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.*

<u>Response</u>

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.*

<u>Response</u>

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*.

<u>Response</u>

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.*

<u>Response</u>

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.*

<u>Response</u>

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.*

<u>Response</u>

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*

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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.

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 ;

<u>Residential Property Acquisition</u>

Portfolio of 200 residential properties 2010 average value £150,000. Total value £30,000,000.

SDLT at point of acquisition = £1,200,000.

<u>Residential Property Sale to Follow on Investor</u>

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

<u>Commercial Property Acquisition</u>

Single office building 2010 value £30,000,000.

SDLT at point of acquisition = £1,200,000.

<u>Commercial Property Sale to Follow on Investor</u>

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

<u>Equities Portfolio Acquisition</u>

Portfolio value at 2010 £30,000,000.

Stamp Duty at point of acquisition = £150,000.

<u>Equities Portfolio Sale to Follow on Investor</u>

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

<u>Bond Portfolio Acquisition</u>

Portfolio value at 2010 £30,000,000.

No Duty at point of acquisition.

<u>Bond Portfolio Sale to Follow on Investor</u>

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

Contents

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.

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.

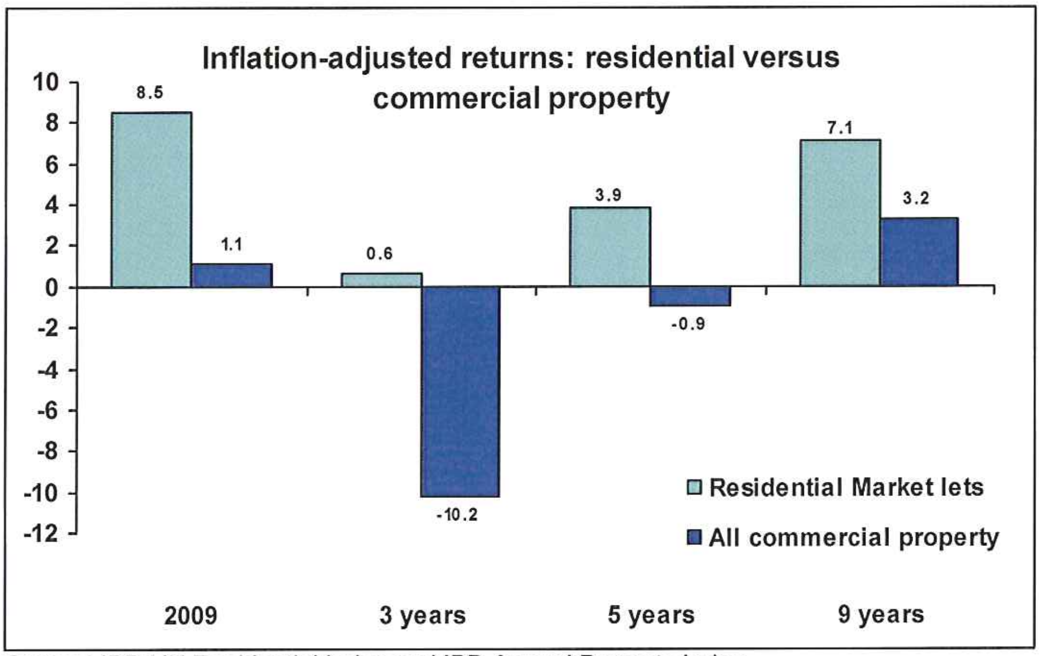
The double-digit 2009 UK residential total return – comprised of an 8.1% capital growth and a 2.7% income return – is the third consecutive year in which the market has outperformed the broader commercial sector, delegates at the **IPD UK 2009 Residential Index Launch** were told.

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

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.

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[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

Secretary and Adviser

DO WHAT IS RIGHT COME WHAT MAY

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PRS investment consultation,
c/o Keith Jackson,
Housing, Regeneration and Third Sector team,
HM Treasury,
1 Horse Guards Road,
London,
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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

THE CHARTERED INSTITUTE OF TAXATION

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.

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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'

Chartered Institute of Housing, Octavia House, Westwood Way, Coventry, CV4 8JP
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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.

Chartered Institute of Housing, Octavia House, Westwood Way, Coventry, CV4 8JP | 024 7685 1700

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

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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

7.1 As 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.

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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:

- Training
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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.

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
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125 Old Broad Street, London, EC2N 2BQ

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

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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:
		  o 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
		  o Can buy without seeing the property
		  o More certain outgoings, certain ou8tgoings in earlier years
		  o Avoids bother of buying and renovating a 2nd hand property
		  o 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.

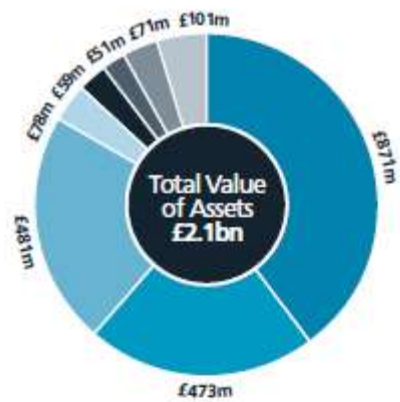
Our business has grown significantly and we expect this to continue as the market evolves with more people seeking to release cash to supplement their pensions, improve their lifestyles or realise their dreams.

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

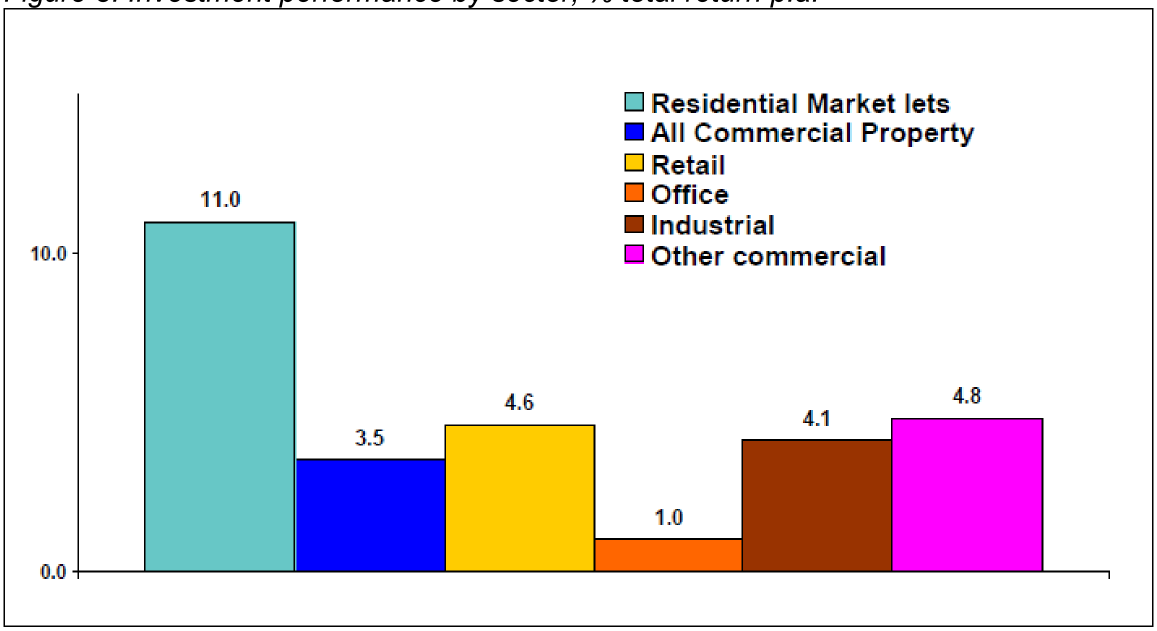
3.2.4 : Commercial and residential annual total returns, 2001 to 2007

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.



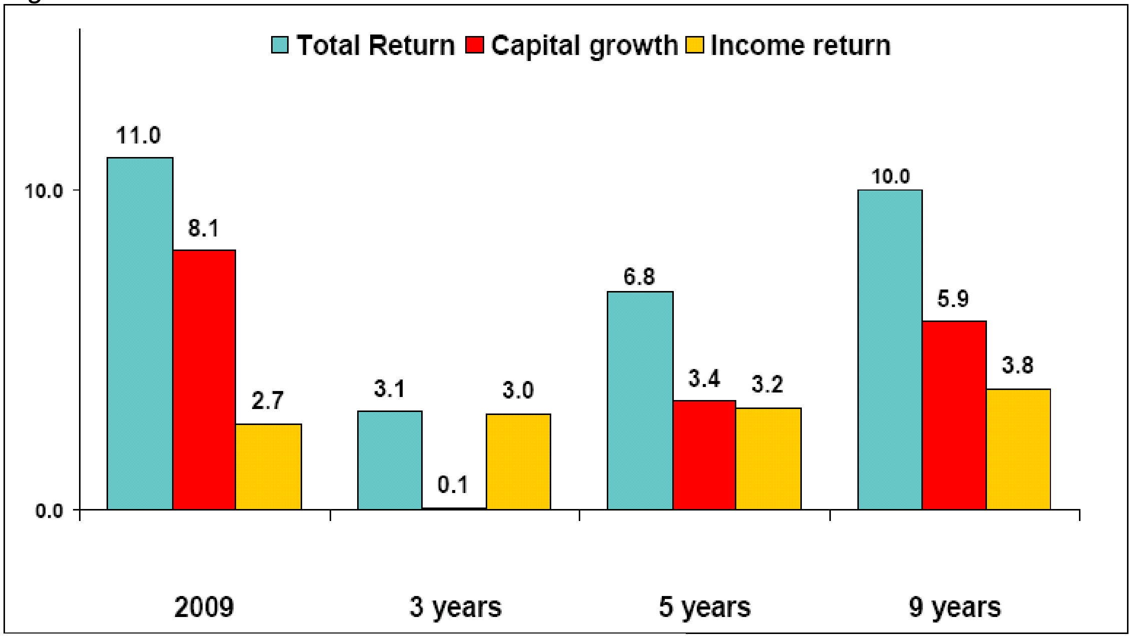
Source: IPD UK Residential Investment Index, 2009

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.

grainger plc

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.

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[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".

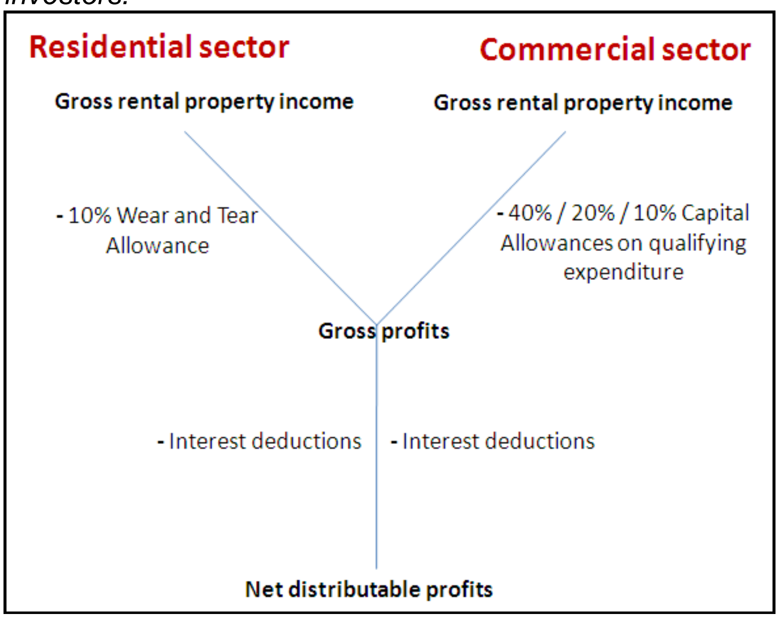
11.8. Calculation of 90% income distribution requirement

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.



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.

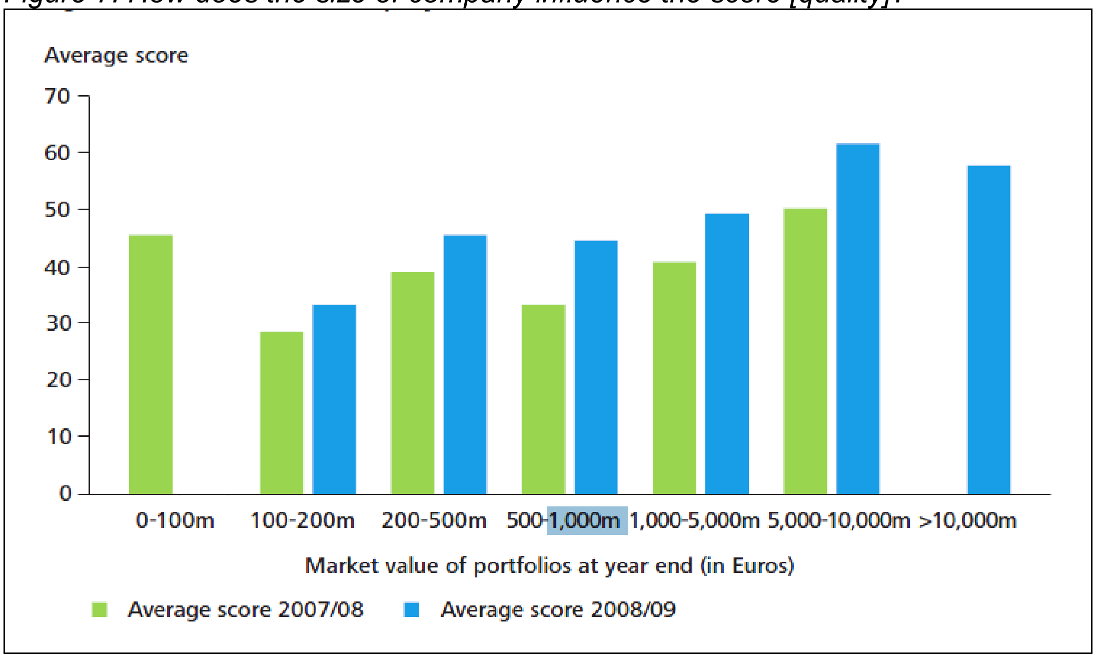
15.8.6. Greater institutional investment in the private rented sector will be better able to deliver the sustainability standards that are required.

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

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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, <u>and</u> (b) earn an adequate development margin, <u>and</u> (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 <u>total</u> 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.

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[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:

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[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.

<u>Private sector leasing</u>

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

Contents **Paragraph**

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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.

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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.

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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

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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.

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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

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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 R Allen
Director, Taxation

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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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