



**HM Treasury consultation paper on**

# **Investment in the UK Private Rented Sector**

**The combined response of the:**

**Property Industry Alliance (PIA)\***

**Council of Mortgage Lenders (CML)**

**Association of Real Estate Funds (AREF)**

**28<sup>th</sup> April 2010**

\*The Property Industry Alliance comprises:

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

# EXECUTIVE SUMMARY

## THE CURRENT INVESTOR AND HOUSE BUILDER SITUATIONS

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

- a. **Need for housing** – There is increasing need for housing of all tenures as a result of population growth and new household formation, but new supply is falling well short of requirements.
- b. **Private investors** – Buy-to-let (BtL) investors have been responsible for substantial growth in PRS housing since 2000, but access to debt is likely to constrain growth in BtL for the foreseeable future. If need is to be met new sources of equity finance need to be found.
- c. **Institutional investors** – Of the few funds that began investing from 1999 onwards, many are now approaching the end of their investment lives. Despite interest, few have converted to more tax efficient vehicles; instead many of these funds are selling their assets into the owner occupier market. New funds are slowly being created in response to the HCA's PRSI, but material and psychological barriers exist and are the subject of this Consultation Paper.
- d. **House builders** – revisions in planning policy in 1998 drove a move towards higher density development on brownfield land. The next decade saw house builders become highly dependent on off-plan sales of high density apartment schemes to investors. There are currently few off-plan sales being made and house builders will need to find sustainable business models that can attract off-plan investors as a means of reducing their risks; some are already returning to building medium density housing and others are investigating building blocks of flats for rent that may attract long term institutional investors.

## THE OBSTACLES TO GREATER INSTITUTIONAL INVESTMENT

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

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

Table 1

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

- a. **Scale** – The residential sector may be the largest asset class in the UK, but for most institutional investors it remains effectively a new asset class; investors will only be

attracted to a new asset class if they can make a material investment in the sector, and that it offers an attractive balance of risk and returns relative to other asset classes. Institutional investors need any new asset class to be scalable, as this will allow them to make sizeable investments, whilst scale is also critical to asset management efficiencies.

- b. **Investment costs** – Institutions investing in housing have a number of higher costs than others investing in the sector, such as owner occupiers and individual investors; this reduces the investment attraction of a new asset class, reduces investment returns and has led to limited investment by only a small number of major institutions in the PRS and new housing.
- c. **Tax efficient vehicles** – Residential investments are highly management intensive and therefore collective investment funds are generally the preferred institutional route to investment in the sector. Investors need tax efficient investment options that offer comparable tax transparency to commercial property vehicles in order to attract the widest range of long term investors. Existing unlisted fund structures would be suitable (subject to the 'solutions' section below). REITs are of considerable benefit to commercial property companies but have had no success in the residential sector, for the reasons discussed in the attached paper.

## THE SOLUTIONS THAT WILL ATTRACT GREATER INSTITUTIONAL INVESTMENT

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

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

- a. **Scale issues** – At present it is difficult for institutional investors to invest in the sector on a significant scale as many existing units are in fragmented ownership and there is a lack of new build properties to buy off-plan from house builders. Increasing the supply of new housing should provide scale, asset management efficiencies and geographic concentrations within PRS markets. The UK house building sector remains a casualty of the "credit crunch" and this has led to a material reduction in supply and a failure to meet demand for housing in some regional markets. Political parties have expressed an interest in making much better use of Government land holdings and the HCA's recent market-facing initiatives have offered encouragement to institutional investment that this type of land release can make a real difference to achieving scale.
- b. **Tax efficient investing**
  - Level the playing field with private investors – The higher costs of SDLT paid by institutional investors on scale purchases needs to be reduced to the current SDLT rate payable on each individual property purchased and VAT can be a higher cost for institutions.
  - Investment vehicles – The encouragement of tax efficient investment vehicles (e.g. REITs, private funds and PAIFs) will attract many liquidity driven institutional investors to invest in the sector; these vehicles may also allow current portfolios (owned by institutions) to remain in the sector. Some existing non-listed tax efficient investment vehicles will also attract new domestic and international investors, many of whom already have experience of similar residential sectors, if a level tax playing field exists between private and institutional investors.
- c. **Tax changes generally** – A number of our recommendations are likely to carry at least a risk of net cost to the Exchequer, because reliefs from or reductions in taxes which currently hinder greater investment in residential are not certain to deliver sufficient indirect or longer term tax revenues to pay for themselves. However, it is important to keep the wider context in view: both as regards the importance of the policy objective for more and better housing delivery in the UK, and as regards the –

probably significantly higher – cost of alternative ways of seeking to achieve that policy objective.

## THE FULL BENEFITS TO THE GOVERNMENT

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

- a. **Current housing needs** – There is a growing housing crisis, as house builders and mortgage lenders struggle to meet current demand; encouraging institutional investment now will assist the house builders to open new sites, allow Government to make better use of its' land holdings and help reduce the funding needs of mortgage lenders. The PRS is a low cost means of delivering flexible tenure to meet the needs of those unable/unwilling to become owners, but the sector needs encouragement.
- b. **Future housing need** – There will be considerable future demand. The HBF figures show growth in house building would need to average 18% per year for the new build targets by 2020 to be met. Many of future first time buyers already have to wait until they are in their late thirties to own their first property, given the much higher deposit now required by mortgage lenders; this will bring additional demand, which is likely to will lead to an unhealthy and unsustainable supply / demand imbalance for PRS properties and for intermediate renters.
- c. **Investing for all** – Long term investors are critical to the sustained growth of the PRS, whether they be individuals, or the many individual savers that contribute to life insurance products and pension funds. It is critical that investment managers can offer their savers attractive returns and tax efficient means of investing in the PRS sector, whilst helping to reduce the need for individuals to make illiquid investments in markets they may not be fully conversant with and where high levels of leverage are often utilised.
- d. **Costs** –
  - A change in the SDLT regime is low cost, as little or no investment in the sector is currently being made.
  - A reduction in VAT would add value to the sector and lead to higher quality properties. The current problems with VAT recovery in the residential sector (both on development and on operating costs) present a disincentive to invest in residential property. Such a reduction could even result in increased revenue for HM Treasury through the greater use of contractors within the VAT regime.
  - Creating a level tax playing field for institutional investing vehicles has a very marginal cost, as currently no new residential vehicle has been created.
  - A change to the listed vehicle regime will attract a new investor base, SDRT from the trading in these vehicles could off-set the VAT costs.
- e. **Quality assurance and service innovations** – institutional investors will help raise standards by offering tenants greater access to redress and a more co-ordinated approach to property maintenance and management.

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# INDUSTRY EXPERTISE THAT HAS CONTRIBUTED TO THIS RESPONSE

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

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# BACKGROUND

## THE IMPORTANCE OF THE PRIVATE RENTED SECTOR

### To housing need

a.1 The private rented sector has delivered nearly all household growth over the past decade. Whilst owner-occupation has been relatively stagnant and the social rented sector has shrunk over the period, the private rented sector has grown to accommodate an additional 1.1 million households. Housing 14.2 per cent of all households, the sector is now the largest it has been since the 1970s.<sup>1</sup>

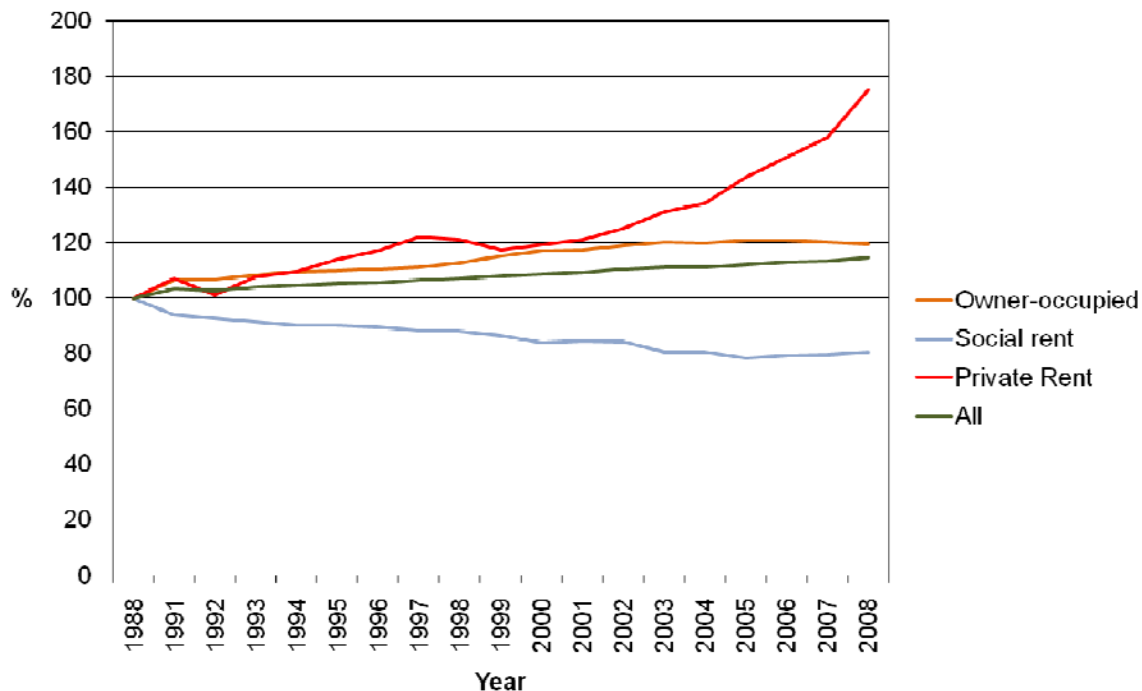
Although it lags the total social rented sector in size (housing association and council housing combined), it is an important part of the housing market for several categories of occupier:

- more couples are now in the PRS than social renting;
- virtually the same amount of couples with children are in the PRS as in social renting;
- as many lone parents with children in the sector as either housing associations or council accommodation;
- as well as the sector's more traditional customer base of singletons and multi-person households (students, etc.).

**Two-thirds of all new households created find their first home in the private rented sector**

a.2 The PRS is supplying the majority of household need – two-thirds of all new households created in 2008/09 found their first home in the private rented sector.<sup>2</sup>

**Chart 1 - Growth in Household Tenure**



Source: English Housing Survey

<sup>1</sup> English Housing Survey, Headline Report 2008/2009

<sup>2</sup> Ibid, p21.

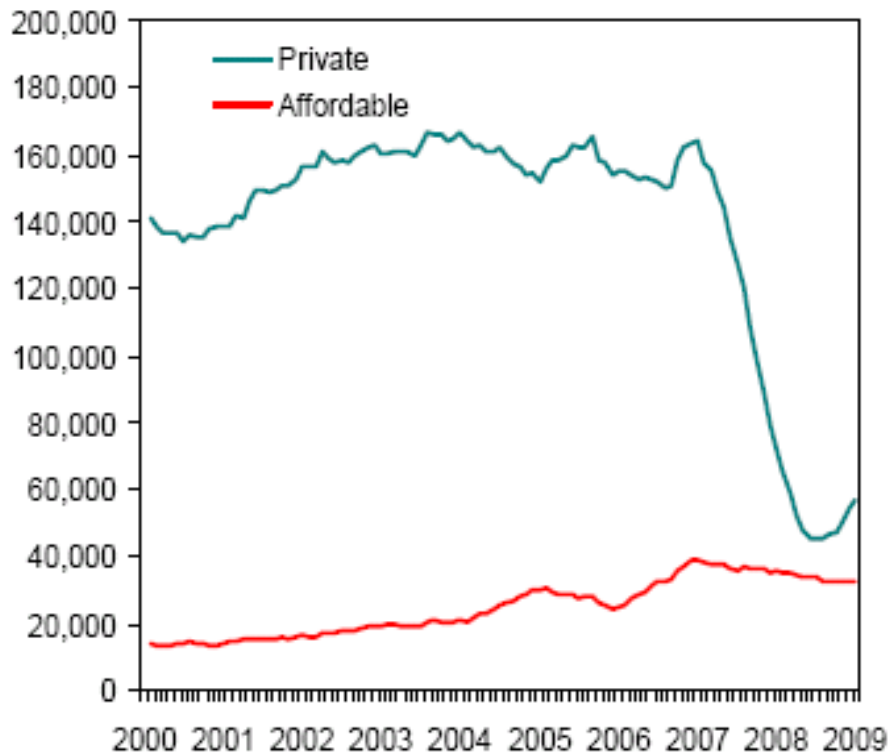
## To development

- a.3 The private rented sector has made a disproportionate contribution towards development. As the consultation paper recognises, the PRS accounts for one-fifth of new build, and in turn that equates to 35,000 units per annum and between 42,000 and 52,000 construction jobs. The ability and willingness of investors to forward purchase new units became a vital part of funding of new development, particularly higher density and brownfield schemes.<sup>3</sup>

**For every £1bn invested in building new rented property 7,500 new construction jobs would be created**

- a.4 Through support for development private investors have also made a significant contribution towards the provision of affordable housing, at the peak of the boom contributing towards the provision of 6,000 homes per annum via the s106 process.

**Chart 2 – Rolling 12 month Housing Starts**



Source: Hometrack using NHBC data

## To labour market flexibility

- a.5 A higher proportion of households in the PRS are in employment than in any other sector. Part of this is explained by the relatively higher proportions of households in social renting and owner occupation that are retired. For every three people that are in full time employment in the social rented sector one is unemployed. The corresponding ratio in the private rented sector is fewer than one in twelve.<sup>4</sup>

<sup>3</sup> Home Builders Federation Manifesto 2010 estimates direct job creation per home at 1.2 to 1.5

<sup>4</sup> English Housing Survey, Headline Report 2008/2009

- a.6 The PRS, although only accounting for 14.2% of all households, accounts for about 50 per cent of all household moves each year, oiling the wheels of the housing market and providing much needed labour market mobility.<sup>5</sup>
- a.7 The economic downturn has illustrated just how important the PRS is, providing a place to live for those who have either voluntarily, or via repossession, vacated their homes because of mortgage arrears. For those unable to find employment, the PRS has also been hugely important in allowing them to move around to find work. It is easily forgotten that prior to the 1988 Housing Act, it was very difficult to find private rental accommodation and queues outside lettings agents were not uncommon.

### **To affordability**

- a.8 The average first-time home buyer is now 37 years old. In part, this reflects social trends, but also increasing difficulty in accessing mortgage finance. As one recent survey illustrated, 59 per cent of private renters expect to eventually own their home, 24 per cent within the next two years - but that is down from 34 per cent two years ago, whilst the proportion expecting to have to wait five years or more has grown from 35 per cent to 42 per cent over the same two-year period.<sup>6</sup>
- a.9 Availability of mortgage funding is improving, but for those first-time buyers without the support of family or friends, raising a deposit is now a significant hurdle. The average deposit paid by a first-time buyer to purchase a home is now £33,000. For the average 25 year-old this represents about 18 years of savings.
- a.10 In contrast, the private rented sector is very accessible. The would-be occupier often only requires a month's rental deposit, which should now be protected in one of three Government recognised schemes. Repairs and maintenance are included – costs that an owner-occupier would incur.
- a.11 Relative affordability in comparison with owner-occupation has changed significantly over the past decade. Growth in private rented sector rents has broadly kept pace with average earnings, meaning for those in work, the PRS is no more expensive than it was a decade ago.<sup>7</sup> Average house prices on the other hand, even allowing for the corrections over the past two years, have nearly doubled. At the present time, 80 per cent of private renters cannot afford to buy their own home, The PRS is therefore providing an essential service, supplying homes for people who cannot afford to buy, but equally have no chance of accessing social housing.

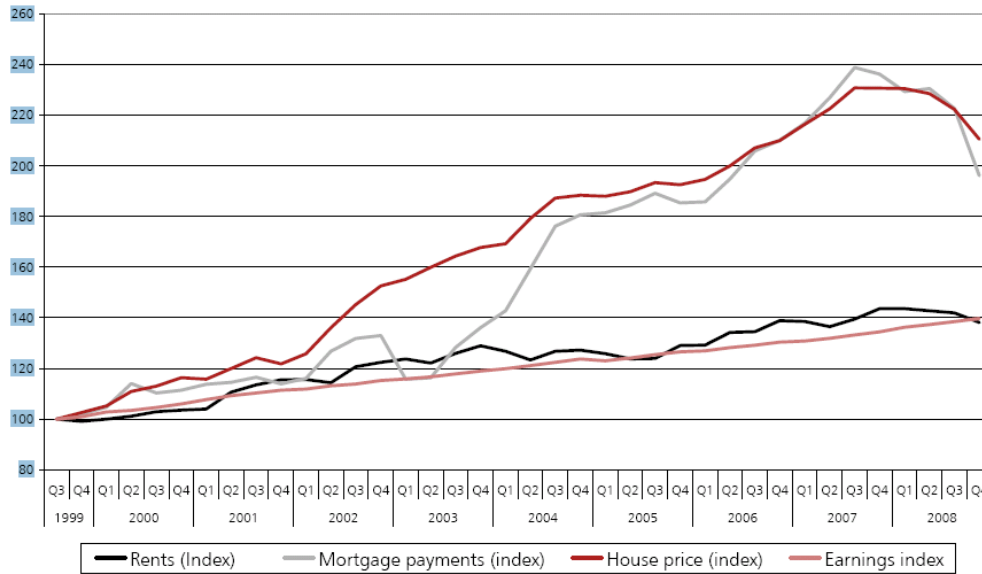
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<sup>5</sup> Can't Buy, Can Rent, Wilcox for Hometrack, 2007

<sup>6</sup> English Housing Survey, Headline Report 2008/2009

<sup>7</sup> Another important consequence of the close correlation between PRS rents and average earnings is that it renders PRS rental income very attractive to institutional investors like pension funds, as their liabilities, too, are linked to average earnings. This is discussed further below.

**Chart 3 - Comparison of rents, earnings, house prices and mortgage payments**

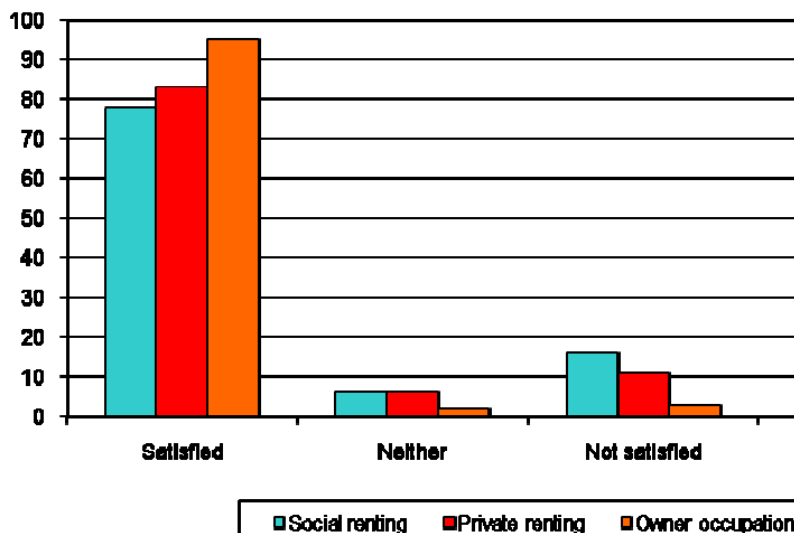


Source: Survey of English Households, Communities and Local Government; Survey of Mortgage Lenders, Communities and Local Government; Department for Work and Pensions.

**To quality housing**

- a.12 The private rented sector achieves good satisfaction ratings. In the latest English Housing Survey, 83% of private tenants were content with their accommodation, compared with 78% of social tenants and 95% of owner-occupiers.<sup>8</sup>
- a.13 There is a legacy of older stock in the PRS, with over 40% of housing in the sector pre-1919. The influx of new-build accommodation into the sector is however, having a very positive outcome on quality, with decent homes in the sector rising from less than 800,000 in 1996, to over 1.8 million in 2008.<sup>9</sup>

**Chart 4 – Occupier Satisfaction by Tenure**



Source: English Housing Survey

<sup>8</sup> English Housing Survey, Headline Report 2008/2009

<sup>9</sup> Ibid

## THE STATE OF THE HOUSING MARKET

- a.14 The private rented sector is playing a vital and increasingly important role in the housing market as:
- the primary source of supply for new households;
  - a key customer and (through its willingness to buy new stock off plan) mitigator of risk for the development industry;
  - a flexible tenure which helps our housing market and labour market to function more efficiently;
  - an affordable tenure, as owner-occupation becomes increasingly difficult to access and social housing is rationed by what the nation can afford;
  - and, an improving sector in terms of quality and customer satisfaction.
- a.15 If anything, owner-occupation and social renting face even greater challenges in the years to come than they have faced over the past decade. Whether the private rented sector can continue to take up the slack is therefore critical to meeting future housing demand.
- a.16 In terms of housing numbers, the number of new homes built each year has ranged from around 130,000 to around 170,000 in recent years. By contrast, the NHPAU estimates a range of 238,000 to 290,000 new homes per year are required to meet housing need, as particularly demographics, but also factors such as net migration, fuel demand.
- a.17 As the HBF points out, however, the backlog of undersupply, added to the pent-up demand suppressed so far by the recession, combined with high levels of projected household growth mean that there is a high risk of serious under-supply. The HBF shows that from the low point reached in 2009 (when only 118,000 new homes were completed, the lowest since 1947), **growth in house-building would need to average 18% per year for the new build targets to be met by 2020**. Given that the average rate of growth between 2001 and 2007 – the booming pre credit crunch era – was less than 5% per year, this raises serious questions about whether the nation's housing needs can be met via owner-occupation and about the social and economic consequences if they cannot.<sup>10</sup>
- a.18 Challenges for the future include the expectation of a higher number of new households forming over the next decade than over the previous decade. Between 2011 and 2016, an average 272,000 increase in households each year is expected, followed by an average 266,000 between 2016 and 2021. This compares with an average of 199,000 new households each year between 1996 and 2001.<sup>11</sup>

### The challenges facing owner-occupation

- a.19 The owner-occupied sector was facing significant challenges even before the recession, with affordability becoming ever more an issue for first-time buyers. The growth of shared ownership and shared equity was a reflection of this.
- a.20 Affordability pressures have if anything been exacerbated by the recession, and although mortgage finance is becoming more available and house prices have eased a little, more first time buyers seem unable to access a mortgage. With the average deposit at £33,000 for a first time buyer and loan-to-values currently hovering at 75 per cent for that clientele, the problem is not so much affordability, as accessibility.

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<sup>10</sup> Home Builders Federation

<sup>11</sup> CML Budget Submission 2010, based on NHPAU data



a.27 Research by BDRC illustrates that landlords with more than 20 properties tend to have a very different approach and outlook to their smaller counterparts. For example, gearing is

**Buy-to-let lending in 2009 was only one-quarter its peak level in 2007**

significant amongst smaller landlords, peaking at about 50% loan to value for landlords with 2 to 4 properties, whereas landlords with 20+ properties have gearing on average of 25%. As a landlord passes from having 2 to 4 properties to 20+, it becomes their vocation, rather than something they do in their spare time. Two-thirds of landlords with 20+ properties cite it as their main source of income. The average landlord now has a portfolio of £1,260,000, annual gross rental income of £40,000 and 14 tenants.<sup>14</sup>

a.28 As in the case of other tenures, a significant constraint on future growth could be access to loan finance, particularly for small landlords and potential new entrants. Buy-to-let now represents 11.5 per cent of the total value of mortgages outstanding in the UK and so is an important source of housing finance. Buy-to-let lending in 2009, however, was only about one-quarter its peak level in 2007. Several major lenders to the sector have greatly curtailed their activities as they are themselves unable to secure funding. Survey evidence suggests though that there is significant latent demand for funds with landlords keen to add to their portfolios whilst house prices are lower. The buy-to-let sector is therefore likely to remain an important source of housing finance, but will be more constrained by access to loan finance.<sup>15</sup>

a.29 To conclude this introduction to our response, given the projected future demand for housing and constrained lending markets it seems sensible to suggest that the private rented sector will play an even greater role in meeting housing need over the next decade, than it has over the past decade. Sources of funding for housing, particularly loan finance are likely to be constrained for some time to come and therefore if need is to be met there is likely to be a greater reliance on equity finance. The sheer quantum of housing needed would suggest that all sources of equity will be required, whether that be individual landlords with spare equity (40% of landlords have no borrowing at all)<sup>16</sup>, individuals wanting to invest collectively in a bit of the sector, or institutions investing their pension and life funds. The need to support additional supply and support the construction industry as an important creator of jobs and wealth should also focus any Government support on adding to supply and therefore on helping the rented sector to provide the demand for more new build.

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<sup>14</sup> BDRC Landlord Panel Q4 2008

<sup>15</sup> CML

<sup>16</sup> BDRC Landlord Panel Q4 2008

## QUESTIONS

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

- *The vast majority of buy-to-let investors did not enter the new build market.*
- *Those who did, however, have been the focus of much attention, because they were often investing in the wrong place, creating an unsustainable investment for themselves, empty properties and a headache for local authorities.*
- *Property Investment Clubs were a strong influence on these bad investment decisions.*
- *Some investors don't want the hassle of preparing properties for renting, but want 'oven-ready' product and therefore will always have a propensity to go for new build.*

- 1.1 The leading buy-to-let lenders report that only some 10% of new buy-to-let lending was on new build properties prior to the credit crunch and they report that the proportion has since fallen further. Buy-to-let lending on new build property has attracted a disproportionate amount of attention because it has been the source of many problems that have not afflicted the mainstream buy-to-let market which consists of lending on existing properties.
- 1.2 New build tended to attract a different type of investor than mainstream buy-to-let. The mainstream buy-to-let investor typically buys property close to where they live, often undertaking management and minor repairs themselves with a long term investment horizon – the latest ARLA landlord survey shows that 76% of landlords expect to keep their properties for 10 years or more and less than 1% expect to keep them for less than 2 years.
- 1.3 This can be contrasted with the new build buy-to-let market where many investors were encouraged to buy by unregulated property investment clubs, often using high pressure sales techniques. Many of the investors lived hundreds of miles from the properties they bought and were looking for a relatively hassle free investment where management and repairs would be undertaken by local professionals.
- 1.4 A lot of such activity was also speculative, or what has been termed 'buy-to-flip', with the investor buying off plan and selling the property for a profit before completion.
- 1.5 During the housing boom property investment clubs were able to offer developers the advantage an institution would provide – off-plan finance for a bulk disposal – but without the disadvantage of a hard bargain on price to reflect the benefit of lower risk to the developer. Many of the PICs received fees from both investors and vendors; this lack of transparency led to problems.
- 1.6 The improvements and conversions that will be required to make an existing property suitable to be rented can also add cost and uncertainty to the process. The time taken to make the improvements will lead to a significant void period where no rental income is being received and there can be unknown risks associated with conversions which can cause delays and cost increases.
- 1.7 New build properties also present a range of advantages including a better quality product which more adequately meets the expectation of tenants. One example of this is that many new build properties will have more than one bathroom. There is also a perception that new build properties will require less spending on maintenance in the short term and that they are cheaper to run on a day to day basis. New build properties will also be more likely to meet fire safety rules as they will have smoke alarms and fire retardant materials already in place.

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

- *The change in planning policy and commitment to 60% new build on brownfield land led to a whole new city centre housing market being created.*
- *Investment sales also helped facilitate this, off-plan sales helping to reduce risks and improve cashflow for house builders.*
- *Lenders have become a lot more cautious about financing the purchase of new-build property.*
- *Institutions could form a key part of providing forward sales to developers and unlock a large volume of residential consents that may otherwise remain undevelopable for many years to come.*

- 2.1 The quantity and format of house supply has been driven by a number of factors over the course of the last decade. The change to planning policy in 1998 and commitment to 60% of housing development on brownfield sites has been a major influence, as has the broader policy support for an urban renaissance, both have led to more development in-town and therefore more high density flats, rather than houses.
- 2.2 A whole new city centre housing market that had previously not existed was created – in 2000, the average value of a new flat was 120% that of a re-sale flat. This made the development of apartments highly lucrative and developers started chasing higher volumes through high-density development. By 2007, 45% of all homes started were flats compared to just 15% in 1998.
- 2.3 The capital intensive nature of high-density development meant developers and their funders become increasingly reliant on ‘forward sales’, which could be more readily achieved from investors who were willing to buy ‘off-plan’ up to two years ahead of completion. The attraction for these investors was that they were offered a very highly leveraged call on house prices, which were rising at the time, as they only needed to pay between 5%-10% on exchange of contracts (and the remainder on completion), often many months in the future. By contrast, owner occupiers would only purchase much closer to completion. Investor sales became a key part of enabling new high-density developments to proceed over the course of 2000-07.
- 2.4 However, after about 2004 – the point at which yields and mortgage rates converged – some investors began to see housing as a commodity, rather than looking at a realistic exit value of the property into the owner occupier market. Thus investors distorted pricing for new-build flats and this has resulted in a greater re-correction in prices in this segment of the market than in the mainstream housing market. In Northampton, for example, an average 2-bed flat is currently trading 35% below its peak level in 2007, while a 3-bed home in the same city is down by just 6% over the same period.
- 2.5 The ready supply of investment buyers willing to purchase flats, has therefore been a major factor in making the move to a more brownfield-orientated planning policy work. Building flats is significantly riskier for house builders than building houses, because the sale to individual owner-occupiers tends to only proceed once the block is significantly complete. In the meantime, the developer is having to find cashflow and is exposed to risks, both specific to the development and broader economic risks.
- 2.6 At the height of the boom in 2007, a report by Molior for the GLA (Who Buys New Market Homes in London?), estimated that around two-thirds of new build flats and houses in the capital were bought by investors. Summarising the benefits of this to developers, the report states that:
  - *Investors perform a valuable market function by allowing perceived development risk to move from the developer to the purchaser, therefore increasing confidence among house-builders. Forward buying is often a condition of bank lending and it also helps reduce development interest costs for developers, as investors are willing and able to buy homes ahead of construction completion. Owner-occupiers, on the other hand, generally purchase homes following or just*

*before construction completion. The report concludes that many housing schemes, particularly larger ones in emerging areas, would simply not go ahead without sales to investors.*

- *Market participants generally concurred that investor demand leads to more new homes being developed, especially in emerging areas where there is not an established residential market.*
- *The report concludes that if the investment market were to shrink there is a real danger that the number of new homes being built would fall to the detriment of all. It believes that investment sales should be viewed as providing a valuable function in the market for new homes.*

- 2.7 However, lenders have become a lot more cautious about financing the purchase of new-build property both for owner-occupiers and buy-to-let investors. Buy-to-let mortgage lenders experienced a higher proportion of write downs in values on new properties than on older properties in more established rental markets.
- 2.8 The net result of the major re-correction in new-build pricing is that a significant proportion of new-build housing that was both under construction and in the planning phase was, and has been, rendered unviable. Developers are now adopting a much lower risk approach to development - moving the emphasis of their development activities back towards house-orientated schemes on smaller sites.
- 2.9 Houses are likely to account for 75%-80% of new housing starts in 2011. This changing mix of housing starts presents a major challenge for the planning system and has implications for future level of new housing development. On the basis that the house building industry built 180,000 homes in 2007, with a mix of 45% flats and 55% houses, reaching 240,000 homes a year with just 25% of these homes developed as flats would require 67% more land for housing to be delivered through the planning system.
- 2.10 Attracting institutional investment into the private rented sector could form a key part of providing forward sales to developers in order to help unlock a large volume of residential consents that may otherwise remain undevelopable for many years to come.

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

- *Renting a room can make a useful, but relatively small contribution to addressing housing need. For practical and psychological reasons supply and demand for such accommodation is limited. Current economic circumstances are probably leading to some cyclical increase, but not the sustained increase in housing numbers the country needs.*
- *Anecdotal evidence suggests that the rent-a-room allowance is not used by many potential users, because of a lack of awareness of it.*

- 3.1 The consultation paper states: *"...there is no published data that allows the number of private landlords with lodgers to be estimated with any degree of accuracy, and Government cannot be precise about the numbers benefiting from the rent-a-room scheme, as provided the income does not exceed the threshold for the relief there is no need to declare it."*
- 3.2 Given the lack of data, it is difficult to respond, and by their very nature many of these arrangements are private so difficult to track.
- 3.3 Intuitively, we believe that homeowners who rent out part of their home to individuals make a helpful, but modest and marginal, contribution to improving the efficiency of the housing market. There is well recognised under-utilisation of existing housing stock, although the biggest contributor to this is the demography of an older population, with couples or a surviving partner occupying the family home. Older people, however, are probably not the most likely candidates to rent out a room to younger people in housing need.
- 3.4 Anecdotal evidence suggests that there has been an increase in owner-occupiers renting out rooms as economic conditions impact on some household incomes. By its very nature, however, such housing 'supply' is cyclical and not likely to lead to a significant long-term improvement in housing numbers.
- 3.5 The rent a room scheme also encourages homeowners to let out spare space, but is not cost free, the relief forgoing £120 million per annum in income tax revenue. As a scheme it is of some benefit and is used by c. 100,000 households with a home, but it is difficult to calculate how much of this provision is additional and dependent on the allowance, likewise there is anecdotal evidence in the sector that awareness levels result in proportionally low take up. What is clear is that it only scrapes the surface in terms of need for rented accommodation, and has to be seen in the wider context of 1.1 million households finding a home in the private rented sector in the period 2000-2008/9. There has been a recent campaign to raise the rental limit from £4,250 to £9,000 per annum. HMRC estimates this would cost another £10m, and therefore help about another c. 5,500 income tax payers, with some deadweight cost.

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

- *For a variety of reasons individual investment in residential has proved attractive relative to other forms of saving.*
- *Individual investors have also been able to make their investment go further through leveraging in the buy-to-let market.*
- *The buy-to-let lending market is currently constrained and likely to remain so for some time to come, but demand for rented housing shows no signs of easing.*
- *There will be unwelcome social consequences if demand is not met.*
- *The smaller investor will also miss out on a relatively stable and well performing asset class.*

- 4.1 Part of increased popularity of residential investment reflects its relative attraction compared to other forms of investment – residential has offered a higher return than the traditional savings account, which in the low interest rate environment of the past decade has been perceived as relatively unexciting. Equity investment, on the other hand, has offered perhaps too much excitement, with significant volatility.
- 4.2 Residential investment has therefore appealed to the man in the street. It has performed well in terms of capital gain. The nation's housing shortage makes investors believe that the downside risks are capped. It is tangible – easy to point to and say: “that is my investment” – a not inconsiderable factor in the era of Equitable Life, endowment mis-selling and banks on the brink of failure.
- 4.3 The growth of the buy-to-let mortgage market and commensurate access to lending on competitive terms has also played a significant part in attracting individual investors – buy-to-let mortgage loans grew from some £9bn at the end of 2000, to some £73bn in 2005 and now stand at some £140bn.
- 4.4 The political environment has also been relatively stable in comparison with past decades, even between changes of Government, with the assured shorthold tenancy now well embedded in the sector.
- 4.5 Looking ahead, it is going to be more difficult to expand PRS housing provision at the same rate relying on the individual buy-to-let market. The buy-to-let lending market is currently constrained and likely to remain so for some time to come.
- 4.6 The constraint on lending has been driven by the funding constraint lenders have faced since the start of the credit crunch. Those buy-to-let lenders that are dependent wholly on wholesale funding, such as Paragon Mortgages, have been unable to do almost any new lending while banks and building societies also face funding constraints. This has reduced competition in the market and made it harder for landlords to source debt finance.
- 4.7 Gross buy-to-let mortgage lending, which was running at £8.7bn a quarter in the peak year of 2007, reached a low of £2.2bn in Q2 of last year and had only recovered to £2.6bn by Q4. Lenders have scaled back lending by tightening their lending criteria and by reducing their maximum loan-to-value ratios with many lenders now offering buy-to-let loans only up to 75% of the property's value.
- 4.8 This means that landlords will need to have access to significant cash or equity to grow their portfolios. This is not necessarily a bad change as credit conditions were overly loose prior to the credit crunch, but it will potentially constrain the rate of growth of the buy-to-let market going forward.

**1.1 million additional households have been accommodated by the private rented sector since 2000.**

- 4.9 We believe, however, that there remains a strong appetite among individuals to invest in the residential market. Partly, investment will continue to flow from existing investors, who have a strong equity position, and can either generate internal funds or access the lending market. It is worth reiterating that 80% of stock in the private rented sector is owned by 20% of investors, many of whom are individuals who started with one or two properties but now have a significant portfolio.<sup>17</sup>
- 4.10 A significant reduction in the availability of buy-to-let finance, however, will reduce housing provision, with the social and economic consequences that implies. Fewer homes will mean fewer jobs in the construction industry, more overcrowded accommodation and more family tension as generations live under the same roof, and greater reliance on commuting, with the strain that puts on people and infrastructure.
- 4.11 It will also deprive some individual investors of the opportunity to invest in housing and its performance as an asset class, which provides a good mixture of capital growth and steady income returns. For the smaller investor unable to access buy-to-let lending, there will remain a desire to invest in residential property and some of that market might be satisfied in future via the collective investment, rather than individual investment, route.
- 4.12 Changes to pension rules might also lead to some changes in strategy for individual investors. The withdrawal of higher rate tax relief from pension contributions by high earners may lead to reduced investment in pension funds and SIPPs, and investing in the PRS may be an attractive alternative investment option.

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<sup>17</sup> Hometrack

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

- *Entering a new asset class is costly and will have minimal impact on performance if there is not sufficient scale of investment, c. £50m for smaller funds and c. £200m for larger ones.*
- *Non-recoverable management costs - void rents, repairs, maintenance and letting costs – mean that net rents are only about two-thirds of gross, and therefore any efficiencies can have a significant impact on returns.*

- 5.1 Scale is important both in management as well as in quantum; for institutional investors to invest in a new sector requires them to be able to show that this can make a material benefit to their overall returns, particularly as there will be entry costs. For many of the largest institutional investors, this suggests a minimum investment of £200m, for smaller institutional investors commitments of £5m to £50m are required for sector returns to make a significant contribution to their overall investment portfolio returns. Being able to invest in scale is often critical in terms of 'do we' or 'don't we'.
- 5.2 Operationally, economy of scale is an important component to an investor's business plan because of the following:
- residential is far more of a 'service offering' than commercial property and therefore marketing efficiency requires a geographic concentration and range of homes to attract the largest number of tenants.
  - scale is critical to manage the repairing, insuring and regulatory costs efficiently. Management costs are very significant The gross rents are netted down by non-recoverable management costs, including void rents, repairs, maintenance and letting costs so net rents are only about two-thirds of gross.
- 5.3 Most investors will enter the market through investment in a number of residential funds, offering them a wider access to different business plans, portfolio types and operating platforms. Minimum lot size is important in three aspects:
- The size of a 'club' investment vehicle – Like-minded experienced institutional investors are likely to invest larger sums in closed ended fixed life 'Club' funds (managed by a third party). Scale in this case may mean an individual investment of £50m-£75m per investor.
  - The size of indirect investment vehicles – Liquidity of underlying assets is far more critical in a listed vehicle (or an open-ended vehicle); investors may be constrained by internal restrictions, as well as UK regulatory constraints, and often limit their investment in residential property to well under 20% of the total value of the respective vehicle.
  - The ability of the indirect investment manager to invest minimum amounts in local property markets – The fund manager's business plan is critical to investors in indirect residential funds; the fund manager must be able to show that it has the experience and knowledge to invest sufficiently large scale in terms of concentrations, type of property (such as flats) and by percentage of total assets.
  - Minimum lot size is critical for larger vehicles (£200m or more) as few will want to invest in less than 150 units in each location, at a cost of £30m-£50m per portfolio. In the current UK environment these portfolios will have to be sourced off-plan either from house builders, or 'built-to-rent' on land owned by the HCA, or Government departments.
  - There are almost no funds currently available to institutional investors with existing residential stock of any meaningful scale given the lack of attractiveness of the sector and the long time it takes to build a portfolio of scale due to the relatively low unit cost of residential property (c. £150k per unit versus say £10m+ for commercial property).

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

- *There is consistent and wide feedback from institutions that the SDLT bulk purchasing rules are a barrier to investment by them.*
- *Practical examples and modelling illustrate the rules have a material impact on capital usage and yield.*
- *The best remedy would be to charge on a per unit basis.*

- 6.1 The SDLT anomaly through the 'linked transaction' rule that imposes a higher charge on large scale investment compared to single acquisitions has been identified consistently by property companies, fund managers and others who have made or are considering making, or advise in relation to, investments in residential property, as the biggest tax barrier to large scale residential investment. The use of calculations and models makes it clear that the extra cost arising from this anomaly represents a constraint to building up residential portfolios. This will increase in the future on certain acquisitions when the new 5% charge is implemented. Furthermore, its continued existence is widely perceived as a sign that the Government is not particularly interested in stimulating greater institutional interest in residential property investment.
- 6.2 The simplest and most neutral way of eliminating the anomaly would be to provide that the acquisition of more than one dwelling should be chargeable to SDLT at the marginal rate applicable to each dwelling, based on a just and reasonable apportionment of the aggregate price. The value of such a measure would be greatest to the viability of the investment model where low value dwellings are involved, as the marginal change in the applicable rate of SDLT would be greatest. For a PRS portfolio with an average per unit value in the range £150,000 to £200,000, the measure would allow acquisition on a large scale at a marginal rate of 1% rather than 4%. The impact of that on returns is discussed briefly in response to Question 7 below.
- 6.3 It is of course impossible to say whether eliminating the anomaly and reducing the SDLT cost of bulk purchases of residential property "would" lead to increased investment. However, the impact on yields would be material, and we would expect institutional investors in particular be more attracted to investing in residential property, because they are perhaps more likely than individuals to need to purchase in bulk (see further the response to Question 5 above).
- 6.4 It is worth mentioning that the current SDLT anomaly also operates to discourage existing large scale residential investors from disposing of portfolios as a whole (which could remain within the PRS), rather than of individual units. The higher SDLT cost payable by the purchaser would otherwise be reflected in a lower price. There are of course broader reasons for large scale investors to sell individual units, not least the fact that it may be the best way to capture capital growth (as owner-occupier purchasers may be willing to pay the highest price). However, as the UK currently lacks a liquid large scale PRS investment market, there is little scope for designing business strategy on the basis of a sale to another PRS investor. It would be easier to change that position if the SDLT regime did not make a bulk transaction within the PRS more expensive than individual sales out of it.

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

- *Lowering the SDLT rate to the individual unit costs and investing the SDLT saving in a larger number of units, makes a material difference to returns.*
  - *The three year unleveraged total return is improved by 120bp and the five year return by 70bp.*
  - *A leveraged portfolio can lead to a three year total return improvement of 150bp and a five year improvement of 100bp.*
- Note: these figures were arrived at independently by various organisations' modelling work and the calculations can be available.*

- 7.1 The quantifiable impact on the rate of return differs, depending on whether the investment is leveraged or not and the time held.
- 7.2 For unleveraged investments, reducing SDLT to 1%, from 4% provides a better capital usage and increases the rate of return. Using a £50m portfolio as an example, an SDLT reduction to 1% increases the 3-year total return by 120bp and the 5-year return by 70bp, helping the PRS to compete with other investment classes.
- 7.3 With regard to leveraged investments, the lower rate of SDLT will affect both the number of units that can be purchased and the total return. For example, assuming leverage of only 25% to invest £50m in a portfolio and paying only 1% SDLT, the reduced cost could lead to the purchase of 15 additional properties, with the leveraged total return being increased by 150bp over three years and 100bp over five years.
- 7.4 That difference of 15 new homes (depending on whether SDLT is payable at a marginal rate of 4% or 1%) represents properties which are simply not acquired if the SDLT has to be paid – and if they are not acquired, not only is the rent from them not collected, but the capital growth they could have delivered is not secured. Regardless of the SDLT cost, the investor has invested £50m, but a higher SDLT cost reduces both the yield and capital growth components of the total return on the investment, reducing the attractiveness of residential property as an investment asset class for large scale investors. In policy terms, the apparently higher SDLT revenue implied by the current rules may be illusory. This is on the basis that transactions subject to it are simply not done because the commercial return is not sufficient. Alternatively, if some new homes are sacrificed to cover the SDLT cost of transactions that do go ahead, it may come at a price.

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

- *UK residential performs well in comparison with most other asset classes over most timeframes on a total return basis. However, income returns are often the key attraction for institutional investors and these are much higher for commercial property than residential. The higher management costs of investing in residential plus irrecoverable VAT costs exacerbate this and are a major drag on residential investment income returns and a significant disincentive to institutional investors.*
- *Residential is usually considered part of a wider property allocation and therefore compared with UK commercial property, which it must compete with.*
- *'Institutional investor' is a generic phrase, which actually encompasses a variety of different investors with different income, capital and total return expectations.*
- *For some pension and life funds income is important and the 'income' component of residential is generally below their expectations.*
- *To attract greater pension and life fund interest this response focuses on ways of reducing operating costs via the tax system.*

8.1 The historic returns from the main UK asset classes, including residential, are set out in the table below. Based on house price inflation and the average net income return from residential according to the Investment Property Databank (IPD) dataset, PRS investment would have outperformed the returns from all the other asset classes since 1971, assuming the current rules for Assured Shorthold Tenancies had applied throughout this period.

**Table 2**

Correlation of Annual Returns (1971-2009)	UK Residential	UK Equities	UK Gilts	UK Cash	UK Commercial Property
UK Residential	1.00				
UK Equities	0.05	1.00			
UK Gilts	-0.21	0.58	1.00		
UK Cash	-0.12	0.13	0.20	1.00	
UK Commercial Property	0.70	0.29	0.04	-0.04	1.00
<b>Average total returns pa (%)</b>	<b>13.4</b>	<b>12.6</b>	<b>10.1</b>	<b>8.5</b>	<b>10.8</b>
<b>Historic volatility (Standard deviation) (%)</b>	<b>11.6</b>	<b>30.2</b>	<b>13.8</b>	<b>3.7</b>	<b>17.4*</b>

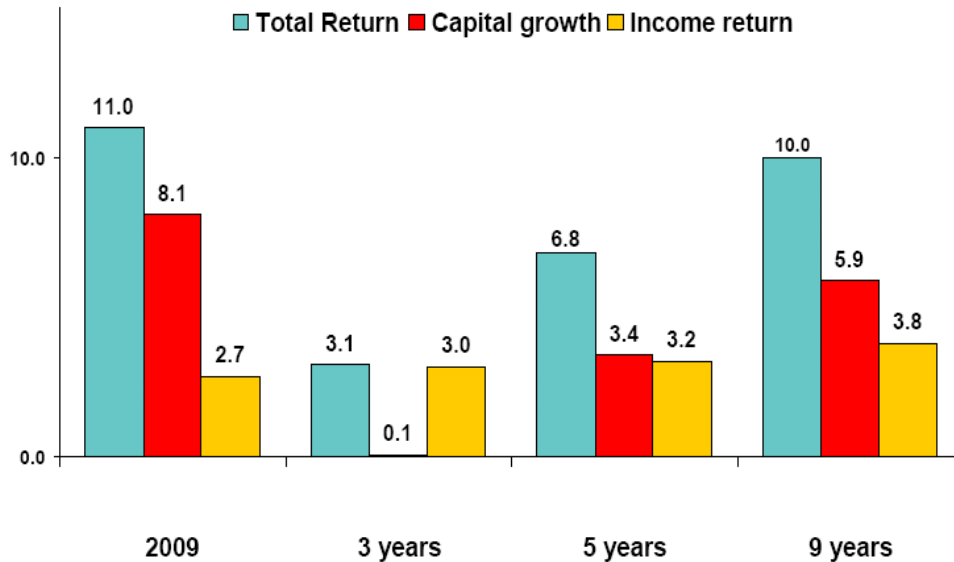
Source: Nationwide, IPD, DataStream & LaSalle Investment Management

\* Unsmoothed, 11.6% smoothed

8.2 Investors in UK commercial property expect a return of 2.5%-3% in excess of the risk free rate. The risk free rate today, as expressed through medium-dated index-linked bonds and gilts, is below the long term average so, in practice, commercial property investors are seeking 7%-8% pa (unlevered).

8.3 Residential property has to deliver a return in excess of commercial to attract attention and the historic data suggest that it can. Once residential is established as a natural part of most property portfolios, investors will probably accept a similar return to commercial because the income stream it delivers is probably more stable in all economic circumstances. However, more of the return is delivered through capital gain which is inherently more uncertain.

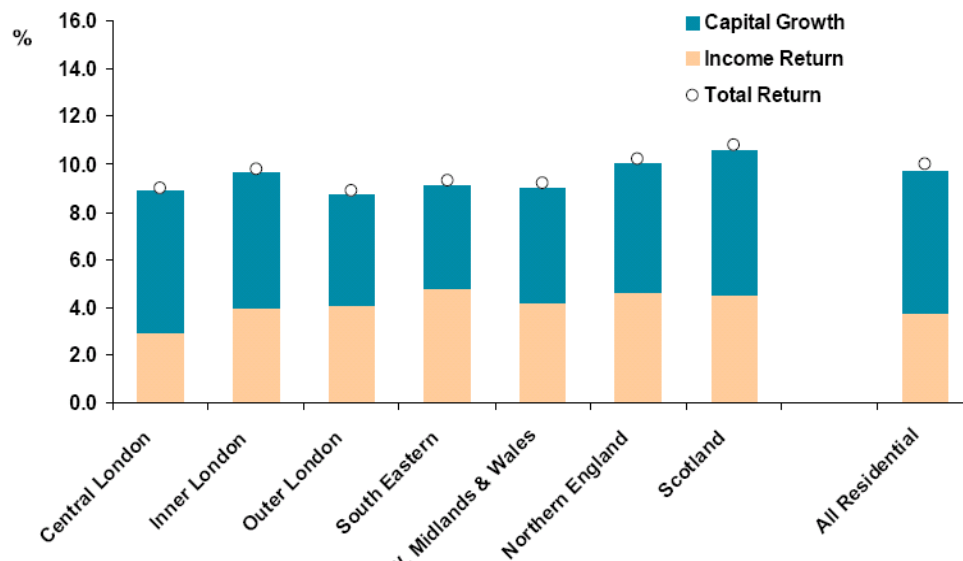
**Chart 6 – IPD Residential Performance to Dec 2009**



Source: IPD

8.4 Chart 6 shows that the overall performance of residential over various timescales relies heavily on capital growth, for example, of 5.9% per annum over the last decade, compared with 3.8% per annum income return. For that reason, the mainstream residential sector is generally seen by the market as a 'total return' investment class, delivering a combination of a relatively modest income yield and (historically, at least) relatively predictable and substantial capital growth. Chart 7 shows some variation in regional performance.

**Chart 7 – Regional Performance 2000-2009**



Source: IPD

8.5 Institutional expectations/requirements will differ. Generalising, there are a number of existing and potential investors in the sector whose expectations are met in terms of total returns. However, some pension and life fund investors are looking for a better balance between capital and income return, the latter being about 200 basis points below the long-term performance they would expect.

- 8.6 The responses to Questions 6 and 7 above discuss ways in which the tax system can help attract a broader range of investors in the residential sector.

**Different institutional investors**

The term 'institutional investment' is used generically, but actually encompasses a diverse range of different types of investor, with different income, capital and total return expectations, for example:

- larger public and private companies;
- pension and life funds;
- sovereign wealth investors;
- investment funds, using a variety of different 'wrappers' (vehicles)
- other institutions, such as charitable trusts

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

- *A nexus of different issues currently explains interest in residential investment – the comparable performance of other assets; state of the house building market; less access for buy-to-let investors, on-going strong demand for housing; correction in house prices; difficulties people face accessing home-ownership; and, the HCA and HM Treasury's interest.*
- *If housing demand is going to be met then it is important Government considers long-term measures that will draw investment into the sector.*
- *There are some valuable lessons to be learnt from the HCA's Private Rented Sector Initiative – being market focused, providing scale opportunities, and tangible support.*

- 9.1 There are a number of reasons for recent institutional interest in the PRS. These include:
- The downturn in the commercial property market has led institutions to review their existing portfolios. The residential sector differs from the commercial property sector and therefore offers opportunities to reduce volatility of returns and diversify investment risk.
  - Distress in the house building industry - new private housing work in 2009 was 28% lower compared with the previous 12 months and lower still than the levels in 2006 and 2007 (ONS, Q4 2009), which may present a new opportunity for institutions to invest in residential property in the lot sizes they require.
  - Encouragement given by the HCA and HM Treasury. For example, the recent offer of six HCA sites provides residential funds (and their institutional investors) with another means of entering the sector in scale. The HCA in the future could offer many more Government or Department owned housing or mixed use sites to residential funds, which will bring forward developments at a time when house builders are finding their balance sheets constrained and funding hard to source.
  - The correction in house prices and the tightening of bank lending criteria to the residential market as a whole, and to the buy-to-let market in particular.
  - Recognition of the importance of the the PRS and the leading role it has to play in providing housing for those in need, particularly a generation of 25-34 year olds who may have to wait to their mid-30s, to make their first home purchase.
- 9.2 It is too soon to say whether these factors will lead to a long-term change in investment opinion but current discussions with institutional investors do indicate that there is a significant latent long term appetite for investing in the residential sector if some of the issues raised in this paper can be addressed. We think that period 2010-12 represents the best opportunity to effect a change in investment opinion among institutions in a generation.
- 9.3 The Homes and Communities Agency's Private Rented Sector Initiative has illustrated that there is wider latent investor demand than perhaps is appreciated.
- 9.4 The PRSI has been well supported in the sector. Raising an initial £1bn of investment will be a useful contribution to increasing housing supply in current economic conditions.
- 9.5 We believe, however, that meeting future housing need requires sustained investment by institutions in the PRS, and whilst the PRSI is a useful programme, it is about the 'here and now' predominantly, and the wider PRS needs to be encouraged and supported by Government for years to come if it is to meet demand for housing.
- 9.6 Emphasising the lessons of the PRSI, what matters to institutions is scale of opportunity and meeting institutions' return expectations. The way this is being achieved in the PRSI is predominantly by using HCA land and therefore ensuring the price paid for the stock provides a competitive return.

- 9.7 If institutional investment is to be maintained after the PRSI, however, and to make a useful contribution towards satisfying housing market needs, the Government will need to consider how a competitive return and scale of opportunity can be delivered on an ongoing basis.

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

- *Practical measures are needed to encourage institutional investment in the PRS, but Government should also not ignore the psychological barriers and how much it can achieve with appropriate signals, or how much it can stop with the wrong messages.*
- *A combination of practical measures is required to ensure appropriate support for continued housing development and supply for those in housing need. What support is provided is ultimately down to Government and its ambitions for the sector.*
- *Per unit SDLT, reductions or refunds of VAT and changes to the REITS regime (outlined below) could make a significant difference to the returns from the sector and investment in it, send a strong psychological signal of support and help to stimulate institutional investment.*
- *A further huge barrier to investment is access to stock. In the short term this can be satisfied by access to existing mothballed schemes and access to land via the HCA. In the longer term, sustained investment on the scale the country requires would require a steady source of stock.*

- 10.1 Institutional investment must be seen within the wider context of the rental and housing markets and shortfall of housing supply. Appropriately channelled, institutional capital invested in new stock can help add to housing and reduce the gap in supply.
- 10.2 Barriers will differ between institutions and resolving them will depend on the Government's ambitions for the sector. At their most basic, institutional investors in the PRS are no different than any other business investor, wanting a stable economic and political climate, with no shocks to the system.
- 10.3 Beyond the general, there are specific barriers that Government might consider addressing. As stated, the extent will depend on what contribution the Government believes the sector should be making to housing shortfall. If its ambitions match the scale of the UK's housing supply problems then a combination of reforms will be required.
- 10.4 The main economic problem pension and life funds investing in new build face is that the very dominant owner occupier market sets prices according to what people are prepared to pay (and can borrow) to live where they want to live. The result is that rents (which depend on earnings rather than on capital values) cannot deliver a sufficient yield, so the PRS is structurally reliant on capital growth on an ongoing basis to deliver an acceptable total return.
- 10.5 That reality has probably contributed significantly to the resistance that many institutional investors appear to have as regards residential property. That resistance is probably the result of two key factors. First, institutions are generally conservative organisations and significant departures in asset allocation need to be justified. As residential is a new and unfamiliar asset class for many of them, a certain amount of caution and hesitation is probably inevitable.
- 10.6 Secondly, potential investors can see that residential is more than an asset class: it is also housing, and therefore very sensitive socially and politically. As a result, there is perceived to be a high risk (as compared to other asset classes) of regulatory intervention (which may be driven to varying degrees by sound policy justification or short term political concerns). That regulatory uncertainty is something which makes institutional investors and asset allocation advisers nervous. While it clearly cannot (and should not) be eliminated altogether, Government must carefully manage the signals it sends through regulatory initiatives and policy announcements if it wishes to encourage substantial, stable and lasting institutional investment in residential. The HCA's PRS Initiative has shown that the mental block can be overcome, and more messages from the Government indicating that there is a strong policy desire to

encourage greater institutional investment in housing, and that it understands the need for certainty and predictability in the tax and regulatory environment would also help enormously.

- 10.7 It is not realistic to expect radical price change in the UK housing market and thus if the institutional investment market is to grow and make a significantly greater contribution to housing supply some policy intervention is necessary. There are some relatively simple and quick ways of improving the income yield and thus attracting more institutional investment in the sector.
- 10.8 As discussed in our responses to Questions 6 and 7 above, the acquisition cost of residential portfolios can be reduced (increasing the gross income yield) by changing the application of the SDLT legislation in relation to bulk purchases of residential property. For example, 1,250 homes each of which is worth £200,000, if sold individually to owner occupiers and small investors, will yield £2,500,000 in SDLT (ignoring the potential impact of the temporary first time buyer incentive). However, an institutional buyer of the same portfolio would have to pay £10,000,000 (which would of course reduce the amount available to buy properties). Levelling the playing field so that the bulk purchaser pays at the rate applicable to the unit price would still deliver £2,500,000 in SDLT to HM Treasury, while at the same time, the effective reduction in purchase costs would help improve the rental yield for investors, as well as sending a message to the market that the Government wants to support large scale investment in the PRS. Our understanding is that the unfavourable SDLT position itself is enough to dissuade institutional investors, particularly as it must be paid upfront and therefore acts on a drag on investment performance in a fund's early years.
- 10.9 In the context of residential investment, operating costs consume around a third of the gross yield from rental income, significantly reducing the net yield actually available to investors. A significant element of those costs is attributable to unfavourable tax treatment – most importantly, irrecoverable VAT. Uncertainty as regards the trading/investment distinction is also unhelpful. Improving the tax treatment of residential investment to tackle those issues would also send a very encouraging message to institutions uncertain about whether to invest in residential property.

## VAT

- 10.10 As regards VAT, two specific proposals that the Government should consider are extending the reduced rate for renovation and repairs (taking advantage of existing flexibility in the applicable European legislation), and introducing a refund scheme to reduce the VAT cost associated with management of a residential portfolio.
- 10.11 The operating costs of managing a large residential portfolio are relatively high as compared both to commercial property (where most costs are generally passed down to tenants) and to small scale residential investment (where costs are often absorbed by the individual investor carrying out management, repairs and maintenance in his own time, or are outsourced to contractors below the VAT threshold).
- 10.12 Any large scale institutional investment in residential property would need to benefit from efficient external management of the portfolio to manage relationships with tenants, lease renewals and voids, repairs and maintenance. The external manager would inevitably be VAT registered, adding, under current law, 17.5% to the commercial cost of its services. The impact is to reduce the yield available to investors and eat into the efficiencies of scale which ought to encourage large scale investment in residential.
- 10.13 The Government should consider:
- reducing the VAT cost to 5% to the maximum extent permitted by European law;
  - and/or introducing a refund scheme to reduce the VAT cost of operating a large residential portfolio, either for all investors or at least for institutional investors who are registered as such.

10.14 We would specifically recommend that any refund scheme should be operated by a department or agency primarily concerned with the social policy aspects of the measure rather than with tax collection.

10.15 It is worth emphasising in this context that the zero rate for new build remains vital for the delivery of new homes, which is in turn essential both in broad policy terms and for the emergence of an institutional PRS capable of flourishing in the longer term. The impact of VAT needs to be reduced overall – both on housing delivery (through maintenance of the zero rate) and on improving the quality of the existing stock (through a reduced rate for repairs and alterations). Those two elements should not be seen as alternatives.

#### **VAT**

VAT on the labour element of housing repairs, alterations and renovation reduces the net yield to institutional investors. It is a cost that individual investors are often not subjected to, either because they do their own repairs, alterations and renovation, or use contractors that are not VAT registered.

The 'Cut the VAT Coalition' recently published research by Experian, which showed cutting VAT on the labour element of such costs to 5% would have significant benefits for the economy:

net revenue loss from this measure of £102m to £508m per annum. This would stimulate £1.4bn of additional economic activity in 2010 alone, which in turn should generate sizeable taxable profits;

creation of up to 24,200 extra full time equivalent jobs in 2010 alone with total jobs created in the construction sector rising to 34,500 by the end of 2019;

31,000 jobs created in the wider economy;

a release of £450m of funding to spend on the UK's social housing stock; and,

an extra 174,000 homes being retrofitted with loft and wall insulation, double glazing and energy efficient boilers over the next decade. This would lead to a saving of up to 337,000 tonnes of CO2.

Reducing the VAT rate on housing repairs, alterations and renovation is permitted under EU law. There are also precedents in that a number of existing housing-related activities attract a rate of 5%:

conversions of premises to a different residential use;

renovation or alteration of empty residential premises;

installation of energy saving materials;

installation of mobility aids for the elderly.

#### **Trading/investment uncertainty**

10.16 The potential uncertainty inherent in whether profits on disposals of residential property are taxed as trading profit or capital gains can be unattractive for institutional investors. As explained in more detail in our response to Question 11, in order to provide an acceptable return for investors, it is normally the case that some property in a residential portfolio will need to be sold so that capital growth in the portfolio as a whole can contribute to total returns on an ongoing basis. Whether profits realised on any such disposal are treated as arising in the course of a trade will be question of fact and law and while it may be relevant in particular to a REIT (see further Question 11), it will also be relevant to an investor who is exempt from tax on capital gains (such as a UK pension fund or a non-UK resident).

- 10.17 In our response to Question 11 below, we propose that a 'white list' should be introduced for transactions by a REIT in residential property, similar in concept to the definition of "investment transaction" in the Authorised Investment Fund Regulations. This would provide clarity that investment treatment will apply in certain cases which might otherwise be uncertain. While addressing this uncertainty is critical for REITs, however, it is also important for other types of institutional investor, who will be seeking certainty in their investment. Accordingly, we would recommend that such a 'white list' also applied more generally to transactions in residential property by any collective investment vehicle, registered pension scheme or offshore fund.
- 10.18 It is worth noting that the critical nature of the trading/investment distinction gives rise to particular problems in the context of shared ownership. In the first place, where the investor acquires a new home and immediately sells part of the interest in it to the occupier, that sale may be regarded as a trading transaction, even though it is, as a matter of commercial reality, no more than a necessary step in creating the shared ownership structure. In the second place, the flexibility of shared ownership which allows the occupier to increase his interest in the property a short period after entering the structure can also give rise to trading risk – the sale of a further proportionate interest by the investor may be regarded as a trading transaction. If shared ownership is to help improve the affordability of owner-occupation, legislation needs clearly to recognise that it is fundamentally an investment activity despite the transactional activity that it may encompass.

### **Other possibilities**

- 10.19 In current economic conditions, we believe that making the operation of a residential investment business more tax efficient and less uncertain, as outlined in the preceding paragraphs, would improve the yield to investors and improve their confidence in residential, and should therefore deliver increased investment in the sector.
- 10.20 To create such scale of investment will require a significant delivery of new build property. This is being achieved in the HCA's PRSI, for example, via access to 'public land' in return for some share in later returns seems a successful model.
- 10.21 To allow the broadest possible access to the sector by individuals and institutions, it is important to ensure that appropriate vehicles exist through which such investment might be made. The most natural choices under current law would probably be offshore tax transparent vehicles such as an FCP or Jersey Property Unit Trust and (but for a number of issues identified in our response to Question 11 below) REITs. These tax transparent vehicles are well understood investment vehicles, where the rent is taxed in the hands of investors and gains are outside the UK tax net, so that different sophisticated investors are able to invest together without losing their individual tax status/attributes. The REIT regime represents a tremendous opportunity for a well regulated, transparent, liquid, UK resident alternative, open to a broader investor base, and our response to Question 11 discusses a number of changes that should be made to it so residential REITs can emerge.
- 10.22 We believe that both the UK's REIT sector and the UK's PRS are incomplete in the absence of residential REITs. However, it is important to remember that neither the REIT nor any other vehicle represents the single vehicle of choice for residential investment. Different vehicles will suit different investors or categories of investors better – so a healthy legislative environment would be one that allows fund managers and investors to choose between them, just as it should accommodate different business models (with different levels of debt and property disposals for example). Our responses to Questions 13 and 14 discuss the main options in terms of vehicles for collective investment in residential property.
- 10.23 It is worth making it clear that investment by institutions should not be seen as a rival or replacement for buy-to-let, but as another important source of equity finance without which new housing cannot find its way into the market – particularly as debt finance for housing in its various forms is likely to be scarcer for the foreseeable future. The private investor will remain a key source of capital and investment in the PRS and

buy-to-let an important method of raising finance for housing. As an important component of the buy-to-let sector is the new entrants who start with a single rented property substantially financed using debt, reviving the buy-to-let mortgage market should therefore be seen as another policy imperative. It is from the ranks of those new entrants that the buy-to-let investors who build much larger, professionally run portfolios with lower gearing are drawn.

10.24 Partly in that context, it is worth noting that capital gains tax suffered by the seller of a rented property is one of the costs inherent in a thriving transactional market and rollover relief should be introduced for individual PRS so investment in a social good – housing – is maximised.

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

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

11.1 As explained above, the fundamental attributes of the residential property sector in the UK mean that, in order for an investor to obtain an attractive return having regard to their risk of investment, it is normally the case that property will need to be sold regularly to crystallise some profit to return to investors. This is because (unlike commercial property) residential property in the UK tends to produce a modest net income yield which cannot alone provide sufficient return to compete against other asset classes for institutional capital. The reasons for this characteristic of residential property are that:

- There is a disconnect between the amount that needs to be paid to acquire a property and the rents that are possible to achieve. This is because a landlord needs to compete with owner occupiers who do not value properties based on a multiple of rental yield (as would be the case for commercial property). The result is a low income yield but a high expectation of strong capital growth.
- Investors in residential property generally meet the cost of maintaining the property themselves (whereas these costs are generally met by the tenant of commercial property).
- Lease lengths of residential property tend to be relatively short term – typically 6 months (versus 5 to 21 years for commercial leases). This, coupled with the low individual unit value and rent, means that there is a potentially higher incidence of annual void periods and increased costs of re-letting.

11.2 The result is that rental yield alone is generally insufficient to deliver an acceptable return to investors. Furthermore, where a residential portfolio has even a modest amount of gearing (e.g. more than around 20%-25%), the rental yield may not be sufficient to meet financing costs. Generally, therefore, residential is seen as a total return asset class, with capital growth typically delivering two thirds of the return. As a result of that position, under current rules, some residential funds are treated as holding their property on trading account – something that is incompatible with the REIT regime. Even for other funds which hold their property on investment account, the investment/trading distinction (and the dramatic consequences of falling on the wrong side of it) can introduce a problematic degree of uncertainty, both generally and in the context of the REIT rules.

11.3 It has also been explained above that there are a number of aspects of the UK tax system which adversely affect the return to investors in residential property:

- The SDLT aggregation rules mean that a large scale investor suffers a higher effective rate of SDLT on bulk purchases than would be applicable to independent purchases of the individual units. That operates to reduce the gross income yield generated by the portfolio, as well as the total quantity of stock that can be acquired and the capital return that can be delivered.
- A residential landlord is unable to recover input VAT incurred on property repairs and renovation. The effect is to increase the costs which eat into the gross income yield, reducing the net income yield available to investors.

- The absence of any tax depreciation for investors in residential property also reduces the net income yield available to investors.
- 11.4 These issues also apply to residential REITs. However, in addition to this, we have described below the features of the UK REIT regime which represent specific barriers to investment in residential property through REITs. After describing each barrier, we make recommendations as to how it might be addressed with minimum disruption to the existing regime.
- 11.5 Of the five key factors outlined below, the first three (trading risk, interest cover ratio and distribution condition) derive from a mismatch between the current REIT rules and the existing attributes of the UK residential property market; the fourth factor (diverse ownership condition) has impacted on institutional investment in REITs and the fifth factor (entry charge) may impact on the launch of new REITs.

### **Legislative barriers to residential investment by UK REITs**

#### **Risk of disposals being treated as trading**

- 11.6 As explained above, in order to provide an acceptable return to investors, a residential REIT would need to dispose of property regularly in order to realise capital growth in value. Maximising this capital growth in a residential portfolio requires the asset manager to actively manage the portfolio and dispose of and acquire assets to anticipate or respond to changes in market sentiment.
- 11.7 A profit on a disposal of property may be taxed as either a trading profit or a capital gain. The dividing line between the two depends on principles derived from tax case law which are complex, uncertain and often contradictory. As a practical matter, however, it is probable that a residential portfolio is more likely than a commercial portfolio to be viewed as trading because of the larger number of individual transactions carried out by a residential landlord and the greater reliance on accessing capital growth in the investment proposition.
- 11.8 The distinction is critical to a REIT because a trading profit is fully taxable whereas a capital gain would be tax exempt (and under current rules would not be required to be distributed to shareholders). In addition, while it is possible for the returns in a REIT to withstand tax on a small proportion of its disposal transactions, if some transactions are characterised as trading by HMRC, it makes it more likely that the entire residential portfolio of the group will be 'tainted' and viewed as trading because one of the case law tests looks to the types of transaction that a property vendor would typically carry out.
- 11.9 Even if the portfolio is not so tainted, the treatment of individual property disposals as trading transactions could generate significant tax costs and, if there are enough such transactions, it is possible that a REIT could fail the condition of the regime that requires at least 75% of its assets to relate to its property rental business. In this case, it would lose its status as a REIT. A similar issue arises in relation to satisfying the 75% profits condition.
- 11.10 In bringing a residential REIT to market it is obviously critical that there is certainty over whether the vehicle will be able to meet the conditions of the regime and also that an accurate forecast can be made of the likely returns to investors, and hence the tax costs to be suffered. Given the lack of statutory definition on what constitutes a trading or capital disposal of property, this certainty cannot currently be obtained.
- 11.11 It should be noted that the issue of the trading/investment boundary is also important to non-REIT vehicles that may be used to invest in residential property because, for example, a pension fund would be tax exempt on a capital profit arising via a tax transparent vehicle such as partnership whereas it would be taxable on a trading profit. A non UK resident company has a similar issue. As a policy matter, the Government may wish to consider whether any proposed solution has general application in the context of residential property investment, or should be limited to REITs.

*Recommendation:*

- 11.12 We would recommend that a “white list” is introduced in the REIT legislation for transactions in residential property only, similar in concept to the definition of an “investment transaction” in the Authorised Investment Fund regulations (SI 2009/2036).
- 11.13 Those regulations essentially state that all transactions involving specified types of asset will be treated as investment transactions, regardless of the conclusion to which the application of case law principles might lead.
- 11.14 We would suggest adopting a similar approach and providing that all transactions involving interests in residential property will be treated as investment transactions, with profits accordingly being treated as tax exempt for the purposes of the REIT rules.
- 11.15 We discuss how ‘residential property’ might be defined (both for these purposes and, potentially, in relation to other suggestions made in this section) below.
- 11.16 We recognise that it may be appropriate to qualify that proposed rule so that, for example, disposals by house builders continue to be subject to normal case law principles.
- 11.17 We also recognise that, even within the context of large scale investment in the PRS, government may wish to set boundaries around automatic investment treatment. If so, one approach that we would support would involve a three step analysis:
- (1) A ‘gateway test’: Does the overall rate of ‘churn’ in the relevant portfolio exceed 20% of the total value of the properties at the start of the accounting period. If not, chargeable gains treatment applies to all disposals. If the churn exceeds this level, proceed to the next step.
  - (2) A ‘safe harbour’: Has the individual asset being disposed of been held for at least three years prior to disposal? If so, chargeable gains treatment applies. If not, proceed to the next step.
  - (3) If neither the portfolio test nor the asset test results in investment treatment, apply normal case law principles to determine the correct treatment.

**Interest cover ratio**

- 11.18 The legislation requires a REIT to meet an interest cover ratio between rental profits from exempt property and financing costs relating to this property of 1.25:1. The consequence of failing to meet this test is that the REIT is taxed on a notional additional profit that equals the amount of “excess” financing costs i.e. the amount of cost that caused the REIT to breach the ratio.
- 11.19 As explained above, net rental yields from a residential portfolio are typically low. With anything more than a modest level of gearing, therefore, it can be difficult to meet the ratio set by the REIT regime. While some institutional investors are likely to prefer a low gearing (which would not give rise to difficulties with the interest cover ratio), it is also common for large scale investment in the PRS to use higher levels of gearing, such that financing costs are often partially funded through realising capital uplift on residential properties. We recommend that the REIT rules should be rendered capable of accommodating both approaches.

*Recommendation:*

- 11.20 We would recommend that a REIT should be able to include tax exempt profits from the disposal of residential property in the amount of “profits” used to calculate the interest cover ratio if it is otherwise unable to meet the test. This would also have the merit of reflecting commercial reality on how the interest costs on the residential portfolio are met.

11.21 To the extent that a REIT needs to add disposal profits into the calculation in order to meet the test, that element of profits should then be subject to the distribution requirement. The policy objective of the interest cover ratio is to prevent a REIT from reducing its distribution requirement by introducing a high level of gearing. If the REIT does not wish to include disposal profits in the interest cover ratio because it does not wish to distribute further amounts of its profit, or indeed if it still fails the test having included all its available disposal profits in the ratio, it will be subject to the penalty in the normal way.

### **Distribution requirement**

11.22 A REIT is required to pay out 90% of its rental profits to shareholders year on year. Rental profit for these purposes is calculated as for a corporation tax computation. In a commercial property portfolio, the amount required to be paid out is significantly reduced, therefore, by the availability of capital allowances. However, capital allowances are not available on residential properties (a concessionary wear and tear allowance of 10% of net rents is allowed as a tax deduction against rents from furnished residential lettings only).

#### *Recommendation:*

11.23 There are two broad approaches to this issue with a view to making it easier for a residential REIT to meet the distribution requirement.<sup>18</sup>

11.24 The first approach is conceptually REIT specific, and would involve reducing the distribution requirement for a REIT's residential investment business profits to, say, 80% (see below for how one might approach defining 'residential property').

11.25 The second approach would be to allow REITs to calculate the profits of their residential property rental business (whether furnished or unfurnished) by applying a notional wear and tear allowance (similar to that currently available for furnished lettings). This solution, while not conceptually REIT specific, would operate to reduce the amount that a REIT holding residential property needs to distribute with no more than a modest revenue impact – it would chiefly operate to soften the impact on residential REITs of the 90% distribution requirement.

### **Legislative barrier to institutional investment in UK REITs**

#### **Diverse ownership requirement**

11.26 The current legislative form of the diverse ownership requirement may be an impediment to institutional investment in a REIT. For example, a listed company held by five major pension funds and life companies could fail this requirement despite all these institutional shareholders being diversely owned themselves. This could prove to be a barrier to large-scale institutional investment in residential REITs. The diverse ownership requirement is as described below.

11.27 The REIT regime requires that the principal company of the REIT group should be widely held by investors. The test is based on the 'close company' rules already available in the tax legislation, but with some modifications. Without these modifications, a REIT which is controlled by a corporate shareholder which is not itself 'close' would be able to meet the close company requirement.

11.28 The original policy reason for the modifications to the close company rules as applied to REITs was to prevent a REIT from meeting the test simply by being held by a single large corporate. This might, for example, have enabled 'internal' REITs to be set up within an occupier group. This situation, however, could now be prevented by use of

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<sup>18</sup> We note, in this context, the Government's recent announcement of an intention to allow the 90% distribution requirement to be satisfied by an issue of new shares, allowing scrip dividends to be used to improve cash retention by REITs generally. While that will be very welcome, we do not believe that it is sufficient to support residential investment in REITs, because scrip dividends should be an option available to a REIT, not something on which it is structurally reliant.

the Prescribed Arrangements Regulations brought into effect in 2009 and the modifications are therefore no longer required to meet that policy objective.

- 11.29 Furthermore, there are arguably good policy reasons today for making it easier for organisations (for example, financial institutions which have repossessed numerous properties) to assemble a portfolio within an initially wholly owned or closely held REIT which might gradually be sold out into the market.
- 11.30 The removal of the modifications would make it more likely that any new REIT would be able to get off the ground as, especially in the early stages, there is likely to be a concentration of share ownership. The promotion of new REITs is especially important in the context of residential assets as there are currently very few existing large residential portfolios within corporate structures which could easily convert to REIT status.

*Recommendation:*

- 11.31 The REIT rules should be amended to change the 'close company' test such that a REIT is no longer precluded from taking advantage of s444 or s447(1)(a) CTA 2010 to meet the test.
- 11.32 Furthermore, (once re-instated) the exceptions in s444 and s447(1)(a) should be further relaxed so that the close company test can be met where a REIT is controlled by diversely owned entities that are not companies (such as registered pension schemes, fund of funds, ISAs, or overseas REITs).
- 11.33 A list of permitted entities could perhaps be set out in a statutory instrument, in a similar way to Regulation 7 SI 2006/2867. We would point out that there is already a precedent for relaxing the close company rules in the REIT context (in respect of limited partnerships).

### **Financial barriers to investment in UK REITs**

#### **Entry charge**

- 11.34 The current entry charge requirement is another key factor which is stifling the formation of residential (as well as commercial) REITs, because it is very difficult to justify paying it in connection with the launch of a new REIT which assembles a new portfolio and has no deferred tax provision in respect of latent gains.
- 11.35 The entry charge is calculated as 2% of the gross market value of the property assets held at the point of conversion to REIT status. The policy purpose for the entry charge was expressed by HMRC at the time of the initial launch of the regime as being to ensure that the introduction of the regime was cost neutral for the Exchequer. The entry charge therefore needed to equate to the present value of the future loss of tax to the Exchequer as a result of gains on sale of properties and rents being exempt from corporation tax. Gains on sale comprised both latent gains at the time of conversion and potential future gains.
- 11.36 Property businesses converting, or considering conversion, to REIT status have overwhelmingly tended to regard the entry charge as a quid pro quo for being able to write off existing latent gains. It was largely on that basis that the UK's existing listed property companies – which generally had substantial latent gains at the point of conversion – concluded that it made sense to enter the REIT regime and pay the charge.
- 11.37 That logic does not apply for new entrants. Where a new portfolio has to be acquired, there are no latent gains at the point of conversion. An entry charge calculated in this way therefore results in a significant cost compared to the benefit obtained by entry into the regime. That cost is difficult to justify commercially, and has led to many potential (generally commercial) REITs choosing a different structure capable of delivering tax efficiency without the cost of the entry charge.

11.38 Indeed, the Government needs to appreciate that tax efficiency for property investment is available through the use of different vehicles, each of which has its own attributes and characteristics (which particular investors may view positively or negatively), but none of which is subject to an entry charge. Entry charges such as that for access to the UK REIT regime are also unusual in REIT regimes internationally.

11.39 A number of existing tax efficient residential funds which might consider converting are substantially held by UK pension funds and life companies. As such investors may not pay tax on capital gains, here too, it is extremely difficult to make a commercial case for paying the entry charge.

*Recommendation:*

11.40 The entry charge is a major barrier to the emergence of new REITs (as opposed to conversion by groups with existing portfolios), both residential and commercial, because the way it is calculated exaggerates the tax benefits from entry into the regime.

11.41 If the Government wishes to encourage the emergence of new residential REITs (and growth of the REIT sector more generally), we would recommend a time-limited entry charge 'holiday' (along the lines of the stamp duty holidays with which we are familiar). The holiday should last at least two or three years, recognising the lead in time for assembling a new portfolio and launching a new REIT. Existing anti-avoidance provisions provide ample protection to ensure that the regime is not used in an inappropriate way to derive tax benefits outside the policy objective.

11.42 An alternative approach would involve not automatically (or not wholly) linking the entry charge to the market value of the relevant portfolio, but instead linking it to the amount of latent gains in that portfolio (possibly at the election of the relevant REIT).

**Other factors**

11.43 We have previously identified other issues which may militate against residential REITs being launched in the UK. In this response, we have deferred them to this final section because we consider them to be less critical, and so lower priority, than the points discussed above. In particular, those other issues include:

- The requirement that REITs list on a recognised stock exchange and therefore incur the costs of this listing.
- The lack of rollover relief which would enable vendors of residential property (whether buy-to-let investors or institutions wishing to reduce their exposure to an existing portfolio), to exchange their properties in return for shares in a REIT without the crystallisation of capital gains until a later disposal of those shares (as discussed briefly at the end of our response to Question 10 above).

**Defining residential property**

11.44 There are numerous existing definitions of residential property in UK statute law, including for different stamp duty, VAT and capital allowances purposes. To the extent that the REIT rules might be amended for residential property only, we would suggest that a simple definition would be attractive, probably identifying residential property by reference to its key characteristic of occupation (or intended occupation) as a person's home. We would be very happy to assist officials in exploring how residential property might best be defined for these purposes.

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

- *The available evidence is generally theoretical and anecdotal, with the experience of other countries of very limited help in predicting how changes to the specific UK REIT environment would impact on market behaviours.*
- *There is no reason to believe that UK-REITs investing in commercial property would be disadvantaged by measures designed to support the emergence of residential REITs – and they may benefit, either directly or simply through the growth of the UK REIT sector overall.*

- 12.1 We believe that certain relatively modest changes to the existing REIT rules, as set out in our response to Question 11 above, are required to create a viable UK-REIT market specialising in the residential property assets.
- 12.2 Institutions invest on an asset allocation basis. The residential property asset class is clearly different from the commercial property sector. Importantly, it has a weak correlation with commercial property (and other asset classes), rendering it a good risk diversifier as part of a balanced portfolio. For that reason, we would expect new residential REITs to complement, rather than compete with, the existing commercial REITs, supporting the expansion of the UK REIT sector and bringing greater specialisation – both features likely to attract more capital to UK property overall, particularly from global and institutional investors. None of the commercial REITs in our membership have expressed concerns about residential REITs restricting their access to capital. Neither have we seen any evidence from the United States to suggest that the housing sub-sectors of the REIT market impact negatively on other sub-sectors. It is true that one would typically expect an institution to make a single allocation to property to cover both commercial and residential (if any) – but the size of that single allocation can and does vary significantly over time, it is not a zero sum game whereby a pound allocated to residential is a pound taken away from commercial.
- 12.3 Institutions are wary of investing in sectors with low net income yields (as in the case of the residential property business model). Lowering the barriers identified in our responses to Questions 10 and 11 would help to increase the income yields generated by residential property. Having said that, it seems to be an inescapable fact that residential property is a total return investment proposition, with 2/3 of the total return typically resulting from capital growth. As explained in the response to Question 11, reducing the trading/investment uncertainty affecting residential portfolios (particularly in the context of REITs, where particular problems arise) should help institutional investors to get comfortable with the total return nature of residential property.
- 12.4 Institutions are also unable to invest where sufficient scale of investment product is not available. The slight modifications to the rules that are required to accommodate the residential business model will make it easier for a residential REIT sector (and residential funds more generally) to emerge, thus allowing for that scale of investment product to become available.
- 12.5 Offering investors another class of investment (residential) in this way will assist in the delivery of the Government's vision and policy objectives set out in 'Promoting more flexible investment in property: a consultation' through the REIT regime. We acknowledge that there is limited concrete evidence to substantiate this view, but we would also point out that a number of UK residential property companies have cited legal rules which are at odds with their business models as the reason for not converting to REIT status.
- 12.6 Ultimately, asset allocation decisions by investors are not likely to be materially influenced by the availability or otherwise of one particular 'wrapper' (vehicle or structure), unless there is an absolute lack of acceptable alternatives. We do not consider that to be the position here: the fact that REITs are currently unavailable for residential investment is disappointing, and may have prevented a small number of

conversions. However, the success of the commercial UK-REIT sector so far owes nothing to the unsuitability of REITs for residential investment – and it is the broader changes discussed elsewhere in this response, not changes to the REIT rules alone, which are needed to prompt the emergence of a residential PRS on a large scale.

- 12.7 The changes we have recommended in our response to Question 11 would make it possible for REITs to invest in residential property, either alone or alongside commercial property. Two of the most useful of those changes – modifying entry charge and reducing trading/investment uncertainty – as well as some of the others (like amending the diversity of ownership test) would deliver real benefits to the wider REIT sector if they are implemented generally (as we would recommend), rather than being limited in their scope to residential investment through REITs.

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

- *Different vehicles with different characteristics (e.g. listed or unlisted, open or closed ended) will be appropriate for different investing models (e.g. geared or ungeared, fixed or indefinite life) and different target investor types (e.g. retail or institutional). It is vital that a range of different investing options should exist.*
- *Cost efficiency (including as regards tax) is a key consideration at the outset, particularly in the context of the modest income yields offered by residential.*

- 13.1 There are a wide range of potential collective investment vehicles for residential property investment. The table set out as an appendix to our response to Question 14 sets out some of the most common investment vehicles, by way of example.
- 13.2 In choosing an appropriate investment vehicle, particularly in the residential sector, where the income yields are low, cost efficiency will be crucial. This will clearly include tax efficiency in the vehicle itself, as well as any additional costs that could further reduce the yield and make the investment less attractive when compared with alternatives. While many fund managers would like to use a UK vehicle where possible for practical reasons, particularly if aimed at the UK market and UK real estate assets, in practical terms the need to achieve tax efficiencies where possible - in particular VAT in the residential sector and stamp duty on transfers of units - is often driving them to use non UK situs structures.
- 13.3 Precisely which vehicle is selected for any particular fund will depend on a number of factors. These factors will depend on the product offered and the detail of the business plan - for example is the fund to be open or closed-ended, of fixed or indefinite life, geared or ungeared.
- 13.4 Another relevant factor is the make-up of the investor base – is the investment to be marketed to the public at large or, say, only institutional investors?
- 13.5 Where a fund is aimed at the public the options are closed-ended vehicles, like ordinary listed companies (which are, however, not tax efficient) or REITs (their tax efficient equivalent), or open-ended vehicles such as a property authorised investment fund (“PAIF”). REITs could also be used for products aimed at sophisticated investors, as could “PAIFs”, possibly structured as a Qualified Investor Scheme (“QIS”).
- 13.6 Non-UK income transparent structures, such as the offshore property unit trust (e.g. the Jersey Property Unit Trust or “JPUT”), are popular in the institutional commercial property market and are fairly flexible. There is, for example, no tax leakage in the fund for exempt investors and capital gains can be rolled up in the vehicle tax free, where appropriate. Also, there are no regulatory constraints in terms of financing, units in the fund can be traded without stamp duty, stamp duty reserve tax or SDLT and management fees are outside the scope of VAT. The UK unauthorised unit trust could also be useful, being tax efficient for income and gains for institutions, although they are more constrained in terms of the investor base, being restricted to UK exempt funds and life companies.
- 13.7 The challenges identified elsewhere in this response generally apply for residential investment regardless of the particular vehicle chosen. However, certain vehicles present additional problems. Those affecting REITs are discussed in our response to Question 11.
- 13.8 PAIFs, which could be attractive open-ended vehicles for sophisticated investors looking at residential property, continue to grapple with the challenge of dealing with the three streams of income required by UK tax rules and the low gearing threshold may make the Non-UCITS Retail Scheme (NURS) unattractive to certain business models (specifically, where gearing is required) – though both these aspects may be manageable in a fund for sophisticated investors only.

- 13.9 Offshore structures have additional costs and practical implications that need to be built into the business model as a result of the need to be run overseas. This is particularly important in a low yielding model. The regulatory cost likely to be imposed on property funds by the EU Alternative Investment Fund Managers Directive and potential adverse affect on marketing into the EU may also impact on use of these structures in the future.

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

- *A number of the alternative available structures have greater flexibility for achieving lower costs (including tax costs) than REITs, because REIT specific requirements (such as the payment of conversion charge or the need to obtain a listing) do not apply.*
- *The alternatives also generally have more general business flexibility (e.g. because there is no balance of business test to satisfy).*

14.1 Appendix 2 sets out in tabular form some of the principal differences between REITs and some of the more common alternative residential property investment vehicles.

14.2 The principal differences are:

- for start-ups, the alternatives do not have to pay the listing costs or the conversion charge required in the REIT. This effectively improves the returns those alternatives can deliver;
- PAIFs and the offshore vehicles are able also to benefit from not having to pay UK VAT on management fees, either through the availability of an exemption (as in the PAIF) or through the supply being outside the scope, again improving yield;
- save for the PAIF structures (which are subject to certain constraints in order to be able to benefit from the tax benefits, some of which were referred to in the response to Question 13 above), the alternatives are generally more flexible than the REIT structure. There is, for example, no limit on the amount of finance available (subject to the usual rules on transfer pricing etc) and there is no balance of business test that must be satisfied to be sure that the intended tax consequences will remain available. There is also, generally, no constraint on the holdings of any particular investor nor any restriction on the payment of dividends to any corporate investor owning 10% or more, which may be important as institutions investing will be likely to include UK life companies, who may wish to take a substantial interest;
- dealing with distributions and funding of expenses is likely to be more flexible with the ability to have accumulation units etc. (again, putting REITs at a disadvantage relative to most of the alternatives); and
- retail investors (including ISAs) are not able to invest in the alternatives (other than the PAIF NURS and the offshore listed company), effectively restricting investors to the institutional market. If the Government would like to encourage the public to invest in residential property indirectly (rather than only directly in bricks and mortar as tends currently to be the case) enabling them to do so through UK-REITs would be an extremely important step.

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

- *The need for increased housing supply is undeniable, as is the recent phenomenal growth in the private rented sector, current constraints on mortgage finance and lack of public finance for housing.*
- *Institutional investment could help underpin housing supply and therefore provide support for the construction sector.*
- *Against the backdrop of the credit crunch making the sector less reliant on debt may also be seen as a good thing.*
- *On a more practical level institutional investment would bring tangible benefits in terms of service innovation, quality assurance, and a broader range of opportunities for investors to invest in housing.*

- 15.1 The private rented sector is large and growing. It houses a sizable number of households who, for different reasons, are unable or do not wish to access the owner-occupier market. This is a key point at a time when house building output is low and funding affordable housing is a major challenge against a reduction in Government spending.
- 15.2 The PRS is part of the wider affordable housing market and for many is more accessible than grant-funded, low-cost home ownership products which have been the primary way of meeting housing demand for those who can access social housing. The PRS also punches well above its weight in housing market liquidity terms, accounting for half of all moves a year in the private housing market, something that is vital in supporting labour mobility and economic growth.
- 15.3 A sizable proportion of privately rented homes are owned by private landlords that deliver a decent offer (66% stock is decent and satisfaction rates are higher than those for social housing). This group will continue to play an important role and they should be encouraged to do so.
- 15.4 The PRS needs an approach that sees an increase in new supply to deliver greater choice of quality supply for households through investment. The growth in the PRS over the last 10 years has come largely from individual investors, who have benefitted from tax and leverage benefits. Institutional investment is more likely to be lowly (if at all) leveraged, which will help reduce house builders, developers and constructions companies' dependency on the banking sector at a time when finance from this source is extremely limited.
- 15.5 Residential investment has a very low correlation with other institutional asset classes and so has attractive characteristics in terms of portfolio diversification. Therefore, once engaged; and providing the regulatory environment does not change detrimentally, institutions are likely to invest consistently in the sector in the long term. Experienced investors have the financial scale and commitment to encourage the provision of 'build to rent' properties from new entrants, such as construction companies and mixed use developers. This in turn will help underpin the construction industry, which employs nearly 1.9m people (ONS, Q1 2008), and maintain the number of newly-built properties at times when the house building sector may see only limited owner-occupier demand.
- 15.6 Reputation is of key concern to institutional investors. Given this, they will be concerned to channel their funding to the most responsible managers - those that will meet or exceed the Government regulatory requirements for the sector; have a vested interest in maintaining their properties and being responsive to the Government's energy saving targets and ensure that the quality of build-to-rent properties is improved.
- 15.7 As with the commercial property market, given the appropriate legal and tax regimes, experienced fund managers would promote long-term investment vehicles to attract

individual and overseas investors. This would provide still greater funding for the increase and improvement of the PRS stock.

- 15.8 There is clear evidence that can be drawn from existing activity that institutional investment would be beneficial, but also a lot of claims and counter claims that cloud the issue.
- 15.9 It is probably unhelpful to make comparisons with rental markets abroad, the USA or Germany, for example, which have very different housing and planning conditions, availability of land, etc. A larger institutional sector in the UK will reflect UK conditions, although if attractive, could attract capital from beyond our shores.
- 15.10 What the evidence shows is that a UK institutional sector would deliver:

### **Support for development**

- 15.11 The buy-to-let sector over the past decade has illustrated the importance of investment sales to housing delivery. Off-plan sales to buy-to-let investors have reduced risk for house builders, particularly on riskier products, such as high density flats. A source of long-term development capital that similarly is prepared to commit to buying stock before completion will be beneficial to development and will therefore help deliver more stock overall. That in turn will mean more construction jobs and the benefits that flow from additional economic activity.

### **Less exposure to debt markets**

- 15.12 If the big pension and life funds can be encouraged to invest in the sector, it will provide relatively patient money for housing. Debt itself can be very helpful and generally the £140bn of debt that buy-to-let has raised over the past decade has meant significantly greater finance for housing. That debt, however, has in large part been raised off the back of peoples' equity - smaller investors being prepared to put some of their savings in housing. Attracting more long-term equity finance into the sector, will help to ensure a better balance of sources of finance for the sector and less exposure to changes in interest rates. That is not to say that all institutions will be totally ungeared, but they are likely to raise the majority of their funds as equity, and that should make a positive contribution to the stability of the UK's housing market.

### **Innovation in services and service delivery**

- 15.13 The student sector has illustrated that new innovative players in a sector can make an impact beyond their own activities. Companies like Unite in the student sector have had an impact far beyond their own direct activities, forcing universities to consider the quality of their own provision and smaller landlords how they will differentiate themselves in the market.
- 15.14 Unite and the like are providing greater choice in the market. Customer satisfaction levels are very high. New concepts, such as branding are being introduced to the sector – not something that would be seen as innovative to other sectors, but that is currently rare in the private rented market. With branding come service delivery standards and the qualities that are embedded in a brand. Service itself has benefitted from competition. For example, the broadband access that private student accommodation providers have introduced has become commonplace also in university provided accommodation. Being able to book your accommodation online, again may not sound innovative, but should be as commonplace in the PRS as it is in booking a hotel.
- 15.15 The competition in the student sector is not all one-way traffic. The larger private providers have adapted their product over the years to incorporate some of the things that make smaller student houses attractive, for example, allowing a group of friends to co-ordinate their booking of a group of cluster flats.
- 15.16 The growth in the private provision of student halls has also helped alleviate housing pressures in some local markets.

## Quality assurance

- 15.17 There is a lot of claim and counter claim about the quality of private rented accommodation and what institutions can provide. What can be said with confidence is that an institutional sector will be different offering some aspects of service that small landlords cannot provide.
- 15.18 One aspect of institutional provision that it is not so easy to replicate with small landlords is direct redress. Institutions that sign up to the BPF's Code of Practice are required to provide independent third party redress to tenants via the Housing Ombudsman or Surveyors Ombudsman. Currently small landlords provide redress for tenancy deposits via one of three Government schemes, but not wider independent redress directly, although indirectly if they work via a professional agent about 50% will have access to redress via the agent's membership of RICS, ARLA, NAEA or NALS.
- 15.19 Another differentiation between larger and smaller landlords will be in blocks of flats. With an institution the block management and lettings management would mostly be done by one firm, meaning the management of the whole entity is relatively seamless. This is something institutions strive for to maximise co-ordination and economies of scale, although sometimes a social housing element to the development can hamper that. By contrast, individual investors will sometimes manage the letting themselves or via their agent. For the block as a whole there will then be a managing agent. Where there are problems, for example anti-social behaviour, this can be problematical in terms of co-ordinating a response, for example who does the tenant complain to – the landlord, letting agent, managing agent of the flat, or managing agent of the block?
- 15.20 Large landlords may also be able to on-sell other services to tenants at discount. Cable TV, high speed broadband or telecoms for example, which a small landlord cannot negotiate.
- 15.21 Standardisation may also be seen as a benefit, in terms of branding and the values and service standards that encapsulates. As the student sector has shown, however, some tenants prefer a small landlord and the 'personal' service they provide, and a small landlord can be very good at pastoral care and providing a more flexible service.

## Greater choice for investors

- 15.22 Much of the focus of this response has been on the economic and social benefits for expanding the PRS for Government and occupiers. Supporting growth of an institutional sector, however, should also bring benefits that Government would want to see for investors. At present, for the 'man in the street' wanting to invest in housing, the only avenues are to buy for oneself or as an investment for others to occupy. Both of these avenues usually involve significant gearing, exposing the buyer to interest rate risk. There are many groups in society who probably benefit from being able to make a collective investment in residential property. The saver, who wants the returns residential can offer without having to invest in the whole property by way of a loan. Also, today's youth is going to find it harder to get on the housing market without parental help. Being able to save for a deposit in a product that is shadowing house prices would seem to make a great deal of sense. At the other end of the investment spectrum, making it easier for institutions to invest in the sector should have benefits in terms of creating a more liquid market and allowing investors to more easily diversify their holdings.
- 15.23 To conclude, institutional investment is needed to support housing delivery and the development sector. Having a sector that is less reliant on debt will bring economic benefits and reduce volatility. Institutional investors will also bring service innovations and different standards. Through their investment in new build the standard of accommodation in the sector will rise and indirectly, through innovation, competition and difference it should help raise the quality of the PRS overall.

## **APPENDIX 1 – PROPERTY INVESTMENT CLUBS**

Unregulated PICs became synonymous with the housing boom. Typically, would-be investors would be offered a free evening seminar promoting the benefits of investment in property, focusing particularly on the potential for large capital gains and the ability to buy with little or no money down. In many cases more in-depth seminars, commonly a two-day course over a weekend, would be promoted at a cost of up to £5,000. Even larger sums would then be charged for club membership.

The main purported benefit of membership was that the club could negotiate significant bulk discounts by sourcing property direct from developers and passing these discounts onto its members. However, the discounts were often more illusory than real and lending on the back of such deals was more risky than appeared because of the lack of transparency around the incentives paid by builders to the buyer or to the club. Deposits paid by borrowers often turned out to have come from the builder, so the reported loan-to-value was distorted.

Not surprisingly, in the wake of the downturn property investment club activity has become subdued, while the introduction of the CML disclosure of incentives form, which builders must now complete before lenders will grant a mortgage, has increased the transparency of new build transactions. The new build market is thus likely to be less beset by the problems that have arisen over recent years.

PICs also benefitted hugely from the distortion in the SDLT system, individual investors paying only the unit rate, whilst benefitting from bulk purchase. A single large scale investor, by contrast, would have to pay SDLT at the rate attributable to the total price, which might be three or four per cent higher.

**APPENDIX 2 TO QUESTION 14: COMPARISON OF DIFFERENT RESIDENTIAL INVESTMENT VEHICLES**

	<b><u>REIT</u></b>	<b><u>Limited Partnership (LP)</u></b>	<b><u>JPUT/ELP</u></b>	<b><u>PAIF (OIS)</u></b>	<b><u>PAIF (NURS)</u></b>	<b><u>Listed closed-ended offshore company</u></b>	<b><u>UEUT</u></b>
<b>Suitable investor type</b>	Suitable for marketing to all  Not fully tax efficient for offshore investors	Not retail	Not retail	Sophisticated investors only	Suitable for all	Suitable for marketing to all  Not tax efficient for UK tax-exempt investors	UK exempt investors / s.431 life companies
<b>Open/closed-ended</b>	Closed	Either	Either	Open	Open	Closed	Either
<b>Conversion charge</b>	2%	None	None	None	None	None	None
<b>Listing costs</b>	Yes	No	No	No	No	Yes	No
<b>Gearing restrictions in vehicle</b>	No limit, but 1.25:1 profit:financing ratio	None	None	100% of Net Asset Value  and 1.25:1 (profit:financing ratio)	20% of Net Asset Value	None	None
<b>Management jurisdiction</b>	UK	UK (assuming ELP)	Jersey for JPUT/ UK for ELP	UK	UK	Typically Guernsey/Jersey	UK
<b>Tax in vehicle</b>	PRB <sup>19</sup> : income and gains exempt  Residual taxable	Tax transparent	Transparent for income  Exempt for gains <sup>20</sup>	Nil	Nil	20% on net income  Exempt for gains <sup>20</sup>	20% on income, paid out as annual payment

<sup>19</sup> Property Rental Business

<sup>20</sup> Provided managed and controlled offshore

<b>Potential withholding tax</b>	20% on property income distribution (unless gross recipient)	20% on rent to non-residents (unless NRL clearance in place)	20% on rent to non-residents (unless NRL clearance in place)	20% on interest and property distributions	20% on interest and property distributions	None	20% (credited against tax in vehicle)
<b>Streaming</b>	2 streams	None	None	3 streams	3 streams	None	None
<b>Distribution requirements</b>	90% of PRB income	None	None	100% of income	100% of income	No	None
<b>Potential close company issues</b>	Yes	No	Yes	No, but widely held requirement	No, but widely held requirement	Yes	No
<b>VAT on management fees</b>	Yes	Yes (assuming ELP)	Yes in ELP	No	No	Yes	Yes
<b>SDRT/ SDLT on transfer of units</b>	0.5%	4% SDLT	No	0.5% Schedule 19	0.5% Schedule 19	No	0.5% Schedule 19
<b>ISAable</b>	Yes	No	No	No	Yes	Yes	No