

**REVITILISING THE PRIVATE**

**RENTED SECTOR**

**EXECUTIVE SUMMARY**

* This report represents a response from the Residential Landlords Association to Professor Michael Ball’s recent Report on investment in the private rented sector (PRS).
* Much of the apparent boom in the PRS is as a result of increasing numbers of “accidental landlords” who rent out property not by choice, but as a result of the housing market. Once market conditions improve, there is the potential for significant disinvestment in the sector as such landlords seek to sell their properties.
* Prof. Ball calculates that annual tax on rental income paid by England’s 3.4 million market tenancies totals £3.5 billion – equivalent to £1,000 per tenancy or 17% of tenants’ average annual rent costs. This compares with owner occupiers who save £11 billion annually in tax on the (imputed) rental values of their properties. A further £8.8 billion is saved in capital gains tax also on the disposal of main residences.
* Prof. Ball highlights that disinvestment is also resulting from, in some cases, a neglect of continuous property maintenance and improvement. High tenant demand, matched with insufficient supply of accommodation and the impact of the tax system has the potential to lead to lower standards.

* Given such dangers, and the on-going rising demand for rented property, policy needs to support and encourage investment in the sector, whilst regulation is targeted on the minority of landlords who bring the sector into disrepute.
* The Ball Report makes a compelling case for change to sustain a responsive PRS where landlords will continue to invest in and improve property. Importantly there needs to be a more appropriate and fairer tax regime, for tenants who ultimately pay the tax through their rents and for landlords to help stimulate new investment. This would be revenue neutral. We propose:
* Roll over-Relief for Capital Gains to encourage landlords to re-invest in rental property.
* Entrepreneur’s Relief for CGT to bring the sector in line with other businesses and encourage disposals where the proceeds are not to be re-invested.
* Capital Allowance for enhanced repair – recognising that property devalues as is it is lived in and periodic refurbishments are essential.
* Self-Invested Pension Plans (SIPPs) should be allowed to be used to buy residential accommodation for a limited period and with certain conditions geared at boosting rented supply.
* An expanded landlord’s energy saving allowance (LESA) needs to be incorporated into the general allowance for improvements to cover a wide range of energy efficiency improvements.
* To bring empty homes back into use, all publicly owned empty accommodation should be subject to an auction to include landlords in the private rented sector. A one year deadline should be imposed for the property to be let to encourage swift investment in the property sold.
* Greater use should be made of robust accreditation schemes to enable local authorities to better use finite resources to target those landlords who fail to provide the service to which tenants should be able to expect. Such accreditation should be used as a driver to improve standards.
* Councils should reconsider their use of article 4 directives which re-strict the development of Houses of Multiple Occupancy. With changes to the Shared Accommodation Allowance, increasing numbers of young people will be dependent on shared housing at a time when many authorities are using the planning system to restrict their availahility.

**1.0 BACKGROUND**

The Residential Landlords Association commissioned Professor Michael Ball from Reading University to produce a major report on investment in the private rented sector (“PRS”). Prof. Ball is an acknowledged expert on the sector.

Published in November 2011, his Report is unique because it is based on detailed financial information provided by around 600 landlords. He has created a financial model which shows the costs to landlords of providing accommodation. This calculates returns on landlords’ investments and shows that real rates of return are very low. Also, for the first time the Report makes a detailed assessment of the impact of tax and particularly how this adversely affects tenants who rent accommodation from a private landlord.

The financial crisis following the credit crunch has profoundly changed the PRS. Outside certain hotspots, particularly in London, house prices have fallen by an average of over 20% in real terms since the peak in 2007 and there is no realistic prospect of any real capital growth for some years to come. Speculation, in the boom years, on property price rises became the basis for investment and contributed to overheating in the market. The ability of rent to service debt was inflated by the availability of interest only products. Short-termism displaced the long-term view of traditional landlords who still pre-dominate. With the lack of capital growth, the emphasis has now to be on rental income.

**1.1 The Housing Shortage**

Everyone is agreed that we do not have enough housing. We have a growing population and household sizes are getting smaller which also means that more accommodation is needed. This shortage is now the cause of rent increases and as David Newnes, Director of LSL Property Services warns:

*“across the country, the limited supply of rental accommodation means there will still be strong upward pressure on rents in the early part of 2012.”*

In the immediate future it is going to be more difficult for owner/occupiers to get mortgage finance and this sector has been shrinking. It is likely that we will increasingly replicate the continental European model with much greater dependence on the PRS. The RLA has taken a hard look at its own policies and reviewed them in the light of Prof. Ball’s findings. This paper sets out a plan which we strongly believe will help promote a healthy thriving PRS throughout Great Britain and ensure that tenants can access the accommodation they need at a reasonable price and a standard they should have a right to expect.

**2.0 THE CURRENT STATE OF THE PRIVATE RENTED SECTOR**

If the press headlines are to be believed, everything for the PRS landlord is rosy. Far from it, according

to the Report by Prof. Ball who sees the spectre of disinvestment hanging over the sector, with a prospect of low, future returns. Those prospects are generated by constraints on real wage and house price growth as the UK continues to experience slow growth and constrained mortgage availability. In such a context, many PRS landlords will want to get out. These will be involuntary landlords who are renting out properties which they cannot sell but will do so as soon as property values start to increase in order to make a capital gain on their investment. As Ian Cowie, Head of Personal Finance at ‘The Daily Telegraph’ wrote in July last year:

*“A growing army of ‘accidental landlords’ is being created by the stand-off between potential homebuyers unwilling to overpay and would-be vendors reluctant to cut asking prices.*

*“According to Land Registry figures, the number of homes sold last month has collapsed to little more than a third of the level seen a decade ago. That means many inheritors of property and those who would like to trade down on retirement are letting rather than selling.”*

Prof. Ball highlights another form of potential disinvestment as well, resulting from the need for

continuous property maintenance and improvement. High tenant demand, matched with insufficient supply of accommodation and an inefficient tax system, unfortunately, gradually leads to lower standards which lead to effective disinvestment.

Another factor highlighted in Prof. Ball’s report is that returns from the housing market have now entered

a more volatile era than in the decade up to 2007. Boom conditions then also depressed many investors’

risk perceptions. Greater risk will remain a feature of residential investment returns. In consequence, investors will require higher risk premiums. This will further raise required yields.

**2.1 Investment Returns**

Now that substantial annual capital growth is no longer likely for the foreseeable future, rental income relative to house values has to be the driver for investment. As rents have been rising in absolute terms, the perception is that landlords must be getting an ever-increasing return. In reality, as Prof. Ball demonstrates in his Report, the impact of inflation, the rising costs of repairs, greater regulation and the adverse impact of current tax policies, mean that rental yields are historically low. He argues:

*“To sustain landlord investment, gross rental yields have to rise back to the much higher levels that existed in the late 1990s and early 2000s, prior to the dual house price and buy-to-let booms of the 2000. They depressed rental yields by encouraging an unsustainable surge in private rental supply. The market has yet to readjust back to more viable combinations of rent levels and supply.”*

Furthermore, as the Treasury’s own paper on Investment in the PRS, published in February 2010 concluded:

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

Yields have to be improved without making rents unaffordable. Reforming the PRS tax regime would assist this process along with making the tax system more equitable for tenants. Further assistance would come from reforming the regulatory regime applying to the sector. Professor Ball notes that regulation has the net effect of:

* Raising landlord costs.
* Increasing landlord administrative time.
* Heightening risks because of the liabilities associated with regulations.
* Elevating the ‘hassle-factor’ of being a landlord.

**2.2 Impact of Taxation on the Private Rented Sector**

When it comes to property taxation, the two key taxes are income tax (or corporation tax for companies) on rental income and capital gains tax when a property is sold. The PRS is at a disadvantage in comparison to the social sector and owner/occupiers. In the social sector the landlord will either be a housing association (which is a charity) or a local authority. Neither pays these taxes. Owner/occupiers are in a particularly privileged position with their main home exempt from capital gains tax and no tax on owning your own home.

The Ball report calculates that annual tax on rental income paid by England’s 3.4 million market tenancies totals £3.5 billion – equivalent to £1,000 per tenancy or 17% of tenant’s average annual rent costs. This equates to the vast majority of the Government £4.5 billion affordable homes programme and compares with owner occupiers who according to Wilcox and Pawson save £11 billion annually in tax on the (imputed) rental values of their properties. A further £8.8 billion is saved in capital gains tax also on the disposal of main residences.

Furthermore, on top of rental taxed, capital gains tax is payable by landlords, typically at the rate of 28% at the time of sale. In 2007-08, over 100,000 sales of residential land and buildings provided the Inland Revenue £5.7 billion, many of which would have been of rental housing.

As Prof. Ball points out, it is important to realise that as with any other product or service, much of the tax notionally paid by the provider (i.e. the landlord) is in fact paid by the consumer (i.e. the tenant) even though this is indirect. The pass through is high given the relative elasticities of demand and supply in the private rented sector. Landlords therefore set rents to allow for taxes.

Furthermore, a landlord, unlike other businesses, gets no tax relief if they make a capital gain even though they then reinvest the sale proceeds back into a new property. Normally, a business gets roll-over relief from capital gains tax but a landlord letting out property cannot claim this relief. What is more, PRS landlords cannot claim tax relief straight away when it comes to making improvements to their properties; nor is there any allowance for depreciation as properties become worn out through use. Depreciation cannot be set off against tax which means that in reality the profit from renting out a property appears to be greater than it actually is due to the building becoming worth less as time goes by.

A different tax regime could encourage better property standards. As the independent Rugg Review into the sector, commissioned under the previous Government, concluded:

*“Government policies need to regard landlords as active business people rather than passive investors. The notion that buying property to let is principally an investment obscures the fact that letting is a business that requires management. Policies should be developed to ‘grow’ the business of letting. Growth should take place from the bottom up: good landlords, however small, could be encouraged to expand.”*

**3.0 FUTURE OF THE PRIVATE RENTED SECTOR**

**3.1 Rental Yields**

A business model based on capital growth is unsustainable, so rental returns are, and should remain, the main driver for investment in the private rented sector. To improve housing supply and to prevent disinvestment, yields need to be rebalanced. It is generally accepted that a long term yield of 6% is attractive for those considering investment in the PRS. Rent levels have to adjust in order that they are sufficient when compared with the current value of the property itself. It is the return from the property relative to its value which is the key. This is what someone looks at when making an investment decision. Whether this figure is a 6% return or a 10% return will depend on the location and type of property and whether or not there is any possibility of capital growth. This return has to be adequate ignoring any requirement to repay capital on loans taken out to buy the property. Since the start of the credit crunch levels of returns have begun to re-adjust to the new economic climate and will be influenced by the supply and demand for rented properties as explained in the next paragraph. We have to make sure that rebalancing does not drive up rent levels to the point where many simply cannot afford them. It should be noted that rent levels are falling in real terms outside of London.

**3.2 Stabilise Values**

Tenants are limited as to what they can afford in rental increases. The ability to pay rent depends on income and at the moment most peoples’ incomes are falling in real terms due to inflation, higher taxes, reduced benefits and restrictions on pay rises. To keep rents affordable, there needs to be a stabilisation of property prices/values. By keeping down property values we can get the rent/value equation right, which encourages landlords to invest and improve their properties. At the moment, property values are being held down because of a lack of demand but market conditions will improve eventually. What we do not want to happen, however, is for there to be a return to the bad old days of boom following bust. Vitally, as most people agree, increasing the supply of new housing of all kinds is essential and if this can be done then it will hold property values down in real terms. This will have two consequences. Firstly, we will have stable values. Secondly, income return on properties will be the key and it will be the new business model for the PRS; not unsustainable run away increases in capital values which disappear when the inevitable crash happens.

**4.0 TAXATION**

**4.1 Taxation**

The RLA believes that the Ball Report makes a compelling case for change to sustain a viable and responsive PRS where landlords will continue to invest in and improve property. Importantly for tenants and labour mobility, we need a more appropriate and fairer tax regime because it is they who ultimately pay taxes rather than landlords. Not only this, but the tax system can be used to help stimulate the PRS, without losing tax take overall. We propose:

* **Roll–over Relief for Capital Gains When Re-Invested** - To encourage landlords to reinvest, roll-over capital gains tax should be allowed where the sale proceeds are being re-invested in a rental property for rent. Landlords are traditionally good at re-generating property, but they also need the ability to move with the market and release capital without CGT liabilities.
* **Roll–over Relief for Capital Gains When Sold to a First Time Buyer** - To help first time buyers, roll-over capital gains tax should be allowed where the sale is to a first time buyer with suitable controls to prevent abuse such as an upper limit on price. This would free up rented property.
* **Entrepreneur Relief for CGT** – This would bring the sector in line with other businesses and encourage disposals where the proceeds are not to be re-invested. This, together with roll-over reliefs proposed would result in a churn of properties with more being refurbished.
* **Capital Allowance** – Properties devalue as they are lived in and periodic refurbishments are essential if property standards are to be maintained. The tax system currently allows no relief for reinvestment and improvement until, and only if, a sale is eventually made. Indeed, the increased rent resulting from improvements is taxed making retention of quality and standards very difficult.
* **SIPPS** - To help to get the property market moving again, Self-Invested Pension Plans (SIPPs) should be allowed to be used to buy residential accommodation for letting. This is prohibited at the moment. To avoid possible abuse, the letting would have to be via a recognised agent, the property would have to be retained and let for a certain number of years and it would only apply to lower value properties. The RLA suggested a one property limit of £300,000 inside London and £200,000 outside. This would help the less well-off obtain accommodation. This could be a short-term measure to stimulate the market. There is over £1 billion invested into over 800,000 SIPPS, of which 200,000 could potentially invest into the PRS.
* **LESA** - An expanded landlord’s energy saving allowance (LESA) needs to be incorporated into the general allowance for improvements to cover a wide range of energy efficiency improvements. The current limit is £1,500 which doesn't go far on many properties, particularly older ones which comprise a high percentage of rented accommodation. The RLA is calling for the limit to be increased to £14,500, spread over four years.

We support Prof. Balls’ view that tax relief should facilitate investment in building improvements, urban regeneration and energy saving. At present, however, capital expenditure on a dwelling can only be offset against capital tax liabilities at a later date which inhibits investment.

There would be no loss of revenue to the Treasury because:

* These measures would bring many properties into use which are currently unoccupied so generating fresh income.
* They bring forward in time tax allowances which would otherwise be claimed at a later date.
* A greater turn-over of property would boost stamp duty receipts.
* The result would boost other taxes. Figures suggest that every £1 invested in the PRS provides a return to the economy of £3.50 through expenditure on building work and furniture. On average, a sum equivalent to 10% of the purchase price of a property bought for renting is spent on renovating the property. Other businesses are very dependent on the private rented sector so we would see an increase in the tax-take from VAT and tax on workers earnings. Vitally such policies would also help create new jobs and take people off benefits.

**5.0 NEW INVESTMENT**

**5.1 Working with Investors**

We need to bring in new investment into the PRS. Generally speaking the PRS is made up of small and medium sized landlords. The average portfolio size is 4 and even the largest portfolios are unlikely to exceed 350 properties. Governments say that they want to see corporate investment and we are not against this. The reality is that companies do not seem to want to invest directly in privately rented accommodation. Getting portfolios of sufficient size together is not easy. Hands-on management poses problems. International evidence suggests that in mainstream private renting small landlords are more competitive and cost efficient than larger ones. This is in line with elsewhere in the world. The PRS lends itself to smaller operators, so, what we need to do is to bring in corporate funding rather than corporate landlords.

**5.2 Attracting New Investment**

Up to now the PRS has been largely dependent on loan finance from banks and specialist lenders. As the credit crunch has shown it is the specialist lenders who tend to disappear in difficult times. Also, as a result, banks themselves have increased their rates of interest/margins and more are wanting capital repayments as well. We need to explore new ways of financing rented properties in the PRS. This could take the form of specialist bonds or equity investment. These new forms of funding need to complement existing debt financing. We need more investment overall to help increase housing supply. At the same time we must have stability to avoid a repeat of the speculative lending that helped fuel the unsustainable growth in house prices which occurred up to 2007/8. More investment and more housing stock is the way to stop this happening again.

**5.3 Bringing Empty Homes Back into Use**

The most recent figures from DCLG suggest that there are just under 300,000 empty properties in England. To support efforts to bring them back into use, the RLA proposes that all publicly owned, empty accommodation should be subject to an auction, to include landlords in the private rented sector. A one year deadline should be imposed for the property to be let again to encourage swift investment in the property.

**6.0 REGULATION**

Whilst the RLA recognises that regulation needs to be improved, this does not mean more regulation as there is already a vast array of legislation for landlords. As Prof. Ball himself outlines:

*“Housing in general and landlord-tenant relations specifically are subject to a wide-variety of housing, health and safety, planning, social policy, and environmental legislation. This has all developed in a haphazard, uncoordinated manner over many decades. Once in place, repeal is rare. Moreover, the cost-effectiveness of many requirements was never assessed when the measures were implemented nor have recent ones been reassessed after several years in place.”*

Managing agents and letting agents do need to be regulated because they handle clients’ money. The self regulation of landlords through robust accreditation schemes needs to be extended. Such schemes, such as that operating in Leeds with one of the highest proportion of private rented properties of any UK city, allow tenants to identify good quality, compliant landlords. Importantly, it would take these landlords outside day to day local authority control allowing councils to concentrate their finite resources on the poorer quality, non- compliant landlords who bring the sector into disrepute using their existing powers of regulation. Too often it becomes easier for local authorities to concentrate on those landlords who comply with regulations and who provide a decent service as a result of the difficulties in tracking down landlords providing sub-standard accommodation to tenants. Furthermore, increasing supply would give tenants a real choice resulting in improving housing stock in the PRS. With proper income based returns, a fair tax system, more investment and competition we will see a better PRS than we already have.

**6.1 Professionalism in the Private Rented Sector**

There is much that is good in the PRS – it provides 17% of housing stock at no direct public cost. The vast majority of tenants are satisfied with their property and their landlord, a greater proportion than in social housing. There is still room for improvement and scarcity of accommodation means a lack of choice for tenants which can lead to lower standards of both property and landlords. Continuous improvement of landlords’ professional knowledge and performance is essential and the RLA endorses accreditation and self-regulation. We need to concentrate these efforts on those landlords who self-manage and the managing agents, the ones who are in day to day contact with tenants.

**6.2 Supporting Young People seeking Housing**

The attitude of some local authorities towards the PRS needs to change, especially in relation to younger people and young sharers. The make-up of the population is changing, and as a result, more single people are looking for accommodation. Many want to share including young professionals, nurses, students and working people. This will only be exacerbated further by the Government’s decision to increase to 35 the age limit at which housing benefit claimants can claim only for a room in a shared house, up from the current threshold of 25. Given that, according to the most recent English Housing Survey, 1,161,000 (34.6%) of renters in the PRS are aged between 25 and 34, and given rising youth unemployment, it is likely that many more people in this age bracket will be requiring shared accommodation.

Some local authorities are conducting what can only be described as a witch hunt against PRS landlords who provide shared accommodation. They want to restrict the numbers of shared housing and set quotas, largely in response to the phenomenon known as “studentification”. Landlords are simply following the market and meeting demand. Where are the young sharers going to live? Central Government policies which have allowed this to happen need to be urgently reviewed and reversed. The PRS needs to be able to cater for the demands of all sectors of the community whilst being able to respond to the concerns of residents not about the material existence of a shared house but the behaviour of the tenants inside. By restricting the growth of such accommodation in certain communities, it will serve only to see them spread to areas not accustomed to such housing.

**6.3 Educating Tenants**

Tenants themselves need a better knowledge of the standards of protection given to them by

allowing them to make informed choices at the point of “purchase” which will help drive out

poor quality landlords. Tenants need to be treated as consumers. A Code of Practice should be

part of this process, so both landlord and tenant know what is expected. The RLA will be working with organisations such as the National Union of Students, Royal College of Nursing and Shelter to establish how practically this could be achieved.

**7.0 HOUSING BENEFITS**

Rents for tenants on lower incomes assisted through local housing allowance and the universal credit, once this is introduced, must track market rents for non- benefit assisted tenants. By improving the supply side, rents will stabilise. Importantly, this will mean that the housing benefit budget is kept in check so the tax payer will benefit. Low income tenants themselves need the assurance that their rents will be met to encourage them into work. Due to the recent changes to the benefit system landlords are intending to leave this market. To retain them they need the assurance of a proper return on their properties like any other landlord. At the same time, we need to give tenants the choice as to whether housing benefits are paid direct to the landlord or to the tenants themselves. Arrears are a real problem for landlords letting to benefit customers. Tenant choice over who gets the payment helps tenants to budget and gives them a secure roof over their head, as well as securing landlords’ income. We need a more effective system for dealing with tenants who are vulnerable or when there are arrears.

**8.0 CONCLUSION**

This country needs a vibrant private rented sector to cater for the housing needs and demands in all sections of the community. As a matter of priority we need to improve the supply of housing in the long term. Booming housing prices followed by an inevitable bust help no one and damages the economy. We all then pay the price. We need to find new ways of providing finance to expand the PRS. This means new housing rather than one sector of the housing market squabbling with another over a limited supply. You would think that a landlord representative body would support ever increasing rents. Not so. We see the real advantages of a stable PRS providing a decent rental return for landlords, reasonable rents for tenants and good quality, well managed accommodation. The current system has clearly failed and we believe that the measures we advocate for a successful revolution will lead to a much improved PRS for the benefit of the whole country.

For more information, please contact Ed Jacobs on 0113 278 0211 or email policy@rla.org.uk

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