CONSULTATION RESPONSE

Investment in the UK Private Rented Sector 16th April

HM Treasury Consultation: Investment in the UK Private Rented Sector

Response by the Home Builders Federation (HBF)

1. The Home Builders Federation (HBF) is the principle trade association representing the interests of private home builders in England and Wales. Our membership, which includes companies ranging from major national firms, through regional companies to smaller local companies, is responsible for more than 80% of the new homes built every year.

2. The bulk of this submission outlines our views about the private rented sector within the overall context of housing supply. In the final section we address the consultation questions applicable to the home building industry.

EXECUTIVE SUMMARY

3. There are good grounds for believing there will be strong demand for private rented housing in the future. Demographic trends point to rising numbers in the key 25-34 first-time buyer age group, but a range of financial constraints will limit the ability of many younger households to become home owners.

4. However long-term housing undersupply, created primarily by planning restrictions on the supply of permissioned land, leads to higher house prices in relation to incomes. This in turn creates persistent affordability problems for home buyers, drives up residential land prices, and makes it difficult to achieve satisfactory rental yields for private rented housing, especially for institutional investors which rely primarily on rental income rather than capital growth.

5. It is very difficult for home builders to (a) generate sufficient land value to buy land competitively, and (b) earn an adequate development margin, and (c) sell new dwellings to institutional investors at a price sufficient to generate an adequate institutional rental yield, even after allowing for bulk discounts.

6. **The only long-term solution to Britain's persistent housing affordability crisis, and to inadequate rental yields, is therefore substantially to increase the supply of housing for a prolonged period in order to lower house prices in relation to incomes.**

7. Any special fiscal or other measures to stimulate private rented housing supply should focus on tackling undesirable transactions costs and other disincentives within the sector itself, while maintaining a level playing field between private rented and owner-occupied housing development. Such measures certainly should not favour one particular type of housing provider within one tenure. The Government's overall housing objective should be to increase the total supply of housing, not simply change the tenure of dwellings.

8. Therefore we do not support establishing a special private rental planning use class. We do not support relaxation of regulatory burdens, such as S106 demands, for developments of one tenure – the excessive cumulative regulatory burden needs to be reduced for <u>all</u> housing development. And if public land value subsidy is to be used to support private housing development, this should be equally available for owner-occupied or private rented housing development.

9. We support the following measures to help stimulate new investment in private rented housing:

   - Amend the current bulk purchase SDLT rule which unfairly disadvantages larger bulk-purchase investors compared with small-scale investors and adds significantly to the acquisition cost of rental units;

   - Amend the treatment of VAT on rental housing repairs to help reduce the large net/gross yield gap in the private rented sector;

   - Create special residential REIT rules covering the treatment of trading income, leverage and income distribution.

   - Buy-to-let borrowers should not be specially regulated - it should not be the regulator's role to protect people from what are essentially business decisions; lenders should be protected from unwise lending decisions by better risk assessment and risk pricing.

10. The Government should avoid focussing excessively on trying to stimulate institutional investment, a goal of governments since at least the early 1980s. It should instead seek to stimulate all sources of residential investment – small-scale individual investors, medium-sized corporate and professional individual investors, and large-scale corporate or institutional investors. This would maximise the flow of capital into housing and the increase in housing supply.

DEMAND FOR PRIVATE RENTED HOUSING

11. Although survey evidence suggests the aspiration for home ownership is undiminished, at a rate well above the current rate of owner occupation, there are good grounds for believing that financial barriers to home ownership will lead to strong demand for private rented housing in the future:

    a. The recent improvement in housing affordability is heavily reliant on ultra-low interest rates, so that affordability will quickly deteriorate as rates rise. And the deposit gap created by the absence of higher LTV mortgages, which excludes many potential first-time buyers, is unlikely to close for some time.

    b. Mortgage funding seems likely to constrain overall mortgage availability for some time. This, plus tighter mortgage regulation, means many households will find access to home ownership delayed, and some may never be able to buy a home.

    c. High levels of student debt, and the disproportionate impact of the recession on young people, seem likely to delay the age at which many young people will be able to become home owners.

12. Yet despite these constraints on access to home ownership, demographic projections show we are in a period of very strong growth in the core first-time buyer age group. According to the 2008-based population projections, the number of people aged 25-34 will grow 17% between 2008 and 2016. If a large proportion of these adults are not able to gain access to home ownership for the reasons outlined above, most will either have to stay at home with their parents and not form independent households – recent ONS data reveal nearly a third of men aged 20-34, and nearly a fifth of women in this age group, live with their parents – or they will have to find housing in the private rented sector if they want to form independent households.

THE CONSEQUENCES OF HOUSING UNDERSUPPLY

13. The Barker Review (2004) confirmed that Britain (England in particular) has a serious long-term problem of housing undersupply. Supply has been running below need/demand for several decades, a situation which has worsened significantly as a result of the recession. In addition, housing supply is very unresponsive to increases in demand/need.

14. The primary reason for housing undersupply is that the planning system – particularly the plan-led system introduced in 1991 – severely restricts the supply of permissioned residential land. Since the Barker Review, this problem has been compounded by the escalating cost burden of policy and regulation which renders many sites unviable for housing development, a situation made even worse by the fall in land values since 2007.

15. As a result of supply constraints, the price of housing is substantially higher than it would be with an adequate supply. And because household incomes are determined largely independently of house prices, this means house prices are high in relation to incomes.

16. Among the many adverse consequences of housing undersupply and high house prices, three are especially relevant for the current consultation:

    - Persistent affordability problems in the owner-occupied sector - many households on lower and even middle incomes cannot afford to buy suitable housing (good quality, of the right size, in the right location);

    - High residential land prices, which are a function of dwelling sale prices;

    - Low rental yields on new housing because of the high capital cost of housing in relation to tenant incomes.

17. **The only long-term solution to Britain's persistent housing affordability crisis, and to inadequate rental yields, is substantially to increase the supply of housing for a prolonged period in order to lower house prices in relation to incomes.**

18. The Government's primary housing supply objective should be to increase total housing supply, regardless of tenure. If total supply was adequate, the relative supplies of housing in the owner-occupied and private rented sectors would resolve themselves in line with consumer preferences, as expressed through the housing market.

19. In conditions of persistent undersupply, any attempt to promote one private tenure risks compounding existing distortions and, at best, simply increasing supply in that tenure at the expense of the other private tenure, with no overall increase in housing supply and no impact on affordability.[1]

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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.

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.

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

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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.

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: 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.

[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.

34. Amending the rules seems unlikely to result in any significant loss of revenue for HM Treasury, compared with current SDLT revenues, 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 them from themselves. Yet this is, in effect, what is being proposed for the investor market.

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[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.

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.

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