NLA
NATIONAL LANDLORDS ASSOCIATION

Taxing Homes: Assessing the Economic Impacts of Government Policy on the Private Rented Sector

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CAPITAL ECONOMICS

Introduction

The National Landlords Association (NLA) exists to campaign for a fair and viable private rented sector (PRS) that works for everyone and to help landlords make a success of their lettings businesses by supporting them at every stage of their journey.

The association aims to facilitate growth of a sustainable PRS through recognition of the sector as a legitimate business environment. We believe that this is achieved by encouraging regulation and practices which support a fair balance between landlords and tenants.

As a larger proportion of households rely on the PRS for a home it has become increasingly important that landlords are able to provide high quality accommodation and are incentivised to do so by the prospects of reasonable returns on investment.

Unfortunately, recent changes to tax policy have threatened to disrupt landlords' business environs to such an extent that investing in private residential property may become unappealing, diminishing the sector's ability to meet demand and ultimately forcing up prices.

In order to meet the challenges presented by this fiscal upheaval and to help us better represent NLA members' interests we commissioned Capital Economics to undertake a comprehensive economic assessment of this impact these changes are likely to have on landlords, their customers and the wider economy.

Capital Economics is one of the leading independent economic research companies in the world, with a team of more than 60 experienced economists with expertise in financial markets, macroeconomics, and the property sector.

Leveraging these skills and experience, Capital Economics were tasked with assessing the likely – and realistic – impact of the government's use of these fiscal levers and the effects expected to be felt by those interacting with the PRS.

Executive summary

NLA commissioned Capital Economics to produce a report on the impact of government policy changes on landlords, the buy-to-let sector and the wider economy.

Key findings:

- Policies aimed at curbing buy-to-let activity will impact the UK economy at a time when there are already significant risks including ongoing Brexit negotiations and the new Trump administration in the US

- The 'average' buy-to-let property owned by a higher-rate tax payer is set to make £850 less profit annually after the withdrawal of mortgage interest rate relief

- Individuals and entrepreneurs all earning £50,000 per annum will pay significantly different tax bills depending on the source of their income

- Once the policy is fully implemented rents could be pushed up by over 7 per cent nationally over four years to cover some of the cost; this is equivalent to £250 each year or 1.4 per cent of households' annual gross disposable income

- Withdrawal of mortgage interest relief will hit net returns and as such some landlords will decide to either sell up completely or reduce the size of their portfolio; we estimate that the total size of the buy-to-let backed PRS stock will fall by 46,000 properties

- Landlords will absorb some of the increased cost which will reduce their spending and investment; landlords are set to lose a total of £400m annually which is equivalent to over 2 per cent of the total value of construction orders for private housing in 2015

Capital Economics also looked at other factors which may exacerbate the impact of these fiscal changes. In summary, they determined that impacts could be greater if economic circumstances turn out differently:

- If prices in the housing market stagnate after the withdrawal of mortgage interest rate relief, more landlords will be inclined to exit the market, leading to a loss over 90,000 homes from the rental market

- If interest rates rise faster than we expect the policy change is likely to amplify the strain on landlords as more would struggle to service mortgage debt with rental income; at mortgage rates of 6 per cent we expect a fall of around £15m in the stock of mortgage lending and a £600m annual loss to landlords

These findings support the NLA's view that these government policies are detrimental to supporting a viable PRS and risk removing incentives to investment in residential property for business purposes.

As a consequence we recommend:

- The government halts the further implementation of the change to the tax treatment of landlords' finance costs while the impact of the first phase of introduction is assessed
- A package of measures is developed to support the incorporation of existing private rented portfolios
- Policies to support the sale of privately rented properties which:
  a) Are appropriate for sale to an existing tenant
  b) Have been held, and utilised as rented accommodation, for a period exceeding five years

1 The economic context

The UK economy

The PRS does not operate in isolation from the rest of the UK economy, and as such must be viewed in a much wider context. It is influenced by a wide range of outside factors and has an influence on seemingly unrelated industries and communities.

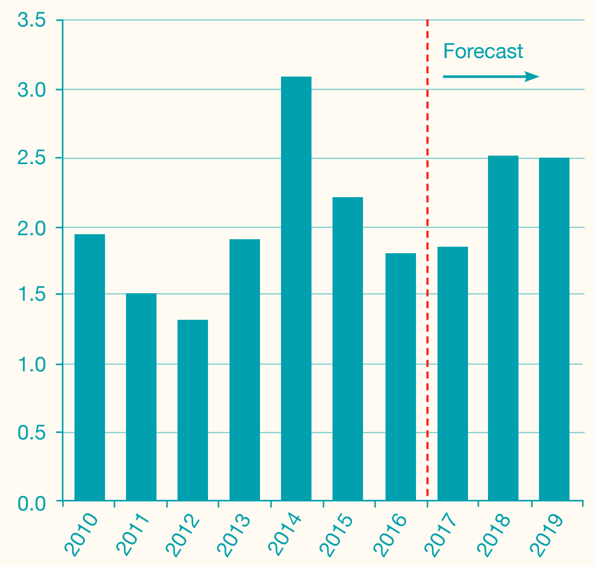
It is thusly crucial that we understand the backdrop against which these forecasts are likely to play out.

Growth on the horizon

The UK economy is set for reasonably strong growth to the end of the decade and has continued to defy expectations of a sharp slowdown, with growth remaining resilient following the referendum on EU membership in June 2016.

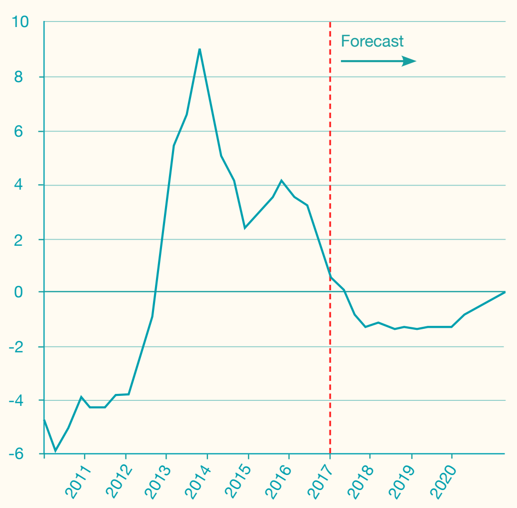
We expect some slowdown in growth in 2017 as inflation puts pressure on real household income growth. Given the past falls in sterling and recovering commodity prices, consumer price inflation is likely to reach 3 per cent by early 2018. The triggering of Article 50 could also have a negative impact if concerns around a 'hard Brexit' hit business sentiment and investment.

However, we don't expect household spending to collapse and the pound's decline will have beneficial effects on the export sector. Overall, we expect growth in gross domestic product of around 1.8 per cent in 2017, followed by growth of around 2.5 per cent in 2018 and 2019.



Annual percentage change in gross domestic product

Sources: Thomson Datastream, Capital Economics



Annual percentage change in house prices

Sources: Thomson Datastream, Capital Economics

Property market to cool with downside risks

House price growth has slowed since the UK's decision in June 2016 to leave the EU, falling from 3 per cent a year to around half that at the end of last year. We expect the property market will continue to cool off as with prices already so high and regulatory restrictions on income multiples starting to bite, buyers' ability to bid up prices is now very limited.

There are four main risks that could lead to a more sizeable correction in house price:

- A downturn in the economy, triggered by Brexit, Trumpism or other shocks
- Interest rates rise faster than the market currently anticipates
- Falls in prime London property prices, leading to a wider market downturn
- In reacting to policy changes, investors trigger a more substantial downturn

There is plenty of uncertainty around the general economic outlook

As the housing market is closely correlated with the economy as a whole, an unanticipated slowdown in the economy would also negatively impact the outlook for property. While we expect economic growth to be relatively healthy over the medium term, there are a number of things that could derail the outlook.

Brexit negotiations are likely to loom large for at least the next few years. The prime minister has raised the possibility of some sort of phased implementation in order to avoid a so-called ‘cliff-edge’. But the tight timetable could nonetheless limit the scope of a trade agreement and potentially weaken the UK’s bargaining position. If Mrs May chooses ‘no deal rather than a bad deal’ that would mean exports to the EU would be subject to common EU tariffs and, to begin with at least, our exports elsewhere would be subject to normal World Trade Organisation rules.

In addition, the inauguration of Donald Trump as the 45th president of the US has added another layer of uncertainty. In particular his policies regarding free trade pose a great many questions which are yet to be addressed. He has already promised to start renegotiating the North American Free Trade Agreement and if he were to follow through with some of his campaign rhetoric surrounding China there is risk that his actions could trigger some sort of global trade war. As an open economy the UK would certainly not be immune to such a shock and economic growth would be likely to slow as a result.

Date	Event/deadline
End March	Article 50 triggered
April - May	EU (excl. UK) summit
Late May/early June	Terms of separation discussed
Post June	Negotiations on trade deal begin
October 2018	Possible decision on date of trade deal
Late 2018/early 2019	Ratification by national parliaments
April 2019	UK leaves EU

Proposed timeline for Brexit negotiations

Source: Capital Economics

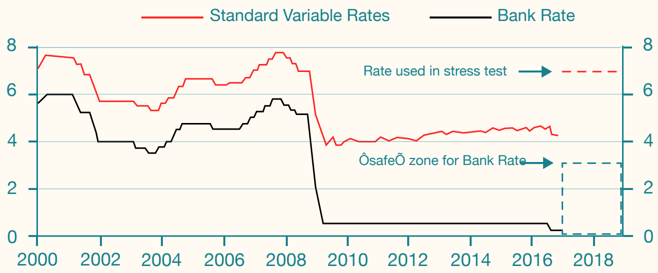
Stress tests are not a cast iron guarantee that rising interest rates won’t rock the boat

Since mid-2014, lenders have been required to check that borrowers could afford a loan, not just at today’s interest rates but also if rates were to rise. In practice this has meant that loans have been stress-tested to check affordability against a 7 per cent mortgage rate.

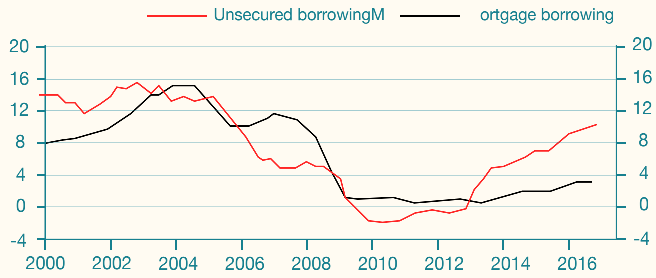
While the vast majority of new mortgages are short-term fixed-rate loans, in due course these loans revert to the lender’s standard variable rate of (typically) 4 per cent above base. To breach the 7 per cent test rate, the Bank Rate would need to rise above 3.5 per cent.

One problem with the stress tests is that lenders cannot prevent households from taking on additional debt once the mortgage has been drawn. Unsecured consumer credit has been growing rapidly in recent years. Survey data suggest at least 45 per cent of households have neither credit card nor other forms of unsecured debts. So, for those who do, the rise in unsecured debt levels has probably been in the region of 40 per cent over the past 18 months.

Stress tests may therefore be less effective than is sometimes suggested. The upshot is that if average mortgage rates rose by more than around 2.5 per cent, there will be increased risks to the housing market.



Bank Rate and standard variable mortgage rates (%)



Household borrowing by type of loan (£bn)

Sources: Thomson Datastream, Capital Economics

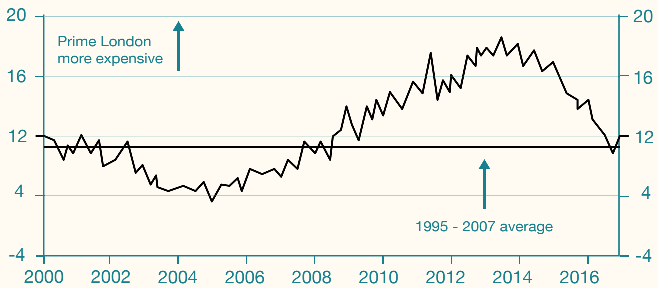
Further corrections in prime London property prices could ripple outward

Over the past two years, prime London property prices relative to the rest of London have gone into reverse. The significance of this, however, is that two years ago, prime prices were so disconnected that they could have dropped by a third without making prices in the rest of London look too high. Today however, past price differentials within the capital have been largely restored. So if prime values fell by say 10 per cent or more, it wouldn't be long before those falls rippled out to other boroughs.

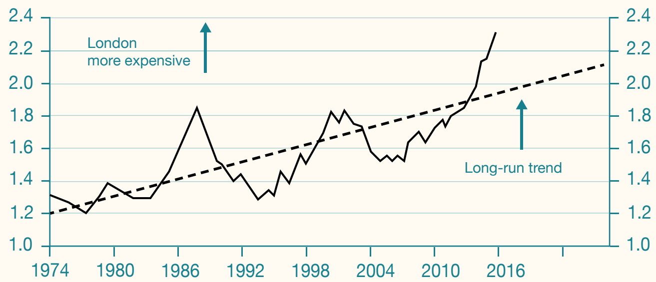
A fall in London prices would not necessarily trigger a chain reaction across the rest of the country. Using the same logic of relative price adjustment, prices in London are as high as they have ever been.

Indeed, from current levels, it would take a 15 per cent drop in London to bring relative prices back into line with their trend.

So unless prices in the capital were to drop by significantly more than 15 per cent prices elsewhere might fall a little, but would not necessarily collapse.



Ratio of prime to non-prime London house prices



Ratio of London to UK average house prices

Sources: Thomson Datastream, Capital Economics

2 The role of the PRS

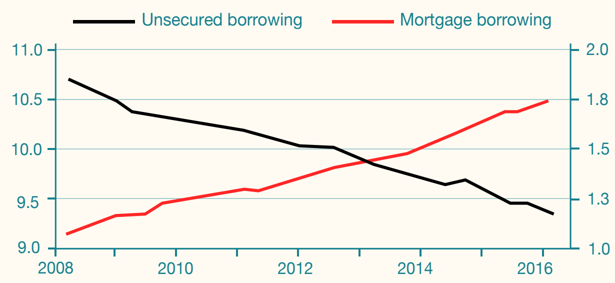
The PRS has become increasingly important

The PRS's share of the dwelling stock has risen from around 9 per cent in 1999 to over 19 per cent in 2015.

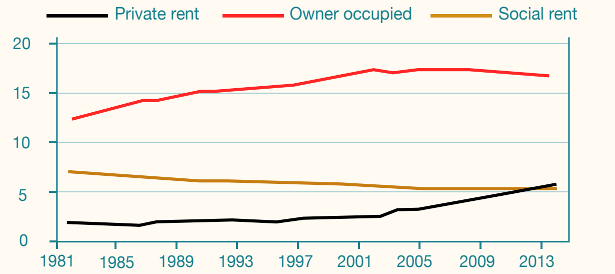
This has coincided with the diminishing importance of the social rented sector and also a decline in the number of owner occupiers.

The introduction of buy-to-let mortgages in the mid to late 90s has certainly been an important factor in the rise of the PRS.

The recession of 2008/09 did nothing to alter the trend – the number of outstanding buy-to-let mortgages has continued climbing since, while the number for owner occupiers has been gradually dwindling.



Number of outstanding mortgages by buyer type (£millions)



Dwelling stock by tenure in the United Kingdom (£millions)

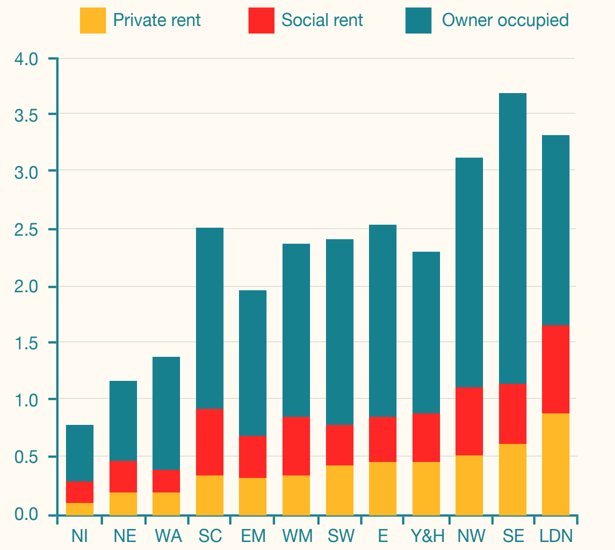
Sources: Council of Mortgage Lenders, Department for Communities and Local Government

London and the South East are the largest markets for private rentals

London has the largest PRS of any region in England. In 2011, the latest year for which data is available, there were 880,000 properties being rented privately in London accounting for over a quarter of all dwellings in the capital.

The PRS accounts for a smaller proportion of dwellings in regions other than London, ranging from 15 per cent in the North East and West Midlands to 19 per cent in Yorkshire and the Humber.

The London market accounts for over one fifth of all privately rented properties in England, while the South East accounts for over 15 per cent and the North West is the third largest market accounting for around 12 per cent of the total.

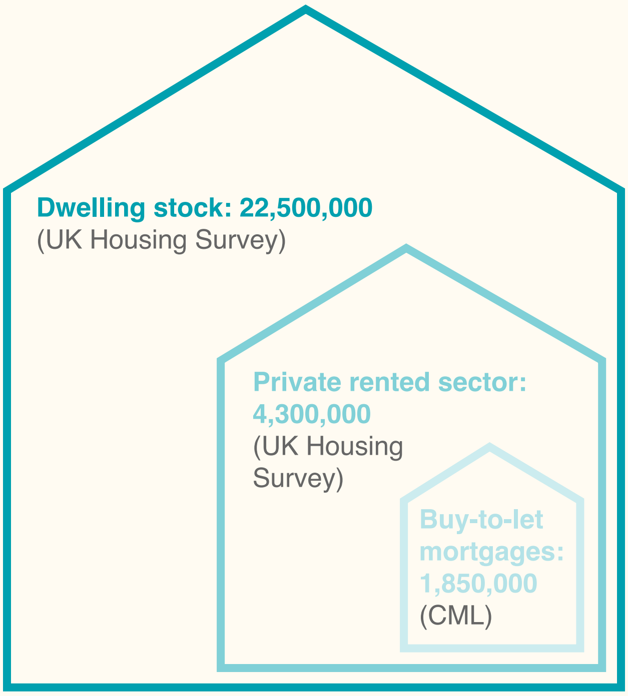


Number of dwellings by tenure by region in England, 2011 (millions)

Sources: Capital Economics, Department for Communities and Local Government

Buy-to-let is a key component of the PRS

The current stock of nearly 2m buy-to-let mortgages makes up roughly 40 per cent of the PRS dwelling stock. The majority of buy-to-let landlords are private individuals, with only around one tenth operating through a corporate structure. Combined they hold over £225bn of mortgage debt.



64%
Estimated higher rate tax payers
(National Landlords Panel Survey, Q1 2015)

90%
Buy-to-let mortgages are to private individuals
(National Landlords Survey, Council of Mortgage Lenders)

£227bn
Outstanding buy-to-let borrowing
(Council of Mortgage Lenders)

61%
Average leverage of buy-to-let landlords
(Capital Economics estimate based on Council of Mortgage Lenders' data)

Landlords' activities support further economic activity in the letting sector

Real estate activities, which include activity related to buy-to-let landlords, provide up to 366,000 jobs and contribute almost £40bn of added value to the UK economy.

Official economic statistics do not provide a breakdown sufficient to identify the scale of letting activity directly related to buy-to-let activity. However, data on real estate activities shows that the sector overall is a significant creator of jobs and activity.

In 2015, 113,000 people were employed letting or operating their own real estate, 155,000 worked in real estate agencies and a further 98,000 conducted work managing real estate on a fee or contract basis.

	Employees (thousands)	Gross value added (£bn)
Letting and operating of own or leased real estate (SIC code 68209. Excludes Housing Association real estate and conference and exhibition services, includes commercial property)	113	24.1*
Real estate agencies (SIC code 68310. Includes buying and renting)	155	9.0
Management of real estate on a fee or contract basis (SIC code 68320. Rent-collecting agencies)	98	6.0
Total	**366**	**39.1**

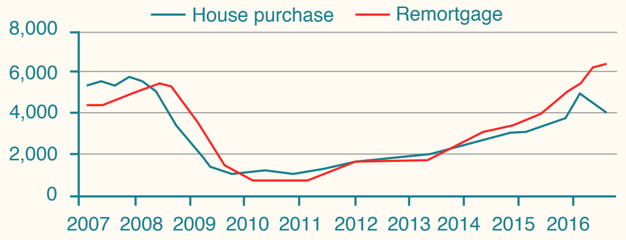
Scale of letting related activities, 2015

Sources: Business Register and Employment Survey and Annual Business Survey.
* Includes letting and operating of conference and exhibition centres.

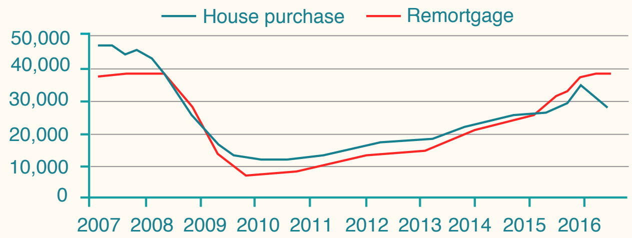
Strong growth in buy-to-let advances for house purchase has faltered recently

The strong recovery in buy-to-let lending ground to a halt in 2016. In value terms annual mortgage advances for house purchase rose to £15.6bn from £4.5bn in 2015, below the peak of £23bn reached back in 2007. Data for this year indicates that the number is likely to have fallen for the first time in seven years in 2016.

Meanwhile, remortgage lending rose above its 2007 peak with £22bn advanced in 2015 and looks to beat that again this year with remortgage advances totalling £2.3bn more in 10 months to September 2016 than in the previous year.



Number of BTL mortgages advanced, £ thousands



Value of BTL mortgages advanced, £ billions

Source: Council of Mortgage Lenders

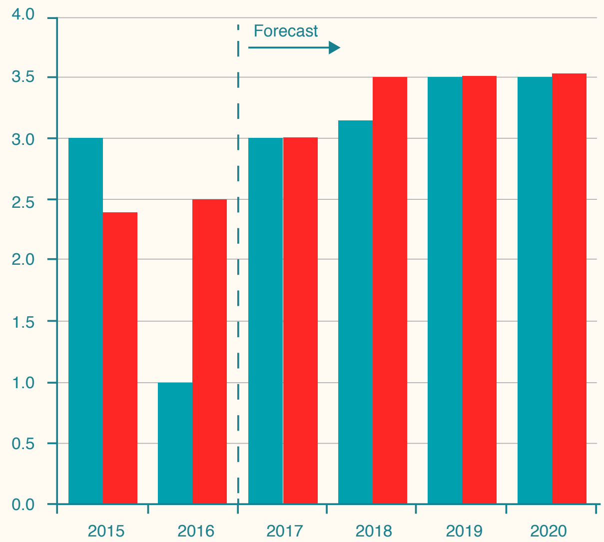
We expect rents to rise in line with earnings

With house prices still very high relative to incomes and rents, many tenants have little choice in terms of the decision to rent or buy.

Indeed, given the large deposit sizes involved, and signs that banks are starting to put a check on higher loan-to-income mortgages, a surge in first-time house buying looks unlikely, keeping tenant demand strong.

At the same time buy-to-let demand will be dented by the new rules regarding stamp duty and the tax deductibility of mortgage payments for landlords.

Continued solid tenant demand, alongside slower supply growth would suggest strong rental growth. However, rents are already high in relation to incomes. So beyond 2017, any further increases in rents are likely to be constrained, at least in broad terms, by the pace of average earnings growth.



Forecast annual percentage change in average earnings and nominal national rents

Sources: Capital Economics and Office for National Statistics

3 Policy changes explained

There have been a number of policy changes announced over the past couple of years that will have an impact on the PRS.

1

Withdrawal of mortgage interest rate relief for higher and additional rate tax payers

In his last budget the then chancellor George Osborne announced the measures to restrict relief for finance costs on residential properties to the basic rate of income tax with the state objective of making the tax system fairer.

Currently buy-to-let landlords pay no tax on mortgage interest which is seen as a business expense. Starting in April 2017 this relief will be gradually withdrawn by a quarter each year until all financing costs incurred by a landlord will be given as a basic rate tax reduction in 2020/21. This will effectively mean that higher rate tax payers will pay 20 per cent tax on the amount of their mortgage interest and additional rate tax payers will pay 25 per cent.

An additional related policy change is that from 2016/17 landlords will no longer automatically receive tax relief to the value of 10 per cent of rent on maintenance costs. Tax relief for allowable expenses will now have to be claimed back separately.

2

Three per cent surcharge on purchases of additional properties

As part of the government's stated commitment to support home ownership it announced in the autumn statement a higher rate of Stamp Duty Land Tax (SDLT) on purchases of additional residential properties. Effective as of April 2016 it is levied at 3 per cent of the purchase price, over and above the standard rate.

3

Banning of upfront letting fees for tenants

In the 2016 autumn statement chancellor Phillip Hammond announced the banning of letting agent fees for tenants, stating fairness and a desire to help those 'just about managing' among motivations for the policy, which will reportedly be introduced 'as soon as possible'.

4 The financial impact

‘Typical’ landlord set to lose over £850 per year

The additional cost to an ‘average’ landlord once the policy of reducing mortgage interest rate relief is fully implemented by 2020 will be £850 per annum.

The table shows the impact on a higher rate tax paying landlord with one property at average loan to value levels and mortgage rates of 3.5 per cent.

Following withdrawal of tax relief reduction, for a typical £122,000 buy-to-let mortgage with a 3.5 per cent interest rate, a landlord paying income tax at 40 per cent will need to pay an extra £850 of tax.

At a 4.8 per cent gross yield, and assuming some maintenance costs, the landlord would have pre-tax income of £4,370 post-tax income, would be £2,622 a year – falling to £1,768 following the removal of tax relief; a significant hit of nearly a third to the landlord’s bottom line.

Landlords who are paying tax at the additional rate face an even larger reduction in profit as they will have to pay an effective tax of 25 per cent of their mortgage interest payments. Given an equivalent property and mortgage as above, their net profit would fall from £2,400 to £1,330 per year; a reduction of nearly 40 per cent.

	With relief	With only basic relief
House price	200,000	200,000
Gross rental yield	4.8%	4.8%
Rent	**9,600**	**9,600**
Loan to value ratio	61%	61%
Mortgage	122,000	122,000
Interest rate	3.5%	3.5%
Mortgage interest payment	**4,270**	**4,270**
Allowable expenses (10% rent)	960	960
Pre-tax income	**4,370**	**4,370**
Tax paid	**1,748**	**2,602**
At 20%	0	854
At 40%	1,748	1,748
Net profit	**2,622**	**1,768**

Impact of withdrawal of mortgage interest relief for higher rate tax payers

Source: Capital Economics

It will place highly leveraged landlords in a precarious position

The withdrawal of mortgage interest relief will create a precarious position for those who have highly leveraged portfolios, who will face larger losses as a result of the policy change. Some landlords will have margins wide enough to withstand it, whereas the change will push others into the red.

For example a landlord with a property bought for £200,000 achieving a 4.8 per cent gross yield and with a 3.5 per cent cost of finance will see their profit fall by £1,250 if they are leveraged at 90 per cent – making their property barely profitable.

Relationship between net profit and leverage ratio, assuming a £200,000 property, 4.8% gross yield. 3.5% mortgage interest.

Sources: Capital Economics, Thomson Datastream

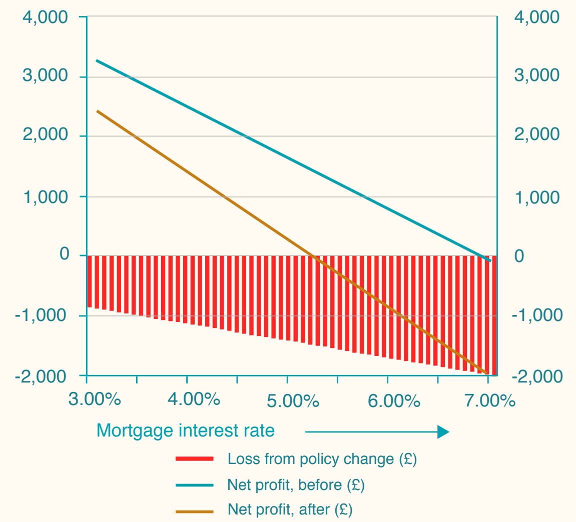
The withdrawal of relief will exacerbate interest rate risk

One worry for the government around the buy-to-let sector has been the risk to the sector of rising interest rates. As interest rates rise so does the risk that the cost of finance will exceed gross rental income for some landlords.

The withdrawal of interest rate relief will only exacerbate this, with rises in interest rates effectively leading to a 20 per cent larger increase in costs than had it been left in place.

This will reduce landlords' ability to weather interest rate hikes. For example, £200,000 property leverages at 70 per cent and a gross yield of 4.8 per cent will become loss-making at interest rates of 5.2 per cent.

Previously this threshold would not have been reached until interest rates reached around 7 per cent.



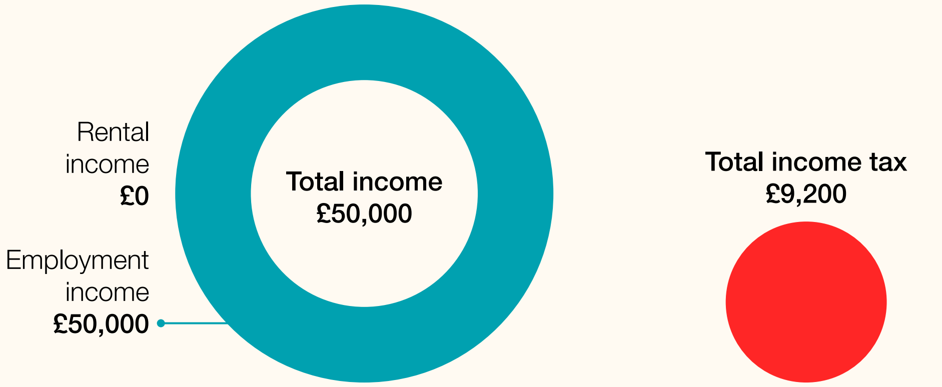
Relationship between net profit and mortgage interest rates, assuming a £200,000 property, 4.8% gross yield and 70% loan to-value.

Sources: Capital Economics, Thomson Datastream

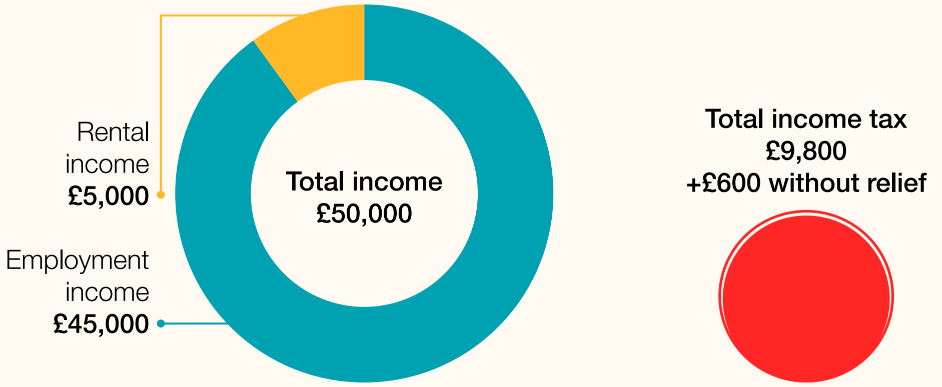
Changes will penalise those who earn more of their income through property

After the withdrawal of mortgage interest relief, four people earning £50,000 per year will pay vastly different amounts of income tax

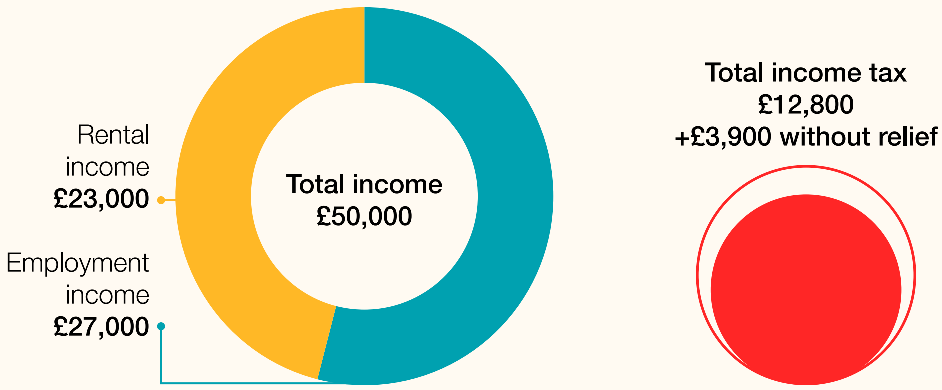
Alice works full time as an operations manager and owns no rental property



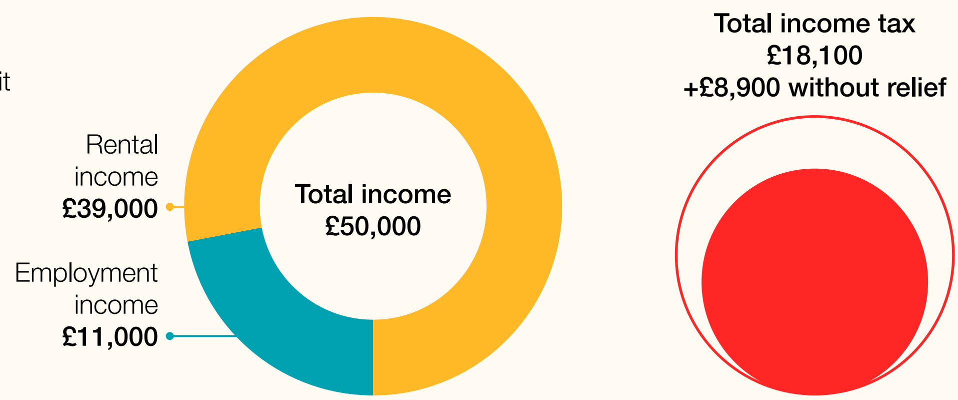
Bill works full time as an accounts executive and rent out his £155,000 flat which he owns with a 50% mortgage



Catherine works part-time as a college lecturer and owns three £300,000 rental properties, at an average leverage of 70%



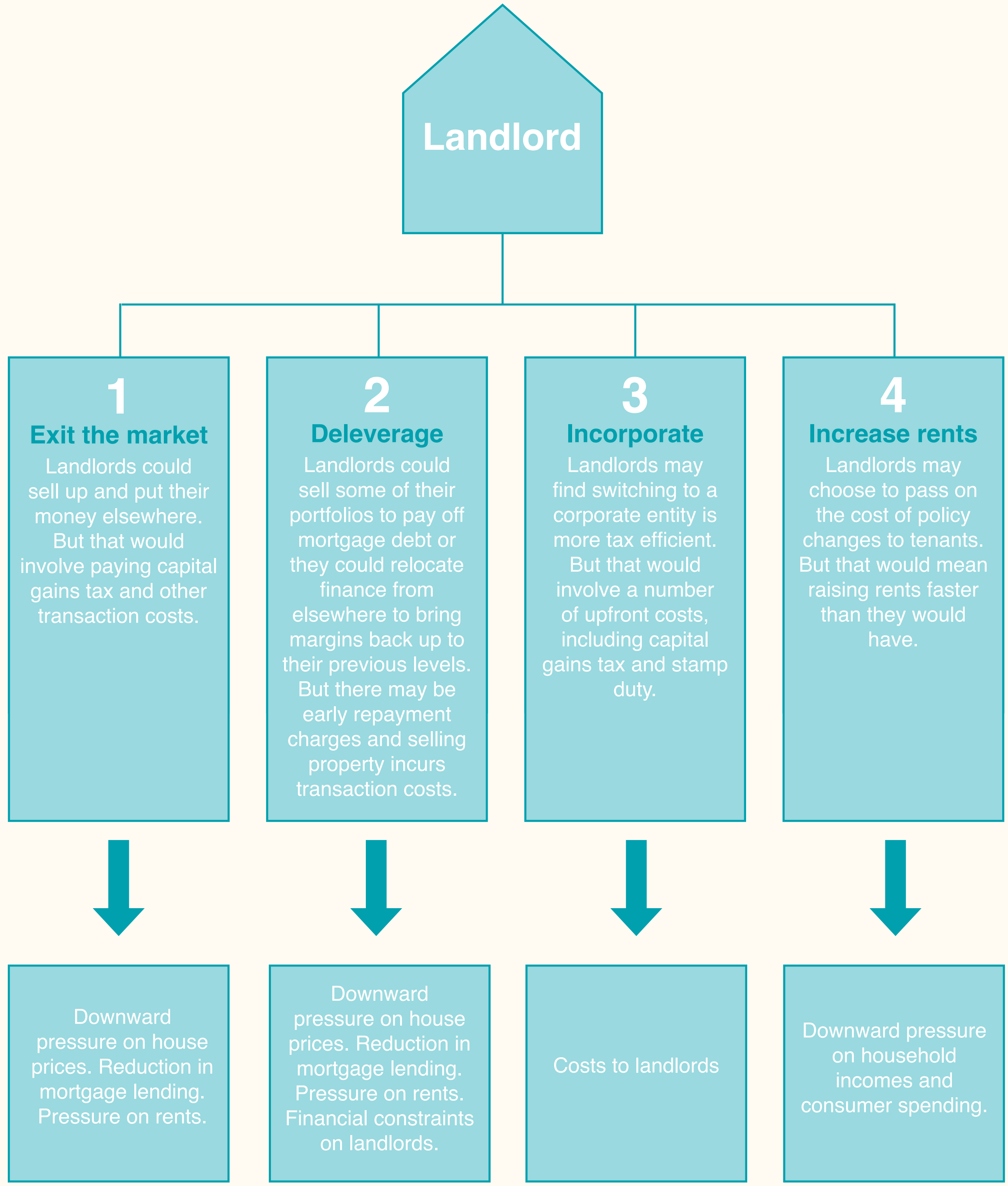
David is a property entrepreneur who earns money on the speaking circuit and has an 80% leveraged portfolio worth £1,750,000



All assume 3.5% mortgage interest rates, average gross rental yields of 5%

5 The options

There are four main ways landlords can respond:



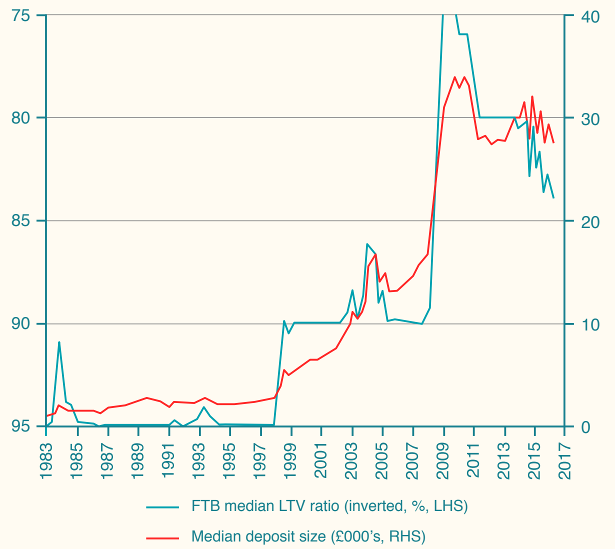
1

Exit the market

The reduction in the profitability of buy-to-let investments could persuade landlords that their money would be put to better use elsewhere. An increasing number of residential properties for sale on the market would drive down prices, as well as hitting mortgage lenders and reducing the stock of private rented accommodation.

A reduction in the stock of homes available would put upward pressure on rents. While some at the margin may now be able to buy because of lower house prices, for many the need for a large deposit would still be a limiting factor. With rents rising faster this would only make it more difficult for would-be first time buyers to save up for a deposit.

The average level of deposit required for a first time buyer has increased sharply over recent years, having almost doubled from around £16,000 before the financial crisis in 2008 to a little under £30,000 currently.



Average required deposit size and first time buyer loan-to-value ratio

Sources: Council of Mortgage Lenders, Nationwide, Capital Economics

2

We expect rents to rise in line with earnings

Landlords would have to pay off a significant chunk of their existing mortgage in order to maintain the same yield. Highly leveraged landlords would have to pay off close to a third of their mortgage to maintain their margins. Even those with proportionately smaller mortgages would have to deleverage by around a quarter. This does not account for the various costs associated with doing so.

Some landlords may try to refinance on lower interest rates. Although if the opportunity to decrease interest payments existed, landlords are likely to have already have taken it.

Additionally, they could use savings or other forms of finance to pay off some of their existing debt. However many landlords may face early repayment charges on their mortgages and one also has to weigh the opportunity cost of the decision, whereby the money used to pay down the mortgage could have been earning a return elsewhere.

Landlords with a portfolio of properties could sell off some of that portfolio and use the proceeds to deleverage. This would mean incurring transactions costs and realising capital gains tax.

Example buy-to-let landlord		After tax profit		Yield after tax and mortgage interest		LTV to achieve previous yield
	Annual rent	Before change	After change	Before change	After change	
£200,000 property 90% LTV	£10,000	£1,620	£360	0.81%	0.18%	**66.5%**
£300,000 property 70% LTV	£15,000	£3,990	£2,520	1.33%	0.84%	**52.5%**
£500,000 property 50% LTV	£25,000	£9,150	£7,400	1.83%	1.48%	**37.5%**

Leverage ratios needed to achieve previous net profit levels

Source: Capital Economics

3

Incorporate

Switching to a corporate structure could lead to a lower tax bill for buy-to-let landlords. Corporates pay 18 per cent on their profit, which will have fallen to 17 per cent by the time mortgage interest rate relief is withdrawn. And there is a £5,000 allowance before any dividend tax is payable. This means that the exemplar landlord as shown in the table would save over 70 per cent on their tax bill.

However there are a number of reasons existing landlords will be reluctant to do this:

- The advantages of incorporation would be eroded by dividend tax at higher profit levels. Landlords with more valuable or multiple properties will enjoy a lower relative tax saving.
- Shifting to a company structure requires the property to be purchased by the new commercial entity, incurring stamp duty and capital gains tax, as well as the additional stamp duty charge on second properties. At the UK average rate of house price growth, a house bought five years ago and transferred for £200,000 now could incur an upfront cost of £16,000. It would take over eight years to recoup this in tax savings.
- There are a number of associated costs with incorporation including the cost of producing annual accounts and tax returns and the premium on commercial buy-to-let mortgages.

	Higher rate taxpayer without relief	Higher rate taxpayer through a corporate entity
House price	250,000	250,000
Gross rental yield	5.0%	5.0%
Rent	12,500	12,500
Loan to value ratio	70%	70%
Mortgage	175,000	175,000
Interest rate	3.5%	3.5%
Mortgage interest payment	6,125	6,125
Allowable expenses (10% rent)	1,000	1,000
Pre-tax income	**5,375**	**5,375**
Tax paid	**3,375**	**968**
Income tax at 20%	1,225	0
Income tax at 40%	2,150	0
Corporate tax at 17%	0	968
Dividend tax at 32.5%	0	0
Net profit	**2,000**	**4,408**

Exemplar tax liabilities for private landlords and corporate entities

Source: Capital Economics

4

Increase rents

Landlords are likely to transfer some of the cost of the policy changes to their tenants. To cover the full cost of the withdrawal of relief would require some rather large rent increases. For example, a landlord with a 50 per cent mortgage would have to up rent by around 8 per cent and a highly leveraged landlord would have to increase rents by over 20 per cent.

Much will of course depend on how much landlords will be able to raise rents. The fact that demand in the PRS remains strong will give them some space to do so, but in some areas affordability may be reaching a limit. (See page 19.)

Example buy-to-let landlord		After tax profit		Yield after tax and mortgage interest		Rent increase to achieve previous yield
	Annual rent	Before change	After change	Before change	After change	
£200,000 property 90% LTV	£10,000	£1,620	£360	0.81%	0.18%	**+£2,100**
£300,000 property 70% LTV	£15,000	£3,990	£2,520	1.33%	0.84%	**+£2,430**
£500,000 property 50% LTV	£25,000	£9,150	£7,400	1.83%	1.48%	**+£3,000**

Total rent rises needed to fully compensate landlords for withdrawal of mortgage interest relief

Source: Capital Economics

6 Overall economic impacts

What will landlords do?

In December last year the Council of Mortgage Lenders published a profile of the PRS in which they asked landlords how they would cope with deterioration in their cash flow position. The question does not specify the magnitude or the reason for the deterioration, but it nonetheless gives us a useful idea of how landlords may respond to deteriorating returns as interest rate relief is withdrawn.

By far the most common response would be to hike rents for new and existing tenants. A sizeable proportion also suggested they would engage in some sort of deleveraging, either by selling some or all of their properties or reducing their reliance on mortgage debt.

In addition, answers to this survey question highlight that business supporting the PRS may suffer, with 8 per cent of landlords saying they'd reduce reliance on lettings agents and 7 per cent saying that they would spend less on property maintenance.

Coping strategy if cash-flow position worsened

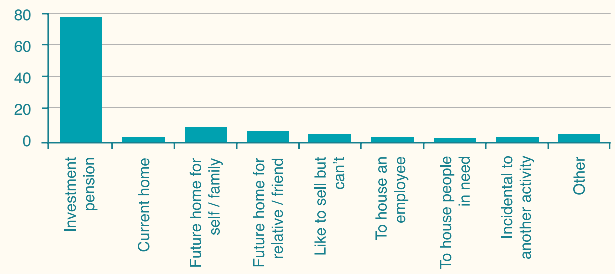
Increase rents for new tenants	41%
Increase rents for existing tenants	34%
Not buy any more rental properties	27%
Sell some rental properties	20%
Sell all rental properties	18%
Use income from other sources	16%
Refinance buy-to-let loans to reduce mortgage costs	16%
Reduce reliance on mortgage debt	15%
Don't know	10%
Reduce usage of letting/full management agents	8%
Prioritise certain property types/tenant types	8%
Spend less on property maintenance	7%
Slow down purchase of rental properties	5%
Other	2%

Sources: Council of Mortgage Lenders, the Profile of UK Private Landlords, December 2016

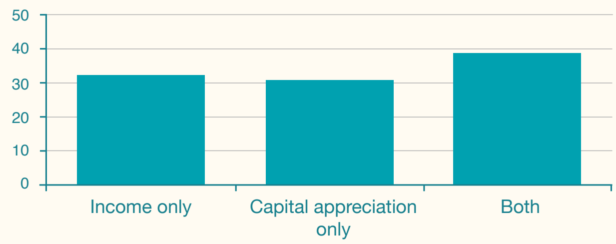
Buy-to-let activity isn't purely driven by income returns

Not all landlords own property for the rents they receive. For many (30 per cent according the Private Landlords Survey) property is primarily held as a store of value and for future capital appreciation. Property fills the role of a retirement nest egg, or a safe place to put their money.

Why people hold property of course influences how they will react when the income on their property changes. For those who hold property for purely income purposes, a drop in that income to very low levels is likely to encourage them to sell up and put their money elsewhere. In contrast, those holding property purely for capital appreciation such as future retirees, an equivalent fall in income would not elicit the same response.



Type of return expected on investment, percentage of dwellings, 2010



How property is regarded by private landlords, percentage of dwellings, 2010

Source: Private Landlords Survey

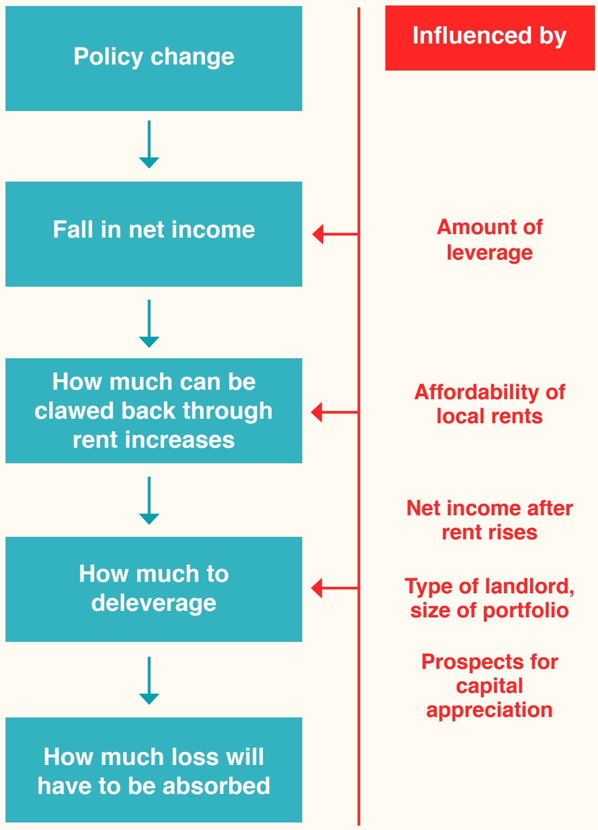
Modelling overall impacts

To understand the aggregate effect of the policy change we first model individual landlord behaviour in response to a squeeze in their net income.

The model splits landlords by region, to reflect the diversity of local rental markets and the ability of landlords to raise rents in response to the change. Landlords in regions with lower rent to income levels have more scope to raise rates, those in areas where rents are already high relative to incomes, such as London, have less scope.

Using survey data we segment landlords into groups based on the size of their portfolios and the amount of leverage they have taken on. The model accounts for the fact that the more highly leveraged landlords will be more affected by the withdrawal in relief. Modelling reactions separately based on the size of a landlord's portfolio helps to proxy for the different types of buy-to-let landlords and their motivations for holding property. We assume that those with large buy-to-let portfolio are more interested in rental income than those with just one property. We estimate the rent increases they will be able to make and judge the profitability of their portfolios.

We scale these results back up based on the size of the buy-to-let sector in each region.



Decision model for landlords

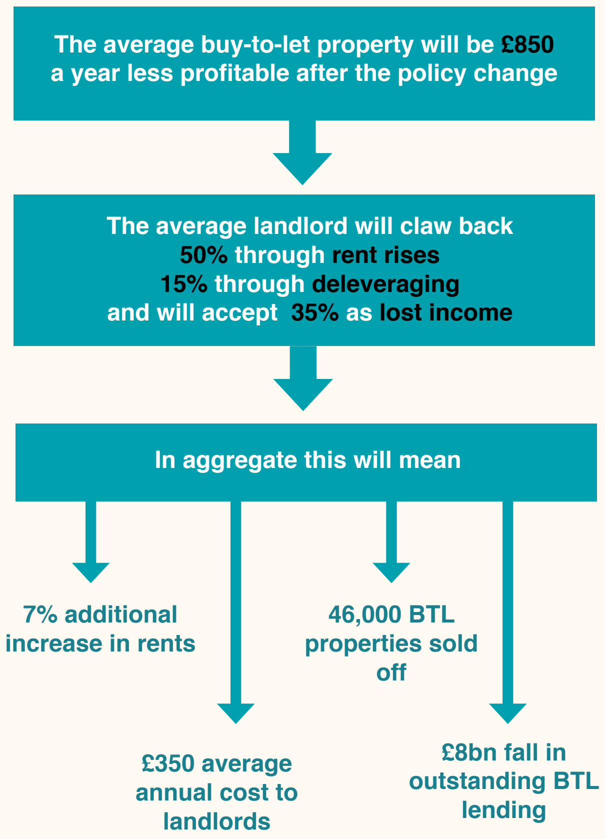
Source: Capital Economics

Overall impact

Our model of landlord behaviour gives an indication of how landlords might react to the withdrawal of mortgage interest relief.

On average we estimate that landlords will offset 50 per cent of the loss from the change by increasing rents for tenants. Even after accounting for rent increases, yields will fall to the extent that some landlords will look to deleverage or exit the market, meaning that on average landlords will offset 15 per cent of the cost by selling some of their portfolio and paying down debt. Finally, landlords may have to take a hit, which we estimate will be around 35 per cent of the loss from the policy change.

On aggregate this will mean that the average landlord will raise rents by an additional 7.2 percentage points by 2020/21. The deleveraging in the market is likely to sum to around 46,000 buy-to-let properties being sold off, resulting in a £8bn hit to buy-to-let lending. And once landlords have tried to offset the withdrawal of relief they are still likely to be worse off – to the tune of £350 each year for the average buy-to-let property.



Individual reactions

Bearing in mind the array of differing types of landlord, investment model and motivation for investing in residential property it is worth looking at the different ways in which these personas may interpret their options.

Capital Economics modelled these responses (broadly) by type of landlord.

Consequently it is clear that individual circumstances will play a significant part in forming mitigation strategies for private landlords.

Likewise, their actions will be limited and influenced by factors outside of their direct control.

	Barriers	Type of landlords likely to take option
Exit the market	• The low interest rate environment means other assets offer low returns • High up-front costs • Many landlords hold property as a pension investment or for a future home • Some only look for capital appreciation	• Small portfolio landlords looking for good return
Deleverage (alternative finance)	• Difficult to find alternative financing sources	• Landlords with larger portfolios in high rental price areas who may have other finance options
Deleverage (reduce portfolio size)	• Low interest rate environment means other assets offering low returns • Lose out on future capital appreciation	• Landlords with larger portfolios and high leverage • Landlords who are more reliant on property as their primary source of income
Increase rents	• Rents are reaching affordability limits	• All landlords likely to try to some extent • Areas with relatively more affordable rents likely to have more scope to do so
Incorporate	• High costs of changing to corporate structure	• New entrants to the market
Take lower yield	• Landlords will try to minimise this	• Smaller landlords in high rent areas who are less focussed on income returns

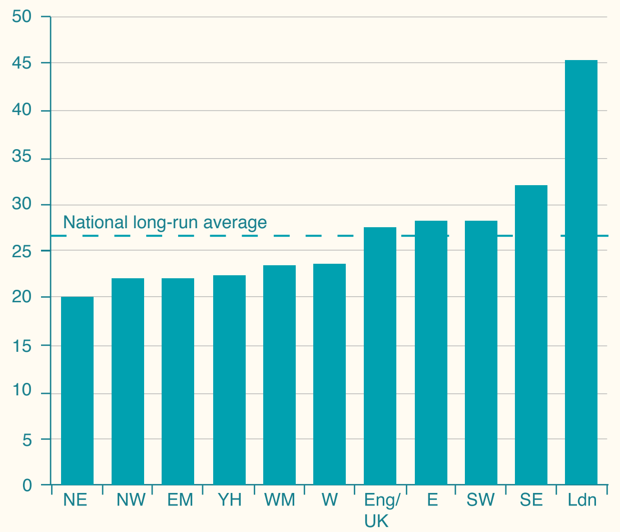
Affordability constraints will limit rent increases in some areas

Although London is set to benefit from the largest population growth, it is also where rents are most stretched.

In 2015 rents as a share of pre-tax average earnings in London were 45 per cent, well above the national long-run average of around 27 per cent.

Although the economic prospects for the capital are sound, affordability is pushing its limits and may reduce the pool of potential tenants.

Elsewhere, especially in the north of England, rental price pressures are much less of a constraint.



Rents as a share of pre-tax average earnings by region, 2015 (per cent)

Sources: Capital Economics, Office for National Statistics and Datastream

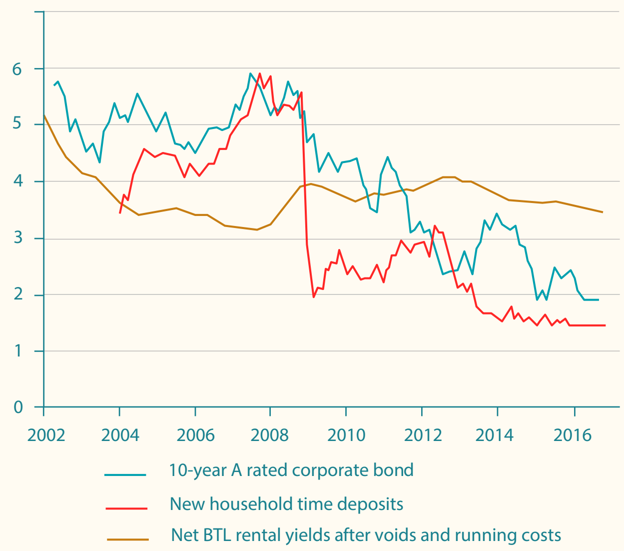
Relatively strong yields may delay the impact

Net buy-to-let yields have been trending slightly downwards since 2013. They stand at around 3.5 per cent at present.

In relation to bonds yields and savings accounts they have remained fairly attractive, especially since the big rally in bond prices at the start of last year.

There are reasons to think the spread will narrow over time. For one the withdrawal of interest rate relief will make leveraged buy-to-let investing less profitable. Furthermore, with the election of Trump and inflation back on the agenda we may begin to see an end to record low global interest rates which have driven the global 'search for yield'.

The majority of the buy-to-let sector is made up of small-scale investors, many of whom do not behave like large sophisticated investors, frequently switching between asset classes based on relative returns. Nonetheless, a shrinking spread between buy-to-let returns and other asset classes will add to the list of factors that make the sector look less attractive to investors.



Comparison of returns, percentage yield on deposits and investments

Sources: Bloomberg, Thomson Datastream, Capital Economics

We will not see the full impacts immediately

The phased withdrawal of mortgage interest relief and the high up-front cost nature of the industry means that the impact of the policy change is likely to be spread out of a number of years. In particular, landlords' decisions to deleverage or exit the market are likely to be spread over a number of years, particularly with the current low rate environment limiting investment options elsewhere.

We expect that:

- Buy-to-let landlords are likely to raise rents each year the withdrawal of mortgage interest relief is phased in, by around an additional 1.75 percentage points
- Most deleveraging will be concentrated towards the end of the four year period and beyond
- Landlords will be unable to fully offset all their losses and will have to absorb more as relief is phased out

We expect the following progression throughout the transitional period:

17/18	18/19	19/20	20/21
Higher annual rental inflation (percentage points)			
1.25pp	1.5pp	2.0pp	2.0pp
Buy-to-let properties sold off as result of the change			
1,000	3,000	12,000	30,000
Deleveraging of buy-to-let mortgages			
£0.17bn	£0.5bn	£2.0bn	£5.1bn
Aggregate loss to landlords			
£100m	£200m	£300m	£400m

Annual impact of withdrawal of mortgage interest relief

Source: Capital Economics

In the longer term more landlords will decide to sell their properties

The withdrawal of mortgage interest relief is likely to push some landlords to exit the market.

For some, especially landlords who are more highly leveraged, the policy change will wipe out their profits completely. For others, it may reduce their post-tax profits to below returns that could be made elsewhere.

The decision to exit the market will depend on the preferences of the landlords. Around 30 per cent of landlords only hold property for income purposes, and these are most likely to sell up if returns fall.

Those who hold property solely for capital appreciation, around 40 per cent, are less likely to exit (CML, the Profile of UK Private Landlords, 12/16).

	Total BTL dwellings (thousands)	Total stock sold (number)	Share of total stock (%)
South West	131	5,000	3.9%
East	133	5,500	4.0%
North West	163	3,500	2.1%
South East	204	8,000	3.9%
North East	57	800	1.4%
East Midlands	107	3,000	3.0%
Yorkshire and the Humber	136	3,500	2.6%
West Midlands	113	3,500	3.0%
London	282	8,500	2.9%
Wales	65	900	1.4%
Scotland	122	3,000	2.6%
Northern Ireland	40	1,000	2.6%
Total	**1,553**	**46,000**	**3.0%**

Buy-to-let private rented stock

Source: Capital Economics

Rent increases will hit household finances over a number of years

The first reaction of a landlord is likely to be to try to pass on the cost of the policy to tenants. We estimate that on average across the country landlords will increase rents by 7 per cent (or around 1.7 per cent annually) by the time the policy is fully implemented. This represents 50 per cent of their loss as a result of the policy change.

This will put increasing pressure on households' finances. On average it will account for £250 per person each year or 1.4 per cent of gross disposable income.

As the table illustrates, rental inflation is expected to vary throughout the UK.

London is expected to be hardest hit in terms of pure rental values and income share.

	Gross disposable household income per head (£, 2014)	Annual increase in rent (£)	Share of disposable income
North East	15,189	204	1.3%
North West	15,776	226	1.4%
Yorkshire and the Humber	15,498	224	1.4%
East Midlands	16,217	233	1.4%
West Midlands	15,611	190	1.2%
East of England	18,897	250	1.3%
London	23,607	378	1.6%
South East	20,434	212	3.0%
South West	18,144	227	1.2%
Wales	15,302	187	1.2%
Scotland	17,095	206	1.2%
Northern Ireland	14,645	179	1.2%
United Kingdom	**17,965**	**246**	**1.4%**

Estimated annual rent increases as a proportion of incomes

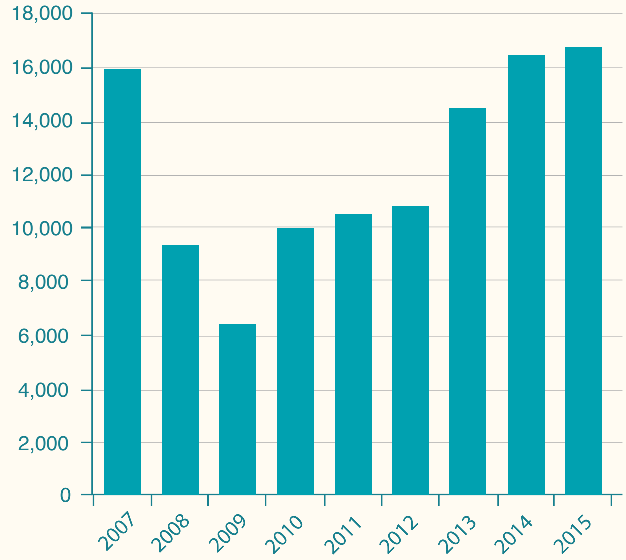
Sources: Capital Economics and Office for National Statistics' gross disposable household income

Financial cost to landlords will have a wider impact on spending and investment

The additional financial burden of the policy that is not recouped through rent increases or selling properties will be borne by the landlord. We estimate that private landlords will be £400m worse off each year as a result of the withdrawal of mortgage interest rate relief, which will have knock-on impacts on the wider economy.

Private landlords are an important source of investment in housing stock and a worsening of their financial position will likely result in less investment. An annual loss of £400m is equivalent to 2.2 per cent of the value of construction orders in 2015.

A survey by the Council of Mortgage Lenders shows that some landlords would reduce their spending on services such as letting agents or maintenance in response to a worsening of their financial position. This poses a threat to economic activity and jobs in the lettings and maintenance industries, as well as potentially reducing rental standards for tenants.



Construction orders for private housing, £m, current prices

Source: Office for National Statistics

7 Investment

The damage will not be limited to existing investors

The reduction in mortgage interest relief will act as a deterrent to new investors in the market as yields become less attractive.

Assuming that the current buy-to-let yields after tax and mortgage interest are around market clearing levels, then prices would have to decline substantially before the market settled again at those yields.

To take a few examples, a highly leveraged landlord with a £200,000 property would have to see house prices fall by around 20 per cent to achieve yields equivalent to those enjoyed before the withdrawal on interest relief. A landlord with a £300,000 property and 70 per cent leverage would need to see house prices fall 15 per cent and a landlord with 50 per cent leverage and a £500,000 property would need to see prices fall around 11 per cent.

Example buy-to-let landlord		After tax profit		Yield after tax and mortgage interest		House price decline to achieve previous yield
	Annual rent	Before change	After change	Before change	After change	
£200,000 property 90% LTV	£10,000	£1,620	£360	0.81%	0.18%	-£38,000
£300,000 property 70% LTV	£15,000	£3,990	£2,520	1.33%	0.84%	-£45,000
£500,000 property 50% LTV	£25,000	£9,150	£7,400	1.83%	1.48%	-£54,000

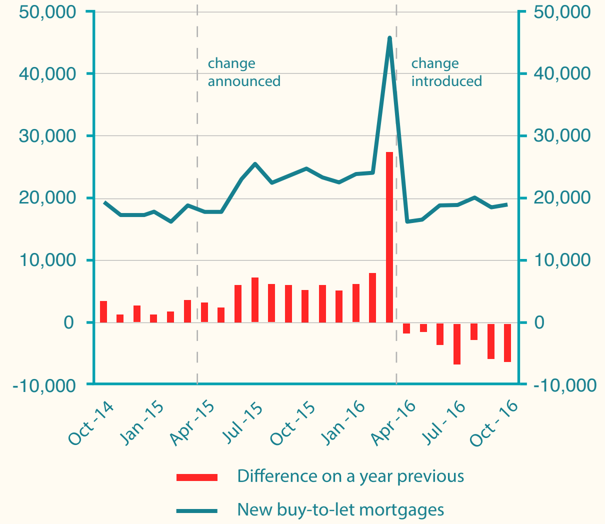
House price falls required for properties to achieve same post-tax yield as before withdrawal of mortgage interest relief

Source: Capital Economics

Stamp duty changes will further deter entry to buy-to-let sector

Data from the Council of Mortgage Lenders indicates that the buy-to-let market has been the primary driver of the peak and subsequent fall in home sales around the introduction of the 3 per cent stamp duty hike on purchases of additional property. Its mortgage advances data mirrors the Office for National Statistics and Land Registry's data on property sales completions.

This policy has distorted the market by shifting demand. Buy-to-let mortgage applications rose in volume compared to a year previously from March 2015 when the policy was announced and peaked at over 45,000 more in March 2016, the month before the change took effect. Buy-to-let mortgage advances have not settled lower than before the policy was announced.



New buy-to-let mortgage advantages, number

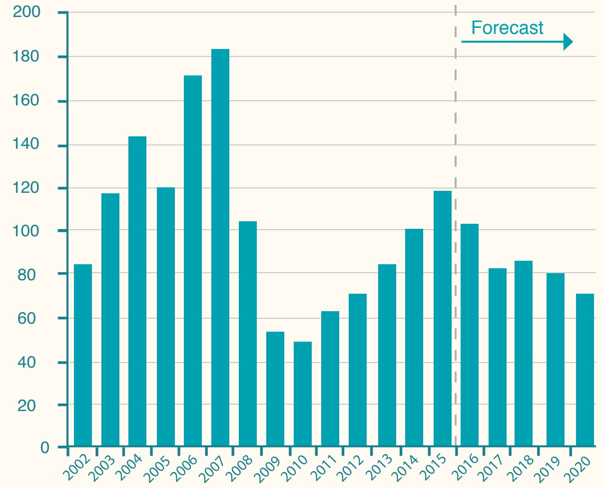
Source: Council of Mortgage Lenders

New buy-to-let purchases likely to slow

The combination of the withdrawal of mortgage interest relief, increased stamp duty on additional properties and the banning of up front letting fees is likely to make the buy-to-let sector increasingly unattractive to new entrants.

Withdrawal of mortgage interest relief will make post-tax margins in the sector tighter, especially for investors looking to utilise higher leverage to maximise the return on their equity. The additional 3 per cent stamp duty on additional properties will increase the upfront cost to investing. Meanwhile, costs are likely to increase as lettings agents pass on fees that were previously charged to tenants.

As a result, we are likely to see a falling number of new buy-to-let mortgage advances. We expect the number to fall by around 40 per cent from 2015 to 2020.



Number of BTL mortgages advanced, thousands

Source: Council of Mortgage Lenders

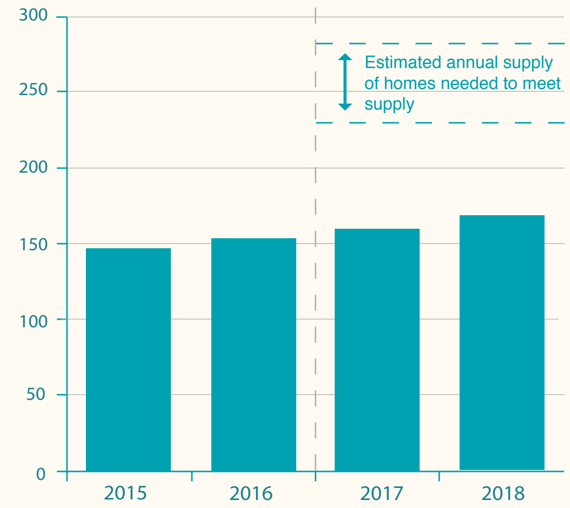
Housing investment will be hit

A reduction in buy-to-let activity will have a knock-on impact on new investment in housing. There is not reliable data on how much new housing stock is directly related to demand from buy-to-let investors. However, a paper produced by HM Treasury suggests that between 2004 and 2007 around 10 per cent of buy-to-let loans were for a new build and these accounted for in the region of one fifth of total supply of new housing in 2007.

Based on these estimates, a 40 per cent reduction in buy-to-let demand would have wiped out demand for nearly 15,000 homes annually by 2020.

Buy-to-let investment also tends to result in new properties of a higher than average quality as they often buy 'off plan' from housing developers. HM Treasury also notes that buy-to-let may have been effective in providing developers with forward funding for high density developments with significant infrastructure requirements.

Meanwhile, the UK is already falling well behind the stated consensus that between 225,000 to 275,000 or more homes per year are needed to keep up with population growth and start to tackle years of under-supply (DCLG, Fixing our broken housing market, Feb 17).



Forecast of housing starts, thousands

Sources: Capital Economics and Department for Communities and Local Government

8 Alternative scenarios

Varying economic circumstances will lead to different impacts

This report is predicated on a number of assumptions concerning the way in which the market, and wider economy, will operate in the foreseeable future. However, we are living through a period of significant uncertainty and should these economic circumstances vary from the expected norm it is likely that the predicted impacts of the discussed policy changes will differ also.

We asked Capital Economics to explore a number of alternate scenarios to the base case:

Zero house price growth – no capital appreciation over the next five years.

Around 30 per cent of buy-to-let landlords are happy to hold onto their property even if returns are low as they still stand to benefit from capital appreciation. However, if house price growth is expected to be not much more than zero over the medium term this may change. In this scenario a larger proportion of landlords are likely to deleverage in response to their returns being squeezed by the withdrawal of mortgage interest relief.

Sticky rents – those in tight rental markets are unable to raise rents and those in looser markets only able to raise rents slightly.

It may be that the ability of landlords to put up rents in response to their higher costs is more limited than assumed in our base case. In a scenario where this ability is more limited, we would expect landlords to absorb more of the cost and rates of deleveraging to be higher.

Interest rates increase faster than we expect – average mortgage interest rates rise to 6 per cent by 2020/21.

As interest rates rise the relative impact of the withdrawal of relief will grow. Faced by higher losses and unable to raise rents by more than the prevailing market dictates, landlords are likely to deleverage more.

Summary of landlords' potential reactions

The reaction of landlords to the withdrawal of mortgage interest relief will differ under different prevailing market conditions.

If house price growth is non-existent and is not expected to be much above zero for some time, landlords are more likely to offload property with low returns as they will have less of an incentive to hang on for capital appreciation. Under this scenario our model suggests that deleveraging in response to the change to be around double that in our base case – totalling £15bn or equivalent to 92,000 homes.

If landlords are unable to raise rents to claw back some of their loss from the withdrawal of relief then they are likely to absorb more of the loss themselves – around a quarter of a billion pounds more per annum. Sticky rents are also likely to persuade more landlords to deleverage. Our model estimates deleveraging to be around £8bn under this scenario.

In a higher interest rate scenario the cost of withdrawing mortgage interest relief will be more severe. The proportion of their loss landlords will be able to claw back through rent increases will be smaller, meaning that more are likely to respond by deleveraging. After raising rents and deleveraging, the aggregate costs to landlords of the policy change will be around £600m. This is equivalent to 50 per cent higher than under our base case.

	Base case	No house price growth	Sticky rents	6.0% mortgage interest rates
Annual losses absorbed by landlords	£400m	£230m	£660m	£600m
Additional annual rental inflation (percentage points)	1.75	1.75	0.7	1.75
Total buy-to let properties sold off as result of the change	46,000	92,000	50,000	92,500
Total deleveraging of buy-to-let mortgage lending	£7bn	£15bn	£8bn	£15bn

Impact of policy change under alternate scenarios

Source: Capital Economics

9 Recommendations

The decision to remove the ability for private landlords to deduct finance costs from taxable income is set to have a devastating impact on the PRS and wider housing market. A typical private landlord is likely to lose over £850 per year, while the sector will forfeit 46,000 properties; sold as a consequence.

Even assuming that landlords are able to absorb part of the increased costs of providing rental accommodation losses are likely to exceed £400m per annum with a downstream cost of renting households of £250 each year, or 1.4 per cent of gross household income.

The NLA believes that the government must take action to alleviate the harm this policy will cause to landlords, businesses, and households living and working in the PRS.

We recognise the desire for HM Treasury to maximise its income, and agree that every person and business should shoulder their fair share of the burden. However, it is clear that the cost of this policy will be disproportionate to its ability to raise taxes.

Consequently, we make four practical recommendations:

1. Embark on an immediate review of the removal of finance cost relief for private landlords. The transition period, during which time the existing relief will be gradually replaced with the restricted 'tax deduction' provides an opportunity to pause the implementation at 25 per cent to review the impact. This will allow HM Treasury to benefit from increased revenue from tax year 2017/18 while reviewing the impact that full implementation is likely to have.

2. Introduce a package of Capital Gains Tax reduction measures to encourage the sale of:
   - **Poorly performing investment properties.** Performance criteria could be established taking into account energy efficiency performance, suitability for letting, void history etc. in order to reduce the potential for disrepair and empty properties.
   - **Properties, where the proceeds of the sale will be entirely reinvested into the lettings business.** In common with the disposal of capital assets in other forms of business landlords should be able to 'roll-over' gains which are used to fund the business.
   - **Properties invested in, and utilised, for a period of more than 10 years.** This would differentiate between investors set on 'flipping' property for short-term profit and long-term landlords who invest in properties and communities.
   - **Properties eligible, and suitable, for sale to existing tenants.** Where landlords need to sell properties, they should be encouraged consider sale to existing tenants.

3. Introduce measures to facilitate the tax efficient movement of a letting portfolio into a corporate structure. Many landlords have grown letting portfolios gradually, and as such hold numerous assets as a private individual. These landlords and their customers would in many cases be better served by being able to envelop their properties in a commercial vehicle by means of incorporation. At present the cost of incorporating includes significant SDLT charges (including the 3 per cent levy) and liability for Capital Gains Tax on disposal, this should be reduced in order to allow landlords to restructure appropriately.

4. Establish a government backed investment vehicle to allow the sale of properties into a managed fund. This could take the form of a residential Real Estate Investment Trust and be managed in line with legal standards and agreed industry best-practice in order to ensure that stock remains available and of decent quality.

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