clients' concerns and many of our management team were formerly estate agents. In our experience, the treatment of simultaneous purchases of multiple properties as though they were a single more expensive property for SDLT purposes is a clear deterrent for those organisations with a clear investment strategy for sector. To avoid larger SDLT payments, investors are forced to make a series of individual purchases. This leads to a loss of potential efficiencies resulting from larger, one-off purchases of portfolios of properties with a single source of finance. We believe that by changing the current rules to avoid this scenario, the Government could generate more revenue in the long run (as greater numbers of organisations purchase larger quantities of properties) whilst achieving its overarching objective of encouraging greater investment.

- **Investment yields.** For any landlord, large or small, void periods are one of the most concerning hazards of letting property. Like any business pursuing an investment, those organisations who have a potential interest in being an institutional investor in the PRS will naturally seek to maximise their return whilst seeking to minimise the risks that their business model faces. Recent research has suggested that void periods cost UK landlords £3.7 billion each year[1], an average of £1,444 per property - this is a substantial amount of which would be of concern to any potential investor.

In seeking to minimise this risk and promote the potential of the PRS to investors, the Government should recognise how it could do so whilst using the sector to greater effect to house those families currently waiting for social housing that we have highlighted above. The Rugg Review found that 34 per cent of private tenants in receipt of HB had stayed in their tenancy for five or more years, whereas the equivalent figure for non-housing benefit tenants was just 14 per cent[2]. For Fast Trak Solutions, this figure supports its own experience on the ground of housing tenants in receipt of HB; once the initial barriers relating to housing those people are overcome, they provide landlords with a stable and constant source of rental income. It is this kind of stability and certainty of return that will make property investment in the sector more attractive if approached in the right manner. By recognising the existence of and then tackling the long-term barriers that discourage landlords from letting their property to HB claimants, the Government could reduce the risks that institutional investors face from void periods, increasing the likelihood of them being able to maximise their return and so encourage investment. We believe that greater recognition and support of landlord engagement and guarantee models amongst local authorities such as (but not exclusively) Fast Trak Solutions would be one way of achieving this.

Conclusion

I hope that this short submission is helpful to your team's work on investment in the PRS. Fast Trak Solutions takes pride its position as a pioneering organisation is at the cutting edge of welfare and housing policy development. As we have stated, our scheme is an innovative mechanism based on a radical vision of how the capacity of the private rented sector should be harnessed more effectively to help find accommodation for Britain's low-income households and we are keen to ensure that policymakers recognise the role it can play in making the PRS more attractive to institutional investors.

Kind regards

Damon Thomas
Managing Director
Fast Trak Solutions

[1] According to uPad.co.uk, April 2010. See http://www.simplelandlordsinsurance.com/news/article/00373/landlords-to-receive-void-period-advice.aspx

[2] P. 20 The Rugg Review

Appendix A

Fast Trak Solutions

The Fast Trak Solutions model provides an innovative public policy solution to all the above-mentioned problems by providing a streamlined LHA application process that moves households off social housing waiting lists, takes advantage of the available supply in private rented sector and addresses landlord concerns around the suitability of potential tenants. This solution works as follows:

1. Prospective tenants are directed to Fast Trak Solutions through recommendation and referral from local authorities and local private property rental agencies or direct contact.
2. Trained staff collect individual applicants' data in order to provide a pre-assessment of the individuals or family's entitlement to LHA. Fast Trak Solutions staff advise on the relevant paperwork and information required.
3. In addition to the pre-assessment, a tailored referencing process is undertaken to establish the applicant's credit history, including previous landlord references as well as fraud and money laundering checks.
4. On completion of this process, if approved, the prospective tenant will receive an Agreement in Principle (AIP) document that contains information on the total rent approved.
5. The issuing of the AIP is a guarantee to the tenant for the rent figures quoted. This rental value is, in turn, guaranteed by way of and insurance backed rent warranty that assures the private landlord of the tenants' ability to pay.
6. In addition, should the tenant so wish, an additional insurance policy can be taken out that insures the private landlord to the value of one month's rent against any dilapidations that may occur during their tenure. This avoids the tenant having to find deposit one month's rent.
7. The tenant now armed with the AIP, approaches landlords or the landlord's agents who recognise the scheme. The recognition of the Fast Trak scheme allows the tenancy agreement to be drawn up as soon as the Tenant has found suitable property and no further referencing is required.
8. The pre-assessment data and other information is then collated with the tenancy agreement and submitted to the Local Authority for priority processing

This process can be completed rapidly, and Fast Trak Solutions'' pilot projects are already proving Fast Trak has the ability to house social tenants in a matter of days, rather than the years they may wait on social housing lists.

The advantages of Fast Trak for…

The Tenant. The tenant is at the heart of the Fast Trak solution. The scheme allows those tenants on housing waiting lists, with no realistic chance of receiving a tenancy before being listed as in emergency need, the opportunity to find a home quickly and efficiently. Moreover, Fast Trak complements the original spirit of LHA, by placing an emphasis on the individual to find a suitable property and to gain maximum benefit from their LHA entitlement. The Fast Trak system helps the tenant get into new property before the situation becomes an emergency and assists the tenant in an orderly and timely application for LHA. The scheme provides a low cost alternative to the high costs normally associated with renting in the PRS, reducing the average cost of dilapidations deposit, first month's rent and administration fees from £1500 (£2500 in London) to just £400.

Local Authorities. Local authorities are simply inundated with social housing requests. Costs are rising sharply as the numbers increase and the ability to deal with applicants in a timely manner is being curtailed. Fast Trak speeds up the application process and helps to reduce costs, assisting the local authority both in the delivery of value for money services and in the execution of their responsibilities in this area.

Landlords. In a difficult market, Fast Trak delivers a readymade and substantial source of new, credit worthy tenants to private landlords. The scheme gives assurances on the suitability of potential tenants and provides the guarantee that rent payments will be made in full, providing the financial security necessary to incentivise attitude change amongst private landlords to accepting social tenants.

Letting Agents. In the current market conditions, many property agents are surviving on their letting business. Competitive pressures are mounting. Fast Trak provides letting agents with increased market opportunity within his area that will enhance existing businesses.

Response to HM Treasury Paper on the private rented sector
From First Base Limited
Released: 28 April 2010
Response date: 28 April 2010

	Question	Answer
1	What has led to individuals in new-build properties in preference to purchasing and converting existing owner-occupied housing?	• Not convinced the statistics are right. It may be that many individuals buy a dwelling, then move out and rent it whilst buying another. They do not declare this to their mortgage company. So believe more 2nd hand homes may be rented than the statistics indicate. • However in relation to the question the points to raise are: ○ Comparative ease of purchase of newbuild properties (professional experienced vendor), simplicity and ease of purchase, relative ease of mortgage compared to 2nd hand homes where there is much greater variability ○ Can buy without seeing the property ○ More certain outgoings, certain ou8tgoings in earlier years ○ Avoids bother of buying and renovating a 2nd hand property ○ May be easier to rent (consistent high quality)
2	To what extent has the growth of the PRS already influenced the house building industry? How might it do so in the future?	• Little influence in the UK • In the future may be more – see the US examples where more recently, an increasing proportion of apartment schemes are built by developers to pre-sell to the rental funds/ REIT's. Some of these funds are specific about the product they require which has resulted in developers creating bespoke schemes for the rental funds. There is none of this tailoring in the UK yet. • In the US, some REITS are now large and develop themselves. Others

		deliver through JV's with developers, where the REIT may have a stake in the developer.
3	What is the contribution of the individual homeowners renting out part of their own home making to housing supply? Are there significant constraints limiting this contribution to addressing housing demand?	• Renting part of a home helps to satisfy housing demand but does not directly help deliver new supply. • Scope to increase the use of this aspect if the tax free limits could be increased
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 keys prospects and risks for individual investment in the PRS?	• Individuals can 'create' value from the remortgage of their own home and invest this into a new property tax free • Individuals can use their 1st property tax free allowance to generate tax free capital gains (if they can be bothered to move from house to house) • The fact that value appreciation is not taxed is an important driver for individuals in this sector • Many invest as a form of pension • Relative poor performance of pensions in recent years and the relative good performance of housing has driven individuals to invest in the sector • However, we would advocate REIT's as the next rational step in the move towards a more sustainable housing market. • REIT's will need to develop to grow. However it's chicken and egg. For a REIT to become established it needs critical mass, and there are not the big schemes for sale on a 100% basis to investment vehicles.
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 commercial viable?	• Minimum lot size is critical to a properly functioning market • For institutions, residential competed with other asset classes which are transacted in relatively large lot sizes and a standardised product. • A minimum building size would be c£50m+ and 200 homes. • Management efficiencies and management effectiveness become greater in schemes of greater than 200 homes • Conversely institutions are less likely to buy 2nd hand stock as it is likely to become available in the lot sizes suggested above.
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	• None that we are aware of. However removal of SDLT from the first sale when a bulk purchase is contemplated, say 100 homes per purchase,

	residential properties would lead to increased investment, either by institutions or individuals, in the private rented sector?	would be a positive move
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?	• Reducing the transaction costs to stimulate investment to the sector may help build a more competitive sector more quickly than would be otherwise possible • Institutions can use Jersey PUT's to avoid SDLT inefficiencies • Removal or lower SDLT would help to narrow the 'value gap' between the value of open market for sale homes against open market rent homes and hence stimulate investment in the sector
8	How do the rates of return on investment in the PRS compare to those expected/required by institutional investors?	• Useful to look to the US where REITs have been established over the last 25 years and there is good market evidence of gross and net yields from residential • In the US, institutions see residential rental assets as being lower risk than retail or commercial investments • When the property market was improving, rental yields on residential were c4-5% net. Now that the property market has fallen, rental yields have improved to c6-8% net. 6-8% net is a more attractive proposition for an institution, whereas a 4% yield will be less competitive when compared against other investments (commercial and retail) • Developers need a c2% headroom on their schemes to account for development and letting risk, whereas let investments trade at a 2% better (ie lower) yield than development opportunities. • It is important to understand that Institutions are unwilling to take development risk so they need to rely on developers to take development risk • The issue with the UK market is most developers see that by the time planning and development risk has been managed; there is a good opportunity to make a reasonable profit from direct sales, rather than selling to an institution. • A market needs to be developed where developers build and pre-sell to institutions, if supply to institutions is to be encouraged.
9	What factors have prompted the recent institutional interest in investing in the PRS, and	• Factors that have prompted the recent institutional interest in investing in

	do these reflect a long-term change in investment opinion?	the PRS are: Lower open market values, better yields on investment, opportunity to get in at the bottom of the market, cheap build costs; policy requirement of government. None of these factors are long term and enduring. To ensure that the benefits could be enduring, other changes need to be made. Our suggestions are: 91) removal of SDLT for bulk purchase of more than 100 units, and no requirement fop affordable housing to be delivered in a build-to-let private rented scheme (so long as scheme is private for rent for at least 25 years).
10	What are the key barriers to future 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?	● The availability of developers to deliver specifically for institutions to buy – this can be addressed by some shorter term incentives it encourage development in the area. Could use the old area based tax relief's that were used in the days of LDDC – can also stimulate regeneration in certain areas without significant displacement? ● The risk that as the residential market returns, developers will make higher margins from developing and selling on the open market rather than developing and selling to institutions
11	What are the key barriers to investment in residential property through UK-REITs, and what changes would be needed to address them?	● All the successful UK REITs have to date been created from existing organisations with an investment portfolio. There are currently very few substantial UK residential rental businesses with large investment portfolios. Until such entities form, the application of REITs in this sector will be limited. To address this 'gap', entities need to be encouraged to form that can create these investment assets, which institutions will buy, and in due course, once the asset portfolio is large enough, the institution can convert its holding into a REIT.
12	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?	● We need to encourage developing organisations to build for rent buy providing specific incentives – eg holiday on capital gains where the development is transferred to a long-term investor.
13	How suitable are other collective investment vehicles for residential property investment? What are the current barriers to investment through these vehicles?	● Not our area of knowledge
14	How do these collective investment vehicles compare to UK-REITs?	● Not our area of knowledge
15	What evidence is there that institutional investment in the PRS would bring real benefits to the sector, and the housing market more generally?	● Analysis of the housing market concludes that there is an ongoing and growing shortfall between supply and demand in the housing market

		• There need to be more players in the UK housing market to step-up demand • There is concern that the housebuilder model only has a certain capacity to deliver in the UK • In the US, over the last 20 years, a REIT model has developed which allows individuals to invest directly in the asset class, • The REIT model in the US has helped to generate a specialist developer that delivers homes for the REIT and takes the development risk • There is the opportunity for institutional investment in the sector to create a source of development demand which will help speed up the pace of newbuild development in the UK, and so help supply move towards meeting demand. •

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grainger plc

Investment in the UK private rented sector

A response to the HM Treasury consultation document issued in February 2010

April 2010

Introduction

Grainger fully welcomes this consultation. Grainger has been involved in promoting the prospects for the private rented sector (PRS) in the UK for many years now.

This consultation demonstrates that the sector is beginning to gain the attention that we believe it deserves, and we hope that the consultation leads to clear and direct action by the UK government to increase the prospect for investment in the PRS.

Grainger = residential

Grainger is the UK's largest specialist residential property owner traded on the London Stock Exchange. Grainger holds a unique position in the UK residential market; that of being an owner, property manager, trader, asset and fund manager. As a result, few people understand the complexities and opportunities of residential property as well as Grainger.

Grainger owns, acquires and trades regulated and market-let tenanted properties and has a substantial portfolio of home reversion properties. Grainger also undertakes fund, property, and asset management and is active in residential-led development. Grainger's operations benefit from a size and scale which provides greater access to acquisition opportunities.

Grainger is involved in the residential market from „cradle to grave'. Our business is involved in the full life cycle of an individual's experience with accommodation from when they are young tenants, to when they can purchase their own house, through to when they wish to either release equity from their house or move into retirement living.

Grainger's success is built upon taking the lessons learned over time in one part of Grainger and applying them to another. For example, the experience and expertise gained from the property management activities in the rental market and sales and acquisition activities in the core business offer insight into developing properties which meet the needs of potential tenants and buyers.

We are organised into six divisions:

- Regulated and assured tenancies (our „core' portfolio)
- Retirement solutions (home reversions)
- Fund management
- Property services
- Development
- Germany

Regulated and assured tenancies

Our core business owns, manages and trades UK residential properties in an irreplaceable and unique portfolio, centred on regulated tenancies and comprising mostly low-value, geographically diversified properties assembled over a long period of time. These bring stable rental income and sales proceeds whilst retaining value through short-term fluctuations in the market.

Retirement Solutions

Grainger is an industry leader in home reversion plans having established a 31% market share. Our Bridgewater Equity Release brand was voted “Best Home Reversion Provider 2009” at the Equity Release Awards – the fourth consecutive year that we have won this award.

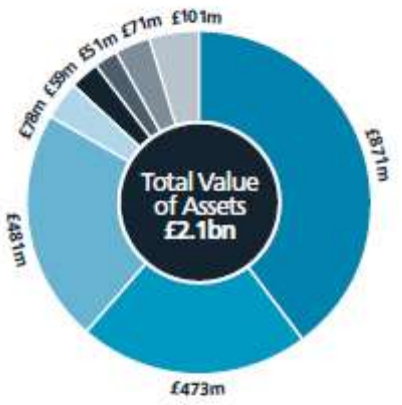
Our business has grown significantly and we expect this to continue as the market evolves with more people seeking to release cash to supplement their pensions, improve their lifestyles or realise their dreams.

Fund management

Grainger is an expert in the management of residential investment funds which generate income from management and performance fees. We manage and are co-investors in G:res1, ResPUT and manage GenInvest, a joint venture with Genesis Housing Association. We currently manage funds holding approximately 3,975 properties in the UK valued at £696m.

Property services

We have an ability to operate throughout the UK, the size and scale of the property services and fund management businesses within Grainger is crucial to the company’s ability to realise the benefits of both acquisitions and expansion of assets. In total, we managed 17,470 units as at 30 September 2009.



As at 30 September 2009

Wholly owned	No. of units
● Regulated	6,327
● German portfolio	7,180
● Home reversion	6,101
● Assured	495
● Other	50
● Vacant	286
● Development	–
● JV/associates	–
Total	**20,439**

Development

Grainger’s development focus is on residential-led, mixed use sites where we can work with local authorities and communities, joint venture partners and other stakeholders to add significant value. We take a long term interest in the communities that we create and have the perspective of an investor rather than a developer/trader.

Germany

In addition, Grainger is an international business, with a large portfolio of residential units in Germany. Grainger’s German portfolio, which is now composed of over 7,000 units, reached critical mass with the 2008 acquisition of FRM. Allied to the scale of our German property manager, Gebau, which manages about 20,000 properties, it is now able to benefit from economies of scale in the development of new business opportunities as well as areas such as repair, maintenance, expenditure and procurement.

Grainger in the PRS

Grainger has been operating within the private rented sector (PRS) for nearly one hundred years and with that experience we believe we understand the sector very well. We would like to see greater policy support for the sector, which would likely increase our competition, but also increase the scope of the sector and provide more opportunities. Such support will assist the PRS in helping to deliver the wider housing objectives of government. However, whilst seeking support for the sector, we recognise that the current fiscal deficit means that such support will have to be managed in a broadly tax neutral or revenue raising manner.

Long term and compliant

Grainger is a long term investor in residential property with our focus on providing good value to both our tenants and our shareholders through our assets. An additional benefit that we believe we provide to the PRS is that our business is compliant with FSA regulations, planning regulations, building regulations and property management regulations. Increasing the number of homes provided by large institutional investors, like ourselves, would increase the professionalism, transparency and regulation of the sector.

Low income return model, supplemented by capital growth

Residential investment faces a big challenge: a model with low rental income and yields compared to other peer asset investment classes. The lack of a tenable income-only based residential investment model requires that returns are supplemented through trading. Grainger, to both optimise portfolios' assets and to take advantage of growth in capital values, regularly trades properties within its portfolios to increase returns to levels expected by our investors. This „churn' of properties is also required to service our financing costs.

Over the years we have learned how to balance the needs of both our investors and our tenants, ensuring we have a successful business model. One of the main lessons we have learned is that residential investment can work much better when various aspects of the business can be brought together and synergies found and exploited.

Customer focused and investor minded

Our experience has proved that returns as well as tenant satisfaction in residential investment can be improved by bringing all the various parts of the business together. For example, the investment managers – responsible for securing returns for their investors – work alongside our property managers – responsible for maintaining the properties and ensuring tenant satisfaction. Property managers now see their part of the business as contributing value to the asset and securing rental income for our portfolios, while the investment managers understand the importance of tenants' satisfaction and how they can benefit from taking good care of their tenants.

Grainger's recommendations

To attract institutional investment and international investment into the PRS, the investment model must provide the right level of returns and so yields must be more attractive. Grainger has proven that its residential property business model works effectively and safely over the long term, although it is fundamentally different from the commercial property investment model for which the current UK REIT regime is based on.

In our view, to attract more investors into the sector three different aspects must be addressed: improve returns, ease portfolio assembly, and create an appropriate and effective investment vehicle in the UK residential property market to bring in scale investment. Current investment vehicles, such as Jersey property unit trusts (J-PUTs), are workable, but have not attracted the sort of scale that the commercial property sector has seen from international funds which have invested into real estate investment trusts (REITs).

Currently, most residential investment is made through offshore unit trusts. They are a well understood investment vehicle, rent is taxed in the hands of unit holders and gains are outside the tax net. This allows different investors to invest together without losing their individual tax status.[1]

The REIT regime should be an attractive vehicle to HM Government as it is regulated, transparent, onshore and liquid. It also presents a much more suitable alternative to buy-to-let direct investment.

We strongly believe that with a few minor modifications the existing REIT regime can accommodate residential property companies, like ourselves, and thereby attract significant levels of investment.

The residential REIT would be a transparent, onshore, globally recognised investment vehicle. Many international property investment funds have restrictions on the type of vehicles in which they are allowed to put their money. REITs are one of the accepted vehicles for property investment by these international investors, and at the moment they are unable to invest in UK residential property.

In addition to attracting international investment, a residential REIT would serve as a suitable vehicle for individual investors, giving those who would have invested as a buy-to-let landlord another option for investment in residential property. A REIT would allow investors to replicate the returns of direct property ownership, yet benefit from the REITs large diversified portfolio, thereby minimising risk. This type of alternative residential investment should assist in avoiding particular „bubbles' within the property market such as that seen recently in off plan city centre apartments.

[1] Property Industry Alliance, Council of Mortgage Lenders, Association of Real Estate Funds, "Response to HM Treasury's consultation, Investment in the UK private rented sector", April 2010.

We believe that only minor modifications to the existing REIT regime are needed to immediately address insufficient yields and allow residential REITs to be established:

(i) The introduction of the „residential property' class of asset to expand the scope of the existing REIT regime to include properties held on trading account but to exclude developers, allowing for certain residential property transactions to be treated as investment under the existing rules thereby allowing companies to convert into the regime.

(ii) Adopt and apply a 10% „wear and tear' allowance on gross residential sector property income within the REIT to create comparable distributable profit requirements across the commercial and residential sectors.

(iii) To introduce a fairer capital structure restriction allowing the interest cover test to be met.

It is understood that these measures are revenue neutral or revenue raising for the Exchequer.

These measures could, in turn, be supported by further initiatives once public finances allow, e.g. disaggregation of property purchases for SDLT purposes, which would help to attract further and ongoing investment into the sector.

Responding to this consultation

Grainger supports the joint response submitted by the Property Industry Alliance[2], Council of Mortgage Lenders and Association of Real Estate Funds, and the response by the Home Builders Federation, but considers it worthwhile to submit a separate response.

[2] British Council of Offices (BCO), British Council of Shopping Centres (BCSC) British Property Federation (BPF), Investment Property Forum (IPF) and Royal Institution of Chartered Surveyors (RICS)

Question 1- 4:

We have decided not to respond to the first four questions of this consultation as they do not directly relate to Grainger's business.

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?

5.1 Economies of scale require action across various fronts

5.1.1 Scale in residential investment is important, but it is more than just scale in management. Scale in investment is also important. Institutional investors will not find the private rented sector attractive until they are able to invest at levels of investment that are large enough. It is not in their interest to slowly assemble a residential portfolio over decades, as we have done. Instead they would prefer to put their money to active use over the short to medium term.

5.1.2 Scale in residential investment requires action across various fronts – consistent government leadership and policy support; action and buy-in of the construction and house building industry; and demand from investors for scale in investment.

5.1.3 To achieve these is not a quick fix. It would likely take, at a minimum, five years to truly increase the scale of investment in residential investment. Five years is even optimistic with regard to investment in new build private rented accommodation, as building out, at scale, takes time.

5.1.4 This possible time scale differs from the situation in the commercial property sector before UK REITs, which had large amounts of existing property stock owned by institutional investors – with scale ownership already partly there.

5.2 Economies of scale in management

5.2.1 Coming back to the specific question at hand, scale economies in management are key to improving viability and returns. The main challenge for residential investment to compete in the capital markets is the constrained rental income/ yield, which is primarily due to increased costs in both management and transactions.

5.2.2 Dealing with the first of these, management/ maintenance costs, we strongly believe the „service offering’ that good property management represents is essential for profitable residential investment and in turn a strong PRS. If service/ management is poor, tenants are unhappy (and therefore rental income is not steady or guaranteed) and the asset value will deteriorate (as the property itself is in need of refurbishment). To ensure continuity of income (both through rents and sales), the property must be maintained and possibly improved. Rental income and capital values will only improve if the asset is managed well.

5.2.3 Our ability to successfully manage our properties is very different than managing commercial property stock. Residential management is much more intense and hands on. We believe that there should be a greater „carrot and stick' approach to drive professionalism. Greater carrots and sticks would drive professionalism, as this in turn would encourage property management providers to consolidate and improve services to achieve the returns required.

5.2.4 We have an owner manager mentality, and have captured the efficiencies of property management by bringing that operation in-house. Furthermore by partnering with housing association and RSLs, we have been able to extend and share our customer and tenant focused processes.

5.3 Lot size – no „golden rule'

5.3.1 In respect of minimum lot size there is no golden rule. Management costs are primarily affected by the type, age and state of the properties, the tenants and how well they care for their properties and how closely the properties are located to one another to increase economies of scale (e.g. reduce transport costs of maintenance staff).

5.3.2 Depending on those variables, an investor might decide to invest in a small portfolio of units, which may not allow huge savings in scale, but where the properties are in good condition and are unlikely to require large amounts of maintenance – thereby decreasing costs and increasing yield returns. On the other hand, a larger portfolio of 150 units may be attractive, not because they are better quality properties or the rents paid are higher, but because they are all located in the same town and have the same construction, therefore allowing large savings in economies of scale by employing several maintenance staff to live in the area and provide upkeep to the properties. The properties being of the same construction will allow more rapid repairs once the maintenance staff are familiar with the fittings and costs can be reduced through procurement efficiencies (i.e. buying fittings at wholesale which will work for the entire portfolio).

5.4 Streamlining

5.4.1 A large investor, like Grainger, with sufficient experience in managing residential properties can further scale economies by automating/ streamlining maintenance processes, e.g. Grainger's dedicated tenant helpline.

5.5 Economies of scale are not enough to deliver the required returns

5.5.1 Economies of scale in management help Grainger to meet the returns expected by its investors, as we have found bringing our property services business in-house. The importance of our property services division to our bottom line was proven over the last several years during the recession, when we were able to maximise value from our assets by decreasing void periods and providing good upkeep as well as refurbishment on our properties.

5.5.2 However, the savings available through economies of scale alone are not enough to boost the yield of residential investment to the levels required by institutional investors.

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?

6.1 In our experience, SDLT has never been the sole reason a transaction has not gone ahead. SDLT is, however, a key cost consideration as it becomes part of transaction costs, which needs to be financed, and therefore represents a constraint to building up large scale residential portfolios necessary for institutional investors.

6.2 It is difficult to judge whether a change to the bulk purchasing rules would substantially increase investment in the PRS but there would certainly be benefits for institutional investors. The additional SDLT cost certainly reduces appetite from investors for particular purchases and so removing the inequality between individual and bulk purchasers would certainly be welcome.

6.3 Disaggregation of SDLT is a possible solution and we would welcome it. We appreciate, however, the possible impact on public finances.

6.4 One way to mitigate against this impact may be to find a halfway house, where residential REITs are allowed to make bulk purchases on which a SDLT rate of 2% is levied, which would help to encourage investment through the preferred vehicle, residential REITs.

6.5 Changes to SDLT would not only help scale in investment in the PRS, by easing portfolio assembly, but it would also be a clear signal from the government of its commitment to the sector and its desire to level the playing field between individual buy-to-let investors and institutional investors. This gesture in itself could go a long way to convincing institutional investors to entering into the PRS.

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?

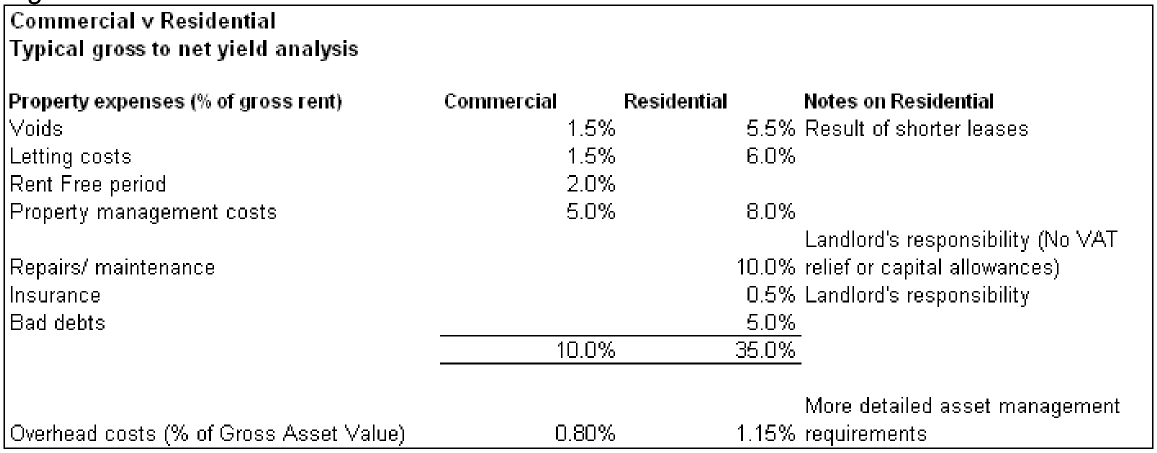
7.1. We agree with Property Industry Alliance’s response to this question.

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

8.1 Commercial property investment v. residential

8.2 Rents generated from residential property are significantly lower, relative to asset value, than from commercial property with returns principally generated from capital rather than from income yields. Furthermore, residential property involves substantial outlays for maintenance, voids, service charges and property management costs which tend to be borne by the tenant in the case of commercial property. Overall costs averaged at 35% of gross income in 2006. Together, these factors mean that a residential property investor is required to routinely dispose of assets to service capital.

Figure 1

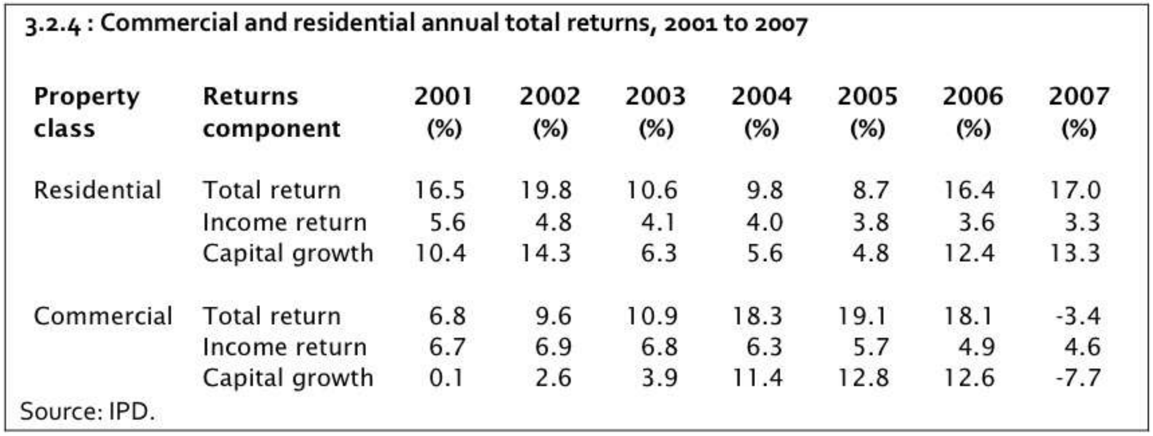


Commercial v Residential
Typical gross to net yield analysis

Property expenses (% of gross rent)	**Commercial**	**Residential**	**Notes on Residential**
Voids	1.5%	5.5%	Result of shorter leases
Letting costs	1.5%	6.0%	
Rent Free period	2.0%		
Property management costs	5.0%	8.0%	
Repairs/ maintenance		10.0%	Landlord's responsibility (No VAT relief or capital allowances)
Insurance		0.5%	Landlord's responsibility
Bad debts		5.0%	
	10.0%	35.0%	
Overhead costs (% of Gross Asset Value)	0.80%	1.15%	More detailed asset management requirements

8.3 Income returns in residential investment tend to be 1% to 3% lower than the returns expected by institutional investors familiar with investing in commercial property. Residential investment often has a yield of between 3% and 4%, excluding sales, while commercial often has between 5% and 7%.

Figure 2



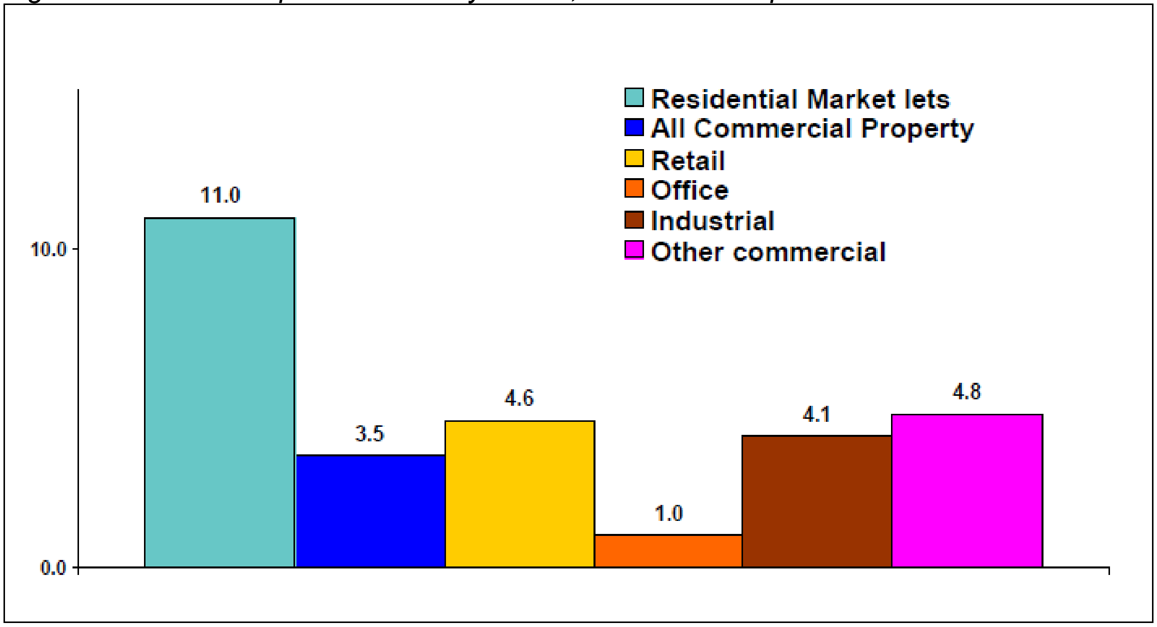
3.2.4 : Commercial and residential annual total returns, 2001 to 2007

Property class	Returns component	2001 (%)	2002 (%)	2003 (%)	2004 (%)	2005 (%)	2006 (%)	2007 (%)
Residential	Total return	16.5	19.8	10.6	9.8	8.7	16.4	17.0
	Income return	5.6	4.8	4.1	4.0	3.8	3.6	3.3
	Capital growth	10.4	14.3	6.3	5.6	4.8	12.4	13.3
Commercial	Total return	6.8	9.6	10.9	18.3	19.1	18.1	-3.4
	Income return	6.7	6.9	6.8	6.3	5.7	4.9	4.6
	Capital growth	0.1	2.6	3.9	11.4	12.8	12.6	-7.7

Source: IPD.

8.3.1. Latest figures from IPD's Residential Investment Index show that to 2009 total returns were 11.0%, income returns were 2.7% and capital growth was 8.1%.[3]

Figure 3: Investment performance by sector, % total return p.a.



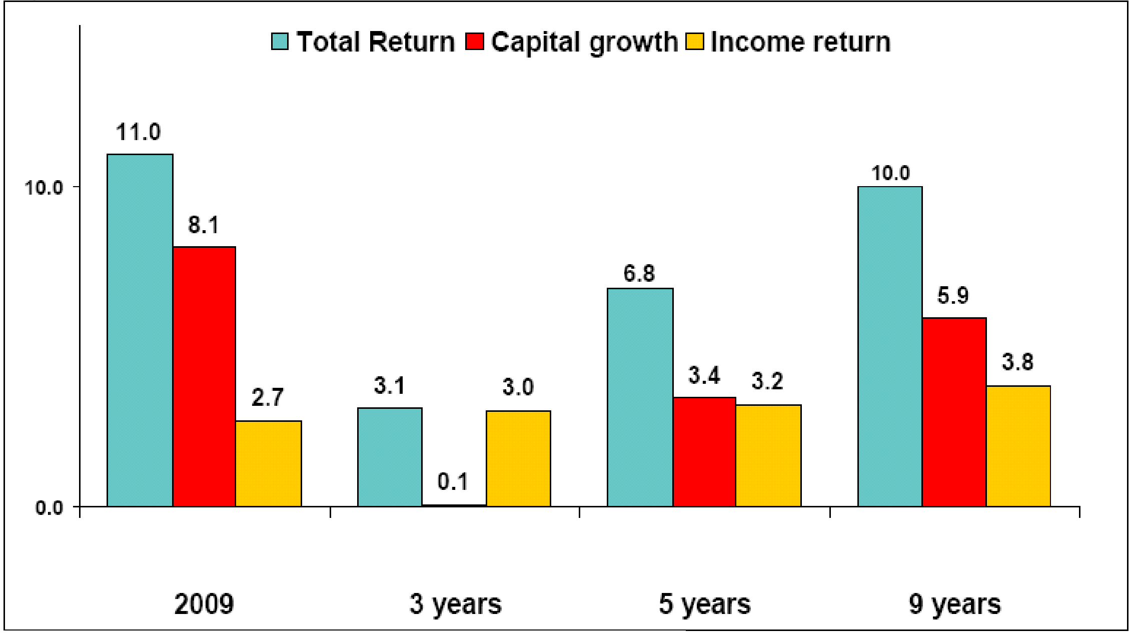
Source: IPD UK Residential Investment Index, 2009

8.4 Institutional investors prefer long term investment, with steady returns. Compared to other asset classes, residential property is not very attractive because of its low yield and rental income.

8.5 The total rate of return on residential has, however, been very favourable when looked at over various timescales. The latest IPD Residential Investment Index shows that residential has performed very well in comparison with commercial property, for example, over 1, 3, 5 and 9 years.

[3] Investment Property Databank, "IPD UK Residential Investment Index", 20 April 2009.

Figure 4: IPD Residential Performance to Dec 2009



Source: IPD, UK Residential Investment Index, 2009

8.5.1 The overall performance of residential over all these timescales relies heavily on capital growth of 5.9% per annum over the last decade, compared with 3.8% per annum income return.

8.5.2 However, it is worth noting three points in relation to this study:

- income returns are very stable over all periods of time and regardless of economic conditions;
- capital growth varies considerably over the different time periods in the property cycle – this uncertainty is likely to deter investment in the sector in the near future;
- the income return alone is insufficient to even cover the cost of capital for an investor and therefore no rational investor would invest in the residential property market unless a strong capital return is assumed or income yields can be improved.

8.6 Residential model

8.6.1 The relatively smaller yield must be supplemented by other means to deliver the returns expected by institutional investors. The current residential investment model does not provide adequate rental income returns alone. The main way that current residential investors supplement yield is through churning portfolios to take advantage of house price inflation/ capital value increases.

8.6.2 If changes were made to improve the yield/ income returns for the basic residential investment model, trading to would not be as important as it is today. Whereas currently, capturing increases in capital values are a necessary part of the residential property market, an improved investment model with stronger income yields could make it secondary.

8.6.3 Some of the changes which could improve the residential property model are mentioned in other parts of this and other responses, including stamp duty land tax, capital allowances and an appropriate, residential property class of asset to establish the formation of residential REITs.

8.7 Returns expected by investors

8.7.1 As pointed out in the Property Industry Alliance's submission, "Investors in UK commercial property expect a return of 2.5%-3% in excess of the risk free rate. The risk free rate today, as expressed through medium-dated index-linked bonds and gilts, is below the long term average so, in practice, commercial property investors are seeking 7%-8% pa (unlevered)."[4]

8.7.2 The charts above clearly show that residential income returns are well below what investors are used to receiving in commercial property investments.

8.7.3 Alternatively, total returns in residential investment are well above commercial, and therefore explain the inclination to churn portfolios, thereby realising the capital value increases.

8.7.4 Grainger, in order to make sure its business is attractive to investors, uses its diverse business divisions – development, its core portfolio, fund management, property services, retirement solutions and Germany – to match its spread returns to the returns expected by investors.

8.7.5 There is typically a proportion of churn within our portfolios. This could be for two reasons, either to optimise the portfolio – replace under performing assets for better ones – or simply to take advantage of house price inflation upon the tenant vacating the property. This approach allows us to take advantage of increases in house prices, but during a falling market, as we just experienced, our income returns and revenue from other parts of the business allow us to remain an attractive business.

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?

9.1 We agree with Property Industry Alliance's response to this question.

[4] Property Industry Alliance, Council of Mortgage Lenders, Association of Real Estate Funds, "Response to HM Treasury's consultation, Investment in the UK private rented sector", p 23, April 2010.

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?

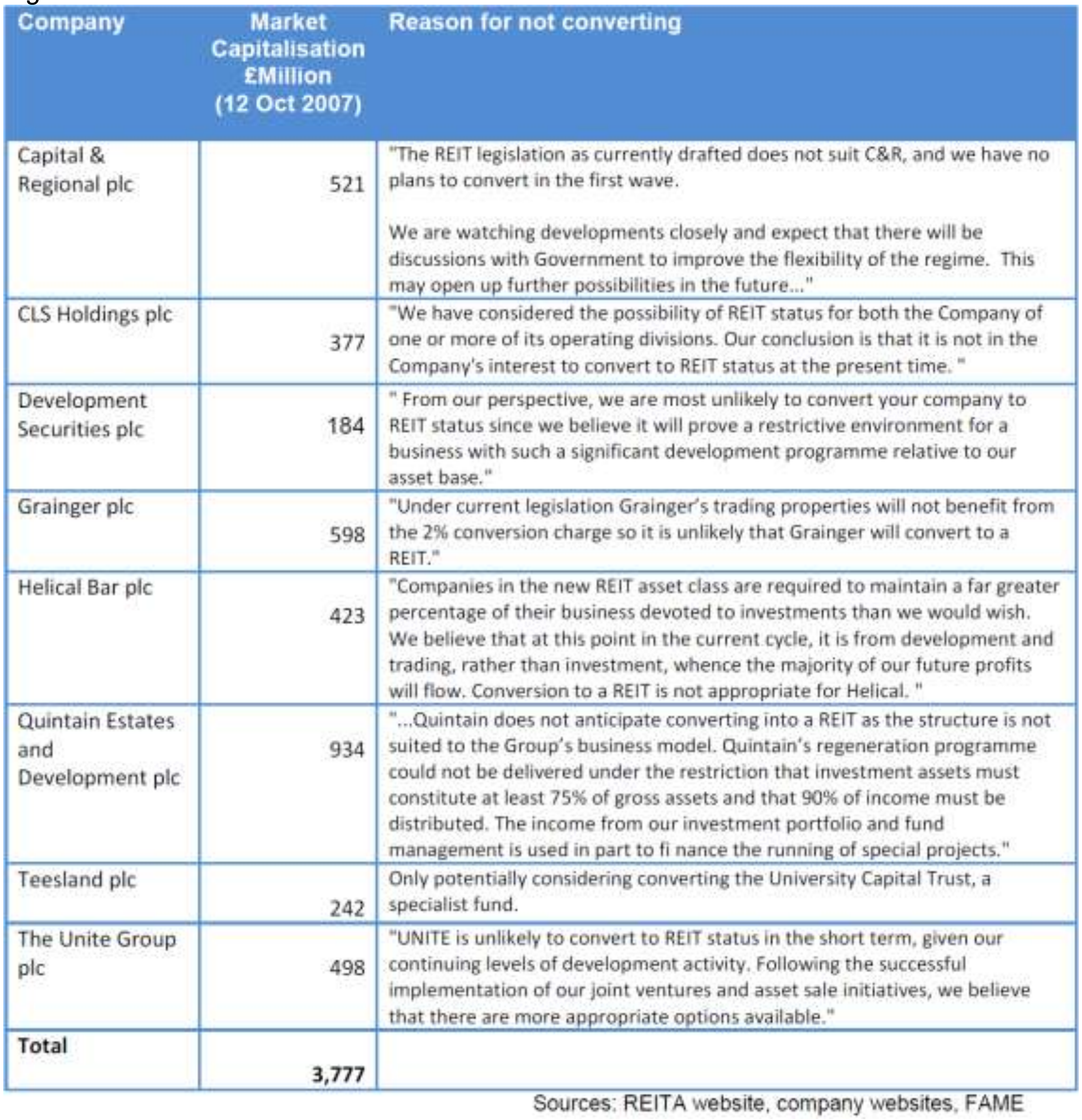
10.1. We agree with Property Industry Alliance's response to this question, but would like to re-highlight one additional key point.

10.2. Lack of an attractive investment vehicle

10.2.1. We believe that a significant barrier to further institutional investment in residential property is the lack of an appropriate vehicle. The residential property market lacks a transparent, on-shore, globally recognised investment vehicle. In contrast, the commercial property sector has the REIT regime.

10.2.2. The Government set out its policy objectives in "Promoting more flexible investment in property: a consultation", one of which was to "improve the quality and quantity of finance for investment in both commercial and residential property". The introduction of the REIT regime succeeded in this for commercial property, but not for residential, with many listed residential-focused property companies citing various reasons as shown in the chart below, such as Quintain Estates and Development plc and Unite Group plc.

Figure 5



Company	Market Capitalisation £Million (12 Oct 2007)	Reason for not converting
Capital & Regional plc	521	"The REIT legislation as currently drafted does not suit C&R, and we have no plans to convert in the first wave. We are watching developments closely and expect that there will be discussions with Government to improve the flexibility of the regime. This may open up further possibilities in the future..."
CLS Holdings plc	377	"We have considered the possibility of REIT status for both the Company of one or more of its operating divisions. Our conclusion is that it is not in the Company's interest to convert to REIT status at the present time. "
Development Securities plc	184	" From our perspective, we are most unlikely to convert your company to REIT status since we believe it will prove a restrictive environment for a business with such a significant development programme relative to our asset base."
Grainger plc	598	"Under current legislation Grainger's trading properties will not benefit from the 2% conversion charge so it is unlikely that Grainger will convert to a REIT."
Helical Bar plc	423	"Companies in the new REIT asset class are required to maintain a far greater percentage of their business devoted to investments than we would wish. We believe that at this point in the current cycle, it is from development and trading, rather than investment, whence the majority of our future profits will flow. Conversion to a REIT is not appropriate for Helical. "
Quintain Estates and Development plc	934	"...Quintain does not anticipate converting into a REIT as the structure is not suited to the Group's business model. Quintain's regeneration programme could not be delivered under the restriction that investment assets must constitute at least 75% of gross assets and that 90% of income must be distributed. The income from our investment portfolio and fund management is used in part to fi nance the running of special projects."
Teesland plc	242	Only potentially considering converting the University Capital Trust, a specialist fund.
The Unite Group plc	498	"UNITE is unlikely to convert to REIT status in the short term, given our continuing levels of development activity. Following the successful implementation of our joint ventures and asset sale initiatives, we believe that there are more appropriate options available."
Total	**3,777**	

Sources: REITA website, company websites, FAME

Taken from the Property Industry Alliance's "REIT representation" paper, December 2007

10.2.4. It is unfortunate that the companies listed or their property investment elements have not been able to access the REIT regime and therefore to this extent the original policy objectives for introducing REITs were not met.

Question 11: What are the key barriers to investment in residential property through UK REITs, and what changes would be needed to address them?

11.1. Barriers to investment in residential property through UK REITs

11.2. The failure of the REITs regime to stimulate investment in residential property in the UK is in stark contrast to experiences of property investment funds (PIFs) around the world. The economic downturn in 2008 and 2009 may have impacted investment decisions generally, but it appears unlikely that the failure of residential REITs can be entirely (or even mostly) attributed to the prevailing economic conditions.

11.3. Indeed, the Economic Affairs Parliamentary Committee does not view the economic downturn as a sufficient explanation. In their report on Finance Bill 2009, they:

> "...[noted] with concern the policy failure to see any residential REITs established. In our view it is not sufficient simply to blame the market and hope that in the medium term REITs will expand into the residential sector as the market returns. We believe that there are market opportunities which could be taken now in order to begin the original policy objectives, albeit at some cost, and we recommend that the detailed proposals put to us should be investigated as a priority"[5].

11.4. Looking beyond the economic climate, a number of factors have been proposed as contributing to the apparent failure of residential REITs.

- Opportunity cost: As with any vehicle, investors consider the returns available elsewhere. Investment in commercial property tends to offer greater rewards than those in the residential market, and so the disparity between the results in those areas may reflect a time lag as investors seek to prioritise their investments against the highest rate of return for their capital.

  Residential property not only offers lower yields than commercial property, but also entails a higher level of management costs, and is associated with a greater frequency of lease problems. The commerciality of investing in the residential sector is therefore less obvious and less compelling than in the commercial sector. Although some would argue that these are different subsets of the market, attracting very different types of investor.

- Distribution requirement: The requirement for 90% of profits to be distributed annually has also been cited as a reason for the lack of residential REITs. The REIT regime requires distribution of 90% of the taxable income. A residential property portfolio will generally have significant depreciation costs. However, in contrast to commercial property investment, the costs will not be deductible (as capital allowances) in computing in case below apply the 90% test and hence the income requirement is effectively higher

[5] Economic Affairs Committee, report on The Finance Bill 2009, Chapter 5: Real Estate Investment Trusts, paragraph 265.

for residential property. This is further exacerbated by the fact that residential landlords will generally bear more of the costs than commercial landlords.

- Stamp Duty Land Tax ("SDLT") provisions: Another frequently cited obstruction to the assembly of a residential property portfolio (and therefore the promotion of residential REITs) is the SDLT requirement to apply SDLT rates thresholds to the aggregate value of a transaction. Where a transaction involves multiple units, each of which if sold separately would attract a lower rate of SDLT, there is a clear incentive for the vendor to fragment and to sell to different buyers who will not have to pay the 4%. The tax system therefore acts against large-scale property ownership.

- Investment v trading distinction: The distinction is critical to a REIT because a trading profit is fully taxable whereas a capital gain would be tax exempt (and under current rules would not be required to be distributed to shareholders). A profit on a disposal of property may be taxed as either a trading profit or a capital gain. The dividing line between the two depends on principles derived from tax case law which are complex, uncertain and often contradictory.

  As a practical matter, however, it is probable that a residential portfolio is more likely than a commercial portfolio to be viewed as trading because of the larger number of individual transactions carried out by a residential landlord and the greater reliance on accessing capital growth in the investment proposition.

  In addition, while it is possible for the returns in a REIT to withstand tax on a small proportion of its disposal transactions, if some transactions are characterised as trading by HMRC, it makes it more likely that the entire residential portfolio of the group will be „tainted' and viewed as trading because one of the case law tests looks to the types of transaction that a property vendor would typically carry out.

  Even if the portfolio is not so tainted, the treatment of individual property disposals as trading transactions could generate significant tax costs and, if there are enough such transactions, it is possible that a REIT could fail the condition of the regime that requires at least 75% of its assets to relate to its property rental business. In this case, it would lose its status as a REIT. A similar issue arises in relation to satisfying the 75% profits condition.[6]

11.5. An additional barrier to further investment in the PRS is that there are several cases where large international investment funds are given mandates to invest in property stocks, but those stocks must be REITs. UK commercial REITs have seen a large amount of this type of international money come forward, which we would expect to happen similarly with residential REITs. At the moment however, these funds which have such restrictions are unable to consider investing in the UK residential market because we do not offer them exposure to the market through the trusted REIT vehicle.

[6] Property Industry Alliance, Council of Mortgage Lenders, Association of Real Estate Funds, "Response to HM Treasury's consultation", Investment in the UK private rented sector, p34, April 2010.

11.6. Possible changes to address the barriers

11.6.1. International experience indicates that the REIT model can be effective at injecting large scale institutional investment into the property, including the residential, market. UK experience is partly aligned with international experience where REITs have successfully stimulated institutional investment in the commercial though not the residential property market.

11.6.1. This suggests that the existing REIT model, whilst conceptually sound, does not cater for the unique differentiating characteristics of the UK residential property market. We therefore recommend the following design revisions to the existing REIT model to ensure a regime which is supportive to both residential and commercial sector property investment. The principles which guide the development of recommended revisions are twofold, to maintain the policy objectives of the existing regime, and to avoid a cost in terms of lost revenue to the Exchequer.

11.7. Qualification: Residential property class

11.7.1. A REIT is designed, as indicated by the name, as an investment vehicle for property. In applying the regime to the residential market, the definition of investment needs to be adapted. The low yield means that residential property investment companies will be disposing of properties and this can lead to properties to be held as trading stock, notwithstanding the investment nature of the portfolio. Consequently, a key feature of a residential property investment vehicle will be to allow the inclusion of assets held on trading account.

11.7.2. One reason for the investment criteria was to exclude property developers from the REIT regime. A possible way of retaining this prohibition, whilst allowing the operation of residential REITs, would be to exclude home builders using the definition of “residential property” set out in the current Stamp Duty Land Tax provisions, in Finance Act 2003, s 116.

11.7.3. A definition of a “residential property business” for the REIT regime could therefore be a business which, to ensure the exclusion of home builders, has:

- A profit motive, demonstrated by the generation of income, profit or gains;
- A tenant who occupies the residential property; and
- The residential property is occupied for a minimum of three years.

11.7.4. Income and gains on sales from residential property by a residential property business would therefore be within the scope of the REIT regime and be tax exempt. In order to assess and ensure compliance with these tests, property trading companies could be required to prepare certified accounts as though the company were treated as investment for tax purposes.

11.7.5. **Recommendation 1**: Expand the scope of the REIT regime to include properties held on trading account but to exclude property developers, based on the definition of “residential property business”.

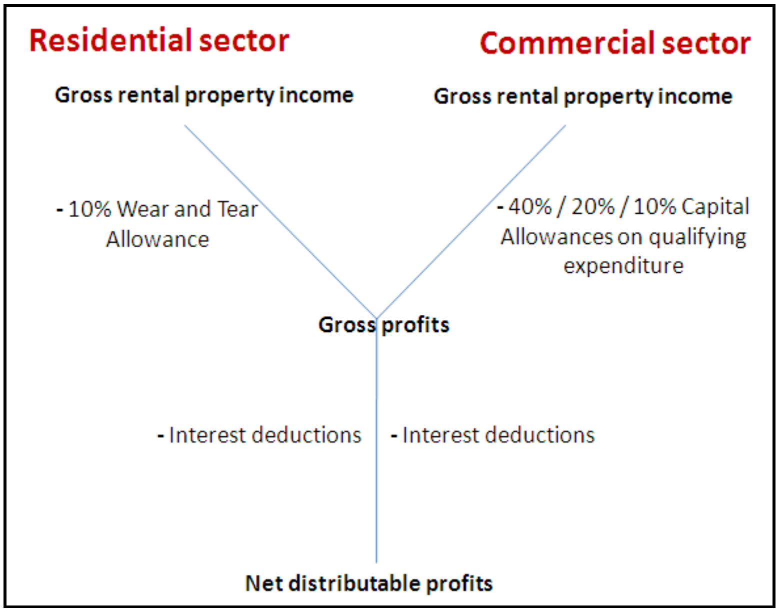
11.8. Calculation of 90% income distribution requirement

11.8.1. The 90% requirement on the distribution of income is to deliver the required level of tax transparency, ensuring that investors cannot use the REIT as a “money box” to defer tax payments. The same concern arises in both commercial and residential REITs. However as noted above, the calculation of net income for a commercial REIT involves a deduction for capital allowances. From a policy perspective, it is clear that a similar level of distribution should be acceptable for residential REITs, notwithstanding the lack of capital allowances.

11.8.2. One way of achieving this would be to identify notional capital allowances. Whilst this would achieve parity, this would introduce some potentially complex calculations and detailed analysis. In contrast a 10% Wear and Tear allowance would achieve broadly the same impact but at a fraction of the administration burden.

11.8.3. This gives the following calculation structure for commercial and residential property:

Figure 6: Arriving at comparable net distributable profits for residential and commercial property REIT investors.


Residential sector
Commercial sector
Gross rental property income
Gross rental property income
- 10% Wear and Tear Allowance
- 40% / 20% / 10% Capital Allowances on qualifying expenditure
Gross profits
- Interest deductions
- Interest deductions
Net distributable profits

11.8.4. **Recommendation 2**: Adopt and apply a 10% Wear and Tear allowance on gross residential sector property income within a REIT to create comparable distributable profit requirements across the commercial and residential sectors.

11.9. Capital structure restrictions

11.9.1. The REIT regime includes a minimum level of interest cover in order to maintain sufficient equity capital. A similar concern can be expected for residential REITs. As noted above, the lower level of yield means that this test is more onerous for residential property than for commercial property, and interest cannot be readily serviced by net rents.

11.9.2. Consequently, an alternative test based directly on loan to value ratios may be more appropriate for the residential REIT. Or as the Property Industry Alliance proposes, modifying the existing test "to the extent that a REIT needs to add disposal profits into the calculation in order to meet the test, that element of profits should then be subject to the distribution requirement."[7] A REIT with both residential and commercial property could satisfy either requirement.

11.9.3. **Recommendation 3**: To introduce possible alternatives to the interest cover test, such as a test based on loan to values or to allow the residential REIT to add an element of disposal profits into the interest cover test calculation so as to meet the test.

11.10. Within the regime: SDLT

11.10.1. Stamp Duty Land Tax provisions require that a transaction or a series of transactions between the same vendor and purchaser are treated as linked, so where a property investor purchases multiple properties from a single vendor the applicable rate of SDLT is for the combined value of the properties. Institutional residential investment, as opposed to individual residential investment, tends to involve the acquisition of multiple properties at the same time. The linked transactions rule results in a combined sale to an institutional vendor facing a higher SDLT charge than separate sales to independent purchasers. Whilst this provision is not specific to the REIT regime and applies equally to institutional investors outside the REIT regime, the rule acts as a marked disincentive to the large-scale investment which REITs seek to stimulate in favour of small-scale individual investment.

11.10.2. The costs to the Exchequer of disapplying this provision are not expected to be significant, given that currently large-scale institutional investment in the residential private rented sector is minimal. To ensure that the Exchequer is at no disadvantage to the status quo, it is recommended that a standard 2% SDLT rate applies to residential property purchases within a REIT, except where the individual lot size exceeds £500,000. The expected increase in the volume of residential property transactions that is expected to occur following this policy change together with those recommended in this paper is expected to yield a net increase in revenues to the Exchequer.

11.10.3. **Recommendation 4**: Residential property purchases within a REIT should be subject to a flat 2% SDLT rate.

Question 12: 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?

12.1. We agree with Property Industry Alliance's response to this question.

[7] Property Industry Alliance, Council of Mortgage Lenders, Association of Real Estate Funds, "Response to HM Treasury's consultation, Investment in the UK private rented sector", p36, April 2010.

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

13.1. We agree with Property Industry Alliance's response to this question.

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

14.1. We agree with Property Industry Alliance's response to this question.

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?

15.1. Below we build on the Property Industry Alliance's response to this question by explaining Grainger's business and how it contributes to and can further contribute to the PRS, which we believe is evidence of the benefits that institutional investment bring to the sector.

15.2. Protecting assets and income

15.2.1. Grainger has been involved with the PRS for nearly one hundred years. Our commitment is long term. As the UK's largest specialist residential property owner traded on the London Stock Exchange, we have seen how institutional investment benefits the PRS.

15.3. Financially, this means we want to maximise the capital value out of those assets when we sell them and secure our rental income while we hold onto them. We do this by:

15.3.1. Protecting our assets
We review our portfolio of assets to assess the inherent and operational sustainability risks to which it is exposed and identify opportunities to add value, but also manage the environmental and social impacts.

15.3.2. Protecting income
Our dedicated in-house property services team manages all of our properties throughout the UK. We work hard to maintain and improve the service that we provide to our tenants. By putting in place processes to improve customer satisfaction, we are able to protect our income stream by quickly securing happy tenants and keeping them for longer.

15.4. Maintaining our reputation

15.4.1. We take our corporate and social responsibilities seriously, as well as all our other financial and regulatory requirements.

15.4.2. Grainger is compliant with FSA regulations, planning regulations, building regulations and property management regulations. In this way, by increasing the number of institutional investors, like Grainger, the PRS would benefit from increased professionalism, transparency and regulation.

15.4.3. For example, Grainger is signed up to the British Property Federation's residential code of conduct and uses the standard AST agreement provided for by the British Property Federation.

15.4.4. Grainger is a member of the housing ombudsman and therefore tenants have access to independent redress. Likewise, all of Grainger's property managers are ARMA qualified, and our lettings agents are ARLA qualified.

15.5. Additional benefits to the PRS

15.5.1. There are a number of additional key benefits:

- Engaging with and investing in communities. This is an essential part of a good property management business, from training good tenant-focused property managers to undertaking targeted refurbishment and regeneration projects.

- Working to continually improve the quality of the services that we provide and the relationships with our tenants and suppliers. To do this we are always working toward improving our processes to ensure best practice (something which smaller landlord businesses may not be able to achieve to the same standard).

- Extending greater awareness of environmental issues and taking relevant energy saving and monitoring initiatives.

15.6. Caring for communities

15.6.1. As a landlord and property developer we recognise our responsibility to the local communities in which we work and acknowledge the potentially large impact we can have on the people and places located around our assets and development sites.

15.6.2. It has always been our approach to ensure we give something back to society and to ensure we listen to the opinions of those affected by our business. This helps us to create valuable new communities and to maintain positive long term relationships.

15.6.3. In some cases, Grainger will employ maintenance staff to live on-site at a block of properties. This brings Grainger benefits through economies of scale, but also benefits the tenants who know they have a dedicated maintenance service available to them.

15.6.4. Grainger is committed to helping individuals, groups of tenants or whole communities. Here are a few examples of how we have contributed to the sector:

Dot in Eastbourne
Dot is one of our regulated tenants and she lives in one of our properties in Eastbourne. This property is the same house she was borne in and she has lived there her entire life. Recently, she asked us if her friend, Joan, could move in with her, as they were both getting old and would benefit from the company. We were happy to allow Joan to move in with Dot.

Refurbishment of community space
Grainger Geninvest LLP, a joint venture between Grainger plc and Genesis Housing Group invested £1 million in the Walwouth Estate to refurbish existing homes and transform a derelict space – an old air raid shelter, which was cordoned off – into a community garden accessible to all residents.

Newlands, Waterlooville
Newlands Major Development Area, located to the west of Waterlooville, is approximately 211 hectares (521 acres) in size. Grainger has already obtained planning permission for 1,550 new homes, employment, open space and local facilities within the Plant Farm Zone of Newlands.

Winchester City Council has since identified the need for an additional 1,000 new homes in their draft core strategies (the emerging planning policy). In order to ensure the proposed development encompasses the additional homes in a truly sustainable manner Grainger has taken the decision to re-masterplan.

Grainger is now working on a new planning application for a development of 2,550 homes. The Grainger team is committed to achieving the highest quality of urban design in order to create a sustainable mixed-use community. The development will aim to achieve best practice in all aspects of design and sustainability.

15.7. Customer focused – taking care of our relationships

15.7.1. Without our tenants our business could not function and therefore our duty to them is extremely important to us.

15.7.2. We recognise that our properties are more than just assets – they are people's homes. Therefore we are continually looking at ways to engage more effectively with our tenants and to improve our service to them.

15.7.3. We have been collecting date on the satisfaction level of our customers for some time. Surveys from Grainger's property management division show that 93% of tenants would rent from Grainger again. 95% would recommend Grainger to a friend. Compared to the findings in the latest English Housing Survey where 83% of private tenants were content with their accommodation, there is evidence that large institutions can achieve higher satisfaction rates.

15.7.4. We regularly survey our tenants upon vacating our properties, here are some of our recent results. On a scale of 1-5, (ranging from 1 = very bad, 3 = good to 5 = excellent):

- 69% of Grainger's tenants gave our contractors a „very good' or „excellent' for being well mannered;
- 70% gave our contractors a „very good' or „excellent' for being helpful;
- 81% gave our contractors a „good', „very good' or „excellent' for being punctual;

15.7.5. We are happy with these results, though there is clearly room for improvement as there always will be. We plan on exploring with our tenants how we can improve their experience with us, so that we can help our customers stay happy.

15.7.6. It is clear that large investors have greater scope for monitoring and measuring their services and assets in this way. By being able to better keep track of properties and the services they provide to tenants, there is a greater potential for continually improving services.

15.8. Environment

15.8.1. Despite challenging economic times, we remain committed to the environment. Grainger takes its impact on the environment seriously. We continue to make progress in helping our contractors and tenants to reduce their environmental impact and therefore to reduce our direct and indirect impact on the environment.

15.8.2. We believe that a PRS with greater institutional investors would follow suit and be able to address sustainability more effectively than a disparate market of individual landlords with small portfolios.

15.8.3. In the past few years:

- Grainger reused 99% of construction waste from its Newlands Commons development on-site;

- Grainger recycled and reused 8,000kg of furniture and electrical items in conjunction with charity Emmaus; and

- All of Grainger's newly developed homes were fitted with real time display energy monitors, as were all newly refurbished properties in our managed portfolio in 2009.

15.8.4. Currently:

- We are continually increasing the number of properties in our portfolio with loft insulation and smart meters.

- We have begun compiling eco-packs for our tenants to help encourage all of our residents to live in a more sustainable manner.

15.8.5. Sustainability reporting standards will undoubtedly increase into the future. We have already seen the introduction of Energy Performance Certificates in all property types and Display Energy Certificates in commercial and public buildings. The ability of larger investors to cope with these increasing demands is greater than individuals.

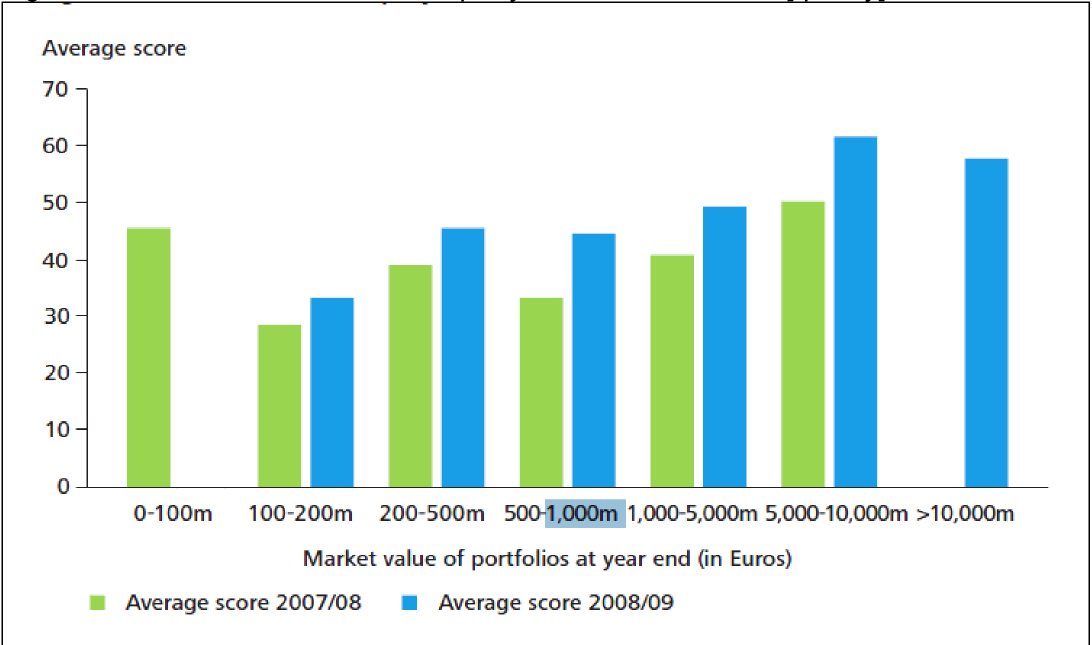
15.8.6. Greater institutional investment in the private rented sector will be better able to deliver the sustainability standards that are required.

15.9. Financial reporting

15.9.1. Grainger, as a plc, holds a high standard of financial reporting, both in transparency and quality. Other institutional investors will also adhere to higher standards of financial reporting than individual investors.

15.9.2. Figures from the European Public Real Estate Association's (EPRA) recent Annual Report Awards 2008/09 show that company size relates to the standard of financial reporting, with larger companies having greater quality reporting.

Figure 7: How does the size of company influence the score [quality]?



Source: EPRA, "Raising the bar: Annual Report Awards 2008/09",

15.10. Conclusion

15.10.1. We would like to extend our thanks and gratitude to the HM Government for conducting this consultation process, and for allowing us to comment on it.

15.10.3. We believe that the residential REIT regime, if slightly modified, will allow for greater investment in the PRS, but also improve the REITs sector as a whole. From our experience it is clear that institutional investment will help to support the emergence of a more "professional, high-quality, private rented sector"[8].

[8] "The Private Rented Sector: Professionalism and quality; the Government response to the Rugg Review Consultation", May 2009, page 5.

15.10.4. Grainger is keen to promote the private rented sector and we would be happy to offer any additional information that may assist HM Government to deliver a more “professional, high-quality, private rented sector”.

15.10.5. We look forward to seeing this consultation process through to completion and hope that decisive action is taken to realise the potential of the private rented sector and its key role within the UK housing market.

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GROSVENOR

28 April 2010

PRS Investment Consultation
C/o Keith Jackson
Housing Regeneration and Third Sector Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Sirs

HM TREASURY – INVESTMENT IN THE UK PRIVATE RENTED SECTOR

I refer to your document of February 2010, asking for submissions in relation to investment in the UK Private Rented Sector.

Grosvenor is one of the largest real estate companies in the world with assets under management of £10.2bn. Internationally Grosvenor has £2.9bn of residential assets under management. Within the United Kingdom, Grosvenor has £1.3bn of residential assets under management.

Grosvenor has been involved in the creation of the submission made by the Property Industry Alliance (PIA) and fully supports all the points set out in that submission.

Grosvenor would welcome the opportunity to be involved with further discussions alongside other interested parties. Should this take place, please contact John German at this office, email: john.german@grosvenor.com, telephone: 020 7312 6328.

Yours faithfully

John German
Residential Fund Manager

From:
Professor Alan Hallsworth
2, Heather close
Waterlooville
PO78EE

10 Feb 2010

I am happy to make the following observations which I hope may be useful.

The first is that, whilst understandable, the decision to restrain the scope to Treasury-related matters is restrictive. Agendas from other Departmental perspectives do distort the picture badly and may exaggerate what we might describe as "mis-housing". (Broadly, where people occupy property that, in an undistorted market, they would not be occupying and who may thereby be blocking access of those more in need of that location and, indeed, able to pay.)

It does, also, make it rather surprising that, from the very first page, mention is made of the Barker review of Planning. Not only is Planning a CLG responsibility but, as has elsewhere and widely been noted, it actually does not contribute greatly to the present problem (to find out if it does, we need first to know how many of the present vast stock of empty properties can be filled) It might also help to calculate how many of the present legal migrants will return home as the economy stagnates and the currency continues to fall. Planning restraints have been in place for decades* whilst the worst excesses of unaffordability and over-borrowing are a product of the last decade. Much more plausible blame for the present situation can be laid at the door of the sub-prime/derivatives/MBS tsunami that was driven by the flow of Chinese funds into the USA. Addressing those aspects first would appear to be a more fruitful way ahead. Indeed, the present distorted market (with rents artificially supported by housing subsidies, and mortgages artificially lowered by QE) entirely prevents us from knowing the future levels of real demand might be.

With debates continuing on the future of demand for University education, etc. the picture is cloudier still. Knowing the housing implications of multinational corporations buying UK-based companies, closing their factory and exporting jobs to Poland would also help.

To me, however, two issues stand out

One is the topic of capital gains.

Had capital gains always been levied then house prices would never have risen beyond reasonable ability to repay. The temptation to extract equity for non-housing purposes would be diminished and the buy-to-let sector would more closely resemble the position in much of Europe where provision of housing for others is seen as a source of steady revenues not of speculative capital gains. That said, I doubt if our low-wage, income-polarised, job-insecure economy parallels many in near Europe.

The second – in fact closely-related - aspect is how to create (and this is particularly a London/ large city problem) acceptable rental housing for middle-class families. Such individuals can find rental properties in Europe. In the UK, these individuals are unlikely to be subsidised but are likely to want security of tenure over many years whilst children are at school. The 1988 Housing Act may have facilitated greater speculative investment in the sector but it also unstitched the likelihood of affordable and acceptable rental housing for middle-class families.

* 1947 Town & country planning act – foreshadowed by the Barlow report from the 1930s

Investment in the UK Private Rented Sector
HM Treasury Consultation
April 2010

Response by the Home Builders Federation (HBF)

1. The Home Builders Federation (HBF) is the principle trade association representing the interests of private home builders in England and Wales. Our membership, which includes companies ranging from major national firms, through regional companies to smaller local companies, is responsible for more than 80% of the new homes built every year.

2. The bulk of this submission outlines our views about the private rented sector within the overall context of housing supply. In the final section we address the consultation questions applicable to the home building industry.

EXECUTIVE SUMMARY

3. There are good grounds for believing there will be strong demand for private rented housing in the future. Demographic trends point to rising numbers in the key 25-34 first-time buyer age group, but a range of financial constraints will limit the ability of many younger households to become home owners.

4. However long-term housing undersupply, created primarily by planning restrictions on the supply of permissioned land, leads to higher house prices in relation to incomes. This in turn creates persistent affordability problems for home buyers, drives up residential land prices, and makes it difficult to achieve satisfactory rental yields for private rented housing, especially for institutional investors which rely primarily on rental income rather than capital growth.

5. It is very difficult for home builders to (a) generate sufficient land value to buy land competitively, and (b) earn an adequate development margin, and (c) sell new dwellings to institutional investors at a price sufficient to generate an adequate institutional rental yield, even after allowing for bulk discounts.

6. **The only long-term solution to Britain's persistent housing affordability crisis, and to inadequate rental yields, is therefore substantially to increase the supply of housing for a prolonged period in order to lower house prices in relation to incomes.**

7. Any special fiscal or other measures to stimulate private rented housing supply should focus on tackling undesirable transactions costs and other disincentives within the sector itself, while maintaining a level

playing field between private rented and owner-occupied housing development. Such measures certainly should not favour one particular type of housing provider within one tenure. The Government's overall housing objective should be to increase the total supply of housing, not simply change the tenure of dwellings.

8. Therefore we do not support establishing a special private rental planning use class. We do not support relaxation of regulatory burdens, such as S106 demands, for developments of one tenure – the excessive cumulative regulatory burden needs to be reduced for all housing development. And if public land value subsidy is to be used to support private housing development, this should be equally available for owner-occupied or private rented housing development.

9. We support the following measures to help stimulate new investment in private rented housing:

   - Amend the current bulk purchase SDLT rule which unfairly disadvantages larger bulk-purchase investors compared with small-scale investors and adds significantly to the acquisition cost of rental units;

   - Amend the treatment of VAT on rental housing repairs to help reduce the large net/gross yield gap in the private rented sector;

   - Create special residential REIT rules covering the treatment of trading income, leverage and income distribution.

   - Buy-to-let borrowers should not be specially regulated - it should not be the regulator's role to protect people from what are essentially business decisions; lenders should be protected from unwise lending decisions by better risk assessment and risk pricing.

10. The Government should avoid focussing excessively on trying to stimulate institutional investment, a goal of governments since at least the early 1980s. It should instead seek to stimulate all sources of residential investment – small-scale individual investors, medium-sized corporate and professional individual investors, and large-scale corporate or institutional investors. This would maximise the flow of capital into housing and the increase in housing supply.

DEMAND FOR PRIVATE RENTED HOUSING

11. Although survey evidence suggests the aspiration for home ownership is undiminished, at a rate well above the current rate of owner occupation, there are good grounds for believing that financial barriers to home ownership will lead to strong demand for private rented housing in the future:

    a. The recent improvement in housing affordability is heavily reliant on ultra-low interest rates, so that affordability will quickly deteriorate as rates rise. And the deposit gap created by the absence of higher LTV mortgages, which excludes many potential first-time buyers, is unlikely to close for some time.

    b. Mortgage funding seems likely to constrain overall mortgage availability for some time. This, plus tighter mortgage regulation, means many households will find access to home ownership delayed, and some may never be able to buy a home.

    c. High levels of student debt, and the disproportionate impact of the recession on young people, seem likely to delay the age at which many young people will be able to become home owners.

12. Yet despite these constraints on access to home ownership, demographic projections show we are in a period of very strong growth in the core first-time buyer age group. According to the 2008-based population projections, the number of people aged 25-34 will grow 17% between 2008 and 2016. If a large proportion of these adults are not able to gain access to home ownership for the reasons outlined above, most will either have to stay at home with their parents and not form independent households – recent ONS data reveal nearly a third of men aged 20-34, and nearly a fifth of women in this age group, live with their parents – or they will have to find housing in the private rented sector if they want to form independent households.

THE CONSEQUENCES OF HOUSING UNDERSUPPLY

13. The Barker Review (2004) confirmed that Britain (England in particular) has a serious long-term problem of housing undersupply. Supply has been running below need/demand for several decades, a situation which has worsened significantly as a result of the recession. In addition, housing supply is very unresponsive to increases in demand/need.

14. The primary reason for housing undersupply is that the planning system – particularly the plan-led system introduced in 1991 – severely restricts the supply of permissioned residential land. Since the Barker Review, this problem has been compounded by the escalating cost burden of policy and regulation which renders many sites unviable for

housing development, a situation made even worse by the fall in land values since 2007.

15. As a result of supply constraints, the price of housing is substantially higher than it would be with an adequate supply. And because household incomes are determined largely independently of house prices, this means house prices are high in relation to incomes.

16. Among the many adverse consequences of housing undersupply and high house prices, three are especially relevant for the current consultation:

- Persistent affordability problems in the owner-occupied sector - many households on lower and even middle incomes cannot afford to buy suitable housing (good quality, of the right size, in the right location);

- High residential land prices, which are a function of dwelling sale prices;

- Low rental yields on new housing because of the high capital cost of housing in relation to tenant incomes.

17. The only long-term solution to Britain's persistent housing affordability crisis, and to inadequate rental yields, is substantially to increase the supply of housing for a prolonged period in order to lower house prices in relation to incomes.

18. The Government's primary housing supply objective should be to increase total housing supply, regardless of tenure. If total supply was adequate, the relative supplies of housing in the owner-occupied and private rented sectors would resolve themselves in line with consumer preferences, as expressed through the housing market.

19. In conditions of persistent undersupply, any attempt to promote one private tenure risks compounding existing distortions and, at best, simply increasing supply in that tenure at the expense of the other private tenure, with no overall increase in housing supply and no impact on affordability.[1]

NEW HOUSING SUPPLY AND PRIVATE RENTED HOUSING

20. Any stimulus to the private rented sector should therefore aim to increase the total supply of housing, rather than simply lead to a change in the tenure of new or existing dwellings.

[1] For ease of discussion in this response, the supply of social rented housing is assumed to be largely independent of the housing market. In practice, however, the requirement for Affordable Housing through S106 agreements on private housing sites has established a link between social rented housing supply and the housing market.

21. The escalating price of housing up to 2007, alongside rental growth in line with earnings[2], resulted in falling rental yields.[3]

22. In the boom years to 2007, it appears many buy-to-let landlords were willing to accept a low rental yield because they expected strong capital growth to result in an adequate overall return. In other words, their total return relied on strong capital growth, with a relatively modest rental contribution. However we understand institutional investors have a very different requirement: their total return must be largely rental based, with only a modest contribution from capital growth.

23. Despite the fall in house prices since 2007, we understand house builders generally cannot (a) generate sufficient land value to buy land, and (b) earn an adequate development margin, and (c) sell dwellings to institutional investors at a price sufficient to generate an adequate institutional rental yield, even after allowing for bulk discounts.[4] In order to sell new homes to an institutional investor at a low enough price to generate an adequate institutional rental yield, the house builder would either have to accept an extremely low profit margin, which would be unacceptable to shareholders, or the residual land value would be inadequate to buy the land, in which case no housing would be developed.[5]

24. The one possible exception is large regeneration sites where there is little or no land value, and where development viability is highly problematic. The ability of a developer to secure the guaranteed sale of a significant number of dwellings to a single investment buyer at an early stage in the development may help underwrite the scheme financially, while also introducing a larger number of occupied dwellings onto a site at an earlier stage than would be possible solely through sales to owner-occupiers. Also, regeneration sites will often be in inner-city or town-centre locations where there tends to be a relatively high proportion of rented housing, and a ready supply of tenants.

ENCOURAGING INCREASED PRIVATE RENTED HOUSING SUPPLY

25. It will be obvious from our comments above that we support an expansion of private rented housing supply. This will be necessary to meet housing needs for some time into the future, while it would also benefit home builders who are the ideal suppliers of rental products:

[2] Steve Wilcox *Can't Buy, Can't Rent. The affordability of private housing in Great Britain*. Hometrack, 2007

[3] As an aside, this divergence suggests owner-occupied and private rented housing are not perfect substitutes, so that any shortfall in the supply of owner-occupied housing (e.g. because of mortgage availability constraints) could not simply be made up by a corresponding increase in the supply of private rented housing.

[4] Bulk discounts effectively mean accepting a lower profit margin to reflect the reduced sales risk from having a single buyer, in advance, for a large number of dwellings.

[5] Because most land is bought in a competitive situation, a developer has no option but to offer a competitive price for the land if he is to have any hope of successfully buying land.

new housing sites provide housing for sale in single locations, on the scale required by larger investors.

26. As already noted above, the only long-term solution to the high capital cost of housing and high residential land values – and therefore to the affordability crisis in the owner-occupied sector, and the yield problem for institutional investors in the private rented sector – is a substantial and sustained increase in the total supply of housing.

Maintaining a Level Development Playing Field

27. Any measures specifically targeted at expanding private rental housing supply should maintain a level playing field between owner-occupied and private rented housing development. In particular, we could not support any measures which promoted the private rented sector *at the expense of* owner-occupier housing development. This would fail to solve the housing crisis because it would simply substitute one form of housing development for another, without leading to any increase in total housing supply. Also, housing supply is already massively distorted by planning and regulation, so we do not wish to see yet more distortions introduced.

28. Therefore we do not support creation of a special private rental planning use class. The planning system should not be used to promote one tenure over another, and certainly not one particular type of tenure provider (institutional investors). In effect, creating a special use class for private rented housing would amount to using the planning system to manipulate (i.e. force down) residential land values to make rental housing development viable. The tenure mix between private rented and owner-occupied housing should reflect consumer preferences, not local authority preferences. As consumer preferences may change over time, it would seem unwise for planning authorities to fix the tenure of housing at a single point in time – i.e. when the land happens to be developed. At present, individual dwellings can easily switch between owner occupation and private renting in response to the changing needs and preferences of owners and renters. In addition, we do not believe local authorities could ever have sufficient knowledge of local market demand to pre-determine the tenure of housing sites in the local development plan. Finally it would seem undesirable to use the planning system to try to overcome a problem (high capital values, therefore low rental yields) which was created by the planning system itself in the first place (because of land and housing shortages) – in effect, trying to overcome an existing distortion by introducing yet another distortion.

29. Similarly, we are also opposed to simplistic ‘solutions’, such as waiving S106 demands for private rented housing development. Many potential residential sites are not viable at present because of the current and future regulatory cost burden (including S106 demands) on land values. It is not at all clear why these burdens should be lifted for one

tenure, or for one type of provider of one tenure. Rather, if housing land is not viable because of the regulatory burden, clearly the regulatory burden needs to be lifted for all housing supply. As already noted, we do not believe the planning system should be used to manipulate land values in favour of one tenure, or one type of tenure provider.

30. We also do not support the public sector putting in ‘cheap’ or ‘free’ land for institutional rental development, in effect offering a state subsidy for one type of provider within one tenure. In any event, there is no such thing as ‘cheap’ or ‘free’ land – all such land has an opportunity cost in terms of the value lost through this hidden subsidy. If private rental housing development is to be made viable, it must stand on its own two feet, and not rely on hidden state subsidy. If the state decides to subsidise housing development by putting in ‘cheap’ land, this should be available equally and transparently for all private housing development, and not restricted to one particular tenure provider.[6]

Positive Measures to Promote Increased Private Rental Supply

31. However, we believe there are Government measures that could help promote a greater supply of private rented housing without being detrimental to owner-occupied housing development. Apart from the fundamental need to promote a long-term increase in the supply of residential land to bring down house prices (and land values) in relation to incomes, the Government’s focus should be on measures to reduce the cost of building, acquiring and/or managing housing for rent in order to lift yields.

32. The most obvious measure would be to amend the current **SDLT** treatment of bulk private rented housing acquisitions. While we appreciate this was introduced to stop buyers avoiding paying stamp duty by artificially breaking up the value of transactions, it cannot have been HM Treasury’s intention to erect an obstacle to private rented housing supply. This must be an even more pressing need since the Budget’s introduction of a 5% rate for properties valued at more than £1 million.

33. Also, it seems undesirable that an individual investor can buy several dwellings, with each being treated as an individual transaction for stamp duty purposes, whereas a large-scale investor buying a number of properties in bulk ends up paying a significantly higher rate of stamp duty. There should be a level playing field between all rental investors, of whatever size.

34. Amending the rules seems unlikely to result in any significant loss of revenue for HM Treasury, compared with current SDLT revenues,

[6] The case for using public sector land for social rented housing is rather different. Because this type of housing can only be provided with a heavy subsidy, it matters little whether this subsidy takes the form of a hidden public land value subsidy, or a direct cash subsidy through public sector grant.

because there are probably few such bulk purchases at present. This measure would benefit all larger-scale investors. It would have no direct impact on development of owner-occupier housing.

35. We would also support changes to the **VAT** treatment of repairs. This would lower the cost of managing rented housing by narrowing the wide net/gross yield gap in residential, thus helping to improve yields, while not disadvantaging owner-occupied housing development. This would equally benefit individual, institutional and other corporate investors.

36. HBF does not have expertise in the detailed operation of **REITs**. However we understand there are some rules which, while not a problem for commercial property REITs, constrain the establishment of residential REITs. It must surely be possible for HM Treasury to design a special, ring-fenced residential REIT structure, without any adverse consequences for non-residential REIT operators or for HM Treasury in terms of revenue from non-residential REITs.

37. Three key measures would encourage establishment of residential REITs:

- Removing the double taxation due to the distinction between investment and trading property by allowing a new class of residential asset for REIT purposes – achieving adequate total returns would require the release of capital gains through trading activity, but such trading is too restricted in the current REIT structure;

- Allowing a LTV/leverage test, as is used elsewhere, rather than the income test currently required for REITs – greater leverage is needed to achieve the required returns from residential investment than is allowed in the current REIT structure;

- Relaxation of the 90% distribution requirement because depreciation/wear and tear of residential property already reduces gross rents by around 10%, which means no income can be retained for reinvestment.

38. There cannot be an absolute guarantee that changes to SDLT, VAT, and the rules for REITs would lead to a significant increase in the supply of private rented housing. However these measures would seem to offer little risk to HM Treasury: if they do not work, then there would be little impact on Treasury revenues, and if they do work there will be many benefits, both to Treasury and the wider economy.

ENCOURAGING ALL NEW SOURCES OF PRIVATE RENTAL SUPPPLY

39. We understand the Government's desire to see institutional money flow into housing. Capital for housing development and for residential

mortgage finance is likely to be constrained for some time, so any new injection of funding is to be welcomed. We can also appreciate the benefits to tenants and communities of large-scale, well-managed institutionally-funded residential portfolios. However this should not blinker the Government to other sources of rental investment.

40. As noted in the Treasury consultation paper, private rented housing remains primarily a small-scale enterprise, run by individual investors. We understand this is also common in many other countries, despite very different circumstances (e.g. tax treatment). Therefore it would seem desirable to work with the grain of what currently works, rather than concentrating excessively on trying to introduce a new source of funding which governments have been trying, unsuccessfully, to attract since at least the early 1980s.

41. The most obvious impediment to demand from individual investors at present must be the severe shortage of affordable mortgage finance. However, as discussed at the recent Treasury seminar, the solution to buy-to-let mortgage finance must be to solve the mortgage funding crisis in the round. The buy-to-let mortgage famine is merely one element of the wider mortgage famine, and clearly cannot be solved in isolation.

42. On the issue of buy-to-let mortgage regulation, we quote below from our submission to the recent FSA consultation on mortgage regulation:

> While we do not have an accurate estimate of the investor share of total new home sales[7], in the boom years investors clearly accounted for a significant proportion of new home sales, particularly in town-centre and inner-city apartment schemes.
>
> The investor market has contracted sharply since 2007, but we believe investors will remain an important source of demand for new homes in the future.
>
> The FSA Discussion Paper highlights the disproportionate increase in arrears and possessions among investment borrowers since the downturn. However we would urge the FSA to be mindful of the real reason for this. It was not that all the individual investors who are now in trouble made bad decisions about the particular property they bought. Rather, they misjudged the housing market and economic cycle, as did most people in Government and the Treasury, the Bank of England, the FSA, the economics profession, business and the population at large. Because businesses expanded in the upturn, we do not now say that those who have suffered in the recession made poor decisions and should therefore be regulated to protect

[7] Since HBF's submission to the FSA, the Treasury's private rented sector consultation has estimated that buy-to-let sales represented about one fifth of new home sale.

them from themselves. Yet this is, in effect, what is being proposed for the investor market.

In addition, we cannot see how in practice lenders could adequately discriminate between naïve investors who, we might argue, need protecting from themselves, and investors who are making informed commercial decisions which may, in the long-term, turn out to be right or wrong, as with any commercial decision.

While we understand the FSA's desire to bring BTL mortgages into the regulatory framework, we are not convinced this is a practical proposal. We note in particular the Discussion Paper's observation that BTL mortgages often involved poor lending decisions and low margins. This would seem to suggest the solution, as with so many other problems in the mortgage market, lies with better risk assessment and risk pricing by lenders.

43. Along with institutional and individual buy-to-let investors, there are other larger 'corporate' investors who could contribute to expanding the supply of private rented housing. The most high-profile is Grainger, but there are other organisations, or individuals operating as full-time professional landlords, with sizeable rental portfolios. These investors are likely to fall somewhere between institutional investors and individuals in terms of their requirements for the balance between capital growth and rental income within total returns. And while we understand institutional investors – following the US model – may seek to acquire several hundred units on a single development, other larger 'corporate' investors will tend to seek smaller numbers of units on single development sites, although numbers would be greater than the very small numbers purchased by most individual investors.

44. Assuming the yield problem can be overcome, a diverse range of private rental providers would offer greater benefits to home builders and overall housing supply. The demands of different investors, in scale and location, would benefit a larger number of housing developments, whereas institutional investors seeking large numbers of dwellings on individual sites would only be able to consider a very restricted range of sites.

TREASURY CONSULTATION QUESTIONS

Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting owner-occupied housing?

45. HBF does not have any survey evidence. However it seems likely buyers were attracted by the hassle-free nature of new home purchase (brand new so no initial repairs or decorating, no chain), by sales

incentives, and by the ready availability of suitable products in suitable locations for the rental market.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

46. Again, HBF does not have hard statistical or survey evidence, but we can offer some views. If, as seems likely, a high proportion of buy-to-let and investor buyers purchased new apartments rather than houses, often in town-centre or inner-city locations, the PRS provided additional sales for the industry which might not have been possible from owner-occupier buyers alone (i.e. it increased total new home sales); it played a significant role in enabling home builders to regenerate large sites in many town-centre and inner-city locations which would have been much more difficult to achieve without strong investor demand; it probably allowed home builders to achieve higher prices than would have been possible if they had been solely reliant on owner-occupier buyers, with a consequent impact on land values; it increased the industry's willingness to build apartments, including large apartment blocks requiring large numbers of buyers; and therefore it made it easier to achieve the higher density requirements set in PPG3 in March 2000; and it enabled some home builders to forward sell product off-plan (investment buyers are likely to be more willing to buy off-plan units for delivery some considerable time in the future, than owner-occupier buyers), whereas without these certain sales and early cash inflow some larger schemes would probably not have gone ahead.

47. The future impact will depend on the scale of demand from various investor types: small amateur landlords buying one or two units, professional or corporate bodies buying larger numbers of units, institutionally-funded bodies buying large numbers of dwellings on sites. It was clear from the Treasury seminar that the first of these groups is heavily dependent on a restoration of affordable mortgage finance, while the second group, although apparently less highly geared, is also reliant on borrowed funds. Institutionally-funded demand is an unknown quantity.

48. In any event, the industry seems unlikely to wish to develop as many apartments as in the later years of the boom, even if investor demand revives. It will also be some time before developers are ready to start new apartment schemes in the most over-supplied inner-city and town-centre markets, even if demand slowly revives. And because buy-to-let demand up to 2008 was apparently heavily dependent on capital growth, with landlords accepting relatively low rental yields, as long as house price growth remains subdued it seems unlikely investor demand will expand to anything like the scale we saw up until 2007.

49. Also, with subdued house price growth, investors are likely to seek higher rental yields than in the period up to 2007). If so, this would put

downward pressure on new home prices, with a corresponding impact on land prices, and on home builders' ability to meet the cumulative regulatory and policy burden, causing particular problems for regeneration sites with substantial viability problems. This also seems likely to compress the price differential between what owner occupiers and investors would pay for the same property. All of which suggests home builders will, for some time, have to carry out their development appraisals, and design their housing mixes, on the assumption that most units will be sold to owner occupiers at owner-occupier prices.

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

50. We do not have solid evidence. But as noted above, while it is probably very difficult for anyone to judge the likely outcome of changing the bulk-purchase rule on its own, there seems little risk to HM Treasury from such a change because we suspect there are very few bulk residential purchases currently caught by this rule. Also, as noted above, while we understand the bulk rule was designed for a specific purpose (to stop artificial attempts to avoid SDLT), the adverse impact on bulk purchases of private rented units is presumably an unintended consequence. Finally, it seems an undesirable distortion that individual, small investors, buying only a few units, pay a low rate of stamp duty (or none at all), whereas a corporate or institutional investor buying a significant number of units on a single development would be hit with a very large SDLT bill, probably at the highest 5% rate.

Questions 11: What are the key barriers to investment in residential property through UK-REITs, and what changes would be needed to address them?

51. See our comments above in Section 5.2.

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?

52. From the home builders' perspective, the key benefits would be (a) to inject new capital into the housing market, given that capital (both development and mortgage finance) seems likely to be constrained for some time into the future, and (b) to provide a new, less cyclical source of demand, particularly for new housing, while housing market volumes from traditional sources of demand are likely to recover only slowly. Institutional investment should be less cyclical than demand from small landlords or owner occupiers because it would not be dependent on short-term mortgage finance or mortgage rates, and it should be less prone to bursts of speculative demand during periods of rapidly rising

house prices (it would be driven primarily by rental yields rather than anticipated capital gains).

53. This would enable the industry to expand house building more quickly than would otherwise be possible, thus expanding capacity, increasing employment and reducing the many adverse impacts on society and the economy of inadequate levels of home building. However all these benefits assume adequate institutional yields can be generated from new housing.

John Stewart
16 April 2010

improving living in scotland

HOMES FOR SCOTLAND

INVESTMENT IN THE UK PRIVATE RENTED SECTOR
HOMES FOR SCOTLAND RESPONSE TO HM TREASURY
APRIL 2010

Introduction

Homes for Scotland is the representative body of the Scottish homebuilding industry, with over 190 full and associate members. Its members build around 95% of all new homes for sale built each year, as well as a significant proportion of the affordable housing output annually. Homes for Scotland makes policy submissions on National and Local Government policy issues affecting the industry, and its views are endorsed by the relevant local committees and technical advisory groups consisting of key representatives drawn from within our members.

Homes for Scotland welcomes the opportunity to respond to many of the issues raised in this consultation and is pleased that HM Treasury is considering seriously ways in which investment in the UK private rented sector can be increased. We fully appreciate the role that an expanded private rented sector can play in the Scottish housing market, in particular its role in providing a much-needed bridge between owner-occupation and affordable housing provision. Lending restrictions combined with general market conditions have dramatically increased the number of people unable to secure mortgage finance. Our response is therefore not to argue against the benefits of home ownership which we as an organisation fully support, but to increase the supply and choice of much needed new homes across all tenures in Scotland. It is clear in that context that one of the most effective ways to increase housing numbers at this time is to encourage institutional investment in new build homes for the private rented sector.

We understand that much of the growth in the private rented sector in the past has been among small-scale, amateur landlords or speculators. We must not forget the beneficial impact of Buy to Let on the expansion of the private rental sector or the economy, and this enterprise should not be damaged. However with macroeconomic conditions further weakening the capacity of small landlords to invest in properties in the short to medium term, we fully accept that any significant expansion in private rented stock will depend on an injection of institutional investment. We also welcome the additional benefits that a professionally managed, quality private rented sector can bring to housing supply in Scotland.

Rather than answering each of the questions directly, we have raised a number of important points under selected questions. We have aimed to be clear on what fiscal measures HM Treasury must take to aid the attractiveness of residential investment and crucially allow it to compete on a more even keel with the commercial sector.

Questions 6 & 7 - Stamp Duty Land Tax

We agree with the proposal referred to in questions 6 & 7, that the Stamp Duty Land Tax (SDLT) rules should be changed to reflect the individual value of the properties purchased, rather than on the total amount paid for the whole collective transaction. The fact that the Stamp Duty levels have changed since the publication of this consultation should not affect this proposal. This change is required immediately to level out the playing field for different types of purchasers and to make residential property a more attractive proposition for investors.

Question 8 – rates of return on investment

Rates of return are at the moment disappointing in the residential investment sector. Figures quoted in Property Week (October 2009) indicate a return currently of around 3%. An increasing number of investors may accept a yield of 3% if the return could be guaranteed, as with schemes such as the National Housing Trust noted below where the Scottish Government is takes on part of the risk. However, rates more in the range of 6% would be much more acceptable to institutional investors and in comparison do seem to be achievable in the commercial sector.

Suggestions for interventions that could sustain a higher return to allow the residential sector to compete with commercial investment are noted below in response to Q10.

Question 9 – recent institutional interest in investing in the private rented sector

Our understanding is quite the opposite with low take up of REITs investing in residential property. We are led to believe that Legal & General have pulled out their interest, leaving only Aviva offering residential investment as part of their portfolios. We hope, as part of this consultation process, that HM Treasury are in discussions with Legal & General to establish what barriers they were faced with leading to the decision to withdraw.

Question 10 – key barriers to institutional investment in residential property and how they could be addressed

Barrier: Lack of fiscal incentives - VAT

The current VAT structure offered in the UK does nothing to incentivise institutional private investment in the private rented sector. As your consultation paper notes, the private rented sector is currently occupied by a vast number of small-scale, amateur landlords in most cases private individuals. Those private individuals that have expanded their portfolios greatly may well be classed as 'SMEs' and the transition from one or two properties to a small portfolio of say fifty properties is relatively smooth and crucially VAT free.

The disincentive comes when that SME wants to sell its property portfolio to an investment company or pension fund, where the properties would become professionally managed. Here the interested investor would face a 17.5% VAT charge on the price of the properties, making the investment extremely unattractive. Without taking a knock on the value of the portfolio to compensate for the VAT charge to the investor, for the SME to release the capital it is a more attractive option to sell the properties on the open market individually. Likewise, the only way for the company or pension fund to avoid the 17.5% charge would be to buy properties individually on the open market. The hassle and bureaucracy involved in this process would put many investors off from the start. Buying properties individually could also have implications for the Stamp Duty Land Tax changes proposed which we fully support.

Changes to the structure of VAT charges through these transactions are crucial if the Treasury is serious about increasing the attractiveness of residential investment in the private rented sector. Put simply, we believe that VAT charges should not be applied to transactions where ownership of property portfolios is transferred between corporate bodies.

We would also support reductions to the VAT treatment of repairs. This would lower the cost of managing rented housing by narrowing the wide net/gross yield gap in residential, thus helping to improve yields, while not disadvantaging owner-occupied housing development. This would equally benefit individual, institutional and other corporate investors.

Barrier: Short-term leases impacting rental return

Unlike the commercial sector which commonly offers leases on a five or ten year basis, the private rented residential sector offers tenants short assured tenancies for a minimum period of six months. The turnover of tenants is therefore significantly higher in the residential sector, resulting in gaps in income from the property. If the government is serious about promoting this sector as a) an attractive investment and b) a quality tenure choice, viable tax incentives or interventions must be considered and where they already exist, expanded.

The Scottish Government and Local Authorities already use the private rented sector in a number of ways. Three examples are listed below which demonstrate successful interventions by the public sector which support the expansion and use of the private rented sector.

Private sector leasing

Private sector leasing arrangements allow properties leased by local authorities to provide temporary accommodation for homeless households and/or asylum seekers. These leasing agreements can guarantee the owner of the property a level of rent for a defined period of time. The properties are also professionally managed by the Private Sector Leasing Company for 3 or 5 years. Local Authorities are increasingly finding this a far more economically efficient option to increase the accommodation they have available to house those in need rather than for example relying on Bed & Breakfast lodgings.

The advantage of these schemes to the property owners is of course a guaranteed rental income stream for a defined period of time, on top of that a guarantee that the property will be maintained and returned after the defined time in the same condition. An example of a company operating this scheme is Orchard and Shipman, who currently have contracts in Edinburgh City Council, Mid Lothian Council, East Lothian Council and Scottish Borders Council within Scotland.

Rent Deposit Schemes

Local authorities also increasingly encourage and assist households into the private rented sector through rent deposit schemes, as part of their wider homelessness prevention agenda. Although this only guarantees the tenants deposit and not the payment of rent or the length of the tenancy, consideration could be given to how this and other such schemes could be expanded in its offerings to the benefit of the sector. This would certainly go some way to assisting Scottish Local Authorities to meet their legally binding 2012 homelessness targets.

National Housing Trust

It seems apparent that one area where institutional investment has flourished in the residential sector is student and retirement housing, where the investment has been transformed into something that looks like a commercial investment. This model can be transferred to other parts of the residential market where the rental cash flow is either wholly or partially underwritten by government. This has been proven through the development of the National Housing Trust by the Scottish Futures Trust.

The National Housing Trust in Scotland will aim to deliver up to 2,000 homes suitable for mid market rent. Tenant groups would be households on low to moderate incomes who cannot afford market rents, but are not currently in a priority group for accessing social rented housing and are unlikely to afford owner occupation. The Trust will deliver a series of special purpose vehicles set up to procure and acquire completed houses, governed by a Board whose membership would include participating Local Authorities. The homes would remain available for affordable rent for between five and ten years, after which time the houses would be sold and the public funds recycled.

The introduction of this new form of tenure has high benefits for the households themselves who are able to access high quality accommodation at affordable rents. Households are also able, during the five to ten year window, to build up savings for a deposit allowing them the opportunity to move on to owner-occupation, where desired. Access to deposits and saving history are likely to continue to feature heavily in the assessment of personal affordability for mortgage finance.

The National Housing Trust, or a variation of the scheme, would have the potential to be grown significantly if investment was attracted from private institutions with an appropriate level of guarantee from Government to protect yield returns.

Question 11 – key barriers to investment through UK-REITs

As mentioned above (question 9), we hope that HM Treasury are consulting closely with those financial institutions that showed initial interest and then withdrew from REIT models. Those organisations would certainly hold the key to the question of what barriers exist. Other issues affecting our member companies directly are listed below.

Barrier: the requirement to be ‘listed’

We understand why many listed home building companies are converting to REITs, despite the initial cost the advantages of them doing so are greater – i.e. capital gains and corporate tax exemption within the fund.

For those currently not listed however it is less attractive and it is unlikely that smaller companies will 'float' to take advantage of REITs. The hassle of becoming a listed vehicle is the main reason for this. We are led to believe that some organisations are considering overseas listings in jurisdictions where the listing obligations are not as onerous as in the UK (i.e. Channel Islands and Ireland). The question our member companies would ask here is why 'listing' of companies is necessary to take advantage of REITs in the first place?

Barrier: the 10% rule

Given that the REIT rules state that no one shareholder can own more than 10% of the share capital (to benefit from the tax favoured status with dividends), REITs do not always make financial sense for the shareholders. We would suggest the limit be amended to 25% or 33% to allow smaller businesses to benefit yet still preventing amateur or ill informed, speculative personal investors.

The 10% rule is currently another reason why REITs will be more popular to large property groups. However, if at this time even large public limited property companies are failing to show interest in UK-REITS then the arrangements must undoubtedly be reconsidered to ensure they are structured in a more attractive way.

Barrier: Status of rented properties

We understand that the status of certain rented properties is causing problems for REITs. These should be investments that fit the 'exempt business' criteria of a REIT but if properties are previously held as 'trading stock' we understand that they cannot be transferred to a REIT. HMRC must consider this stumbling block which could unknowingly affect companies.

Self Invested Personal Pension (SIPPs) and Small Self Administered Schemes (SSAS)

In addition to assistance to promote the expansion of REITs, consideration should be given to the revision of qualifying trades for both SIPPs and SSAS. At the moment SIPPs and SSAS can invest in residential property, either in the UK or overseas, provided it is via a genuinely diverse commercial vehicle. This means that a SIPP or SSAS cannot directly wholly own a residential property. It must be a part owner (not more than 10%) and there must be no right for any personal use, with a large list of definitions provided by HMRC. As with REITs, the 10% rule causes unnecessary restrictions. We understand the Government is concerned that the tax breaks available through SIPPs would lead to unfair advantages of higher-rate taxpayers in the market for second homes at the experience of first time buyers. However we feel that the higher rate tax payer question could now be a red herring and a debate on the approach to inclusion of residential properties in SIPPs/SSAS needs to be had. At the very least, as with our suggestion on REITs, the 10% limit should be amended to 25% or 33% to allow smaller businesses to benefit.

Question 15 – evidence of the benefits that institutional investment can bring to the private rented sector and the housing market generally

We were surprised to read that HM Treasury is not clear on the benefits that institutional investment might bring to the housing market.

With regard to the concern that if investment is geographically concentrated it will have an impact on house prices, we would suggest a referral to a wide range of industry commentaries that suggest when the market over-heated in the early and mid noughties, first-time buyers where frozen out by speculators, not long-term investing landlords or professionally managed and delivered private rented sector portfolios.

For further information on how we as an industry believe HM Treasury can assist the supply of much needed new homes, please refer to our manifesto policy document.
http://www.homesforscotland.com/buildingfortheirfuture.aspx?Site=1

ICAEW REPRESENTATION

TAXREP 23/10

INVESTMENT IN THE UK PRIVATE RENTED SECTOR

Memorandum submitted in April 2010 by The Institute of Chartered Accountants in England and Wales, in response to the HM Treasury consultation, Investment in the UK private rented sector, published in February 2010

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the HM Treasury consultation, Investment in the UK private rented sector, published in February 2010.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the Institute who pay an additional subscription, and a free weekly newswire.

MAJOR POINTS

Questions in the consultation document

5. We have made a specific response to questions 1, 3, 4 and 6 only.

6. The paper appears to hint at an understanding of the burden taken on by an individual buy-to let investor. We consider that this should be reflected properly by the tax system and we recommend that the tax treatment of property income generally is reviewed. This should include all taxes, including national insurance and also tax credits.

7. The amount of the rent a room scheme tax exemption should be uplifted to reflect current rent levels.

SPECIFIC COMMENT

Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

8. Para 4.7 notes that small individual landlords dominate the private rented sector (PRS) supply. Individuals or couples own 74% of the PRS housing stock with over two thirds of these owning five or fewer properties. It seems unlikely that all of these individuals can use this as their sole source of income and many will therefore be employed or self employed in other areas. The time and work involved in converting housing stock for letting can be considerable. New build properties will already meet required standards and can be let immediately.

9. Recent legislation such as that affecting houses in multiple occupation, have increased the costs for landlords purchasing older style properties. For example, replacing existing Edwardian panelled doors with modern fire doors will not enhance the capital value of a property, indeed it may reduce it. Buying a new property which already meets these standards although having less aesthetic appeal, will be a cheaper option.

10. Tenants generally prefer houses which already incorporate modern kitchens, showers, satellite or cable and wireless broadband. These will often come as standard in a new build, but will necessitate modernisation of older properties, involving cost for the landlord which may not be recoverable through comparably higher rents.

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?

11. Since its introduction in 1992, tax relief through the rent-a-room scheme has relieved most householders from the administrative burden of making tax returns for income from letting a room in their own home. The current exemption of £4,250, dates back to 1997 and should now be uprated to reflect inflation since then.

12. While we do not have figures for average rent paid, it seems likely that rents have risen considerably since the limit was set. In particular, the cost of renting a room in London or the South East is more likely to be in the region of £100 per week. A more accurate figure should be obtained from estate agents or letting agencies and we recommend uplifting the exemption to this amount.

13. We do not think that this uplift will carry a significant cost to the Treasury.

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?

14. In the past 10 years, many more private individuals have seen investment in the PRS as a viable business opportunity. The tax system has not been changed to reflect or encourage this this. Indeed, the only proposal for change has been to abolish the special rules which allow furnished holiday letting income to be taxed like a trade. The abolition is currently on hold pending the outcome of the general election.

15. Historically, a schedular system was used both for income tax and for corporation tax. This required property income to be treated separately and differently from income of other trades. Although the schedular system no longer exists, the separate rules for taxing a property business continue to apply. In particular, capital allowances are not given for plant and machinery used in a dwelling house.

16. The consultation paper recognises that individual landlords often manage the properties they let themselves. It is difficult to see why this is different from any other trading activity, particularly where several properties are being let and it becomes a full time occupation for the landlord.

17. We note that a buy-to-let investor is frequently tied to a particular property investment through the absence of any form of rollover relief. If a substantial capital gain would be realised on selling a house, the investor will not be able to reinvest all the proceeds in a new property for letting after having paid the tax. This is particularly difficult where the investor is relocating to another part of the UK for unconnected reasons, such as employment or retirement. An owner managed investment is managed far better if the owner lives nearby.

18. We recommend that the tax treatment of property income generally should be reviewed through a public consultation specifically focussed on this area. This should include all taxes, including national insurance, stamp duty land tax and also tax credits.

19. The proposals in the recent consultation document, False self employment in construction: taxation of workers, would in our opinion add both to the administrative burden of the construction industry and also to the costs of the industry.

20. At this time, the proposals appear to be on hold, although a statement in the 2010 Budget book states that the Government remains committed to legislation in this area. We said in our response, TAXREP 54/09, that the proposals would require many individuals involved in construction and correctly trading as self employed, to be recategorised as employees. A proportion of the additional cost of this would undoubtedly fall on individual landlords. A mobile and flexible workforce is essential to support the residential lettings sector.

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?

21. We do not know whether the SDLT bulk purchasing rules are a constraint to building up property portfolios, but it seems likely that an individual landlord owning several properties which have been let over many years, would see this as a continuing business and would prefer to sell it as such if a buyer could be found. The alternative is to sell the houses individually, often to owner occupiers rather than buy-to-let investors.

22. A single buyer for all the properties as a single lot would have to pay considerably more stamp duty. This seems to work against the Government's intended policy of maintaining the stock of residential property for letting.

23. Any change to the stamp duty regime should first be included within the consultation referred to in paragraph 18 above.

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APPENDIX

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory**: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain**: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple**: the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate**: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted**: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant**: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation**: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed**: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160

THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

DRA/cf
Ref: PRS Investment Consultation28

PRS Investment Consultation
c/o Keith Jackson
House, Regeneration and Third Sector Team
HM Treasury
1 Horse Guards Road
LONDON
SW1A 2HQ

28 April 2010

Dear Sirs

Consultation: Investment in the UK Private Rented Sector

The Institute of Chartered Accountants of Scotland welcomes the opportunity to comment on the consultation on investment in the UK private rented sector. The Institute's membership is based throughout the world and a significant proportion of its membership is based in and practices in England. We note the document is titled 'The UK Private Rented Sector' but the introduction comments on 'housing policy in England'. Our comments would apply to the UK private rented sector including Scotland (and Wales and Northern Ireland).

Q1: What has led individuals to invest in new build properties in preference to purchasing and converting existing owner occupied housing?

A: If a property is being purchased with a view to investment and income generation from rentals, purchasers of new properties value the NHVC guarantee and expect low maintenance costs. New properties are a more certain form of investment rather than the refurbishment of older properties. New properties tend to look more attractive to tenants and should therefore be more easy to let. Many people purchase older properties and are prepared to lovingly restore these for their own use. People who purchase with a view to rent, especially in properties of multiple occupation like apartments and flats will be prepared to purchase old properties with a view to renting these out to students. Those wishing to invest at the higher end of the market will wish to purchase brand new or newish properties as these are easier to market.

Q2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

A: For many years there has been an underlying assumption that the value of residential property was secure and likely to rise. As a result, investors believed that not only could an attractive rental income be achieved but the underlying capital value of the property was likely to increase. For years investment in property was reported in the media as being 'a good thing and a one way bet'. Many potential investors lost faith in the equity market and in long term savings arrangements like pension funds. As a result, many individuals entered into buy to let properties, often looking for flats in particular and many house builders responded to this demand. It would appear that when the credit crunch came, there was a far bigger supply in apartments and flats than demands for such property and prices have fallen significantly in a good number of cases. It would appear that the buy to let property purchasers encouraged house builders to build modern flats.

Q3: What is the contribution of individual home owners renting out part of their own home making to housing supply? Are there significant constraints liming this contribution to addressing housing demand?

A: The attitude of a home occupier to renting out a part of their home is very subjective. Rent-a-room relief has stood at £4,250 for many years and it is thought to be a useful tax exemption for encouraging a home owner/occupier to consider letting part of the home where there are other advantages. For example, an elderly person might benefit from a student occupying part of their house because there is a symbiosis to the relationship. The level of £4,250 is not sufficient to encourage investors. Advisers would comment that it is very rare for clients to rent out a room in their own house. If rent-a-room relief was to encourage investors to release space in their homes, we recommend that the threshold needs to be reviewed.

Q4: To what extent have the incentives for individual investment in private rented accommodation changed over the last ten years and why? Going forwards, what are the key prospects and risks for individual investment in the PRS?

A: Many individual investors in the buy to let market perceived it either as a get rich quick idea with the incentive of large capital growth. Interest rates were low and so it was possible to borrow cheaply. The return on property compared favourably with the return on cash deposits. The stock market recently has suffered a number of downturns and was viewed by many as too uncertain to produce returns whereas the impression created in the media was that investing in property was a one way bet.

The main risk for investors is that they purchase property at too high a price to obtain an economic return on the investment. Confidence in the property market has been undermined. The worry for many investors who acquired properties with high borrowings is that in the future rental income will fail to cover the outgoings.

Q5: 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?

A: We are not in a position to answer this question which we believe is best addressed by institutional investors. Our limited experience of institutional investment is of companies investing in long assured tenancies. Such properties have rental income which is low and as a result the properties do not command a high price. The investor is hoping that vacant possession of the property will be obtained so that the property can be sold at a substantial capital gain.

Q6: 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?

A: SDLT is a constraint where a person is seeking to buy a number of properties from another person. We believe that the purpose of the provision was to prevent disaggregation of a single property transaction thereby trying to reduce artificially the rate at which SDLT would be chargeable. We believe that the legislation is poorly targeted and should be improved, perhaps by the introduction of a motive test. This answers question 7.

Q9: What factors have prompted the recent institutional interest in investing in the PRS, and do these reflect a long term change in investment opinion?

A: Investment in the commercial property sector has performed badly in the last few years. As a result of over supply, many new build flats will have been available at relatively low prices encouraging institutional interest in investing in buy to let properties.

Q10: 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?

A: The big issue is the administration in cost of dealing with many tenants paying fairly low rents with tenants changing fairly frequently. Companies would need a very efficient administration system. We also question whether it is appropriate to continue the archaic difference in the schedules. There must come a point when investment in property assumes an activity in the nature of trade. We believe that this would allow the tax reliefs available to a trader including capital gains tax rollover relief, loss offset against other income, capital allowances, and other incentives to be available to a landlord.

Q11: What are the key barriers to investment in residential property through UK-REITs and what changes would be needed to address them?

A: We are not really in a position to answer this. We suspect that the entry charge is a significant deterrent for new residential REITs. We also believe that a significant deterrent will include the anti avoidance measures directed at bulk purchases of property being charged to SDLT at the rate applicable to the aggregate consideration. In practice, administration costs may be a significant deterrent especially if there are many residential tenants paying fairly low rents and changing fairly frequently.

Q13: How suitable are other collective investment vehicles for residential property investment? What are the current barriers to investment through these vehicles?

A: Other vehicles might include a limited company but this is unlikely to be as tax efficient as, for example, a REIT. A normal limited company might suffer a capital gain on a property disposal and then there might be a further gain on individual shareholders if the company is liquidated or, more likely, there is additional tax on the individual shareholders if the gain is distributed to them.

It its final question, the consultation seeks evidence that institutional investment in the PRS would bring real benefits to the sector and the housing market more generally. We are not aware of such evidence. We speculate that if institutional investors purchased some of the current surplus of new build flats that are for sale, this might help the construction industry and might improve the supply of housing generally.

Yours faithfully

Derek Allen

Derek R Allen
Director, Taxation

Response to the HM Treasury consultation

Investment in the Private Rented Sector

Submission by the
Joseph Rowntree Foundation

April 2010

The Joseph Rowntree Foundation (JRF) is delighted to submit the following response to the HM Treasury's consultation on Investment in the Private Rented Sector. We would be happy to supply any further information as required.

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The Joseph Rowntree Foundation (JRF) is one of the largest social policy research and development charities in the UK. For over a century we have been engaged with searching out the causes of social problems, investigating solutions and seeking to influence those who can make changes. JRF’s purpose is to search, demonstrate and influence, providing evidence, solutions and ideas that will help to overcome the causes of poverty, disadvantage and social evil. The Joseph Rowntree Housing Trust (JRHT) shares the aims of the Foundation and engages in practical housing and care work.

JRF has a longstanding interest in housing issues including the private rented sector, the outcomes of housing investment and the operation of the housing market. The JRF convened Housing Market Task Force supports this long-standing interest and aims to:

- identify the principles that would support a more 'socially sustainable' housing market, i.e. one in which extreme fluctuation between 'boom and bust' is avoided and vulnerable households are less exposed to its consequences; and
- set out possible policy approaches to achieve these principles.

Summary of response

JRF welcomes the consultation *Investment in the private rented sector* and is supportive of measures to increase housing supply. We are particularly interested in how to achieve this goal within a constrained public spending environment. The scope for an increased supply of private rented housing to create a more socially sustainable housing market forms a key element of the JRF Housing Market Task Force's considerations. This includes consideration of the scope of the private rented sector:

- to address housing market fluctuations by absorbing increased housing demand; and
- to provide a high quality, viable alternative to home ownership for those households who may be very exposed to the consequences of fluctuations in the housing market and economic cycle such as negative equity, mortgage arrears and interest rate rises.

Introduction

The JRF is pleased to respond to the HM Treasury's consultation on Investment in the Private Rented Sector.

JRF is currently exploring the principles that would underpin a more socially sustainable housing market. Through our work on the JRF Housing Market Task Force we plan to set out the policy approaches that might generate a housing market which is less subject to extreme market fluctuations and where low income households are less exposed to the consequences of extreme fluctuations in the market. We welcome consideration of the how to expand the private rented sector through institutional investment. We recognise the important role of the private rented sector within the wider housing market. Our evidence also demonstrates the crucial importance of understanding the interplay *between* housing tenures ***and*** the *detail of local housing markets* which can differ markedly from the national picture. These factors have the potential to distort the local housing supply impact and housing market outcomes of any investment changes in the private rented sector. As such we would underline the importance of considering the impact of any interventions in the private rented sector:

- **across the housing market** regarding the interplay between housing tenures;
- in terms of its potential **local and regional economic and housing market impacts**;
- in relation to **which groups might benefit or be crowded out**, on both the supply and demand side of the sector; and
- regarding the **trade offs** between any public policy (and associated spending) on this sector versus potential housing supply gains from investment in other areas. This would also include explicit consideration about how investment could improve the accessibility and viability of the private rented sector for low income households. We would also welcome consideration of how far existing housing stakeholders might be encouraged to diversify into the private rental sector, through the creation of a larger intermediate rental market.

Consultation question 1

What has led to investment in new build properties in preference to purchasing and converting existing owner occupied housing?

Research with purchasers of new build property suggests that the following factors were important in their decision to purchase new build (Leishman et al 2004):

- Certainty of entry date and price; and
- Avoiding a complex chain of purchasers (and competitive bidding in Scotland).

There was little evidence in this study that purchasers were attracted to new build because of its ‘newness’ or quality. Although the purchasers in this study were not landlords these factors may well apply to individual investors in the private rented sector, given that they generally own only small numbers of properties. However this assertion would require empirical testing to identify any distinct issues in buy to let purchasers' attitudes to new build.

Given that JRF research shows that institutional investors are likely to be interested in purchasing at the middle to top end of the private rented sector market (in order to be more certain about financial returns) and have concerns about the implications surrounding direct management of property (Cook and Kemp 1999) issues of quality and newness may well be of more concern in their purchasing decisions.

Consultation question 4

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

We welcome the consultation's acknowledgement that much of the increase in the PRS does not represent new stock. Although the private rented sector has increased as a proportion of the overall housing stock it is worth noting that much of the increase in the PRS was in areas where the sector had previously declined the most (Rhodes 2006). This suggests a supply lag with stock moving into the PRS as a result of following demand shifts, rather than in anticipation of them as individual investors would not want to bear the risk of getting ahead of demand and holding vacant property (Ball 2010). The supply of housing in the private rented sector also responds to the housing market cycle, which can shift the potential balance between returns from rented property versus any capital gains profit from selling.

This raises the important consideration of how far individual investment varies in relation to the economic cycle. As markets recover and improve the attraction of holding rental stock versus selling it may shift. There are clear demand drivers for a shift in stock from the owning to private rented sectors including:

- House price and related affordability pressures which shift the relative attractiveness between buying and renting (Ball forthcoming 2010),

coupled with other factors affecting access to owner occupation such as access to finance for deposits and mortgages;
- People living longer in the private rented sector (Heath 2008) generating an increased and more sustained demand.

Another key feature of individual investment is holding small numbers of properties and operating in local market contexts (Ball forthcoming 2010). Rhodes (2006) study demonstrates the individual nature of the PRS market in different locations: although London has the largest private rented sector, coastal and student towns also have sizeable rented sectors. There is also some variation in how 'open' private rented sectors are in terms of the open advertising of vacancies.

Forthcoming work for the JRF Housing Market Task Force also re-iterates the nature of the PRS as very attractive to small investors. As there appear to be few economies of scale in the sector smaller landlords are able to remain competitive within the market (Ball forthcoming 2010). The local nature of investment also means that smaller landlords do not necessarily factor in their management time to their calculations of rental yield or profit on the properties they rent out (Ball forthcoming 2010) which would be a crucial consideration in the institutional sector. It is also notable from earlier JRF research (Crook at al 1995) that:

- Only half of private lettings in the mid 90s were regarded as investments;
- Although most landlords wanted rents to cover their costs, landlords of only a third of lettings wanted commercial returns from their rental property.

This suggests that operating on a local scale brings many advantages for an individual investor in the PRS. The local nature of the PRS also highlights the importance of considering the impact on local housing markets of any investment shifts in the sector.

It is also important to consider the relationship of housing to pension and retirement provision. A review of housing wealth which drew on the recent Wealth and Assets survey data highlights how housing is seen as a vehicle to accumulate wealth and provide for individual welfare and retirement needs in older age (Rowlingson et al forthcoming 2010). The *Wealth in Great Britain* report (ONS 2009) also notes the importance of property in relation to people's retirement plans with 35% people tending to agree and 15% strongly agreeing with the statement that property is the best way to save for retirement. More of those who are self employed favour property as a way of saving for retirement with 60% for those who are self employed agreeing that property is the best way to save for retirement. As such housing remains relatively attractive when compared to other asset classes (Ball 2010).

Moving forward to look at the potential prospects and risks for individual investment in the PRS we would welcome further consideration of:

- The impact of demographic shifts on demand for private rented housing. Citing 2006 population projection figures from CLG, Ball (2010) argues that 90% of the predicted growth in the population between now and 2031 is expected to be in the 35 plus age group. Taking this and other factors into account Ball (2010) argues that demand for private sector housing may be peaking although as absolute numbers of households grow there may be some further growth in the sector. As part of its on going Young People and Housing programme JRF is pursuing work exploring how young people's housing issues, expectations and demands in relation to housing are changing and potential policy responses to address any shifts in these issues. We would be happy to keep HM Treasury informed of progress on this study and the programme as a whole.
- The impact of mortgage market lending constraints on small landlords ability to realise their investment goals. Although Ball (2010) suggests that the leverage of the private rented/buy to let sector is likely to mean that individual investors can realise their investment goals in many areas; he argues that there may be a continued weakness in markets in the North and Midlands;
- The trade offs inherent in encouraging greater institutional investment which carries with it a risk of crowding out smaller individual landlord investors (Ball forthcoming 2010). The diversity of those groups living in the private rented sector includes households who are owed statutory

homelessness duties by local authorities, those assisted by bond deposit schemes and those supported by housing support providers as well as the key groups of young professionals and students (Kelly 2008). As such it will be crucial to consider impacts both within the private rented sector itself and across local housing markets to ensure that the sector can work effectively for both low and high income groups;

- Policy measures which would build on the existing landlord profile to increase the supply of private rented housing and the ability of more low income households to access it such as the German model of providing subsidies such as tax concessions in the form of depreciation allowances for private landlords in return for providing access to low income households (Oxley forthcoming 2010). This would of course require further discussion and consideration of the required checks and balances in return for such public subsidy, including the opportunity cost and cost-benefit returns of investing public subsidy in this way; and
- Policy measures which might exploit the best of both approaches to create a more socially sustainable housing market where increased private supply continues to develop in more niche markets (such as for students, young professionals and older people) ***and*** to grow the potential for the PRS to successfully provide for more vulnerable/low income households (Kelly 2008). Social landlord innovations such as St Basil's Starter Home Initiative (St Basil's 2008) and London and Quadrant's DowntoYou schemes offer the potential for social landlords to offer an intermediate rented sector with associated savings models to low income households. These offer a number of potential advantages in terms of attracting private finance, enabling development and recognising the inter play between tenures – including the need to free up social rented housing. These potential benefits could be explored more fully in order to assess how private finance could address both imperatives of improving access to rented housing and continuing to stimulate economic growth.

Our evidence base shows that developing and evaluating such policy tools would require explicit consideration of:

- The interplay between housing tenures (Ball forthcoming 2010; Cole 2007);
- The housing tenure structure of local housing market areas. This could distort any growth in favour of already active local markets and niche client groups (eg students, young professionals) at the expense of weaker housing market areas and demand side groups with less purchasing power (eg lower income households);
- The supply and demand side effects this would create. Institutional investors are likely to require stock in the the middle to higher ends of the PRS where investment is more certain (Crook and Kemp 1999). It is uncertain how this would play out in terms of local housing market areas, although we might expect a stronger impact in more vibrant housing market areas. As such this would be a crucial consideration in terms of the differential impact of any growth in the sector and would merit specific consideration in relation to weak housing market areas.
- The balance and interplay between social and market concerns such as any trade offs between creating a more socially sustainable housing market and increasing housing market activity purely as a stimulus for economic recovery and growth. An explicit consideration of this trade off would be necessary in order to assess the social impact and sustainability of outcomes resulting from any public and private investment shifts in housing supply. The unintended consequence of crowding out low income or vulnerable households would need clear explicit consideration as this could lead to undesirable impacts such as an increase in demand for social housing.

Consultation questions 5, 9 and 10

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?

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

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?

The scale of holdings was identified as an issue in earlier JRF studies of institutional investors' attitudes to investing in private rented housing (Crook at al 1995; Crook and Kemp 1999). As noted in relation to question 1: individual investors are able to successfully compete with large institutional investors as the private rented sector does not appear to offer many economies of scale. The requirement to manage and maintain private rented sector properties may also offer advantages for landlords who are based locally and can act as a disincentive to some institutional investors (Crook and Kemp 1999).

As such the size of a landlords operation is a key issue for institutional investment. Ball (2010) argues that small to medium sized landlords of 1 to around 100 properties are more cost competitive than larger property holdings over a large proportion of the private rented stock. This is due to their low overheads, an ability to flexibly invest their own time and to move fast in response to local market signals. Issues concerning the diversity of private rented stock, the costs of managing this diverse and varied stock and the trading pattern of 'churn' in properties being bought and sold all favour smaller scale landlords.

However there are clear sectors of the private rental market where larger scale investors do have a competitive advantage due to the existence of economies of scale and/or enhanced skills sets in terms of management which can create distinctive and cost effective rental products (Ball 2010). These include the provision of accommodation for students, retried households and key workers. Student housing is a key example of how larger landlords have been able to successfully compete due to successful branding and a distinctive service package. Ball (20120) also argues that there is considerable scope for growth in serviced apartments for mobile, high income professionals and health care related housing. As Ball (2010) notes however the market is largely working without intervention in these sectors. Whilst there may be a case for increasing institutional investment in order to accelerate housing supply, as a trigger for economic growth, JRF would pose the crucial questions of:

- What are the trade offs inherent in a policy to promote more institutional investment?
- How might this type of private investment in housing enable the housing market to work more effectively for low income households?

Forthcoming JRF work on young people and housing highlights how private rented provision and investment might operate serviced apartments for young, low income working households (Rugg forthcoming 2010). This type of provision could enable the housing market to work for a broader range of young people i.e. those who do not qualify for social housing and are crowded out of the private rented sector due to a lack of open market 'purchasing power' resulting from lower paid and relatively insecure jobs (Rugg forthcoming 2010). As such JRF would argue that it is crucial to think across the market in terms of how large scale investment could create a more socially sustainable housing market.

Recent practice developments such as St Basils' Starter Home Initiative and London and Quadrant's DowntoYou scheme also suggest that there may be more scope to consider existing social landlords potential role in leveraging investment into the private rented sector to create an intermediate rented market which might contribute to achieving a more socially sustainable housing market that includes an accessible and vibrant private rented sector. We would suggest that the propositions that would need empirical testing in relation to these interesting market innovations include:

- How far they generate increased mobility within local housing markets;
- Sustainability for residents and providers;
- Interplay with other tenures including which tenures residents move on into, how many social rented units are freed up and developed as a result of this investment;
- Private finance institutions attitudes to investing in these innovations (which could, subject to any limitations on the legal structure of registered providers, offer advantages for those investors who prefer to

indirectly invest in order to avoid property management responsibilities);

- Long term management costs, including the relationship to wider neighbourhood management which has proved important in existing mixed tenure housing developments (Bailey and Manzi 2008; Bretherton and Pleace 2008) and is likely to also be key in any large scale private rented sector development.

In summarising the growth of institutional investment key features appear to include:

- The growth of niche markets such as student housing that enable clear branding and economies of scale (Ball 2010);
- The long run capital returns associated with housing coupled with a relatively uncorrelated relationship to returns on other types of property which can facilitate portfolio diversification (Ball 2010); and
- A more conducive political environment which has generated less political and associated reputational risk for investors (Crook and Kemp 1999).

There have also been previous schemes to encourage institutional investment such as the Business Expansion Scheme and Housing Investment Trusts (Crook and Kemp 1999) which might have helped to build an interest in investing in residential housing.

However barriers do remain for some institutional investors and the work reviewed here suggests that these include (Ball 2010; Crook and Kemp 1999):

- The poor liquidity of residential property;
- The low returns compared with other asset classes; which has prompted some investors to suggest that returns were not competitive without tax concession or grants – with financial institutions at the time of Crook and Kemp's (1999) study favouring grants over tax incentives.
- A lack of clear economies of scale in much of the private rented stock which does not offer any competitive advantages for larger holdings and favours smaller scale landlords;

- A need for clear disaggregated geographical information on the private rented sector which would inform investment decisions;
- The small scale of holdings couple with high investment transaction costs; and
- The requirement to manage and maintain properties which generates two distinct approaches to investing in the private rental sector:
  - Direct management and maintenance of residential holdings, particularly by those who had already invested; and
  - Indirect investment in property owning companies, thereby avoiding the need to be involved in management and maintenance.

The holding of stock in companies, rather than directly owning the housing itself, was seen as a key way around ten problem of illiquid assets for some institutional investors (Crook and Kemp 1999).

In considering the issue of institutional investment across Europe it appears that (Ball 2010):

- Switzerland is relatively unique with its major pension and insurance institutions having substantial holdings in Swiss rental property. However although Switzerland does have a high proportion of private rented housing at 70% of ten housing stock, the majority of rental properties are still owned by small scale individual landlords. The reason for large institutional holdings could relate to taxation, regulatory issues and state-business relations;
- Institutional investors in ten Netherlands own less than 5% of ten housing stock and operate at the upper market ‘free rent’ sectors. However Rabo bank has a major real estate division which includes both residential and an active development arm within its business. Ball (2010) argues that the fact that Rabo Bank operates across much of Europe indicates that it is possible for financial institutions to build up successful real estate operations. It is perhaps notable that Rabo Bank spreads its risk by being active across a wide range of real estate activities in a variety of locations, whilst retaining a specialist core in ten Netherlands and links with social housing institutions;

- In Germany large scale investors exist due to social housing legislation which stipulates that social housing converts to private ownership after a stipulated time period, plus privatisations by municipalities and employer owned estates. Although some of these were bought by investors with the intention of selling to tenants they have not proved particularly successful with many investors selling out after only a few years (Ball 2010a);
- In Finland insurance companies have been pulling out of the private rented sector due to unattractive returns.

This suggests that the issues facing institutional investors in the private rented sector are not dissimilar in other parts of the world. It also raises related issues of regulation, Government subsidy and taxation structures which must be considered in tandem with increasing investment. The planning system is of course also an issue here particularly in relation to new build property.

Consultation question 8

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

It is notable that only a quarter of landlords regard housing as their prime source of income (Ball 2010). Earlier work funded by JRF also showed that (Crook at al 1995; Crook and Kemp 1999):

- Only half of private lettings in the mid 90s were regarded investments with a third of company owned lettings aimed at housing employees;
- Although most landlords wanted rents to cover their costs, landlords of only a third of lettings wanted commercial returns from their rental property;
- Net rental returns on the largest Business Expansion Scheme entrepreneurial companies was 6.5% (for those with more than £4m capitalisation). Although half the companies would like to continue in business they felt that returns were not competitive without tax concession or grants – with financial institutions at that time favouring grants over tax incentives.

This work also suggests that average rental yields do not compare favourably with alternative investments. Gross rental yields were 7.6% and net rental yields were 5.5% on average. The landlords of two fifths of lettings regarded the rent as insufficient and required a return that was on average 3.4% higher at that time (Crook et al 1995). At the time of the study the returns being obtained on gilts were 6.5% with comparative returns needed by investors in commercial property of 8-10%. In taking all these factors into account the study suggested that equity returns of 10-13% net rental yield would be required by financial institutions investing in private rental housing; over twice the net yield that was being obtained at that time.

As noted earlier however the diversity of the private rental sector means that yields may be greater in niche markets within the private rented sector. Ball (2010) highlights the student accommodation sector as an example of potentially high rental yields citing Savills (2007) Student Housing Report which showed this market as worth £6.6bn in 2007, almost doubling in value over the previous two years.

Question 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?

In reviewing the role of large investors in the private rented sector Ball (2010) notes that the private rented sector is generally a small scale operation around the world. This raises a need to think carefully about the likely scale of institutional investment in the UK's private rented sector through REITS or other investment vehicles. For example Ball (2010) highlights that:

- Although the US has both a tax friendly environment and the potential for widespread initiatives at state and national level only around 8% of stock is owned by large scale investors. Large scale investors generally own and manage large, standardised apartment blocks for middle to low income households, although there overall impact is small given the size of the US rental housing stock. Residential REITs own around 1% of the stock;

- REITs in the US have tended to focus on the mobile, affluent market within the private rented sector and have been active in ‘growth’ cities such as Dallas and San Diego. This means they have had little impact in the sector in the older, industrial cities of the US. Ball (2010) argues that the key to this is that REITs are dividend driven and the older cities, where the need for affordable housing is strong, do not have residents who can pay for new REIT housing. This suggests that REITs are suitable for young, wealthier residents who want more up-market housing and demand flexibility of terms. Stronger demand in growth cities also fits the structure of funding and management of REITs;
- Looking across Europe, REITs are virtually nonexistent. The REIT in Belgium has remained a small niche player and German REITs were explicitly restricted from active involvement in the residential sector due to residents’ concerns that the commercial ‘bottom line’ would take precedence over residents interests (Ball 2010a).

Encouraging institutional investment, whether through REITs or other investment vehicles or incentives, requires careful consideration of the likely differential impact on local private rented sector markets across the UK. If the US experience were to be replicated in the UK context then we might see already weak housing markets in the North and Midlands suffer further due to a lack of investment and already overheated markets such as the South East might further price out low income households from private sector full market priced housing. This proposition would require careful testing and raises a need to be explicit about the desired outcome from increasing institutional investment in the private rented sector and how this might generate a more socially sustainable housing market where the market can successfully work for both lower and higher income groups. This more nuanced debate that takes into account local market context would enable policy deliberations to flush out more clearly the potential unintended consequences from increasing institutional investment and the trade offs this might entail, particularly where any element of public subsidy would need to be included.

Consultation question 15

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

A crucial issue in considering the answer to this question is that of which groups who would like to, or who currently already live in, the private rented sector would benefit as well as the housing market implications.

In terms of increasing housing supply, JRF's review of the Business Expansion Scheme (BES) which operated between 1988 and 1993 with the goal of attracting risk capital (Crook et al 1995) showed that:

- 903 assured tenancy companies raised £3.4bn through the BES and provided 81,000 dwellings at a cost of £1.7bn in foregone tax;
- At that time the net rental returns for larger BES entrepreneurial companies were 6.5%;
- Although half the companies at that time said they would like to continue in business they thought the returns were not competitive without tax concessions or grants, with grants preferred by investors; and
- Grants of £12,000 at the time of the study could generate about 23,000 homes for rent at a cost to the Exchequer of £276m.

Given that Ball's (2010) work argues that the elements of the private rented sector that can best support institutional investment appear to be already operating successfully, JRF would welcome greater exploration of the following issues:

- How investment could be used to generate a more socially sustainable housing market, such as through the provision of an intermediate rented sector for low income households;

- How existing stakeholders such as housing associations might expand their operations to provide a vibrant private rented sector as outlined in our response to question 4; and
- The policy tradeoffs that might be involved in increasing institutional investment in the private rented sector and how these could achieve alignment between the goals of increasing housing supply and enabling low income households to successfully access and sustain tenancies in private rented housing.
- We would also reiterate our earlier points about understanding the interplay between housing tenures, particularly as the private rented has lower satisfaction rates than other tenures, with London residents being the least satisfied amongst the regions (Wallace 2010). Private rented tenants with higher incomes also tend to be more satisfied with private renting (ibid).

Conclusion

In conclusion, consideration of how to increase the supply of private rented housing through investment is much needed. However we would welcome greater clarity around how this could contribute to creating a more socially sustainable housing market where the impacts of the economic cycle might be more levelled out and where low income households might be better able to access and sustain private rented accommodation. The private rented sector could have a crucial role to play for those low income households who would be at greatest risk from market shocks in the owner occupied sector. In achieving this more nuanced debate around the implications and likely impacts of institutional investment in private rented housing it will also be crucial to consider the different local housing market impacts of any policy innovations *and* the interplay between housing tenures in those markets.

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RICS the mark of property professionalism worldwide

Submission

Investment in the UK Private Rented Sector: RICS response

The Royal Institution of Chartered Surveyors (RICS) is the leading organisation of its kind in the world for professionals in property, construction, land and related environmental issues. As an independent and chartered organisation, the RICS regulates and maintains the professional standards of over 91,000 qualified members (FRICS, MRICS and AssocRICS) and over 50,000 trainee and student members. It regulates and promotes the work of these property professionals throughout 146 countries and is governed by a Royal Charter approved by Parliament which requires it to act in the public interest.

RICS welcome the Treasury's decision to consult on increasing investment in the private rented sector. The sector is essential to provide an effective tenure mix within housing in the UK and has a range of advantages when compared to both affordable housing and owner occupation including increased flexibility in the labour market.

In addition to this response RICS has contributed to the joint submission from the Property Industry Alliance (PIA), Council of Mortgage Lenders (CML) and the Association of real Estate Funds (AREF) and support the views it puts forward.

Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

- Increased supply of new build flats in city centres
- Incentives from housebuilders to buy new properties
- The need to improve and convert existing properties can lead to long void periods
- New build properties are more likely to meet the needs of tenants eg more than one bathroom
- To overcome some of these issues VAT on repair and maintenance of homes should be reduced to 5%.

A variety of factors combined to make investment in new build properties more attractive that conversion of existing housing. At the highest level Government planning policy, in particular increased density targets, meant that new build flats were more common. These were particularly in city centre locations and were often marketed to attract investors rather than owner occupiers.

Part of this process often included discounts from housebuildiers for investors purchasing properties off plan which added to the incentive to buy new build properties. The general buying process is also easier as there will be no chain threatening to jeopardise the deal and mortgage availability at higher loan to value ratios in the pre-credit crunch period helped boost this market.

The improvements and conversions that will be required to make an existing property suitable to be rented can also add cost and uncertainty to the process. The time taken to make the improvements will lead to a significant void period where no rental income is being received and there can be unknown risks associated with conversions which can cause delays and cost increases.

New build properties also present a range of advantages including a better quality product which more adequately meets the expectation of tenants. One example of this is that many new build properties will have more than one bathroom. There is also a perception that new build properties will require less spending on maintenance in the short term and that they are cheaper to run on a day to day basis.

The ten year building warranties which tend to come with new build properties tend to be easier to rely on than warranties for conversion work as it is clearer where responsibility lies. It is generally also much easier to comply with safety regulations with a new build property. For instance they will be more likely to meet fire safety rules as they will have smoke alarms and fire retardant materials already in place.

One of the major additional costs for conversions is VAT which is charged at the full rate on renovation and repair work but is zero rated for new build. RICS is a member of the Cut the VAT coalition (http://www.cutthevat.co.uk/) which is campaigning for VAT to be reduced to 5% on repair and renovation work for residential property. This would significantly reduce the cost of converting new build property and could help boost supply in the sector. The coalition has recently published research which shows that cutting VAT on repair and maintenance work would lead to an additional £373m in construction output in 2010 which would lead to multiplier benefits of £1.06 billion

It would also bring about the creation of up to 24,200 extra full time equivalent jobs in the construction sector alone with knock on effects of an additional 31,000 jobs in the wider economy to address demand for related materials, products and services and as a result of the greater spending power of construction industry workers.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

- The private rented sector was linked with the growth in the number of city centre apartments
- Problems in the buy to let market as the recession took hold helped contribute to reduced levels of housing supply
- Increased investment needed to improve the image of the sector as a realistic alternative to owner occupation
- The private rented sector can help support affordable housing in its widest sense, particularly as government spending falls.

During the “boom years” the PRS helped lead to a growth in the number of new build apartments. Homes for young professionals and single people and couples became a dominant factor in design criteria as yields were better and sales easier to secure. This was particularly the case in major cities but was less noticeable in other areas. During the recession the collapse of the buy to let market has contributed to the fall in housing production as it substantially reduced the number of potential off-plan or pre-completion buyers/sales and increased developer risk.

Growth in the PRS through institutional investment and public sector gap funding could enable developers to anticipate pre-sales on new developments – even if these are at a discounted price the certainty and benefit from a block sale would contribute positively to the development financial appraisal. This means improved confidence to start new developments. Institutional investment in the PRS must be coupled with higher quality management standards which in turn help the reputation, image and sustainability of new developments. Industry based minimum standards for management and lettings are essential through agreed standards enforced by regulation of the process.

The market rent product also offers an alternative to ownership to sit alongside affordable housing (rent and low cost home ownership) and market sale, thereby improving access to housing, widening choice of commitment to a home and helping to create a mixed tenure, mixed income community.

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?

- Tend to be private arrangements so it is difficult to get a full understanding of impact
- Often a short term solution for both sides in the arrangement
- As such they will only have a small impact on the overall PRS.

Rent a room schemes tend to be very private arrangements between owner and lodger so it is difficult to get a full understanding of its impact and it is unlikely to provide a significant boost to housing supply. It is possible that the bulk of people with this arrangement will be renting a room to a family member, particularly as older children are tending to live in family homes longer. Other circumstances in which renting part of a home may be appropriate include:

- Extra income during a short term or prolonged period of financial difficulty
- Company and security for a lonely person - home owner and/or tenant
- Reduced home running costs so the home-owner does not have to move to a smaller home.

Encouraging owners to rent out part of a home will only ever have a small impact in the sector as it requires significant compromise on the part of both the landlord and the tenant. It tends to be a short term option for both parties and can have significant disadvantages such as the tenant not having a self contained unit, the landlord being worried about risk and security and the tax implications for the owner.

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?

- Increases in property prices have made the PRS a more attractive than other investments such as pensions
- Mortgage availability in the past meant that it was relatively easy to access finance
- The mortgage market has changed significantly and this will impact on individual investment along with uncertainty in the short term over property values
- Inappropriate regulation of the sector, for instance changes to the Use Classes Order for Houses in Multiple Occupation, will limit growth of the sector
- The Government should reconsider the inclusion of residential property in Self Invested personal pensions (SIPPs).

The growth of the PRS came about largely due to the rapid increase in property prices and the easy availability of relatively low cost mortgage funding. Mortgage availability was a key issue and this required low capital input from the investor and was based around buy to let mortgages with high loan to value ratios with minimum deposits. Mortgage costs were covered by rent in most cases and tenants were relatively easy to find. Properties were also available with housebuilders willing to sell at a discount for buy to let investors. These were seen as attractive discounts but could have been based on inflated prices.

In recent years the principal drivers have been the availability of high percentage low cost mortgages, a market anticipation of continuing capital value growth and good demand from potential tenants. The first and second factors no longer exist and this is deterring small and medium sized investors. As a result it is likely that individual investment in PRS will remain constrained due to:

- Uncertainty on property values including overcoming possible negative equity issues, also some PRS purchases have been within certain sectors of the market which have been more volatile during the downturn (ie oversupply of flats).
- Mortgage loan to value percentages at a low level meaning a higher capital investment by the landlord.
- Mortgage restrictions on apartments as a mortgage-able product.
- General mortgage conditions relating to rent to mortgage repayment ratios, more stringent credit checks on individual borrowers and other restrictions on loans for rented property.
- Lenders want low risk loans to borrowers with good credit history on sound properties in good locations.

There are risks that other Government activity may discourage additional individual investment in the private rented sector. Regulation in the sector needs to be effectively targeted and should help ensure that minimum standards of professionalism are being met. RICS has particular concerns about recent regulations that will require change of use planning permission for homes being rented to between three and six unrelated people. This may discourage landlords from investing in property if it is likely to be rented by students or young professionals as there will be additional cost and hassle in the system.

The inclusion of residential property within a SIPP should be considered by the Government to allow for a greater set of assets to be used for pension saving and provide an increase in transactions within the housing market. Increasing demand would support the market, help encourage housebuilders to start building again and boost the number of properties available in the private rented sector.

Introducing residential SIPPs would not be without difficulties and any changes should be carefully considered alongside better regulation of both landlords and agents in the private rented sector. The impact on affordability and accessibility for first time buyers also needs to be considered so they are not unfairly affected by changes to SIPPs.

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 commercial viable?

- Scale economies should help reduce the maintenance costs of private rented sector blocks
- Institutional investors will probably prefer to purchase and run large blocks rather than individual properties scattered over a large area
- Management could be linked with Registered Social Landlords (RSLs) who already have experience of managing significant stocks of residential property.

There are competing challenges in relation to scale; too many PRS units would be counter to the principle of a balanced and mixed tenure community for a new development, but be more efficient to manage. Too few would make the investment unattractive and the management more expensive.

However, the wider view of the community has to be taken into account and a single development of 25 or even 50 homes within an established residential area could be seen as opening up the tenure and household mix of the neighbourhood. There are other factors at play as well as the number of homes for rent in a single development; the mix of the surrounding area, level of demand, the affordability of the PRS properties and the quality and range of the product. In medium sized new developments of say 50 to 100+ homes we would suggest that numbers should be limited to say 25% of the whole.

Linking the management of new rented homes with existing (or other new) stock within a catchment area can counter the impact of higher management costs by achieving the desired economies of scale. Many RSLs are geographically spread and have established high quality management services for their affordable housing. These RSLs may be better suited to provide “dispersed management” services at an economical cost whilst maintaining a high standard.

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?

- Investors purchasing large numbers of properties are at a disadvantage to those buying single properties as they will pay stamp duty based on the full value of the transaction
- Stamp duty should instead be calculated on average unit price
- RICS believe there should be more fundamental reform of stamp duty moving towards a marginal system similar to income tax.

RICS believe that rather than simply tinkering with the current stamp duty system there should be more fundamental reform to remove the current slab structure and introduce a marginal system. This would mean that higher rates only apply to the property value over a threshold rather than the whole transaction.

This will create a more efficient market by removing the distortions around the current thresholds. The slab thresholds mean prices jump significantly from just under the threshold to several thousand pounds above it. This can cause other problems such as tax avoidance through high values for fixtures and fittings. Reform is even more necessary in the current market where prices are flat or only rising slightly. For example, a young couple moving from their first £200,000 flat to a £300,000 family home currently pay £9000 tax to Government.

One of the current barriers to greater levels of investment in the private rented sector is the discrepancy over stamp duty on bulk purchase compared to the purchase of individual properties. This acts as a disincentive for large investors and could potentially disadvantage tenants who might enjoy higher standards of management. Where there is a bulk purchase stamp duty should be calculated on average individual unit price. This change is particularly important if the Homes and Communities Agency Private Rented Sector Initiative is to be a success.

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?

- Lower stamp duty would reduce the upfront costs of investing in the PRS and could encourage more investors.

Currently, the market cost of acquiring good quality units does not provide an adequate yield to attract institutional investment on any scale. Any change in SDLT which reduces the cost will benefit the financial model and contribute to the closing of the yield gap thereby making investment more attractive. On a portfolio acquisition where the average price is £150,000 per property the SDLT at the current portfolio rate of 4% is £6,000 per unit. If treated as a single unit the SDLT would be 1% or £1,500, a net saving of £4,500. There may also be a case for extending the exemption from SDLT on properties below £250,000 to all purchasers rather than just first time buyers.

By increasing the cost of purchasing properties, the current stamp duty rules will also discourage investors due to resulting reductions in net yields. As these are already tight in the residential sector, failing to change the rules will act as a further disincentive to investors. Changing the stamp duty rules may make the net yield sufficiently high to attract investors.

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

- Investors in commercial property have historically sought to achieve returns of 6%
- Yields in the residential sector typically run at around 30 to 40% below the commercial property sector.

Institutional investors are looking to achieve minimum hurdle rates of return over the risk free rate which compensates them for the added risk of holding a particular asset class. Historically, in the commercial property sector institutional investors have typically looked to achieve at least 6% income return when investing in commercial property. This 6% return can be broken down between the real interest rate plus a spread for risk of income void periods, illiquidity and depreciation risk. In the UK total returns on commercial property since 1987 have averaged around 9% although the high inflationary periods of the late 1980s help to push the long run average upward.

It may be argued that prime commercial properties exhibit income hedging characteristics as rents tend to appreciate over time in line with inflation. As such the initial yields on such properties should be compared to the real cost of borrowing. Non prime properties however may not display the inflation hedging characteristics and as such should command a higher premium over government bonds.

IPD data shows that yields on residential property yields have fallen consistently below 4% over the past 9 years to around 3% in 2009. This compares to commercial property yields which are currently running at almost double this figure at 6.8%.
The reason for this difference can be partly attributed to better inflation protection over time in the residential sector. It is important to note that when looking at residential

properties, institutional investors are more likely to view the residential property yields against real interest rates.

IPD data also demonstrates that over the last 50 years real house prices have risen by 274% whilst average commercial property prices have fallen by around 55%. As such entry yields at sub 4% now could still be attractive to long term institutional investors where pension liabilities will need to be matched on ageing populations with assets that offer inflation hedged income streams. Furthermore, to enhance yields which typically run at around 30-40% below the commercial property sector institutional investors may seek to develop properties to add value.

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

- House prices are stabilising and residential property could be seen as a more attractive investment than other asset classes.

Now that house prices are starting to stabilise the residential property market could look marginally more attractive at a time when the commercial/retail/industrial property sectors are still facing prolonged uncertainty.

The move by the HCA to encourage institutional investment in the PRS is supported by the market's aspiration that the HCA may provide some form of gap funding to create a viable model for investment. Such an initiative by the HCA would help to close the yield gap and make large scale investment financially viable. The house building industry is also keen to attract such investments either in free-standing all private rented developments or as part of larger mixed tenure developments. In the current uncertain market, house-builders are likely to be willing and able to offer attractive discounts against full market value, for volume purchases.

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?

- Potential for insufficient yields in the PRS to attract a significant number of institutional investors
- Image problems with the PRS from both potential tenants and potential investors
- An unsympathetic tax system in terms of stamp duty, VAT and capital allowances.

The yield on new build housing for market rent is not sufficient for the current market conditions. This would need to be increased but it is actually likely that build costs will rise as energy standards, including the Code for Sustainable Homes are introduced thereby widening the yield gap. This will be made worse by ongoing uncertainty on growth in property values over coming months.

Market acceptance is also needed by prospective tenants of a quality PRS product as historically renting a home has been from a council/housing association, a low quality private sector and latterly a better quality small time investor landlord. Marketing has to make it an attractive option to rent from a new type of landlord – institutionally financially backed, but with a quality service image/reputation.

The tax regime is also unsympathetic to investment in residential property when compared with the commercial sector. Stamp duty has been identified in the consultation document as a potential barrier but the situation capital allowances for residential properties and VAT also needs to be addressed. There are also ongoing issues to do with management and repair obligations which differ between the residential and commercial sectors.

Changes to the tax system would also be needed to make residential property an attractive investment, particularly when compared to commercial property. One of the key differences is the cost of repairs and ongoing management. Commercial leases tend to place the cost of repairs on the tenant of the building and these tend to be funded through service charge payments and sinking funds.

Institutional investors are also at a disadvantage compared to individual investors in residential property in terms of repairs and maintenance. Individual investors will often keep costs low by carrying out maintenance of homes themselves rather than paying for builders to do the work. This option is not available or necessarily desirable to institutional investors who will employ professional managers.

Changes to the tax treatment of repairs to residential properties would also help increase the attractiveness of residential property as an investment. Tax reliefs to support capital improvements to buildings could be one way of making this change. Currently landlords in the residential sector are able to claim a 10% wear and tear allowance from net rent to cover depreciation of items within the property such as furniture and white goods. They are also able to claim a renewals allowance the net cost of replacing a particular item of furniture, but not the cost of the original purchase.

There should be a full set of capital allowances similar to the commercial sector for all landlords in the PRS, both institutional and individual. These capital allowances apply to plant and machinery within buildings and allow for replacement as they reach the end of their useful life. This will ultimately help reduce costs and increase yields

Question 11: What are the key barriers to investment in residential property through UK-REITs, and what changes would be needed to address them?

- Allow for portfolio churn with an acceptable level of turnover for residential stock
- Address problems with the distribution requirement
- Amend gearing restrictions to accommodate lower net yield
- Consider the use of AIM and unlisted REITs

Changes should be made to the Real Estate Investment Trust (REIT) regime to encourage their use in residential investment. The following changes may help encourage the use of REITs for investment in residential property.

Allow for portfolio churn
The structure of tenancies and the levels of yield in the residential sector mean changes would be needed to allow access to a REIT regime which is largely designed for commercial property. For example, leases in the residential sector tend to be for 6 months rather than the 5 to 21 years in the commercial sector.

In the commercial sector valuations are based on yield and the income either from the lease in place or a potential lease. Difficulties arise in the residential sector where there is competition with the owner occupier sector where value is based on other factors such as desire to live in a particular area or a particular property. Decisions made this way will not take into account potential yields.

To overcome this, large residential companies will rely on regular sales of properties, or churn, to access capital and provide a better return to investors. This differs from the commercial sector where net income yields are large enough to provide new capital for investment and dividends for individual shareholders. Potential residential REITs need reassurance that HMRC will not treat this as trading activity which would be taxable and put the company's REIT status at risk.

Two steps can be taken to help address the need for portfolio churn:

- An acceptable level for turnover of residential stock which HMRC will not consider trading activity
- Specific legislation and guidance regarding acceptable business models for residential REITs. This should ensure affordable housing activity such as shared equity and discounted rents are within the qualifying tax exempt activities for a REIT.

Address problems with the distribution requirement between residential and commercial property companies

Issues with costs of repair and maintenance of property impact on the ability of a residential REIT to meet the 90% distribution requirement as a result of lower net yields. This arises because under commercial tenancies the tenant is responsible for repairs but the landlord is responsible under residential tenancies. This additional cost reduces the average net yields, including management costs, to 2.9%.

A further problem is the lack of capital allowances in the residential sector. Capital allowances are available on certain purchases and investments and allow a proportion of costs to be deducted from taxable profits, reducing a company's total tax bill. Lack of capital allowances represents an additional risk in terms of a residential REIT breaching the 90% distribution requirement.

Two steps can be taken to address these issues:

- The introduction of a wear and tear allowance to reduce taxable profits to which the distribution requirement applies
- A reduction in the distribution requirements for residential REITs from 90% to 80%

Amend gearing restriction to accommodate lower net yield

One of the barriers to the establishment of residential REITs is that is most cases the yield is to small for a company to operate effectively under the current REIT structure. To address this issue changes should be made to the gearing restriction to accommodate lower yields from residential property.

Any residential REIT would be more reliant on income from sales of properties than a commercial property REIT. As a result the gearing restriction which is imposed by the 1.25 interest cover test is harder to satisfy then with commercial property. This happens because the profits section of the interest cover test only includes income profits and not capital gains from property sales.

Three steps can be taken to address this issue:

- Allow residential REITs to include capital sale proceeds in the profits section of the interest cover test
- Provide a lower interest cover limit for residential REITs

- Use a loan to value restriction rather than income restrictions

Allow AIM and unlisted REITs

Currently a company has to be listed on a major stock exchange before it can convert to REIT status. There are currently only a very small number of residential property companies listed on public markets, giving a very small pool of potential investors. This is partly due to the cost of listing compared to the AIM or an unlisted vehicle which acts as a barrier to entry, particularly for smaller REITS focussed on a specific activity. With residential properties there are issues with the number of units required to build sufficient critical mass to make the set up and running costs of a full listing economically viable. If AIM REITs were allowed it would be far easier to set up an AIM listed vehicle with the possibility of moving to a full listing in the future as the vehicle grows.

To address this issue, the following step should be taken:

- The REIT regime should be extended immediately to include AIM listed companies. The Government should consider the possibility of an unlisted REIT.

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?

The Government's stated object is to increase production of housing to meet the forecasted demand contained within the Barker report. At a time when the industry will be operating at circa 60% of the output levels of 2007, any new end users of homes able to invest in housing will mean more houses will be built. The impact of more new build housing activity will be beneficial on all associated business sectors, reducing unemployment and contributing substantially to economic activity.

The provision of more market rented homes will also help labour mobility and enable particularly younger people to occupy good quality well managed homes at a time when there is some scepticism about enticing them into more rigid and long-term forms of home ownership that could prove financially unsustainable.

Increased activity in the PRS would also come at a time when output of affordable housing is vulnerable to cuts in Social Housing Grant and the reduction in output from Section 106 agreements. This could mean rented housing being available with Housing Benefit support for those who cannot afford to buy and are unable to access affordable housing due to a shortage of supply.

Benefits from increased investment in the PRS are also likely to be focussed on London and other major cities as these areas tend to see the highest levels of demand. Rural areas may not see any improvement but there should be changes in urban and regeneration contexts.

There are several key areas where increased institutional investment in the PRS could have an impact:

The decline in housebuilding levels

The levels of housebuilding have fallen significantly as a result of the declining property market and the reluctance of housebuilders to undertake developments if there is not sufficient demand. Housing completions are now significantly below the Government's target of building at a rate of 240,000 homes per year by 2016 and below the level of new household formation which is around 220,000 per year. All steps should be considered to increase supply including council house building and also attracting capital investment from institutions to increase the number of homes in the private rented sector.

Providing an alternative to owner occupation
Significant price rises in the late 1990s and early 2000s saw the gap between household income and house prices increase significantly. This has led to the creation of a growing intermediate market in housing where households are not eligible for social housing but are unable to buy a home out right. There are a range of solutions to this issue including shared equity schemes but the private rented sector will always play a significant role. If the sector is to continue to fill this role it needs to become more professional and offer a better standard of service. Encouraging institutional investment can help achieve this.

Increasing economic flexibility
A thriving private rented sector can help assist labour mobility by providing flexible accommodation on a short to medium term basis. The standard tenancy in the sector lasts for at least 6 months and a person can chose to move with a relatively short notice period. This contrasts with the owner occupied sector where selling a home and buying a new one can take several months. This problem has become more acute as a result of current market conditions where the number of homes being sold has dropped significantly. Flexibility is particularly important for young professionals before they chose to live in a particular area.

Assisting regeneration
Most regeneration schemes will contain a significant residential element and in many cases houses will be inappropriate, for instance in a central urban area. Many schemes previously contained small flats which were aimed at first time buyers and the buy to let market. The recent downturn in the housing market has meant many of these flats remained empty as buyers were unable to obtain mortgages for them. Building properties specifically to let in a regeneration area means they can link in more effectively with ongoing management of affordable housing and commercial property, giving extra continuity to schemes.

Improving housing quality and management
Large investors are more able to provide higher quality housing standards and better levels of management than many buy to let investors. It is likely that an investor will own all the properties in a particular block rather than a fragmented arrangement of owner occupiers and buy to let landlords making management more efficient and reducing costs. Management should also be more professional than in many cases in the buy to let sector. Although some buy to let landlords employ professional managing agents there are still a significant number who will carry out management themselves in addition to their day job. The whole sector needs to become more professional, as recognised by the Government in its response to the Rugg Review, and increased levels of institutional investment can help encourage this.

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PRIVATE AND CONFIDENTIAL

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Dear Keith

Response to HM Treasury Private Rented Sector Consultation

Please find attached our response to HM Treasury's Investment in the private rented sector consultation document.

If you require any clarification or further discussion on any of the points raised, please do not hesitate to contact me.

In any event, I would like to be kept informed of the progress of this consultation.

Yours sincerely

Philip Callan
Director

Response from Philip Callan, Director of Savills Housing Investment & Consultancy
to
HM Treasury: Investment in the UK private rented sector

Consultation February 2010
PRSinvestmentconsultation@hmtreasury.gsi.gov.uk

Prepared for:

HM Treasury

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Comments on the specific issues identified for consideration

Question 1: What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

Evidence suggests that a proportion of new buy to let has focussed upon new build properties; however it would be wrong to conclude that this was a purposeful decision made in isolation to the availability of supply. Buy to let investors have been driven by a number of investment decisions but predominant amongst these, for the majority of new investors, has been the potential for capital growth. Many buy to let investors have assumed that higher capital growth will be achieved in the utilisation of new build rather than in the utilisation of existing properties or through conversions. Evidence suggests that more than 50% of new supply in London between 2004 – 2007 went to buy to let.

A number of investors have entered into the buy to let market accidentally when the market downturn removed the anticipated value growth between reservation off plan and completion.

Other factors that have accentuated investment to new build are:

- certainty of availability;
- certainty of price;
- lettability.

Most buy to let investors have a portfolio of 1–4 properties. These are often inexperienced investors who want to invest in property with minimum effort. New build offers certainty of availability and price, often lacking in existing properties (together with the potential for sellers to abort the transaction) and the cost of conversions.

Buy to let investors will be advised that a new property will be let faster and is likely to generate a rent premium against an existing property. However, it is important to recognise that there is a further subset of buy to let investors who will not anticipate significant capital growth but be motivated by rental yield. Here the focus will be on existing properties and the potential to enhance rental through sub division, student properties etc.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

It is suggested that there is limited evidence that the house building industry has been influenced by buy to let investors – although much of the supply has gone to buy to let investors, there is little evidence to suggest that the specification of individual properties or the operation of blocks of apartments has been modified to reflect the rental market.

The importance of investors in the past has been their capacity to provide forward-funding for build projects by buying off-plan. When active, they can provide a valuable source of finance or the certainty of end sales that banks need to justify loans. House-builders and developers have tended to develop apartments with the anticipation of maximising sales particularly off plan to investors. What impact this has had on design and specification is debatable. Apartment based schemes have been designed to be as efficient as possible from a size and therefore cost perspective and small units have therefore been the norm. The impact has been that renters have not tended to remain in their properties for long.

Whereas on the continent and in Canada and the USA, evidence suggests that the properties are designed for rental, with an expectation of longer lets and properties designed for this. Within the UK, there is little evidence of this within the UK outside of the social rented sector.

However, it is possible to argue that the existence of the buy to let market both enhanced and sustained the rise in house prices – particularly so for large urban apartment driven developments.

Future supply could be allocated to the rental market but it is unlikely that this will be driven by the standard house-builder model. That model looks to short term development, sale and capital recycling rather than patient investment. It is difficult to see circumstances where this model would switch to large scale rented developments. In the event that larger-scale investors do get involved in purpose-built rental housing, it is more likely that contractors/construction companies will build them rather than conventional house builders.

This is important because it means that investment in large-scale, volume rented product is likely to involve a considerable degree of land development and construction. We think that there is a strong case for extending the tax transparency available on standing investment portfolios through REITS to this type of activity as well.

The need for increased supply and substantial growth in the private rented sector will require new entrants to the production of housing pulling together landowners, contractors, property managers etc. Savills has created a Property Fund model to promote, deliver and manage the provision of rented housing.

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?

The potential for this to increase supply is significant but the incentive has diminished by government failing to adjust the tax free allowance to recognise the growth in property values. This is particularly so in London and the south east. If the allowance had tracked property prices then it would be more than double the current level. The current allowance is a particular block for new entrants in London and the South-East

Utilisation of this allowance could prove an effective way for First Time Buyers to enter the market. The differential between one and two bedroom property would then be offset by the renting of the second bedroom.

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?

It is worth restating that there are two cohorts of buy to let investors – i.e. those seeking capital growth and those looking to secure a rental yield. Survey evidence suggests that a key motivation for recent buy to let investors has been longer term capital growth, with many stating that their property investments are a major part of their pension provision. A significant incentive in the last ten years has therefore been the under-performance of standard pension investments. Post credit crunch, there is also anecdotal evidence to suggest that third parties (particularly parents and grandparents) are willing to donate or stake significant equity stakes in their offspring's housing because the opportunity cost of their money on deposit is so low. Continuing low interest rates may encourage more equity investment and may make some net property yields look more attractive.

In the past, many investors have been prepared to accept low rental yields focused on servicing their mortgage rather than a yield on their equity (deposit). In practice the tax system has provided an incentive allowing mortgage interest to be offset against taxable returns from the rent. For many investors the level of equity required has been modest and the scale of the return significant

Recent falls in value will impact upon the maintenance of existing investments that is, the ability to refinance existing mortgages due to drops in value and sentiment re further investment. Again, if future value growth is modest, it is likely to affect investment decisions. Anecdotal evidence suggests that many investors have sustained the buy to let investments to avoid crystallising potential losses. Further, the lack of attractive investment opportunities has encouraged others to stay put.

Some investors will have experienced longer void periods and the loss of rental income or rent reductions on relets. Much of this has been driven by the competition from unsold properties and the impact of job losses. Given the overall paucity in new supply, these factors are only likely to have a transitory impact on future investment decisions.

For all buy to let investors, the biggest risk remains the sale of their portfolio. Investors are attracted to the potential long term rental of housing and the scope for rent/value growth, however most have 1-4 properties and do not have a risk spread in terms of type, location etc. The absence of structured collective investment vehicles in residential remains an impediment.

Given the level of interest by individuals in property investment it is reasonable to conclude that there would be demand for collective investment vehicles if these could be made as attractive from an investment and tax perspective many would prefer to invest in these vehicles rather than run the risks associated with an individual portfolio.

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 commercial viable?

Our survey of institutional investors for the BPF and GLA showed that the lack of suitably large portfolios (managed at arms length by a reputable operator) is probably the biggest single factor impeding the involvement of this type of investor in the sector.

Scale is important as it:

I. Provides the opportunity to address a spread of property markets;
II. Targets a mixture of renters;
III. Provides a cushion against voids risks and property defects.

Management efficiency can be achieved by relatively low numbers. This is evidenced by the ability of letting agents to operate effectively at 500 plus properties in management.

Institutions are generally interested in investments of £200 million plus which would suggest a portfolio of 1000 plus properties. Portfolios of this size would create management efficiencies and a balance against voids risk and property defects. Outside of a small number of residential investment property companies and student let portfolios, there is little supply of this size.

To date, institutions have demonstrated a reluctance to initiate the creation of new residential portfolios. It is often stated that the lack of such portfolios is the key reason why investors do not invest in residential property. This catch 22 situation is likely to persist unless the Institutions have a change of policy or effort is taken to create new supply that can be traded on to Institutions.

Savills has initiated action that could increase the supply of such portfolios. However, the underlying tax regime remains a block to the creation and trading of portfolios.

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

Para 6.8 of the consultation document comments that representatives of the property industry; banks; tax advisers have highlighted that the SDLT treatment of bulk purchase of property as a key impediment to investment in the PRS. We agree with this comment.

At one level, the lack of residential portfolios perhaps demonstrates that the bulking of transactions for SDLT acts as a constraint to the establishment of a structured private sector market. During the downturn in the housing market where house builders had surplus unsold completed properties, few bulk sales were achieved.

Changing the SDLT rules to allocate the tax to individual properties would assist in the building of portfolios. Yields from residential portfolios are constrained, especially so in the early years post construction. SDLT at 4% plus on portfolios damages the initial yields. In our view, this acts as a strong disincentive. Residential property is held in a disparate market with multiple landlords with limited property numbers. It is an innovative market that would benefit from consolidation. We have already evidenced our view that Institutions are unlikely to initiate new production or the consolidation of the market.

Amending the SDLT rules could enable entrepreneurs to consolidate small portfolios and trade these on when a reasonable scale has been achieved. This would create a momentum for the consolidation of the market and attract other investors who were prepared to invest in rented housing.

Further we propose that where housing is produced for rent and held for rent for a defined period that SDLT should be abated –

We suggest three possible alternatives:

(i) Abate the SDLT payable by 50% where the property is held for rent for 5 years or more;

(ii) Defer the payment of the SDLT until the property is sold for owner occupiers. The SDLT chargeable would be determined at the point of initial acquisition; and

(iii) Change the rate of SDLT on portfolios of more than, say, 5 properties to a much lower rate, equitable with that of stamp duty on other types of investment, for example

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?

Residential portfolios traditionally produce low initial yields – generally sub 5%. Over time, rents are likely to rise above inflation, whereas other costs will generally rise at a lower rate. This pattern creates the potential for satisfactory returns of 5% plus to be generated. The imposition of bulking SDLT will typically add 2-3% to the acquisition cost of a property. At a base level this may not appear to be significant, however given the low level of initial yields, this will be sufficient to shift a portfolio of properties from a suitable and fundable investment to one that fails this test.

Removing or reducing the SDLT payment would widen the number of properties that could be acquired by Institutions and other investors and held for rent.

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

Initial yields from residential property are low. Many buy to let investors have acquired properties producing yields as low as 3%, net after property costs (and as low as 2.5% at the height of the market in prime central London). This compares to typical yields in the commercial property market currently around 7%. Private investors have subsidised their investment by not seeking a yield on their equity, merely seeking to meet their financing and letting costs. Without this non rewarded equity the Buy-to let market could not have flourished. Institutional investors are unlikely to be attracted by these sorts of returns when they can participate more easily in the known quantity and perceived lower-risk universe of commercial property.

Generally, the spread between gross and net yields from residential property will be 30-35% and results in initial yields of sub 5%. This appears to be less attractive than other investment options for institutions such as commercial property.

We have noticed that yields are more dependent on capital values, set in the owner occupied market, which are more variable between different types of property than are rental values. This means that there are wide variations in yield levels, Cheap properties, usually with fewer capital growth prospects, will be favoured by investors looking for income return whilst high value properties, usually with greater prospects for value growth, will be favoured by those looking for high long term returns from capital growth.

It is only in markets where capital values are not set by owner occupiers (e.g. the student housing market) where investors are likely to enjoy combined yields and capital growth on a par with commercial property. These sectors have seen much more active institutional interest. This suggests that incentives for purpose-built rental property products may be important.

The PRS could however produce attractive yields were an investor prepared to take a medium term view i.e. 10-15 years. Over this period, the net yield should rise at RPI plus and move marginal investment returns to acceptable returns. Amendments to the tax system that enabled the tax efficient trading of portfolios built up by Institutions and other investors could enhance these initial returns and encourage a range of investors to enter the residential market.

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?

It should be recognised that institutions have “invested” in residential property particularly through the provision of debt funding / bonds etc to housing associations. Their participation in this market is illustrative of their desire for certainty of income stream.

Institutions are best placed to comment on the factors that may have prompted greater interest in residential investment; however we suggest that the following factors will have a contributing impact:

I. Reduced returns from the stock markets;

II. Reduced yields and increased uncertainty within the commercial sector;

III. Increasing growth in the private rented sector with emerging trends that indicate the significant shift to rent from prospective ownership is underway and will continue;

IV. The attractive nature of an indexed income stream that rented residential property can produce.

Items (i) and (ii) may affect short term investment decisions. We believe that item (iv) is the factor that creates and maintains the underlying interest from institutions in this market. To date, the inability to structure a product (outwith social rent) that produces this has been the main barrier.

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?

All investors make comparative investments. Commercial property provides a yield that is only reduced by letting costs and the potential for voids. Generally, investors acquiring good quality accommodation can select tenants who will produce a certainty of income and an obligation to retain the property in a suitable standard.

In many cases, residential property for institutional investment needs intermediary, arms-length managing operators to act more like the single institutional lease tenants in commercial property, returning comparable income streams from widespread residential portfolios. Residential property suffers a significant drop from gross to net yield and is further disadvantaged by the lack of certainty over the income stream. Where investment decisions are focused upon income returns, the natural reaction of an investor/institution would be to select commercial over residential investment. Where decisions are made on long term income and value growth, residential should win out against commercial. Savills and others have demonstrated the ability of residential to outperform other investment classes over time.

Our view is that the key barrier to institutional participation in residential is the lack of certainty of the income stream and the impact of tax on the creation of saleable portfolios. We suggest that it is possible to create structures that place residential on a par with commercial investment in relation to the certainty of income stream.

Scale is crucial to the creation of certainty of income in that the party underwriting an income stream will be more willing to do so on a diverse portfolio of 5,000 properties as opposed to a single apartment block in a city centre.

The house builder model is not attuned to the holding of property assets and unless there is significant change in this sector, it is unlikely that much will be produced through this route. Therefore, it is essential that there is an intermediary vehicle that sits between construction and the onward placing of portfolios with institutions. We suggest that scope exists to create a market where intermediaries acquire land interests, cause properties to be constructed and provide opportunities for investment by potential investors such as institutions, sovereign funds etc.

However, the tax system acts as a barrier to the establishment and operation of such intermediaries. The existence of bulking SDLT and the repetition of SDLT as it passes from construction to intermediary to institution, adds unnecessary cost, reduces yields and confines investment to limited high rental markets.

Our paper, “the Case for Housing” attached to this submission, demonstrates the potential positive impact of house building on the economy. There is sufficient gain to the Exchequer from house production for amendments to be made to the application of SDLT to properties held for rent.

Aside from the need to treat properties on an individual as opposed to bulk basis for SDLT, we suggest that government should go further and reduce SDLT on properties held for rent.

We suggest three alternatives:

(i) Abate the SDLT payable by 50% where the property is held for rent for 5 years or more;

(ii) Defer the payment of the SDLT until the property is sold for owner occupiers. The SDLT chargeable would be determined at the point of initial acquisition; and

(iii) Change the rate of SDLT on portfolios of more than, say, 5 properties to a much lower rate, equitable with that of stamp duty on other types of investment, for example.

Further we propose that the potential SDLT on residential leases should be removed where properties are held in leases of 15 years or less.

Finally we propose amendments to the Capital Gains regime. This should apply at 3 levels:

(i) Where investors hold property for rent for 10 years or more, the chargeable gain should be abated by 50%;

(ii) Where investors sell to an intermediary which has been established to consolidate existing property holdings, that they should be entitled to a 20% discount on their capital gain;

(iii) Where an intermediary creates a portfolio of 500 or more properties by, say, 2020, that they receive an abatement on their Capital Gains of 60%, where the portfolio is traded on to an institution or to another investor who commits to hold the bulk of the properties for 10 years or more.

All of these changes would have a positive impact on the PRS.

Question 11: What are the key barriers to investment in residential property through UK REITs, and what changes would be needed to address them?

REITS could operate successfully if there were significant portfolios of residential property to acquire. This is not the case, and in practice, the model will continue to fail unless changes are made to the structure – at least through a transitory period over the next 10 years as portfolios are created.

The key changes required are:

(i) Scale of percentage holding by a single party;

(ii) The requirement to distribute profits. (We note that since the issue of the consultation document, the 2010 budget has set out changes via the Finance Bill which will allow UK REITs to issue stock dividends in lieu of cash dividends in meeting the requirement to distribute 90% of the profits from the property rental business of the REIT);

(iii) The requirement for listing;

(iv) The cost of conversion;

(iv) Change rules regarding development within the REIT to allow for large-scale building programmes;

(v) Provision for land acquisition and build process to come within the tax transparent wrapper of the REIT so that development 'profit', taken as enhanced income will not be taxed until it is distributed

We suggest that government should adopt a REIT Transitioning Provision whereby it is 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.

Effectively the Transitioning REIT would commit to being fully compliant within say 10 years or agree to sell to another compliant REIT or lose the tax and operating benefits.

This would enable parties to create saleable portfolios, reinvesting profits to build up the portfolio, acquire stock etc. They would then agree to sell down their share to achieve the standards of a REIT.

Question 12: 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?

No comment.

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

Existing legal structures, in the form of Limited Partnerships, Limited Liability Partnerships, companies, mutuals and other legal structures could be used to create portfolios of residential properties. However, all potential vehicles suffer in comparison to REITs in relation to the tax benefits that REITs may enjoy.

There is an argument to add flexibility to the REIT structure or for the granting of tax incentives to other vehicles where their purpose is the acquisition of properties for rent. In addition to changes to SDLT and capital gains tax highlighted in the response to Questions six and ten, we suggest that further changes are required in relation to the recovery of VAT where properties are constructed for rent. The current rules are confusing and there is an imbalance between the production of housing for sale and the production of housing for rent.

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

If we take the investment vehicle which we have been developing with LAs and RSLs, we make the following comparisons:

Element	UK REIT Position	Savills Proposal
Shareholding	REITs limit shareholders to no more than 10% equity holding. Therefore requires multiple unconnected investors. REIT to be available to "man in the street" as potential investor.	Allows a smaller number of investors
Class of Shares	UK REITs limited to a single share class.	
Distribution of Profit	UK REITs must distribute at least 90% of profits from rental income in the form of dividends to shareholders.	Can put profits back into the delivery of further housing and are not required to distribute a set percentage of profit.
Tax Treatment	UK REITs not taxed where rental profits are distributed. Tax liability follows investors.	Structured as an LLP and therefore tax transparent. Tax liability also follows investors.
Owner Occupation	UK REITs unable to own properties where also occupiers.	
Disposals	UK REITS limited to rental income producing business activities. Disposals	The model is predicated on return from rental income.

	may attract tax and therefore not qualify.	
Set up costs	REITs require a LSE or recognised exchange listing. The trusts are therefore linked to the timetable set out for listing. The IPO and ongoing costs of maintaining these have deterred some fund managers as these are likely to be high.	Single structure with limited set up costs.
Valuations	REITs valuations are subject to NAV discounts and additional stock market sentiment	
Gearing	REITs have limits on gearing	No restriction (other than funders view of appropriate gearing)
Liquidity	One of the reasons for using a REIT is its liquidity, shares can be sold on stock market	Interest can be traded if required however participants have signed up to the timetable.

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?

It is extremely important that the PRS is allowed and enabled to further expand significantly. Our research department predict that demand for renting will continue to grow significantly in the coming decade and beyond as increasingly higher income and older households are excluded from owner occupation for longer by high entry costs. If rented accommodation is not supplied, housing shortage will become a big social, economic and political problem by the end of the decade.

The consequences of current undersupply is already the prospect of significant rent rises, our research team is forecasting +8% in 2010 alone. If it continues, more people will be forced through lack of affordability into the intermediate sector, putting unsustainable pressure on social housing providers.

The current PRS offering is fragmented, the market is largely made up of individuals holding a small number of properties whose key driver is to generate income rather than maintain the property to a good standard and offer potential tenants a responsive housing management. With an increase in demand for private rented property caused by a shortage in property available for private rental, this situation is likely to continue.

We believe that the institutional investment in the PRS could bring the following benefits:

1. Bring good housing management practices (for example RSL) into the PRS. We believe that funds will wish to grow their involvement in the PRS market and that over the next five years we will see the growth of brands of private sector landlords who have more extensive holdings. Where funds include public sector participation, we believe that there will be an emphasis upon improving the offering to renters;

2. Assist in meeting the targets for the provision of new homes. Where funds involve the development of land for housing for rent rather than for sale;

3. Stimulate local economy (please see Appendix one).

General comments on the overall factors holding back the development of the Private Rented Sector

Savills has undertaken detailed appraisals of the current and future direction of the housing market and in particular of the private rental market. This work ranges from research reports on different aspects of the market to a more detailed appraisal of the private sector market and the blockages to investment. Our general conclusions on this market are that:

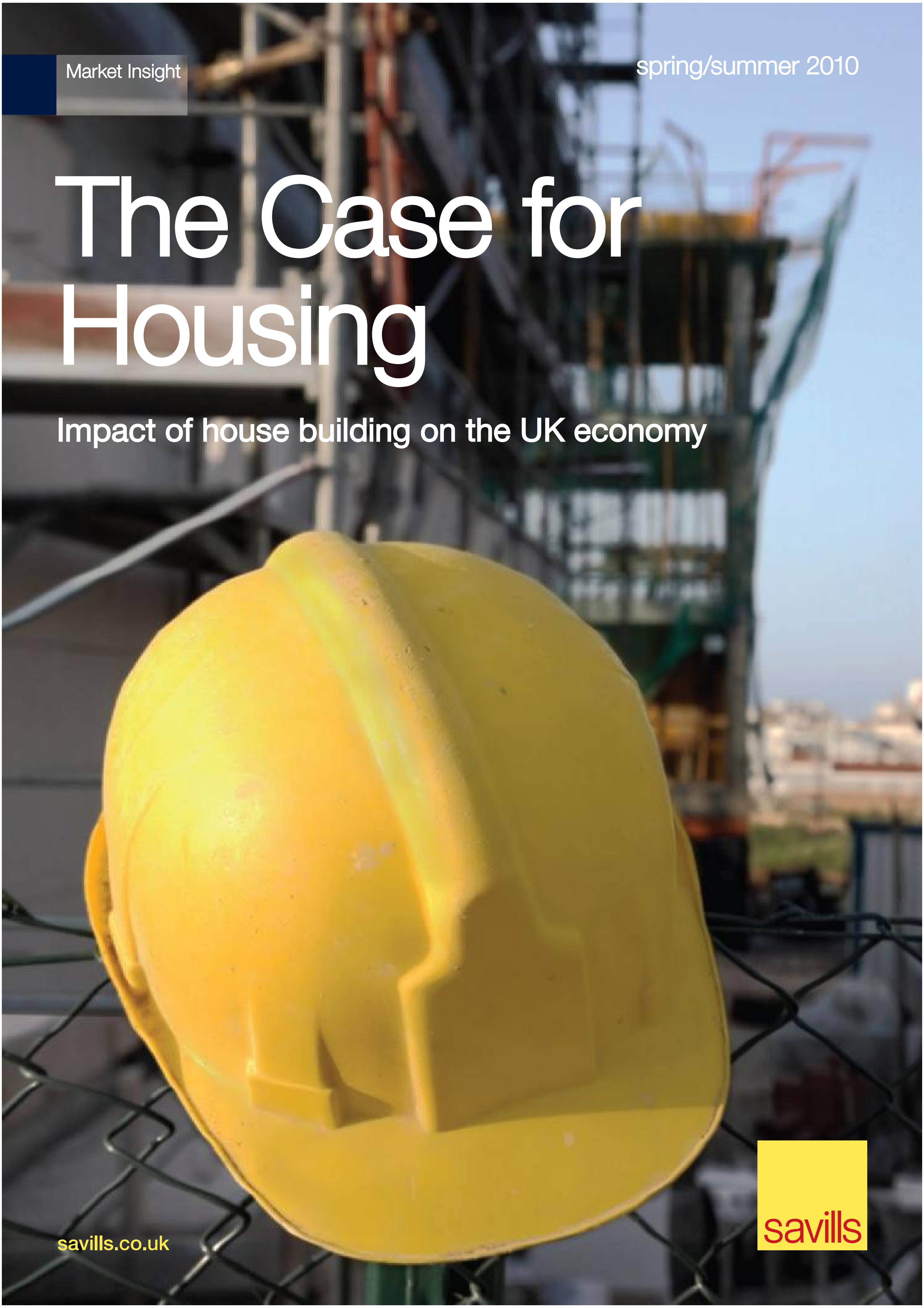
- there is a growing demand for rented housing;
- current provision is haphazard;
- the unstructured buy-to-let market is nearing the peak of its growth capacity;
- investors will not create the rental product – it needs to be provided by others;
- inhibitors to the development of this market include the current arrangements around the Stamp Duty Land Tax (SDLT);
- other inhibitors include the current arrangements relating to VAT;
- arrangements around REITs may create consistent taxation treatment for investors and help to attract certain investors however some of the conditions around the REIT structure do not assist in making this proposition attractive to other potential investors such as public sector participants;
- housing associations are natural participants in the private sector rental market;
- market and intermediate rents can provide a solid, secure investment return;
- such income streams need to be enhanced if this market is also to charge affordable rents.

Market Insight

spring/summer 2010

The Case for Housing

Impact of house building on the UK economy



savills.co.uk

The case for housing

A substantial increase in house building of 100,000 homes per annum would not only deliver much needed housing, it would create jobs, boost tax revenues and cut government borrowing by £23 billion over the life of a new parliament.

This paper details the positive benefits that housing supply can have on the UK economy and demonstrates the "loss" to the UK economy that flows from the reduction in house building from 200,000 properties in 2007 to the 100,000 properties that are likely to be provided in 2010.

It argues for concerted action to stimulate supply, why government should take action, and explores a number of steps that it could take to create a positive environment for investment in housing.

Housing supply post war

The graph below details the level of housing production from 1946 onwards, giving a breakdown between sources of production. (See Graph 1)

Private sector production has averaged around 140,000 properties per year since 1955, exceeding this with short lived peaks in the early 1960s and then the mid 1980s.

Local authorities represented the bulk of the production in the 1950s, with an average of 150,000 properties, dropping down to 100,000 in the1970s. Housing associations have largely replaced local authorities, albeit at much lower levels.

The case for a rapid expansion in the provision of new homes

Housing starts have fallen rapidly as the country has sunk deeper into recession. In 2007 around 200,000 additional homes were delivered.

This represented the peak of activity for the decade, but even this falls short of the government target of 240,000 and the levels of up to 290,000 that both the National Housing and Planning Advice Unit and the Barker Review have suggested are needed to solve affordability problems.

In 2009 we saw less than 120,000 new homes delivered and less than 90,000 started. It is likely that, overall, around 100,000 new homes will be delivered in 2010.

Government action in the form of housing stimulus packages has been instrumental in enabling this housing supply and maintaining capacity within the construction sector. Analysis suggests that more than half of this output has benefitted from government support of some kind.

The potential spending reductions trailed by all parties suggest that this support could be withdrawn. This is likely to further reduce supply and have an adverse economic impact.

Economic boost

Based on an impact analysis that Savills has undertaken with Oxford Economics, we know that housing development has a positive impact on the economy.

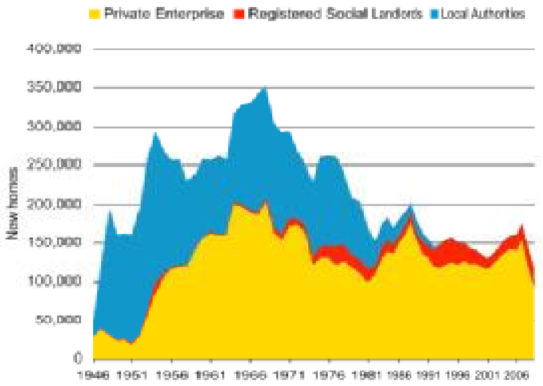
- The lag between investment and impact is short – less than a year
- It creates jobs in the UK
- It creates significant tax revenues

We would argue that the size of the impact is such that, whatever the result of the next election, any incoming government should adopt a commitment to boost supply by 100,000 properties and to maintain this through the life of the next parliament.

Without intervention the market will recover but at a much slower pace. If action was taken to reverse the current trend and to boost supply by 100,000 new homes a year, the impact on the economy would be substantial.

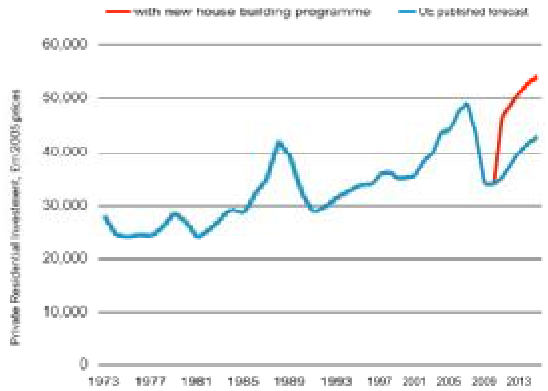
It would create a surge in residential investment and provide a significant and early boost to the economy. (See Graph 2)

Graph 1
Housing completions in England by source



Source: CLG

Graph 2
Impact of an extra 100K new homes pa on private residential investment



Source: Oxford Economics

The measurable economic impacts of building 100,000 new homes

- Boost jobs
- Reduce benefit expenditure
- Boost tax revenues
- Reduce borrowing
- Impact positively on the growth of GDP
- Positively impact on economic confidence and potentially the cost of borrowing

100,000 new homes would

Boost jobs

This action would create around **228,000** direct construction jobs and a further **228,000** jobs on the supply side. These would be real jobs and many of them would be provided by the small businesses most affected by the recession. This action would also have wider benefits, boosting activity and creating an environment where enterprise could flourish. It would encourage businesses to take on apprentices and boost the future capacity of the construction industry.

Housing is a local product and any stimulus to the housing market is likely to have a positive impact in all regions.

Reduce benefit expenditure

Given the scale of the downturn within the construction industry, there is significant unused capacity. The jobs created would lift many of the unemployed construction workforce off the unemployment list and, again, the year on year commitment would boost the opportunities for apprenticeships.

The reduction in unemployment would significantly reduce the benefit take. It should result in annual savings that would increase to **£1.1bn** per year by the end of the new parliament.

Boost tax revenues

The direct benefit from the production of 100,000 new homes per annum would be to increase tax revenues by at least £2.3 billion a year, rising to **£3.1 billion** a year by the end of the new parliament.

Table 1: Tax revenues in 2015

Tax	£m
Stamp duty	180
Council tax	573
Corporation tax	431
Income tax	823
Employees NICs	757
Employers NICs	352
Total	3117

Additional tax revenues would flow from linked activity and the boost to the economy from this output, producing a total revenue gain of **£5.8 billion** annually, as shown in Graph 3.

Reduce borrowing

Over the life of a parliament these new homes would reduce government borrowing by around **£23 billion**, through increased tax revenues and the reduced benefit bill.

Impact positively on the growth of GDP

At a time when the wider economy is restrained and growth limited, a boost to the construction industry would feed through to the headline rate of growth and do much to lift further expectations of growth.

This level of increased housing output could add **1% of growth** to the economy (by the end of the second year). (See Graph 4)

Positively impact on confidence and the cost of borrowing

The UK economy is likely to hover around low levels of growth for some time. The extent of debate within the financial markets as to whether we achieved 0.1% or 0.3% growth in the last quarter of 2009, illustrates how the potential boost from housing could positively impact the wider economy and a new government's ability to manage it.

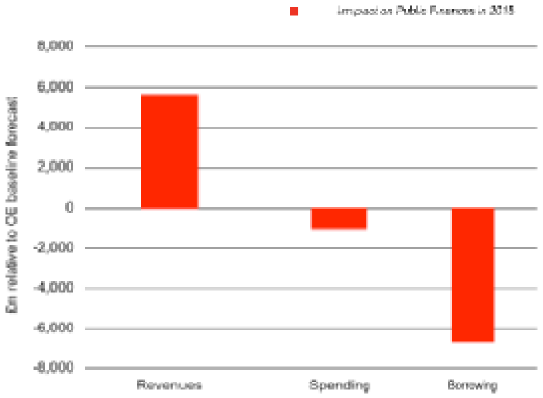
This could flow through to the cost of borrowing. Given the scale of debt, action that boosts confidence could have a substantial impact, assuming that the increased activity uses up spare capacity in the economy, therefore not leading to inflationary pressures. If government debt is £850 billion then an increase of 10 basis points to an interest rate of say 4.0% would add £850 million to the cost of serving debt. Therefore, any positive action that reduces pressure for this must be beneficial.

Potential methods of delivery

Providing housing to rent

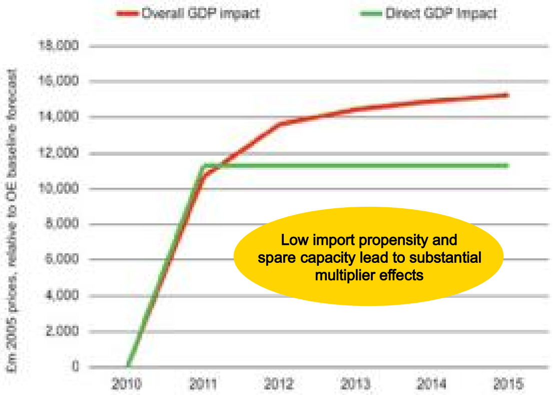
In 1951 the UK economy faced an equally demanding set of financial circumstances and a high unmet demand for housing.

Graph 3
Impact on public finances in 2015



Source: Oxford Economics

Graph 4
Impact on GDP (direct and indirect)



Source: Oxford Economics

The solution was for government to support the delivery of new housing. Much of their effort focused on the delivery of rented housing.

We suggest that similar action is required in 2010 and that any government should support a significant increase in the number of new homes provided for rent. There is substantial unmet demand for housing within the UK. The Barker report and others have highlighted the need for 3 million additional homes to meet the demands of a growing, ageing and increasingly single population. The impact of university fees and the changing nature of employment point to an increased demand for the housing flexibility that renting can deliver.

The global economy demands that the UK has a flexible, mobile workforce that is able to respond to job opportunities and has the flexibility to match its housing expenditure to its income.

It is not by chance that the most active part of the UK economy is London and that it has one of the highest levels of rented housing.

There is strong evidence of the continuing demand for market rented housing. Over the last decade over 1 million more people have taken up renting in the private sector. The buy-to-let market has gone from virtually nothing to more than 3% of our total housing stock.

Demand for owner-occupation remains strong and it is likely that the UK market will continue to be dominated by housing for sale. Unless measures are taken to boost the supply of private rented housing, access to affordably priced accommodation will be restricted. Many of the current purchasers will have rented in advance of purchase.

An increase in market rented homes, via the proposed boost to supply, would act as stimulus to the wider housing market, bringing forward many sites where the sales risk is preventing house builders from opening up new sites. It would enable the mortgage market to recover, with some of the demand for house purchase deferred through renting in advance of purchase.

Delivery and cost

These additional market rented homes could be delivered by the private sector using private sector funding. The cost of delivery would be driven by construction costs and the value of land. An extra 100,000 new homes would cost somewhere around £12 billion to deliver each year.

To put that figure into perspective, around £17 billion was lent to fund buy-to-let mortgages for house purchases during 2007-2008. The cost of construction and a land value would be financed through the rents generated by the properties. Over time, as rents rise in line with earnings, the returns for investors would grow and the debt would be repaid.

Creating the environment

Government could assist by creating an environment where these market rented houses could be delivered. It could:

- provide tax incentives by reducing the Capital Gains Tax when properties were sold into owner occupation, on the understanding that they had been available for rent for say 5 - 10 years
- place rented housing on the same VAT base as housing for sale
- invest public land for a revenue return and a share of future proceeds

All of these would be helpful additions.

Above all, what is required is the political will to make it happen, working with the private sector to deliver new housing to create jobs, reduce borrowing and boost the economy.

Housing Investment Consultancy - Our services and track record

Savills Housing Investment and Consultancy team provides practical solutions for the utilisation of property assets and delivery of residential led development. Working across the UK, we create strong partnerships with the public and private sector, delivering housing, healthcare and education facilities. We also open opportunities for investment and source funding for development.

Our skill lies in working as part of your team helping you to deliver your business objectives. We have:

- Surveyed 1 million homes for stock condition in the last 5 years
- Delivered £7 billion of major works during the last 5 years
- Advised on the creation of the UK's largest Local Asset Backed Vehicle
- Initiated the development of 3,500 properties
- Arranged the sale of 5,500 tenanted homes for a total of £250 million
- Sold or acquired over 25,000 student properties
- Valued around £1 billion worth of care homes
- Advised on the transfer of over 600,000 local authority homes

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Annex A

Investment in the UK Private Rented Sector: Responses to Questions in the Consultation

Question 1: What has led individuals to invest in new build properties in preference to purchasing and converting existing owner occupied housing?

Acquiring existing owner-occupied housing can be time consuming, involves a certain level of risk and the purchaser is probably less able to negotiate a discount with the seller. With the developer seeking to finance a project securing a buyer "off plan" early on helps finance the scheme and so they may be able to negotiate a favourable deal particularly if they are taking more than one unit. Also in the initial years there is likely to be a lower repair requirement.

Question 2: To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

By buying "off plan", PRS landlords are providing important upfront funding to developers.

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

The contribution is difficult to quantify. In Scotland, those renting out part of their own home are exempt from the landlord registration regime. If a resident landlord is letting to two unrelated parties, they would in effect be operating a House in Multiple Occupation (HMO). The requirements of HMO licensing aside, there are no significant restraints.

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

In the past 10 years inexpensive mortgage to let finance together with stable rental appreciation and substantial capital appreciation made the PRS sector very attractive at a time when other areas of investment such as the stock and bond markets and savings accounts have been relatively unattractive. Looking ahead, Buy to Let mortgages are likely to continue to be harder to access, but household formation pressures and the inability to access social or owner-occupied housing will maintain demand which is likely to keep private rents increasing and allow landlords some capital appreciation. Also the performance of the stock market and the bond markets remain far from assured so there should be scope for expansion of the private rented sector if reasonable returns can be achieved.

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?

Scale economies in management are very important to viability and it may be that institutional investors would not be interested in small lot sizes. It is difficult to predict the threshold below which lot sizes become unattractive.

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?

The evidence relies on the mathematics of the appraisal. If one landlord has a higher upfront cost than another then they will receive a lower rate of return unless they pass on the cost in higher rent, which presumably the market may not sustain. There is no real evidence about bulk sales because there are currently very few of them. It is not possible to state that SDLT is the only reason that there are very few bulk purchases at the moment, but it has been referred to as a key issue by some landlords.

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?

Equalising the rate of SDLT so that institutional and single landlords paid the same rate would improve the rate of return for institutional landlords which should attract more investment into the sector than otherwise. However investors are always looking at the spectrum of yields across the stock market, commercial property, agricultural land, bonds and savings accounts and the attractiveness of the PRS will depend on wider market fluctuations.

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

It is hard to generalise about investors' appetites, but there may be an appetite for predictable, relatively secure investments offering a steady income (and possibly eventual sale into vacant possession) to match the liabilities of life assurance companies or more particularly pension funds who have had to rebalance their portfolios out of equities into bonds.

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?

Other investment sectors are not particularly attractive to institutional investors at the moment. Residential investment is relatively low risk, and it provides a stable and predictable return which suits some portfolios like that of pension funds.

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?

The barriers to further institutional investment include the high rate of SDLT on bought transactions, the difficulty of setting up a residential REIT when portfolios are being built up from scratch, and there are onerous requirements on companies listing. The price of residential sites is inflated by the vacant possession market, i.e. they are priced in the expectation that the land will go for more lucrative owner occupation. Investors may also have some concerns about the possibility of any future increases in regulation of private landlords. As a result, the Scottish Government will continue to maintain an effective and proportionate means of raising standards in the sector.

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

There are hardly any ready made residential property portfolios to put into a REIT. Given that there are significant entry costs to REITs and onerous listing requirements it is very difficult to set one up. A consortium of Registered Social Landlords looked at putting their private rented and mid-market (intermediate rented) stock into a REIT and concluded that it was not economically advantageous. The key advantage of a REIT though is that tax is only paid once.

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

There are some specially constructed property unit trusts that have much the same tax characteristics as REITs and may have lower entry costs. Again the main barrier is difficulty in growing a portfolio of private rented properties from scratch to a decent size. A private rented investment requires not just construction of suitable buildings, but also letting them to tenants to ensure a steady and reliable income with few voids and low management costs.

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

No comments. Not enough comparative evidence available.

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?

There is not much actual evidence that institutional investment would bring real benefits as we are breaking new ground. However it seems likely that the investment would be relatively long term, it would draw in capital from different sources than buy-to-let mortgages from banks (backed by the international money markets), and it might help develop more professional property factoring services. There is clearly a gap between social housing and owner-occupation which in the medium term looks likely to be filled only by the private rented sector. If an investor is going to have to manage a block long-term or sell it to a long-term management group, then it is likely to design it with that in mind offering good quality construction, low maintenance, low running costs due to high levels of energy efficiency and sustainability.

c/o Keith Jackson
Housing, Regeneration and Third Sector team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

April 30th 2010

Dear Keith,

Shelter response to the HM Treasury consultation paper *Investment in the UK private rented sector*

Shelter welcomes this consultation paper and the interest it hopefully signifies in the private rented sector (PRS). The sector increasingly houses more vulnerable people for sustained periods and its operation therefore is a significant issue for Shelter clients. We consider it vital that the government establishes a long term policy strategy in this area to support tenants and contribute to the overall requirement for more housing.

The majority of the consultation questions relate strictly to investment returns, barriers, futures and stakeholders. Given the nature of our perspective, this response is not directly structured around them. However, it does relate directly to the issues raised in the paper and we would be happy to discuss further any of the points made below.

A home for vulnerable households

As the consultation paper notes, the PRS has continually grown since the late 1980s and is home to 14% of households. The Rugg Review[1] highlighted that the sector houses a diverse group of households which increasingly includes some of the most vulnerable in society. Analysis of our client data highlights this further. An examination of 120 Shelter cases where the client was a private tenant and their problem concerned their finances, debts or housing affordability reveals that there were:

- disproportionately high rates of lone parenthood (28 per cent) and the presence of dependent children (52 per cent)
- high levels of mental and physical health problems among these clients and their dependents – for example, one-fifth reported that they had mental health problems

It concerns us that the paper pays insufficient attention to the PRS's provision of homes for those in Temporary Accommodation or those claiming Housing Benefit or Local Housing Allowance. Though these benefits are rightly aligned to individual households, they nonetheless form a substantial state intervention in this market. Any future strategy for the PRS must consider the impact on these tenants, who make up over a third of those in the sector, and the related aspects of public policy.

Furthermore, it is important to note that while the PRS is a tenure of choice for some, for many it is their only option. As the paper notes, many households cannot access home ownership and council waiting lists totalling 1.8m households stand testament to the decreasing availability of the social housing.

Institutional investment

[1] Rugg, J & Rhodes, D *The private rented sector: its contribution and potential,* Centre for Housing policy, University of York, 2008

Shelter has long been a supporter of increasing institutional investment in the PRS. While not a silver bullet, it does present a good opportunity to directly increase housing supply and increase landlord professionalism. Other organisations are better qualified to note which mechanisms would best facilitate greater investment, but the general principle is one which we endorse.

Individual investment

The consultation paper rightly avoids the temptation to view institutional investment as a silver bullet for the PRS's problems. While its increase would be very welcome and would likely have positive effects in the wider sector, it is unlikely to become the dominant investment channel in the near future. Indeed, the paper's helpful examination of experience elsewhere highlights that even in countries which have typically favoured and facilitated institutional investment, like Germany, the majority of landlords still tend to be individuals or couples.

Therefore, any policy strategy needs to centrally consider the role and regulation of small scale landlords. With this in mind, we would again stress the need for buy-to-let mortgages to be regulated. This is common practice in Europe and a sensible provision for any system of regulation charged with monitoring financial stability. While buy-to-let mortgages are, in effect, business loans, there is evidence to suggest that some landlords enter the market without considering it to be a business investment and often do not have to develop a business plan. Unlike many forms of business when done badly, poor landlordism can threaten the stability of something as fundamental as someone's home.

On this point the Rugg Review noted that:

"Applicants for buy-to-let mortgages should be required to demonstrate sound understanding of their local market and provide an appropriate business plan. Mortgage lenders and property developers have been culpable in promoting the idea that purchasing a property to let is an investment activity that requires little knowledge of the rental market or of tenancy law"[2].

Furthermore, recent Shelter research into the effects of the recession on the private rented sector showed that around 1 in 10 landlords were constantly struggling or falling behind. Of newer landlords – those who entered the market less than five years ago – this rose to more than half[3]. Tenants and the wider housing system need the better protection from amateurism and risky investors that regulation would provide.

Landlord registration

Shelter supports the parallel work, mentioned in the paper, being conducted by the Department for Communities and Local Government on landlord registration, tenant advice and letting agent regulation. It is vital that these two pieces of work are coordinated.

The enclosed briefing paper details the benefits of implementing a registration style regime for landlords and notes the benefits of regulating letting agents. Shelter recognises the good conduct of many landlords and agents, registration would help this become the standard.

Rent-a-room allowance

We welcome the attention the paper draws to the rent-a-room allowance. In this period of severely constrained housing supply it is vital that the most is made of existing stock. However, since rent-a-room's inception there has only been one increase to the threshold to

[2] Ibid.
[3] *Taking the strain: The private rented sector in the recession,* Money Advice Trust & Shelter, 2009

the current level of £4,250 (in 1997/98), despite subsequent rent inflation of more than 110 per cent[4]. Data from Spareroom, a website that lists flat- and house-share opportunities, suggests that the majority of rent-a-room opportunities are now above the threshold. Sixty per cent of its UK listings in 2009 to November, where the landlord was living in the property, were advertised at annual rents above the rent-a-room threshold[5]. In addition, the average annual room rent where the landlord was living in the property was £4,324, which is above the threshold.

Based on the rate of rent increases, our calculations suggest that the rent-a-room threshold could be increased to £9,000 of rental income per year[6]. This is comparable to the limit for the equivalent scheme in Ireland, the threshold for which was increased to €10,000 in 2008. According to official figures, it is estimated that raising the threshold in line with inflation would cost an additional £5 million per year over and above the current cost of £120 million[7]. We would urge the Treasury to examine this further with a view to increasing the threshold.

Investment in existing stock

Given the scale of the need for new housing in the UK it is tempting to overlook the needs of existing homes. This is particularly the case for the PRS. The English Housing Survey notes that over 44% of homes in the PRS do not meet the Decent Home Standard, higher than any other tenure. Unsurprisingly, issues relating to conditions or repairs form a significant proportion of the presenting problems of Shelter clients living in the sector.

Greater consideration should be given by government to the mechanisms by which greater private investment can brought into the PRS to deal with this problem. This should mirror the effort being devoted to the issue for home owners. We note the difficultly of providing adequate incentives when the property-owner and utility bill payer are separate people, but this does not seem like an unsurpassable problem. Success in this area could be very significant, leading to reduced fuel poverty and poor-housing related health conditions while improving general well being and the fight against climate change.

As has been noted, Shelter welcomes this paper as improving the quantity and quality of PRS homes is vital. Many cross sections of society would benefit from this, but it would particularly support the lives of the sector's more vulnerable tenants. Done well, PRS policy could contribute to increasing overall housing supply, providing stable homes for vulnerable households, and helping to combat climate change. This highlights important need for a long term cross-departmental government strategy on the PRS. We hope that this paper signals the start of its development.

Yours sincerely

Roger Harding
Head of Policy
Shelter

[4] From 1997/08 to 2005/06, rents for properties with resident landlords increased by 75 per cent. Extrapolating rent increases to 2009/10 would increase this to 113 per cent, which would be equivalent to a threshold of approximately £9,000. See CLG [online], Survey of English Housing, Live tables: Table S503 (Trends in mean rents): http://shltr.org.uk/1e

[5] *Rethinking housing taxation: options for reform,* Shelter 2009 (from data provided to Shelter by www.spareroom.com)

[6] Ibid.

[7] Ibid (citing House of Commons Official Report, 22 Oct 2008: Column 358W)

Sir Richard Leese, Chair; **Phil Robinson,** Chief Executive;
Tel: 01942 737922; Email: peter.hart@4nw.org.uk

Our Ref: HMTresponse280422010

28 April 2010

PRS investment consultation
c/o Keith Jackson
Housing, Regeneration and Third Sector team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Dear Mr Jackson

Investment in the UK private rented sector: HMT Treasury consultation paper

4NW is the Regional Leaders Board for the Northwest of England. We place public, private and third sector stakeholders at the heart of decisions that shape the future of the Northwest, its people and places.

The Northwest Regional Development Agency (NWDA) and 4NW are jointly responsible for preparing the Regional Strategy RS2010 for the region. The strategy will promote the sustainable economic development and regeneration of the region, and 4NW will ensure it is democratically accountable and relevant to the needs of this region.

4NW has a board of members including council leaders from each of the five sub-regions, Cumbria, Cheshire, Lancashire, Merseyside and Greater Manchester, along with seven representatives from the private, non-governmental sector such as Manchester Airport Group, North West Universities Association and the North West Trades Union Congress - people who are responsible for delivering the strategy proposals at local level in the Northwest. (www.4nw.org.uk)

Given the recent 'purdah' period, this is a 4NW officer response to the consultation which has involved significant consideration by a range of partners from across the region. The response has been co-ordinated by the North West Private Sector Group. The focus of the group is private sector housing and the make up of the group includes local authority officers and practitioners as well as other stakeholders/partners involved in developing and implementing private sector housing policy and strategy.

The consultation document sets out 15 questions on individual and institutional investment and asks for consideration of the contribution that the Private Rented Sector (PRS) can play in addressing demand and increasing housing supply and to look at what the barriers are to investment. Our response does not attempt to answer all 15 questions but focuses on the individual investment aspect. Specific detailed points are therefore appended to this letter. The group have taken the view to leave the detailed technical input needed to answer the questions on institutional investment to those better placed such as Savills the property consultancy who will be responding to this consultation.

That said we welcome the opportunity to respond to this consultation and to offer our thoughts from a North West perspective.

In general terms, we welcome proposals for institutional investment in the PRS and see this as a positive move to increase housing supply, improve property and management standards and contribute towards the proposed key housing objectives of the North West Regional Strategy (RS2010), which are:

- Securing high-quality housing in locations which support sustainable economic growth
- Meeting housing need through the provision of affordable housing units via a range of different products.
- Ensuring that the private rented sector plays a full role in extending housing choice by driving up quality and management standards
- Improving the quality of our housing stock and tackling poor energy efficiency and fuel poverty

Our main concerns, however, are that the consultation paper appears to treat the private rented sector as a homogenous market. The reality is that both from the supply and the demand side the market breaks down into multiple market segments. On the supply side, at the top end of the market is the high value, high quality rental unit usually for high earning professionals with monthly rentals between £700 and £1,500+. These properties are often owned by professional landlords who buy to invest and live off the income earned. At the opposite end of the market is a mixture of well intentioned amateur landlords who often let out sub-standard properties to an increasingly desperate and vulnerable group of households who are unable to access decent homes in the social rented sector.

In between these extremes there are a range of market segments such as reluctant landlords who are unable to sell property and therefore rent; inheritors who have inherited property; relatively wealthy individuals who have chosen to invest in property rather than other investments; professional landlords who manage a small portfolio of properties themselves; professional managing agencies; and overseas investors. The one thing that all of these investors have in common is that they are operating in a market that needs to be, better regulated whereby the market itself is expected to drive up standards through competition. Therefore property condition or quality of management has to be challenged by tenants who are supposed to have the ability to go elsewhere if the landlord doesn't resolve issues.

This may be the case at the top and middle end of the market but at the lower end, the ability of tenants to influence the management style of their landlord is extremely limited. This is particularly evident where local housing allowance is paid for on properties with tenants who are out of work or in low paid, infrequent or temporary work. The poor quality of this sort of property is well documented and for most local authorities the highest incidence of vulnerable households living in non-decent homes is to be found in the private rented sector.

Another issue raised by the introduction of assured short hold tenancies is the ability of the landlord to evict their tenant. Whilst on the one hand this has probably encouraged more people to invest in the private rented sector and provides flexibility to support employment and labour markets, on the other it has presented a barrier to individuals making complaints about their landlord or establishing firm roots in local communities because of the short term nature of the tenancy agreement.

Most good quality landlords welcome a good tenant who is prepared to live in their property for a number of years. It would therefore make sense for a better balance between the rights of the tenant and the responsibility of landlords to be achieved. For example a 5 or 10 year tenancy guarantee providing the tenant complied with conditions or if the landlord/owner received some form of financial assistance.

What is needed is a three way approach;

- Encouragement and support for high quality higher value market rent with light touch regulation, primarily through self certification.
- Accreditation for the majority of good and well intentioned landlords, again with a light touch approach to regulation but with a higher degree of support and advice. Self certification on matters such as property condition, gas and electric and management standards. Incentivisation such as direct payments of local housing allowance to accredited landlords, loan finance for improvements, access to local authority housing registers and support from supported housing schemes.
- Licensing and enforcement for the bottom end of the market with licensing applying to individual landlords or their agents or company. Restrictions on payment of local housing allowance dependant on property condition and good management practice.

So, to support our views/ vision/objectives of RS2010 on improving and making best use of the PRS we welcome institutional investment if it meets the objectives of increasing the supply of new builds in the region, professionalises the sector and promotes economic development.

To the extent this model will be useful in the North West is unclear. This type of model lends itself to focus on a certain sub sector of the PRS and the most profitable one, namely provision for economically active people. There does not seem room for investment at the lower end of the market without government intervention.

In addition, given the scale needed to make it attractive it is almost certain that institutional investment will go for large scale development or acquisition, usually in the form of apartment blocks. This may not reflect current demand or the need for family homes within the Northwest region.

Overall we welcome the opportunity and flexibility that the PRS could make to addressing demand and increasing housing supply, and in attracting investment to an otherwise much maligned sector.

If you wish to discuss this response further please contact my colleague Andrew Malone in the first instance on 01942 776930 or andrew.malone@4nw.org.uk

Yours faithfully,

PEHart

Peter Hart
Regional Housing Manager
On behalf of 4NW

Appendix

Detailed response to the HM Treasury consultation paper

Individual investment

Question 1
What has led individuals to invest in new-build properties in preference to purchasing and converting existing owner-occupied housing?

There is no doubt that Government planning guidance has resulted in many new housing developments being built to very high density levels. This culminated in a trend to build apartment blocks in many of our towns and cities, which were attractively marketed, although many housing practitioners would contend these were lacking in appropriate space standards and build quality.

The marketing efforts undertaken by developers proved highly successful in moving many new and some existing investors away from the older stock, which had been the traditional market for the private rented sector. The opportunity to buy a new property with the likelihood of minimal maintenance, backed by a 10 year house builders guarantee, was particularly attractive to new investors entering the market, who had little or no experience of property management.

Other incentives included bulk buying, when substantial discounts were offered by developers for investors buying more than one property. In some cases, companies bought large portfolios to gain maximum discounts and then sold on to individual investors for an appropriate mark up in price. Some of the more dubious practices encouraged investors to buy on the promise of imaginary rents and capital growth, which in most cases never materialised.

The trend towards this investment was supported by easy access to buy to let mortgage products, which did not involve the more testing mortgage requirements for purchasing existing stock and often relied on self certification of income and nonsensical income ratios. Moreover, the purchase of a new build property was viewed as an ‘investment’ opportunity giving rise to speculators and ‘investment clubs’ that tapped into peoples ‘aspirations’ for a new modern home and promised high returns. In a rising house price market, with low interest rates, many saw the chance to make money. Purchase of a new build home also means that no costs are involved in renovation or refurbishment as the property is already in good condition, with many still under warranty.

Question 2
To what extent has the growth of the PRS already influenced the house building industry? How might it do so in future?

At a time of buoyant housing markets, accessible finance and a strong economy, the PRS presented itself as a good investment opportunity. The house building industry responded to this by developing relatively inexpensive accommodation, much in the form of small apartments in multi-storey developments often with poor design and space standards. However, a major and underlying influencing factor in this, as previously mentioned, was planning guidance and density factors. It is worthy of note that the share of ‘buy to let’ in new developments increased in line with the market peak in 2007. This would suggest that landlords/investors were influencing build rates and rental yields.

In the current economic climate, the PRS influence on the industry has been diminished. In the NW, some managing agents are managing smaller portfolios of properties as landlords withdraw from the market and are not being replaced by new investors entering the market.

The uncertainty of artificially low interest rates is an issue for investors, particularly ‘buy to let’. To provide a degree of certainty and to develop further the ‘buy to let’ market some level of stability around interest rates will be required for a period of years.

However, in the future it is far more likely that house builders and developers will be positively viewing the PRS as a means of supporting sales in new build developments. There is significant interest from several major players in Manchester for developing a PRS investment model for new house building. These are all based generally around an equity investment, high quality management model, with a desire to mix home ownership with market renting. In addition the Northwest has a large number of University/colleges and student accommodation providers have very much concentrated on new build, small flats etc in order to cater for a particular market segment of students. There is however an apparent missed opportunity to provide move-on accommodation for students once they have graduated.

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?

The rent a room scheme is a valuable addition to meeting housing need, particularly for single people who may be low priority cases for social housing. The scheme also contributes to economic mobility, supporting people on short term or temporary employment contracts that need accommodation.

Renting out a room in a home is also a useful tool to many local authorities and when a room/rooms can be rented out to young often vulnerable people, who then have lodgings for a few nights (as an alternative to B&B’s), these local schemes are often supported by charities who provide the support element and allow and local authorities to prevent homelessness.

Rental income from lodgers is exempt from income tax up to a threshold of £4,250. This threshold has not changed since 1997/98, even though rents in most parts of the country have more than doubled. This equates to a monthly rent of just over £350 or £88 per week. As a means of comparison, in April this year the 1 room self contained LHA rate was £103 for the central Greater Manchester area and around £86 for Bolton and Bury. The weekly rates in the open market may be significantly higher.

The tax incentives aligned to such scheme should be uplifted in line with inflation over the years to provide greater incentives for homeowners or tenants who are in a position to sub let.

The Northwest intend to commission research to understand the extent of homeowners renting out part of their home within the region, as part of the evidence base for developing the regional integrated strategy – RS2010.

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?

The beginning of the last decade saw the advent of buy-to-let mortgage. This of course, since the onset of the banking crisis/recession has fallen away as the availability of mortgage products have dried up.

In addition, the nature of the housing market itself has changed. Ten years ago, many of the core cities of the Northwest, along with coastal town and former industrial towns had found that their housing market had collapsed. This was characterised by empty and vandalised property, very low property prices, falling population and the poor quality of neighbourhoods. The work of the Housing Market Renewal Pathfinders has in many areas helped to stabilise this problem.

However one issue and disincentive that seems to dominate discussions with private landlords, particularly those operating in the benefit market of the PRS, is the introduction of Local Housing Allowance, when benefit is paid direct to the tenant. Whilst, most local authorities report that the introduction of LHA has had some teething problems, they maintain that the scale of the problem has been overstated. This is certainly not the view of landlords operating in this market and whilst they appreciate that LHA rates are generally more generous than Housing Benefit, rent arrears are now considerably worse.

If LHA is here to stay, incentives to pay direct to the landlord should be considered, for example when a landlord is an accredited to a Landlord’s Accreditation Scheme.

Appreciation in property prices up and until the summer of 2007 had been a significant incentive for landlords and as the consultation document suggests, was essential to make up for the shortfall on income through rent. Now, that property prices have fallen and interest rates are at an artificially low rate, financial planning and investment realisation are uncertain for individual investors. Most ‘buy to let’ investments are highly geared and access to suitable mortgage products is currently restricted. This together with the absence of any appreciation in capital assets discourages investment.

In the Northwest, much of the PRS is found in poor quality pre 1919 terraced properties. The nature of the stock and its age requires maintenance and refurbishment on a more regular basis than stock built in more recent years. In some areas this has been a major contributing factor to housing market failure and to the declining quality of neighbourhoods. Maintenance and refurbishment costs have to be built into business sustainability models for the PRS and the consideration of VAT reductions or exemptions would be a significant incentive for individual investors to improve their stock.

In addition, regulation and housing policy may deter some landlords on entering certain sub markets. such as the Housing in Multiple Occupation (HMO) market, by the introduction of mandatory and additional licensing- the introduction of a new HMO class order and the requirement of planning permission to operate an HMO if a material change of use has taken as well as decreasing the range of mortgage products for HMO properties.

As previously stated the Local Housing Allowance (LHA) is a growing concern to both landlord associations and housing charities who view this as not working. Landlords may remove themselves from the market thereby reducing supply especially if payments are made direct to tenants which increasingly is leading to rent arrears and consumer debt.

Demand for the PRS is growing and looks likely to become very important in meeting the needs of a range of people. This is because of a mix of factors; the demographics of the country are changing with more single households and an ageing population; the limited availability and turnover within social housing; and increasing difficulty in accessing owner occupation. While increased regulation of the PRS should drive up standards, undoubtedly it will also remove poor landlords from the market.

Institutional investment

The private sector housing group appreciate the level of expertise needed to formulate a response to questions 5 – 14 on institutional investment and therefore make reference to the responses of others, such as Savills, a leading property consultant and partner who will be responding separately to this consultation.

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?

On the whole, institutional investment should be a good thing if it meets its desired objectives of increasing the supply of new build in the region, professionalises the sector and promotes economic development.

The extent that this model will be used or successful in the North West is unclear. This type of model would seem to lend itself to focus on a certain sub sector of the PRS and the most profitable one, namely provision for economically active people. There does not however seem room for investment at the lower end of the market without government intervention.

In addition, given the scale needed to make it attractive for investment it is likely to focus on large scale apartment blocks. Of which there are already a large numbers of apartments in the city centres that are underused. This may not reflect current demand or current expectations for family housing within the region. Inevitably we would then question is this would create ‘mixed’ communities by alone – possibly only if some type of shared equity element is included.