A let-down for landlords

Richard Northedge examines how tax and regulatory changes have hit the UK buy-to-let market and made it a less attractive prospect for investors

If an Englishman's home is his castle, buying his second home is his pension scheme – as is his third, fourth or even hundredth. Courtesy of cheap bank finance, private individuals have bought residential properties to let, collecting the rents and accumulating the capital gains. Over the past decade, the number of privately rented homes has increased by 2.2m to 5.7m – one household in five. The gross value is estimated at £1.4tn.

The buy-to-let (BTL) rush continued through the financial crisis without a blip – until now. The past year's 3 per cent growth is the lowest for a decade: the 5,500 new BTL mortgages agreed in May 2018 was down 10 per cent on 2017. BTL may well be going into reverse.

Politicians have a problem with BTL. A healthy rental market fulfils a demand from people without the capital to buy – including young tenants saving for a deposit – and those wanting geographical, financial or spatial flexibility. That demand is met by the army of private landlords who filled the gap vacated by institutions and local authorities.

Yet landlords compete for purchases with first-time buyers, pushing up demand and reducing supply, and politicians value most the votes of would-be owner-occupiers. Landlords also compete for finance – not just from banks but in savings: parents who might have funded their children's home purchases may prefer BTL. Officials see BTL as exacerbating the housing problem, not solving it.

Policymakers have, therefore, tipped the balance against landlords to support owner-occupiers. A 3 per cent additional stamp duty was imposed on BTLs and second homes in 2016. Offsetting interest costs against rent for income tax calculations is also being phased out and will end in 2020. Last year's further stamp duty changes help first-timer buyers but not landlords.

Meanwhile, the Prudential Regulation Authority (PRA) told lenders in January 2017 to apply 5.5 per cent interest rates for affordability tests except for long-term fixed-rate loans. Nine months later, it required landlords with four or more properties to be assessed on the whole portfolio, not individual assets. That means preparing business plans and cash flow statements, which increases the workload for borrowers, brokers (almost all BTL loans are via intermediaries) and bankers. Even so, lenders were told that BTL loans do not qualify for small-business concessions on capital requirements.

Those tax and regulatory clampdowns are blamed for the slump in new BTL purchases and lending, but they coincide with the wider housing market slowing, especially in London, which accounts for 41 per cent of privately rented property by value. Without the prospect of capital gains, BTL's attraction diminishes.

Before the market turned, London had the fastest-rising prices, strong tenant demand, a supply of suitable properties and many affluent investors. Landlords tend to buy near their own home – it is handy for maintenance and they understand the market – but high prices gave London the lowest yields. To increase total return, Londoners are now looking at BTLs in places where prices are still rising.

> *Politicians value most the votes of owner-occupiers and have tipped the balance against landlords*

Properties are also cheaper outside the capital: purchases under £125,000 incur just 3 per cent stamp duty; above £250,000 it is 8 per cent and the average London property costs twice that, which may be beyond the buyer's budget.

Flat or falling capital values make yield more important. Student lets or houses of multiple occupation can generate returns above 7 per cent when other returns are below 6 per cent. Taxing gross rents (only fees and maintenance will be tax offsettable) greatly reduces or eliminates the net return, especially for higher-rate taxpayers. Yet raising rents is tricky, especially in London, where tenant demand has weakened. Nationally, rents rose just over 1 per cent year-on-year to May 2018.

The tax and regulatory curbs are deterring many small landlords. Some are selling but more have stopped buying. While 9 per cent of BTL owners bought in the past year, 8 per cent sold, according to a survey for Kent Reliance, the specialist mortgage provider, with portfolio landlords gaining in importance. For this year, expected sellers exceed buyers by 4 per cent. The survey found that, for 31 per cent

of landlords, letting is now their full-time living and increasingly they operate through limited companies. Companies can still offset interest against tax and recover VAT. Corporation tax is also less than income tax and borrowing terms are better for companies.

Some 72 per cent of new BTL mortgages are to companies, but stamp duty and remortgaging costs mean few privately owned assets are being switched. Yet, despite the slowing BTL market, more banks are offering more mortgage products. The choice of 2,000 products is up 13 per cent since January and 36 per cent over two years. The main product has also changed. Before 2016, most mortgages had two-year terms; now most are five-year fixed-rate loans because their affordability test uses the actual interest rate, not the PRA's 5.5 per cent stress test. But interest-cover tests have toughened: lenders previously happy with rental income of 1.25 times a 5 per cent nominal interest charge now want 1.40 times 5.5 per cent – or even 1.80@5.5, to use BTL jargon. That has effectively brought down loan-to-value ratios, and therefore the investors' gearing, with 70 per cent typical.

But more lenders chasing less new business produces a competitive market. Even as the Bank of England raised rates in August, one BTL lender cut its fixed-rate two-year loan to 2.49 per cent for a 65 per cent loan-to-value. That product's income cover for individuals is 145 per cent but for companies is only 125 per cent.

The main lending activity is remortgaging, however, as the pre-2016 short-term loans mature. Some 14,600 BTL remortgages were completed in May – up 15 per cent on 2017 – compared with the 5,500 new loans. And while the value of new loans was down 22 per cent, reflecting tougher affordability tests, the remortgage amount rose 21 per cent to £2.3bn. Average new loans are 20 per cent smaller than remortgages.

Most borrowers renew with existing lenders, not only because of the hassle and fees of changing but because the PRA is, for a transitional period, allowing lenders to renew using the old affordability rules. In theory, a lender accepting a switch can also use the original test, but, in practice, few do and the application might be rejected.

The BTL market is still in transition. Some banks may withdraw as remortgaging reduces – BTL did not really diversify their lending. But there will always be a demand to rent, even if a softer housing market and banks' overtures to first-time buyers encourage buying. Property portfolio sizes will continue increasing, with landlords becoming more professional. Institutional lessors may return, but not with the ragbag of secondary single properties bought by private owners.

But perhaps BTL's greatest strength is the interchangeability of the letting and owner-occupation markets. If landlords have to sell, they can sell to occupiers, not just other beleaguered landlords. So for all the worry by the Financial Policy Committee – "buy-to-let investors could behave pro-cyclically, amplifying cycles in the housing market as well as affecting the resilience of the banking system," it warned in 2016 – both landlords and lenders have an exit route by selling into the wider market, although some, particularly in London and the south-east, might have to accept losses.

Buy-to-let is now a less attractive investment that can be easily exited. Do not expect relaxed tax or regulation to revive it, but do not be surprised either that this once booming market now shrinks, leaving would-be tenants the losers. ■

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