Buy to let: under pressure

February 2018

Executive summary

- **80% slump in buy-to-let investment since tax changes.** Since July 2015 the buy-to-let market has been hit with a series of tax and regulatory changes. This has already spooked investors. We estimate that net buy-to-let investment fell from £25 billion in 2015 to £5 billion in 2017, a steeper fall than following the financial crisis. Anecdotally, agents are also reporting an increase in landlords selling up. Although it is hard to say exactly how much is down to policy changes, they are clearly the key factor stunting investment.

- **Some higher rate buy-to-let investors face tax rates of over 100%.** A higher rate buy-to-let investor with an averaged priced property producing average rents with a 75% LTV mortgage at 4% interest could have expected to see a post-tax profit of £212 before the tax changes transform this into a loss of £1,144 once the tax changes fully take effect. This takes the tax rate on their buy-to-let from 40% to 116%.

- **75% LTV higher rate investors facing post-tax losses in all regions.** Regionally, northern England produces the best gross rental yields (the highest yield being in the Northeast at 5.1% followed by the Northwest at 5.0%). However, for a higher rate tax payer with a 75% LTV mortgage on an average priced property producing average rents, cash flow after tax will be negative in every region of the country once new taxes fully take effect.

- **Profile of buy-to-let landlords is changing and lending landscape is changing in response.** The tax and regulatory changes seem to have had the greatest impact on smaller scale landlords with lenders reporting that larger portfolio landlords now account for a higher share of new lending for house purchase. There has been a realignment of lending in response to this and the PRA's new buy-to-let mortgage regulations. Some lenders are no longer servicing portfolio landlords, some are providing a limited proposition to portfolio landlords, while specialist lenders are increasingly focused on the portfolio segment.

- **Buy-to-let mortgage regulation lesser impact than tax changes.** The implementation of the PRA's new buy-to-let mortgage regulations in January and September 2017 has run relatively smoothly. The monthly profile of buy-to-let lending shows no sign of an impact of either change.

- **Despite the adverse tax and regulatory changes affecting buy-to-let, gross lending in the sector has stabilised.** Total gross lending was running at £3 billion a month up to October 2017, above the £2.9 billion recorded in the final nine months of 2016. Even buy-to-let lending for house purchase rose over this period to £890 million from £840 million.

- **Emergence of buy-to-let mortgage prisoners.** Some borrowers face the prospect of becoming buy-to-let mortgage prisoners not because of the PRA's new affordability requirements but because the removal of the interest tax deduction will lead them to fail lenders' affordability assessment, even where they are not seeking to borrow more.

- **Threat of further adverse policy changes remains.** The threat of further adverse policy changes remains, perhaps most seriously with the possibility that rent controls could return. The Labour party is proposing to cap rent increases at the rate of inflation. But in Scotland, the government has already introduced the private residential tenancy (PRT) to replace assured shorthold tenancies (ASTs). The PRT represents a break with the market rental system – tenancies no longer have a termination date and tenants can appeal rent increases to a rent officer.

- **IMLA is concerned with the degree of 'policy layering' that has impacted the buy-to-let sector since 2015** – where a series of changes are put in place before the authorities have had time to evaluate the effect of any of these changes. **IMLA believes that a brake should be placed on further adverse policy interventions in the PRS.** More generally, IMLA believes that politicians should publicly acknowledge the benefits that market mechanisms have provided in the PRS in encouraging investment and raising standards.

1. Introduction

1.1 Buy-to-let's unexpected blow

When the Conservative Party unexpectedly won a majority at the May 2015 General Election many buy-to-let investors[1] celebrated what they saw as the removal of the risk of greater regulation and the victory of what has traditionally been seen as a landlord friendly party. Yet within two years of that election, adverse tax and regulatory changes have significantly altered the outlook for both buy-to-let and the wider PRS.

It would not be an overstatement to say that many commentators see this as a sea change for buy-to-let, eroding the rationale for further investment in a sector that has brought forth enormous investment over the past two decades. This paper explores how these policy changes might affect buy-to-let and the PRS going forward but first let us recap all the new policy measures relating to the PRS that have been announced since the 2015 General Election:

1.2 Tax changes

July 2015 budget

In an attempt to manage housing demand from investors to encourage more first time buyers, then Chancellor George Osborne announced two adverse tax changes for landlords:

- Restricting the mortgage interest tax deduction for landlords to the basic rate of income tax.

The tax change will be phased in over four years commencing in the current tax year (starting April 2017). The change will be fully implemented by 2020-21. Technically, the deduction of mortgage interest will be fully removed and replaced by a tax credit providing relief at the basic rate of tax. So landlords' taxable income will not include a deduction for mortgage interest, pushing some basic rate taxpayers into the higher rate bracket. The change will not apply to property held by limited companies.

- Removing the wear and tear allowance for furnished rented property.

Legislation was introduced in the Finance Act 2016 with the wear and tear allowance for fully furnished property replaced from the tax year starting April 2016 with a new provision allowing landlords of all types of property to deduct the cost of replacement items on a like-for-like basis.

2015 Autumn Statement

[1] We use the terms buy-to-let investor, landlord and borrower interchangeably in the paper.

Further adverse changes were announced in that year’s Autumn Statement:

- A stamp duty surcharge of 3% was announced for rented or second homes.

The measure was applied from April 2016, causing a rush of buyers trying to beat the implementation deadline. In contrast to the graduated stamp duty regime that was introduced in 2014, the surcharge operates on a slab system. All properties over £40,000 being bought for rent or as a second home face an added 3% stamp duty on the whole purchase price.

- Requiring capital gains tax to be paid within 30 days of the sale of a rented property.

HM Treasury forecast that this measure would boost tax revenues by £930 million when it comes into effect in 2019-20, although this was deferred to 2020-21 in the Autumn 2017 budget. The measure contrasts with the requirement for payment of capital gains tax on other assets with payment due on 31 January following the end of the tax year.

March 2016 budget

- The government introduced a further change that disadvantaged property relative to other investment assets with the announcement that the higher rate of capital gains tax would be cut from 28% to 20% and the basic rate from 18% to 10% for other assets but would remain unchanged for residential property.

November 2017 budget

- The centrepiece of the Autumn 2017 budget was the decision to raise the stamp duty threshold for first time buyers to £300,000. This measure increases the advantage for first time buyers relative to investors.

1.3 Regulatory policy changes

Macro-prudential policy

On 17 December 2015 the government launched a consultation on granting powers of direction over the buy-to-let market to the Bank of England Financial Policy Committee (FPC). On 16 November 2016 the powers were granted.

Under these powers, the FPC is able to direct the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to require regulated lenders to place limits on buy-to-let mortgage lending based on loan-to-value (LTV) ratios and interest cover ratios (ICRs).

Required minimum underwriting standards

On 29 September 2016 the PRA issued new requirements to lenders on underwriting standards for buy-to-let mortgage contracts. The minimum standards that lenders are required to meet under these rules are:

- Affordability assessments should take into account: borrower's costs including tax liabilities, verified personal income (where used by the lender) and possible future interest rate increases.

- Lending to portfolio landlords (defined by the PRA as being those with four or more mortgaged buy-to-let properties) should be assessed using a specialist underwriting process.

- The PRA clarified that the provision in the Capital Requirements Regulation (CRR) which reduces the capital requirements on loans to small and medium-sized enterprises by around 25% should not be applied where the purpose of the borrowing is to support buy-to-let business.

PRA regulatory changes of January 2017

The PRA's new requirements were introduced in two stages. On 1 January 2017 enhanced affordability requirements were introduced. The PRA now requires lenders to include an ICR and/or a personal income affordability test when assessing a buy-to-let mortgage application. The lender is required to take into account any tax liability in the affordability test. The personal affordability assessment will carry more weight if the landlord relies on personal income to support the rent.

The PRA prescribes that lenders must use an interest rate of at least 5.5% in their affordability assessment and that the ICR based on this interest rate cannot be below 125%.

PRA regulatory changes of September 2017

On 30 September, the PRA imposed a new set of underwriting requirements on lending to portfolio landlords even if the other mortgages are with a different lender. Lenders are now required to assess affordability based on the landlord's whole portfolio as well as paying consideration to the landlord's level of experience and business plan.

Mitigating factors of PRA regulatory changes

The PRA regulatory changes of 2017 came into effect for new purchases or remortgages where additional capital was being raised. Remortgages without capital raising are exempted. Other loans including holiday lets, bridging loans, property investment lending and corporate lending are also exempt from the underwriting standards.

Basel capital requirements for buy-to-let

In December 2015, the Basel Committee on Banking Supervision published the second consultative document on Revisions to the Standardised Approach (SA) for credit risk. The consultation proposed changes to the way banks and building societies on the standardised approach would calculate minimum capital ratios. Most contentiously, the consultation proposed the introduction of a separate scale of risk weights for income producing residential property that would see higher LTV buy-to-let loans assigned higher risk weights than unsecured personal loans.

In December 2017 the Basel Committee published *Basel III: Finalising post-crisis reforms* which contained details of the risk weight scales for firms on the standardised approach for loans secured on ordinary residential property and income producing residential property. The risk weights are higher for income producing property, for example for 80-90% LTV loans the risk weight is 40% for standard residential property and 60% for income producing residential property. Although lending to an individual with a small (undefined) number of rented properties are excluded from the higher risk weights, this change disadvantages buy-to-let lending to portfolio landlords relative to conventional mortgage lending.

Letting agent fees

In the 2016 Autumn Statement the Chancellor announced proposals to ban letting agents in England from charging fees to tenants. The latest English Housing Survey shows tenants typically pay £223 in such charges. Although the National Landlord Association (NLA) is broadly supportive of the policy, there is concern that these fees will inevitably be passed onto landlords, although this proposal has yet to be enacted into law.

Quarterly tax reporting

In November 2015 the Chancellor announced that small businesses, the self-employed and landlords will have to update HMRC on their income and expenditure quarterly, rather than annually as currently applies. This is likely to add to the administrative burden on many landlords. Under current plans the change will be fully implemented by 2021.

1.4 Build to rent initiative

In 2012, the Government commissioned the Montague review (*Review of the barriers to institutional investment in private rented homes*), which was published in August of that year. It recommended that the government provide a number of targeted incentives to encourage the development of build-to-let business models, which could include sharing development risk in the short term.

The government accepted these recommendations, announcing its intention to support the delivery of 5,000 build-to-rent units in its September 2012 Housing

Stimulus Package, through a £200 million Build-to-Rent Fund for England and a UK wide £3.5 billion private rented sector guarantee scheme to allow build-to-rent investors to borrow more cheaply. By March 2016 it was confirmed that construction of 4,500 rental homes funded by the Build-to-Rent Fund had been started.

At a time when buy-to-let landlords are facing new tax measures and tighter regulation, to see institutional investors in the PRS offered subsidies is surprising. Admittedly, these subsidies have been focused on encouraging new build rented properties, but nonetheless the contrast between subsidies for large landlords and extra taxes for individual landlords is rather striking.

1.5 Housing white paper

When she became Prime Minister in July 2016 it was clear that Theresa May was prepared to alter the direction of policy to reflect her preferences. This appeared to be true of housing policy when the government's housing white paper (*Fixing our Broken Housing Market*) was published in February 2017. It presented a more balanced approach to tenure after the Cameron government's emphasis on promoting home ownership above all else.

But when it came to detailed policies, the white paper's clearest proposal was for more regulation of the PRS with measures to tackle poor quality private rented accommodation including a plan to consult on whether to introduce mandatory electrical safety checks and plans to extend mandatory licensing of Houses in Multiple Occupation (HMOs). There was no attempt to reverse the adverse tax changes of the Cameron administration. Thus it would seem that the thrust of policy may not have changed very much, with 'professionalising' the PRS still seen as a priority.

1.6 Scottish and Welsh government measures

In 2006 the Scottish government introduced a mandatory registration scheme for all private landlords. But in December 2017 it took a more significant step, introducing the Private Residential Tenancy (PRT) to replace the Assured Shorthold Tenancy (AST). Most significantly, the new tenancy is indefinite, with no fixed termination date, while the tenant can give 28 days' notice at any time. This removes the no fault eviction that allows a landlord to gain vacant possession with an AST.

There is also an element of rent control. Rent increases are limited to once a year with a required three months' notice while a tenant can refer any rent increase to a rent officer, who can decide if it is fair. Additionally, local authorities can apply to Scottish Ministers to cap the level of rent increases in areas where rents are rising too much. It could be argued that the PRT represents the end of a genuine market rental system in Scotland, seriously undermining landlords' incentive to make further investments.

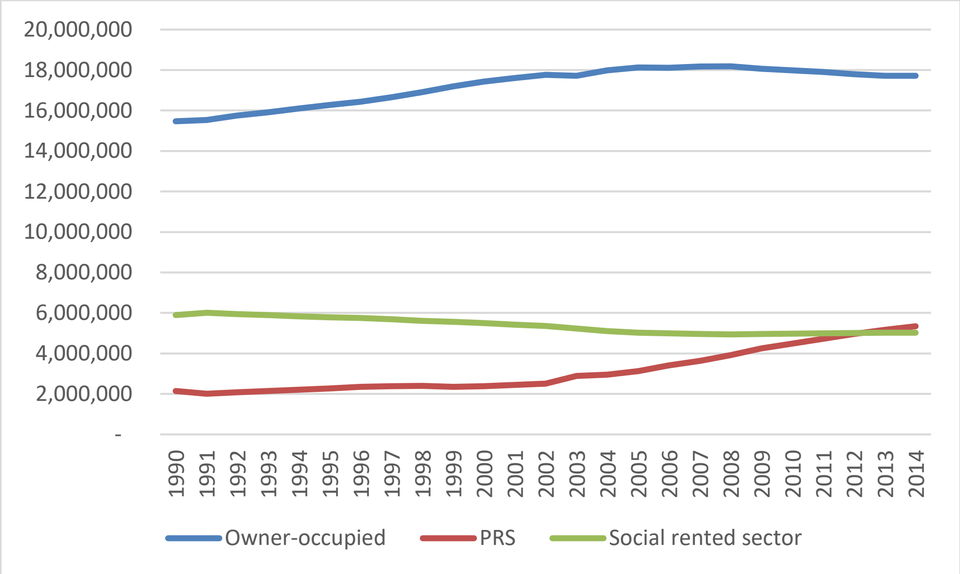
In Wales, the Housing (Wales) Act 2014 brought in compulsory registration for landlords but the Renting Homes Act (Wales) 2016 maintains a market rental system through its standard tenancy, modelled on the existing AST.

2. How has the PRS performed?

2.1 The scale of investment in the PRS

Since the PRS reached its low point in size around 1990, it has added 3.3 million properties (see Chart 1), doubling the proportion of homes in the sector from 9% to 20%.

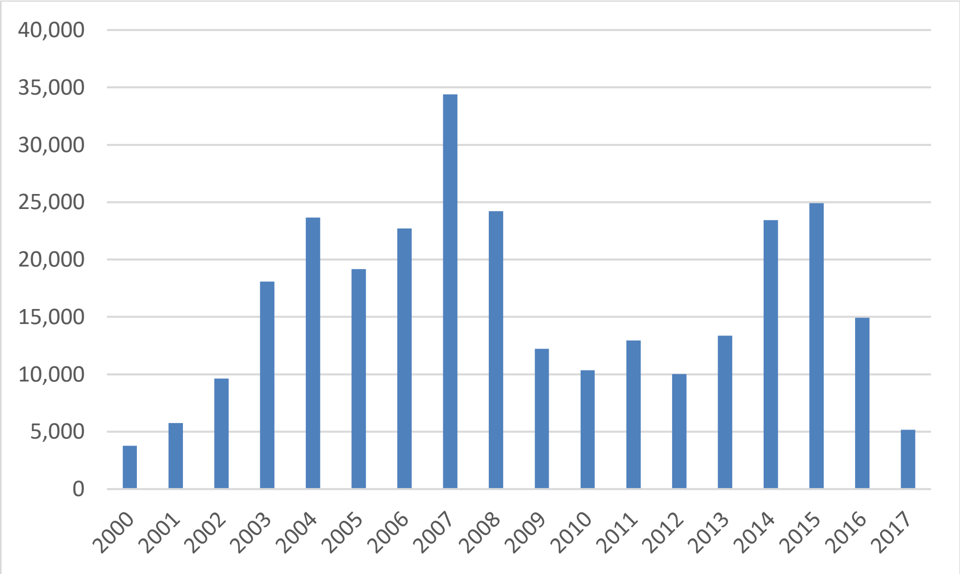
Chart 1 – UK housing stock by tenure



Source: DCLG

There are two sides to this story; that of changing patterns of demand creating a rise in the number of people seeking to rent privately and that of increased supply, driven by landlord investment. Chart 2 shows our estimate of the net investment by buy-to-let landlords purchasing additional properties between 2000 and 2016.

Chart 2 – Estimated net investment in new buy-to-let properties (£ millions)



Source: IMLA estimate. 2017 is projection based on year to October data. UK Finance and Nationwide

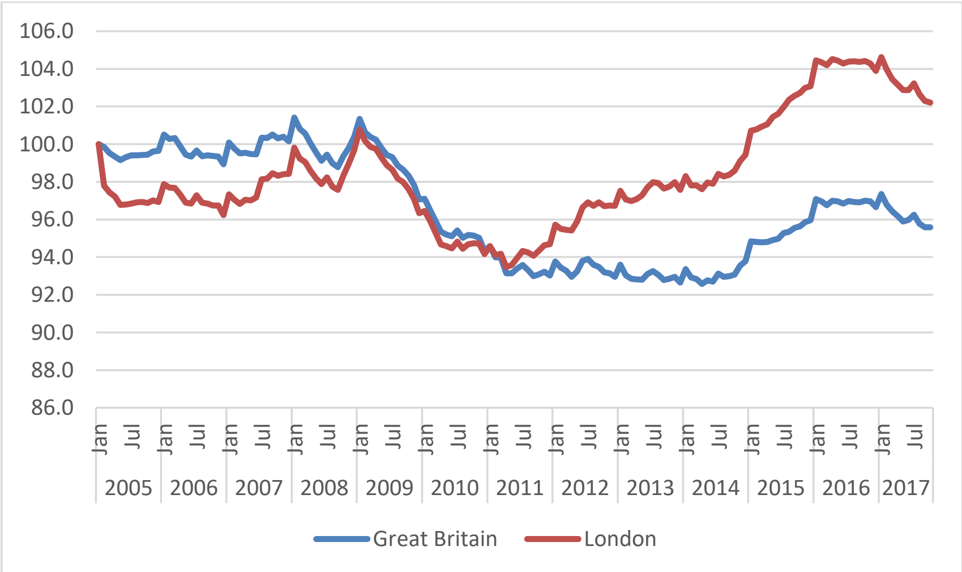
We estimate that cumulatively, between 2000 and 2017 buy-to-let landlords invested £289 billion bringing 1.8 million properties into the PRS. Another 1.2 million properties entered the PRS through cash purchases and other means. Without this scale of investment, the PRS could not have met rising demand, suggesting that our national housing crisis would have been far more severe.

But the story of supply is not just one of rising numbers of properties. Quality has also been upgraded. This is evidenced by tenant surveys in the English Housing Survey which show an increase in the proportion of private tenants who are happy with their tenure from 48% in 2004-05 to 65% in 2014-15. The 2017 Homelet tenant survey also showed that only 14% of private tenants were not happy with the standard of their property. A rising proportion of properties also meet the government's decency standard: 28% of homes are now defined as non-decent compared to 37% in 2010. It is harder to estimate the scale of investment to improve the quality of the existing rented housing stock but it is likely to be in the tens of billions.

2.2 The balance of supply and demand

We can consider the relative strength of supply and demand by looking at the evolution of rental prices. Chart 3 shows rents in real terms (adjusted for CPI inflation) since 2005. Across Great Britain real rents fell 4.4% between January 2005 and October 2017, suggesting that despite robust growth in rental demand and the worsening housing shortage more generally, investment in the PRS has more than kept pace with demand. This is an impressive performance, especially given the quality improvements the PRS has also enjoyed.

Chart 3 - PRS rents adjusted for CPI inflation (Jan 2005=100)



Source: ONS

Even London, the region which has seen the largest increase in rents since 2005, recording an increase of 41% between January 2005 and October 2017, has seen only a 2.2% rise in real rents over this 12-year period based on CPI inflation and a fall of 3.3% if the RPI is used. So while the price of property has soared in real terms in

London, the price of renting property has barely changed. Using rental data for England we can go further back in time. Between October 1996 and November 2017 rents adjusted for CPI inflation fell fractionally (by 0.2%).

The concern going forward must be that adverse tax and regulatory changes will stunt or even reverse this positive investment flow. Already it is clear from the steep fall in estimated investment between 2015 and 2017 (see Chart 2) that investors are taking a much more cautious approach while the 2016 CML survey entitled *The profile of UK private landlords* found that 29% of buy-to-let landlords now plan to reduce the size of their portfolio and research by the National Landlords Association (NLA) shows that the number of existing landlords planning to sell has more than doubled since July 2015, rising from 7% to 16%.

2.3 The sector's public image failure

With rising numbers of tenants accommodated with improving quality standards at a falling real cost, you might think the PRS would have established quite a positive public image. But this has not been the case - the sector still has an image problem. Several factors seem to have contributed to this state of affairs:

- Firstly, there are still substandard properties and rogue landlords. The acute shortage of properties in many cities allows rogue landlords to get away with renting substandard or over-crowded homes.

- Secondly, for the overwhelming majority of people owner-occupation remains the tenure of choice and the PRS is still seen as a tenure that has to be endured rather than being a preference (although this attitude is by no means universal). For example, the 2015 Homelet tenant survey showed that 71% of tenants would prefer to buy with only 14% happy to keep renting.

- Thirdly, the shrinkage of the public rented sector has pushed those who in the past would typically have rented from the council into the PRS. As the social rented sector is both subsidised and offers greater security of tenure, it should come as no surprise that the PRS would be seen as an inferior option for these tenants (although again this is not a universal reaction).

In short, the UK's housing crisis, with an inadequate overall stock of properties and shrinking housing options for young people, has fueled dissatisfaction that has found an outlet in anger directed at private landlords. The windfall that many landlords have enjoyed from rising property prices and falling mortgage rates has added to this resentment.

The tax and regulatory measures outlined in Section 1 above are in part a political reaction to this popular sentiment as well as an attempt to promote owner-occupation by undermining the case for investment in the PRS. In this climate, few politicians are prepared to articulate support for market forces in the PRS, although the government did signal a shift to a more tenure neutral stance in the housing white paper *Fixing our broken housing market*. But with politicians of all stripes calling for more regulation, the private landlord seems politically friendless at present. While recent policy changes may benefit those who are seeking to step onto the property ladder, they risk disadvantaging the millions of others who rely on the PRS to put an affordable roof over their head.

3. Is buy-to-let a systemic risk?

3.1 Regulators' concerns

Chancellor Osborne's tax changes of 2015 and 2016 were explicitly designed to benefit first time buyers by reducing competition from property investors, as well as raising revenue. There was no mention of the risks that investors or buy-to-let lending might pose to the financial system or wider economy.

However, regulatory concerns with buy-to-let were quick to follow the first tax changes. Following its policy meeting of 25 September 2015 the FPC's statement included a discussion of the buy-to-let lending sector. This flagged several areas of concern through the following statements:

"The stock of buy-to-let lending might be disproportionately vulnerable to very large falls in house prices. Buy-to-let mortgages are typically extended on interest-only terms and therefore do not amortise. As a result, loan to value ratios on older vintages of buy-to-let loans fall more slowly over time."

"Buy-to-let mortgage lending has the potential to amplify the housing and credit cycles, though the extent of the amplification is hard to judge because the market has only recently grown to significant levels."

"Buy-to-let investors may further exacerbate a downturn if they expect rental incomes to fall below their interest payments, and consequently add to selling pressure. Survey evidence suggests that around 40% of buy-to-let investors would respond to a fall in their rental income below their interest payments by seeking to sell their property."

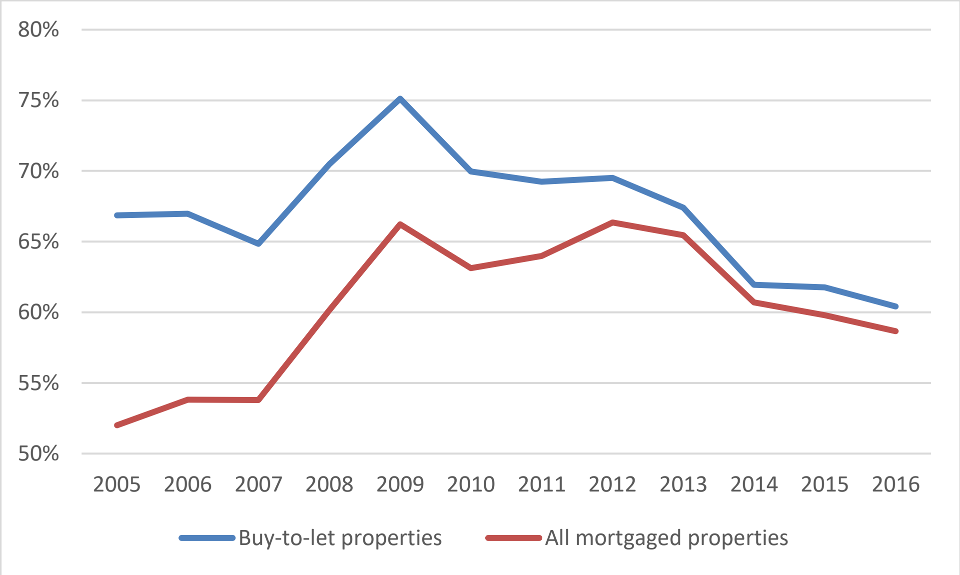
The sense that regulators were concerned with the risks posed by buy-to-let lending was reinforced by the PRA's decision to set minimum underwriting standards for the sector, citing concerns that some lenders were not adhering to industry norms.

3.2 Assessing the risk of buy-to-let

Are regulators right to be concerned about the risks that buy-to-let poses? One problem is the lack of historical evidence on the behavior of the buy-to-let sector given its relative immaturity. This makes detailed analysis more difficult, as the FPC acknowledges. However, this is what we do know:

- Overall the PRS has a low rate of leverage. Of the 5.3 million properties in the PRS at the end of 2014 (the latest figures), only 1.7 million (31%) have a buy-to-let loan outstanding. Maximum LTVs on new loans are also lower than in the owner-occupied sector, making buy-to-let less vulnerable to the risk of negative equity. Turning to average LTVs on the existing stock of buy-to-let properties, Chart 4 compares the sector with the wider mortgage market. While until recently average LTVs were higher on buy-to-let properties, reflecting the high proportion of relatively new loans, the gap has all but disappeared in recent years, as average buy-to-let LTVs fell from 75% in 2009 to 60% in 2016.

Chart 4 – Estimated aggregate LTV ratio



Source: Bank of England, UK Finance and Nationwide Building Society

- The profile of the average buy-to-let investor fits that of a more secure borrower than the average owner-occupier. They are older and have higher incomes and greater wealth than the average owner-occupier. This is likely to make them more resilient in the face of a property downturn. According to the 2016 CML landlord survey, the median gross income band for landlords, including rental receipts, was £60,000 – 69,999. For comparison, UK median household income as of end-2015 was around £25,700.

- We know that buy-to-let purchasers tend to be long term investors, with low rates of resale. Since the sector started in 1996 investors have shown limited appetite to sell when housing prices were weakening or interest rates rising, although the sector has not been tested by a dramatic rise in interest rates. Even after the adverse tax changes, according to the 2016 CML landlord survey 81% of landlords expected to continue renting for at least 5 years.

- In the past, during property downturns as fewer first time buyers entered the market, the number of tenants correspondingly rose. This provided landlords with a degree of counter-cyclical demand.

We estimate that the PRS has rental income of approximately £60 billion a year. Assuming that buy-to-let investors pay a mortgage rate 3% above Bank Rate, their total interest bill amounts to £8.2 billion a year (on £233 billion of mortgage debt). Mortgage interest thus averages only 14% of gross income across the PRS, a relatively modest figure, although this average masks a wide variation.

In conclusion, the FPC was right to consider the risks that the buy-to-let sector could pose to the wider housing market and beyond. It was also right to highlight the uncertainties given the rapid growth of buy-to-let lending and the lack of in-depth understanding of the sector, although we questioned the decision not to provide details of the evidence base on which their consultation was based[2]

But insufficient acknowledgement was paid to the stabilising role that buy-to-let can play in the housing market and insufficient attention to the risk of policy layering. The sector has had to absorb a raft of major tax and regulatory changes, all within a two-year period, too short a time for the authorities to be able to assess the impact of a single major new policy let alone all the changes announced since July 2015.

The risk is that the tax and regulatory changes will not simply take the froth off an overly buoyant sector but that the supply of privately rented property will be affected structurally. If demand for private rented accommodation continues to rise as it has, driven by a lack of social housing supply and inaccessibility to owner-occupation, this will increase the risk that a rise in structural under-supply will lead to upward pressure on real rents, disadvantaging tenants in the sector. Surely, this is not the outcome that policymakers want. But it is the outcome that logically flows from the policy interventions of the last two years.

[2] PRA Consultation Paper on its Supervisory Statement on 'Underwriting standards for buy-to-let mortgage contracts' A response by the Intermediary Mortgage Lenders Association (21st May 2016)

4. What impact will the tax and regulatory changes have?

4.1 Scale of tax changes

We estimate that UK PRS landlords have total gross income of around £60 billion a year. This income can be compared to the scale of tax increased from new measures as outlined in Table 1 (the government has provided figures on the actual and expected revenue that new taxes on buy-to-let are expected to raise). In 2020-21 HM Treasury expects these new taxes to raise close to £2 billion, only 3.2% of current gross rental income. But for landlords with low profit margins or high gearing the new taxes represent a large additional burden.

Table 1 – Projected revenue raised from new tax measures (£ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Mortgage interest restriction				225	415	665
End of wear & tear allowance			205	165	165	170
3% stamp duty surcharge	30	625	700	760	825	880
CGT accelerated payment					930	230
	30	625	905	1,150	2,335	1,945

Source: HMRC

The government presented these tax changes as a levelling of the playing field between a tax advantaged buy-to-let sector and owner-occupation. But this was misleading as the tax treatment of owner-occupied property in the UK is highly advantageous. Owner-occupiers pay neither capital gains nor any income tax on imputed rental income (the rental value of the homes they own), this having been abolished in 1963.

In contrast, buy-to-let investors pay both capital gains tax and income tax on any surplus of rent over rental costs. However, these investors have benefitted from other advantages. Through their ability to extract equity from existing properties by remortgaging, buy-to-let investors can access lower LTV loans on new purchases than a typical first time buyer. This became a significant advantage when maximum LTVs available to owner-occupiers were reduced in the wake of the financial crisis.

4.2 An example of the impact of new buy-to-let taxes

Table 2 compares the returns a buy-to-let investor could expect under the old tax rules and the new rules once fully implemented, assuming they are a higher rate tax payer purchasing in person rather than through a company. It assumes the investor takes out a 75% LTV mortgage at an interest rate of 4% to buy the average priced property in the UK with the average monthly rent. This property would produce a gross yield of 4.5%.

We have further assumed that the property is rented for 94% of the time (i.e. has a 6% void) and that non-mortgage costs are equal to 25% of gross rental income. With purchase costs coming to approximately 3% before the stamp duty surcharge was introduced, the total cash investment in this property would have been £63,300. After tax operating profits would have been £212. Coupled with a capital gain of £4,519 assuming 2% house price growth, the total return on the invested equity would be 7.5% - a modest but respectable return.

Table 2 – Impact of stamp duty surcharge and interest deduction restriction

Assumptions	**Old tax basis**	**New tax basis**
Purchase price	225,956	225,956
Annual average rents	10,116	10,116
Purchase costs including stamp duty	3.0%	6.0%
Occupancy rate	94.0%	94.0%
Operating costs	25.0%	25.0%
Expected HPI	2.0%	2.0%
Returns calculation		
Pre-tax profit	353	353
Income tax	141	1,497
Post-tax profit	212	-1,144
Capital gain	4,519	4,519
Return on equity invested	7.5%	4.8%

Source: IMLA estimates. House prices from ONS. Rents for LSL Property Services plc

Under the fully implemented new tax rules the cash investment will have risen to £70,000 because of an additional stamp duty bill of 3% (£6,800). The income tax bill will have risen from £141 (40% of operating profits of £353) to £1,497. This pushes a £212 post-tax profit into a £1,144 loss, taking the tax rate of buy-to-let profits from 40% to 116%. The investor would still enjoy a capital gain of £4,519 but the overall return on equity would have fallen to a modest 4.8%. Most landlords will be reluctant to accept or unable to afford negative cash flow from their property.

Moreover, lenders must make an assessment of the financial viability of each buy-to-let mortgage application. If the tax bill pushes a landlord into losses the lender may conclude that the loan is not affordable as even though that landlord is a higher rate tax payer, their other income may be needed to meet personal expenses. In the example shown in Table 2 the ICR, the traditional measure of mortgage affordability in the buy-to-let market, is a healthy 1.49 (i.e. gross rental income is 1.49 times annual mortgage interest based on the actual interest rate of 4%). Yet despite this apparently healthy ICR, under the new tax rules, the investment will be losing money and mortgage finance will not be forthcoming at all.

4.3 Regional impact

With house price growth far outstripping rental growth in the southern part of the country in recent years, landlords have increasingly looked to northern England for acceptable rental yields. Table 3 confirms that gross rental yields are substantially higher in the northern regions and lowest in London and the Southeast.

Table 3 – Regional impact of restricting mortgage interest tax deduction

	House price	Rents	Rental yield	Post-tax profit (old basis)	Post-tax profit (new basis)
North East	126,118	6,432	5.1%	451	-306
North West	151,920	7,596	5.0%	479	-433
Yorks and Humber	152,800	6,876	4.5%	158	-759
East Midlands	193,800	7,752	4.0%	-349	-1372
West Midlands	180,293	7,392	4.1%	-197	-1200
East	277,895	10,560	3.8%	-892	-2203
London	480,000	15,360	3.2%	-3571	-5023
South East	319,636	10,548	3.3%	-2153	-3209
South West	243,273	8,028	3.3%	-1638	-2443
Wales	150,638	7,080	4.7%	283	-620
Scotland	143,500	6,888	4.8%	331	-530

Source: LSL Property Services plc

Even before the recent tax changes, an investor buying at current prices with a 75% LTV buy-to-let mortgage at 4% could not expect positive cash flow in the south or midlands. But as the final column of Table 3 illustrates, with the removal of the full tax deduction of mortgage interest, high rate investors would expect negative net cash flow in every region.

4.4 Impact of tax and regulatory changes

Impact on borrowers

What Chart 2 in Section 2 on page 9 shows is that net investment in additional properties by buy-to-let landlords has fallen 80% since 2015, going from an estimated £25 billion to £5 billion in 2017, the lowest total since 2000. It seems likely that the overwhelming majority of this decline can be attributed to the tax changes, coupled with the fear of further adverse policy measures. The regulatory changes of 2016 have been less visible to landlords and the monthly profile of lending through 2017 shows no obvious impact from them. Indeed, average gross monthly buy-to-let lending was higher in 2017 up to October than in Q2-Q4 2016.

Surveys confirm the adverse impact of the tax changes. The 2016 CML landlord survey (conducted in early June 2016) asked landlords who intended to reduce their portfolio why they were planning to do so. 14% cited the change to interest tax relief and 15% to other tax changes although 17% cited the regulatory burden (i.e. increased rented property regulations).

In total 27% of landlords planned to sell some or all of their properties over the next 5 years against 14% who planned to acquire more. However, the survey also found that 14% of buy-to-let investors were unware of the changes to the tax treatment of mortgage interest while another 27% said they did not understand them. Thus as the tax change kicks in this year it is likely to increase negative sentiment in the sector.

There are mechanisms by which landlords can mitigate the impact of higher tax bills. New purchases can be made in limited companies, preserving the mortgage interest deduction and landlords can restructure their existing portfolios by moving properties into limited companies, although this will typically trigger stamp duty and capital gains tax bills. Kent Reliance's data shows that in the first three quarters of 2017, seven in ten buy to let applications for house purchase were via limited companies, up from 45% in 2016 as a whole[3].

However, as lending to limited companies remains a specialism within the buy-to-let market, interest rates are still significantly higher. So it is by no means clear that using limited companies will provide savings. Borrowers will need to carefully assess the financial pros and cons before making a decision to set up a limited company or restructure their portfolio.

For the worst affected landlords - those in the higher or further rate tax band depending entirely on rental income with high borrowings - the need to sell off some properties may be all but inevitable. These landlords not only face negative cash flows once the interest deduction is fully phased out in 2020-21 but potentially face a vicious circle in funding their portfolios, as they will fail lenders' affordability assessments, leaving them potentially unable to refinance on competitive terms. Thus we face the prospect of buy-to-let mortgage prisoners, not as a result of new buy-to-let mortgage regulation, but as a consequence of the tax changes and lenders' required response to them. When these borrowers face mortgage redemption they may be unable to refinance at any rate, leaving sale as the most viable option.

Comparing larger and smaller scale landlords, anecdotal evidence from lenders suggests that the recent tax and regulatory developments have reduced the appetite for further investment on the part of smaller landlords as a cohort while portfolio landlords have generally responded more positively. Thus government intervention does seem to be driving the professionalising of the PRS that is a stated objective of government. As tenant demand is likely to remain robust, reduced supply from one group of landlords should incentivise others to fill the gap.

[3] Buy-to-let Britain – December 2017

Ironically, the tax changes may have stimulated remortgage activity in the buy-to-let market, as landlords facing larger tax bills look for other ways to cut costs. Lending to landlords who are not raising additional sums is exempted from the recent regulatory changes which should support remortgage activity levels. However, again lenders will be wary of lending to those borrowers who are heavily impacted by the withdrawal of the mortgage interest tax deduction, which could limit any boost to remortgaging.

Lenders' response to the regulatory changes

For lenders that have always catered to portfolio landlords, the PRA's specialist underwriting requirements do not represent much change. They were already assessing applicants based on an overview of the whole portfolio. But lenders that had not previously assessed clients on a portfolio basis have had to make a decision either to enhance their underwriting process or exit the portfolio lending market. Platform has ceased new lending to portfolio landlords while Santander has limited such lending to selective like-for-like remortgages.

Other lenders have revamped their portfolio underwriting processes and imposed a variety of different criteria. In November 2017, TMW (part of Nationwide Building Society) re-entered the market in lending to limited companies on a pilot basis through brokers, Mortgage Intelligence and The Buy to Let Business. Some lenders have imposed specific portfolio ICRs (typically between 125% and 145% stressed at a 5.5% mortgage rate).

Indeed, in their buy-to-let affordability assessments, lenders are now having to use a number of different stress rates based on whether the borrower is taking a fixed or floating rate loan, whether they are a basic or higher rate tax payer and whether they are classified as a portfolio landlord or not. This adds complexity to the mortgage assessment process, and one consequence of this and the rise of differential criteria for portfolio lending has been that lenders report an increase in the role of brokers that specialise in serving portfolio landlords.

Despite the increased complexity of buy-to-let underwriting, lenders report that the implementation of the PRA's new rules went smoothly. Gross buy-to-let mortgage advances did not fall in either January or October. Indeed, survey evidence suggests that most landlords were unaware of the changes.

4.5 The risk of policy layering

In previous reports on the mortgage market we have repeatedly drawn attention to the issue of policy layering – the combined effect of a number of different interventions, any one of which might be innocuous enough alone, but which in combination can be debilitating to the marketplace. The interventions above seem to constitute a classic example of policy layering. Together they have created a more hostile environment for landlords and sent a signal to them that policy makers are not supportive of further investment.

4.6 An uncertain policy environment ahead

As well as having to deal with the stream of new taxes and regulations, participants in the buy-to-let market also need to keep one eye on the possibility of further policy interventions, regardless of which party is in power in the future. Indeed, the PRS currently appears friendless politically.

The Conservative housing white paper contained no olive branches for small scale landlords, just the threat of more regulation. But the Labour party wishes to go further, reintroducing an element of rent control despite the debilitating effect this has had on the PRS in the past. The current Labour manifesto says:

“We will end insecurity for private renters by introducing controls on rent rises, more secure tenancies, landlord licensing and new consumer rights for renters.”

“Labour will make new three-year tenancies the norm, with an inflation cap on rent rises. Given the particular pressures in London, we will look at giving the Mayor the power to give renters in London additional security. We will legislate to ban letting agency fees for tenants.”

Coupled with the PRT in Scotland, which removes fixed term tenancies and gives tenants the right to appeal any rent increase, these proposals could yet prove the most serious threat to landlords with equally dire long term consequences for private tenants.

4.7 IMLA calls for brake on further policy interventions

IMLA believes that the PRS and the buy-to-let mortgage market need time to adjust to the significant policy changes that have been announced and implemented since 2015 without further inventions by government. With the changes to the tax treatment of mortgage interest not yet fully implemented it is too early to understand the full implications. However, the information that is available to date on the rate of growth of the buy-to-let sector suggests that policy changes have already put off investors to a degree that could prove harmful to the PRS and the tenants that depend on it to put an affordable roof over their heads.

IMLA welcomed the shift to a more tenure neutral approach taken in the housing white paper *Fixing our broken housing market.* But IMLA believes it is unfortunate that the government and politicians in general no longer seem to be prepared to articulate support for market forces in the PRS despite the demonstrable benefits these have brought to the sector as landlord investment has increased the range and quality of available property.

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About IMLA

The Intermediary Mortgage Lenders Association (IMLA) is the trade association that represents mortgage lenders who lend to UK consumers and businesses via the broker channel. Its membership unites 39 banks, building societies and specialist lenders responsible for more than £200 billion of new lending in 2016, including 17 of the largest 20 UK mortgage lenders.

IMLA provides a unique, democratic forum where intermediary lenders can work together with industry, regulators and government on initiatives to support a stable and inclusive mortgage market. Originally founded in 1988, IMLA has close working relationships with key stakeholders including the Association of Mortgage Intermediaries (AMI), UK Finance and the Financial Conduct Authority (FCA).

Visit www.imla.org.uk to view the full list of IMLA members and associate members and learn more about IMLA's work.

About the author

Rob Thomas is a Director of Research at Instinctif Partners. He previously served as an economist at the Bank of England (1989-1994), a high profile analyst at the investment bank UBS (1994-2001) and as senior policy adviser to the Council of Mortgage Lenders (2005-12). He was also the project originator and manager at the European Mortgage Finance Agency project (2001-05) and created the blueprint for the government's NewBuy mortgage scheme.