findings

Financial institutions and private rented housing

Many UK and overseas financial institutions are now actively interested in providing both loans and equity funding for private rental housing. Building on a 1994 study, new research, by Prof. Tony Crook of the University of Sheffield and Prof. Peter Kemp of the University of Glasgow, shows that there has been a marked change in attitudes among City institutions in the last five years, although there are still important barriers to large-scale funding.

- **Building societies and banks are concentrating on lending, not equity investment. They are now offering longer loans and lower lending margins. Investment banks are also prepared to arrange finance, provided propositions are large enough to seek funds on the capital market.**

- **In contrast to five years ago, pension funds and life companies are actively considering investing. Some have already done so and are buying residential portfolios. Those still examining the possibility are interested in indirect investment rather than direct ownership.**

- **A key barrier to indirect investment is the lack of suitable investment vehicles. Many institutions had investigated Housing Investment Trusts (HITs), but felt the returns were too low, HITs were not sufficiently tax transparent, and were too complicated and restricted.**

- **Some investment barriers had become less important, e.g. political risk, but some were still obstacles, e.g. poor liquidity. Institutions were also aware of previously unconsidered problems, e.g. poor housing management.**

- **The lack of adequately sized residential property companies in which to invest or from which portfolios could be bought is another barrier. Most companies are too small to satisfy financial institutions' minimum funding requirements and to generate economies of scale and the returns needed.**

- **A further barrier is the dearth of information. Institutions needed adequate, regular and sufficiently geographically disaggregated market information.**

- **Existing property companies have few problems obtaining finance, but overseas institutions have a better understanding of the business and give better terms than UK ones. But the researchers conclude that new vehicles are needed if the new institutional interest in private rented housing is to lead to significant growth in the sector.**

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JUNE 1999

Introduction

Recent governments have been keen to modernise the ownership of private rented housing. In particular, they have sought to attract financial institutions into this sector, as a way of introducing both new types of landlord and a significant scale of new investment. To this end, the Conservative Governments introduced measures aimed at making investment in private renting attractive. These included 1996 legislation on Housing Investment Trusts (HITs). A 1994 study by the researchers examined financial institutions' perceptions of private rented housing and their attitudes towards investing either debt or equity in this sector. This new research re-examines these perceptions and attitudes in the light of Housing Investment Trusts and other changes since 1994.

Current levels of involvement

Compared with 1994, all types of institution have an increased awareness and understanding of the sector. There is also increased activity in funding and evidence of overseas investment.

Most significantly, funding activity has increased, especially from those institutions, such as insurance companies and pension funds, which had little interest or involvement five years ago. For example, two insurance companies had acquired private rented property, two were considering investing indirectly and only two had not or were not intending to invest. Similarly, two of the four pension funds interviewed were actively considering investment. Although this still represents only a modest amount of equity funding, it is in sharp contrast to five years ago when none of these organisations had plans to invest.

Banks and building societies continue to lend, but there is little evidence of a significant increase in activity. While some have become more proactive in this sector, at least one has become less so. Unlike 1994, banks and building societies are no longer considering becoming landlords themselves or making equity investments. They intend to concentrate on lending. However, investment banks tended not to be involved in lending because to date the private rented sector has required only small-scale loans which are too small to warrant seeking funds on the capital markets.

None of the property companies reported significant difficulties in borrowing. Loans were easy to come by because of their track record, generally low gearing, and portfolio size. One company reported that it was much easier to raise long-term unsecured debt in the USA than in the UK and had raised considerable sums this way. Equity finance was, however, much more difficult to raise (although one company reported that overseas equity investors were more interested than UK ones). Even so, one recently floated Business Expansion Scheme (BES) assured tenancy company reported a strong appetite for its shares from institutions. It was pointed out that the general lack of equity funding prohibited significant growth, as the companies needed a larger equity base to gear up. Companies' pricing on the Stock Exchange was also affected by many factors other than performance and this presented problems when raising equity through share issues. This was a particular difficulty for small companies, where share price movements could be triggered by a relatively small number of shareholders selling. Large investors tended to be cautious in acquiring such shares.

The importance of commercial property

Commercial property investment is a significant part of retail and investment banks loans' portfolios, although lending criteria have been tightened. Loan costs depend on a range of factors, including the borrower's track record and the loan proposal itself. Loans to existing projects let to 'blue chip' tenants in prime locations attract the cheapest terms.

Direct property investment is important to pension and life insurance companies; they must allocate their assets between bonds, equities and direct property ownership so that returns match their liabilities. Property is generally leased on full repairing and insuring leases, which minimises management costs. In addition to income and capital growth, property is also a significant asset because of its diversification potential, since income and capital growth cycles tend not to synchronise with those for bonds and equities. Direct property ownership means that institutions receive the rental income directly and it is taxed in accordance with their individual tax liability. Hence, for example, gross funds, including pension funds, pay no tax on income from their commercial property portfolio.

In general, there was a consensus that total returns of 3 to 4 per cent above gilts were needed from investment in commercial property. Market information about returns from commercial property investment throughout the UK is very important for measuring performance.

Attractions and problems of private rented housing

Private renting is attractive to both lending and investing institutions. Potential equity investors stressed both the income earning and diversification potential of residential lettings. Rents were thought likely to rise in line with prices or earnings in the long run and therefore matched liabilities, especially for pension funds. In addition, residential property offers extra diversification potential within a property portfolio, since it is thought that returns move in a different cycle from commercial property income. However, owning a single house poses more risks than attractions. Many also pointed out that the middle and top end of the market, where capital values are more secure and there is less risk of capital losses, were much more attractive than the bottom end.

Nevertheless, private renting was still regarded as risky and problematic. Although political risk is no longer seen as a problem, funders are deterred by a wide range of perceived problems, including market risks, the small scale and amateur nature of most landlords, the paucity of corporate landlords, small lot sizes and high transactions costs, the difficulty of assembling stock for a portfolio that will yield adequate returns, high cost and poor quality management, and the lack of market information. Although large and geographically diverse portfolios could overcome many of these problems, currently very few exist.

Compared with five years ago, loan terms have improved. Lenders reported longer term loans, at lower margins and at higher loan-to-value ratios than before, especially to established landlords with good track records. However, the cost of funds is still higher than for other housing market loans and equity investors still require a higher risk premium than for commercial property investment. In part, this reflects the lack of large residential property companies as well as the novelty premium needed for what is still a relatively untried asset.

Equity investment and Housing Investment Trusts

Financial institutions differed over the relative merits of direct versus indirect investment in the private rented sector. Organisations that had already invested, or were on the verge of investment, had opted for direct ownership. This was tax-efficient, gave control over the investment, and provided an asset whose performance was reasonably predictable and moved in line with the property market, unlike shares in a listed company. Organisations currently considering investment preferred indirect ownership through the purchase of shares in a property company. Indirect investment was liquid, obviated the need to get involved in housing management, and did not require their name on the rent book. Managing agents in the private rented sector, however, were thought to be poor quality and expensive.

Those considering indirect investment required four key characteristics: liquidity, critical mass, tax transparency, and good quality housing management. A number of vehicles had been explored. A few institutions had looked at Authorised Property Unit Trusts and Limited Partnerships. All were aware of HITs to some extent and some had been involved in trying to set one up. None of these had got off the ground, despite considerable effort in some cases. HITs were not fully tax transparent, the potential returns were too low, they were thought unlikely to provide sufficient liquidity, and they had too many complications and restrictions, especially those related to capital value limits and property acquisition. The general conclusion was that HITs had failed as a concept and that something completely new was required to encourage substantial investment by financial institutions into the private rented housing market.

Conclusion

Although there has been a significant change in attitude by many financial institutions, neither current nor future levels of debt funding and equity investment are likely to transform the private rented sector in size, ownership structure, or funding sources.

There will, however, be some growth amongst the existing small-scale residential property companies - and new ones may be set up. But until these companies become large enough, the main financial institutions are unlikely to provide equity funding, except in ‘niche’ markets. The funding is likely to come from entrepreneurial funds, allied to debt funding from UK and overseas financial institutions. Once these companies have grown in number and portfolio size, financial institutions will become more active, especially in equity investment because companies will then be delivering the required yields and looking for the scale of investment the institutions want to make.

The evidence suggests that the current period is critical for the private rented sector. Many of the measures needed to revive the sector as a whole are in place - and many have also provided a much more positive environment for the development of residential property companies with institutional funding. Although recent government initiatives (including the BES and HITs) have not achieved all their objectives, they have reintroduced City institutions to the private rented sector and thereby significantly raised awareness and knowledge. They have also demonstrated the extent and nature of the constraints that remain in place.

A number of policy changes would help draw in more equity funding from pension and life companies. The absence of large residential property companies means that there are few current opportunities for financial institutions to invest in private rented housing. Assuming that most pension and life funds will not want to own property themselves, new investment vehicles are needed. These vehicles will need to produce equivalent returns to those that institutions would obtain if they owned the lettings themselves.

Two changes would help create a positive environment for setting up these new indirect investment vehicles:

- *create a tax transparent vehicle (TERLS – Tax Exempt Residential Lettings Schemes)* enabling investors to receive their returns free of tax from the investment vehicle. This would require tax law changes to allow the income from the investment vehicle (less costs) to flow directly to the vehicle's shareholders and be taxed subsequently in accordance with the tax liability of the investor. Tax arrangements would need to allow income to pass straight to investors; otherwise, pension funds and life companies would suffer a tax loss if they placed assets currently held as directly owned commercial property into a new residential investment vehicle;

- *introduce industry-wide codes of practice* setting out minimum standards for the management and maintenance of privately rented properties; this would help to improve the image of the sector, give confidence to tenants and, most important, make financial institutions confident that their reputations would not be sullied by association with poor standards.

Although many institutions wanted a better information base, the University of York's new Index of Private Rents and Yields now meets this need.

These changes would provide a much more conducive environment for equity investment. They would also increase the amount of debt funding since these new vehicles would enable institutions to gear up by borrowing. The evidence from the research shows that margins and loan terms can be more favourable for larger borrowers, especially where the required loan is large enough to be raised in the capital markets. Hence these changes are as important for attracting large-scale borrowing as they are for attracting institutional equity investment.

About the study

The research was conducted by interviewing senior staff in a sample of 27 financial institutions and residential property companies. The researchers conducted interviews with 18 of the 20 institutions which had taken part in the 1994 study. In addition, interviews were carried out with another nine organisations, including overseas financial institutions, residential property companies and a number of other UK financial institutions not interviewed in 1994 but known to have been active in funding private residential lettings.

How to get further information

The full report, **Financial institutions and private rented housing** by ADH Crook and Peter A Kemp, is published for the Foundation by YPS (ISBN 1 902633 07 5, price £13.95 plus £2 p&p).