Resolution Foundation

Making a Rented House a Home: Housing solutions for 'generation rent'

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Executive summary

Individuals and families on low-to-middle incomes are falling through the gap in the housing market between home ownership and social housing. Historically high house prices, a tighter mortgage market and stagnating wages have left this group shut out of ownership for the medium to long-term. In 2010, it would have taken the average low-to-middle income household 31 years to accumulate a deposit for the average first home if they saved 5 percent of their income each year and had no access to the 'bank of Mum and Dad'. The picture looked a lot worse in London and a bit better in the North of England.

At the same time, cuts to government support for social housing will put further pressure on already long waiting lists, making it even less likely that working households will get access to council homes. This leave many people on low-to-middle incomes stuck in a private rented sector that is poorly suited to providing a stable long-term home. In addition, an asset divide between those who own a home and those who rent long term is opening up.

A new approach to build-to-let development using institutional investment has the potential to be part of the solution to the housing needs of individuals and families on low-to-middle incomes who are unable to buy a home in the medium to long term. Attracting more institutional investment from pension funds and life insurance companies into the private rented sector would allow more rental accommodation to be built at a time when public funds are limited and the buy-to-let market is recovering only slowly. More importantly, it would support a shift in the type of rental product that the sector offers. Longer term contracts, higher quality, more consistent management and the ability to make home improvements would replicate some of the desirable features of home ownership for those who become long-term tenants.

The other important features of a new approach to build-to-let development are:

- The public sector invests its land for development rather than selling it upfront;
- Local Authorities take a more flexible approach to planning, balancing affordable housing requirements with the housing needs of working people;

- Investors retain an option to sell some rental units after a fixed period of time if necessary to secure competitive returns on investment; and

- Rented homes are managed at scale by professional landlords who can provide tenants with a high quality service at the same time as keeping management costs down.

Institutions were important investors in the private rented sector in the early twentieth century. But their role dwindled over time and currently only 1 percent of their overall investment in property is in the residential sector, much less than in other countries. This is, in part, because investment in the private rented sector has been perceived as less competitive than investment in alternative assets and investors have been concerned about the potential reputational risks related to tenant management. Previous government efforts to bring in institutional investment, such as the Private Residential Sector Initiative, have stumbled because they have not been able to guarantee adequate returns.

The new approach to build-to-let set out in this report could change that. Making it work will depend on close partnership between Local Authorities, institutional investors, developers and landlords with the flexibility to renegotiate established approaches to addressing local housing needs. Investors will need to look again at their opportunities for investment in the residential sector rather than continuing to focus exclusively on the commercial property sector. In its forthcoming housing strategy, central government will need to give greater priority to build-to-let in the disposal of public land rather than focusing exclusively on homes for sale. For their part, Local Authorities will need to balance their ongoing commitments to housing the most vulnerable with a broader economic agenda for local growth and employment that depends on housing those on low-to-middle incomes in the private rented sector.

Introduction

We have a housing crisis on our hands. House building has failed to keep up with growth in the number of households in Britain, creating a massive undersupply of housing.[1] In 2010, levels of house building in England fell to their lowest level since the introduction of the Town and Country Planning Act in 1947,[2] creating a shortfall in supply of 140,000 homes.[3] Without rapid growth in supply, this gap can only grow given that the OECD estimates a 60 percent increase in single-person households in Britain by 2025-30.[4]

The main consequence of Britain's massive undersupply of housing has been to push up the price of home ownership, making the average first home unaffordable for many ordinary families. Although house price inflation is currently weak, particularly in the North of England, steep rises in house prices over the last decade have resulted in historically high prices.[5] The National Housing and Planning Advice Unit estimates that even if 240,000 homes per year were built for sale– over double the number that were actually built in the last year–lower quartile house prices would still be nearly eight times lower quartile earnings in 2016.[6]

Prior to the financial crisis, the impact of the chronic undersupply of housing on affordability was in part masked by easy access to high loan to value mortgages. Easier access to credit allowed some people on low-to-middle incomes to get on the housing ladder. In 2007-8, 30 percent of this group bought a house with a 100 percent mortgage.[7] By 2010 tighter access to mortgage credit, high house prices and stagnating wages meant that it would have taken the average household on a low-to-middle income, 31 years to accumulate a deposit for the average first home if they saved 5 percent of their income a year which most cannot afford. According to the Council of Mortgage Lenders, 800,000 potential first time buyers have been frozen out of the market as access to mortgage credit has been tightened.[8]

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[1] JRF Housing Taskforce, '*Tackling Housing Market volatility in the UK*', May 2011
[2] Savills, '*Residential Property Focus Q2',* 2011
[3] DCLG, 'House-building: permanent dwellings completed by tenure live table', *Live table 244.* Shortfall calculated on basis of difference between numbers built and government target to build 240,000 homes per annum.
[4] OECD, '*Doing Better for Families',* 2011
[5] DCLG, 'Mix-adjusted house prices by new or other dwellings, type of buyer and region UK', *Live table 507*
[6] Cited in JRF Housing Taskforce, '*Tackling Housing Market volatility in the UK*', May 2011
[7] Whitaker, M '*Squeezed Britain: the 2010 audit of low-to-middle earners'* 2010
[8] Council of Mortgage Lenders, 'News and Views', Nov 2010. Available at: *http://www.cml.org.uk/cml/publications/newsandviews/79/286* [accessed 18 July 2011]

The barriers to home ownership faced by those on low-to-middle incomes are not the temporary consequences of the recession. Access to mortgage credit will ease but access to high loan-to-value mortgages will not return to the levels seen in 2006. House price growth is currently weak but without access to high loan-to-value mortgages, prices are still too high for most low-to-middle income households, particularly as wages for the bottom half of workers are expected to stagnate until at least 2015.[9] Furthermore, with limited homes available for sale, those on low-to-middle incomes are likely to lose out in the race to buy to those with more to spend.

People on low-to-middle incomes who are locked out of ownership have become increasingly dependent on the private rented sector. There are currently 3.36 million households living in the sector, with 900,000 households becoming renters since 2005.[10] This includes 1.1 million households on low-to-middle incomes.[11] While low-to-middle income households of all ages are more likely to find themselves in the private rented sector than their more affluent peers, younger people have been most affected by the difficulties of getting on the housing ladder. A generational divide is opening up between those on low-to-middle incomes in their 40s and 50s who already own a home and their younger counterparts. More than 50 percent of 'generation rent', as this younger cohort has been dubbed, has given up the prospect of ever owning a home.[12]

Given the current housing reality, a significant proportion of the increase in housing supply needs to be in new housing stock in the private rented sector. Yet, if rented accommodation is to become a long-term housing option, rents in London and the South East need to be made more affordable. Nationwide, there needs to be a shift in what the private rented sector offers those looking for a long-term home. In a country in which home ownership continues to be a deeply held aspiration, building some of the features of home ownership into long-term renting, for example security of tenure and the ability to make home improvements, will be critical to shifting public attitudes towards renting as a long-term option. There is also a need to address the asset gap that will emerge as more people become long-term renters. Failure to get on the housing ladder will quickly translate into a growing asset divide in society unless people can be encouraged to save in other ways.

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[9] Plunkett, J '*Growth without Gain: the faltering living standards of people on low-to-middle incomes*, 2011
[10] Savills, '*Marching on who's leading who's lagging?'*, May 2011
[11] Whittaker, M '*Squeezed Britain: the 2010 audit of low-to-middle earners'* 2010
[12] National Centre for Social Research, '*First Time Buyer Report'*, 2011

The UK private rental market has been dominated in recent years by buy-to-let landlords, many of whom own only a handful of properties each. They currently account for 73 percent of landlords, up from 61 percent in 1993/4.[13] With billions of new investment required to redress decades of undersupply of housing, relying on buy-to-let landlords is unlikely to create the capacity required in the sector or bring about a change in the rental product on offer. In other parts of Europe and the US, investment by individual landlords sits alongside investment by institutions such as pension funds and insurance companies. Although institutions are major investors in the commercial property sector in the UK, their role in the residential sector is more limited. Only 1 percent of residential rental stock in the UK is owned by institutions compared to 10 to 15 percent in most European countries.[14]

Now is the time for that to change. This report argues that a new approach to build-to-let development based on a partnership between public land owners, institutional investors, developers and landlords could be part of the solution to the housing needs of ordinary working people. But this will require fresh thinking from all parties concerned and a new conception of how best to pursue housing affordability, land use and planning. Investors will have to look again at their opportunities for investment in the residential sector rather than continuing to focus exclusively on the commercial property sector. To support this shift in investment, central government will need to give greater priority to build-to-let in the disposal of public land in its forthcoming housing strategy. For their part, Local Authorities will need to balance their ongoing commitments to housing the most vulnerable with a broader economic agenda for local growth and employment that depends on housing those on low-to-middle incomes in the private rented sector.

Chapter one of this report outlines the housing needs of those on low-to-middle incomes. Chapter two describes the new context for institutional investment in the private rented sector in the UK. Chapter three provides international perspectives on institutional investment and draws lessons for the UK. Chapter four outlines an approach to build-to-let development based on the investment of publicly owned land. It highlights how this approach could address some of the common concerns raised by investors with regard to residential investment. The concluding chapter puts forward recommendations to take institutional investment in the private rented sector to scale.

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[13] Rugg, J. and Rhodes, D. '*The Private Rented Sector: its contribution and potential*', 2008
[14] Williams, P. Salisbury, N. and Caven, R. '*Opportunities for Institutional Investment in Affordable Housing*', 2011

Chapter 1: The housing needs of low-to-middle income households

In 1918 close to 80 percent of households in Britain lived in rented accommodation. By 1998, renting had hit an all time low of 10 percent of households.[15] Over the course of the twentieth century, Britain transformed itself into a society of home owners. Home ownership was not just about having a secure place to live, it became the main way that people accumulated assets for themselves and their children. Owning a home became an increasingly important aspiration, a sign of moving up in society, but one that was within the reach of large numbers of working people. Eighty six percent of Britons continue to say that, if they had a free choice, they would choose to buy a house, while only 14 per cent say they would choose to rent their accommodation.[16]

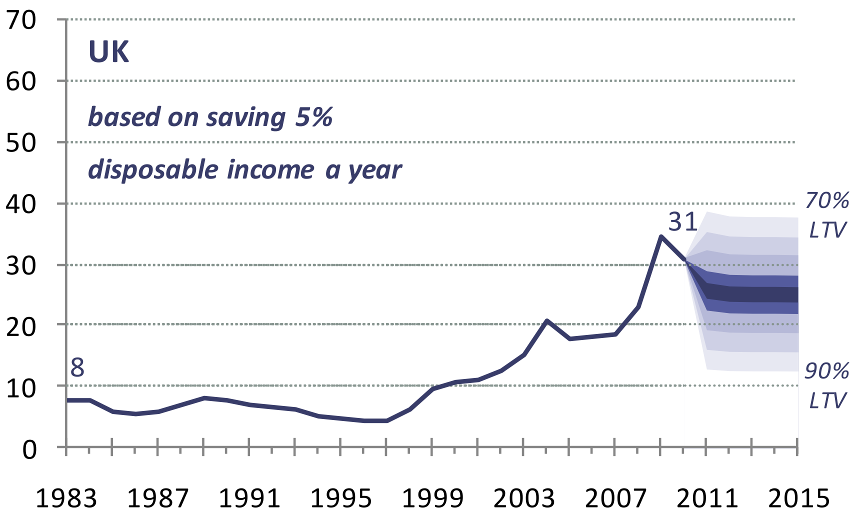
For most of the post-war period, becoming a home owner has been within easy reach of ordinary working families. This is reflected in the fact that among low-to-middle income households with a head of household between 55 and 64 years of age, over 80 percent own their own home.[17] But the aspiration to own is becoming more difficult for younger people on low-to-middle incomes to realise compared to their more affluent peers as a result of historically high house prices, limited access to high loan-to-value mortgages and stagnant wages for those in the bottom half of the earnings distribution.

Given average first-time buyer house prices and the typical mortgages advanced on them, the average low-to-middle income household putting aside 5 per cent of their disposable income each year would haven take 31 years to save an appropriate deposit in 2010, up from just eight years in 1983 (see Figure 1). Expectations of stagnant wages and gradual recovery in house prices mean that, by 2015, the time required for the average low-to-middle income household to save for a deposit will depend primarily on the availability of mortgage credit. Access to relatively high (90 per cent) loan-to-value mortgages would reduce the time required for low-to-middle income households to 13 years. But the period rises to 38 years for low (70 per cent) loan-to-value mortgages. The figures vary dramatically by region, because of significant differences in house prices. For example, low-to-middle income households would have needed to save for 54 years

[15] Darian, L *'Meeting the housing needs of low-to-middle earners'*, 2011
[16] Taylor, E '*Public attitudes to housing in England: report based on the results from the British Social Attitudes survey*', 2011
[17] Whittaker, M '*Squeezed Britain: the 2010 audit of low-to-middle earners'* 2010

to accumulate a deposit for the average first home in London in 2010, compared with 24 years in the North of England.

Figure 1: Number of years required to save for a typical first time buyer deposit by the average low-to-middle income household



Notes: Lines show numbers of years saving required by applying median first-time buyer LTVs recorded in each year to mix-adjusted average (mean) first-time buyer house prices. Bands show projections on basis of LTVs in the range 70%-90%. Average low-to-middle income household disposable income based on deciles 2-5 in the ONS release, 'the effect of taxes and benefits on household incomes'. House price projections for 2011-2015 are based on UK level projections from the OBR. Low-to-middle income household income projections for 2011-2015 are based on OBR projections for average earnings (earnings make up three-quarters of gross income among low-to-middle income households on average).

Sources: ONS, *The effect of taxes and benefits on household incomes*; Lloyds Banking Group, *Halifax House Price Index*, Historical data FTB (ANN); CML, Table ML2; OBR, *Economic and fiscal outlook*, March 2011

Access to the 'bank of Mum and Dad' to secure a deposit continues to allow younger people from more affluent families to get a foot on the housing ladder. In 1997, fewer than 10 percent of first time buyers under 30 had help from family or friends. By 2005, the figure had risen to 45 percent.[18] But younger people on low-to-middle incomes have limited access to this kind of financial support. Among those aged 25 to 34 on low-to-middle incomes, 47 percent own their own home compared to 67 percent among higher income households.[19]

In recent years, those on low-to-middle incomes have also found it more difficult to access social housing, even if they are priced out of home ownership. Constraints in supply and growth in demand for social housing have meant that waiting lists for a council home have grown and vacancies have been increasingly targeted at those most in need. There are currently 1.75 million people waiting for a council house.[20] Social housing tenants are much more likely to have very low incomes and not to be in employment compared to people in other types of housing, with

[18] Hills, J *'Ends and means: the future roles of social housing in England'*, 2007
[19] Whittaker, M '*Squeezed Britain: the 2010 audit of low-to-middle earners'* 2010
[20] CLG 'Rents, lettings and tenancies' *CLG live table 600*

seventy per cent having incomes within the poorest two-fifths of the income distribution.[21] While 17 per cent of low-to-middle income households currently live in the social housing sector, this is in comparison to 51 per cent of households that are benefit-dependent. This situation is unlikely to be reversed in the current climate of cuts to the capital grant available for the expansion of social housing. Government investment in the sector is set to fall during the current Spending Review period from £6.8 billion in 201-11 to £2 billion in 2014-15, a cut of 74 percent.[22]

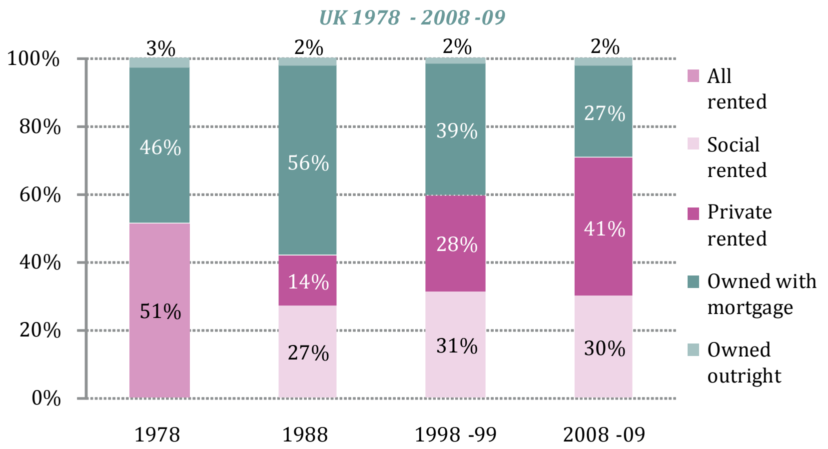
Low-to-middle income households in the private rented sector

Caught between home ownership and social housing, 1.1 million low-to-middle incomes households are reliant on the private rented sector to make their home. They include a mix of household types: one third are families with children, a quarter are single people and around one in ten are adult sharers.

Low-to-middle income households of all ages are more likely to be renting than higher income households. But younger people trying to get on the housing ladder for the first time face the greatest challenges. The percentage of low-to-middle income households under 35 in private rented accommodation has increased sharply from 14 percent in 1988 to 41 percent in 2008. Meanwhile, ownership has shrunk from 58 percent of households under 35 to 29 percent.[23]

[21] Hills, J *'End and means: the future roles of social housing in England'* 2007
[22] Darian, L *'Meeting the Housing Needs of Low-to-Middle Earners',* 2010
[23] Whittaker M *'Squeezed Britain: the 2010 audit of low-to-middle earners'* 2010

Figure 2: Housing tenure among low-to-middle income households with heads aged under 35



Note: The data split for rented properties in 1978 differs from that provided in subsequent survey years. Therefore, all rented data is grouped together in this year.

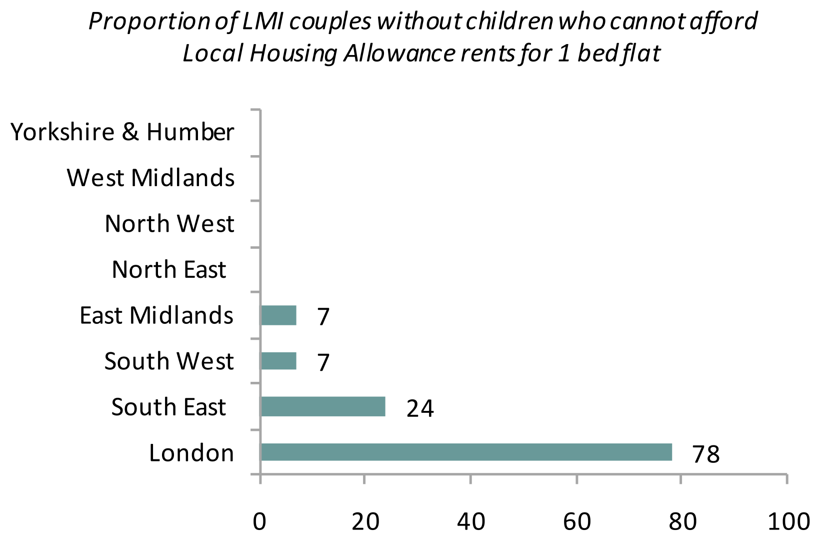
Sources: RF analysis of DWP, *Family Resources Survey* (various); RF analysis of ONS, *Family Expenditure Survey* (various)

As with home ownership, growing demand from private tenants has kept rents high. Rents rose by 37 percent in real terms between 1995-96 and 2007-08 in the private rented sector, compared with increases of 18 per cent for Housing Association rents and 9 per cent for Local Authority rents over the same period.[24] The cost of renting has now reached an all time high, driven by growth in rents in London and the South East of 7.9 percent and 5.7 percent respectively over the last 12 months. Other parts of the country, for example the East of England, have seen slight falls in the cost of renting.[25]

High rents put an additional squeeze on the living standards of people on low-to-middle incomes, with less money available for other necessities and to add to savings. Analysis of the affordability of rents in different parts of the UK highlights the affordability challenge in London and the South East for households on low-to-middle incomes. Assuming households spend 35 percent of their income on rent[26] and using local housing allowance rates for a one bedroom flat as an indication of local rent, Figure 3 below shows that 78 percent of couple households on low-to-middle incomes in London and 24 percent in the South East could not afford rent at local housing allowance rates. Affordability is much less of a problem for those on modest incomes in the rest of the country.

[24] Ibid.
[25] LSL Property Services, '*Buy-to-let index*', June 2011
[26] Thirty five percent is commonly identified as the percentage of income that households should expect to spend on rent if rent is to be considered affordable.

Figure 3: Rental affordability for low-to-middle income couples living in the private rented sector



Source: Analysis of DWP, *Family Resources Survey and Family Expenditure Survey;* Local Housing Allowance rates by Government Office Region.

For some young households, the flexibility of private rented accommodation can be an advantage. It allows for job flexibility and for changes in lifestyle and circumstances. But for many people who find themselves in private rented accommodation for the long term, the lack of security and the inability to make home improvements are significant draw backs. According to the British Social Attitudes Survey, people cite the main advantage of owning a home as being that it is a good investment, is more secure than renting and that it gives you the freedom to do what you want with the property.[27] Renting currently provides none of these desirable features.

Families face particular challenges when renting becomes a longer term solution. First, there is a lack of family size accommodation in the sector. This can lead to families paying beyond their financial means for housing near work, schools and other local services. Second, the insecurity of short term tenancies creates particular difficulties for families who fear that they will be forced to uproot their children at short notice. One mother described the possibility of having her tenancy terminated as follows:

'I know it could happen but I push it to the back of my mind because I have enough on my plate to worry about. It's a six-month tenancy agreement, so I forget about it for six-months. I would

[27] Taylor, E, *Public attitudes to Housing in England. Report based on the results from the British Social Attitudes survey*, 2011.

prefer a longer contract because then I wouldn't have to pay admin fees every time it comes up for renewal – they use it to get money out of me' (Rita, 40).[28]

With home ownership out of reach of many people on low-to-middle incomes and the social housing sector unlikely to grow to meet their needs, the private rented sector will have to step in. The sector currently makes up 17 percent of overall housing stock compared to 9 percent in 1991 but will need to continue to grow in capacity.[29] Measures to address affordability in London and the South East will also be required as well as a change in the type of product the rented sector is able to offer to better meet the needs of 'generation rent' for a long term home.

Bringing institutional investors into the sector is a potential way of meeting this pressing public need. Institutions could support the necessary expansion of the sector and shift the nature of the product the sector is able to provide because long-term security for tenants translates into predictable returns for investors. The next chapter discusses the current context for institutional investment in the private rented sector and argues that barriers to home ownership and social housing for those on low-to-middle incomes create new incentives for investors to enter the private rented sector.

[28] Darian, L '*Meeting low-to-middle earners housing needs*', 2011
[29] CLG, '*English Housing Survey 2009-10 household report*', July 2011

Chapter 2: The new context for institutional investment

In the early twentieth century, institutional investors such as pension funds and life insurance companies were important owners of residential property in Britain. In more recent years, investors have switched focus to the commercial property sector, leaving growth in the private rental sector in the hands of buy-to-let landlords. Attempts have been made to lure institutions back into the sector, for example the previous Government's Private Rented Sector Initiative (PRSI). The PRSI initiative failed to deliver the scale of institutional investment expected, in large part because government was unable to provide the rental guarantees initially promised to investors.

The absence of institutions playing an active part in the UK residential sector in contrast to other European countries has been put down to a range of barriers.[30] First and foremost, there has been a perception among investors and those in the property industry that the returns from investment in the residential sector are too low and too insecure to be attractive to investors, particularly compared to commercial property or the social housing sector which is government backed and highly secure. Other issues such as the perceived reputational risk involved in investing in the private rented sector and the lack of land on which to build homes for rent at scale are also commonly cited.[31]

The context for investment in the private rented sector is set by both trends in the housing market and by changes in government policy. These in part shape how the returns from investment in the residential sector compare to alternative investments. In recent years, both the housing market and government housing policy have changed, creating an opportunity to reassess the viability of institutional investment in the private rented sector. House prices have soared, land values are low and the buy-to-let market is less buoyant. The Government has introduced policy changes to social housing and has adopted a more pro-development stance. Together, these changes create a more favourable environment for institutional investment in the private rented sector than in the past.

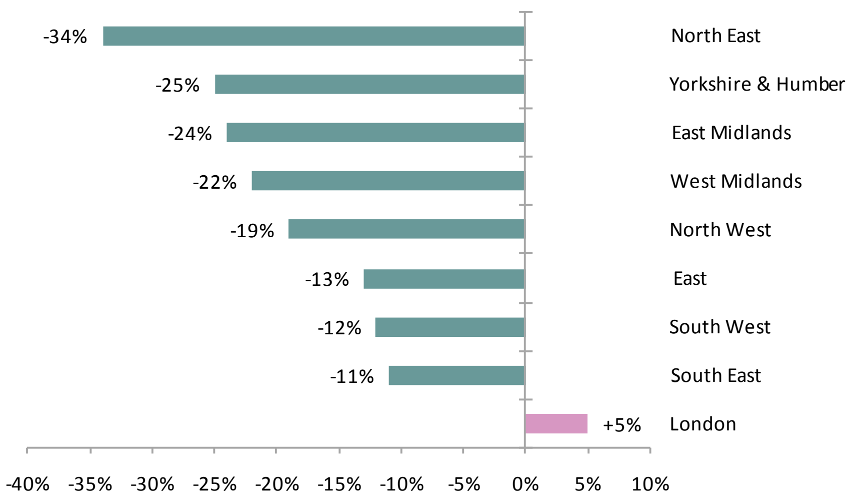
[30] Daly, J '*Overcoming barriers to institutional investment in residential property*', 2008
[31] Darian, L '*Meeting low-to-middle earners housing needs*', 2011

The new environment for investment

Without significant intervention in the housing market, households on low-to-middle incomes look likely to be priced out of home ownership for the medium to long term rather than temporarily renting to accumulate a deposit for a home. From the perspective of investors, this means more predictable rental income and less tenant turnover which reduces management costs and the volatility of returns. This is particularly the case if families become long term renters as continuity of schooling and friendships encourage families to move less often. Investors such as pension funds are attracted to predictable long term income streams from rental properties to match their liabilities. They will also look to diversify their rental income steams, creating incentives to develop a mixed portfolio of residential investments aimed at different population segments, including those on low-to-middle incomes.

Alongside changes in home ownership, the private rented sector now exists within a new social housing context. The introduction of 'right to buy' in the 1980s and the failure to replenish social housing stock as properties were sold off has seen the social housing sector shrink over the last 30 years and waiting lists grow. Figure 4 below shows the change in the social housing stock by region, with London being the only region in which the capacity of the sector has grown, although everywhere it has failed to keep up. This is unlikely to be reversed in the current climate of cuts to the capital grant available for the expansion of social housing.

Figure 4: The Collapse of Social Housing (regional percentage change 1980-2010)



Source: The Times, 2011

The Government's decision to change the definition of affordable rent which is applied to social housing rents from 60 percent of market rent to 80 percent and to end lifetime tenancies is being resisted by many registered providers[32] who argue that it will hurt vulnerable people, especially families. As a result, many will not raise rents, making it more difficult to raise the revenue required to increase the capacity of the social housing sector. The Government has also proposed to allow Local Authorities to meet their homelessness duty by using the private rented sector in addition to social housing.

Together, these trends make one thing clear: social housing alone cannot be the solution to the housing problems of those on low-to-middle incomes under the current circumstances. It seems more likely that Local Authorities will look to the private rented sector to house low income working people on the social housing waiting list rather than social housing absorbing more of this group. This is already happening in some parts of the country. For example, the Terrace Hill Group worked with Southwark Council to house tenants claiming housing benefit who were nominated by the Council in private rented accommodation.[33] Using the private rented sector to house those on the social housing waiting list creates additional pressure to expand the private rented sector.

Low land values in many parts of the country could provide further support for institutional investment in the private rented sector. Average residential land values are currently around 40 percent lower than their peak at the end of 2007.[34] Land banking has been the traditional response to low land values which means that no development takes place and land is retained until its value increases and sale is more lucrative. But a more creative solution is possible. Under the approach to build-to-let set out in Chapter four, there is an opportunity for Local Authorities and other public land owners with low land values to invest land for the development of private rented accommodation. In return, they receive a deferred rather than upfront payment. Over time, this could provide better value to Local Authorities than selling in the current market and would kick start the development of new rented homes for those on low-to-middle incomes.

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[32] The term registered social landlord to describe agencies that are registered to own and manage social housing on behalf of Local Authorities has been replaced by the term registered provider of social housing to take account of the fact that providers can now be profit making. Non-profit registered providers are frequently referred to as Housing Associations.

[33] Winstanley, P and Hill B for London Councils and British Property Federation, *'Invest to Rent: a guide to developing partnership investment in new private rented homes for Londoners'*, 2011

[34] Knight Frank Residential Development Land Index: Q1 2011 results - Public bodies become key vendors as demand for well located sites remains strong, May 2011 *http://www.knightfrank.co.uk/news/Knight-Frank-Residential-Development-Land-Index--Q1-2011-results---Public-bodies-become-key-vendors-as-demand-for-well-located-sites-remains-strong-0612.aspx*

Fewer obstacles to investment

In a recent report, the OECD criticised restrictive land use planning policy in the UK since the 1990s for hampering the responsiveness of supply to demand and contributing to housing shortages and reduced affordability.[35] A new national planning framework is now out for consultation and the Government has stated that its top priority for the planning system is to promote economic growth and jobs. This pro-development stance could give investors some comfort that development is now more likely to get the go-ahead than in previous years and that the costs of negotiating the planning process may be lower. However, many of these decisions are in the hands of Local Authorities not central government and there remains a lack of consistency between councils.

Despite the investment potential of the residential sector, it has been argued that institutions were previously crowded out by buy-to-let investors fuelled by the easy availability of buy-to-let mortgages. The number of buy-to-let mortgages increased 10-fold between 2000-1 and 2007, with the buy-to-let mortgage market now worth £122 billion.[36] This injection of investment brought one million new homes into the private rented sector.[37] In the wake of the financial crisis, lending was temporarily constrained but has started to recover. However, buy-to-let mortgage approvals remain relatively low compared to 2007 and industry experts expect a steady but not rapid recovery. The number of buy-to-let mortgages available has dropped dramatically from a high of 3662 in autumn 2007 to just 304 in spring 2010.[38] Recovery may also be hampered by proposals to include buy-to-let mortgages within regulation which could increase the costs of securing a mortgage or reduce supply. This creates a need and an opportunity for institutional investors that did not previously exist.

Without a new source of private investment, it seems unlikely that the private rented sector can adequately expand to meet the needs of 'generation rent'.[39] Higher, more persistent demand for rented accommodation alongside other changes in the housing market creates a new opportunity for institutional investment in build-to-let accommodation that is targeted at those looking to rent for the medium to long term. This would bring our housing market closer into line

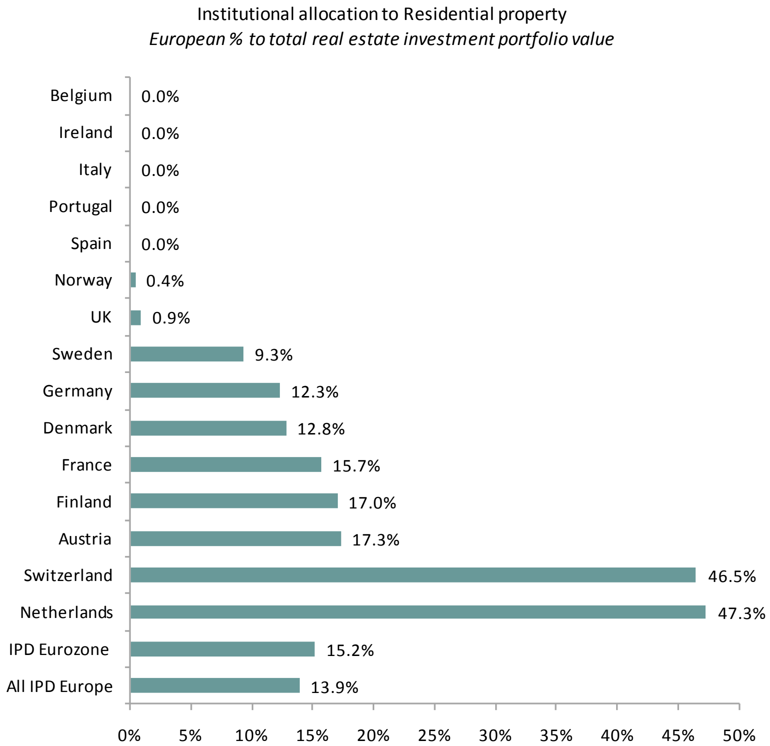
[35] OECD '*Economic Surveys: United Kingdom 2011',* March 2011
[36] HM Treasury '*Investment in the UK private rented sector'* 2010
[37] Winstanley, P and Hill B for London Councils and British Property Federation, *'Invest to Rent: a guide to developing partnership investment in new private rented homes for Londoners'*, 2011
[38] Ibid.
[39] National Centre for Social Research, *First Time Buyer Report*, 2011

with other developed countries where institutions are active investors in the private rented sector for long-term tenants. The next chapter looks at the drivers of institutional investment in Europe and the US and draws lessons for the UK.

Chapter 3: International perspectives on institutional investment

Individual landlords make up the bulk of investment in the private rented sector in most developed countries. However, other countries have been far more successful than the UK at securing institutional investment. As Figure 5 shows, in a number of European countries, 10 to 15 percent of institutions' overall investment in real estate is in residential property, with the Netherlands and Switzerland leading the pack with close to half of all real estate investment being in residential property. This is in contrast to the UK where less than 1 percent of real estate investment is in the residential sector. In most countries, a significant proportion of institutional investment in the residential sector is at the top end of the rental market. However, institutional investment has also been secured at the affordable end of the market. In the Netherlands, for example, approximately 40 percent of the rental accommodation owned by institutions is let at under £333 a month.[40] The experience of other countries in drawing in institutional investment to the lower and middle end of the rental market is instructive for the UK.

Figure 5: Percentage of real estate investment portfolio in residential property by value



Source: IPD/KTI, 2011

[40] Haffner M et al '*Belied Voor de private huur*', 2010

Why do other countries do better?

Countries where institutional investment in residential property is strong tend to have relatively large rental markets. In Switzerland and Germany, for example, private rental housing makes up around 50 percent of overall housing stock and both countries have more tenants than home owners.[41] Internationally, the majority of rented units are in multi-family apartment buildings that contain a mix of units suitable for individuals, sharers or young families. Eighty percent of rental stock in Germany is multi-family, 60 percent in the USA, 70 percent in Switzerland and 63 percent in the Netherlands. Rental properties that are not multi-family are detached or semi-detached houses.

These well developed rental markets offer security of tenure for tenants, creating greater certainty over rental income for investors and the possibility of long stretches of occupancy for tenants, particularly families. In Switzerland, rental contracts can only be terminated by the landlord if certain legal formalities are met and in Germany, landlords need to give tenants three months notice to vacate the property, if they have been there for at least five years. This goes up to nine months for nine years occupancy. In the Netherlands, the average period of occupation is between 11 and 13 years.[42] While security of tenure creates certainty for investors by reducing voids, indefinite tenure can be unattractive because it makes it difficult for investors to deal with difficult tenants and to realise capital gains by selling rental properties. A balance needs to be struck which protects the rights of tenants without eroding incentives for investors.

Rental markets are supported in some countries by relatively high barriers to home ownership, similar to the situation that is now emerging in the UK. In Germany, for example, mortgages at more than 80 percent loan to value are typically not available, making it harder for those on lower incomes and without family help to get on the housing ladder.[43] In Switzerland, lenders also require large deposits for home purchases and home owners incur additional taxes compared to renters. However, long-term renting in these countries also provides tenants with a

[41] Oxley M '*Promoting investment in private rented housing supply: International policy comparisons*', 2010
[42] Presentation by Haffner M at LSE Workshop, '*The Dutch Private rental sector: some observations*', 2011
[43] Oxley M '*Promoting investment in private rented housing supply: International policy comparisons*', 2010

product that meets their needs and consequently has a level of cultural acceptability that is unusual in the UK where home ownership endures as a sign of social success.[44]

Although the US private rental market is more similar to the UK market than those of continental Europe, in terms of freely negotiated rents and year-long contracts, institutional investment is supported by strong demand for rental accommodation given high house prices and a very small social housing sector, accounting for only 1 percent of all households. A third of US households live in the private rented sector and a third of the sector is owned by institutions and corporations.[45] Urban markets in the US with large pools of tenants can sustain purpose-built, large-scale developments that can be managed to maximise efficiencies and boost returns. These developments are traded between investors as rental blocks without being broken up and sold to owner occupiers.

Alongside security of tenure, rents in several countries are regulated, creating transparency and certainty for investors and tenants. In the Netherlands, private rented accommodation that costs less than 650 euro (£574) a month falls within the regulated sector.[46] Rent increases in this sector are set nationally by government and tenants can apply for rent reductions if landlords do not keep up with repairs. In Switzerland, rents are initially set freely in line with rents in the neighbourhood. Thereafter, rent increases can only be justified to reflect higher costs of operation, maintenance and interest which means that landlords can be forced to lower rents if interest rates falls. In Germany, rents cannot increase by more than 20 percent over a three year period. Specific increases are made in line with a database of reference rents for similar dwellings.[47]

Internationally, the consistency of returns from renting has been critical in securing and maintaining institutional investors. In the Netherlands, for example, the percentage of rented dwellings owned by institutions has been falling in the wake of an end to government subsidies for construction in 2005 and falling house prices since 2008. The ROZ/IPD residential index, an index of returns from residential property in the Netherlands, recorded a total return of only 3.3

[44] Ibid.
[45] Ibid.
[46] Haffner, M; Hoekstra, J; Oxley M and Heijden M '*Bridging the gap between social and market rented housing in six European countries'*, 2009
[47] Oxley M '*Promoting investment in private rented housing supply: International policy comparisons*', 2010

percent in 2008 as a result of negative capital growth.[48] Returns in the US have also faltered since the recession as a result of falling capital values and lower rental incomes. In Germany, investors have been attracted by reasonably stable returns driven by rental incomes rather than capital growth. However, over-supply and changing demographics have hampered returns in East Germany, with 400,000 dwellings vacant in 2003.[49]

The role of government

Government has played an important role in many countries in encouraging investors into the residential sector through a series of subsidies, tax incentives and planning policies. In Germany and the Netherlands, investors were attracted into the sector on the basis of construction subsidies. In the Netherlands, subsidies for social and private landlords who provided affordable housing were withdrawn in 2005, contributing to more recent falls in income returns for investors. In Germany, subsidies were available until the early 2000s for the construction of properties that were used for social housing for a period of usually 20 years before being converted to market rent.[50] In Switzerland, government loans were available to support investors to offer sub-market rents. The amount of the loan was set to enable investors to receive a 10 percent return on their investment, for rent to cover costs after 15 years and for the loan to eventually be repaid.[51]

Preferential tax treatment has also been a feature of government support internationally. In the Netherlands, a depreciation allowance exists for landlords who operate as a business and rental losses can be offset against other income. Individual buy-to-let landlords by contrast, are at a disadvantage by being taxed on imputed rents.[52] Similar tax incentives exist in Germany. A depreciation allowance allows investors to offset the costs of repairs and rental losses can be offset against other types of income for tax purposes. The private rented sector in the US has benefited particularly from the preferential tax treatment of real estate investment trusts (REITs). Of the top ten apartment providers in the US, four have REIT status which enables institutions and individuals to invest indirectly in the property sector.[53] REITs do not have to pay corporation

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[48] Ball M '*European Housing Review*', 2010
[49] Ibid.
[50] Oxley M '*Promoting investment in private rented housing supply: International policy comparisons*', 2010
[51] See Bourassa, S. C. & Hoesli, M. 'Why Do the Swiss Rent? *Journal of Real Estate Finance and Economics',* Vol 40, No 3, pp286-309, 2010
[52] Presentation by Haffner, M at LSE Workshop, '*The Dutch Private rental sector: some observations*', 2011
[53] Oxley M '*Promoting investment in private rented housing supply: International policy comparisons*', 2010

tax but are required to pay out 90 percent of their income to shareholders. The UK currently has no purely residential REITs but the Government announced its intention to consult on changes to REITs to lower barriers to entry in the 2011 Budget.[54] Low Income Housing Tax Credits have supported the development of affordable rented housing in the US, with tax credits available for the construction or acquisition of properties as long as at least 40 percent of the development is available to low-income households for an initial period of 15 years. Depreciation allowances are also available. [55]

Planning and land use are critical factors in the development of private rented accommodation. In the US, inclusionary zoning policy requires developers to make a certain share of planned housing units for low and moderate income households. This is a similar approach to Section 106 agreements in the UK but, at its best, has allowed for greater flexibility. For example, the inclusionary zoning program in the City of Newton, Massachusetts, has helped encourage the development of 237 units affordable to low and moderate income households. For every affordable unit built above the required 15 percent, the developer can also increase the number of market-rate units by one, and projects in which 30 percent of the units are affordable are eligible for an expedited process for planning permission.[56]

In Switzerland, private rented accommodation has its own planning class and does not fall under a broader residential category as in the UK. This supports the development of purpose built developments for rent by reducing the cost of land. Land becomes less valuable because the properties cannot be sold and, therefore, there is no possibility of realising the increase in their capital value. However, since these units have to be held in perpetuity for rent and cannot be sold, this can create a disincentive for investors where capital gains from sales are needed to boost returns. In the Netherlands, local councils play an active role in buying land and leasing it to developers for periods of 50 to 75 years in return for ground rent payments that are indexed to land values. This enables local government to have greater influence over development and land use, as well as generating an income through ground rent.[57]

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[54] HM Treasury, *Budget 2011*, 2011
[55] Oxley, M '*Promoting investment in private rented housing supply: International policy comparisons',* 2010
[56] Wardrip K *'Strategies to expand the affordable private rental stock'* in Parker S (ed.) '*Fragile economics: what America can tell Britain about the squeezed middle'*, forthcoming
[57] City of Amsterdam Development Corporation, '*The use of public ground lease in European cities'*, 2010

Lessons for the UK

International experience of institutional investment in the private rented sector highlights four important lessons for the development of institutional investment in the UK:

- Barriers to home ownership as have been seen in Germany and Switzerland can act as a stimulus for investment in the private rented sector. If large numbers of people are locked out of ownership because of high prices and low availability of mortgage credit, this creates sustained demand for rented accommodation and a steady income stream for investors. Low-to-middle income households in the UK are now in this position, creating new incentives for investors to enter the residential market.

- Greater cultural acceptability of renting as a long-term housing option in other countries supports a more stable rental market. This is helped by the fact that the private rented sector offers long-term tenants a more suitable product than the UK buy-to-let market. Longer leases and transparent rent increases create security for tenants. The ability to improve and decorate the property also narrows the gap between the experience of renting and home ownership. The British preference for ownership is strongly linked to these features that can be found in rental markets elsewhere but not in Britain.

- Institutional investment in Europe has been supported by the availability of long-term leases with transparent rent rises that reduce tenant turnover, lower the costs of empty properties and increase the predictability of returns for investors. This is in stark contrast to assured short-hold tenancies in the UK that generally last for six months to a year.

- Government has played a critical role in stimulating institutional investment in other countries through both tax incentives and land use and planning policies. The UK signalled support for the private rented sector in the 2011 Budget through changes to stamp duty land tax (SDLT) and a consultation on lowering the barriers to investment through Real Estate Investment Trusts. Prior to the 2011 Budget, the high rate of SDLT charged on bulk purchases of properties created significant disincentives to transferring completed properties into an indirect investment vehicle as many investors would prefer. But government could play a more active role through land use planning policy. A creative approach to the investment of public sector land could increase the availability of homes in the sector and attract investment, while not providing a traditional government subsidy. This will be discussed in more detail in the next chapter.

Chapter 4: A new approach to build-to-let development for 'generation rent'

The international experience discussed in Chapter 3 highlights the fact that institutional investment is better suited to the kind of rental market that also provides greater security for tenants. Purpose-built accommodation managed at scale is the mainstay of most successful institutional investment markets around the world. Long-term security for tenants also provides more secure returns for investors. Keeping rents within the reach of those on modest incomes benefits tenants and will ensure sustained demand for rental properties. Allowing tenants greater freedom to improve their properties will give them more incentive to stay for the long term.

The rest of this chapter focuses on the features of a new approach to build-to-let development that is being developed by the Resolution Foundation together with investors, Local Authorities, developers and other property experts to meet the needs of those on low-to-middle incomes for secure, well-managed homes for rent. The approach is intended to meet the needs of individuals and families on low-to-middle incomes at the same time as creating adequate returns from the private rented sector to attract institutional investment.

While the exact details of individual developments will vary, the approach is intended to deliver a mix of town houses and apartments that are suitable for a range of household types on low-to-middle incomes, including families with children. To address the affordability challenge in London and the South East, rents would be set at below market value but this does not appear to be necessary in the rest of the country. The remaining core features of this approach to build-to-let development for individuals and families on low-to-middle incomes include:

- the public sector investing rather than selling land for development;
- a more flexible approach to planning policy;
- the option to sell rental units after a fixed period;

- efficient large-scale management.

These features are described in more detail below. The second half of the chapter assesses the extent to which, together, these features adequately address commonly cited barriers to institutional investment in the private rented sector.

Investing public land

Land is the single biggest cost of housing development and accounts for around 30 percent of total costs. As a result, it is critical to making a development viable from the perspective of tenants and investors. Too high a price for land will push up rents, putting properties out of the reach of ordinary working families and potentially destabilising investor returns. Institutional investment can be made more viable by investing rather than selling land for development. The investment of land lowers the initial cash costs of development. This makes it more likely that adequate returns can be made in the early years of a build-to-let development aimed at those on low-to-middle incomes, thereby attracting the necessary investment.

Public bodies, including the Homes and Communities Agency (HCA), Local Authorities, the NHS and the Ministry and Defence own significant amounts of land that is suitable for residential development. In order to kick start development and address the housing needs of families on modest incomes, this public land can be invested as a stake in an investment fund for the development of rented accommodation. This is the approach being taken by Birmingham Council which has established a joint venture with the property developer, Willmot Dixon, an unnamed funder and the estate agents, Savills. Under the plan, the Council and developer aim to put enough land into a joint venture company to develop 750 homes over the next 5 years. The other parties will then build, manage and market the homes. All parties will share the profits dependent upon the amount invested in the vehicle. The Council is in discussion with other councils in the region to bring forward other sites for the development of a total of 1,500 new homes.[58]

Investing land in this way is not a subsidy for development such as government has tended to provide for social housing. Once the properties are built and rental income begins to accrue, the

[58] Property Week, '*Wilmot Dixon to develop homes for rent*', December 2010

landowner starts to gain income from the investment, for example through an annual ground rent payment or a portion of the rental income. In parts of the country where land values are currently low, this approach to land use can deliver greater returns to public land owners than upfront sale. This is critical because public landowners need to demonstrate best consideration when disposing of land in order to satisfy state aid rules. From the perspective of Local Authorities who currently face significant budget cuts, realising greater returns from the investment of land will be critical in justifying this approach over upfront sale.

A similar approach can be taken with privately owned land that is currently being land banked. Rather than holding onto it and waiting for its value to increase, the land owner could invest it in the development of new rental properties in a similar way to a public land owner. This would generate an income stream over time that could provide a greater return than land banking or selling the land at a low price.

The London Rental Housing Company

The London Rental Housing Company (LHRC) owns land in Bromley in Kent that was purchased in 2006 for the purpose of building homes for sale. However, the collapse of the mortgage market made this less viable. At the same time the growing need for rental accommodation, particularly for a sandwich class of low-income households, meant that using the land to develop rental homes became a more attractive and viable business option.

The LHRC is planning a development that will include 150 three and four bed units targeted at low-income families. They will be let at below local housing allowance rates with a £17 to £25 per week service charge. This is intended to limit voids because low-income families tend to stay in the same rental accommodation for longer. Their children's connections to the local school make them less likely to move area, and their financial situation makes them less likely to move into home ownership.

The units will be let on a 'no frills' basis. Tenants will use their own furniture and there will be centralised utilities, a crèche and a cafe. LHRC's model draws heavily on rental accommodation commonly found in Switzerland. There will be rules to ensure that families can live together harmoniously in a block of flats, for example loud music will not be allowed after 10pm. The costs of rental management and maintenance will be designed out to the greatest extent possible. For example, individual flats will not have washing machines. Instead, a laundry room will be provided to minimise the potential for damage from leaks.

The London Rental Housing Company intends to meet Section 106 affordable housing requirements by offering to use 25 percent of the units to house people currently on the social housing waiting list and is seeking to become a Registered Provider in order to manage the entire development. The Company is seeking a combination of debt and equity finance.

In June 2011, the government announced the sale of £10 billion worth of surplus public land, enough to build 100,000 new homes for sale.[59] This will make an important contribution to expanding housing supply but it is unlikely to meet the needs of ordinary working people because none of the land has been earmarked for build-to-let development. Although the government proposes to offer some of the land on a build now, pay later basis, land is not being invested for the long term. Payment for land is only temporarily deferred until the homes are sold. This is a missed opportunity. A handful of Local Authorities are, however, already moving forward with the investment of public land to support private investment in build-to-let development. The case study below from Barking and Dagenham is an example of how private investment in build-to-let can be kick started using public land. The full details of the scheme are still being agreed.

Barking and Dagenham

The London Borough of Barking and Dagenham is working with the Local Education Partnership, a developer and private finance company, to build 500 units, due for completion in summer 2013. The units are to be built on two plots of council owned land and will be let at sub-market rents: approximately 50 percent of the units will be let at 80 percent of market rent, 20 percent at 50 percent of market rent and 30 percent at 65 percent of market rent. The 80 percent market rent units will be used to house people in work on low incomes and the cheapest rental properties will be used to house people currently on the council housing waiting list.

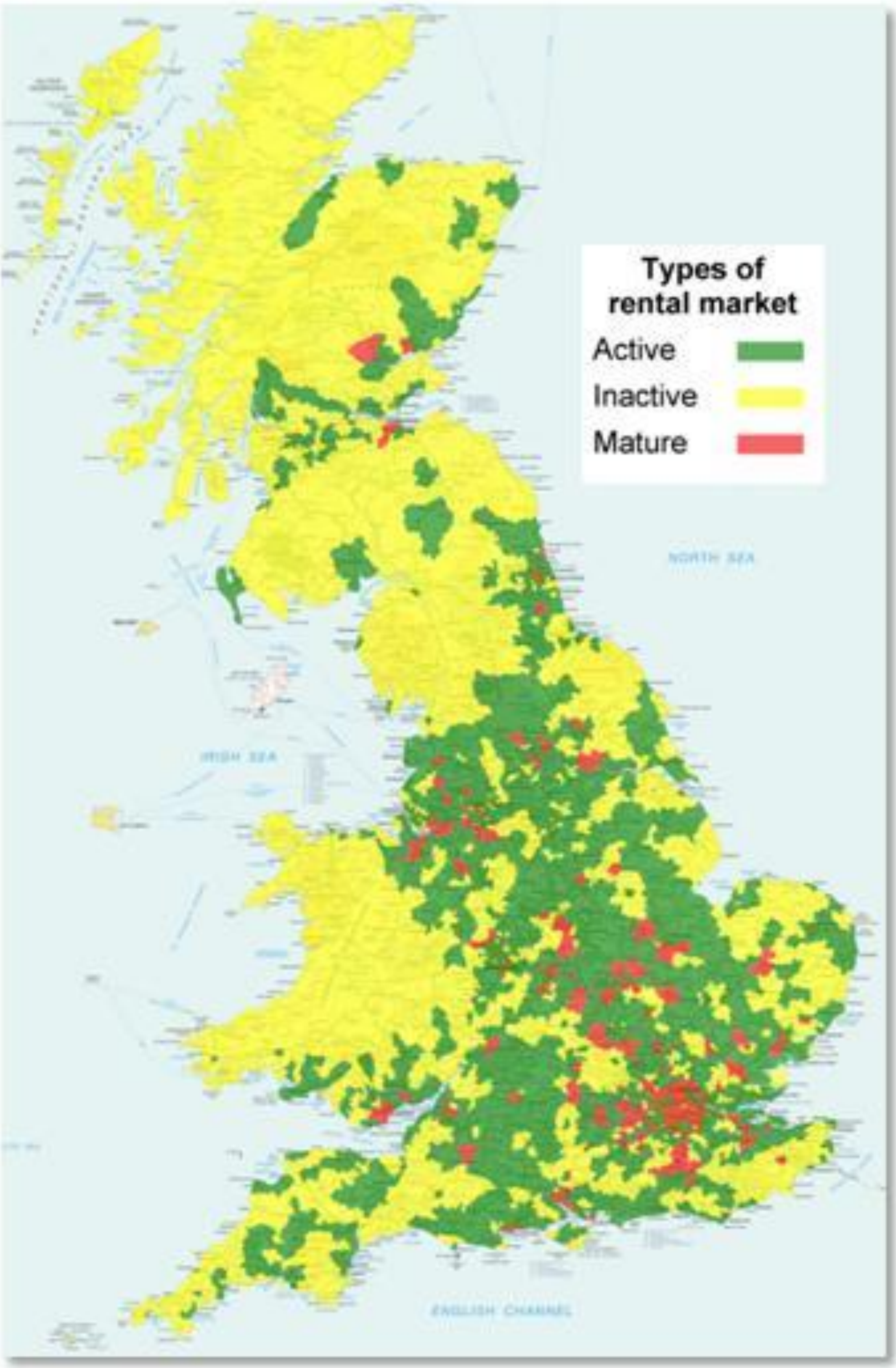
An investor is funding the construction costs of the development. In exchange, the Council has put up the land at no cost and will provide a guarantee for the rents for a period of 60 years minus the costs of management, maintenance and void risk. At the end of the 60 year period, ownership of the units will revert to the Council. Since all the properties are below market rent, there is no Section 106 requirement. The Council will manage all the properties.

The scheme provides an attractive means for the Council to get social and intermediate housing built quickly that could otherwise not be funded and will eventually be owned by the Council. The risk to the Council lies in the length of the rental guarantee. While housing benefit will act as a backstop for tenants who fall out of work today, there is no certainty that it will continue in the future and that demand for rental accommodation will remain at its current levels. This opens the potential for voids and losses. However the Council's experience of guaranteeing social housing in a similar way, and the offer of below market rents, means that the Council is confident that it can mitigate much of this risk.

[59] CLG press notice, '*Government plans release of public land to build 100,000 homes*', 8 June 2011

Investing public land will not always be desirable for public landowners. In a small number of places, particularly in London and the South East, land values continue to be high and, therefore, Local Authorities have a strong incentive to sell their land. Furthermore, for institutional investors to achieve adequate returns from this model, areas need to have well developed rental markets where empty properties are quickly filled and inflation-linked rent increases can be sustained. Analysis by Hometrack, the leading housing research company, shown in Figure 6 below highlights the parts of the country where rental markets are mature (red) or active (green) and are likely to sustain institutional investment. But such markets do not exist in 50 percent of the country outside of cities and major towns. In these areas, attracting more institutional investment into social housing may be a more viable way of meeting the housing needs of people on low-to-middle incomes than build-to-let development. Finally, land needs to be suitable for residential development which means that it needs to be uncontaminated, brown field land that is close to transportation, schools and other amenities. While land in significant parts of the country does not meet these requirements, there is more scope to use public land than has currently been exploited.

Figure 6: UK rental markets



Source: Hometrack, Presentation given at Urban Land Institute, Residential Council, 14 June 2011

More flexible planning policy

Under Section 106 agreements, Local Authorities are entitled to request a proportion of affordable housing in exchange for granting planning permission for residential development. This can be up to 50 percent of the development. These agreements have been an important route through which Local Authorities have managed to increase social housing capacity and ensure that developers invest in local areas at the same time as profiting from development.

However, given that the returns to investors from rental property are initially lower than from building homes for sale, Section 106 agreements that require a large proportion of the overall development to be set aside for affordable housing can threaten the viability of built-to-let developments. The London Mayor's Housing Taskforce estimates that there are 8000 stalled projects in London, some of which could be made viable by renegotiating the Section 106 requirements being made by councils.[60] Student accommodation has been successful in attracting institutional investment in part because it is not subject to Section 106 agreements for affordable housing because it falls outside the residential category for planning purposes.

Local Authorities have discretion over negotiating Section 106 agreements. To make build-to-let development for individuals and families on low-to-middle incomes more viable, they could choose to deem new rental accommodation for this group as meeting a local need and not require any further Section 106 requirements or reduce the amount of affordable housing that is required. In return, they could insist that build-to-let developments be held in rent for a certain period of time, for example a minimum of 10 years. Birmingham City Council and local private sector property developer, Evenbrook, have reached an agreement under which Evenbrook will develop and retain ownership of 155 flats in Handsworth Wood, Birmingham. These flats will be rented privately, with 40 being rented at 80 percent of market rent for a period of 21 years. There are no additional Section 106 requirements. After 21 years, the properties can revert to market rents or be sold. The Council has agreed that anyone earning under £25,000 can access the discounted part of the scheme and Evenbrook's management of the 40 properties will be audited by an established Registered Provider.

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[60] GLA, *Mayor of London's Housing Taskforce report*, 2011

The option to sell after a fixed period

Within the property sector, institutions are most familiar with commercial property. The value to investors of commercial property is in the income returns that are generated by the rent. In contrast to housing, the building itself depreciates rather than growing in value. There is, therefore, little expectation of capital growth of the asset. In time, investors in the UK residential sector may come to view build-to-let development in similar terms. It will provide a steady, long-term income stream to pension and life funds that will trade in and out of investments that are held permanently for rent. This is the investment approach taken in the US with multi-family apartment blocks and one that should be encouraged in the UK to ensure continued growth in quality rental stock for long-term tenants.

However, institutional investment in build-to-let in the UK is very new and needs to be highly competitive against alternative investment options, especially commercial property. If a Local Authority grants planning permission on the basis that properties are held permanently for rent, there is no opportunity for investors to increase their returns through sales that realise the gain in the capital value of the development. At this point, long-term, steady income from rents alone may not be adequate to achieve the rates of return required for investors to choose the private rented sector over other types of investment opportunity. As Table 1 shows, income returns from residential property receive a significant boost from capital returns, making total returns more attractive to investors.

The ability to supplement rental income with a percentage of sales over time may make the difference in some cases between investment in build-to-let getting the go ahead and being unviable. The option to sell can be set up in different ways. Evenbrook's agreement with Birmingham City Council, for example, requires the properties to remain in rent for 21 years before they revert to the open market. At this point, they could be retained for rent, a proportion could be sold or the entire development could be sold. An alternative approach would be to hold the entire development for rent for a period of 10 years after which a percentage, say 10 percent, would be sold off each year. The units could be sold to another investor, to individual home owners or to the sitting tenants. Local Authorities could strike any number of different agreements but allowing investors the option to sell could be critical, at least until build-to-let becomes well understood by investors.

Table 1: Residential average total returns to institutional investors, split by income and capital growth

	Total returns	Income returns	Capital returns
1 year	10.2	3.2	7
3 year	9.4	3.3	6.1
5 year	11.6	3.5	8.1
10 year	15.5	4.5	11
20 year	13.4	5.5	8
30 year	16.2	6.2	10

Source: Savills, *'Overcoming barriers to institutional investment in residential property'*, 2008

Professional management

In contrast to commercial property in which repairs fall to the tenant, management costs are significant in affecting the income from rental accommodation. Management costs, including the costs of empty properties, tend to account for 33 percent of the gross income from rent.[61] Efficient management is, therefore, critical to ensuring adequate rental income as well as providing a high quality experience for tenants. This makes small plots of land less viable for institutional investment because it is harder to realise management efficiencies across many small developments than across developments at scale.

The starting point for creating management efficiencies is to reduce management costs as much as possible in the original design of the properties, as the London Housing and Rental Company has proposed. For example, US multi-family apartment buildings use removable light fittings to make it easier to repaint apartments between tenants, ensure that bedrooms are designed to be the exact width of the carpet rolls used to speed up carpet fitting and all apartments have loading bays and wide lifts to making moving in and out as easy as possible.

Registered Providers who have traditionally played an important role in managing social housing could be significant in this context. They have a wealth of experience in managing rented accommodation for vulnerable tenants and, with a certain amount of reorganisation and up-skilling, could be well placed to manage private rented homes alongside affordable housing. One of the advantages of Registered Providers is that they could manage both the affordable housing units in the development, if these are required under a Section 106 agreement, and the privately

[61] Property Alliance '*Investment in the UK private rented sector consultation responses L-Z'*, 2010

rented units. A private landlord would first need to become a Registered Provider in order to manage both parts of the development.

Addressing the asset gap for long-term tenants

An important issue that is raised by the generational split among low-to-middle income households between those who own a home and those who rent long-term is the growth of asset inequality. Home ownership has become the primary vehicle for asset accumulation in the UK, dwarfing other investments, savings and pensions. In 2008, just over a quarter of people on low-to-middle incomes reported having a pension. Less than half made regular monthly savings and of those who did save, on average, they saved less than £200 a month.[62] This is, in part, because homes are treated more favourably by the tax system than other types of asset. Individuals are exempt from capital gains made on owner occupied property. In addition, home owners can borrow against the equity in their house. In developing an approach to build-to-let to meet the long-term housing needs of those on low-to-middle incomes, it will be important to address this growing inequality in assets. This could be done by allowing tenants to own a small equity stake in the fund that invests in the build-to-let development. This equity stake could be gifted or earned and would have to be sold if tenants chose to move. If the equity stake were gifted, this could be done in return for tenants taking on most of the repairs and maintenance themselves, thus reducing maintenance costs and improving returns. Selling the equity stake would allow tenants to liquidate their asset.

There are complex tax and legal issues that would need to be addressed in developing this concept further. In addition to creating a vehicle for asset building, this approach could create a greater incentive for tenants to invest in maintaining their home. Given a prevailing cultural preference for ownership, this model would encourage tenants to behave more like homeowners with a longer term stake in the property, as in the Netherlands where tenants have responsibility for simple repairs. Such incentives do not exist in the current buy-to-let market. In fact, most short-hold assured tenancies explicitly prohibit tenants from improving their property.

Addressing the concerns of investors

[62] Plunkett, J. '*Growth Without Gain? The faltering living standards of people on low-to-middle incomes*', 2011

The concept of institutional investment in the private rented sector is not new. Previous initiatives such as the Private Rented Sector Initiative have identified several barriers to securing institutional investment. The approach described above is being developed to meet the housing needs of people on low-to-middle incomes but with a sharp eye to also addressing commonly cited barriers to institutional investment. The next section will discuss the most commonly cited barriers and highlight how they are addressed by the approach to build-to-let discussed above.

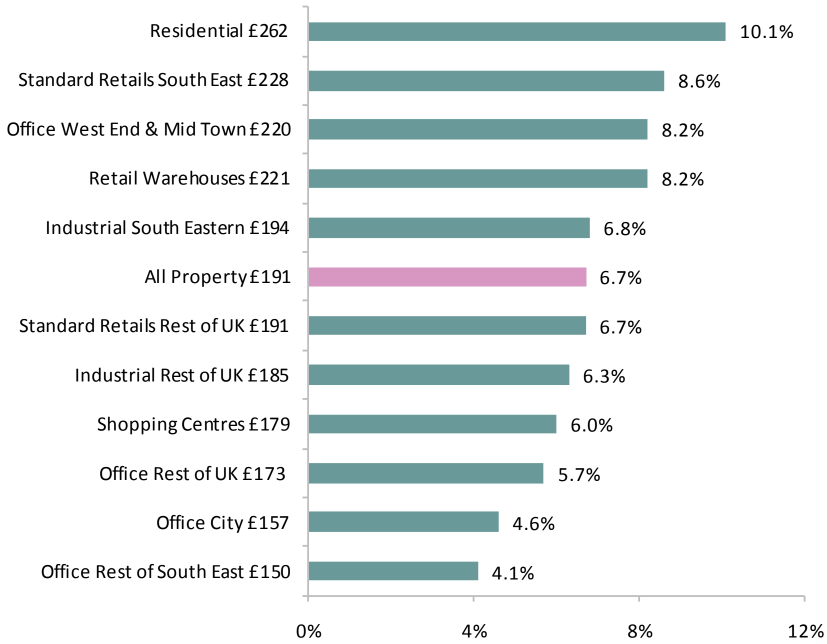
Residential returns are too low

There is a long standing assumption that returns from investment in residential property are too low to be attractive to institutional investors. As a result, institutions have focused their property investment on the commercial sector such as office buildings and shopping centres. They have £68 billion worth of investment in commercial property and own a quarter of all commercial property.[63] Commercial property is considered a safe bet because, once let, tenants tend to stay for many years, guaranteeing a steady income stream for the investor with little reputational risk given the lack of public visibility of commercial property. Commercial property also generates more profit if sold with a sitting tenant, while residential property loses value if it is occupied when put up for sale.

However, the Investment Property Databank (IPD) Residential Index which tracks the overall return on 2,400 residential market-let properties in the UK owned by long-term investors has shown total returns from residential investment outperforming commercial property in each of the last three years. This is based on the total annual return which includes rental income and capital gains. On a ten year view which is as far back as the IPD goes, residential investment has proven itself to be more competitive than other kinds of investment, with an annualised return of 10.1 percent compared to 6.7 percent per annum for commercial property, 5.9 percent for gilts and 3.7 percent for equities.[64] This is illustrated in Figure 7 below which shows how much would be made over a decade from investing £100 in the year 2000 in different types of property in London. Returns from residential property come out on top.

[63] Paul Mitchell Real Estate Consultancy Ltd, '*Property data report 2009*', 2009
[64] IPD, *IPD UK Residential Index*, 2011

Figure 7: Returns from investment in different categories of real estate



Source: Investment Property Databank, as cited in *Invest to Rent*, 2011.

One of the core features of the approach to build-to-let described in this chapter is to allow rental properties to eventually be sold if necessary. This ensures that income returns can be supplemented by capital gains to push up total returns in order to meet investor expectations. While it could be argued that the last 10 years has been particularly unusual in the UK housing market with historically high house prices driving up total returns, particularly in London and the South East, a thirty year, national view provides a similar perspective.[65] In addition, residential property provides better protection against inflation than other kinds of investment, including other kinds of real estate investment.[66] This is significant for pension funds and life insurance companies with long term liabilities that need to be matched by inflation-protected investments.

Furthermore, the investment of land to reduce the upfront costs of development and, therefore, the costs of borrowing, has the potential not only to kick start development but to support higher income returns, especially in the first few years after development. This is particularly important in London and the South East where open market rent is beyond the reach of low-to-middle income households. Income from below market rents will, therefore, need to be boosted by lower development costs, reduced affordable housing requirements and the possibility of sales over time.

[65] Daly, J '*Overcoming barriers to institutional investment in residential property*', 2008
[66] IPD presentation to Urban Land Institute Residential Council, 14 June 2011.

Reputational risk

Investors have shied away from residential investment because of the perceived reputational risks involved with the sector. First, the private rented sector has a mixed reputation, frequently being associated with rogue landlords, a lack of security and poor quality housing. Second, it has high public visibility and is far more emotive than commercial property. Investors worry about the reputational damage caused by evictions or other housing issues that could arise in the residential sector.

Focusing institutional investment on a new type of high quality rented product that offers security and some of the features associated with home ownership will address some of the negative perceptions that are currently prevalent about the sector. These affect tenants' views of it as a long-term home and investors' view of it as an attractive asset. In addition, investors have the option of indirect investment through a third party mechanism in contrast to direct ownership which is more common elsewhere, for example in the Netherlands.[67] Joint ventures and limited partnerships are being used by Local Authorities to secure indirect investment from private investors, for example in Birmingham.

Real Estate Investment Trusts (REITs) also provide an indirect investment option. They are commonly used in the US but have not taken off in the UK residential sector because they do not currently offer investors the right financial incentives. As announced in the 2011 Budget, HM Treasury will consult with the industry about how REITs can better support institutional investment in the build-to-let market.[68] REITs are arms-lengths structures that can be branded separately from their core investors and, therefore, create a significant amount of reputational protection. There are other indirect investment vehicles such as unit trusts currently in use in the UK that can provide investors with a range of options to avoid the reputational risk of direct ownership.

[67] Oxley M *'Promoting investment in private rented housing supply: International policy comparisons'* 2010
[68] Her Majesty's Treasury, *Budget 2011*, 2011

Development risk

The construction phase of a residential development is highly risky. Securing planning permission alone can take two years. There is a general assumption that institutional investors do not want to take development risk and prefer to take on a completed rental development. Therefore, the approach to build-to-let being taken in this report assumes that the development phase is undertaken by a construction company and is financed separately. This removes institutional investors from any risk related to the construction. The costs of construction, however, remain critical to the overall viability of the development. Keeping costs as low as possible in the construction phase helps generate higher returns in the first years after the residential development is complete.

Although construction finance is less widely available now than before the recession, having investors lined up to take on the completed development will make it easier to secure finance for the construction phase. This approach to managing development risk is more viable following the change to Stamp Duty Land Tax (SDLT) introduced in the 2011 Budget. Prior to this, the higher rate of SDLT for bulk purchases of properties created significant disincentives to transferring completed properties into an indirect investment vehicle as many investors would prefer.

Scale

One of the commonly cited barriers to institutional investment is the lack of opportunities for investment at scale. Investors expect to make sizeable investments. Publicly listed bonds, for example, start at around £200 million, although privately negotiated investments can involve smaller sums.[69] Investment on this scale requires plots of land big enough to build over a hundred units per plot or around £10 million worth of investment per plot.[70] Small plots of land can also make it more difficult to manage developments efficiently and, therefore, costs can increase.

Large regeneration projects are ideally suited to build-to-let development because hundreds of units can be built on a single site. For example, Kings Cross Central is the largest capital city

[69] Investor perspective presented at Resolution Foundation meeting on modelling institutional investment in the private rented sector, 21 July 2011.
[70] HM Treasury '*Investment in the UK private rented sector*' 2010

centre urban regeneration scheme in Europe and has the scale for 2000 homes alongside office buildings and a new university campus. Another approach to generating the scale required by institutions is to gather multiple developments into one fund. This is unlikely to make very small plots of land viable but it can create the scale required when large single developments are not possible. One of the proposals put forward by the Mayor of London's Housing Investment Taskforce is the creation of a London Housing and Property Company.[71] This will help secure the scale required by institutions by providing a framework for the investment of any publicly owned land in London that can be used by Local Authorities as well as the Greater London Authority.

Security

One of the reasons why social housing has attracted debt investment from institutions is that it guarantees relatively low but highly secure returns. This is because 60 percent of rental income is currently paid directly to landlords through Housing Benefit and the sector is regulated and government-backed. Providers will not be allowed to fail. Government will step in, guaranteeing the returns expected by investors.

At present, this kind of guarantee is hard to secure in the private rented sector. While greater demand for rented accommodation among those on low-to-middle incomes is likely to sustain rental incomes, it is not a guarantee. Fixing rents at Local Housing Allowance rates can provide a virtual guarantee because tenants can claim housing benefit to cover their rent if they lose their job. This limits the likelihood of voids because tenants who find themselves unable to pay will not be forced to move. Another option would be for Local Authorities or Housing Associations to offer a rental guarantee in the private rented sector as they often do for social housing. Investors then receive a guaranteed, risk-free income that the Housing Association has to deliver through efficient management of voids, repairs and other costs.

[71] GLA, '*Mayor of London's Housing Taskforce report*', 2011

Chapter 5: Taking build-to-let to scale

There is a pressing need to create a new, more secure, higher quality offer for individuals and families on low-to-middle incomes who will rent for the medium to long term. Attracting institutional investment into the private rented sector to build new rental developments has a critical part to play in addressing this housing need. The success of build-to-let will depend on establishing a new partnership approach between Local Authorities, investors, developers and landlords with the flexibility to renegotiate established ways of addressing affordability, public land use, planning and tenants rights. A few entrepreneurial Local Authorities, developers and private investors are currently leading the way but a broader set of actions will be required to take build-to-let to scale. These are discussed below.

Refining a model of build-to-let development for 'generation rent'

There is evidence that investment in residential property can deliver stable, long term returns for institutional investors. However, investors are hesitant in moving forward and continue to favour commercial property. This is in large part because commercial property is where their expertise lies. This leaves them unsure how to price the returns from residential property which can include income and capital returns.

The Resolution Foundation is working with investors, developers, Local Authorities, and other experts in the property industry to examine in greater detail the returns that investors can expect from build-to-let development aimed at individuals and families on low-to-middle incomes. This work will build on the core concepts outlined in Chapter 4 but look in detail at specific issues such as the sales profile that is required over time to generate adequate returns, the appropriate balance of debt to equity financing, the return that the landowner can expect over time and the rights and responsibilities of tenants in this new approach.

This detailed work will inform a more developed model of build-to-let for low-to-middle income individuals and families that will be published later this year. This model will provide the basis for a series of meetings convened by the Resolution Foundation between investors, residential property experts, developers, Local Authorities and representatives from central government.

These meetings will assess the viability of build-to-let development on land in different parts of the country and stimulate partnerships that can kick-start institutional investment in the sector.

Addressing the policy barriers to build-to-let development

International experience of institutional investment in the private rented sector highlights the importance of government policy and incentives to stimulating investment. This next section puts forward recommendations for Local Authorities and central government that could support the development of institutional investment in build-to-let aimed at individuals and families on low-to-middle incomes looking for a long-term home.

Local Authorities

Local Authorities have traditionally prioritised social housing tenants rather than those on low-to-middle incomes and have generally not favoured the private rented sector. However, this is starting to shift as councils realise the benefits to their local economies of keeping working people in the local area. A mixed community supports economic growth and regeneration and is important for local businesses. For example, Wandsworth and Newham have both recently expanded their social housing allocations to include low-income working people.

Recognising the importance to local areas of meeting the housing needs of individuals and families on low-to-middle incomes is critical to the expansion of the private rented sector through institutional investment. With limited government grant available for the construction of social housing, competition over public land for the development of new housing will grow. If Local Authorities prioritise all public land investment for the construction of traditional social housing over housing for those who are in work, local areas and low-income working people will continue to fall through the gap between home ownership and social housing. Local Authorities must balance their duty to house vulnerable groups with a broader agenda for economic growth that includes housing for working people. Failure to do so will leave Local Authorities with long social housing waiting lists and no way of addressing them.

To improve the viability of build-to-let development, Local Authorities need to take a more flexible approach to the negotiation of Section 106 agreements and recognise private rented accommodation aimed at low-to middle income households as meeting Section 106 requirements. In contrast to traditional social housing, these units would not be permanently given over the Local Authority but would be held in rent for an agreed period, say 10 years, before the option to sell could be exercised. In addition, allocations to the units could be managed separately from the social housing waiting list in order to prioritise working people. This would follow the approach taken by Birmingham City Council in its agreement with Evenbrook to build rented accommodation for low income working people that must remain in rent for 21 years. While the Birmingham example is a pure private rented sector approach, an alternative would be for Local Authorities within a single Section 106 agreement to accept a percentage of affordable housing alongside private rental units that are targeted at those in work on low-to-middle incomes.

In return for investing public land and providing greater flexibility over Section 106 agreements, Local Authorities can place conditions on developers and landlords. For example, they could require them to provide longer tenancies for families or could require construction companies to provide a certain number of apprenticeships or other training opportunities. For example, Camden and Islington Councils have been working with Argent, the developer of King's Cross Central, to create a Construction Skills Centre as part of the overall regeneration scheme which is now offering 150 construction apprenticeships a year to young people from the area.[72]

Central government

In the 2011 Budget, the Government introduced two changes to support institutional investment in build-to-let: changes to Stamp Duty Land Tax and consultation on the structure of Real Estate Investment Trusts. These were overshadowed by the introduction of FirstBuy, a £250 million scheme to help first-time buyers earning less than £66,000 a year. Despite strong evidence that house prices are likely to remain out of reach for those on low-to-middle incomes for many years to come, current policy discussions do not appear to acknowledge the housing reality Britons now face.

[72] Winstanley, P and Hill B for London Councils and British Property Federation, *'Invest to Rent: a guide to developing partnership investment in new private rented homes for Londoners'*, 2011

The emergence of 'generation rent' calls for Government to give greater priority to the needs of long-term renters in the development of its housing strategy later this year. This needs to take several forms.

First, the Prime Minister recently announced the sale of public land for the development of new homes. The principle behind this initiative is positive but the opportunity to emphasise homes for rent as well as for sale was missed. The Government must give greater priority to the use of public land as an incentive for build-to-let rather than just build-to-sell development. The emphasis in the Government's build now, pay later approach has not been on the long term investment of land for the development of rental accommodation for those priced out of home ownership but on creating incentives for house builders who are currently unable to raise development finance.

Second, Communities and Local Government (CLG) is currently consulting on a new national planning framework. CLG could use this new planning framework as an opportunity to encourage Local Authorities to recognise private rented housing for people on low-to-middle incomes as meeting Section 106 requirements. The new localism agenda leaves decisions about housing in the hands of Local Authorities and communities. Nevertheless, there is an opportunity for central government to encourage a more coordinated approach to planning across Local Authorities that would support greater institutional investment. Different approaches to planning across Local Authorities currently pose a significant challenge to the large scale expansion of the private rented sector because each development has to be negotiated separately and under different terms. In London, this coordination role could be played by the Mayor's office through the proposed London Housing and Property Company.

To further support the development of the private rented sector, government could create an expedited planning process as part of the new national planning framework for developments that meet the needs of individuals and families on low-to-middle incomes. Given the costs of planning, an accelerated process would create a real incentive for developers to target building at this group, creating a major increase in the stock of rented accommodation fit for individuals and families on below median income.

In many ways, people on low-to-middle incomes are already ahead of government in accepting that they are unlikely to own in the medium or even long term.[73] Only 17 per cent of renters expect to buy a home in the near future.[74] However, the dominance of home ownership as a marker of success in British society creates a perception that renting is less desirable. Shifting this perception is not the task of one government. It will require a medium-term, cross-party approach to address the range of policy issues raised by the growth of long-term renting, including asset inequality and the favourable tax treatment of housing, and to redefine what it means to succeed in Britain in new terms that are less closely tied to home ownership. At the beginning of the twentieth century, Britain was a nation of renters. In the twenty first century, we need to rediscover some of this historical sense of perspective.

[73] National Centre for Social Research, '*First Time Buyer Report*', 2011
[74] Taylor, E 'Public attitudes to housing in England: report based on the results of the British Social Attitudes Survey', 2011

The Resolution Foundation

The Resolution Foundation is an independent research and policy organisation.
Our goal is to improve the lives of people with low-to-modest incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- undertaking research and economic analysis to understand the challenges facing people on a low-to-middle income;
- developing practical and effective policy proposals; and
- engaging with policy makers and stakeholders to influence decision-making and bring about change.

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