UNISON

Open College

BLOCK HFFS.106

FINANCE FOR PRIVATE RENTED HOUSING

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Preface

In this Block we will look at the ways in which private rented housing is financed. We begin by looking at some of the causes of the decline of the private renting sector, in terms of the constraints on landlords; at the causes of low returns on investment in private rented property; and at the kinds of returns which would be needed to induce more investment in what is seen as a high risk area.

We will then turn to the kinds of finance available to landlords, in terms of the different kinds of landlord - companies, institutions and individuals, and their share of the market. We look at sources of finance to companies, including public finance through various government grants; at the operation of the Business Expansion Scheme as a source of housing finance; at Housing Investment Trusts; at an experiment in helping homeless people without deposits into rented accommodation; and at the ways in which loan finance can be raised by companies and individuals.

You will find that some housing statistics, and also some texts on housing, include housing association properties within the private rented sector. We have specifically excluded them: you have already studied housing association finance in Block HFFS.104. For the most part, the financial arrangements for housing associations and for private landlords are very different.

Outcomes

After studying this Block, you will be able to:

- describe some financial factors contributing to the decline in the private rented sector;
- distinguish between capital costs and capital values as the basis for calculating returns on investment in private rented property;
- discuss the risks of investment in private rented houses, and their effect on the return landlords require as an inducement to investment;
- explain the relative importance in the rental market, of various kinds of landlord; and
- outline the funding, internal and external, public and private sector, available to landlords.

Contents

A. A Declining Sector

1. Introduction

Private rented housing, as a proportion of all homes, has been in fairly steady decline in Britain since the First World War. Whereas it once formed around 90 per cent of housing, it now represents just over 10 per cent. It has made a small recovery in the last 10 years, from a low of 9.1% in 1989. In this section, we will examine some of the financial aspects which provide a disincentive to private landlords, and at the returns to be expected on what is seen as a risky investment.

However, we will begin by examining what is meant by the Private Rented Sector: what is it composed of?

2. Composition of the Private Rented Sector

The private rented sector is defined as a residual, i.e. any stock which is not owner occupied or rented from a local authority or housing association. As such, it includes a very wide variety of different lettings including:

- second homes;
- services married quarters;
- accommodation 'tied' to a job;
- homes leased by local authorities from private owners; as well as
- the "main stream" private rented sector, i.e. accommodation rented out by private owners, individual and corporate, to private individuals and households.

3. Financial Disincentives to Landlords

Financial constraints on landlords form an important part of the explanation for the decline of the sector. Problems arise both from the high costs incurred by landlords, and from the low revenue to be gained, in terms of rental income, and capital gains.

3.1 High costs of providing private rented housing

The average costs of private landlords may be higher than local authority or housing association landlords, and many owner occupiers, because:

(a) No special institutional arrangements exist for financing private landlords, such as the Housing Corporation.

(b) They are not, in general, eligible for the range of subsidies and tax concessions, which are currently available to the owner occupier, nor are there general government grants or loans, such as those available to social housing landlords.

(c) Many homes in the private rented sector are old, because they date from the period - pre World War 1 - when private renting was the norm. This means that repair costs are, potentially, significantly higher.

3.2 Low revenue

(a) The revenue of private landlords - income from renting - was held at very low levels for very many years, due to rent controls. Between 1974 and 1989, a "fair rent" was determined by a central government officer called a Rent Officer. Since 1989, however, landlords have been free to charge market rents, the aim of decontrol being to stimulate the provision of more private rented housing.

(b) In theory, landlords may choose to invest their money in a variety of other assets, such as stocks and shares, if returns from these are greater than from housing. However, for many years, most private tenants have had some security of tenure. Due to the low returns available, tenanted property commands a relatively low price. This meant that private landlords could not easily withdraw from the sector by selling the property with a "sitting tenant". Most leave only when the protected tenant vacates the property, which can then be sold with vacant possession, usually to owner occupiers. This gives the property a higher capital value.

3.3 Returns on investment

It seems, then, that one of the key reasons for the decline of private renting is that the *financial returns* to private landlords have been too low. Research, by Christine Whitehead and Mark Kleinman ('The viability of the privately rented housing market', in *Housing and the National Economy*, ed. J. Ermisch, 1990) suggested that:

> *"Few landlords expect to make more than 6% on current capital values from rent alone. They also say that this means they do little more than cover their costs (including the risks of letting) from rental income. The main reason commercial landlords give for being in the sector is the expectation of capital gains... "*

We shall examine the key elements of this quote in more detail:

(a) "Capital values"

Returns are based on capital values, because that is the present worth of the property. The capital cost, the original purchase price, may well have been much lower if the property has been owned for some time. However, the landlord could (in theory) sell this asset and purchase other assets. The full capital value of the house is what should be obtained, for investment elsewhere. This is no different from selling other assets, such as shares. The full current value would be gained if they were sold.

So, to compare investment in housing to other types of investment, we have to calculate returns on current capital values.

(b) "Risks of letting"

The risks of letting mean that returns are, potentially, variable. What are these risks?

- The property may remain vacant for some time, when no rental income is earned.
- The tenant may generate rent arrears, which may not be recoverable.
- The property may be neglected or damaged by the tenant, which increases costs, or reduces capital value.

In contrast, some other forms of investment are much less risky. The least risk is offered by "investment" in one of the financial institutions, which may offer fixed returns for a certain period of time. There is then no risk that returns will vary.

(c) "Expectation of capital gains"

Capital gains are increases in the capital value of an asset. So, landlords may view investment in private rented housing as worthwhile if they expect to make capital gains. They anticipate that the asset - the property - will increase in value. Hence, returns come not only from rent income, but also from increases in capital values.

Compare this to investment in a building society: interest is paid annually (comparable to rent income), but the asset is not increasing in value. Assuming the interest paid is withdrawn, the asset will keep the same value over time.

However, the capital gains available on tenanted property, due to expectations of low returns, are much less than for untenanted property.

(d) What returns are needed?

The continued decline in the private rented sector implies that the returns which have been available - identified by the Whitehead and Kleinman research as 6% - have been too low. So, what returns would be needed to induce a greater supply of private rented housing?

More recent research by Crook, Hughes and Kemp for the Joseph Rowntree Foundation (*The Supply of Privately Rented Homes: Today and Tomorrow,* 1995) found that nearly half of existing private sector landlords felt that returns were inadequate, comparing unfavourably with alternative investments. To expand (or even retain) their investment in the sector, returns some 3.4% higher were required.

The research also found that pension and life funds were unwilling to invest even if returns were to improve: they perceived political risk (i.e. the potential for any favourable investment circumstances to be changed), and the image of the private rented sector, as major deterrents. Banks were also cautious, but building societies were more positive: if more financial assistance was available, they would be willing to invest or lend in the sector.

Summary

1. **The private rented sector has been declining steadily since the First World War.**
2. **Private landlords often face higher costs than other types of landlord because:**
   - **they may have higher borrowing costs;**
   - **they receive fewer subsidies;**
   - **much of their property is old.**
3. **Largely as a result of rent controls, returns on investment in private renting have been low.**
4. **The private rented sector has recently shown a small recovery, although this is not very significant.**

Self Test 1

1. *Why might private landlords have higher average costs than other kinds of landlord, or owner occupiers?*

2. *Why are returns on investment in private rented property calculated as a percentage of capital value, rather than capital cost?*

3. *What are the main risks of letting?*

4. *What is meant by the expectation of capital gains?*

Now turn to the Answers at the end of the Block.

B. Finance For Private Landlords

1. Introduction

Here we first look at the different kinds of landlord operating in the rental market, and at their share of the market. We then look in detail at the finance available to them from public and private sectors, and at how effectively these sources operate as resources for housing.

2. Who are the Landlords?

Before we examine the sources of finance for landlords in the private sector, it is important that we first distinguish between different categories of landlord. To some extent, different sources will be available to some types of landlord than others.

(a) How can we categorise private landlords?

The main types are:

- property companies;
- institutions (such as building societies and pension funds);
- individuals.

We can further classify individuals into *resident* and *non-resident* landlords.

Until relatively recently, little has been known about the individuals and organisations which have provided private rented accommodation. This was remedied in the early 1990s by two surveys in Scotland and England (commissioned and funded by Scottish Homes and the Joseph Rowntree Foundation respectively). These revealed the following profiles of private landlords:

Table 1: Recent lettings by landlord type (percentages)

	Scotland	**England**
Private Individual	48	61
Company/partnership	39	25
Charity/charitable trust	7	4
Church/Crown Commissioner	2	1
Government Department	3	3
Educational Establishment	1	1
Other	0	5
Total	**100**	**100**

While there are differences in the proportions of lettings made by each landlord type in Scotland and England, the *pattern* is the same. Individuals are the largest landlord group, and companies or partnerships are next most significant. All other providers play only a very minor role.

Further research in England was commissioned by the Department of the Environment and published in 1996. This revealed that, of the private individual landlords, a quarter had only one letting and three quarters have less than 40 lets. The average number of lettings for the whole group was only 7.

Although the overall trend for private renting has been one of decline, the sector has enjoyed a very modest recovery in the early 1990s, which has been maintained.

Table 2: Private rented dwellings, 1989-1996 (Thousands)

	1981	1986	1991	1996	2001	2002	2003
England, Scotland and Wales	2,044	1,953	1,927	2,191	2,168	2,192	2.200

There is evidence from the 1996 research that the slight reversal in fortune in the early 1990s relates to the slump in the property market in this period. Individuals who needed to move home were unwilling to sell their former residence at the bottom of the market and instead elected to rent it out until the situation improves. One in ten of all lettings covered by the survey had once been the landlord's own home and was let because they could not sell in the recession. These, and 20% of other dwellings, would not be relet by the landlord if the dwelling became vacant.

However, not all landlords are reluctant landlords. Let us look now at the motivation of others for their involvement in the private rented sector. Since the later 1990s, Buy to Let schemes have encouraged individuals with spare earning capacity to become involved in the property market by buying - generally new pupose-built flats in city centres - to generate a rental income which helps them with their mortgage, and to benefit over the longer term from the capital growth of their assset.

3. Why Are They Landlords?

The variety of landlord types reflects wide variation in the reasons for entering the private rented sector. For individuals, these may include:

- a desire to help friends or relatives;
- to provide financial assistance with mortgage costs;
- an inherited property;
- the desire to generate returns, from rent or capital gain;

In general, we may assume that companies and institutions have profit as their main objective: they are unlikely to hold onto unprofitable properties for long.

4. Sources of Finance

4.1 Internal sources

Institutions and companies may have considerable internal sources of income which can fund property purchase. Insurance companies, for example, invest funds collected from thousands of individual policy holders. Other companies may have profits retained from other enterprises.

One example of institutional involvement is demonstrated by a property company called *Quality Street*. This was set up by the Nationwide Building Society, but has since become a separate, private company. Quality Street borrows funds, primarily from its “parent” building society, to purchase property to rent. So although, strictly speaking, this is a *borrowed* source of finance, the loans come from what is, effectively, an*internal* source. Quality Street has proved to be a successful, profitable company, but has positioned itself at the upper end of the rented market letting to people with above average incomes, at above average rents, mainly in city centres.

Not all property companies have been as successful. With the combination of high interest rates and high levels of unemployment in the early 1990s, many faced heavy losses, and some were ultimately placed into *receivership* - i.e. they went bankrupt.

Individual landlords will generally have far fewer internal sources of finance – though they may have savings or receive a ‘Capital Receipt’ through sale of an asset or maturing of an investment. What sources of assistance are available externally?

4.2 External public sector sources

In theory, there are a number of sources of finance from the public sector which could contribute to provision of accommodation for private renting. In effect, as you will see, most of these make little impact on the private rental sector.

(a) Local Authorities

Under the **Local Government Act of 1989**, local authorities are permitted (with the approval of the Secretary of State) to assist privately rented housing. This power has been used, by a number of local authorities, to assist the *voluntary* rented sector, as you have discovered. However, there is very little evidence that this power has been used to assist private landlords.

Partnerships

Local authorities have provided assistance to private developers, principally in the form of "pump priming". These partnerships have occurred principally in inner city locations, where considerable expenditure on site clearance and new infrastructure, such as roads and sewerage, may be necessary, to attract private development. However, few of these partnerships have been intended to provide, specifically, private rented housing. More usually, they are directed toward industrial or commercial development, to attract new businesses and hence jobs, or else low(er) cost owner occupation.

Most partnerships have developed via the incentive of grants available from central government.

(b) Grants from Central Government

There are a number of central government grants which could, in theory, be used to increase private rented provision. Increasingly, such grants are paid direct by central government, where once they were channelled through local authorities.

It must be stressed, however, that whilst some of these grants are intended to regenerate run down inner city areas, they have largely been directed to commercial and industrial rather than residential development.

4.3 External Private Sector Sources

Private sector landlords must, therefore, rely principally on external private sector sources to find their property development or acquisition. Although some of these sources are available to individuals, the majority are applicable only to companies or partnerships.

4.3.1 Equity finance

Essentially, equity finance means raising funds by acquiring new investors who wish to share in the company ownership. In return for putting money into the firm, these individuals acquire a share in the company. This means that they are entitled to a share of any profits that are made. Conversely, however, if the firm goes bankrupt, then they may lose all of their investment.

Equity finance may be of two types, depending on the nature of the company:

(i) Share issues

This source of finance is available only to public or private limited companies, as you discovered earlier. These are designated by **plc** after the name, for public companies, and **Ltd** for private.

In the case of **public** limited companies (plcs), the shares must be offered for sale to the general public and other firms. **Private** limited companies (Ltd) can only sell to a more select range of individuals or firms, as agreed by the other shareholders.

(ii) Partners

A company with **unlimited** liability is one for which, as the name suggests, the owners' potential liabilities are limitless. Should the firm become bankrupt, the owners can lose not only the money they have put into the company, but they are also liable for any outstanding debts.

These firms are, typically, quite small. Often, they may have only one owner, called a **sole trader**. An individual landlord who wishes to expand may find that creating a partnership is the easiest way to raise external finance. The new partner(s) put money into the business, and so take a share in its ownership. However, these new partners are also, in general, joint owners, and so have a say in how the firm is operated.

4.3.2 Trade credit

Essentially, this generates short term finance, which is "borrowed" from the company's suppliers.

Goods or services are provided, and an invoice is issued by the supplier. However, this often remains unpaid for several weeks, or even months. Hence, the company has the short term use of funds which really belong to the supplier, free of charge.

4.3.3 Tax concessions for companies

(i) The Business Expansion Scheme

The Business Expansion Scheme was a scheme of tax concessions for investors in companies, originally intended for manufacturing firms. However, the **1988 Finance Act** extended it to include investment in companies specialising in providing housing to rent. The concessions applied for five years from the start of the scheme. In 1993, the concession was withdrawn from *new* investment, but existing schemes continued for their five yearly term, so that these continued to operate up until 1998.

(a) What were the tax concessions?

(i) Income invested in the BES was exempt from income tax.

(ii) At the end of the five years, when the shares in the BES were sold, no *capital gains tax* was payable on any increase in value.

This meant that the concessions were close to those available to owner occupiers.

(b) What were the limitations?

(i) The concessions applied only to the first £5 million raised by the BES each year.

(ii) The company must let on assured tenancies (not assured shorthold).

(c) How successful was the initiative?

In answer to a *Parliamentary Question*, on 11 December 1990, BES companies had, to date, raised £550 million to provide around 10,000 new homes to rent (*Hansard* - HC Deb c 366W).

However, most of these dwellings had been offered at high rents. A London Research Centre report in 1990 *(The Independent*, 2 Feb 1990), found that almost 75% of BES rents in London cost between £400 and £800 per month. None were below £200.

Furthermore, research showed that this was a relatively *inefficient* subsidy to rented housing. Peter Kemp and Tony Crook carried out work for the Joseph Rowntree Foundation, which indicated that: ('A private affair', *Roof*, May/June 1992),

- lettings through BES landlords cost the taxpayer *two thirds* as much as those from housing associations;
- rents were much higher;

Furthermore, although in theory there was no reason why dwellings let by BES companies should cease to be let at the end of the five years (the tenants are on assured tenancies), there was no guarantee that this would be the case.

At best, all the BES scheme achieved was a *short term* stimulus to the private rented sector, and at very high relative cost.

(ii) Housing Investment Trusts

As mentioned in an earlier Block, provisions for Housing Investment Trusts were introduced by the government in 1996, to encourage institutional investment in rented property through tax concessions.

HITs were to be companies established to own residential property for rent. They were to enjoy exemption from Capital Gains Tax and to be liable for a lower rate of Corporation Tax. The Trusts were to be quoted on the Stock Exchange, with a minimum size of £30 million.

Although initially these seemed to offer a means of refinancing and retaining use of BES stock, the Treasury quickly acted to prevent this, on the grounds that this would constitute double subsidy.

Some years later, the first HIT has yet to be established. The relatively low rate of return, even with tax breaks, combined with the very high level of minimum investment, has prevented a workable model from coming forward.

For companies and individuals, borrowing from a variety of financial institutions, therefore, remains one of the most significant sources of funding.

4.3.4 Buy to Let

For individual borrowers, conventional mortgages are not available (these being designed for purchase of a main residence for owner-occupation), However, many lenders now offer loans specifically designed for the Buy to Let market. The table below shows estimates of the growth of this kind of lending since its inception in the late 1990s.

Table 3: The growth of Buy to Let loans

Year end	Estimated number of loans outstanding
1998	28,700
1999	73,200
2000	120,300
2001	185,000
2002	275,500
2003	408,300

The concept of Buy to Let was launched by the Association of Residential Letting Agents (ARLA)and a group of participating building societies. The scheme has coincided with the steady rise in residential market values and in the poor performance of the stock market. Those with savings or large bonuses have looked to invest in buy-to-let property as a way of securing a high return capital investment. The value of this market has grown substantially from £2 billion in 1998, as this quote shows:

> "The total outstanding value of buy-to-let lending is now estimated to have reached £39 billion, compared with £31 billion at the end of the first half of 2003 and £24.2 billion at the end of 2002."
>
> (Council of Mortgage Lenders, *Buy to Let lending still growing strongly*. Wednesday 11 February 2004.)

4.3.5 Company borrowing from financial institutions

Most large property companies will have considerable debt finance – i.e. borrowed funds.

The money is raised from a variety of financial institutions, mainly as short to medium term loans (up to five years), rather than long term. For money that will be required for a long period - long term financing - most companies will use equity finance, rather than mortgages.

Capital which is needed only very short term – for a period of weeks or a few months – is generally raised from the firm's or individual's commercial bank, via an overdraft. Large firms with a large asset base are likely to be able to negotiate much lower interest charges than an individual landlord, because they represent a much lower risk.

4.3.6 Home improvement grants

These grants, means tested in England, are paid toward major repair costs, and some are available to private sector landlords in the same way as owner occupiers.

They are examined in detail in the block, “Help for Owners”.

Many English landlords will not qualify for home improvement grants because their income is above the relatively low threshold. In addition, the need to find their own funds to pay for the remainder of the repair costs has proved to be a substantial deterrent. This is clearly demonstrated by the poor average state of repair in the private sector, despite the availability of grant aid for many years.

4.3.7 Premiums (key money) and deposits

Since the **1988 Housing Act**, landlords are permitted to charge *premiums* to assured tenants. There is, as yet, no clear evidence of the levels of premiums which can be set for private rented accommodation, but these are unlikely to provide significant sources of finance for private landlords.

A more important source of *temporary* finance is the *deposit*, set against potential damages. Few private landlords today will rent property unless there is a significant payment as insurance against possible damage. This is, commonly, four weeks’ rent.

5. Homeless Rent Deposit Initiative

A number of charities and not-for-profit organisations have taken the initiative to set up schemes intended to give access to private renting for people without the means to pay deposits. A pilot scheme for homeless people, for example, was set up by the Notting Hill Housing Trust which paid deposits to private landlords for single homeless people of up to £400. The deposits were repayable at the end of the tenancy.

The value of this kind of scheme is shown in this quote:

> *“The scheme is significantly cheaper than the alternative, of a bed space in Riverpoint’s hostel. This costs £4,600 per annum (in grant aid and donations) in addition to the occupant’s contribution”*(*Roof*, September/October 1992). *The average cost of a deposit is, currently, £250.*

This seems, clearly, to represent good value.

Self Test 2

1. *How important is the individual landlord, compared to the institutional or company landlord?*

2. *List some of the sources of public finance which might be used to help provide private rented accommodation.*

3. *What are the main reasons for the growth of Buy to Let housing?*

Now turn to the Answers at the end of the Block.

Summary

1. **The private rented sector includes a wide variety of lettings.**
2. **Private sector landlords include property companies, institutions, and individuals.**
3. **Individual landlords have the largest share of the market.**
4. **Sources of finance differ between individual landlords and companies.**
5. **Companies have *internal* sources of finance.**
6. **Local authorities are, increasingly, involved in *partnership* schemes with the private sector.**
7. **Although there are a number of possible grants available from the central government, few of these actually benefit the private rental sector.**
8. **Companies may bring in new owners, to raise equity finance. This may be via the issue of shares, or by acquiring new partners in the firm.**
9. **Housing Investment Trusts offer tax concessions to investors in private renting, but there has been little take-up.**
10. **Renovation grants are also available to private landlords but have had little impact on the condition of rented housing.**
11. **Private landlords may charge *Premiums* (or *Key Money*) for assured tenancies, as well as deposits. This is a major problem for many renters.**
12. **Funds may be borrowed from financial institutions. This will cost less for large firms with a significant asset base than for small firms and individual landlords.**

Answers

Self Test 1

1. There are no financial institutions (like the Housing Corporation, or the building societies) to meet the needs of private landlords. Nor is there a range of subsidies and tax concessions aimed at them. Properties are mostly old, with potentially high maintenance costs.

2. Capital cost of a property represents the price paid at time of purchase, some time in the past. Capital value represents what the property could be expected to fetch if sold now; and the sum which would therefore be available for investment elsewhere. This means that capital value is a better basis for comparison with returns on other kinds of investment.

3. (a) The property may be without a tenant for a period.

   (b) There may be irrecoverable rent arrears.

   (c) The property may be damaged by tenants, thus increasing costs or reducing capital value.

4. The property may increase in value over time, so that when it is sold, further return on investment, in addition to capital values, is received.

Self Test 2

1. Individual landlords are the major landlord type. They own around 48% of private rented homes in Scotland and 61% in England.

2. Your answer might include:

   (a) Local authority partnerships

   (b) Central government grants.

3. Individuals with money to invest, at a time when the stock market is offering poor returns; plus the development of buy-to-let loans by lenders.