savills

Savills World Research
UK Residential

Policy Response
Buy to Let Tax Relief

Autumn 2015

savills.co.uk/research

In his May budget the Chancellor announced a limit on mortgage interest relief for buy to let investors in order to "create a more level playing field between those buying a home to let and those buying a home to live in".

To put this in context, levels of mortgaged home ownership have fallen by over one fifth, or 1.9 million, households in a decade, while levels of private renting have more than doubled (increasing by 125% or 2.2 million households) according to the English Housing Survey.

But will it make it easier for first-time buyers to get on the housing ladder? Or will it simply reduce the choice of accommodation to a growing number of private renters?

The Role of Buy to Let

The extent to which the restriction on tax relief for Buy to Let mortgage interest impacts on demand for residential investment stock is a function of:

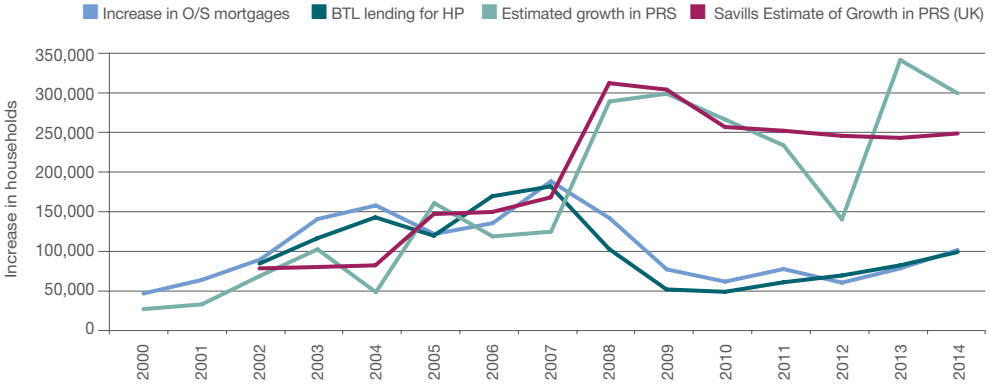
- the extent to which landlords hold mortgages within the private rented sector;
- the level and distribution of debt within that element of the private rented sector; and
- the ability of landlords who are reliant on debt to deliver a positive net rental income (after all costs including mortgage interest and income tax).

In this respect, we know that the expansion of the private rented sector was heavily supported by the growth in the buy to let lending markets in the period from 2001 to 2007. Since that date the growth in the number of private rented households has become dislocated from the growth in the Buy to Let sector, despite the fact that Buy to Let lending has recovered relatively strongly post credit crunch.

Levels of mortgaged home ownership have fallen by over a fifth in past decade

FIGURE 1

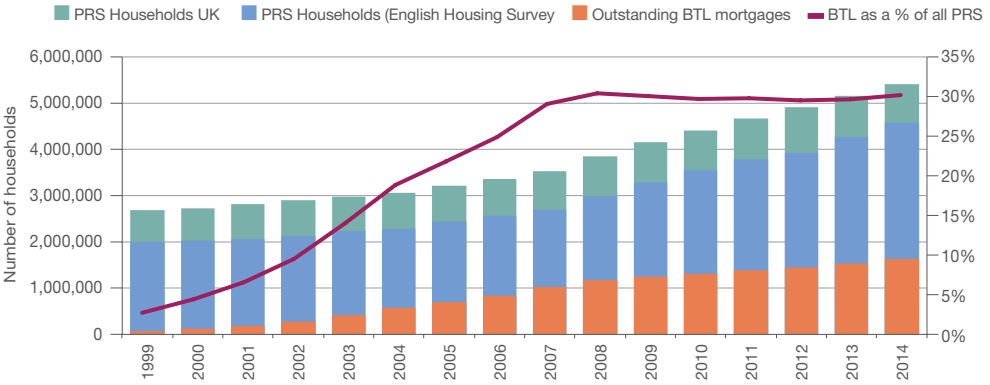
Growth in PRS v BTL lending



Source: Savills Research, CLG, CML

FIGURE 2

Size of the Private Rented Sector



Source: Savills Research, CLG, CML

While that growth in Buy to Let lending has warranted the attention of the Bank of England in their latest Financial Stability Report, our analysis of CLG and CML figures indicates that only around 30% of dwellings in the private rented sector are backed by a Buy to Let mortgage.

This figure has stabilised over the past seven years as equity rich investors and accidental landlords have played a much greater role. Buy to Let lending has supported just 28% of the growth in the private rented sector over this period.

Levels of private renting have more than doubled in the past decade

Levels of indebtedness

Further analysis indicates that the average *outstanding* mortgage in the Buy to Let sector stands at approximately £115,500, broadly in line with the current size of the average mortgage currently *taken out* to *acquire* a buy to let property using debt. Both figures are consistently below the average debt of properties that are being remortgaged, indicating that owners of the most highly leveraged properties are more likely to remortgage to keep their costs of ownership low.

This has contributed to relatively low levels of mortgage arrears in the Buy to Let sector which, having peaked in 2008 at 2.3%, of all mortgaged Buy to Let stock have now fallen back to 0.6% in the current low interest rate environment.

This average Buy to Let mortgage debt of £115,500, compares to our own estimate that the average value of a property in the Buy to Let sector stood at £214,000 at the end of 2014, indicating an average LTV of 54% (for the 30% of private rented stock against which there is a Buy to Let mortgage).

Profitability of Buy to Let

Using this information we can make an estimate of the economics of owning the "average" Buy to Let property as shown in the calculations below. For a 40% taxpayer such a property would deliver a cash surplus of over £2,500, assuming full tax relief on the interest payments. This surplus equates to 24% of the gross rental value of the property having regard to tax relief on mortgage interest of £1,502. If tax relief were restricted to the basic rate with immediate effect, that surplus would fall by £751 to £1,810 or 17% of the gross rent. However, this restriction will be phased in.

This means we need to fast forward to 2020/21, when we expect the average mortgage rate to have risen to 5.25% to see the full effect. At this time the surplus falls to under £1,000 even accounting for rental growth in the intervening period. Were the tax relief on interest payments not restricted that figure would be much higher at £2,162.

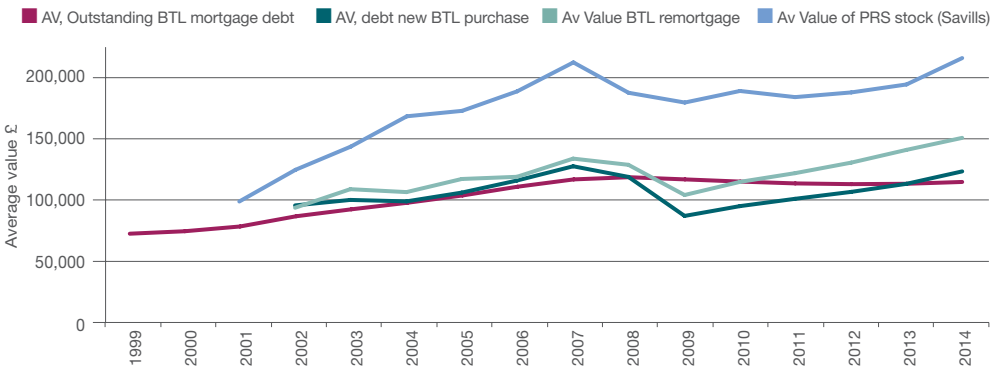
Inevitably, these sums are likely to cause some more highly geared investors (domestic & overseas) to rationalise their portfolios. Equally they are likely to restrict the ability of others to expand their investment as they find it more difficult to make the sums add up and lenders increase the interest cover which they require to reflect the new interest rate and tax environment.

Less competition for first time buyers?

That reduced investor demand is likely to temper some of the competition for housing faced by first time buyers and second steppers. Further, it may mean banks turn greater attention to owner occupiers, as the demand for Buy to Let mortgage finance reduces or is more difficult to service.

FIGURE 3

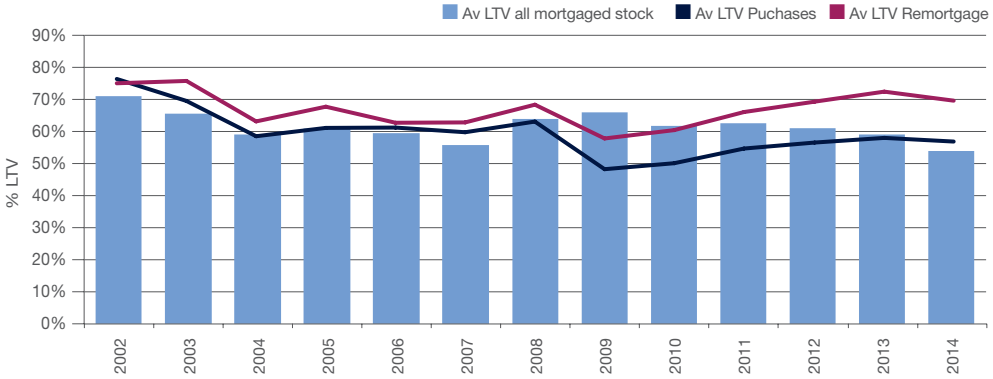
Values in the Buy to Let Sector



Source: Savills Research, CML

FIGURE 4

LTVs in the Buy to Let Sector



Source: Savills Research, CML

FIGURE 5

Buy to Let finances

£214K @ 5.0% YIELD	PRE BUDGET	2020-21
ASSUMPTIONS		
Capital Value	214,000	255,302
Yield	5.0%	5.1%
Repairs Management & Insurance @	25%	25%
Tax at Marginal Rate say	40%	40%
Mortgage at LTV of	**54%**	**45%**
Mortgage	115,560	115,560
Interest	**3.25%**	**5.25%**
Tax relief on interest at	40%	20%
THE MATHS		
Gross Rental Value	10,700	12,894
Repairs Management & Insurance @	-2,675	-3,223
Net Rental Income pre Finance	**8,025**	**9,670**
Tax at Marginal Rate say	-3,210	-6,067
CASH SURPLUS PRE FINANCE	**4,815**	**5,802**
Interest	-3,756	-6,067
Tax relief at	1,502	1,213
Net Cost of Interest	-2,253	-4,854
NET SURPLUS INCOME AFTER BORROWING	**2,562**	**949**
As a % of gross income	24%	7%

Source: Savills Research

However, given the extent to which the expansion of the private rented sector has been funded by equity rich investors in the period post credit crunch it would be naive to believe it will eliminate competition between investors and owner-occupiers in parts of the market.

Impact on the demand for private renting?

Furthermore, the purchasing power of first time buyers and second steppers is still likely to be capped by the recently introduced mortgage regulations. These regulations are also likely to mean those on the lower rungs of the housing ladder will continue to need to find substantial deposits.

The Help to Buy Scheme was introduced to address this deposit issue. The mortgage guarantee element of Help to Buy is due to expire next year while the equity loan element has been extended to 2020.

Even if it were to be extended further, it should be noted that the equity loan scheme currently only underpins around 27,000 transactions per annum. Though a significant support to house building, this is a small figure in the context of the current annual falls in levels of owner occupation and the annual growth in the private rented sector.

Similarly, focused on house building, the Starter Homes initiative which now aims to allow 200,000 first time buyers under the age of 40 to buy with at least a 20% discount to market value over the five year period of the current parliament is unlikely to reverse the underlying shift towards private renting especially among younger households.

Meeting rental supply

This suggests that Government policy also needs to take steps to expand the supply of rental properties in a way that does not create competition with first time buyers and which also provides them with an affordable and flexible tenure until they are in a position to graduate into home ownership.

This would indicate that large-scale institutional investment in the private rented sector remains an important part in dealing with the housing crisis, particularly with planning measures to ensure that the supply is additional. Specifically that would support the need for purpose-built accommodation that delivers a yield premium to investors.

In the absence of such measures there is a risk that the market becomes further under-supplied with a resultant upward pressure on rents.

BUY TO LET: £200K IN 2020

To see how the profitability of Buy to Let will change in different scenarios we have also looked at the theoretical purchase of a £200,000 property in 2020, using different yield and loan to value assumptions (but on the constant assumption that the average effective mortgage rate is 5.25% at this time). The net cash surplus from the rental income is shown in the table below.

This shows that someone with a 70% loan to value mortgage would potentially suffer a cash loss after tax even if their property delivered a gross yield of 6.0%.

FIGURE 6

Cash surpluses in 2020

Based on a £200k purchase in 2020		LTV				
		30%	40%	50%	60%	70%
Gross Yield/ Gross Rental Income	3.0% £6,000	180	-660	-1,500	-2,340	-3,180
	4.0% £8,000	1,080	240	-600	-1,440	-2,280
	5.0% £10,000	1,980	1,140	300	-540	-1,380
	6.0% £12,000	2,880	2,040	1,200	360	-480
	7.0% £14,000	3,780	2,940	2,100	1,260	420
	8.0% £16,000	4,680	3,840	3,000	2,160	1,320

Source: Savills Research

There is a need to encourage institutional investment into the private rental sector

IN CONCLUSION

■ Overall, levels of gearing in the private rented sector are low, limiting the risk of large numbers of investment properties being sold.

■ A combination of increasing interest rates and a capping of the tax relief on interest payments will cause some highly geared investors to rationalise their portfolios and limit the ability of a larger number of others to expand.

■ Some investors will look to lower value higher yielding markets to achieve sufficient cash returns, though caps on welfare payments will reduce the appeal for property in areas where a high proportion of private sector tenants rely on housing benefit.

■ Despite the government scheme to promote homeownership, we believe demand for private rented sector accommodation will continue to grow, given the high deposit requirements on first time buyers and a general lack of access to social housing.

■ The ability to meet this demand is likely to be further restricted by the budget changes. In turn, this is likely to maintain upward pressure on rents. This reinforces the need to encourage institutional investment into the private rented sector to provide tenants with a greater choice of good-quality rental accommodation.

"We believe demand for private sector accommodation will continue to grow"
Lucian Cook, Savills Research

CHANGING PROFILE OF DEMAND?

Higher interest rates combined with the restriction of tax relief on interest payments may push some demand to higher yielding markets where the interest cover is higher, but will limit the capacity for Buy to Let investors to invest in higher value, low yield markets across parts of London and the South.

However, their appetite for such lower value, higher yielding property may be reduced where the Benefits Cap and Working Tax Credit reform have the potential to impact on the rental affordability of those in recent receipt of financial support from the state who make up a significant proportion of the private rented sector.

This will put pressure on rents (and correspondingly constrain investor demand) in markets such as Blackpool, Middlesbrough, Hartlepool and Burnley in the North, Neath Port Talbot, Bridgend and Rhondda Cynon Taff in Wales, Telford and Wolverhampton in the Midlands and Great Yarmouth, Thanet, Weymouth and Southend in the South.

Savills Research team

Please contact us for further information

Lucian Cook
UK Residential
020 7016 3837
lcook@savills.com

Jacqui Daly
Investment
020 7016 3779
jdaly@savills.com

Susan Emmett
UK Residential
020 3107 5460
semmett@savills.com