January 2013

The Future of London's Private Rented Sector

Series Summary

Joanna Wilson and Jennifer Johnson

The private rented sector in the UK can be defined as any property that is privately owned and being rented out as housing, usually by an individual landlord, but potentially by housing organisations.[1] As other tenures decline across the country, it is the fastest growing sector in the country, predicted to surpass social rented housing imminently.[2] However, the PRS is not immune to the challenges facing the construction industry, and a focus on increasing the supply of new build homes for market rent is required if the PRS is to provide homes of sufficient size, quality and rental cost for a diverse range of tenants. This will be all the more important in 2013, when the benefits cap is likely to have an adverse effect on housing choice, particularly for those living in London.

This briefing is based on the series of breakfast seminars Future of London ran with the support of PWC in November and December 2012. Consequently, the paper does not try to cover all aspects of the sector, instead focusing on the national and London policy agenda, attitudes to landlord accreditation and the challenges of attracting institutional investment. Thanks to everyone that took part in the seminars, particularly the speakers: Terrie Alafat (DCLG), Richard Hill (HCA), Professor Christine Whitehead (LSE), Jamie Ratcliff (GLA), Ian Doolittle (Trowers and Hamlins), Andrew Heywood (independent housing consultant), Chris Norris (National Landlords Association), Harvey Griffiths (HIF Group), David Montague (L&Q London Housing Association), and John Webber (PwC).

CONTEXT

Market context

Across the country, private renting is increasing as a tenure share (see Figure 1 and 2, from Whitehead et al.), with households both choosing and being pushed towards the sector.[3] The private rented sector often houses the most mobile households, and is a particularly important tenure for young entrants into the housing market; however, as home ownership and social renting both become more inaccessible, demand for privately rented housing rises out of necessity in addition to choice. Compared with owner occupation and social renting, it is the only growing housing tenure across England, and in London. This push into private renting from a wide range of household types is driving demand for a broader offer from the sector, including family housing and longer tenancy periods. At the same time, the price of renting continues to rise: rents are anticipated to increase by 4 per cent in 2013, twice the increase of 2 per cent expected in house prices.[4]

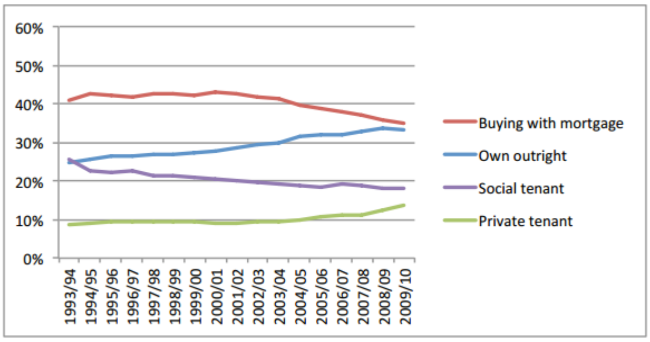

Figure 1: Historical change in housing tenure, England

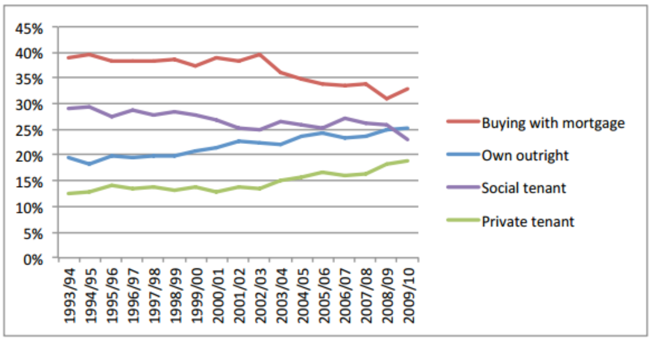

Figure 2: Historical change in housing tenure, London

In London, where the private rented sector has been even more prominent, one quarter of households are private renters.[5] In six London boroughs, private renting houses more than one third of households:[6] The median monthly rent in London is £1,150, almost double that across England of £575, and ranging from

[1] Crisis (2013) 'About the PRS'

[2] IPPR (2012) 'Affordable capital? Housing in London'.

[3] Sourced from: Whitehead, C., Williams, P., Tang, C., and Udagawa, C. (2012) 'Housing in transition: Understanding the dynamics of tenure change'.

[4] RICS (2012) 'House prices to rise 2% in 2013'.

[5] DCLG (2012) 'English Housing Survey: 2010-11 Household Report - Chapter 1 - data and Annex Tables'.

[6] ONS (2012) '2011 Census: KS402EW Tenure, local authorities in England and Wales'.

£412 in RB Kingston upon Thames to £2,058 in RB Kensington and Chelsea.[7] Median rent rises dramatically for family housing in London, at £1,430 and £2,197 for three and four+ bedroom homes respectively.[8][9] Despite these high prices and strong demand, the average yield on privately rented properties is about five per cent, in the middle of the pack amongst the regions of England.[10]

Government responses

The Government's 2011 Housing Strategy recognised the private rented sector as a growing tenure in need of attention[11]. In order to encourage a wider range of investors in PRS, the CLG commissioned a 'Review of the barriers to institutional investment in private rented homes', commonly known as the Montague Review[12]. It viewed the stable regulatory framework over the past two decades – that is, a time of relatively low regulation – as an asset in attracting investment to the sector, while recognising that rental yields and cost of stock management were also important factors. Amongst the report's recommendations was the advice that councils employ flexibility in the planning system to facilitate private rented sector developments, including considering waiving affordable housing requirements, and reviewing currently stalled sites. Central government has responded to many of the report's policy recommendations by introducing the following measures in the 2012 Finance Act[13]:

- A £200-million, Build to Rent fund for equity finance to house builders and developers for new purpose built privately rented homes;
- A debt guarantee scheme that will raise funds to help buy newly built homes;
- A team of experts to support demonstration projects and take-up of these two schemes.

London's government is also turning its attention towards the private rented sector. The Mayor of London's third Housing Covenant 'Making the private rented sector work for Londoners'[14] breaks down the current administration's objectives for the PRS into three strategies, the first of which focuses on supporting new housing supply in the sector. Strategies for achieving this objective include employing central government's schemes (as above), appraising options for PRS investment vehicles and developing bespoke PRS products, along with applying the November 2012 Housing Supplementary Planning Guidance that supports land use planning as an incentive for such developments. The remaining objectives – 'empower consumers' and 'promote standards' – reflect the covenant's emphasis on promoting tenant and landlord responsibilities, through measures such as encouraging landlord accreditation, promoting landlord uptake of longer tenancies and rent increase certainty, building capacity amongst private tenant groups, incentivising landlords to invest in their properties, and working with boroughs to fully utilise their existing enforcement powers. At the same time, the London Assembly Housing and Regeneration Committee is undertaking a review of how the private rented sector could be made more affordable, more secure, and of a higher standard, with the anticipated output of recommendations for all levels of government.[15]

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[7] VOA (2012) 'Table 2.7: Summary of all monthly rents recorded over the 12 months to the end of September 2012 by administrative area for England'.
[8] VOA (2012) 'Table 2.5: Summary of monthly rents for "3 bedrooms" recorded over the 12 months to the end of September 2012 by administrative area for England'.
[9] VOA (2012) 'Table 2.6: Summary of monthly rents for "4 or more bedrooms" recorded over the 12 months to the end of September 2012 by administrative area for England'.
[10] LSL Property Service plc (2012) 'Buy to let index October 2012'.
[11] HM Government (2011) 'Laying the Foundations: A Housing Strategy for England'.
[12] Sir Adrian Montague (2012) 'Review of the barriers to institutional investment in private rented homes'.
[13] CLG (2012) 'Improving the rented housing sector'.
[14] Mayor of London (2012) 'The Mayor's Housing Covenant: Making the private rented sector work for Londoners'.
[15] The London Assembly (2012) 'London's private rented sector'.

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REGULATION

Divergent attitudes

Until 1988, the tenure share of the PRS steadily declined, due in part to rising owner occupation and social renting. This decline was also a reaction to high levels of regulation (particularly from the Rent Acts) that, while achieving high levels of tenure security and rent control, had the indirect impact of discouraging landlord and investor engagement with the PRS. The subsequent Housing Act 1988 and further initiatives enabled landlords to charge market rent, and increased the accessibility of buy-to-let mortgaging. In recent years, there have been minor regulatory tools introduced into PRS: for example, tenancy deposits under the Housing Act 2004, and the Mortgage Repossession (Protection of Tenants) Bill that was tied to Crisis's 'A private matter?' campaign. On the whole, however, government has left PRS relatively unregulated for the past two decades, and this has coincided with growth in the sector.

While regulation is generally viewed as positive from a tenant protection standpoint, other key actors see regulation in the PRS with more trepidation. Only one per cent of landlords manage more than 10 properties [16], the vast majority approaching their involvement with the PRS as small businesses. From this view, the costs and bureaucracy of regulation dissuade entry into the PRS as landlords. At the same time, investors and lenders want control over their investment and so may perceive regulation as a threat. With a relatively low average rental yield in London's privately rented housing of 5.1 per cent[17], the regulatory costs borne by these actors could further compromise returns.

Countering these attitudes against regulation is strong support. As quality is not regulated in the sector (unlike social housing), poor standards are a major challenge: indeed, unacceptable conditions are more prevalent than in any other housing tenure, with 37.2 per cent of privately rented homes failing at least one Decent Homes criteria.[18] Additionally, although most landlords work positively with their tenants, a small minority of so-called 'rogue landlords' act illegally, with the highly-publicised example of 'beds in sheds' [19]. Landlord licensing offers one potential solution to this challenge, a power which was afforded to local authorities under the Housing Act 2004. In London, LB Newham is first to utilise these powers. Following its pilot programme in Little Ilford, a mandatory borough-wide landlord licensing scheme came in to effect on 1 January 2013, with prosecution and fines up to £20,000 for landlords who fail to license, or licensees who are non-compliant with conditions. [20] The challenges of enforcement in practice remain to be seen.

Lessons from other countries

There can be no doubt that many countries – both in Europe and further afield – have more favourable private rented sector strategies, with greater incentives both for tenants to choose private renting as a long-term option, and fiscal arrangements that encourage people to invest in private residential property[21]. Whilst these provide interesting examples, it is not necessarily helpful to see them as direct comparators. The fact, for example, that Germany's housing stock comprises 60 per cent in private rental, is indicative of a flourishing private rented sector, but also of a very small social housing sector in comparison with the UK.[22]

Nevertheless, UK tenants have shorter leases and less security of tenure than the rest of Europe. Similarly, rental prices and increases are unregulated, unless the tenant is in receipt of housing benefit, making them more likely to absorb costs laid on landlords. This implies that examples of regulation that should protect the tenant, such as licencing schemes, could backfire, as tenants' rents could be increased to absorb the costs. These facts, coupled with various incentives for home ownership over the years, make it easy to understand why owner occupation is still seen as the tenure of choice in the UK.

[16] CLG (2011) 'Private Landlord Survey 2010: Tables'.
[17] LSL Property Service plc (2012) 'Buy-to-let index October 2012'.
[18] CLG (2012), 'English housing survey housing stock summary statistics tables, 2010'.
[19] CLG (2012) 'Major clampdown launched on 'beds in shed''.
[20] LB Newham (2012) 'Public Notice: Designation of an Area for Additional Licensing' and 'Public Notice: Designation of an Area for Selective Licensing'.
[21] Christine Whitehead (2011) 'Towards a Sustainable Private Rented Sector'.
[22] ibid

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On the investment side, many countries, including Germany and the US, which have two of the largest and most developed private rented sectors, incentivise private landlords through a range of tax breaks, such as the ability to offset rental losses against other types of income and depreciation allowances. Whilst offering such favourable incentives could boost the UK's Buy to Let market, Government is focused on attracting more significant, institutional investment into the market, seeing this as the key to increasing supply.

INSTITUTIONAL INVESTMEST

The private rented sector is dominated by landlords with just one property.[23] Such people are unlikely to have the resources or appetite to invest in or develop new housing, particularly as mortgages are less readily available than they once were, constraining the Buy to Let market[24]. Therefore, encouraging institutional investment in PRS is seen as the key to increasing supply.

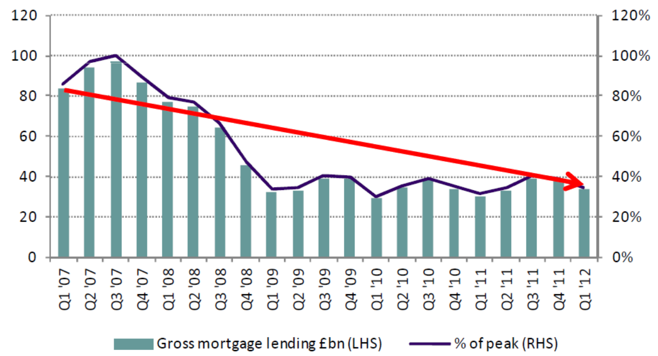

Figure 3: Gross Mortgage Lending 2007 – Q1 2012

Institutional investors require a respectable net cash yield. This is challenging in the PRS for a number of reasons including:

- High management costs, particularly when economies of scale cannot be met
- Rental income not being guaranteed – properties could be left vacant on completion or further down the line.

On the other hand, investors should be attracted by the long-term arrangement that the private rented sector offers, as home ownership becomes increasingly unaffordable for Londoners, provided that the properties being built are of significant quality and an appropriate management strategy in place. And in London, where capital growth is reliably high, investors may be content with a lower cash yield than elsewhere.

Opportunity for registered providers

If institutional investors are looking for economies of scale and a reliable and long-term management strategy for their properties, the opportunity for registered providers is clear. The G15 is the biggest market landlord in London, and the organisations within it are therefore well placed to work with investors to develop and maintain their properties.

Some RPs, most notably London & Quadrant, are setting up private rented sector portfolios using their own reserves, with the twin objectives of supplying new market rent homes and reinvesting the profits back into affordable housing, thus augmenting their core business. This cross-subsidy could be an effective way of creating new mixed tenure developments, but is dependent on RPs having sufficient equity through their current stock. RP issuance of bonds is also on the increase, as they seek other means of financing development.[25]

RPs need to work closely with their London borough partners to make new build provision viable. The boroughs themselves are already exploring ways of managing debt and investment, in order to continue to provide services to their communities in a strained economic climate. They should therefore be open to considering how to support housing development in their areas, such as providing public sector land, or making the case to large public landowners of providing it for house building over other demands.[26]

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[23] CLG (2011) 'Private Landlord Survey 2010: Tables'.
[24] Council of Mortgage Lenders (2009), from Griffiths, H. (6 Dec 2012), 'PRS – Investing institutional capital in the Capital'.

[25] TradeRisks (2012) 'Social Housing Bonds'.
[26] London Councils (2011) 'Invest to Rent'.

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Investment structures

Flexible and straightforward methods of investment are required to encourage institutional investors to commission new build homes.[27] The HCA's 2010 Private Rental Sector Initiative provided equity to investors wishing to establish private rental funds. Through the initiative, they supported Berkeley Homes to create a private rental fund that will build 555 homes across their development sites in London and the South East. However, no other deals were struck through the initiative, and the HCA is now focused on distributing the £200m Build to Rent fund established after the Montague Review.

Through the 2012 Finance Bill, the Government has also aimed to make Real Estate Investment Trusts (REITs) more attractive to investors. REITs are a key investment structure of the private rented sector markets in the US, incentivising property investment companies by exempting corporation tax on rental income. Established in Britain in 2007, they have so far presented too many challenges for the residential sector to take off, and have remained predominantly within the commercial property sphere. The reasons for this are explored in the table below.

	Commercial	Residential
Valuation basis	Vacant possession	Discount up to 30% for tenanted property
Market value driven	Supply & demand of occupiers	Supply & demand of purchasers
Primary source of rental income	Rental income	Sale proceeds
Gross yield	5 - 7%	0 - 6%
Gross net leakage	10%	25 - 35%
Net yield	4.5 – 6.5%	4%

Figure 4: Investment Comparison – Commercial vs Residential[28]

The Bill has sought to increase the appetite for establishing REITs, notably by removing the 2 per cent conversion charge, and dramatically reducing stamp duty on bulk residential purchases.[29] However, the Montague Review suggested that residential REITs in Britain remain insufficiently flexible and accessible as to be attractive to investors.[30]

CONCLUSION

The PRS is the fastest growing housing tenure in the country. Considering ever increasing social housing waiting lists and levels of homelessness, plus the difficulties of owner occupation for the average earner in London, this trend is unlikely to reverse. The Government understands the opportunity that growing the sector presents, both in terms of addressing the housing shortage and of the economic benefits of boosting the construction sector. Consequently, efforts are being focused on increasing the supply of private rented homes through attracting investors with sufficient financial capabilities to be able to support large developments. This is demonstrated both by CLG's measures targeted at the sector after the Montague Review, and by the GLA's recent Housing Covenant.

Both CLG and GLA imply that a focus on boosting supply should not include further regulation of the sector in any way, for fear of deterring institutional investment. However, low Decent Homes standards, inconsistent standards of management and rising rents within the existing sector are a sharp reminder of why higher regulation is commonplace in other countries. LB Newham has just embarked on a borough-wide landlord accreditation scheme in order to improve local housing conditions, but it has been suggested that a smaller, more targeted scale would be easier to enforce. Furthermore, there are numerous ways of improving tenant conditions and protection that need not have an adverse effect on the sector as a whole, and these could be explored further.

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[27] HCA (2013) 'Private Rental Sector Imitative'.
[28] Urban Land Institute (2011) 'Urban Land Institute UK Residential Council: REITs Seminar'.
[29] CBRE (2011) 'Reforming UK REITs'.
[30] CLG (2012) 'Review of the barriers to institutional investment in private rented homes'.

Attracting institutional investment remains challenging to the sector, despite recent Government incentives and pilot schemes. However, it is thought that it would be more favourable if the risks could be appropriately managed, and there are opportunities for both boroughs and registered providers in this regard. This is paramount to achieving the vast levels of new supply required if the sector is to successfully house increasing numbers of London's growing population, as well as boosting the construction sector, and, in so doing, the UK economy.

70 Cowcross Street
London
EC1M 6EJ
www.futureoflondon.org.uk