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Building New Homes for Rent

Creating a tipping point

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Consultation at St George's House, Windsor Castle, 22nd – 24th May 2012

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Foreword

With housing supply in the UK unable to meet the current demands placed upon it, let alone address the accumulated backlog or predicted future needs, new ways and ideas are vital to ensure that the growing UK population has access to decent housing.

The private rented sector is increasingly the only option available for many households, as they are unable to access social housing due to eligibility constraints, or unable to afford owner occupation. This has been reflected in the rapidly growing number of households who privately rent, across all ages and household groups, including families with children.

Against this backdrop, this report examines the potential for new rental homes to be built at scale and without public subsidy, and concludes that there is a real opportunity to create a tipping point. The idea – sometimes dubbed build-to-let – has been discussed for decades, but it now appears that we have a set of institutions in place that could actually deliver it.

This report draws on the discussions at a Consultation that BSHF co-ordinated to consider the subject. In May 2012, experts from a broad range of backgrounds, including academia, central and local government, trade bodies, housing providers (in both the for-profit and not-for-profit sectors), investors, and the media, joined BSHF at St George's House, Windsor Castle. Over three days, these participants engaged in a detailed and wide-ranging discussion of the issue. The Consultation sought to move the debate forward, to highlight new ideas and challenge some current assumptions, and ultimately to provide a strategic approach to addressing the issue.

The analysis emerging from those discussions suggests that if a portfolio of suitable scale were available, which was well-designed to enable management efficiencies, and in the right location to meet housing need and demand, investors would invest in residential property. Creating investment-ready portfolios could reduce perceived novelty risks associated with residential investment, increase the transparency of the asset class, and allow the costs and benefits of large-scale build-to-let developments to be verified. Such portfolios would also suit those investors that would be interested in exposure to rental income streams but not in development-stage risk and return profiles. Providing not only consistent yields, but also an ability to match long-term wage inflation, investment in residential property offers institutional investors a valuable additional component to their asset structure. Participants at the Consultation developed a model for build-to-let that has the potential to provide these features, which are vital to secure institutional investment and increase the supply of quality new homes to rent, without recourse to government subsidy.

As a housing research charity, BSHF's goal is not the enrichment of investors. However, any significant contribution to addressing the UK's chronic housing undersupply will require substantial capital investment. This report therefore addresses the issue of making investment in rental property a more attractive prospect. If successfully drawn in, the investment to build new homes for rent would help to meet housing need and demand, in terms of both quantity and quality. While purpose-built rental homes are unlikely to be the sole answer to the UK's housing supply problems, their delivery would offer a variety of advantages. These include providing greater choice and flexibility for tenants in the private rented sector, whilst also complementing the existing contributions made by individual private landlords and, through competition, encouraging higher standards overall in the sector. In doing so, it would be contributing to BSHF's real objectives: increasing the number of people who have access to decent and affordable housing.

Diane Diacon, Director, BSHF

Executive summary

The **need for more homes** to be developed in the UK is well-established: for many years we have been building fewer homes than the increase in the number of households, a trend that has been exacerbated by the recession. The current market structure of housebuilding for owner occupation has consistently failed to provide the number of necessary homes, and the supply of affordable housing is dependent in part on the level of subsidy that is available. Whilst the private rented sector has been growing rapidly, it has largely done so through the acquisition of existing stock, not through the building of new homes.

At the same time, **demand for privately rented accommodation** is continuing to increase. This is due to a range of factors, which include the affordability and mortgage constraints that limit access to owner occupation, and the attractiveness of private renting as a flexible tenure with a number of potential benefits for some households.

It is in this context of low levels of housebuilding and high demand for privately rented accommodation that increased interest in a new model for the supply of rental housing has emerged. There is particular interest in the potential creation of **build-to-let** developments: housing projects built with the specific intention of providing new accommodation for rent, with portfolios of homes under common professional management. Such a sector would require the creation of sizeable portfolios of homes, and could attract substantial institutional investment, as residential property has a number of features that makes it an attractive investment class:

- Rents have risen in line with earnings, therefore matching the liabilities of investors such as pension funds;
- It is relatively uncorrelated with other asset classes, enabling investors to reduce their risk through diversification;
- It shows lower levels of volatility than other asset classes;
- It has historically outperformed commercial property when total returns are considered.

This report identifies the key barriers to securing substantial investment in build-to-let housing and proposes a particular model that addresses these barriers, as well as setting out additional suggestions that would further support the development of the sector.

The key barriers at present are perceived to be:

- **Yield**: returns from investing in residential property, which often show lower rental returns (but greater capital appreciation), when compared with other property investment;
- Insufficient opportunity to invest at **scale**;
- **Novelty risk**: the lack of a track record for the sector can make residential property appear a riskier investment;
- **Development risk**: many investors are unwilling to commit to the uncertainty of building property, preferring to invest in ready-made portfolios;
- **Reputational risk**: concern among investors regarding the negative stereotypes associated with private renting, such as poor management and low quality accommodation;
- **Political risk**: concern that the government will reintroduce rent controls, or in some other way constrain the sector;
- **Management difficulties**: difficulty in finding suitable property managers and providing a management service in a way that does not adversely affect returns.

The report proposes a new model for build-to-let that addresses these concerns. Several of the largest **housing associations** are particularly well-positioned to overcome these barriers. They have the balance sheet strength and housing experience to create successful **portfolios of sufficient scale**, which could subsequently be refinanced by bringing institutional investors into the portfolio. These portfolios could comprise homes that are specifically designed to be used as rental accommodation – offering advantages in terms of management and quality to tenants – as well as tenancies that are tailored to the needs of their target markets. This model has the potential to enable significant investment in the sector, boosting the supply of housing without recourse to public funds.

The report concludes with a range of ideas to support the build-to-let sector, such as improving the quality of data on local rental markets and examining mechanisms that will guarantee homes remain in the rental sector for an extended period. These are neither necessary nor sufficient for the creation of a successful build-to-let sector, but would contribute to its establishment.

1. Background

1.1 Housing demand and supply

Official projections estimate that the number of households in the UK will grow by 272,000 on average each year until 2033.[1] In England, this equates to 5.8 million extra households forming between 2008 and 2033, a 27 per cent increase over the period.[2] This continues a pattern of growth in population and households in recent years: between the censuses of 2001 and 2011, the population of England and Wales increased by 7.1 per cent, from 52.4 million to 56.1 million and the number of households increased 7.5 per cent, from 21.7 million to 23.4 million.[3]

However, the UK is suffering from a chronic undersupply of housing, with insufficient development to meet existing or future needs. Even prior to the 2007 financial crisis, fewer new dwellings were being built than were necessary; and this situation has been exacerbated by the global downturn. The number of new dwellings completed in the UK each year has fallen sharply from 219,070 in 2006-07 to 140,790 in 2010-11, a drop of 36 per cent.[4]

Recent data for England suggest a continuation of this crisis, with fewer than 100,000 dwellings started on site in 2011, down by four per cent compared with the year before.[5] Comparable trends can be observed in the devolved nations of the UK across similar time periods. The number of homes started on site in Scotland has decreased every year between 2006 and 2011.[6] In Northern Ireland, new dwelling starts fell from 14,731 in 2006-07 to 8,017 in 2010-11[7], while in Wales there has been a decline in dwelling starts for the first time since 2008.[8]

This historic and growing undersupply of housing has a substantial impact on the country: it affects individual households, who struggle to find housing that fits their needs at a price they can afford; it affects the wider economy, creating a drag on growth and hindering labour mobility; and it affects society, worsening inequality and amplifying the challenges of demographic change.[9]

One particular impact of undersupply that is affecting households is constrained tenure choice. There are three main housing tenures in the UK – owner occupation, social rental and private rental – and their relative proportions over time can be seen in Figure 1. Figure 1(a) shows data for England, for which a longer-term trend is available. Figure 1(b), (c), and (d) show that in recent decades similar patterns have been observed across the nations of the UK.

Figure 1. (a) Percentage of households by tenure, England, 1918 to 2010[10]

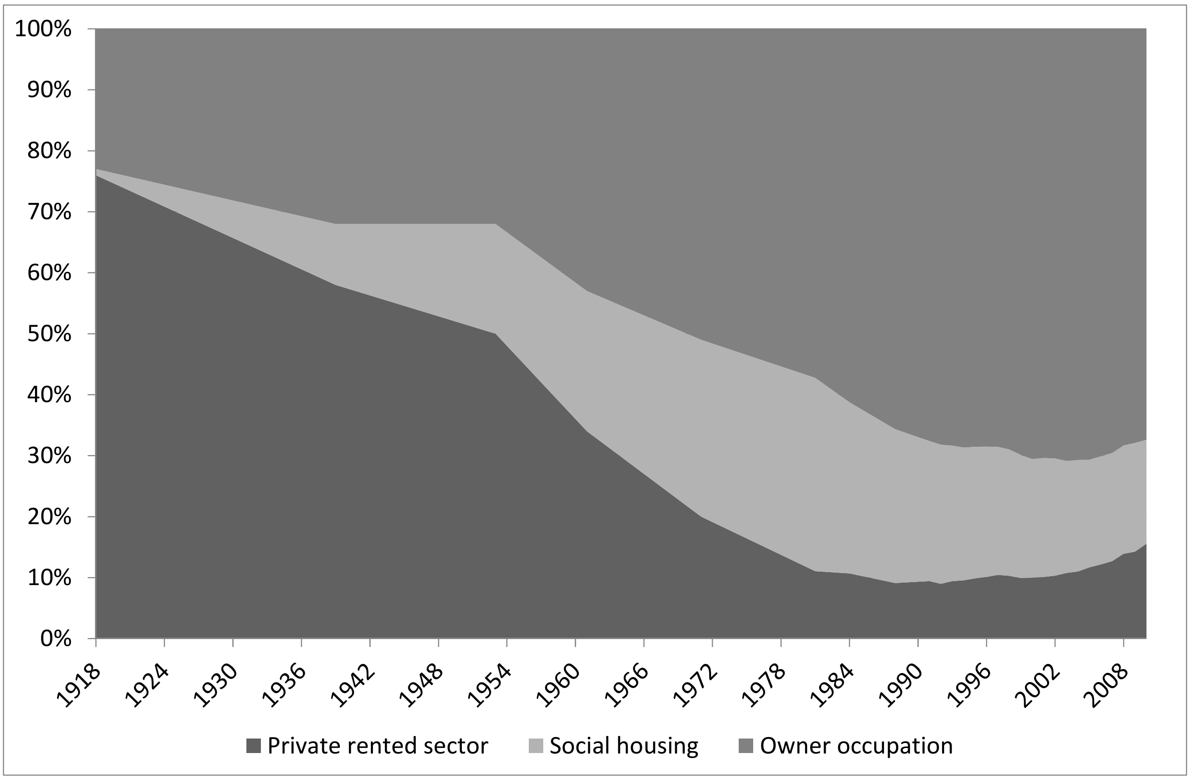


Figure 1. (b) Percentage of dwellings by tenure, Wales, 1971-2010[11]

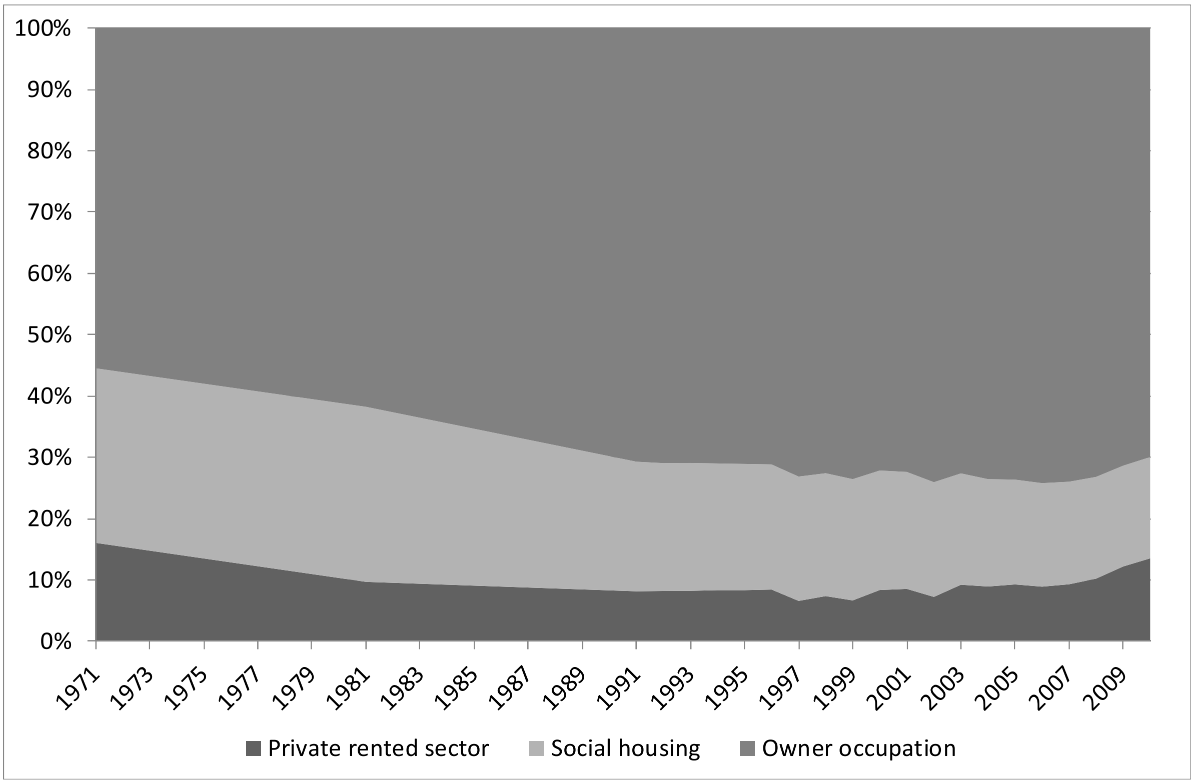


Figure 1. (c) Percentage of dwellings by tenure, Scotland, 1971-2010[12]

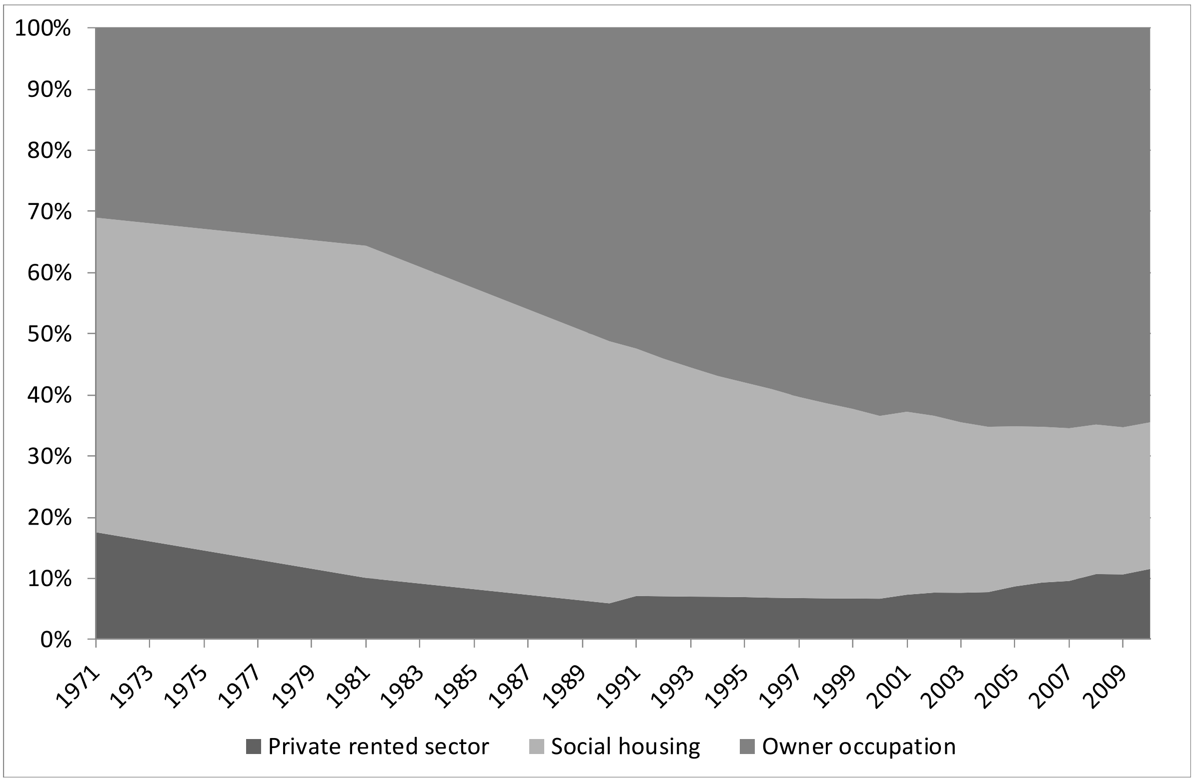
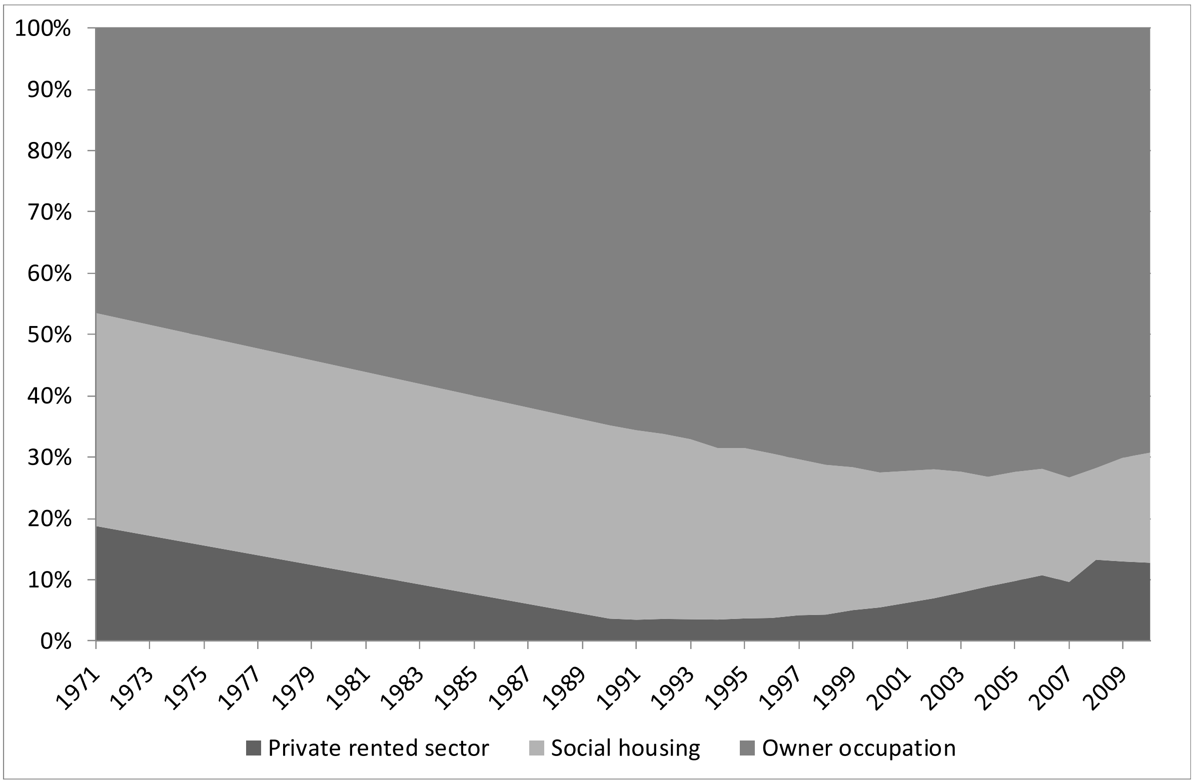


Figure 1. (d) Percentage of dwellings by tenure, Northern Ireland, 1971-2010[13]



Social rented housing has become difficult to access: its limited stocks are in high demand and allocated according to a priority need system. Whilst the 1.8 million households currently on social housing waiting lists is a poor measure of overall housing need, it does provide clear evidence that expressed demand for this type of rental housing is going unmet.[14] The provision of additional homes with capital subsidy is limited in part by the amount of grant that government makes available. Whilst the government has introduced the Affordable Rent regime to decrease the amount of capital subsidy required per home (which is projected to deliver similar numbers of homes to the previous social rented subsidy, albeit at higher rents) this is with the aim of reducing capital spending on social housing rather than increasing supply. There is therefore at present little prospect of a substantial increase in the delivery of social rented homes with capital subsidy.

Access to **owner occupation** is limited by wealth and income constraints, which make it difficult for households, especially first-time buyers, to finance the purchase of a home. Analysis provided by the Council of Mortgage Lenders shows that the size of a deposit is the most significant limiting factor for first-time buyers, meaning that wealth constraints have become a key barrier to owner occupation.[15] Taken alongside the constraints on mortgage credit caused by the global financial crisis, the proportion of owner occupiers in England has begun to fall, with almost 300,000 fewer households owning their home in 2011 than in 2007.[16] Figure 2 illustrates the difficulties households face in mortgage markets, with mortgage approvals per month falling dramatically from 2007.

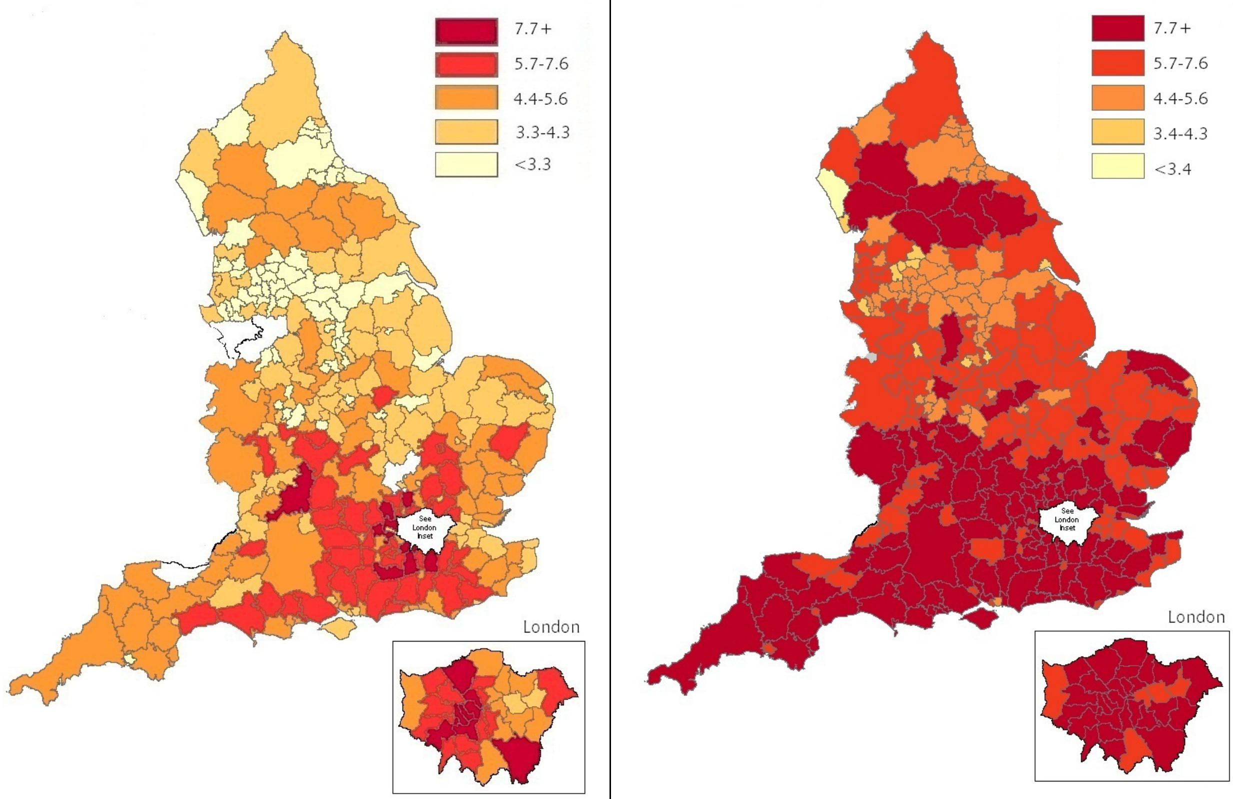
Figure 2. Number of mortgage approvals per month[17]

David Miles, a member of the Bank of England Monetary Policy Committee, has stated that "as a result of the major changes in financial markets in the wake of the crises of 2007 and 2008 the ways in which home ownership is financed are changing. Many of these changes will be permanent."[18] These changes particularly affect young people, who typically lack the wealth to put down a large deposit without assistance (for example, from parents or grandparents). Analysis from the Council of Mortgage Lenders shows that the proportion of first-time buyers aged under 30 that are able to purchase a home without assistance has fallen from 65 per cent in 2005 to 22 per cent in 2011.[19]

The affordability ratios between house prices and incomes are also high, and have worsened since 2000. Figure 3 shows that between 2000 and 2010 the proportion of local authority areas in England where the ratio of house prices to incomes exceeded 7.7 increased from six per cent to 44 per cent.

Figure 3. Affordability ratios in 2000 and 2010, in England[20]

Affordability ratio England **2000 = 4.21** **6%** of local authorities had affordability ratios greater than 7.7	Affordability ratio England **2010 = 7.01** **44%** of local authorities had affordability ratios greater than 7.7



One impact of these constraints has been the rapid growth of the **private rented sector**, accommodating both those lacking the wealth to access owner occupation and those excluded from social housing.

1.2 The growth of the private rented sector

A complex interaction of factors has led to sustained growth in both the actual and relative size of the private rented sector for the first time in a century. These factors include those that have affected the overall balance of housing supply and demand, such as demographic changes and low levels of housebuilding; and those that have influenced tenure choice, including affordability, the mortgage market, confidence in the state of the economy and patterns of household formation.[21]

Over 3.6 million households were living in private rented housing in 2010-11 in England (16.5 per cent of all households) compared with 12.2 per cent, or just over 2.5 million households in 2006.[22] In 1992, only nine per cent of households (1.7 million) were private renters.[23] BSHF research carried out in 2010 indicated that if recent tenure trends continue, 20 per cent of all households in the UK could be private renters by the year 2020.[24]

1.2.1 Demand-side factors

In terms of demand, the increase has been driven by both factors that have attracted households to private renting ('pull' factors) and those that have constrained households into the tenure ('push' factors).

The 'push' factors include:

- the undersupply of market housing, which tends to increase house prices; this can create both income and wealth constraints as the required deposit and monthly repayments on a mortgage are higher;
- further mortgage constraints created by the tightening of credit in general following the global financial crisis; and
- the supply of social rented housing being significantly lower than the level of demand for the tenure.

The 'pull' factors that make rented accommodation attractive for households include:

- flexibility and mobility in housing choice for those who need it;
- the availability of Housing Benefit in the rental tenures provides a more comprehensive safety net than does Support for Mortgage Interest in owner occupation, which may make the tenure more desirable to those not is stable employment;
- not being solely responsible for property repairs and maintenance; and
- the avoidance of housing debt.

The factors that have driven would-be homeowners into private renting instead of owner occupation may be becoming permanent characteristics of the housing market.

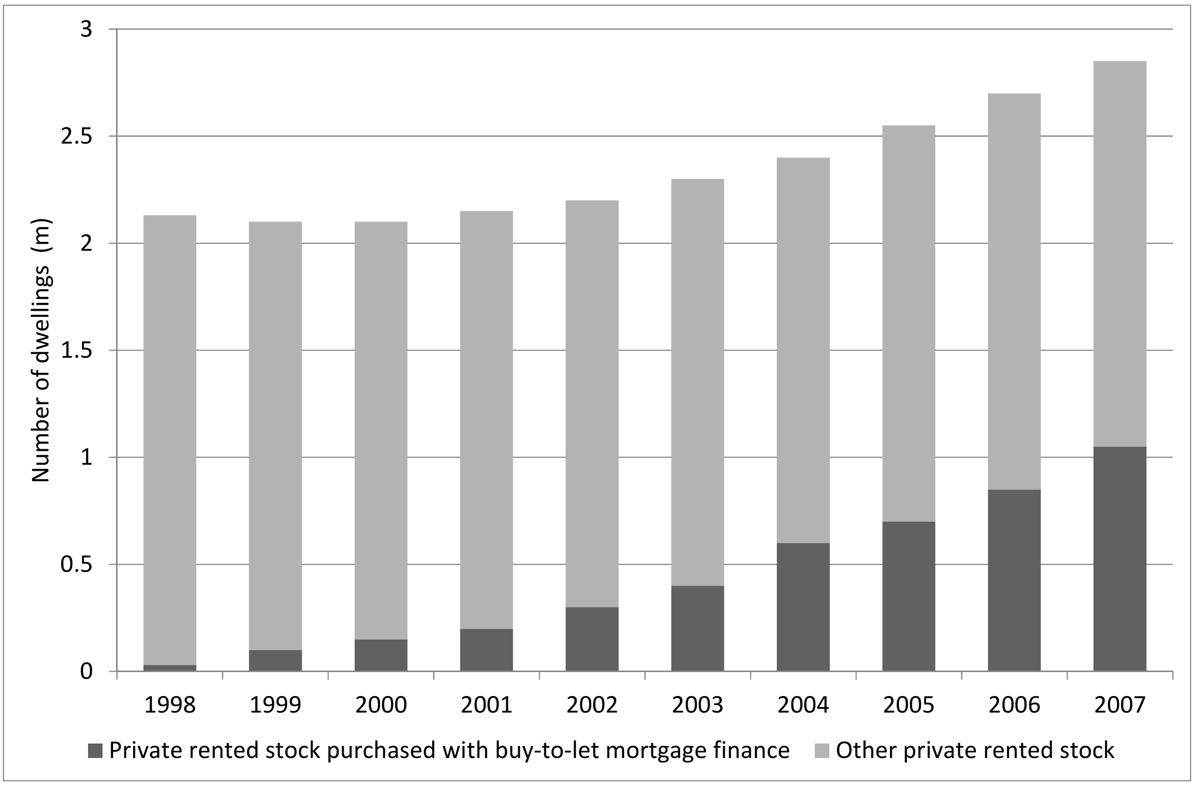
1.2.2 Supply-side factors

On the supply side, one of the most significant factors affecting the growth of private renting was the deregulation of the sector that began in the late 1980s. From 1919 to 1989, rental policy focused on the control and regulation of rents and the provision of statutory security of tenure. These policies in theory benefited existing tenants financially, although in practice many homes were let outside of the controls with landlords either avoiding or evading the rent restriction and security of tenure.[25] The policies certainly did little to increase the quantity of private rental stock and rent controls have also been identified as a significant cause of the physical deterioration in the condition of private dwellings, for example in immediate post war period.[26]

The Housing Acts of 1988 and 1996 deregulated the sector, first creating Assured Shorthold Tenancies (ASTs) as an option and then making them the default for most private sector lettings. ASTs provide a minimum of six months' security of tenure and almost no rent control: the level of rent for the initial contractual period can be at almost any level agreed by the landlord and tenant, and can be varied on any subsequent renewal of the tenancy.[27]

More recently, growth in the supply has been partly attributed to the boom of buy-to-let investment. The availability of specialised buy-to-let mortgages in the last decade – designed for landlords to purchase property for the specific purpose of renting it out – has become a major driver of private rented supply. This coincided with rapid house price growth, meaning that residential property offered high levels of capital return, making it an attractive investment class. Figure 4 highlights the increased contribution of buy-to-let mortgage finance. However, it should be acknowledged that a large part of this buy-to-let activity has gone towards refinancing of existing PRS stock (over 40 per cent of buy-to-let advances between 2002 and 2008), or will have substituted for alternative forms of financing.[28]

Figure 4. Contribution of buy-to-let mortgage finance to the private rented sector[29]



Since the 2007 financial crisis, there has been a growth in so-called 'accidental landlords' who rent property out as a temporary expedient.[30] These may include those who have not been able to sell their homes for the price they want, people who move for work or other reasons but wish to retain their property, and some who have inherited a property. These, of course, existed prior to the credit crunch, but have increased in number as the property market has stagnated. Recent analysis estimated there are around 300,000 accidental landlords who would sell to make capital gains on their property if market conditions improve. This group is thought to hold approximately seven per cent of all privately rented accommodation.[31] Some landlords who start in this category may over time decide to continue renting or even to develop a portfolio as a result of their initial experience.

1.2.3 Demographics of growth

Analysis of tenure patterns suggests that the growth in private renting can, in part, be attributed to the number of young people renting, with significant proportional increases in private renting seen amongst the 25 to 34 year-old age group.[32] This group has been dubbed Generation Rent, as due to affordability issues and mortgage constraints, many of these households are likely to rent in the long term, accessing owner occupation later, or not at all.[33] Recent research suggests that the growing demand for private renting has also altered the demography of private tenants in ways other than simply their average age. Analysis from the housing charity Shelter found that more than 50 per cent of the recent growth in private renting came from families with children, with more than one million families renting privately, which is almost double the figure in 2007.[34]

The private rented sector is also the most diverse tenure in terms of age, income and occupation of tenants.[35] The private rented sector is composed of a range of sub-sectors, including young professionals, students, economically inactive households claiming Housing Benefit, older people and people on high incomes living in luxury accommodation. Each of these sub-sectors has different needs and preferences in terms of their accommodation, location and tenancy arrangements. If the private rented sector is to function effectively, these different needs should be catered for. This also presents opportunities for landlords – institutional or individual – to tailor their business models towards different sub-sectors in a way that is beneficial to both parties. For example, research for Shelter has shown that offering longer-term tenancies – an option that is highly desirable to those seeking to make a stable home in the private rented sector – can actually boost landlord returns.[36]

Whilst further research into the market segments within the private rented sector would improve understanding of the composition of the tenure, in general terms its diversity is already clear. This diverse demand for private rented housing is a consequence of many factors, including economic barriers and the wider shortage of housing that is creating significant unmet housing need.

1.2.4 Public attitudes to the private rented sector

Social attitudes surveys continue to show that a significant majority of the population would prefer to own a home than to rent, given a free choice.[37] However, there are increasing expectations that ownership aspirations will not always be met: a 2011 report found that 46 per cent of survey respondents predicted that “Britain will become a nation of renters within the next generation” and the authors concluded that “if little changes within the housing market, a substantial proportion of people will struggle to get on the property ladder”.[38] Another survey found that only 26 per cent of respondents agreed with the statement: “Opportunities for first time home buyers will improve over the next few years”.[39]

One driver of the ongoing preference for owner occupation is the perception and promotion of housing as a capital investment as well as a consumption good.

Governments of all stripes have talked for several decades of the UK as a "home owning democracy", and 26 per cent of those surveyed on attitudes to housing think the main advantage of owner occupation is that it is "a good investment".[40] Conversely, the Rugg Review (an independent review of the private rented sector conducted for the government) identified that "the perceived problems with property quality, security of tenure and affordability all play a part in persuading tenants that the private rented sector provides – at best – an insecure home".[41] Consequently, to become a tenure that is aspired to, rather than merely accepted, it would need to be demonstrated to the public that private renting can be a secure and high quality option.

1.3 Private landlords' contribution to housing supply

In the UK, private rented accommodation is overwhelmingly provided by individual private landlords. In 2010, the Department for Communities and Local Government (DCLG) conducted a survey of private landlords in England, which found that 89 per cent of longer-term landlords were private individuals and these were responsible for 71 per cent of all private rented dwellings.[42] Furthermore, more than three quarters of all landlords owned only a single dwelling for rent, reaffirming the findings of the Rugg Review that landlordism in the private sector is typically a small-scale activity.[43] These individual private landlords typically invest in housing with the expectation of a steady income stream from rents and future hopes of benefiting from capital gains. The remaining 11 per cent of landlords were either companies or other organisations.

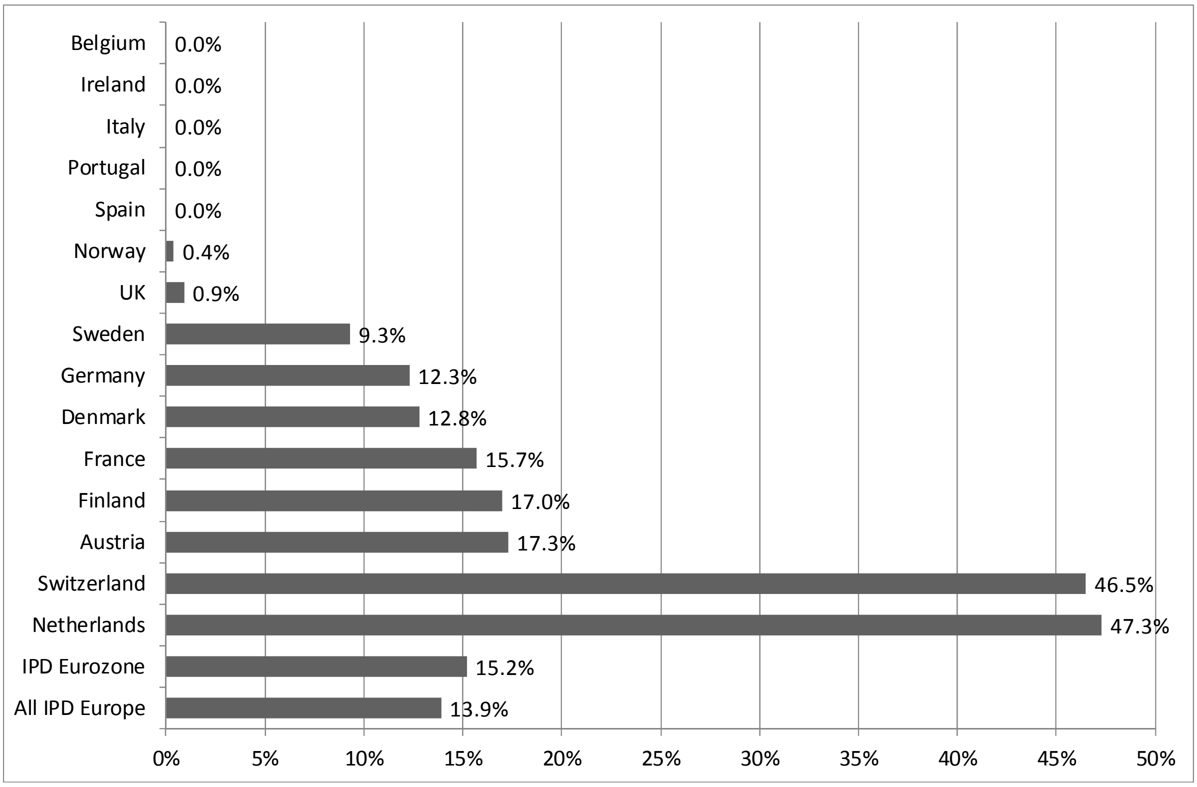
Investment in the private rented sector also tends to be concentrated in existing housing stock. The DCLG survey of private landlords found that only nine per cent of all private rented dwellings had been sourced from new build stock, with only four per cent built specifically for the buy-to-let market.[44] Whilst some buy-to-let activity may indirectly support housing supply (by acting as one end of a chain where there is a new-build home at the other end) the growth of the tenure has tended to largely represent a movement of existing stock between the tenures. Consequently, although the existing private rented sector provides a source of accommodation for rent, it typically does little to increase housing supply, to meet overall need and demand.

In addition, the Rugg Review identified that the small-scale landlordism described here is often intrinsically tied to the mortgage market and the financial probity of individuals.[45] Analysis of the private rented sector in England suggests that there are significant economic barriers faced by landlords in providing accommodation. Professor Michael Ball has commented that "[although] many people are opting to rent… there are deep problems on the supply-side".[46] This is based on recent analysis highlighting that current returns for landlords are low due to the nation's weak economy. Despite reports of rising rents, Ball argues that falls in the value of residential property as a result of the house price crash of 2008, combined with operating costs and inflation, have reduced total returns for landlords. Proponents of the sector have also argued that the "tax treatment of private landlords [stifles] investment in the sector".[47]

Consequently, access to finance appears likely to constrain future investment in rental stock by private landlords. Savills and Rightmove estimate that £200bn of investment is needed to meet demand for private rented accommodation over the next five years, but estimate that just £50bn is expected to come from buy-to-let finance.[48] The extent to which individual private landlordism can meet future demand for private renting is unclear, particularly if recent trends continue: the sector will probably continue to grow as a proportion of households, but possibly not enough to meet demand, and probably making little contribution to the net supply of new homes.

In contrast to many housing systems internationally, the UK's residential property sector has to date captured a very small proportion of institutional investors' funds. Although most European countries have a private rented sector where, like the UK, the majority of investment comprises individual landlords, many have a greater mix of investment and providers. As shown in Figure 5, many countries in Europe have between ten and 15 per cent of institutional investment in property allocated to the residential property market rather than commercial, but in the UK recent figures show that less than one per cent of investment in property is in residential property.

Figure 5. Percentage of property investment portfolios in residential property, by value[49]



2. Providing new homes for rent

The current context is one of limited levels of development in the private homes for sale sector, limits on capital subsidy available to build social rented homes, and a private rented sector that has grown recently, establishing itself as a sizable component of the UK's housing system. Consequently, there is increased interest in the potential for the private rented sector to contribute to housing supply without capital subsidy. However the sector has not to date made a contribution to supply that is proportionate to its growth, and there is uncertainty over private landlords' capacity to meet growing demand.

It is in this context that increased interest in a new model for the supply of rental housing has emerged. There is particular interest in the potential creation of build-to-let developments: housing projects built with the specific intention of providing new accommodation for rent with portfolios of homes under common professional management. These developments could potentially complement the investment activity of individual private landlords in buy-to-let housing, and would have the advantage of contributing directly to overall housing supply.

Whilst build-to-let could add to supply, it could also diversify the range of providers contributing to it. Diversification of housing developers not only increases overall supply, but can also reduce volatility in delivery and provide greater choice.[50]

Creating portfolios of new homes for rent, sufficient to make a significant contribution to housing supply, will require large amounts of long-term capital, as the housing will be held rather than sold. Discussions of build-to-let have frequently considered the potential for funding from institutional investors such as pension and insurance funds. The Resolution Foundation has noted that:

> *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.*[51]

2.1 Advantages of build-to-let for tenants

By drawing in additional finance and contributing to housing supply, a build-to-let sector would help to address many of the problems that are associated with the UK's undersupply of homes. It has also been argued that a private rented sector that featured more large operators might provide particular benefits for tenants, including:

- **Increased choice and affordability.** Greater supply and a variety of different providers will increase choice for tenants. This is particularly important in areas with high demand, where several tenants may be competing for a single property. Equally, greater choice for tenants will improve affordability, as highly constrained supply enables landlords to charge higher rents.

- **High quality and service.** Large players will want to maximise tenant demand for their homes. Providers will become known for the quality of accommodation and service that they offer, which will affect demand. Therefore in a competitive market, there will be a significant incentive for landlords to seek to offer the best product to tenants. This may well lead to the development of branded accommodation, as is the case in the USA (see section 2.7.2 Multi-family housing in the United States).

- **Security of tenure.** Large landlords holding portfolios of properties that are intended to remain rented in the medium or long term will have the flexibility to offer longer tenancies to those tenants for whom it would be desirable. This option is not often available to buy-to-let landlords who are typically limited by their mortgage terms in the length of contract they are able to offer. Research has shown that offering longer-term tenancies with index linked rent increases can be financially beneficial to landlords as well as being highly desirable to significant groups of tenants.[52]

High quality properties and management, and security of tenure are not exclusively the domain of large landlords, and it is not guaranteed that they will always deliver them. However, the issues outlined here demonstrate they are more able and likely to take these steps, and this may over time contribute to such practices becoming the norm in the market in general.

2.2 Government support for build-to-let

The build-to-let model has received support from the government, with the 2011 housing strategy for England stating that it is “supporting new Build to Let models of development, where homes are built specifically for the private rental market, with funding from investors with a medium to long term interest.”[53] The Scottish and Welsh governments both envisage expanding the private rented sector in their recently published housing strategies, with the Scottish Government looking to encourage housing associations to take an increasing role in this, as well as working with institutional investors to increase investment in the sector. [54,55]

In February 2012, a government-commissioned independent review of the barriers to institutional investment in private homes to rent was launched. Led by Sir Adrian Montague, this review examined the potential for investment in the private rented sector in current market conditions and reported in August 2012.[56] The findings of the report have been welcomed by the government, with the housing minister describing the report as a "blueprint" for achieving investment in private renting.[57] The increasing interest in the possible role of investors in the private rental market reflects a recognition of the urgent need to increase the supply of all types of housing if the current large and escalating housing shortage is to be addressed.

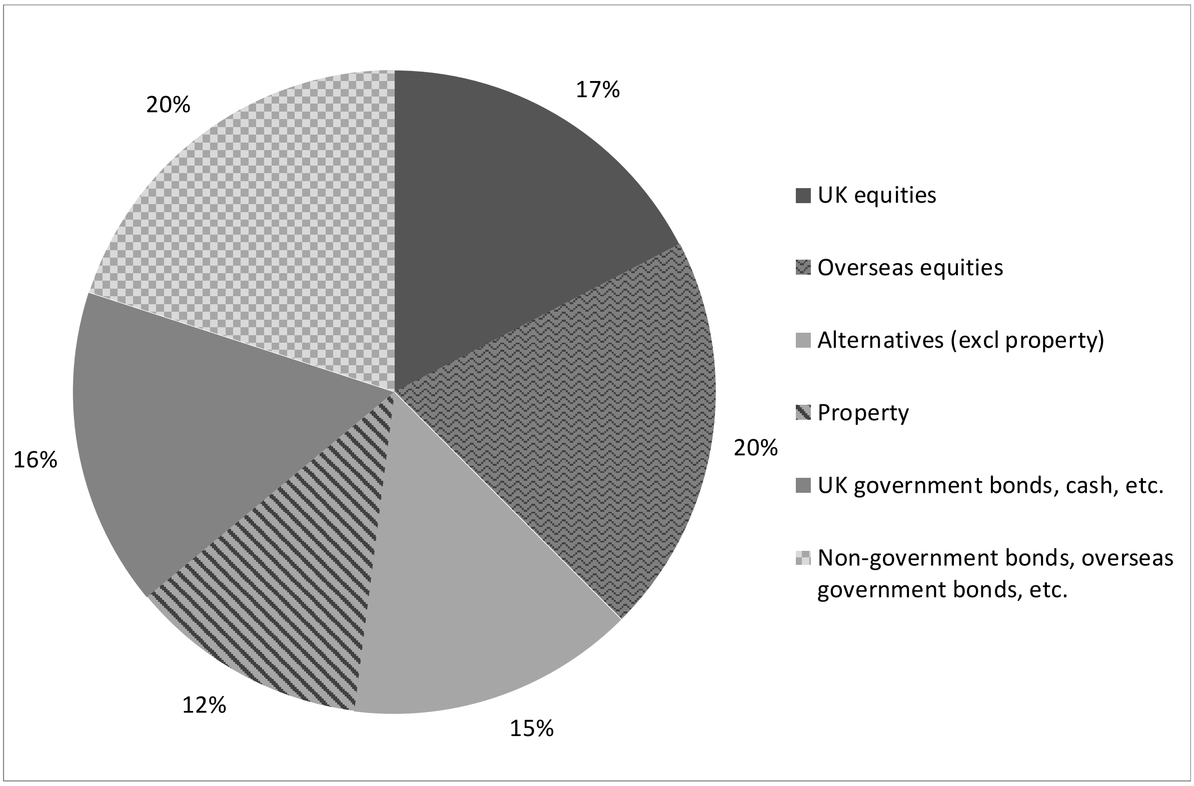
Several examples of build-to-let development are emerging, including in Manchester, Birmingham, and the London Borough of Barking and Dagenham.[58]

2.3 Potential investing institutions

Institutional investors are organisations that pool large sums of money and invest those sums in a variety of different financial instruments and asset classes to ensure that their total returns enable them to meet their liabilities. The main institutional investors in the UK are insurance companies, pension funds, and a variety of investment and unit trusts. Institutions play a large role in the UK stock market: UK-based institutions own around 39 per cent of shares (by value), and overseas ownership (much of which will be international institutions) accounts for another 41 per cent. Individuals own only 11 per cent of UK-quoted shares.[59] It should be noted that there is no one definition of what constitutes an institution: the ONS, for example, produces aggregated data for insurance companies, pension funds and trusts,[60] whilst in one report the Department for Business Innovation and Skills included a sizeable category of "other financial institutions" in addition to those three.[61] For the purposes of this report, the institutions can be thought to include anybody that controls substantial funds for investment purposes.

The institutional investors based in the UK control assets of approximately £3 trillion, spread across a range of asset classes.[62] A typical pension fund asset allocation can be seen in Figure 6 showing the relative proportions of the different asset classes.

Figure 6. A typical pension fund portfolio asset allocation[63]



The role of institutional investors in the economy is to act as highly specialized investors on behalf of others. They are also able to hold high risk and high return instruments, such as shares and financial options. Their large size also enables them to achieve economies of scale in making investments due to proportionally lower transaction costs from larger transactions, and to spread the cost of expert investment managers and analyst reports across a large portfolio. Institutional investors often find it impractical to invest in small cap stocks (i.e. those stocks with a relatively small market capitalisation); large cap stocks, property and commodities fit better with their goals. The largest investors are increasingly looking for alternative investment opportunities to the traditional asset classes of equity and bonds, to meet their return expectations, ensure portfolio diversification and provide stable, inflation-protected cash flows.[64]

Insurance companies are active in both life insurance and non-life (general) insurance. Their investment decisions are influenced by the type of business they undertake. For example their long-term business (mainly life insurance and pensions) has an emphasis on spreading risk over time, and an appropriate balance of assets has to be held to deliver these long-term guaranteed returns. However, the balance of their business is changing: the amount of new investment being made by consumers into with-profits products has declined significantly, falling in real terms to 27 per cent of its 1985 level by 2007.[65] Consequently, investment patterns are changing to reflect this.

The other major institutional investors are **pension funds**, which derive their funds from contributions made in respect of future pension provision by individuals and their employers. There has been a significant shift in the type of pension offered in the last decade, with a move away from defined benefit to defined contribution pensions. For defined benefit pensions (such as final salary schemes) there is a guaranteed fixed return and thus the investments by the pension fund need to be able to deliver this and there is strict regulation to ensure these guarantees can be met. With defined contribution pensions, the pension paid is a function of the state of the investments at retirement and thus the pension holder bears all the risk. With defined contribution funds, the individual may have more control as to the asset structure, but in practice, many individuals will stick with the default allocation, so this remains critical in determining the pension funds' asset structure.

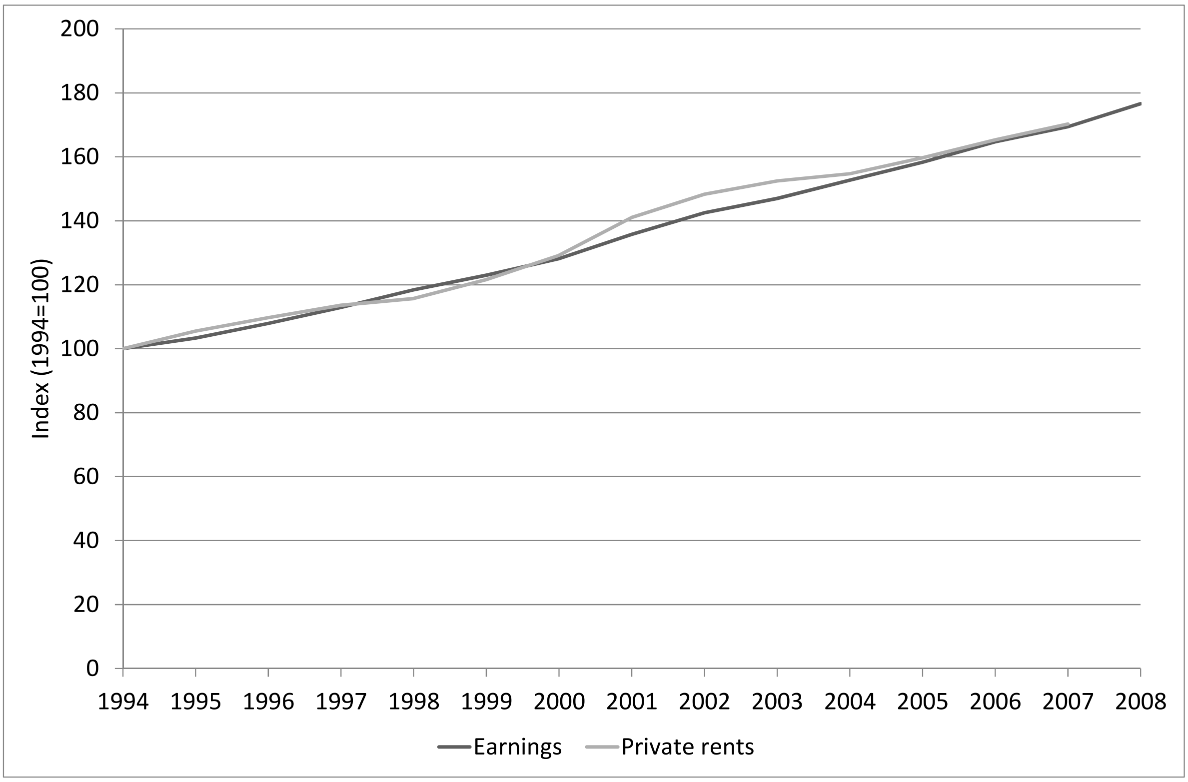
Sovereign wealth funds are the growth area in the institutional investment world, with a number of resource rich countries – notably Norway, Australia, and several from the Middle East, as well as Singapore and the three big sovereign wealth funds from China – heavily investing their countries' surplus wealth in order to provide for their long-term prosperity.

2.4 Residential property as a viable asset class

Residential property is not a niche opportunity. On the contrary, it is potentially a very large asset class, similar in size to the commercial property market. The UK's national accounts provide a balance sheet asset value for all dwellings of £4,280bn; although the specific value of the private rented sector is not provided, assuming a value proportionate to the size of the tenure (17 per cent of dwellings),[66] this is comparable to the value of all non-residential buildings, which is £801bn.[67]

One key feature of this asset class is that rents from residential lettings tend to rise in line with wage inflation (Figure 7) and hence will often match institutions' long-term liabilities (such as pension funds' liabilities to pay pensions in the future).

Figure 7. Rents and earnings compared[68]



Investment in property also has the added advantage that returns tend to move in different cycles from returns on equities and government bonds, helping to provide a steady income stream to meet liabilities (Figure 8). Mathematically, this is measured by the correlations between the movements of different asset classes (between +1 and -1); holding assets of lower correlations in a portfolio allows investors to reduce their risk without giving up average returns.

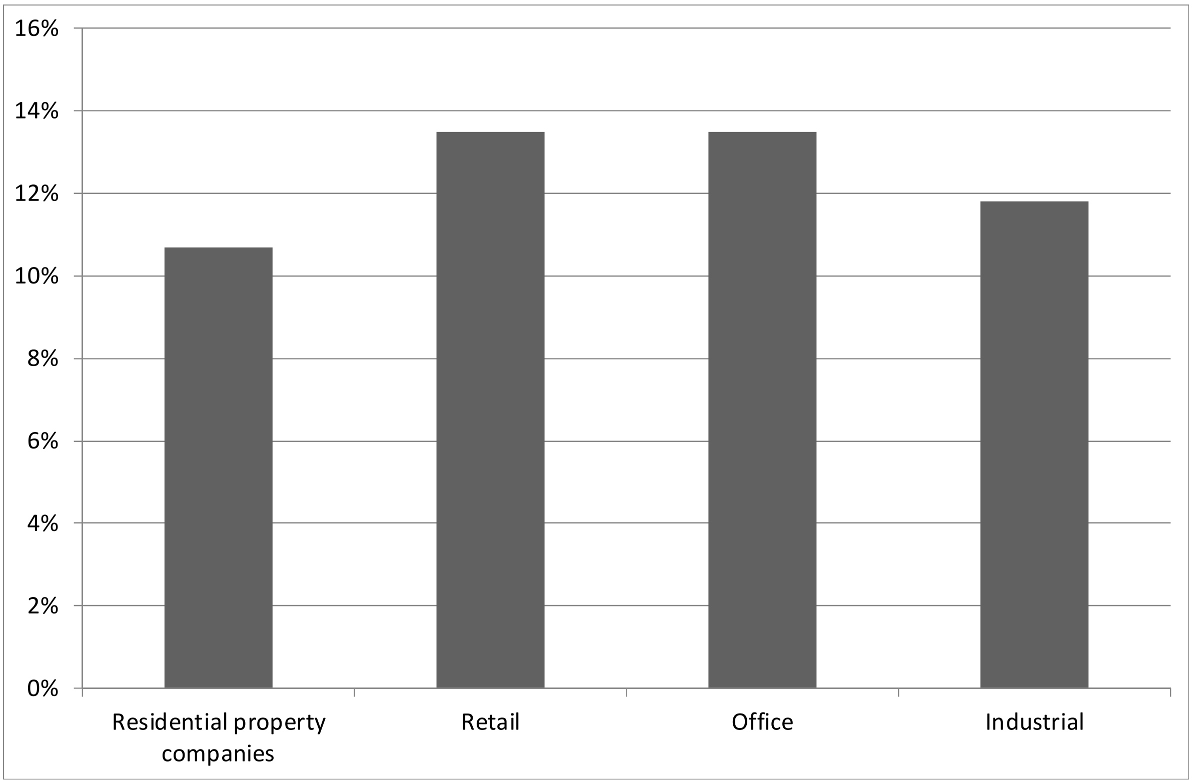
Figure 8. Comparison of returns from different asset classes[69]

Correlation of annual returns (1971-2009)	UK residential	UK equities	UK gilts	UK cash	UK commercial property
UK residential	1.00				
UK equities	0.05	1.00			
UK gilts	-0.21	0.58	1.00		
UK cash	-0.12	0.13	0.20	1.00	
UK commercial property	0.70	0.29	0.04	-0.04	1.00
Average total returns p.a. (per cent)	13.4	12.6	10.1	8.5	10.8
Historic volatility (standard deviation) (per cent)	11.6	30.2	13.8	3.7	17.4*

*Unsmoothed, 11.6 per cent smoothed.

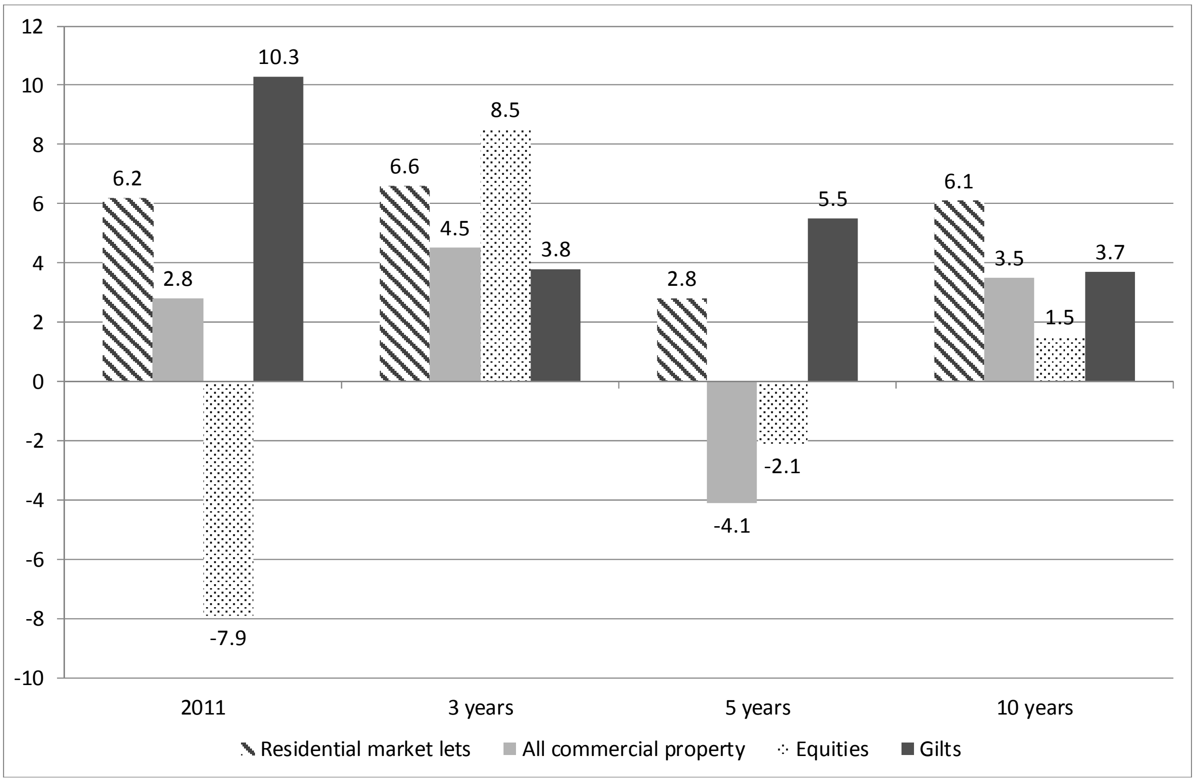
Another important factor in investment decisions is the degree of volatility: assets with more volatile returns are riskier than those that display lower volatility. Whilst house prices are perceived as volatile, residential property is actually not particularly volatile when compared to other asset classes. As shown in Figure 9, the volatility of returns from residential property over the last ten years compares favourably to those of other UK property sectors.

Figure 9. Volatility risk by UK property sector, standard deviation of total returns, ten years 2002-2011[70]



In addition, residential property investment has historically outperformed commercial property when total returns are considered. Indices developed by the International Property Databank (IPD) show that the total return from investment in residential property has been more attractive than other property assets over a range of timescales, as can be seen in Figure 10. It should be noted, however, that residential property's outperformance has occurred due to strong capital growth: over the ten years to the end of 2011 the income returns (i.e., the returns only accounting for rental income, excluding any effects of the value of properties rising) were higher for all of the main commercial property sectors than for residential property.[71]

Figure 10. **Inflation-adjusted (RPI) investment performance by asset class**[72]



Together, the relatively low correlations with other asset classes, relatively low volatility, and relatively high returns, contribute to the value of residential property for diversification in a multi-asset portfolio.

2.5 Lessons from previous attempts to stimulate renting

The potential to secure substantial private capital for the development of rental homes has been considered frequently in the last two decades, with various incentives introduced by government to facilitate investment. Since deregulation, structures and incentives have been developed to attract new sources of capital into the private rented sector and to expand ownership in the corporate sector. However, these have had little significant long-term impact. Three main approaches have been tried.

The **Business Expansion Scheme** (1988-1995) used tax reliefs to encourage individual investment rather than the wholesale investment by financial institutions. It saw the formation of 903 companies attracting over £3bn and 88,000 dwellings built or moved into the sector. It has however had little long-term impact and very few of these companies still exist.

Housing Investment Trusts (HITs) (1996-2006) were an attempt to attract pension funds explicitly through the creation of investment trusts that would own and manage private rented dwellings. Despite many efforts to do so, not a single HIT was set up.

Real Estate Investment Trusts (REITs) were introduced as a potential investment structure in 2007, and initially mooted as a way of attracting institutional funding into residential property. However, they were better structured for general commercial and other property, with most commercial property companies converting to the structure. It has been widely accepted that in their initial form REITs were not well suited to residential investment; subsequently a series of changes have been made, including the abolition of entry charges and the introduction of the option to list REITs on various stock exchanges.[73] Some of these changes are still working through the system, so it may yet be a suitable structure for residential investment in the future.

Crook and Kemp identify four key reasons why these various attempts have not succeeded.[74] These are, briefly, that:

- the tax structures developed through the schemes were not appropriate to deliver the objectives;
- grafting of a new structure of corporate landlords onto the dominant structure of small scale individual landlords was inappropriate;
- the property market cycle was not conducive at the time; and
- there was over-reliance on market mechanisms to address all issues.

It should be noted that the difficulties encountered by these schemes are not necessarily the result of inherent barriers to residential investment, but rather features of the particular approaches adopted and the contexts in which they were applied. Consequently, the problems associated with previous approaches merit attention in the design of any future approaches but do not give cause to assume that residential investment is inherently not a worthwhile asset class.

Crook and Kemp also identify, more generally, institutions' reported reasons for avoiding equity investment in residential property in the mid to late 1990s:

- perceived variations in the earnings potential of different sub-sectors, combined with a lack of **reliable benchmarking**, would require substantial effort to identify attractive investments;
- **political risk**, around the potential for rent controls to be reintroduced or housing benefits to be cut;
- **reputational risk**, specifically associated with being seen to evict tenants in arrears, and generally for involvement in a sector perceived as less than wholly reputable;

- difficulties **acquiring the asset**, with small lot sizes and few existing portfolios to invest in or acquire;
- problems procuring **suitable management** services, operating at sufficient size to offer economies of scale and providing high quality service; and
- a preference for **indirect ownership** (e.g. holding shares in listed property companies or units in property unit trusts) that was not matched by opportunities to do so.

Of these, the issue of benchmarking has been much improved by the IPD UK Residential Property Index, providing a decade of data. More recent efforts to promote the sector, such as the Homes and Communities Agency's Private Rental Sector Initiative (PRSI),[75] have identified that the housing association sector has now developed substantial capacity to manage rental homes, which could potentially be deployed in relation to portfolios of market rented homes.

Those issues that remain pertinent are addressed further below.

2.6 Current barriers to capital investment

Whilst institutional investors potentially have a key role to play in supporting the growth of build-to-let accommodation, their investment in the UK residential property sector has so far been minimal. There is a number of real and perceived risks associated with investment in residential property that will need to be overcome if significant investment is to be achieved.

2.6.1 Yield compared with other property investment

It is commonly thought that the financial opportunities for investors are not attractive enough to encourage a diversion of funds from commercial to residential property investment. In 2010 HM Treasury noted that the net income return from residential has typically been between 3.3 and 3.6 per cent, which is below the five per cent unleveraged net yield that participants at the Consultation felt would deliver income returns that would be attractive to investors.[76] Whilst, as noted in Figure 10, total returns from residential property have historically outperformed commercial property, these total returns are in part due to capital gains. Investors are reluctant to rely on property capital gains for their returns, viewing them as less secure than rental income.

Despite the perception that residential investment offers insufficient yields for investors, other commentators have pointed out that residential stock can help diversify investment portfolios, as it offers a secure and steady investment return, where rental growth tends to track earnings and has little correlation with movements in other asset classes.[77]

The way in which residential property is valued also differs from commercial property, impacting on the valuation of potential yields investors can expect. Commercial property is typically valued as a stream of revenue; prospective landlords approach the ownership of such property as a revenue-generating investment decision. Residential property, however, is typically valued with reference to its capital value with vacant possession; most homes in the UK are owner occupied, and consequently the value to owner occupiers (who will only want to buy empty homes they can move into) is a key determinant of the sale value of the asset class.

Consequently, residential property sold subject to a tenancy will often be valued below its vacant possession value, whilst commercial property that is tenanted is likely to be worth more than if it were empty, as the buyer will not face a period without income while they seek a tenant. The creation of developments that will remain rental assets in the long term, rather than be designed for sale would allow them to be valued on the basis of the steady revenue streams they deliver; this would help to give confidence to investors who are more familiar with commercial property interests, and would also tend to suppress the capital value of the property, increasing the yield.

The Montague Review highlights land values as an important factor influencing yields. Land with residential planning permission can have homes built either for market rental or owner occupation. Consequently, those seeking to build new homes to rent will be competing with the owner occupier market. The high price of owner occupied homes can often result in land values that are too high to deliver acceptable yields if rental homes are built. Furthermore the assumption that the homes built will be sold for owner occupation is typically built into calculations of the value of land, including for the purposes of determining viability when local authorities are negotiating Section 106 agreements and setting Community Infrastructure Levy charging schedules.

2.6.2 Insufficient opportunity to invest at scale

There is a lack of suitable stock available for investment at the scale required by potential investors. There are several aspects to the challenges of scale, notably:

- **Portfolio size** – the total value of the residential property owned by an investor. This matters because a large portfolio is necessary to justify the management costs associated with investing in a sector. Institutions also require their potential investment in a sector to be large enough to comprise a non-negligible part of their total portfolio; if their exposure to a sector is too small to have any noticeable effect on their returns, there is little point expending the effort required to be involved in that sector.

- **Lot size** – the value of property that can be bought in one deal. Larger lot sizes produce economies of scale in transaction costs, for example in undertaking due diligence on a prospective investment.
- **Development size** – the size of any given group of properties in close proximity. The geographic concentration of properties will affect the costs associated with management and maintenance.

Investors in commercial property are used to easily acquiring large lot sizes, either purchasing directly, or indirectly through a property fund. Research by Hamptons International, a London-based estate and letting agent, has indicated that residential investment funds would need a minimum of £500m in assets under management – implying a minimum portfolio size of 2,500 to 3,300 units – in order to achieve the necessary economies of scale that can offset fund management costs.[78]

Anecdotal evidence suggests that a suitable scale of developments to achieve management efficiencies might be a block of around 250 flats or perhaps 50 to 100 houses in close proximity. Providers would also tend to prefer to control whole blocks of flats, without the presence of individual buy-to-let landlords.

There are, however, few existing examples of residential portfolios of the size that could make residential investment attractive, which constrains opportunities for investment. This is commonly cited as a barrier by leading industry figures. For example, in oral evidence given to the House of Commons Select Committee on the financing of new housing supply, Nick Jopling of Grainger plc explained that "an institution wants to invest in scale; it is not interested in buying buy-to-let property. There is no stock for it to go and buy. There are no portfolios of rental stock for it."[79]

Increasing the availability of purpose-built developments could therefore help unlock institutional investment. Such developments could be designed to maximise efficiencies to increase the financial viability of schemes. By being built at a sufficient scale they could address the issues associated with lot size and offer the increased management efficiency of having a collection of property in one area. Furthermore, specific design features could be included that would assist in the management and maintenance of the property.

2.6.3 Novelty risk

The lack of suitable stock for investment is related to a class of risks created simply because this form of investment activity is relatively undeveloped in the UK. Some of those who might be able to develop new homes to rent would be reluctant (or unable) to do so until they can see that investors will be willing to purchase them, while conversely, investors may be unwilling to commit to the sector until they see a supply of property available, and that this supply would generate sufficient returns. Furthermore, international investors are reluctant to invest in sectors where there is no significant domestic exposure.[80]

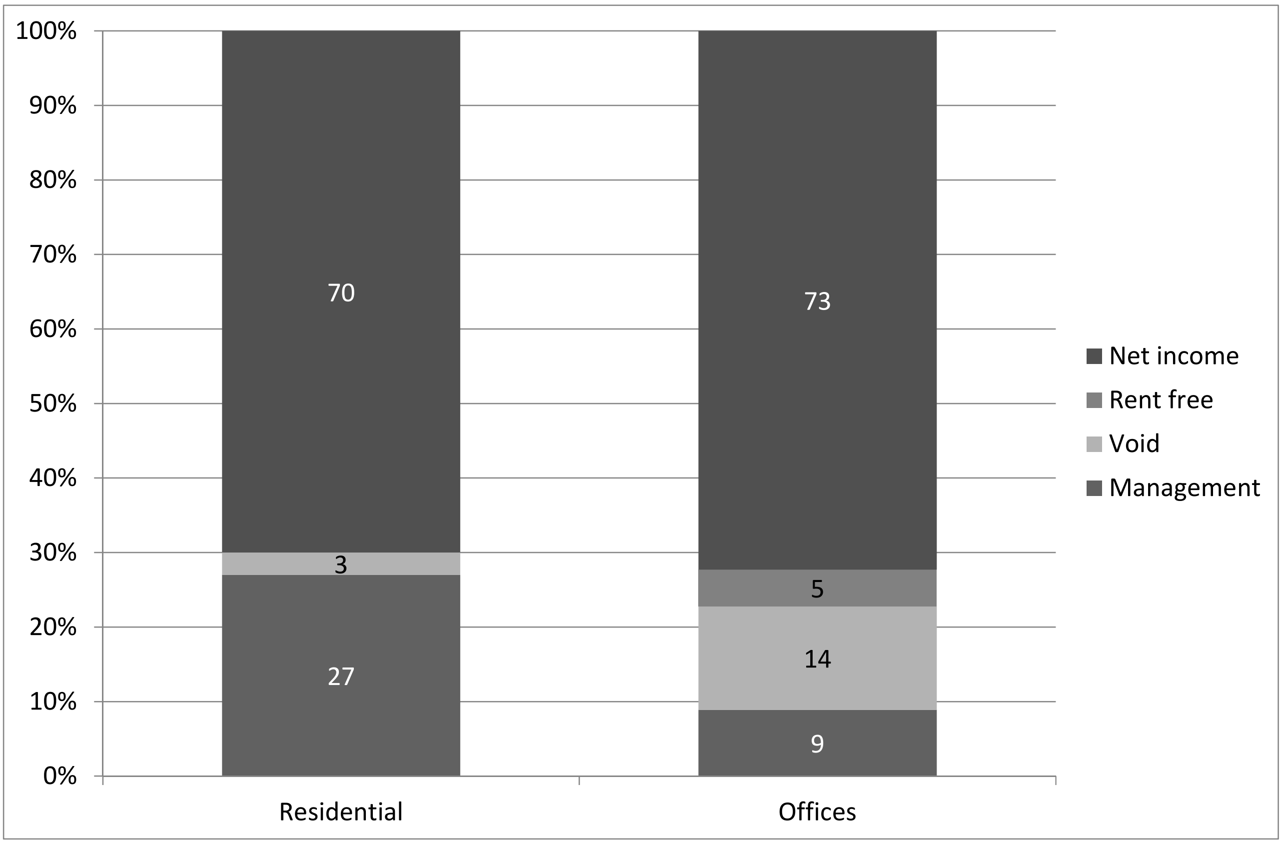
The main novelty risks are:

- a lack of a track record for the sector as a whole (as well as for individual investments) reducing investors' ability to forecast likely returns;
- difficulties acquiring a range of expertise, such as property management.

However, the IPD residential property index, which provides ten years' worth of data on residential returns, somewhat reduces the first of these risks by providing potential investors with some data on the performance of the sector.[81]

One example of a problem resulting from the lack of experience relates to investors' perceptions that an unacceptably high proportion of the gross rental income is lost, because management costs are higher than for commercial property. Whilst management costs are indeed typically a higher proportion of gross income for residential property, the overall gross-to-net erosion can actually be similar to other property asset classes once the other relevant factors are taken into consideration.[82] As shown in Figure 11, the proportion of income lost due to the property being un-tenanted (void periods) or rented rent-free (typically as an incentive at the start of a tenancy), is lower for residential property than for office buildings.

Figure 11. Net income and costs as a percentage of gross income[83]



Novelty risk is problematic because it creates a vicious circle whereby the lack of investment means that there are no examples for people to draw on the provide confidence to investors. Therefore, these investors are unwilling to commit to the sector. The key to resolving this is for trailblazing partnerships of developers and investors to come together to demonstrate the viability of residential investment.

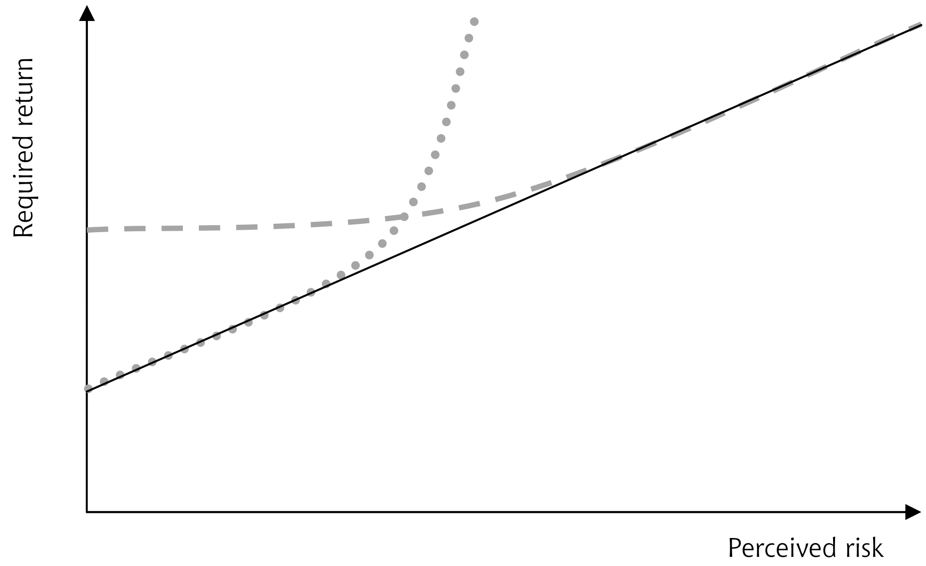
2.6.4 Development risk

Different investment choices present different risk and return profiles. Rational investors demand a higher expected return for investments that have higher perceived risk. The provision of new rented homes comprises a range of stages, which can be characterised as:

- Developing the idea and overall design
- Site identification and land acquisition
- Securing planning permission
- Construction
- Lease up (getting the first tenants in)
- Stabilising the asset (running on an ongoing basis, including management and maintenance)[84]

The existence of different stages creates a difficulty because they present different risk/return characteristics. Simplifying the model into two major aspects – development and ongoing lettings – the development stages are typically much higher risk than ongoing lettings. Because different investors have different risk appetites (Figure 12), it may be that development risk is not attractive to those institutions that would find a long-term rental asset attractive.

Figure 12. Representation of different risk appetites[85]



A risk-averse investor demands the standard market-defined level of return for low risk investments, but increasingly higher returns past some threshold.

Other investors, such as venture capitalists, target high returns, and hence are not interested in the returns normally available from low risk investments.

In addition to the risk profiles, the returns associated with development may not be suitable for institutions due to the nature of their liabilities. Specifically, some institutions will have regular committed outgoings and be interested in assets that will generate an income that is similarly steady; whilst rental incomes may represent good matching for these liabilities, the cash flow in development situations (where capital is tied up for an extended period, before a, hopefully higher, return is made) may not suit.

Recent commentary has noted that "whilst institutional investors recognise that there is a potential opportunity in Build to Let as an access point to residential investment, there is limited appetite to take exposure [i.e. to commit funds and accept risk] prior to the building being a fully-let, stabilised asset."[86]

2.6.5 Reputational risk

There is also a potential reputational risk attached to managing tenancies. For example, investors may be reluctant to be associated with problems such as eviction. More broadly, the private rented sector is, at present, commonly associated with poor management, insecurity and low quality. Although this is by no means true of the sector as whole, investors may be concerned that their involvement with the sector would reflect poorly on their reputations.

In reality, tenants' experiences of the private rented sector may not warrant excessive concern. The English Housing Survey found that 84 per cent of private tenants are satisfied with their accommodation and 72 per cent are satisfied with the way their landlord carries out repairs and maintenance.[87] It also found that only 9.2 per cent of tenancies ending due to the landlord/agent asking the tenant to leave.[88]

Furthermore, some advocates of the build-to-let approach have argued that the creation of developments of new homes for rent could result in more consistent management in the private rented sector and tackle any lingering stereotypes such as a lack of security of tenure and poor quality housing.[89] Although many individual private landlords operate in a professional manner and provide a high-quality service to their tenants, there remains a minority of unscrupulous landlords, including those responsible for criminal acts, who can tarnish the reputation of the sector.[90]

2.6.6 Political risk

There is also a perceived risk that a future government will reintroduce statutory rent control and security of tenure; this anecdotally remains a reservation for investors, especially amongst those who recall the impact of strict rent controls on the private rented sector prior to 1988. (Rent controls and security of tenure are typically instituted together because either in the absence of the other is undermined in its objectives. If rent is controlled but the landlord can easily evict the tenant, then there will be a tendency to do so if an alternative use of the property is more profitable; conversely, if there is security of tenure but no constraint on rents, landlords can simply increase the price by a large amount to effectively evict a tenant.)

These concerns seem to be particularly related to the history of the types of controls that have previously existed in the UK. A review comparing other countries' approaches to the private rented sector found that "[in] Germany, Switzerland and the Netherlands institutional investors are not put off by the strong security of tenure that tenants have. In fact long term tenancies are attractive in keeping down voids and management costs and maintaining a secure long term return. So, long term secure tenancies can benefit landlords and tenants."[91] Research for Shelter by Jones Lang LaSalle suggests that longer tenancies combined with index linking of rents may actually enhance landlords' returns.[92]

Furthermore, the prospect of substantial rent controls being reintroduced in the UK private rented sector appears remote, with few mainstream politicians advocating the policy, and even campaigning organisations steering clear of calling for their restoration.[93]

Insurance companies' investment patterns will also be influenced by the Solvency II Directive, which is due to come into force at the beginning of 2014.[94] This places greater capital adequacy requirements (sufficient capital to give confidence that the assets will cover the liabilities) on the insurance industry and will encourage insurance companies to hold less risky debt investments, rather than equity products or property.

2.6.7 Management difficulties

There is a perception that residential management is resource intensive and that this impacts negatively on net yields. Yields seem particularly low in comparison with those apparently achieved by individual private landlords, who manage and maintain their own properties, and typically do not account for their time when considering the returns they are achieving from their properties.[95]

Compared with commercial property, where tenants typically take long leases and are responsible for most of the management functions, landlords are responsible for these functions with residential property as well as having a much higher turnover rate. The costs of management and maintenance, including voids and arrears, constitute between a quarter and third of gross rents in the UK.[96] These high figures will in part reflect the current stock: a build-to-let model would allow properties to be designed and built with future management and maintenance in mind, and further savings may be achieved through economies of scale.

Earlier concerns around the unavailability of management capacity have largely dissipated. The housing association sector is now mature and, amongst others, represents a pool of potential management experience.

2.7 Successful examples of the build-to-let model

Despite the barriers identified above, there are examples where these issues have been addressed and successful models developed. These include the provision of student accommodation in the UK and multi-family accommodation in the United States.

2.7.1 Build-to-let student accommodation

One sector of the private rented market where purpose built rental accommodation is already being provided at scale is the student housing market. Students are one the key groups of people living in the private rented sector[97] and their numbers have doubled since the early 1990s. Whilst students have traditionally lived in university halls of residence, in shared houses rented from individual landlords or, more recently, with parents, the last 20 years have seen the emergence of purpose-built provision for the student accommodation market. In 2010, such accommodation housed 9.7 per cent of full-time students in higher education.[98] There are currently 160,000 such purpose-built student bedrooms that have been developed by the private sector. This supply has not emerged as a result of any government intervention or support, but rather as a commercial response to an investment opportunity.

The UNITE Group is one such provider. It is the UK's largest developer and manager of purpose-built student accommodation. Established in 1991, it currently provides 42,000 student rooms, in 24 university towns and cities. Its business model involves the entire development process through land and planning, financing, construction and long-term management. Accommodation is provided in purpose-built blocks, containing anything from 100 to 1,500 units, often arranged in group flats for four to six students, with communal facilities. Funding was initially raised on the equity markets, with investors focusing on growth. Once the model had been proven however, an investment fund was established in which institutional investors now invest, typically local authority pension funds. Reasons identified for the success of the model include:

- A clearly defined customer who positively wants to rent;

- Development of properties that are designed to be managed;
- Capacity to generate a strong and reliable income return.

Detailed analysis of the section of the market that they are serving has enabled UNITE and other providers in the sector to offer a product that responds to demographics and trends in customer needs. It is increasingly recognised that there are different segments even within the student market – domestic/international, postgraduate/undergraduate, first-year/non-first-year – and products are delivered to meet the specific needs of those segments. No car parking is provided, although access to car share schemes is made available, enabling higher density development and improved returns as a consequence.

Whole life costing, appropriate layout, materials and design, and on-site management ensure cost-effective and efficient management, providing not only good customer service, but also reduced management and maintenance costs. This minimises the difference between gross and net yield and delivers an attractive return for investors. UNITE currently delivers a return of 6.5 per cent ungeared (net of all operation costs and a life cycle maintenance provision). The ongoing ability to deliver a strong and reliable return also derives from the fact that excess demand enables values and rent levels to remain strong. It is further helped by the fact that the market is relatively stable and secure due to its counter-cyclical tendencies: more young people enter education, rather than the workforce, during uncertain economic times.

In terms of applying this model to other segments of the rental market, it is important that tenant needs are fully understood and there is no stigma associated with renting. UNITE improved returns for investors by achieving high densities (the number of units relative to the site area), which included the lack of car parking and provision of affordable housing. Some of these efficiencies may not be possible for some segments of the private rented sector, such as families with children.

2.7.2 Multi-family housing in the United States

The build-to-let rental model is much more developed in the United States than it is in the UK, providing accommodation for a range of different segments of the private rental housing market. The top ten multi-family rental operators together provide in excess of 1.15 million homes, with the largest companies being Greystar and Riverstone.[99]

With competition between the companies, there is a strong focus on seeking to attract tenants, and this is done primarily through the provision of accommodation and amenities that suit the lifestyle of the particular segment of the market. Each of the developers seeks to establish a strong brand identity for their accommodation and works hard to ensure that tenants remain loyal to their accommodation. Ways in which they do this include assisting with relocation when necessary and encouraging tenants to bring their friends to the building with friendly and welcoming reception areas, guest passes for the use of facilities and a wide range of events and activities.

A variety of development types are built, ranging from high-rise apartments to townhouses. Quality of the construction is high, with detailed whole life costing showing that high quality is cost-effective since durability is important. Understanding how tenants live their lives is crucial to ensuring that the product is popular. Provision will vary depending on the local amenities available and the target tenants, but can include swimming pools, gyms, treatment rooms, guest facilities, external roof terraces and courtyards, meeting rooms and entertaining suites for hire, cinema facilities and social programmes with a wide range of events and activities. Complementary uses are encouraged at the street level, with retail units that house coffee shops and restaurants.

Costs of maintenance and management are reduced through design wherever possible, thus minimising the difference between gross and net income. There is much higher residential mobility in the US than in the UK, and annual turnover rates of 50-60 per cent are typical, although not seen as a problem. Ninety-five per cent occupancy is typical and detailed design enables easy and quick turnaround (e.g. clip off light sockets for easy redecorating, double height lifts for moving furniture, with direct lift access also into delivery and storage bays at the rear of the building).

3. A model way forward: breaking through barriers

By overcoming the barriers identified above, there would be an opportunity for new providers and investors to enter the private rented sector. Significantly, this would offer an increase in the net supply of housing at a time when the UK housing system is failing to build sufficient housing, while also increasing the supply of rental housing that is likely to be in high demand in a wide range of locations due to challenges in the wider housing system.

It appears that if a portfolio of suitable scale were available, that was well-designed to enable management efficiencies and in the right location to meet housing need and demand, investors would be willing to invest in the residential property sector. Many of the barriers could be overcome by creating 'investment-ready' portfolios of sufficient size to attract investors. This could reduce perceived novelty risk of residential development and investment, increase the transparency of the asset class, and allow the costs and benefits of large-scale purpose-built developments of rental homes to be verified.

Consequently, the primary challenge in establishing a successful purpose-built rental sector in the UK is to ensure the development of such initial portfolios. These **trail-blazing developments** would construct portfolios that meet the requirements of investors outlined above. These portfolios could effectively challenge the negative perceptions of investment in residential property.

Given the real and perceived risks faced by investors, there is a role for organisations experienced in property development and management to lead this trail-blazing. It is likely that these organisations would have to possess certain characteristics in order to successfully build, market and manage portfolios of this size:

- Experience of (and willingness to take) substantial development risk;
- Expertise in property management; and
- Financial capacity to bring forward developments.

One group of organisations that is able to fulfil all these requirements is housing associations, particularly some large associations that are active in housing development.

3.1 Housing associations

Over several decades, the housing association sector has developed substantial experience in the delivery and management of rental accommodation. Some of the largest associations are now responsible for portfolios in excess of 60,000 homes. Housing associations are not-for-profit organisations that provide affordable housing, such as social housing at sub-market rent and affordable homeownership products. Most housing associations are regulated by the Homes and Communities Agency (HCA) and are formally classified as Registered Providers of Social Housing (previously Registered Social Landlords). (Some housing associations are unregistered, but these are typically small organisations with only a few homes. Conversely, a small number of for-profit organisations are registered with the HCA.)

In recent years, many housing associations (particularly the larger ones) have expanded their housing activity into the delivery of homes to generate surpluses. While they are not-for-profit organisations, this market activity has been undertaken to generate surpluses that have in turn subsidised further affordable housing provision. Through this activity they have developed into substantial businesses, with sophisticated appreciation of risk, finance, and other commercial considerations.

Consequently, the sector is now well-placed to fulfil the role outlined above: constructing portfolios of trail-blazing developments of new homes for market rent. Some housing associations have already undertaken market rental activity, with recent examples in England[100] and Scotland.[101]

Many of these associations have well-capitalised balance sheets against which they can borrow to build portfolios of sufficient scale to be attractive to investors, while they are also experienced in raising private capital to finance the development and improvement of homes. A small group of large housing associations has issued £5.4bn of bonds since 2008,[102] while the sector as a whole has attracted over £50bn of private finance (mostly long-term loans) since 1988.[103]

While other organisations with similar characteristics and attributes would be able to undertake build-to-let development, some large housing associations stand out as being well-equipped to act as trail-blazers and undertake an initial phase of development at scale. This activity is unlikely to be suitable for all housing associations. The sector is composed of a variety of organisations ranging from small landlords with a not-for-profit focus, to large landlords with growing for-surplus activities within complex group structures.[104] Others, including many housing associations that own stock transferred from local authorities, have relatively high indebtedness, and may not have the balance sheet strength to participate in this activity.[105] A small group of the largest housing associations, which are well capitalised with diversified activity across public and private markets, are likely to be best placed to act as trail-blazing delivery vehicles and portfolio managers.

Furthermore, as an established provider of homes for rent, the housing association sector would be able to provide investors with peace-of-mind property management, and ensure that tenants are decently housed with a high quality landlord service. Housing associations' tenant satisfaction is relatively high, with 83 per cent of tenants reporting being satisfied with their accommodation and 73 per cent being satisfied with the way the landlord carries out repairs and maintenance. These figures are very similar to those in private renting, in spite of the inherent constrained choice of housing in social renting, and significantly higher than for local authority tenants.[106]

3.1.1 Market entry

There are two broad ways that housing associations can start to move into this market at scale: adapting sites already in their development pipelines, to convert homes that would have been for sale to rental, and designing new developments specifically with market rental in mind.

Large developing housing associations have access to bond finance and have pipelines of prospective developments. Some of the developments will be intended for market sale; these could potentially be converted to market rental. Even if the value of the resultant homes would be lower as a result, the effect may be mitigated by the rental homes being built out quicker (and hence returns received sooner), because rental absorption rates are normally significantly higher than sale ones; a smaller amount received sooner can be worth more than a larger amount received later (known as a present value calculation). Equally a return can be generated on land that has already been purchased rather than just having to pay out interest on the finance used to purchase it with no matching income.

Although these developments could probably only receive minor design amendments to suit rental, and hence not receive all of the potential benefits of truly purpose-built rental homes, they would allow the housing associations to quickly gain scale in the rental market. This approach will not make sense in every case: whilst it may be acceptable to create a development that does not achieve all of the efficiencies that may be achieved with build-to-let, it would not be appropriate to sacrifice the overall quality of experience if the homes are actually unsuited to renting, or a poor fit for local rental demand.

In the medium term, housing associations will also be well-placed to create specific new developments entirely for rental. As registered providers of social housing, licensed to provide affordable housing, they would be able to create developments where some homes are rented at market rates and others at affordable rates, and to undertake the management of both elements. Although there may be different management requirements associated with the market and social rented homes, this would facilitate a holistic approach. From a financial perspective, housing associations will be able to consider the total rental income from the development in a way that would not be possible for a provider that would only be responsible for part of the stock; from a management perspective they will retain control to maintain standards across the site.

Whilst many of the largest housing associations have all the core characteristics required to undertake an expansion into developing large-scale portfolios of market rental homes, it should be acknowledged that there will be some differences between this and their traditional activities. In most locations demand for social rented housing significantly exceeds demand, so tenants' choice is highly constrained. Whilst the market for private rented housing is imperfect, it is closer to a true market, and hence landlords will need to be responsive to tenants' needs. There are indications that most housing associations are already responsive to tenants' needs, in spite of the fact that their tenants are typically unable in practice to shop around: in 2011, 65 per cent of housing association tenants reported that they were satisfied that their landlords took their views into account.[107] As noted above, those large housing associations best placed to participate in build-to-let activity will usually already be operating in sectors beyond social housing, so will have experience of acting within less distorted markets.

Similarly, the fact that housing association tenants report levels of satisfaction with their accommodation and repairs/maintenance that are very similar to those in the private rented sector suggests they are not ill-equipped to participate in that market. Housing associations entering this market will, however, have to be conscious that the level of service demanded by private tenants may be different from that demanded by social tenants. This could be important in either direction: if they provide a service that is lower than that expected, tenants will be dissatisfied with the service; if they over-serve, the extra service will be reflected in the rent level, and tenants will be dissatisfied by the price.

3.1.2 Financial exit

Housing associations' decisions about potential exit – the route to disinvest having created a portfolio of purpose-built rental homes – will depend on:

- The availability of further projects to undertake that are sufficiently desirable to warrant releasing capital.
- Their capacity to refinance developments through further bond issues.
- Their risk appetite. Refinancing through further debt finance is riskier than taking on equity finance, as interest on debt always has to be paid, whilst in tight times equity partners can be denied a dividend.
- Their willingness in principle to separate long-term ownership and management of properties.

Options will range from selling off the portfolio outright (whilst potentially bidding for the contract to manage the properties, assuming the new owner seeks a manager) through to retaining the stock and not significantly refinancing it.

Given that they are experienced managers and owners of homes, committed to delivering stable, high quality housing, housing associations are perhaps unlikely to seek an outright exit. One middle-ground option, which would appeal to their desire to remain involved in the homes they have developed, would be the creation of a fund. In this model the housing association would transfer a portfolio of completed and occupied market rental homes into a fund, and seek investors to purchase most of the fund. The housing association would remain a part owner of the portfolio but would be able to release most of its capital (which could then be recycled to deliver more housing). This approach would also have the benefit of demonstrating to investors that the housing association remains committed to the portfolio and believes it will continue to deliver returns. Furthermore, the fund-based approach would help to shield investors from the perceived reputational risk of direct sole ownership.

Whatever form the exit takes, if the housing association remains as the manager, management activity could potentially be a revenue-generating activity, and give it a continued ability to contribute to the development of high quality communities.

3.2 Nature of the product

In developing a new model of market rental housing at scale, housing associations also have the potential to create a product particularly suited to this model. This should be combined with an understanding of the strategic context of any development; the nature of investment and the types of homes being delivered should reflect a broader place-shaping approach to their area.

3.2.1 Design-to-let

Design-to-let refers to creating homes that are designed and constructed with the specific intention that they will remain rental properties under common professional management. Whilst the details of this would need to be sensitive to the specific situation (for example the location of the development and the target tenants), general design principles might include:

- Durability to lower in-tenancy maintenance;
- Minimal disturbance to tenants when repairs are required;
- Ease of redecoration to freshen homes between tenancies; and
- Ease of moving in and out.

The successful delivery of design-to-let homes will include an important a role for design experts. One such organisation, Assael Architecture, has created a Build to Let Design Guide based on its study of the USA's multi-family construction types.

Adopting design-to-let principles should help to increase the net yields achieved from developments. Some features could help to make the property more attractive to tenants, and shorten void periods, increasing gross returns. Others might help to reduce the management and maintenance costs, decreasing the gross-to-net drop.

Designing homes specifically to let would tend to decrease the likelihood that they would be sold to owner occupiers, and hence secure the development as long-term rental. That will tend to adjust the valuation mechanism, making the value of the development more dependent on its rental stream and less on a notional vacant possession value. Investor confidence of continuity of income stream would tend to be improved, with reduced than reliance on more perilous capital gains, which need units to be sold to be achieved.

Successful design-to-let techniques would also tend to improve the experience of tenants, and help to drive up standards in the broader rented sector.

3.2.2 Tailored tenancy agreements

The typical tenancies granted in the private rented sector are assured shorthold tenancies (ASTs) and their equivalent in Scotland, short assured tenancies. The

AST regime contains a high degree of flexibility: ASTs can offer as little as six months' security of tenure, but agreements can be written to provide much longer tenancy terms. There are relatively few restrictions on other contractual conditions, such as break clauses or clauses that permit rent increases, as long as the landlord and tenant agree the clause.

This flexibility is commonly used to mutually beneficial effect when students rent shared houses. Landlords will often grant a tenancy of ten or 11 months, giving tenants the right to stay in the property for the full academic year, but not requiring them to pay rent over the whole of the long summer vacation; conversely, landlords know that they will not be left with a vacant property in the middle of the year, when replacement student tenants may be hard to find.

In other segments of the market, the flexibility appears to be underused, with many landlords offering by default a six or 12 month tenancy. Whilst these terms may suit some tenants, it is probable that for others a different period would be preferable. In broad terms, those tenants who are relatively mobile may prefer short tenancies, whilst those looking to settle in an area may prefer the security of longer ones. Some commentary has focused on the specific case of families with school-age children, and the upheaval of having to move home (and potentially schools) in the middle of a school year; it seems likely that many in this group would value more stable tenancy terms.[108]

For those tenants who would be keen to stay for an extended period, short tenancies provide little of the confidence that would allow them to view the place they are renting as 'home' (even though the landlord may intend to renew the tenancy or allow it to roll on periodically). They also offer little protection against rent rises, as landlords can increase rents at the end of each contract. Some letting agents also charge for tenancy renewal.

Tenancies that are notionally long-term, but which permit the landlord to make unconstrained rent increases during the term, would effectively undermine the security that they provide: the tenant would know that if the landlord wanted to end the tenancy the rent could be increased to an arbitrarily high level, and the tenant would have to leave.

One of the reasons why the legally-permitted flexibility available within the AST regime has not typically been used is that buy-to-let mortgage conditions often insist that tenancy lengths do not exceed one year. This is in part caused by the fact that for single dwellings the vacant possession value is usually higher than the value with a tenant; consequently, lenders desire the ability to be able to regain vacant possession relatively quickly to improve their chances of recouping their investment if the landlord defaults on the mortgage.[109] For developments purpose-built to rent the homes' value should be based on their rental value rather than their vacant possession value, so there should be no similar motivation to constrain tenancy durations.

Tailoring the tenancy terms of rental accommodation to the target market segment should be viewed as being as important an aspect of meeting customer requirements as the physical design of the homes.

Housing associations could offer tenancies that offer greater security of tenure. Depending on the needs of the target tenants, such tenancies might be for a period of several years with a tenant break clause. To enable the landlord to obtain rent increases without leaving the tenant in fear of limitless rises the tenancy might permit rent increases in line with an index (say RPI or an index of wage inflation). Rental increases in line with an index may improve housing providers' ability to forecast their income.

As portfolios grow, another option available to housing associations will be to develop tenancies that give tenants freedom to move between properties within the organisation, creating flexibility across locations but with the security of remaining with the same landlord. For some of those tenants that benefit from the geographic flexibility associated with short tenancies this might provide an appealing fusion of the benefits of both.

If developments are part funded by debt finance, it would be necessary to consider whether any longer tenancies were granted subject to a break clause for "mortgagee in possession" (i.e., allowing a lender to end the tenancy if they repossess the property due to the mortgage not being paid). In principle, if the homes are intended for long-term renting the lender should have no more interest in evicting rent-paying tenant than any other party, but such a clause may give additional certainty to lenders, ensuring a range of finance sources remain available.

3.3 Benefits of this model

3.3.1 Benefits to housing associations

This type of activity would be of interest to housing associations that are considering how they can maximise their social benefit and deliver new homes for rent, whilst generating surpluses to fund further activity. By using their balance sheets and expertise in this way, housing associations could realise a number of benefits.

Most directly, the construction of homes for rent contributes to addressing the chronic undersupply of housing that exists in the UK, and the significant problems associated with this, such as poor affordability. Although the homes will be let at market rent, they nonetheless provide much-needed accommodation to households.

On top of this, investment in market housing will generate surpluses that housing associations can use for social purposes. Profits can be used to supply much-needed social housing, contributing to one of the primary aims of housing associations. This would also diversify the market activity of housing associations: private investment and the creation of balanced portfolios of housing stock will be important to the future of housing associations in light of government cuts to capital subsidy.[110] As a distinct activity, there may be constraints on housing associations' use of existing sources of capital for developing market rental homes, ahead of any refinancing. Associations will need to consider what organisational and financial structure is appropriate in the development phase.

Furthermore, refinancing much of the value of completed build-to-let homes with institutional investment as equity partners in a fund would mean that the development activity does not increase the association's long-term borrowing, but rather strengthens their balance sheet.

At the same time, by becoming involved in developing new homes for rent, housing associations can effectively capitalise on, and further extend, key skills within their organisation. For example, undertaking the ongoing management of the built-to-let properties will enable the provider to expand its management operations and by doing so achieve greater economies of scale. Equally, increasing involvement in development of market homes will help to retain and extend association's construction arms, reducing their susceptibility to fluctuations in the level of grant available to build affordable homes.

Whilst the delivery of new homes for market rent provides a strong business case for housing associations, it can also be conceived of as contributing to their social purpose. Not only does the surplus created allow increased investment in social housing, but housing associations can positively influence the private rented housing developed by offering exemplars of high quality management in the private rented sector. Furthermore, in major developments, housing associations will be able to develop build-to-let properties alongside social housing, which will help to achieve mixed income communities, reducing the stigmatisation associated with low-income areas.

Looking more widely, it is well established that construction can contribute significantly to economic growth, with 1.5 jobs created for every home built,[111] and £2.84 generated for every £1 invested in housing.[112] As many housing associations are increasingly seeking to support the wider well-being of the communities in which they work, this is an important benefit to consider.

Building new homes to rent helps to meet housing need, both in the homes that the activity directly provides and – potentially more significantly – by demonstrating the potential of the build-to-let business model to a new generation of private sector for-profit housing providers, who may follow in their footsteps.

3.3.2. Broader benefits

As a concept, building new homes to rent is inclusive: there should be nothing preventing a range of providers from entering the market. However, the large housing associations discussed here represent a particularly good fit for starting to develop and manage at scale. Consequently, they provide the opportunity to overcome most of the perceived barriers, by demonstrating the potential of the model. Once the potential to generate surpluses has been established, it would be expected that a number of for-profit operators would be emboldened to try to emulate the success.

The model presented here is also compatible with the recommendations presented in the Montague report,[113] which the government has identified as the "blueprint" for developing institutional investment in the private rented sector.[114] This means that the model will fit with the likely direction of travel of policy regarding the private rented sector.

In many respects, the interests of tenants, housing associations and investors may be aligned in delivering this model of housing. All parties would benefit from high quality homes in stable, desirable communities, often with the option for longer-lasting tenancies. Many (but not all) tenants would find longer-term tenancies attractive, as it would increase their perception of a rented house as a long-term home. It could, ultimately, contribute towards a situation where (as in Germany) renting is viewed as a positive long-term choice, further decreasing the incidence of voids. Tenants who stay longer could contribute to the stability of local communities and thus enhance the lived experience and desirability of the development.

If renting becomes viewed increasingly as a positive choice it will enhance people's ability to make a rational decision to select the tenure that best suits their needs.

3.3.3 Overcoming barriers

Key to the value of this model is that it addresses the bulk of the barriers that are hindering the creation of a successful build-to-let sector in the UK. Figure 13 summarises the ways in which this model would contribute to overcoming each barrier.

Figure 13. Summary of barriers

Yield compared with other property investment	• Creation of developments and portfolios by housing associations of homes specifically for market rent would allow the actual achievable yield to be verified. • Development of sufficiently-sized portfolios should improve yields: the fixed overheads to manage a portfolio would eat into a small portfolio more than a large one. • Housing associations may be able to obtain management economies of scale through leveraging their existing management capacities. • Savings obtainable by designing in features that make management and maintenance efficient can be demonstrated. • Where longer tenancies are offered with index-linked rental increases, yields may be improved by decreases in void periods. Returns would also be well-matched to inflation, benefiting investors whose liabilities are heavily inflation-dependent.
Insufficient opportunity to invest at scale	• The largest housing associations have the balance sheet strength to be able to develop sizeable portfolios before seeking to refinance them. Associations would not need to seek investment until the required scale were reached (although early informal interest from investors would give housing associations confidence that refinancing would be possible).
Novelty risk	• Housing associations are experienced at developing and managing rental homes, giving confidence to investors regarding these processes. • By not seeking investment until a sizable portfolio had been developed, the housing association would also be able to demonstrate a track record, including of yields delivered by the earliest developments in the portfolio.

Development risk	●	Investors would not need to take on exposure to development risk, as housing associations would not need to seek finance until a portfolio of completed and let homes were established.
Reputational risk	●	Housing association management of portfolios would reduce reputational risk for investors, particularly if the portfolio is refinanced to bring investors in rather than sold outright.
	●	By having a manager fronting the operation, investors would be less likely to suffer reputational harm from the manager's practices.
	●	Housing associations' experience of managing rental homes would make them less likely to make mistakes that might create an opportunity for reputational harm in the first place.
	●	Where increased security of tenure is offered, the risk associated with the sector being viewed as providing insecure housing is also removed.
Political risk	●	The probability of the reintroduction rent controls and statutory security of tenure appears low at present, but given their experience of social rented housing, housing associations would be relatively well-placed to operate portfolios should such a change occur.
	●	Governments may be reluctant to impose such constraints on housing associations if they are running for-surplus portfolios that are contributing to the supply of affordable housing, lowering the government's need to provide grant to fund that activity.
Management difficulties	●	Housing associations are well positioned to successfully manage market rental homes.
	●	Initial developments would enable them to demonstrate the achievable management efficiencies, and are likely to show less of the gross yield being lost to management than in current portfolios.

4. Analysis of supporting mechanisms

BSHF's Consultation event at St George's House, Windsor Castle, discussed a number of further mechanisms that could be used in support of developing a sector that is able to deliver new homes for rent. None of these are necessary or sufficient to create such a sector, but the more mechanisms that are put in place, the more likely that there will be a significant number of new homes built for rent. Each of these is examined in this section. Broadly speaking, these act either to reduce the risk that would be associated with such development, or to increase the expected returns, or both of these.

Where any of these supporting mechanisms help to create developments that show consistently high returns, they will help to generate investor confidence in the sector in general. Along with using housing associations to build some of the first developments to help create critical mass for a broader build-to-let sector, these additional mechanisms will help the move towards a tipping point.

4.1 Government restraint from market-distorting subsidies

The use of direct government subsidy in relation to the supply of market rented housing has the potential to create a number of problems. From an investment perspective it would hinder investors' ability to consider whether schemes are viable on their own merits, and might consequently undermine their confidence that it is worthwhile investing in developing expertise in the asset class. It would also potentially be seen as diverting subsidy away from social rented housing, and potentially incur political criticism as a result.

Description	In seeking to establish a system that delivers new homes for rent as a fully-fledged element of the UK's housing system, and unlocks institutional investment in the sector, the government should avoid making subsidies that would distort the nascent market, such as capital grants or discounted public-owned land. Capital subsidies should remain the preserve of the social housing sector. The government could, instead, seek to adopt a facilitation role, which could potentially make a valuable contribution to the establishment of the sector without the distorting effects of subsidies.

Participants	Central government and its agencies.
Potential benefits (risk)	By ensuring that the first wave of build-to-let homes is delivered without subsidy, the visibility of the actual returns available from the sector would be increased, decreasing novelty risk on subsequent developments. (If, conversely, an initial phase of development were subsidised, investors would gain little reliable data on how well such developments would have performed in the absence of subsidy.) By avoiding subsidising this sector there would be reduced risk of criticism from those who champion the social rented sector, who would justly complain if subsidy were diverted from subsidised housing into market provision.
Potential benefits (return)	Returns should not be affected.
Outstanding questions	Given that government should not subsidise developments in the market sector, it will need to consider where best to facilitate and assist the sector. Other forms of support for the sector would not have the same distortive effects; these might include promotion of market renting as a positive tenure choice, providing a strategic framework to give confidence to housing providers and investors, or lessening the effects of market failures that create barriers to entry.

4.2 Delivering access to land without providing subsidy

Access to affordable land can be a significant barrier to housing development. In particular, land-banking by house builders can constrain the supply of land, either through the securing of options or through ownership of land with or without planning permission. Evidence presented to the Callcutt Review in 2007 suggested that there are: "concerns that landbanking for profit (rather than to ensure a smooth supply of land as development opportunities arise) and purchase of options of land, both of which are common practice in the house building industry, have a negative impact on both land supply and land price: restricting supply and reinforcing fluctuations in the housing market."[115]

The Communities and Local Government Committee report on the financing of new housing supply identified that cost of entry issues can affect the potential for purpose-built rental accommodation, particularly as large sites for development would be required to achieve economies of scale and the price paid for land will ultimately impact on the yield received by investors. In May 2012 the Committee recommended that "all public bodies, both local and national, consider the potential for contributing their land alongside institutional finance to support build-to-let initiatives."[116]

The government has designed proposals for a Build Now, Pay Later initiative to encourage the development of homes for sale, where payment for the sale of public sector land is deferred until completion and homes are sold.[117]

It should be noted that the concept of subsidy is very difficult to define precisely.[118] The proposal described here is explicitly **not** to provide a public sector asset to private sector actors below their value, so avoids being a subsidy in a narrow definition. However, it could in some senses be conceived of as a subsidy, in that it would be intended to encourage production in a particular sector.

Insofar as it does constitute a subsidy, it is of a constructive sort: one that acts to ameliorate the impact of market failure, rather than to artificially distort resource allocation or transfer resources to a particular interest group. The barriers to entry hinder the smooth functioning of the market, limiting the ability of those seeking to deliver new forms of housing to do so, even when it should be economically viable on its own terms.

Description	Public bodies may wish to investigate mechanisms that would use public land to encourage the development of homes for market rent. This could be achieved either by accepting a deferred payment for land or by investing land into schemes as an equity stake. Such approaches are already beginning to develop: Birmingham City Council, for example, has developed a joint venture with investment partners.[119]
Participants	A range of public sector bodies, including local government, the HCA, various government departments and other agencies with land holdings. Local authorities may wish to play an active role in identifying sites that are suitable for the development of purpose-built homes for rent, using their understanding of the local area and its housing markets. By bringing land forward for market rent, the public sector could play an active role in facilitating the development of new-build rental accommodation where it is needed.
Potential benefits (risk)	Reduces the development risk, spreading the payment for land.

Potential benefits (return)	Should not impact overall returns, as this is not envisaging land being provided at a discounted rate, and the public sector would get full economic value of the land it contributes. However, by removing the need for upfront payment for land it should make it easier for schemes to be funded, lowering the barriers to entry.
Potential additional benefits	Reduced entry costs to the market enable greater participation and competition in the market. By working with a reputable housing provider, local public bodies could be assured that homes would be well developed and managed to meet an identified need and demand, while also accruing a return from the investment of land. Mechanisms that involve the public sector receiving a return on their investment would be preferable to providing land for free as a subsidy, as the latter would be likely to adjust the profitability of the accommodation and would not be a replicable technique for similar developments. The aim of bringing land forward should be to create the conditions in which replicable techniques of development can be honed that work for all parties, rather than to provide a transient and site-specific subsidy that provides an inaccurate picture of the sector's long-term economic viability.
Outstanding questions	It will be necessary to decide whether to provide land in return for a deferred capital fee or to use it to gain an interest in the eventual development to gain rental returns. This decision will probably be best made on a case-by-case basis, taking in various considerations, including the financial requirements of the public body.

4.3 Brokerage

One of the challenges in the creation of a build-to-let residential sector as an asset class for institutional investment will be the need for different industries to work together in unfamiliar ways. This may be eased by the fact that the largest housing associations are already sophisticated financial organisations (and hence can converse with prospective investors) and experienced developers (and consequently are experienced in communicating with local authorities and others), but further attention to the flow of knowledge would be advantageous.

Description	A trusted third party could take on a liaison role, brokering relationships and agreements between parties to assist the smooth delivery of new homes for rent. Such an intermediary between stakeholders in the development process could potentially be useful in supporting information flows and ascertaining scheme viability. An independent broker could mediate between actors and, where there is disagreement over issues such as planning gain, help each party to understand the interests and reasonable expectations of others. A broker would need to have a good understanding of the risks and rewards on offer to all parties, including investors, housing providers and local authorities, and would act as a respected conduit of information. The broker's services would need to be optional and advisory, as if they were compulsory and/or directive they would be likely to increase cost when not needed and undermine parties' confidence by seeming to add bureaucracy.
Participants	It would be important for any broker to be independent and neutral in negotiating the expectations and objectives each party has in the development process. A central government department (most likely DCLG in England) or another public body such as the Homes and Communities Agency may be well-placed to fulfil this role.
Potential benefits (risk)	Building confidence between parties would help to reduce perceptions of risk.
Potential benefits (return)	If productive, the brokerage would ensure that more developments successfully make it through to delivery, so fewer aborted costs from unsuccessful attempts would have to be absorbed.
Outstanding questions	Which body has (or could obtain) the necessary skills and reputation to successfully undertake this role? What sources of funding would be available to run the brokerage? This is the sort of activity that government could fund without risking distorting the market.

4.4 Viability assessments

Various appraisal models are available for local authorities and developers to consider the viability of potential development.[120] One such model, which is specific to London, is the Greater London Authority Affordable Housing Development Control Toolkit (developed by Three Dragons consultancy and

Nottingham Trent University), which can test viability either for a specific scheme, or for a wider area, for example for area masterplanning.[121]

The GLA toolkit is used to test the economic implications of different decisions in relation to residential development, with a valuation approach that is based on a calculation of residual land values. In particular, it facilitates the assessment of the impact of different levels of requirements attached to planning permissions, including requirements that the developer must provide a certain level and mix of affordable housing on the site. As part of this process, it permits the user to enter the number of homes of different tenures that will be offered on the development; however, whilst the current version has five different "Affordable" tenures (social rent, New Build HomeBuy, low cost sale, equity share and affordable / intermediate rent), "Sale" is the only market tenure considered.[122]

As well as the GLA toolkit, the HCA produces a Development Appraisal Tool.[123] Unlike the GLA toolkit, the HCA's tool does include the ability to consider private rented housing.

Description	Public bodies should use appropriate toolkits that include the ability to assess scheme viability where the development includes market rented homes. Existing toolkits that omit this facility should be extended and any new toolkits developed should include the functionality.
Participants	In London, it is particularly important that the GLA Affordable Housing Development Control Toolkit should be extended to include developments that feature market rented housing.
Potential benefits (risk)	A clearer understanding of the likely costs associated with a project would help to provide developer confidence. The use of a toolkit that allows for easy completion and appraisal of scheme viability would provide a more transparent picture of the likely costs of development for investors.
Potential benefits (return)	A shared understanding of the viability criteria for the site would allow the amount of planning gain that is extracted to be set such that it did not undermine the development. (When a site is granted planning permission for housing it typically increases in value, often by a large amount. Mechanisms such as Section 106 agreements and the Community Infrastructure Levy are designed to allow the public sector in the form of local authorities to capture part of this gain for wider benefit, including contributions to the provision of affordable housing.)

Potential additional benefits	Local authorities may be able to capture some planning gain, in addition to an increase in local housing stock. In some circumstances they may find that their normal affordable housing requirements, for example, would prevent a site being delivered, and would be able to make a strategic decision about whether the provision of market rented housing would be beneficial to their area, and consequently whether they wish to moderate their normal requirements.
Outstanding questions	One conclusion of a 2007 review of the existing Development Control Toolkit for London was that in some circumstances legitimate appraisals of viability can still be rejected by some local authorities, who may insist on higher levels of planning gain than can be delivered on a specific site, or simply view developers' use of the toolkit as an attempt to drive down affordable housing provision.[124] While a toolkit designed to appraise the development of purpose-built homes for rent at a large scale may be useful in determining scheme viability, it is unlikely to be a panacea in balancing competing interests. Can all parties be made aware of their limitations?

4.5 Affordable homes requirements

An issue that affects the economics of a development relates to local authorities' powers to capture some of the planning gain (i.e., the uplift in land value created by the grant of planning permission). Historically, Section 106 (S106) agreements have been the main mechanism for this, but recently the Community Infrastructure Levy (CIL) has been introduced; in future, S106 agreements will be used for contributions to mitigate the impact of the site, whilst CIL will fund off-site infrastructure. S106 is, and will continue to be, also used to require developers to fund affordable housing; this can be either on-site, or through payment of a sum to deliver affordable homes off-site.

Because the yield on large-scale residential investments is generally low, it has been suggested that to mitigate this some or all of the affordable housing that would be required on a private development for sale is set aside. Figures in the property industry have suggested that private developments for sale and rent should be treated differently, as the former is locking in capital for a short period, whereas build-to-let would lock in capital for perhaps ten, 20 or more years. It could therefore help facilitate investment and deliver more housing.[125]

The Communities and Local Government Committee, in its inquiry into the financing of new housing supply, encouraged local authorities to "consider taking a flexible approach to affordable housing requirements in planning obligations on a case-by-case basis, where this will help to stimulate build-to-let investment and will not be to the detriment of the wider housing needs of the area."[126]

Description	The level of affordable housing provision required in relation to a build-to-let development should be based on a careful assessment of the overall costs and benefits to the area. Local authorities should factor into their consideration a careful assessment of the tenure needs of the area: whilst affordable housing is in short supply nationally, in some areas there is a reasonable stock of affordable homes and more market rental homes may actually better serve the needs of residents. Local authorities may also want to consider the level of investment that a build-to-let development would draw into their area, and whether this meets housing needs. The alternative to a build-to-let development might be, for example, the provision of no new homes, or an owner occupied development that would be slowly built out and not address the most serious housing needs locally. It may, in some instances, make sense for a local area to trade off some planning obligations and conditions, including contributions to affordable housing stocks and community infrastructure, if it secures the viability of a build-to-let development that meets local needs. This should be done on the basis of a clear understanding of the costs and benefits of each trade-off.
Participants	Local authorities negotiate the level of affordable housing contribution that will be associated with developments in their areas. In London, the Mayor also plays a role.
Potential benefits (risk)	If it is known in advance that a development will be required to make only a moderate affordable housing contribution (whether through a national guideline or an approach that has been adopted locally), it will reduce the risk associated with the planning stage.
Potential benefits (return)	Lower affordable housing contributions will tend to increase the returns made on a development. Where the housing provider is a housing association or other Registered Provider of Social Housing they would presumably be able to manage both the affordable and market elements of the development. In that instance, the level of returns will directly reflect the proportion of the site that is dedicated to affordable housing, and the discount to market rent at with it is offered.
Potential additional benefits	The provision of suitable housing for rent contributes to meeting the nation’s housing needs, and the provision of housing in one tenure can relax pressure in other areas of the housing system.

Outstanding questions	Is it better to address this situation on a case-by-case basis, as recommended by the Select Committee, or to have firm rules (or at least guidance)? A case-by-case approach would tend to retain the benefits that development makes in many areas in terms of affordable housing contributions, which help to ensure a balanced housing stock. Conversely, a blanket approach would make it easier for prospective developers to know at an early stage what contribution to affordable housing they are likely to be required to make. Should any decision of the local authority to improve the viability of a build-to-let development by adjusting affordable housing requirements be conditional on the homes being secured as market rental for an extended period?

4.6 Local market data

Rental markets in the UK are characterised by complexity and diversity in terms of the household types they accommodate. As the Rugg Review of the private rented sector in England noted, the tenure serves several different sub-markets, including students, young professionals, families and individuals, and the configuration of these sub-markets varies in different areas.[127] Furthermore, while private renting is often associated with young mobile households, there is mounting evidence to suggest that the tenure will increasingly be occupied by older households and families, due to difficulties in accessing other housing tenures.[128]

Description	Data on rental markets and the demands for housing in the local area would be collected, analysed and disseminated. This would include information on market segments, and details of the household types whose need for rental housing is at present under-supplied in the area.
Participants	The design of such a scheme would benefit from sector input to ensure that the data made available actually meet the needs of those who will be using it. Potential users include housing providers, investors and local authorities. These sectors should be consulted to consider what data would be of most use.

Potential benefits (risk)	When considering a potential new development, investors and housing providers will need to see the potential for it to be a success, which would be informed by an understanding of both the nature and depth of demand in an area. Understanding the segmentation of local markets and the household types in an area would assist with this, as well as with issues such as the most suitable design, density and management regime for a property. These issues should be considered in relation to the likely needs and demands of identified market segments that the development is targeting; for instance the number of bedrooms and bathrooms in each unit within the development will vary according to the sub-market that requires housing. Consequently, the data would facilitate accurate matching of supply and demand, reducing the risk of long-term voids.
Potential benefits (returns)	Data would enable development of a product that meets a deep pool of identified demand. This would consequently secure consistent rent levels (with reduced void periods) and hence offer consistent returns.
Potential additional benefits	As well as providing visibility to developers and investors that the homes will be relatively easy to let, local authorities should also be more confident that the prospective development will be well occupied, and hence that they are not granting planning permission for a development that will ultimately attract the problems associated with high void rates. Information gathered for the purpose of informing development and investment decisions could also add to the evidence bases available to local authorities to draw on, for example informing their assessments of housing need and demand, and indeed their wider strategies. This enhancement of local evidence bases may be particularly useful for local authorities that have previously felt their interactions with the private rented sector have been hindered by insufficient factual knowledge of market trends.[129]

Outstanding questions	The method of collecting this local dataset should address the requirements and knowledge gaps of providers and investors. These requirements will influence the most appropriate method of obtaining the information and dictate what existing sources of information can contribute. One detail that will need to be considered is the scale at which such assessments are handled. The most suitable areas will need to reflect the areas across which prospective tenants are likely to consider moving. The government uses a set of broad rental market areas (BRMAs) to set housing benefit rates; these may or may not be suitable areas for assessing rental demand. Who will collect this data? Could this be a function that government could undertake, supporting the sector without distorting the market? Would this still allow the sectors using the data to have sufficient control to ensure the data collected would be of maximum value?

4.7 Completed development data

Once a development is completed it typically goes through an initial ‘lease-up’ period, when the newly-built empty homes are let out, before entering a steady state phase where most properties are occupied, with a proportion becoming vacant in any given period as the tenants move out. These two phases will present different risk characteristics.

The Investment Property Databank (IPD) currently provides some data on the performance of private rented sector homes owned and managed within several large portfolios. However, IPD’s existing datasets include a substantial proportion of homes that are not in purpose-built rented developments, and are weighted to the Great Estates, with large holdings in expensive areas of London,[130] and consequently may not be an ideal proxy for the performance of developments of new homes built for rent.

Description	As developments are completed, data on their letting and financial performance could be gathered and shared. This could include information on both the initial lease-up period and subsequent ongoing lettings. The data gathered could include the gross rents as well as management and maintenance costs, how frequently tenants move (known as the rate of 'churn'), void periods, arrears, and other factors that affect the difference between the gross rents charged and the net returns available to investors (known as the gross-to-net ratio). These data could be pooled to create a dataset that assesses the performance of large-scale developments of purpose-built homes for rent.
Participants	The trail-blazing of purpose-built homes for rent would enable this dataset to be seeded. The athletes' village of the London 2012 Olympic Games is scheduled to be transformed into Stratford's East Village in 2013. This represents a known pool of homes that could potentially contribute early data to this collection.
Potential benefits (risk)	Detailed factual information on both gross returns and the gross-to-net ratio across a number of developments would build investors' confidence, allowing portfolio managers to make more informed decisions about the scale, nature and likely risk and return of residential investment. Over time, these data would also provide a perspective on how the returns achieved by investors vary, as well as details that are important for investors, such as the correlation between returns from this sector and others (which facilitate diversification decisions).

Potential benefits (return)	Learning from actual practice may lead to improvements in practice and hence improved returns. It may, for example, highlight aspects of day-to-day property management that are able to reduce costs. The high perceived management costs of residential property can dissuade investors from entering the market.[131] However, when constructed in such a way that management inefficiencies are designed out and economies of scale are achieved, it may be that these losses are minimised, maximising returns. The data could also help attract more finance to the delivery of new homes for rent in locations where it is needed, with the design, construction and management of these new developments informed by an understanding of 'what works' and their relation to enabling higher net yields to be delivered. In the lease-up period, lettings will be subject to the 'market absorption rate' (how quickly a block of new homes can be rented out). Where there is only moderate demand for the homes, the landlord may have to trade off having some sit empty for an initial void period and discounting rents. Greater knowledge of the typical performance of developments during lease-up will allow landlords to make informed decisions about these trade-offs, to maximise returns.
Potential additional benefits	If available to researchers and the public sector, these data may improve understanding of the dynamics of residential markets, improving the quality of decision-making in relation to rental housing.
Outstanding questions	Which data should be gathered and how it should be presented? Who should be responsible for gathering and analysing the data? What conditions would need to be satisfied for providers to be willing to supply their data? Conversely, if there were public funds being used to support the data collection, would it be reasonable for the state to set conditions around quality and standards for those seeking to participate?

4.8 Homes locked into renting

At present, rented homes are typically valued with reference to their value with vacant possession (i.e., untenanted) because there is usually an option to sell the home to owner occupiers; the value of a home with tenants is usually at a discount to a vacant dwelling. This stands in contrast to commercial property that is rented out to businesses, which is valued based largely on the current and projected rental stream.

Furthermore, residential property valued in this way tends to rely on capital gains for a significant proportion of its total returns. This is in contrast to commercial property, which relies largely on rental income returns.

Description	A legal mechanism could be used to ensure that developments delivered for market rent remain in that tenure for an extended period. This could be for a definite but relatively long term (say, 20 years) or for an indefinite period.
Participants	Any system is most likely to be implemented by local authorities, probably in their roles as local planning authorities. S106 agreements are agreed at a local level (although standard clauses would be beneficial to avoid duplication by each local authority seeking to achieve the same end). A new Use Class would have to be created by central government.
Potential benefits (risk)	Improves investor confidence of continuity of income stream (rather than reliance on more perilous capital gains, which need units to be sold to be achieved). It would also reduce novelty risk for investors, as valuations based on income streams are common in their commercial property investments.
Potential benefits (return)	Proponents of these approaches have contended that it would not only preserve the homes as rental property, but would also serve to lower land values by removing them from the demand of the owner occupied market that may push values higher, and allow the value of properties in the sector to relate to rental returns rather than potential capital gains.[132] Lower prices would, all other things being equal, result in higher yields.
Outstanding questions	Which mechanism to use? A number of different potential techniques exist for locking homes into rental and there is not universal agreement on which mechanism would best deliver the desired outcomes. One method would be the creation of a new Use Class in the planning system for rented homes. Another would be to use the Section 106 system, which allows parties promoting a site for planning permission to enter into a contract with the local authority, known as a S106 agreement; whilst the most visible use of S106 agreements is to require the provision of affordable housing on the development, they actually have much wider potential applicability. It is probably desirable that homes that have not been specifically built for rent should remain easy to switch back and forth between renting and owner occupation; in the recent financial crisis the option to become a so-called ‘accidental landlord’ allowed many households to move and rent out their homes, when otherwise they might have faced challenges selling them. Consequently, any mechanism would need to be designed such that it only

	applied to property specifically intended to be in that category. Other desirable features may include: • A categorisation that is robust and widely accepted; • A relatively standardised approach (minimising the potential for error, for example the creation of unenforceable conditions, increasing efficiency, and providing investor confidence that each development in their portfolio has been granted on the same grounds); • As few unintended consequences as possible (for example, avoiding the planning system being overwhelmed later with applications for a Change of Use). It will be necessary to examine whether an exemption is required for "mortgagee in possession". In some previous cases such an exemption has been necessary to avoid sectors being deprived of debt finance.

4.9 Development and adoption of standards

As a new sector, build-to-let housing would benefit from activity that helps to communicate its qualities, both to prospective tenants and to other parties such as investors.

Input from tenant representatives in the development of standards could ensure that they reflect things that tenants value. This could make it easier for housing providers to deliver a product that was of high quality in the eyes of its eventual consumers.

Description	A voluntary set of standards could be developed and adopted to provide a degree of consistency between different providers of new homes built to let. These standards might include model tenancy agreements, management charters that agree a certain level of service, membership of an Ombudsman Scheme, and/or the provision of a Key Facts document that outlines the primary terms of the tenancy. Adoption of these standards might attract a certification mark.
Participants	Representatives of tenants' interests would need to be involved to help identify what might be important to them. Potential providers would need to agree the areas where they would be willing to collaborate.

Potential benefits (risk)	The adoption of standards would ease the job of investors seeking to invest in a given development; as long as they had established that they understood and were happy with the standards, the analysis required to establish whether they wished to make the investment would be much reduced. Developments that are operated within a defined set of standards will reduce reputational risk.
Potential benefits (return)	All other things being equal, tenants may tend to view properties that are offered on tenancies compliant with a standard as being more desirable. This will increase demand for the property, community stability and identity, and potential brand loyalty, reducing rent arrears and void periods.
Potential additional benefits	In time, some investment funds may adopt rules that would only permit investment in residential property that meets the standards, and tenants may specifically seek out compliant properties. This would in turn create a virtuous circle as more landlords would seek to adopt the standards.
Outstanding questions	What should be included in the standard? Who would be responsible for the creation and maintenance of the standard? How will the standards be enforced? What mechanism will be used to prevent non-compliant housing providers claiming that they have adopted the standard? What funding will be available for the scheme?

4.10 Tax levelling

A further issue in considering the attractiveness of renting is the way in which it is taxed. The UK's taxation system distinguishes between tenures to a significant degree, with the net effect being that private renting is less favourable from a taxation position than other tenures, specifically owner occupation.

Owner occupiers receive tax advantages that are not available in private renting. This has been described as a "continuing significant fiscal bias in favour of home-ownership relative to renting".[133] The relative tax positions of the tenures are complex, but there are significant differences between them. For example, landlords pay Capital Gains Tax on the sale of private rented accommodation, but owner occupiers do not on their primary residence.

The level of income that is foregone by the favourable taxation treatment of owner occupation has been estimated at £17.2bn for 2010/11.[134] The specific tax advantages included within that estimate are the absence of a tax on imputed rents (which abolished in the UK in 1963) and the fact that principal residences are exempt from Capital Gains Tax (CGT).

This taxation regime differs from countries with large and well developed private rented sectors, where it is common for there to be fiscal advantages such as deductions for capital gains tax when selling a property if the landlord has held it for a number of years or if the proceeds are reinvested in real estate.[135]

The relative position of different tenures and the fiscal advantages they offer are powerful in dictating not only the nature and extent of investment, but also in influencing the tenure choices and preferences of individual households.

Description	Changes could be made to the taxation treatment of the sector, to reduce the disparity with owner occupation.
Participants	Taxation policies are established by central government (HM Treasury).
Potential benefits (risk)	Fiscal advantages such as this, that provide a systemic opportunity across the residential sector and create the conditions for long-term repeated investment, would be more sustainable and preferable to transient subsidies applicable only to individual developments.
Potential benefits (return)	Improved net returns due to lower tax liabilities (or able to set prices lower and still achieve the same return, hence strengthening demand). As taxation affects the returns received by landlords, and therefore potentially the costs that are passed on to tenants, amendments to the taxation regime that favour market renting may help to adjust the long-term profitability of the sector, and increase its attractiveness for both investors and tenants.
Outstanding questions	Assuming that the taxation treatments are levelled down (rather than increasing owner occupation's taxation treatment to be comparable with that of renting), this would come at a cost to the state. What would be the level of income foregone from various tax changes? How would it be ensured that the benefits remain for the consumer?

4.11 Summary of suggestions and barriers

Investment decisions are fundamentally made on the basis of risk and return, so if investment is not happening it is because the expected returns are not high enough for the perceived level of risk. Consequently, by either decreasing the risk or increasing the returns associated with build-to-let, each of the ideas in this suggestion should contribute to the viability of the sector.

The table below further summarises the ideas presented in this section, and indicates which of the key barriers they address.

	Yield	Insufficient scale	Novelty risk	Development risk	Reputational risk	Political risk	Management difficulties
Government restraint from market-distorting subsidies			✓				
Delivering access to land without providing subsidy		✓		✓			
Brokerage			✓	✓			
Viability assessments	✓		✓	✓			
Affordable homes requirements	✓						
Local market data			✓	✓			
Completed development data			✓				
Homes locked into renting	✓		✓				
Development and adoption of standards			✓		✓		✓
Tax levelling	✓					✓	

Appendix A: Participant list

BSHF is grateful for the contributions made by participants at the Consultation. This report does not claim to represent a consensus opinion of all those present, although in preparing it we have drawn heavily on the discussions held. Responsibility for any remaining errors rests, of course, with the authors.

The Consultation was chaired by **Lord Richard Best**.

There was a presentation by **Sir Adrian Montague**, Independent Reviewer of the Barriers to Institutional Investment in Private Rented Homes for HM Government

Participants at the Consultation were:

Mark Allan, Chief Executive Officer, The UNITE Group

Andrew Appleyard, Head of UK Specialist Funds, Aviva Investors Global Services

Stephanie Bamford, Consultant, Strategy Support Service

Paul Beardmore, Director of Housing, Manchester City Council

Alan Benson, Head of Housing Team, Greater London Authority

David Birkbeck, Chief Executive, Design for Homes

Gareth Blacker, Team Leader, Land and Regeneration, Homes and Communities Agency

Nic Bliss, Chair, Confederation of Co-operative Housing

David Cowans, Group Chief Executive, Places for People

Tony Crook, Emeritus Professor of Town and Regional Planning, University of Sheffield

Robbie de Santos, Policy Officer, Shelter

Diane Diacon, Director, BSHF

Benjamin Dubertret, Director of Savings Funds, Caisse des Dépôts

Paul Evans, Director, UK Regeneration

Ian Fletcher, Director of Policy, British Property Federation

John German, Head of Residential, Grosvenor Fund Management

Robin Goodchild, International Director – Global Research and Strategy, LaSalle Investment Management

Iain Hutchinson, Founder, The London Rental Housing Company

Chris Jackson, Head, Housing Access and Support, HM Treasury

Kenneth Jones, Divisional Director of Housing Strategy, London Borough of Barking and Dagenham Council

Marcus Keys, Affordable Housing Director, Mansell

Richard Lambert, Chief Executive, National Landlords Association

David Montague, Group Chief Executive, L&Q

Tom Moore, Research Assistant, BSHF

Trevor Moross, Joint Managing Director, Dorrington PLC

Michael Oxley, Professor of Housing, Centre for Comparative Housing Research, De Montfort University

Alan Pearson, BSHF Trustee

Russell Pedley, Director, Assael Architecture Ltd

Brian Rowntree, Chairman, Northern Ireland Housing Executive

Julie Rugg, Senior Research Fellow, Centre for Housing Policy, University of York

Duncan Shrubsole, Director of Policy and External Affairs, Crisis

Mary Stallebrass, Policy Lead on the Private Rented Sector, Department for Communities and Local Government

Edward Trevillion, Head of Real Estate Research, Scottish Widows Investment Partnership

Jim Vine, Head of Programme (UK Housing Policy and Practice), BSHF

Keith White, Managing Director, Corporate Residential Management Ltd

The following people contributed to the Consultation as panellists:

Mira Bar-Hillel, Property and Planning Consultant, London Evening Standard

Hannah Fearn, Editor, Guardian Housing Network

Gavin Smart, Director of Policy and Practice, Chartered Institute of Housing

Appendix B: Notes and references

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