



HM TREASURY

Investment in the UK private rented sector

February 2010



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1

Introduction

Subject of the consultation

1.1 The Government's objective for housing policy in England is simple and fundamental – to ensure a decent home for all. We face significant long-term demographic pressures from a growing and more mobile population that will make meeting this objective more challenging. These housing pressures can impact on a broad range of economic and social policy objectives: delivering macroeconomic stability; helping households manage assets, savings and risk; meeting people's housing aspirations; creating sustainable communities and enabling labour market flexibility.

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.

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. It has also played a disproportionate role in funding new-build supply in recent years. It is important that the sector continues to grow and develop to help meet the housing challenge, and that it is able to respond effectively to changing demand.

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.

Policy context

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 Supply¹ 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.

¹ Delivering Stability: Securing our Future Housing Needs, *Kate Barker*, March 2004

1.6 Published alongside the 2005 Pre-Budget Report, *The Government's Response to Kate Barker's Review of Housing Supply*² set out a range of measures to increase housing supply and improve affordability. These were aimed at co-ordinating the efforts of all levels of government and external stakeholders in delivering development that would meet the economic, social and environmental needs of current and future generations.

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.³

1.8 However, the recent economic downturn has had a significant impact on the rate of new build, with net additional housing starts and completions in 2008-09 down 42 per cent and 20 per cent respectively compared to 2007-08.

1.9 The fall in supply was driven to a large extent by a reduction in the supply of affordable mortgage finance. The Government has been addressing this through action to ensure competitively priced credit continues to be available. On 19 January 2009, the Government announced a package of measures designed to reinforce the stability of the financial system, to increase confidence and capacity to lend, and in turn to support the recovery of the economy. These measures built on those announced in October 2008.

1.10 The Government agreed lending commitments with RBS and Lloyds Banking Group that will see them lend an additional £39 billion (£27 billion to business), on commercial terms and subject to market demand, over the 12 months from March 2009. And similar lending commitments were made in respect of the following 12 months to March 2010.

1.11 Other banks have also signalled increases in lending. The Government will continue to take all necessary measures to ensure the stability of the financial system, support lending to the economy, businesses and homeowners, and support our recovery from the recession.

1.12 In parallel to ensuring the stability of the financial system, the Government therefore also took concerted action to support the housing and construction sectors. In response to the economic downturn the Government has been using its substantial investment in affordable housing and infrastructure to support industry, by bringing forward investment and using it to unlock stalled housing developments. The Kickstart Housing Delivery programme was announced at Budget 2009 and extended in June 2009 as part of Building Britain's Future 'Housing Pledge'. It is helping to stimulate housing development in the short-term and boost capacity in the house building industry by reducing up-front development costs with equity, gap and infrastructure funding, and helping to leverage in private development finance.

1.13 As the housing market recovers, the focus needs to move towards ensuring a strong supply-side response to support the recovery by taking action in a number of areas, including land availability, planning and regulatory requirements, industry capacity and provision of supporting infrastructure. And that focus needs to address the supply of all tenures – ownership, or social and private renting – that have each faced different constraints.

1.14 The Government has taken a keen interest in the potential of the PRS to support its objectives for a flexible and responsive housing market, with a review of the PRS in England⁴ (the "Rugg Review") in 2008. The Scottish Executive also looked at this issue in 2009.⁵

² The Government's Response to Kate Barker's Review of Housing Supply, *HM Treasury and ODPM*, December 2005

³ See Chapter 5, paragraph 5.8

⁴ The Private Rented Sector: its contribution and potential, *Julie Rugg & David Rhodes, University of York*, 2008

1.15 The analytical work conducted by these reviews has provided a firm basis on which Government can take forward policy in the area of the regulatory and legal framework for the PRS. While there are inevitably variations between housing markets, both within and between countries in the UK, the general trends and issues for the PRS summarised in this document have been replicated to a greater or lesser extent across the UK.

1.16 The Government has recognised that the PRS is playing an increasingly important role in the housing market and has been concerned to ensure that it continues to react flexibly to housing market conditions while offering a quality accommodation choice to households, and maintaining an appropriate balance of rights and responsibilities between tenants and landlords.

1.17 In England, the Government's response to the Rugg Review⁶ was published for public consultation in Summer 2009, taking forward policy thinking in three key areas: the right regulatory framework; supporting the market to deliver increased supply and professional management; and improving engagement with the sector by local authorities and others (including the local lettings agency concept). Communities and Local Government is continuing to work with stakeholders on these areas, and this consultation should be considered in conjunction with parallel announcements being made by that department on the way forward for the PRS. The Scottish Executive is also taking forward its own reforms in this area.⁷

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.

Structure of the consultation

1.19 The remainder of this consultation document is divided into six sections:

- Chapter 2 – explains the important role of the PRS for individuals and the housing market and its contribution to wider economic and social objectives.
- Chapter 3 – sets out the historical context surrounding the development of the PRS in the UK, recent developments, and potential future demand for the PRS tenure given current policies and demographic trends.
- Chapter 4 – highlights where international experience has diverged from that in the UK and the reasons underlying this.
- Chapter 5 – examines the important contribution of individual investors to the PRS and whether that dominance will continue.
- Chapter 6 – considers the factors holding back institutional investment in the PRS.
- Chapter 7 – summarises the questions raised in this consultation and provides information on how to respond.

⁵ Review of the Private Rented Sector, *Scottish Executive*, March 2009

⁶ The Private Rented Sector: professionalism and quality. The government response to the Rugg Review, *Communities and Local Government*, 2009

⁷ In Scotland, ministers have established The Scottish Private Rented Sector Strategy Group to take forward the conclusions of their Review. The Group published its recommendations on required legislative changes in December 2009.

Responding to the consultation

1.20 This consultation began with the publication of this document and will last for a period of 12 weeks, closing on 28 April 2010. Information on how to respond to this consultation is provided in Chapter 7.

2

The role of private renting

2.1 The Private Rented Sector (PRS) fulfils a vital economic and social role, offering households choice and flexibility in meeting their housing needs, whether for the short or the long-term. It is immensely diverse in nature and quality, encompassing a wide range of sub-sectors. It provides an alternative housing offer for many individuals and households for whom homeownership would be undesirable or unsuitable. There are many households in the PRS who could afford to buy a home of their own but choose not to.¹

2.2 The Rugg Review² 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

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.

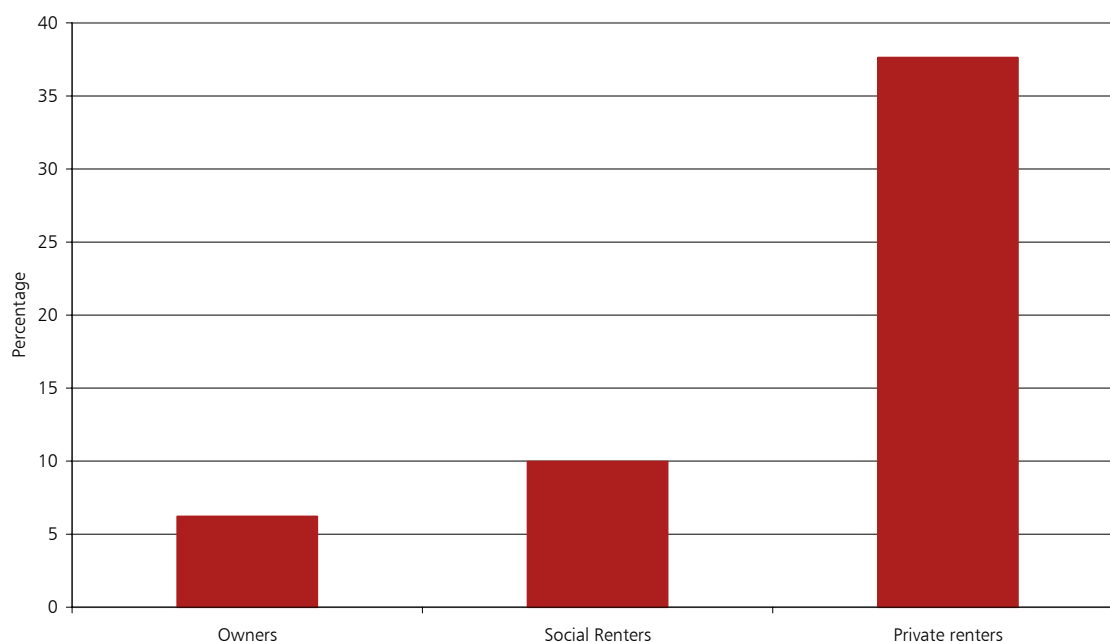
2.4 But for those that need it, the PRS offers unparalleled mobility. Many industries rely on short-term or temporary workers for whom owner-occupation, with its significant transaction costs and lengthy processes, would be expensive and impractical.

2.5 The PRS allows households to move easily both within and between regions, leading to a more efficient allocation of labour and skills. The corollary of this is that if the supply of PRS tenancies were to become limited, those needing uncertain or short periods of accommodation in a particular area would find themselves severely disadvantaged.

¹ The Report of the Shared Equity Task Force, *HM Treasury / DCLG*, 2006, indicated that around a fifth of PRS tenants could have bought a home in their region unassisted.

² The Private Rented Sector: its contribution and potential, *Julie Rugg and David Rhodes*, University of York, 2008

Chart 2.A: Current tenure of households who had moved in the previous year – 2006-07



Source: *Survey of English Housing, Communities and Local Government*

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.

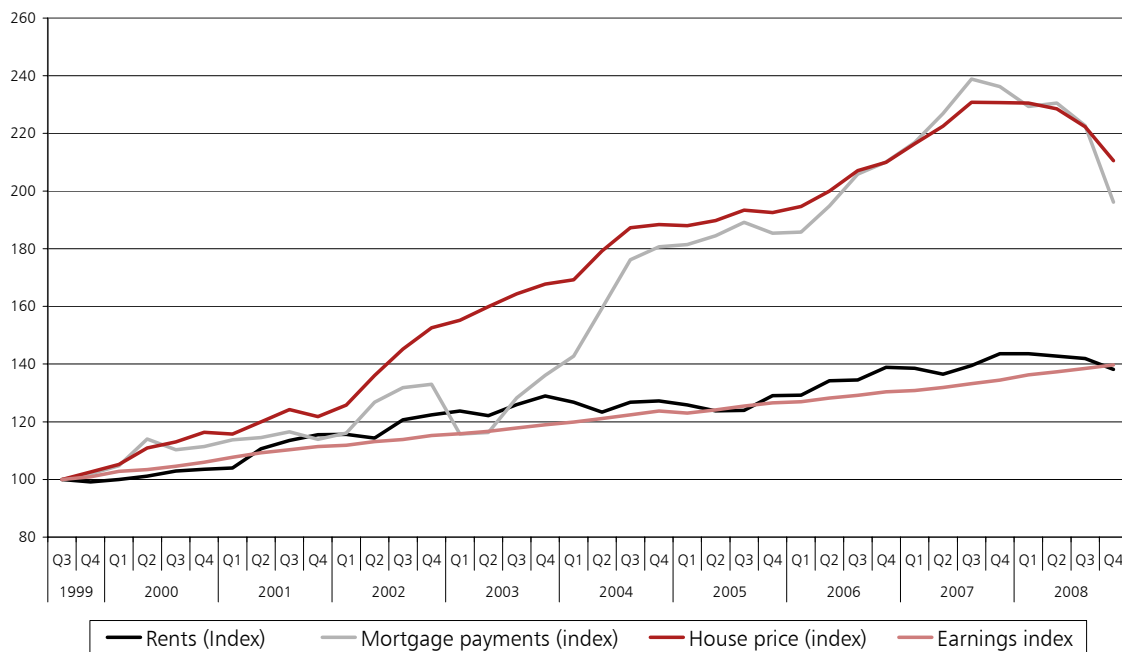
2.7 Younger households have shown an increasing preference for the labour market flexibility of private renting and prefer the locations that they can afford to rent in, over those where they could afford to buy.⁴

2.8 For those that would like to buy at some future point the PRS can act as a stepping-stone to ownership, with 24 per cent of owner-occupiers who moved in the past year having previously been in the PRS. While owner occupation is an important aspiration, many households require significant funds to meet the cost and borrowing requirements associated with house purchase. An affordable PRS allows households to save while still having access to quality accommodation. And over recent years the PRS has become a much more affordable option than homeownership.

³ Survey of English Households, Survey of Mortgage Lenders, both *Communities and Local Government*

⁴ Attitudes to homeownership and moving, *J Smith, Council of Mortgage Lenders, 2004*

Chart 2.B: Comparison of rents, earnings, house prices and mortgage payments



Sources: Survey of English Households, Communities and Local Government; Survey of Mortgage Lenders, Communities and Local Government; Department for Work and Pensions.

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.

2.10 The PRS can therefore play an essential role for many households, at various stages of their housing life, as their needs and demands change. But the PRS also has an essential role both directly and indirectly in enabling a flexible and responsive housing market where supply adjusts to changing demand pressures.

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.

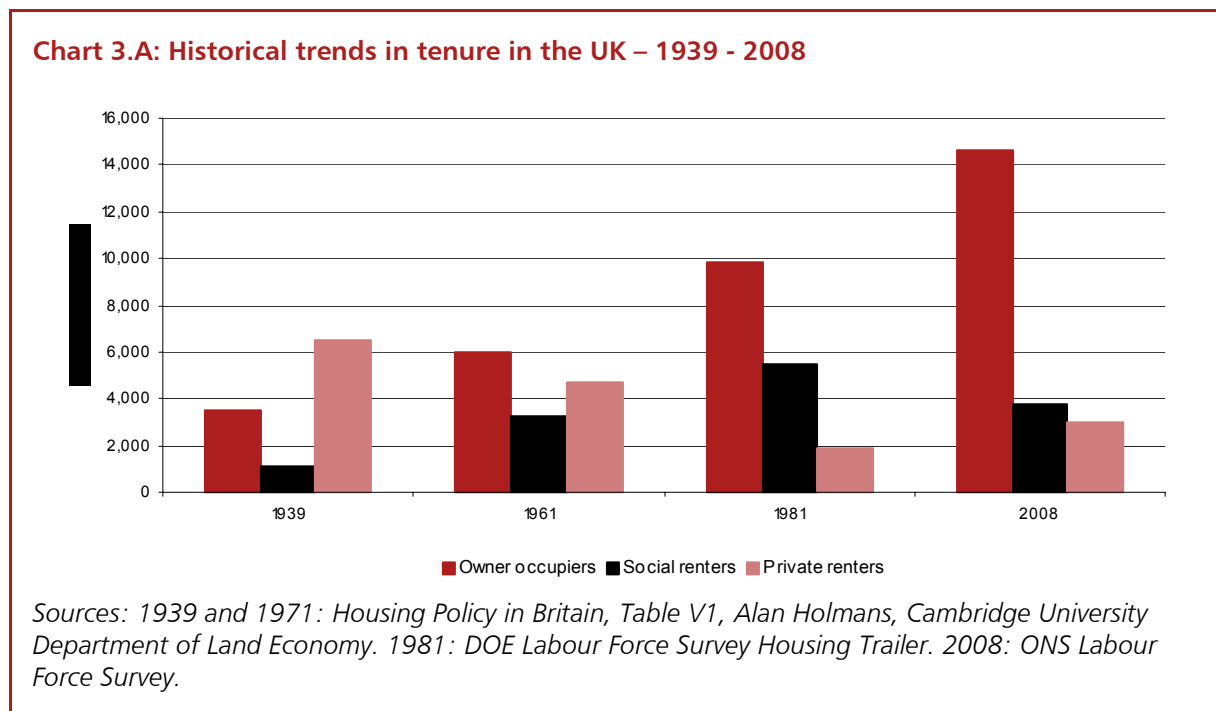
2.12 The PRS can also add to overall housing supply, with investors financing new-build properties specifically designed for the private rental tenure (e.g. serviced student accommodation) or buying new-build market properties from developers.

2.13 Government therefore believes that a thriving PRS is essential to the wellbeing of individuals and delivery of its wider social and economic objectives. It is concerned to ensure that the sector fulfils its potential and is able to offer a quality accommodation choice to those households seeking to benefit from its unique flexibility and value.

3

Tenure choices and changing demand

3.1 The post 1918 period was characterised by a long-run decline in the private rented sector (PRS), although even as late as 1939 over half of households in the UK were housed in the sector, but by 1991 this figure stood at less than 9 per cent. There were a number of reasons for this.

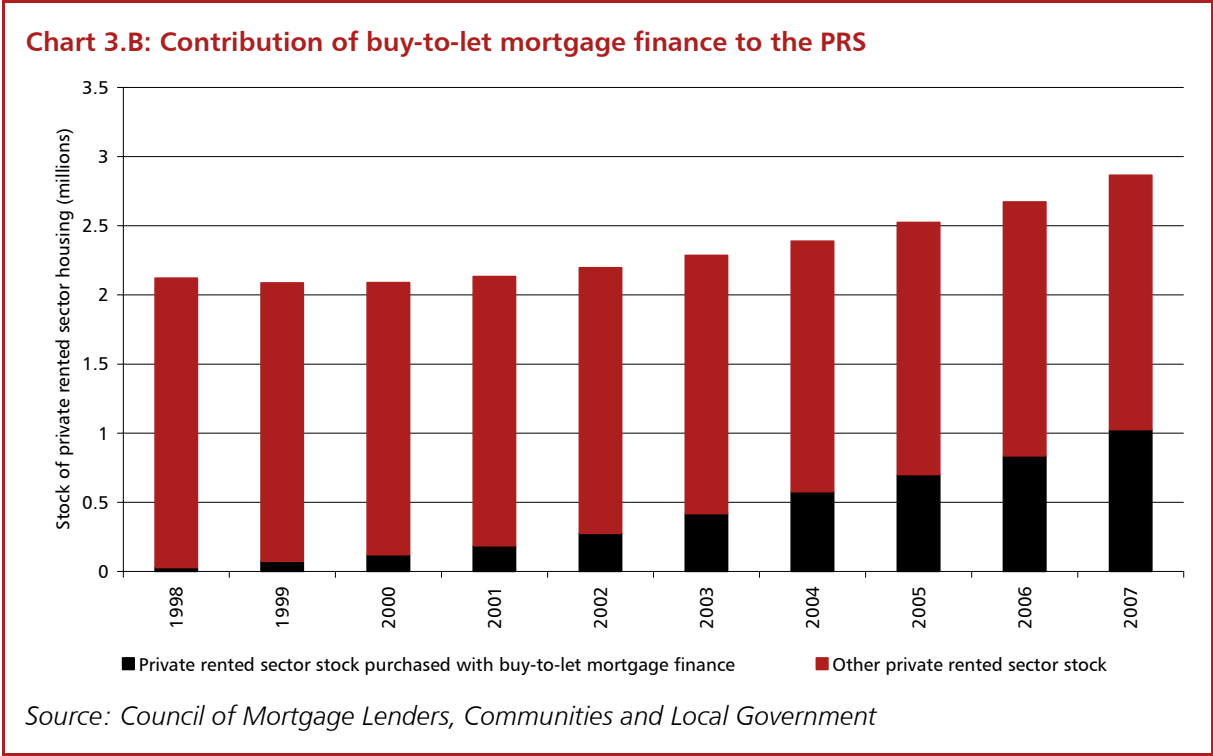


3.2 A key factor behind the decline in the PRS was the introduction of rent controls during the First World War, and these became more extensive over time. Artificially low rents reduced investment in the sector, contributing to a tenure shift to owner-occupation and lower maintenance standards in the stock that remained.

3.3 A turning point was the 1988 Housing Act – which removed rent controls and introduced short hold tenancies. Despite this key reform, recovery in the PRS was initially slow, with its size relative to other tenures reaching a low point in 1991. Investor confidence remained low following decades of low returns, and in a housing market that was depressed at the time. The low quality of stock that had resulted from rent controls also deterred many potential tenants. Nonetheless, the sector saw growth of around ten per cent over the 1990's. Growth since 2001 has been more significant, and coincided with the growing popularity of Buy-to-Let mortgage financing.

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.

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 £122 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.



3.6 A large part of this buy-to-let activity has gone towards refinancing of existing PRS stock (over 40 per cent of buy-to-let advances between 2002 and 2008), or will have substituted for alternative forms of financing. But it does seem probable that buy-to-let financing has contributed towards an overall increase in the level of investment in the PRS, and that this has had a positive impact on both the supply of PRS accommodation and its condition.

3.7 In the UK the PRS tenure now accommodates 14 per cent of all households. While in England the proportion of 'decent' homes within the sector has risen from 37 per cent in 1996 to 59 per cent in 2005, which exceeded the rate of improvement in the owner-occupied sector.¹

3.8 Over recent decades there has been a shift in working patterns and expectations with individuals tending to have a much more varied career history than in the past. This lower level of employment stability feeds through to a requirement for greater mobility in order for individuals to be able to access new employment opportunities. Employment expectations for many households have thus changed, and with them housing preferences.

3.9 The length of time a household expects to stay in one place will affect the relative costs of homeownership (through transaction costs and the period over which they are annualised) compared to renting. The PRS offers particular benefits to a more mobile workforce.

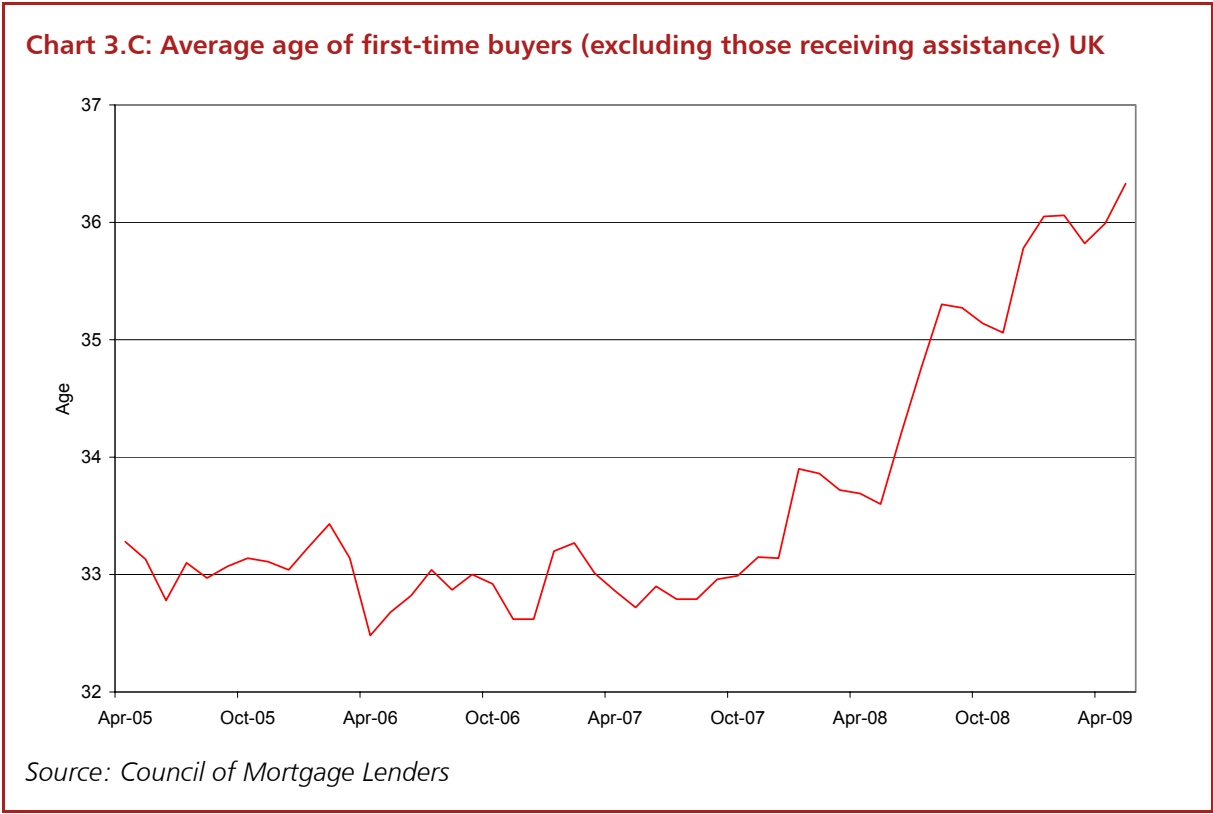
¹ English House Condition Survey, Communities and Local Government, 2006

3.10 Demographic trends and government policy have both contributed towards a boom in higher education student numbers. Student enrolments in the UK grew from 1.6 million in 1994/95 to 2.3 million by 2007/08 – a 47 per cent increase – creating a significant new demand for rental accommodation, concentrated in university towns and cities.

3.11 The growth in higher education has itself contributed to the trend towards later family formation and entry into homeownership.

3.12 Chapter 2 explained that there have also been strong financial incentives to rent, as rent levels have lagged behind the total cost of homeownership. Between 1998 and 2008 private market rent levels displayed relatively low growth rates (similar to earnings), while house prices rose significantly.²

3.13 While aspirations for homeownership have remained high, housing affordability has become increasingly stretched, meaning many households are unable to enter the sector as soon as they might like, increasing demand for the PRS. This is reflected in the increasing age of those first-time buyers who have not been able to access assistance from family or friends to bridge the gap.

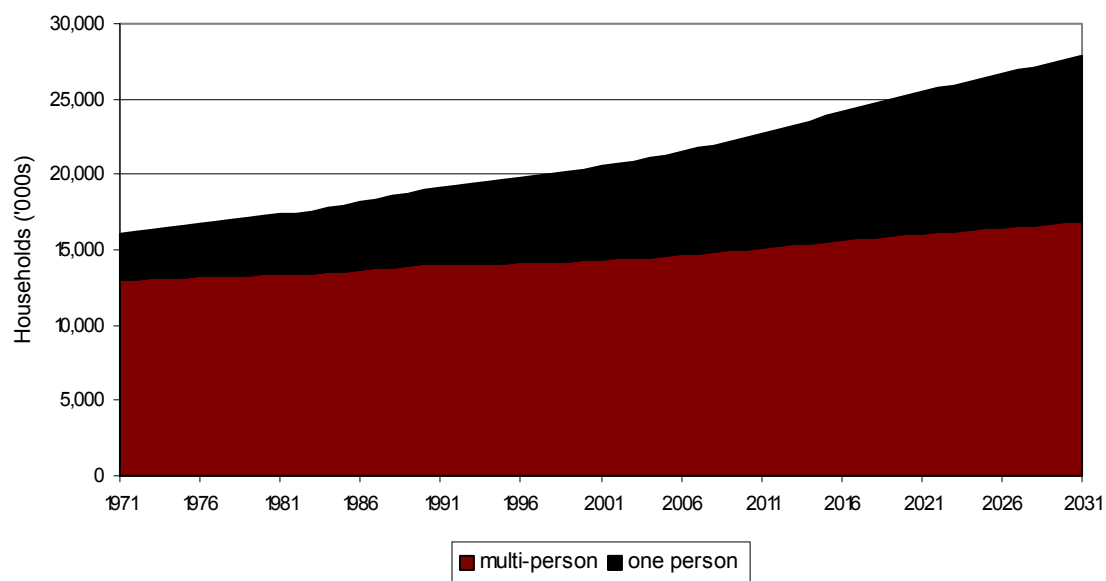


3.14 Various social and demographic changes are also affecting the number and types of household that form and, with that, the demand for the PRS. Household formation is being increased by changing family relationships and circumstances, including increased wealth and longer lives. The number of single person households, in particular, has grown substantially over recent years.

3.15 While individuals may have a preference for owner-occupation, that aspiration can be harder to realise on a single income. So the changing distribution of single-person households and couples can be expected to feed through to changing demand for PRS accommodation.

² See Chart 2.B

Chart 3.D: Growth of one-person households 1971-2031 (England)



Source: Communities and Local Government

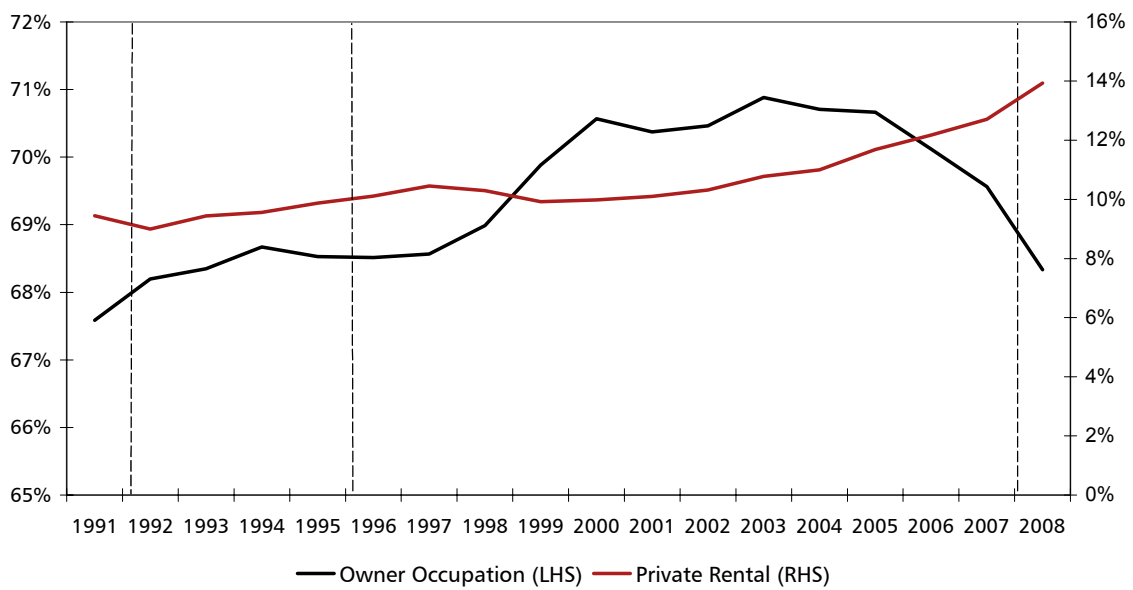
3.16 As the chart for England above, illustrates, this trend is set to continue into the future. Similarly in the UK, while the number of households in the UK is projected to grow to 33 million by 2031 from around 26 million in 2006³ the majority of this growth will be in single-person households, who are expected to increase by around 5 million over this period.

3.17 A large part of this growth in single-person households reflects the impact of a population that is enjoying increased longevity. In England, 42 per cent of the projected increase in single-person households between 2006 and 2031 is in those aged 65 or older, many of whom will have bought a home of their own, and have paid off the mortgage, but have now outlived their spouses. But even so, this still implies a significant increase in single-income households that will not already have purchased a home, and therefore an increased demand for PRS accommodation.

3.18 These socio-economic and socio-demographic changes all impact on the affordability and suitability of different tenure choices, generally to the advantage of renting. Demand for rental accommodation therefore seems set to increase, and the housing market downturn may be expected to produce a short-term boost to this long-term trend. In previous housing market downturns we have seen a reduction in the rate of growth for owner-occupation and a proportionate increase in the PRS. As house prices fall households become increasingly reluctant to buy, believing they will be better off renting until prices bottom out. But these effects were masked to an extent by a strong underlying trend growth in homeownership. While owner-occupation rates still increased, they did so at a slower rate.

³ Communities and Local Government, Scottish Executive, Welsh Assembly Government, Northern Ireland Statistics & Research Agency

Chart 3.E: Comparison of tenure trends over previous and current housing downturns, England



Source: 1988-1991 DOE Labour Force Survey, 1992-2008 ONS Labour Force Survey

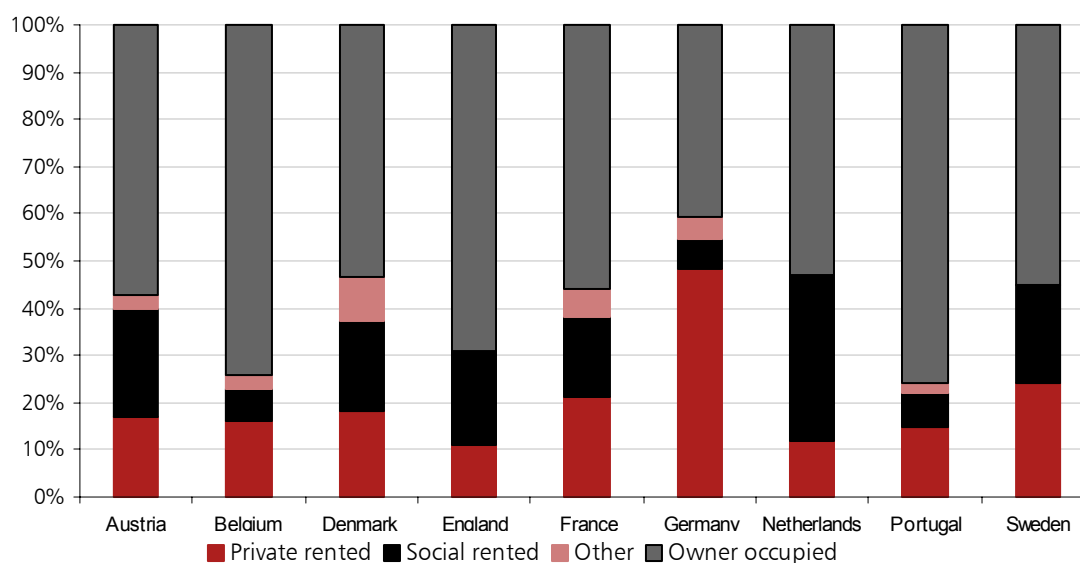
3.19 But the position in this downturn has been quite different. Growth in the proportion of UK homeowners reached a peak by 2004 so there has been no underlying growth to mask the effects in this downturn. In the current housing downturn we would therefore expect to see owner-occupation rates fall slightly, and for renting to continue to rise but at a faster rate than previously. And as this housing downturn has been caused in part by greater credit constraints we may well expect to see an even stronger demand for the PRS than was experienced in the 1990s downturn.

4

International comparisons

4.1 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.¹

Chart 4.A: Tenure distribution for a range of European countries



Source: *International trends in housing tenure and mortgage finance*, Scanlon and Whitehead, 2004

4.2 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.

¹ The data underlying the chart 4A is dated, varying from 1997 to 2002, but it allows for some general comparisons.

4.3 Some European countries have also provided strong incentives for investment into their PRS, and have often geared those incentives particularly towards new-build (build-to-let). In the UK, the majority of investment in the PRS has been in the existing stock.

4.4 For example, since 1984, a number of French schemes have allowed private landlords investing in new build stock to offset a proportion of their investment cost against future income, reducing their tax liability. The most recent scheme in place, “Loi Scellier”, was introduced in January 2009, and in most cases allows for a tax credit of 25 per cent of the amount invested, spread over a period of nine years. In return, landlords offer a commitment to the rental market over this period. Allowances are more generous for new-build units meeting higher energy efficiency standards.²

4.5 Germany has also provided very generous depreciation allowances for newly constructed rental properties. In the early 1980s depreciation allowances were 5 per cent for the first eight years after construction, followed by 2.5 per cent for the following six years, then 1.25 per cent for the remaining 36 years. It should be noted, however, that some measures aiming to support PRS provision in this way have recently been challenged as incompatible with EU law.³

4.6 So while the post-war decline of the PRS in the UK was replicated to some extent in many other countries, in most cases this decline was halted or reversed much sooner and so with a higher level of stock remaining in the sector. And while other countries have over recent decades generally seen some new-build housing provision specifically designed for the PRS, in the UK there has been virtually none apart from specialised student accommodation, and a short-lived surge in general provision between 1989-1993 encouraged by the Business Enterprise Scheme.

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.⁴

4.8 However, there have been important niche roles for larger landlords, who have tended to specialise, catering for students, the retired, or employer provided accommodation. And in many cases these portfolios have been acquired through acquisitions of existing stock, rather than investment in new-build. The largest PRS landlord in the UK, Grainger with 14,000 properties, acquired most of its portfolio through purchases of properties already rented out to elderly tenants on secure regulated tenancies.

4.9 The UK is not an outlier in terms of this dominant role for individual, private landlords. The picture is the same in the majority of high-income countries, although variations result from historical, policy and institutional features of rental markets in individual countries. In France, for example, a higher proportion of the rental stock is owned by individuals and couples than in the UK. In Germany individuals and couples landlords still account for over two thirds of the PRS stock.⁵ And while Germany has some examples of very large residential investment companies (e.g. Deutsch Annington owns over 200,000 properties), these holdings are predominantly the result of privatisations of previously state-owned or employer-provided accommodation.

² Defined in terms of thresholds of primary energy consumption and insulation standards.

³ European Court of Justice, Case C-244/09, OJ C233/4, 26 September 2009

⁴ English House Condition Survey 2006, *Communities and Local Government*

⁵ The Framework of the private rental housing sector in Germany, *ENHR Working Group, S Kofner, 2009*

4.10 The condition of the UK housing stock as a whole compares favourably at an international level. The PRS suffered from a protracted period of underinvestment during the period to 1988. By the 1990s the stock remaining in the PRS was generally older, and in poorer condition than in other tenures. Change to existing stock is normally slow across all tenures. But in recent years there has been a significant improvement in the condition of the PRS, with quality tending to catch up with that in other tenures in the UK.

5

Individual investment

5.1 Individual investors have been crucial to the development of the PRS to date. As detailed in Chapter 2, they have usually been keen to respond to demand for PRS accommodation and have only seemed to withdraw from this market in the past when regulatory barriers made managing these investments difficult or were perceived as increasing the financial risk.

5.2 The impact of pre-1988 rent controls was that little new PRS stock entered the market, with longer-run rates of return being depressed. What stock remained tended to be older than in other tenures, and of lower quality, as the use value of higher quality stock was considerably higher in the owner-occupied sector, resulting in tenure switch. Those who remained often lacked funds (or incentives) for the adequate repair and improvement of properties. Many consider rent control to have been a major contributory factor to the subsequent decay of much of the inner city housing stock.¹

5.3 However, since 1988 Governments have taken a less restrictive approach to PRS regulation. The removal of rent control and introduction of Assured Shorthold Tenancies halted, and began to turn around the previous decline in private rental provision.

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.

Improving standards in the PRS

5.5 Buy-to-let has been a major driver in the increasing role of smaller landlords in the PRS.² It should be noted that there is no significant difference in tenant satisfaction levels by size of landlord, or by whether the landlord is a full-time professional or part-time. Reported tenant satisfaction levels for smaller individual landlords are in fact marginally higher than for those managed by companies, partnerships or other organisations.

5.6 Tenant satisfaction also reflects improvements in the overall condition of the PRS stock. As explained in Chapter 3, over time this new investment through buy-to-let has begun to have a significant and positive impact on the average age and quality of the PRS stock. In the UK, PRS supply had traditionally tended to be from conversions of existing, previously owner-occupied housing, and to occur with properties towards the bottom of the market. The stock of PRS housing had consequently tended to be older than in other tenures, and of poorer quality overall. However, the combination of a lighter touch regulatory framework and improved access to finance in the form of buy-to-let mortgages halted and eventually reversed this trend.

¹ Choice and the End of Social Housing, *Peter King*, 2006

² The Private Rented Sector: its contribution and potential, *Julie Rugg and David Rhodes*, University of York, 2008

Increasing supply

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.

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.³ 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.

5.9 Given Government objectives to increase the responsiveness of housing supply, there is an interest in what has driven PRS investment into build-to-let and the extent to which industry has responded to this.

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

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

5.10 The pattern of rental prices over recent years suggests that the supply of PRS tenancies has also been very responsive to growing demand. The general trend over recent years in the UK, has been for rental prices not to rise (or fall) as quickly as sale prices. While the relationship between demand for sale and rental properties is not clear-cut, the price stability suggests that demand and supply in the PRS have matched fairly well.

Utilising the existing stock

5.11 It is believed that many owner-occupiers also support the PRS by renting out a room in their property. This not only provides an additional income to the owner which could help towards mortgage costs or other expenditure, but also improves the utilisation of the housing stock, reducing demand pressures elsewhere in the housing system.

5.12 The importance of this contribution was recognised by Government when it introduced the rent-a-room allowance specifically to encourage individuals to offer spare accommodation at affordable rents. However, there is no published data that allows the number of private landlords with lodgers to be estimated with any degree of accuracy, and Government cannot be precise about the numbers benefiting from the rent-a-room scheme, as provided the income does not exceed the threshold for the relief there is no need to declare it.

³ Buy-to-Let mortgage lending and the impact on UK house prices, *National Housing and Planning Advice Unit*, 2008

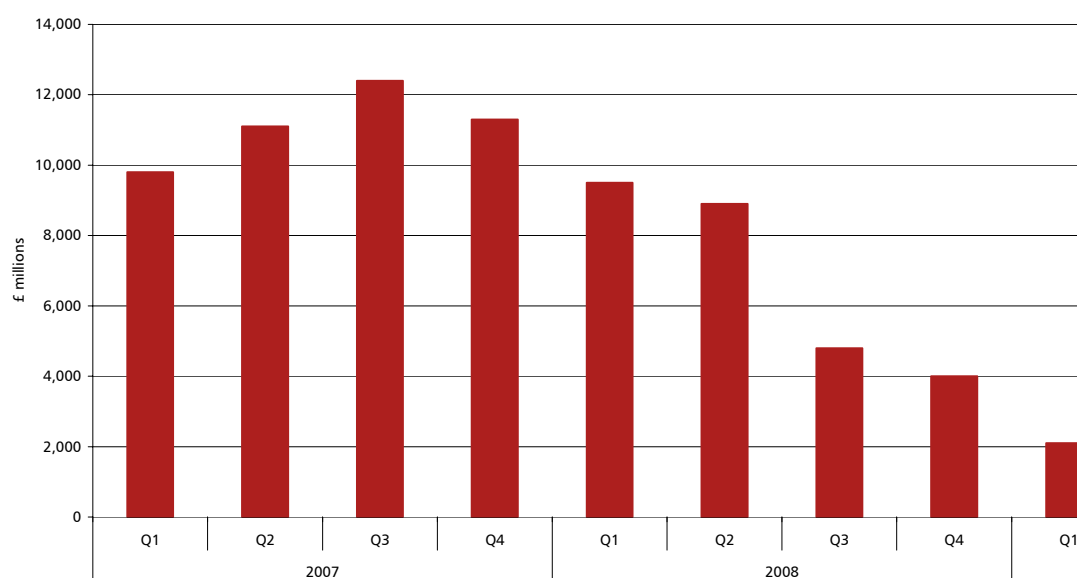
Question 3: What is the contribution of individual homeowners renting out part of their own home making to housing supply? Are there significant constraints limiting this contribution to addressing housing demand?

Financial crisis and housing market downturn

5.13 Of course, the pattern of growing individual investment and PRS supply described above was delivered during a period of sustained economic growth, lower interest rates, readily available finance and rising house prices.

5.14 The recent disruption of the financial markets affected the buy-to-let market, as it affected wider mortgage markets. Many specialist buy-to-let mortgage lenders have withdrawn their products, and others have exited the market completely. Lending has concentrated in the major banks and their subsidiaries, as specialist lenders have virtually stopped lending and building societies have been constrained by increased requirements for liquidity and capital. Consequently, the number of buy-to-let mortgage products has fallen from a high of 3,662 in September 2007 to 185 in September 2009.⁴ Credit conditions for buy-to-let mortgages have tightened, with most lenders reducing the amount they are willing to lend relative to the value of the property and increasing the minimum rental income requirements.

Chart 5.A: Quarterly gross buy-to-let mortgage lending 2007-2009



Source: Council of Mortgage Lenders (CML)

5.15 The demand for buy-to-let mortgages has also decreased during the downturn. A landlord's total return on a property comprises both a rental yield and capital appreciation. While rental yields on new purchases should have risen as house prices have generally fallen faster than rents, prospects for capital appreciation have worsened as conditions have deteriorated in the wider housing market. This, coupled with stricter mortgage lending criteria, has led to reluctance on the part of less-equity rich landlords to invest in new rental properties.

⁴ Moneyfacts Treasury Report, Moneyfacts, September 2009.

5.16 As a result, lending in the buy-to-let market has fallen, and in 2008 the level of gross advances was almost half that of the 2007 peak in lending.

5.17 Evidence suggests, however, that the vast majority of existing landlords view their investments as long-term, with more than 7 in 10 expecting to hold their investment for more than 10 years, and an average overall life expectancy for PRS investments of nearly 17 years.⁵

Government response

5.18 The constraints individual investors face in the short- to medium-term seem to primarily revolve around the availability of finance for buy-to-let mortgages. The Government has been addressing this through action to ensure competitively priced credit continues to be available. On 19 January 2009, the Government announced a package of measures designed to reinforce the stability of the financial system, to increase confidence and capacity to lend, and in turn to support the recovery of the economy. These measures built on those announced in October 2008.

5.19 The Government agreed lending commitments with RBS and Lloyds Banking Group that will see them lend an additional £39 billion (£27 billion to business), on commercial terms and subject to market demand, over the 12 months from March 2009. And similar lending commitments were made in respect of the following 12 months to March 2010.

5.20 Other banks have also signalled increases in lending. And the Government will continue to take all necessary measures to ensure the stability of the financial system, support lending to the economy, businesses and homeowners, and support our recovery from the recession. The Government is currently consulting on proposals for Financial Services Authority regulation of buy-to-let mortgages.⁶

5.21 The expectation is therefore that the supply of mortgage finance for Buy-to-Let should recover in time. But this does not necessarily mean that individuals will have the same appetite for PRS investment as in the past. Previous growth will also have been influenced by the capital returns such investment could generate.

5.22 An issue going forward is whether the recession and the change in lending attitudes may have fundamentally changed the incentives for individuals to invest in the PRS, or to rent out all or a part of an existing property. However, lower house prices potentially increase the revenue yields from renting.

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?

⁵ Review and Index for Residential Investment Q3 2009, *Association of Residential Letting Agents*, 2009

⁶ Mortgage regulation: a consultation, *HM Treasury*, December 2009

6

Institutional investment

6.1 In the UK while banks and building societies have been active in lending to private landlords (mostly individuals), institutional investment, e.g. by pension and insurance funds, has been virtually absent from the PRS.

6.2 Various explanations have been given as to why this has been the case, revolving around reputational and financial risks, the lack of suitable portfolios to invest in, high management costs compared to commercial real estate, and yields. And all of these factors may have influenced institutional investors' decision making to a greater or lesser extent.

Reputational and Financial risk

6.3 For institutions the PRS is a new and relatively untested asset class. Although some will have experience of investments in student and other serviced accommodation, residential investment carries reputational risk.

6.4 In addition, much of the return to current investment in the PRS comes from capital appreciation, as opposed to rental yield. As mentioned in Chapter 5, house prices are more volatile than rents, increasing the financial risk of investments in the PRS.

Management costs

6.5 The costs of managing a large number of rental units dispersed among the existing stock are likely to be prohibitive for larger scale investors – and this is a niche that is dominated by individual landlords, who are often willing to devote much of their time to property management.

6.6 The scale economies in management activity required to make institutional investment commercially viable are most likely to exist where a large number of units may be managed on one site, reducing overheads. Due to fragmented ownership in existing large residential developments, this is likely to arise only in new 'build-to-let' developments, where a site is built out for the specific purpose of providing private rental accommodation. Less frequently, there may also be scope to convert an existing building from non-residential use.

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?

Portfolio assembly and transaction costs

6.7 The current landscape of investment in the PRS is of many small investors with fragmented portfolios of individual properties. For larger institutional investors the average lot size of their property acquisitions is over £10 million, and there are currently few residential investment opportunities that could meet that criterion. Small lot sizes and high transaction costs can make assembling stock for a portfolio difficult and costly.

6.8 In this context representatives of the property industry, banks, tax advisers and academics have highlighted the Stamp Duty Land Tax (SDLT) treatment of bulk purchase of property as a key impediment to investment in the PRS.

6.9 The Government has received representations that the rate of SDLT on bulk purchases of residential property should be determined by the individual value of the properties purchased, rather than on the total amount paid for the whole transaction (as the SDLT regulations currently operate). This means that the SDLT due would be the same as if each property had been purchased separately. In most cases this will result in a lower SDLT bill (it will never result in a higher bill). It has been argued that this change would level the playing field for different types of purchasers to invest in residential property and that, in increasing returns, it would make residential property a more attractive proposition for 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?

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?

Return on investment in residential property

6.10 It is often argued that the principal issue holding back institutions is that, compared with commercial property, the level of distributable income returns from residential property is not high enough relative to the investment. Unlike commercial property, where asset prices are a function of the rental yield of an investment, owner-occupiers drive the market for residential property, meaning that rental yields in the PRS do not reflect the underlying price of the asset.

6.11 The Investment Property Databank (IPD), a benchmark for measuring the investment performance of residential let properties in the UK, has consistently recorded net income returns of 3.3 to 3.6 per cent. This is below the level of commercial net returns and below the minimum level that investors have indicated they would expect to receive for an investment to be an attractive proposition (around 6-7 per cent).

6.12 Stakeholders have also indicated that higher management costs, relating to maintenance costs and void periods, make residential investment less attractive than commercial property. The exception to this is student and serviced accommodation, where the availability of high-density blocks that offer economies of scale with a reduced risk of voids appears to have been able to generate income yields sufficient to attract institutional investors.

6.13 However, partly as a result of the recent downturn, net returns on residential property are becoming comparable to those on commercial property. Perhaps related to this, there have been signs of growing institutional interest in investing in PRS accommodation.

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

New institutional investment

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.

6.15 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.

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?

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?

Collective Investment in Residential Property

6.16 Looking to the future, institutions have previously cited the lack of a tax transparent investment vehicle as being extremely important in unlocking new residential investment. In 2004 the Government began an extensive consultation with the property industry on the design of a new tax regime for property investment companies.

6.17 This consultation culminated in the launch of the UK Real Estate Investment Trust (UK-REITs) regime in January 2007 as a tax efficient vehicle for large-scale indirect property investment. The UK REITs regime removes a distortion in the tax system, which meant that direct investment in property was taxed at a lower rate than indirect investment, for some investors.

6.18 Since their launch more than three-quarters of the UK's major listed property companies have joined the UK-REIT regime.

6.19 It has been suggested that the UK-REIT structure is the most suitable listed vehicle for investment in residential property, however, to date only two UK-REITs contain residential property in their portfolio and there are no REITs that invest solely in residential property.

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

Question 12: What evidence is there of the likely effects of such changes on new, and existing, UK-REITs investing in residential property? And what impact would such changes have on existing UK-REITs investing in commercial property?

6.20 Institutional investment in the private rental sector can take many forms. Beyond the UK-REITs regime, there are a number of other collective investment vehicles suited to property investment, e.g. property unit trusts. Such vehicles could help to overcome institutional reluctance to invest in the PRS, and have the potential to grow into a residential UK-REIT.

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

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

Benefits to the PRS

6.21 It has been suggested that institutional investment will be beneficial, not only in helping to meet growing housing demand, and increase new-build housing supply, but also in encouraging the development of a more 'professional' PRS.

6.22 However, the position is not clear-cut. New institutional investment might simply substitute for supply that would otherwise have been delivered through individuals. Additional investment, particularly if geographically concentrated, and/or directed into the existing stock, could be expected to have some impact on house prices. In addition, the previous chapter explained that surveys of tenant satisfaction rates do not appear to support the argument that larger, more professional, landlords will necessarily provide a better service to tenants than individual landlords. The Government is therefore interested in any evidence of the net benefits institutional investment might bring to the housing market.

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

7

Responding to the consultation

Issues for consideration

7.1 This document has set out the importance of the PRS to individuals, the housing market and the wider economy, and has described the factors that have led it to develop in the way that it has. Looking forward, demand for PRS accommodation seems likely to increase - the key issue is going to be how effective the sector will be at increasing supply to respond to such demand, or whether Government will need to intervene. The Government would be interested in evidence and views on the issues set out in this consultation.

Individual investment

7.2 Chapter 5 sets out the Government's analysis of the issues facing individual investment in the PRS. The questions the Government raises in connection with this aspect of the PRS investment market are set out below.

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

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

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?

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?

Institutional investment

7.3 Chapter 6 presents the Government's understanding of the issues facing potential institutional investors in the PRS. The questions the Government raises in connection with this aspect of the PRS investment market are set out below.

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?

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?

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?

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

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?

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?

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

Question 12: What evidence is there of the likely effects of such changes on new, and existing, UK-REITs investing in residential property? And what impact would such changes have on existing UK-REITs investing in commercial property?

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

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

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?

Other comments

7.4 In addition to the specific questions set out above, the Government would welcome any other comments relating to investment in the UK PRS.

Responding to the consultation

7.5 This consultation began with the publication of this document and will last for a period of 12 weeks, closing on 28 April 2010. This formal consultation represents part of a wider process of discussion and engagement with stakeholders. In particular HM Treasury will be meeting with existing and potential investors in PRS accommodation and representative bodies.

7.6 Comments on the specific questions raised in the consultation are welcome. And in addition the Government would welcome any other comments relating to investment in the PRS. Where possible stakeholders are encouraged to provide evidence to support specific points. Stakeholders do not need to respond to all of the questions in the consultation and should feel free to limit their response to those questions that are of particular relevance to them.

7.7 Responses should be sent by email if possible to:

PRSinvestmentconsultation@hmtreasury.gsi.gov.uk

Or by post to:

PRS investment consultation

c/o Keith Jackson

Housing, Regeneration and Third Sector team

HM Treasury

1 Horse Guards Road

London SW1A 2HQ

7.8 Please note our preference is to receive responses in electronic format (all email responses will be acknowledged).

7.9 This document can be found on the website of HM Treasury (www.hm-treasury.gov.uk). When responding, please state whether you are responding as an individual or as part of an organisation. If responding on behalf of a larger organisation please make it clear who the organisation represents and, where applicable, how the members' views were assembled.

Consultation disclosure

7.10 All written responses may be made public on the Treasury's website unless the author specifically requests otherwise in writing.

7.11 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regime. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act (DPA) and the Environmental Information Regulations 2004.

7.12 If you would like the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as being confidential. If we receive a request for disclosure of information we will take full account of your explanation, but we cannot give an assurance that confidentiality will be maintained in all circumstances.

7.13 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response.

7.14 Subject to the previous two paragraphs, if you wish part (but not all) of your response to be remain confidential, please supply two versions – one for publication on the website with the confidential information deleted, and another confidential version for use by the Treasury.

7.15 Any FOIA queries should be sent by email to:

public.enquiries@hmtreasury.gov.uk

Or by post to:

Correspondence and Enquiry Unit

Freedom of Information Section

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Code of practice for written consultation

7.16 This consultation is being conducted in line with the Code of Practice for written consultation, which sets down the following criteria:

- formal consultation should take place at a stage when there is scope to influence the policy outcome;

- consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible;
- consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals;
- consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach;
- keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained;
- consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation; and
- officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.¹

7.17 If you feel that this consultation does not fulfil these criteria, please contact:

james.paton@hmtreasury.gsi.gov.uk

Or by post:

James Paton

Housing Regeneration and Third sector team

HM Treasury

1 Horse Guards Road

London SW1A 2HQ

Next steps

7.18 As stated above, this consultation began with the publication of this document and will last for a period of 12 weeks, closing on 28 April 2010. After the consultation period has closed, the Government will consider the responses to the consultation.

7.19 In line with the Code of Practice for written consultation the Government will publish a summary of responses to the consultation.

¹ A full version of the Code of Practice is published by the Department for Business, Innovation and Skills (BIS), and is available at: <http://www.berr.gov.uk/whatwedo/bre/index.html>.

HM Treasury contacts

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

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